

**NEW ISSUE**  
**Full-Book-Entry**

**RATINGS**  
Moody's: **MIG-1**  
S&P: **SP-1+**

(See "Book-Entry Only System" under *The Notes*)

*In the opinion of Bond Counsel, under the provisions of the Acts of Congress now in force, (i) subject to continuing compliance with certain tax covenants, interest on the Notes will not be includable in gross income for federal income tax purposes and (ii) the Notes and interest thereon will be exempt from state, Commonwealth and local income taxation. See "TAX EXEMPTION", however, for a description of alternative minimum tax consequences with respect to interest on the Notes and other tax considerations.*

**\$800,000,000**  
**COMMONWEALTH OF PUERTO RICO**  
**Tax and Revenue Anticipation Notes**  
**Series 2002**

Dated: Date of Delivery  
Due: July 30, 2002

Yield: 2.08%  
Interest Rate: 3.00%

The Notes bear interest at the annual rate shown above, computed on the basis of twelve 30-day months and a 360-day year. Principal of and interest on the Notes are payable in immediately available funds at maturity. The Notes are not subject to redemption prior to maturity. The Notes are issuable in fully registered form in denominations of \$5,000 and any integral multiple thereof.

**The Notes constitute direct obligations of the Commonwealth of Puerto Rico and are payable solely from taxes and revenues in the General Fund collected after the date of issuance of the Notes and on or prior to June 30, 2002, as described herein. The Secretary of the Treasury is required to deposit such taxes and revenues, in the manner set forth herein and after certain prior applications, in the Note Fund in an amount sufficient to provide for the payment of principal of and interest on the Notes. Moneys in the Note Fund are subject to prior application for the payment of the general obligation bonds and notes of the Commonwealth of Puerto Rico and bonds and notes of its public corporations guaranteed by the Commonwealth of Puerto Rico to the extent other moneys are not available for such purpose. Neither the full faith, credit and taxing power of the Commonwealth of Puerto Rico nor that of any of its political subdivisions are pledged for the payment of principal of or interest on the Notes.**

The Notes are offered when, as and if issued and accepted by the Underwriters, subject to the approval of legality by Sidley Austin Brown & Wood LLP, Bond Counsel, and certain other conditions. Certain legal matters will be passed upon for the Underwriters by McConnell Valdés, San Juan, Puerto Rico. It is expected that settlement for the Notes, in immediately available funds, will occur in San Juan, Puerto Rico, on or about October 17, 2001.

<b>Banc of America Securities LLC</b>	<b>Lehman Brothers</b>	<b>Morgan Stanley</b>
<b>ABN Amro Financial Services, Inc.</b>	<b>Bear, Stearns &amp; Co., Inc.</b>	<b>First Union National Bank</b>
<b>Goldman, Sachs &amp; Co.</b>	<b>Merrill Lynch &amp; Co.</b>	<b>Salomon Smith Barney</b>
		<b>UBS PaineWebber Inc.</b>

October 5, 2001

# Commonwealth of Puerto Rico

## Governor

SILA M. CALDERÓN

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*Chief of Staff*

FERDINAND MERCADO  
*Secretary of State*

ANABELLE RODRÍGUEZ  
*Secretary of Justice*

JUAN A. FLORES GALARZA  
*Secretary of the Treasury*

CÉSAR REY  
*Secretary of Education*

VÍCTOR RIVERA HERNÁNDEZ  
*Secretary of Labor and  
Human Resources*

JOHNNY RULLÁN  
*Secretary of Health*

FERNANDO TOLEDO  
*Secretary of Agriculture*

JOSÉ IZQUIERDO  
*Secretary of Transportation  
and Public Works*

RAMÓN CANTERO FRAU  
*Secretary of Economic  
Development and Commerce*

YOLANDA ZAYAS  
*Secretary of Family Affairs*

ILEANA ECHEGOYEN  
*Secretary of Housing*

CARLOS MANUEL PADÍN  
*Secretary of Natural and  
Environmental Resources*

FERNANDO TORRES RAMÍREZ  
*Secretary of Consumer Affairs*

JORGE ROSARIO  
*Secretary of Sports and Recreation*

VÍCTOR RIVERA GONZÁLEZ  
*Secretary of Corrections  
and Rehabilitation*

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### *Legislative Officers*

ANTONIO FAS ALZAMORA  
President, Senate

CARLOS VIZCARRONDO  
Speaker, House of  
Representatives

### *Fiscal Officers*

MELBA ACOSTA  
Director, Office of Management  
and Budget

JUAN AGOSTO ALICEA  
President, Government Development  
Bank for Puerto Rico

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HERMENEGILDO ORTIZ  
*President, Planning Board*

No dealer, broker, sales representative or other person has been authorized by the Commonwealth of Puerto Rico or the Underwriters to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the Commonwealth of Puerto Rico or the Underwriters. This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of the Notes by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale. The information set forth herein has been obtained from the Commonwealth of Puerto Rico and other official sources that are believed to be reliable, but is not guaranteed as to accuracy or completeness and is not to be construed as a representation by any Underwriter. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Commonwealth of Puerto Rico since the date hereof. This Official Statement is submitted in connection with the sale of the Notes referred to herein and may not be reproduced or used, in whole or in part, for any other purpose. The Underwriters have provided the following sentence for inclusion in this Official Statement. The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of, their respective responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE NOTES AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

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**\$800,000,000**  
**COMMONWEALTH OF PUERTO RICO**  
**Tax and Revenue Anticipation Notes**  
**Series 2002**

**INTRODUCTORY STATEMENT**

This Official Statement sets forth certain information about the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”) and \$800,000,000 Tax and Revenue Anticipation Notes of the Commonwealth of Puerto Rico, Series 2002 (the “Notes”).

The Notes are being issued under Act No. 1, approved by the Legislature of Puerto Rico on June 26, 1987 (the “Act”), and pursuant to a resolution adopted by the Secretary of the Treasury on October 5, 2001 (the “Note Resolution”), for the purpose of funding a portion of the projected cash flow requirements of the Commonwealth’s General Fund in fiscal 2002, which requirements result from timing differences between expected disbursements and receipts of taxes and revenues.

Without the issuance of the Notes, the Commonwealth estimates that the General Fund would incur monthly cash deficits which would reach a cumulative maximum deficit of approximately \$920 million in October, 2002. For a breakdown of the General Fund cash flow, after taking into account the issuance of the Notes, see “General Fund Monthly Cash Flow for Fiscal 2001 and Fiscal 2002” under *Puerto Rico Taxes, Other Revenues and Expenditures*.

The Notes constitute direct obligations of the Commonwealth payable solely from the taxes and revenues in the General Fund collected by the Secretary of the Treasury after the date of issuance of the Notes and on or prior to June 30, 2002 and deposited in a special fund (the “Note Fund”) for the payment of principal of and interest on the Notes as more fully described herein. All moneys in the Note Fund required for such purpose shall be used to pay the principal of and the interest on the Notes at maturity and shall be used for no other purpose; provided, however, that pursuant to certain constitutional and statutory authorizations, payments on general obligation bonds and notes of the Commonwealth and on bonds and notes of its public corporations guaranteed by the Commonwealth have a claim on Commonwealth taxes and revenues, including amounts on deposit in the Note Fund, prior to the claim thereon of the Notes.

The Secretary of the Treasury covenants in the Note Resolution to compute, on a monthly basis, projected revenues, expenditures and fund balances of the General Fund, commencing in November, 2001, in order to make certain debt service coverage calculations to ensure the full and timely payment of the Notes.

Neither the full faith, credit and taxing power of the Commonwealth nor that of any of its political subdivisions are pledged for the payment of principal of or interest on the Notes. The Commonwealth does not have any notes outstanding on a parity with the Notes, and the Secretary of the Treasury covenants in the Note Resolution not to issue any parity notes, except notes issued pursuant to the Act.

For a discussion of the security for the Notes, see “Payment of and Security for the Notes” under *The Notes*.

This Official Statement includes the cover page and the Appendices hereto and incorporates by reference the Comprehensive Annual Financial Report of the Commonwealth for the fiscal year ended June 30, 2000 prepared by the Department of the Treasury (the "Commonwealth's Annual Financial Report"), which Report includes the general purpose financial statements of the Commonwealth for the fiscal year ended June 30, 2000, together with the independent auditor's report thereon, dated December 29, 2000, of Deloitte & Touche LLP, certified public accountants and which is incorporated herein by reference. The Commonwealth's Annual Financial Report has been filed by the Commonwealth with each nationally recognized municipal securities information repository ("NRMSIR") and with the Municipal Securities Rulemaking Board (the "MSRB"). Any appendix of an Official Statement of the Commonwealth or of any instrumentality of the Commonwealth filed with each NRMSIR and the MSRB or any other document containing the Commonwealth's Annual Financial Report filed with each NRMSIR after the date hereof and prior to the termination of the offering of the Notes shall also be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained herein or in any of the above described documents incorporated herein by reference shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained in any other subsequently filed document modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

The Commonwealth will provide without charge to any person to whom this Official Statement is delivered, on the written or oral request of such person, a copy of the Commonwealth's Annual Financial Report. Copies of the Note Resolution are also available upon request from Government Development Bank for Puerto Rico ("Government Development Bank" or "GDB"). Requests should be directed to Director-General Obligations Division, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, PR 00940, telephone number (787) 722-7060.

A copy of the Commonwealth's Annual Financial Report may be obtained by contacting a NRMSIR. The address of each NRMSIR is set forth in *Continuing Disclosure*. The Commonwealth expects that its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2001, including its audited general purpose financial statements for such fiscal year, will be available to investors in early 2002. Promptly after its release, said Report will be filed with and available from each NRMSIR.

This Official Statement, including information incorporated by reference in this Official Statement, contains certain forward looking statements concerning the Commonwealth's operations and financial condition. These statements are based upon a number of assumptions and estimates which are subject to significant uncertainties, many of which are beyond the control of the Commonwealth. The words "may", "could", "will", "expect", "anticipate", "believe", "intend", "plan", "estimate" and similar expressions are meant to identify these forward looking statements. Actual results may vary materially from those expressed or implied forward looking statements.

## OVERVIEW

The following is a summary of certain information regarding the Commonwealth contained in the Commonwealth of Puerto Rico Financial Information and Operating Data Report, dated September 25, 2001 (the "Commonwealth Report"), attached hereto as *Appendix I*. This summary does not purport to be complete and is qualified in its entirety by reference to more detailed information appearing in the Commonwealth Report, which should be read in its entirety.

Puerto Rico is located approximately 1,600 miles southeast of New York City. According to the U.S. Census Bureau, Puerto Rico's population was 3,808,610 in 2000. Puerto Rico's political status is that of a commonwealth. The United States and the Commonwealth share a common defense, market, currency and citizenship. The Commonwealth government exercises virtually the same control over its internal affairs as is exercised by the state governments of each of the fifty states over their respective internal affairs, with similar separation of powers among the executive, legislative and judicial branches. It differs from the states, however, in its relationship with the federal government. The people of Puerto Rico are citizens of the United States but do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives but no vote.

Most federal taxes, except those such as Social Security taxes which are imposed by mutual consent, are not levied in Puerto Rico. No federal income tax is collected from Puerto Rico residents on income earned in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries. The official languages of Puerto Rico are Spanish and English.

### **Economic Trends**

Puerto Rico has enjoyed eighteen years of uninterrupted economic expansion. Almost every sector of the economy has participated in this expansion and record levels of employment have been achieved. Factors contributing to this expansion include government-sponsored economic development programs, periodic declines in the exchange value of the United States dollar, increases in the level of federal transfers, the relatively low cost of borrowing, and until recently, low oil prices.

Gross product increased from \$30.4 billion in fiscal 1996 to \$41.4 billion (\$34.8 billion in 1996 prices) in fiscal 2000. This represents an increase of 36.3% (14.7% in 1996 prices). Since fiscal 1985, personal income, both aggregate and per capita has increased consistently each fiscal year. In fiscal 2000, aggregate personal income was \$38.2 billion (\$34.6 billion in 1996 prices)\* and personal income per capita was \$9,870 (\$8,925 in 1996 prices).

According to the Labor Department's Household Employment Survey, average employment increased from 1,128,000 in fiscal 1997, to 1,159,470 in fiscal 2000, but declined slightly to an average of 1,157,850 during fiscal 2001. Average unemployment decreased from 13.1% in fiscal 1997 to 10.5% in fiscal 2001. The seasonally adjusted unemployment rate for the month of August, 2001 was 12.4%.

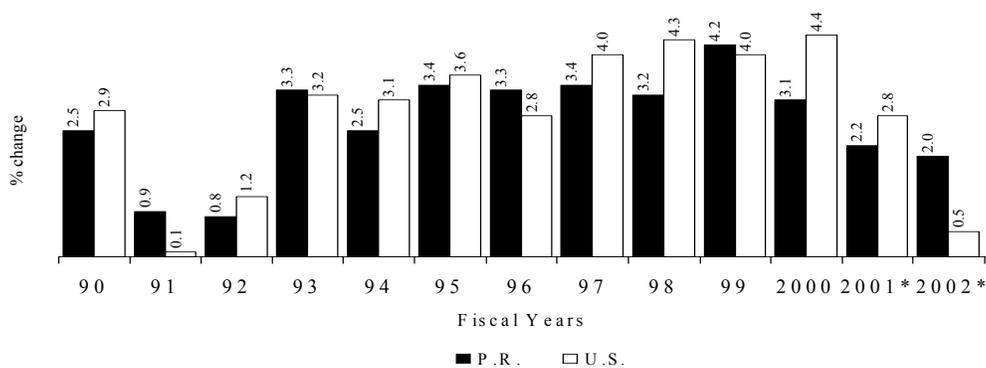
The Planning Board's gross product forecast for fiscal 2001 and fiscal 2002, issued in March 2001, projected an increase of 2.2% for fiscal 2001 and an increase of 2.0% for fiscal 2002.

The performance of the economy during fiscal 2002 will depend primarily on the performance of the United States economy, the level of oil prices and the level of interest rates. In the past, Puerto Rico has been heavily dependent on oil imports for its energy needs. As a result of the construction of two cogeneration plants, however, one of which burns liquefied natural gas and is now operational and the other which will burn coal and is expected to become operational during 2002, Puerto Rico's dependence on oil imports for its energy needs is expected to be reduced by approximately 30%.

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\* Different price deflators are used for gross product and personal income statistics each set of statistics.

## Real G N P Growth Rate



\* DRI Forecast Shock 9/01. The forecast for U.S. growth rate for 2002 takes into account the events of September 11, 2001. The forecast for Puerto Rico growth rate for 2002 has not been revised to take into account such events.

Puerto Rico has a diversified economy with the manufacturing and services sectors comprising the principal sectors. Manufacturing is the largest sector in terms of gross domestic product. According to the Planning Board's figures, in fiscal 2000 manufacturing generated \$27.4 billion, or 43.5%, of gross domestic product and accounted for 13.7% of total employment, as compared with fiscal 1999, when it generated \$26.6 billion, or 44.4%, of gross domestic product and accounted for 13.9% of total employment. See "Economic Performance by Sector" under *The Economy* in the Commonwealth Report.

Manufacturing in Puerto Rico is now more diversified than during earlier phases of the industrial development program and includes several industries less prone to business cycles. In the last three decades, industrial development has tended to be more capital intensive and more dependent on skilled labor. This gradual shift in emphasis is best exemplified by the heavy investment in the pharmaceutical, scientific instruments, computers and electrical products industries in Puerto Rico over the last decade. One of the factors assisting the development of the manufacturing sector has been the tax incentives offered by the federal and Puerto Rico governments. Federal legislation enacted in 1996, however, which amended Section 936 of the Internal Revenue Code of 1986, phases out the federal tax incentives during a ten year period. See "Tax Incentives—Incentives under the Code" under *The Economy* in the Commonwealth Report.

The services sector, which includes hotel and related services and currently accounts for approximately 50.7% of total employment, generated \$24.0 billion, or 38.1%, of Puerto Rico's gross domestic product in fiscal 2000, as compared with \$22.3 billion, or 37.2%, of gross domestic product in fiscal 1999.

Growth in construction contributed to increased economic activity in fiscal 2000. The growth in the construction industry was evidenced by a nominal increase of 7.3% in construction investment for fiscal 2000 over fiscal 1999.

Tourism continues to make a significant contribution to economic activity. Almost 4.6 million visitors spent \$2.4 billion in Puerto Rico in fiscal 2000. San Juan is the largest home port for cruise ships in the Caribbean and the fourth largest home port for cruise ships in the world. Twenty-six U.S. and international airlines offer scheduled service to and from San Juan, and a major U.S. air carrier uses San Juan as a hub for its intra-Caribbean operations. This reflects the importance of Puerto Rico as a tourist destination and as a transportation hub in the Caribbean.

## **Recent Events**

As a result of the terrorist attacks in the United States on September 11, 2001 at present there is uncertainty as to the expected level of economic activity in Puerto Rico during the remainder of fiscal 2002. It is possible that these recent events will cause a temporary loss in consumer and business confidence, thus triggering a reduction in the level of economic activity in Puerto Rico and a decrease in General Fund revenues from those estimated in the fiscal 2002 budget. It is not possible at this time to predict with certainty how the Puerto Rico economy will be affected. One of the sectors expected to be affected immediately is tourism, as the level of leisure and business travel is reduced. Although tourism has been one of the sectors which has demonstrated consistent growth during the last decade, total visitors' expenditures represented only 3.8% of gross domestic product for fiscal 2000. It is too early to estimate what long term impact, if any, the terrorist attacks will have on the economy of Puerto Rico. Except as otherwise expressly provided herein, the information appearing in this Official Statement with respect to periods subsequent to August 2001 does not consider the effects, if any, of these recent events.

The Commonwealth government is in the process of formulating measures to reduce the economic impact of these recent events. The Governor has met with business leaders to discuss how the government and the private sector can work together to restore consumer and business confidence. One of the steps the government proposes to take is to accelerate its capital investment program in order to stimulate economic activity.

## **Fiscal Management**

Fiscal responsibility for the Commonwealth is shared among the Department of the Treasury, the Office of Management and Budget and the Government Development Bank. The Department of the Treasury is responsible for collecting most of the Commonwealth's revenues, overseeing preparation of its financial statements and contributing to the preparation of the budget. The Office of Management and Budget prepares the Commonwealth's budget and has the responsibility for monitoring expenditures. Government Development Bank is the fiscal agent and financial advisor to the Commonwealth and its agencies, public corporations and municipalities and coordinates the management of public finances.

Section 7 of Article VI of the Constitution of Puerto Rico provides that "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law."

The financial statements of the Commonwealth for fiscal 2000 were audited by Deloitte & Touche LLP, whose report thereon is dated December 29, 2000. For a summary of the Commonwealth's significant accounting policies, see Note 1 to the Commonwealth's general purpose financial statements included in the Commonwealth's Annual Financial Report. Preparation of the audited financial statements of the Commonwealth involves the collection and combination of audited financial statements from 50 separate reporting entities.

## **Debt Management**

The Constitution of Puerto Rico limits the amount of general obligation debt that can be issued. The Commonwealth's policy has been and continues to be to maintain the level of such debt within a prudent range below the constitutional limitation. See "Debt Limitation" under The Notes.

Historically, the Commonwealth has maintained a fiscal policy which provides for a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. During the three fiscal years ended June 30, 1996, 1997 and 1998, however, public sector debt increased at a greater rate than the growth of gross product due to an increase in the amount of debt incurred to finance certain key infrastructure projects that are important to the development of the economy and are expected to produce long-term economic benefits, and debt

incurred to refinance outstanding debt enabling Puerto Rico to benefit from historically low levels of interest rates and realize debt service savings. During fiscal years ended June 30, 1999 and 2000, the growth of public sector debt was below the growth of gross product.

Public sector debt for the fiscal year ended June 30, 2001, increased by 12.1%. Corresponding information about the growth of gross product during fiscal 2001 is not yet available. This increase in the rate of growth of public sector debt during fiscal 2001 is in part due to the issuance during such fiscal year of \$1,092,550,000 of bonds of the Infrastructure Financing Authority and \$397,005,000 of bonds of The Children's Trust Fund, both of which are payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations derived from services or products. Excluding these bond issues, the rate of growth of public sector debt for fiscal 2001 was 5.9%. See "Trends of Public Sector Debt" under *Debt* and "Economic Performance by Sector - Construction" under *The Economy* in the Commonwealth Report.

## THE NOTES

### General

The Notes are dated their date of delivery, mature on July 30, 2002 and bear interest at the rate set forth on the cover of this Official Statement. Interest is computed on the basis of twelve 30-day months and a 360-day year. The Notes are issuable in fully registered form in denominations of \$5,000 and any integral multiple thereof. The Notes are not subject to redemption prior to maturity. Principal of and interest on the Notes are payable in immediately available funds at maturity.

### Book-Entry Only System

The following information concerning The Depository Trust Company ("DTC"), New York, New York, and DTC's book-entry system has been obtained from DTC. Neither the Commonwealth nor the Underwriters take any responsibility for the accuracy thereof.

DTC will act as securities depository for the Notes. The Notes will be issued as fully-registered Notes registered in the name of Cede & Co. (DTC's partnership nominee) or such other nominee as may be requested by an authorized representative of DTC and will be deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (the "Direct Participants") deposit with DTC. DTC also facilitates the settlement among Direct Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in Direct Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is owned by a number of its Direct Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (the "Indirect Participants"). The Rules applicable to DTC and its Direct and Indirect Participants are on file with the Securities and Exchange Commission.

Purchases of the Notes under the DTC system must be made by or through Direct Participants, which will receive a credit for the Notes on DTC's records. The ownership interest of each actual purchaser of a Note (a "Beneficial Owner") is in turn recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmations from DTC of their purchases, but Beneficial Owners are expected to receive written confirmation

providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Notes are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of the Beneficial Owners. Beneficial Owners will not receive definitive Notes, except in the event that use of the book-entry system for the Notes is discontinued.

To facilitate subsequent transfers, all Notes deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. or such other nominee as may be requested by an authorized representative of DTC. The deposit of Notes with DTC and their registration in the name of Cede & Co. or such other nominee effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Notes; DTC's records reflect only the identity of the Direct Participants to whose accounts such Notes are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Neither DTC nor Cede & Co. (or such other DTC nominee) will consent or vote with respect to the Notes. Under its usual procedures, DTC mails an Omnibus Proxy to the Commonwealth as soon as possible after the applicable record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Notes are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal and interest payments on the Notes will be made to DTC or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts, upon DTC's receipt of funds and corresponding detail information from the Commonwealth, on the payable date in accordance with their respective holdings shown on DTC's records unless DTC has reason to believe that it will not receive payment on the payable date. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name", and will be the responsibility of such Participant and not of DTC, Government Development Bank, as paying agent (the "Paying Agent"), or the Commonwealth, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to DTC or such other nominee as may be requested by an authorized representative of DTC is the responsibility of the Commonwealth or the Paying Agent, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the Notes at any time by giving reasonable notice to the Commonwealth or the Paying Agent. Under such circumstances, in the event that a successor securities depository is not obtained, definitive Notes are required to be printed and delivered.

The Commonwealth may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, definitive Notes will also be printed and delivered.

In the event that such book-entry only system is discontinued, the following provisions will apply: principal of and interest on the Notes will be payable at maturity in lawful money of the United States of America upon presentation and surrender of Notes at the principal office of the Paying Agent, in San Juan, Puerto Rico. The Notes will be issued only as registered Notes without coupons in denominations of \$5,000 or any integral multiple thereof. The transfer of the Notes will be registrable and they may be exchanged at the principal office of the Paying Agent in San Juan, Puerto Rico, upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

## Authorization of Notes

Section 2 of Article VI of the Constitution of the Commonwealth provides that the power of the Commonwealth to contract and to authorize the contracting of debts shall be exercised as determined by the Legislature. Pursuant to this power, the Legislature enacted the Act which authorizes the issuance of the Notes.

## Purpose of the Notes

The Notes are being issued to (i) fund a portion of the Commonwealth's projected cash requirements for fiscal 2002, which requirements result from timing differences between expected disbursements and receipts of taxes and revenues and (ii) pay certain costs of issuance of the Notes.

## Payment of and Security for the Notes

### *Provision for Payment of the Notes*

The Notes are direct obligations of the Commonwealth. The Notes are payable solely from the taxes and revenues in the General Fund collected by the Secretary of the Treasury after the date of issuance of the Notes and on or prior to June 30, 2002 and deposited in the Note Fund. After any required transfers from the General Fund to the Special Fund for the Amortization of General Obligations Evidenced by Bonds and Promissory Notes (the "Redemption Fund"), the Secretary of the Treasury, beginning April 1, 2002, will withdraw from the General Fund all taxes and revenues required to be deposited therein from April 1, 2002 until June 30, 2002, together with any taxes and revenues collected after the issuance of the Notes and then on deposit in the General Fund. Such taxes and revenues will be deposited in the Note Fund until the amount on deposit in the Note Fund in the months indicated below equals the following percentages of the sum of the principal of and interest on the Notes due at maturity (such sum being herein called the "Note Fund Requirement"):

<u>2002</u>	<u>Percentage of Note Fund Requirement</u>
April	33⅓%
May	66⅔%
June	100%

The Secretary of the Treasury covenants in the Note Resolution to compute on a cash basis on or before the tenth day of each month, commencing November 10, 2001, projected taxes and revenues expected to be deposited in, expenditures from, and fund balances of the General Fund for each month remaining in fiscal 2002. If, on the basis of such computations, the Secretary of the Treasury determines that the Note Fund Requirement less any amount then on deposit in the Note Fund equals or exceeds 85% of the sum of all taxes and revenues expected to be deposited in the General Fund from the later of the date of such determination and April 1, 2002 through June 30, 2002 after accounting for any required transfers from the General Fund to the Redemption Fund, the Secretary of the Treasury shall immediately withdraw sufficient amounts of taxes and revenues as received from the General Fund, shall make any required transfers to the Redemption Fund, and thereafter shall transfer to the Note Fund sufficient amounts of such taxes and revenues as received as will cause the amount on deposit in the Note Fund to equal the Note Fund Requirement.

All moneys in the Note Fund shall be used to pay principal of and interest on the Notes at maturity and shall be used for no other purpose; provided, however, that pursuant to certain constitutional and statutory authorizations, payments on general obligation bonds and notes of the Commonwealth and on bonds and notes of its public corporations guaranteed by the Commonwealth have a claim on Commonwealth taxes and revenues, including amounts on deposit in the Note Fund, prior to the claim thereon of the Notes.

Neither the full faith, credit and taxing power of the Commonwealth nor that of any of its political subdivisions are pledged for the payment of principal of or interest on the Notes.

*Provision for Prior Payment of Full Faith and Credit Obligations of the Commonwealth*

The Constitution of Puerto Rico provides that public debt of the Commonwealth constitutes a first lien on available Commonwealth taxes and revenues. Public debt includes bonds and notes of the Commonwealth to which the full faith, credit and taxing power of the Commonwealth are pledged and, according to opinions heretofore rendered by the Secretary of Justice of the Commonwealth, any payments which are required to be made by the Commonwealth under its guarantees of bonds and notes issued by its public corporations. The Notes do not constitute public debt.

Under the provisions of Act No. 39 of the Legislature of Puerto Rico, approved May 13, 1976, as amended, the Secretary of the Treasury is obligated to fund annual debt service on general obligation bonds and notes of the Commonwealth by monthly deposits into the Redemption Fund. As of September 24, 2001, the amount on deposit in the Redemption Fund was \$128 million, as required. Fiscal 2002 deposits from the General Fund to the Redemption Fund to fund the projected debt service through July 1, 2002, exclusive of debt service on any general obligation bonds that may be issued in fiscal 2002, are expected to aggregate \$314.6 million.

Moneys in the Redemption Fund are not available to pay the Notes.

Pursuant to Commonwealth legislation, the Secretary of the Treasury is authorized to issue up to \$475,000,000 in general obligation debt of the Commonwealth with a maturity of not more than 30 years for long-term capital projects. The Commonwealth expects to issue such debt in October 2002 (see "Debt Limitation with Respect to Full Faith and Credit Obligations" below), although the Commonwealth is not obligated to issue all or any of such debt during fiscal 2002. In addition, the Commonwealth expects to issue the Forward Delivery Bonds (see "Debt Limitation with Respect to Full Faith and Credit Obligations" below) in early April, 2002. See "Public Sector Debt" under *Debt* in the Commonwealth Report. No assurance can be given as to when such debt will be issued or its aggregate amount.

*Debt Limitation with Respect to Full Faith and Credit Obligations*

Section 2 of Article VI of the Constitution of Puerto Rico provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of and interest on such bonds and notes and on all such bonds and notes theretofore issued which is payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceeds 15% of the average annual revenues raised under the provisions of Commonwealth legislation and covered into the Treasury of Puerto Rico (hereinafter "internal revenues") in the two fiscal years preceding the then current fiscal year. Section 2 of Article VI does not limit the amount of debt that the Commonwealth may guarantee so long as its payments during the preceding fiscal year in respect of any such guaranteed debt do not cause the 15% limitation to be exceeded. Certain revenues, such as federal excise taxes on offshore shipments of alcoholic beverages and tobacco products and customs duties, which are collected by the United States Government and returned to the Treasury of Puerto Rico, and motor vehicle fuel taxes and license fees, which are allocated to the Highway and Transportation Authority, are not included as internal revenues for the purpose of calculating the debt limit, although they may be available for the payment of debt service.

On December 21, 1995, Aqueduct and Sewer Authority issued \$400,340,000 Puerto Rico Aqueduct and Sewer Authority Refunding Bonds, guaranteed by the Commonwealth (the "PRASA Guaranteed Bonds"). On January 1, 1997, the Commonwealth began to make payment of debt service on the PRASA Guaranteed Bonds under the full faith and credit guarantee of the Commonwealth. The amount paid by the Commonwealth under the PRASA Guaranteed Bonds will be taken into account for purposes of computing the above described 15% constitutional debt limitation.

On June 7, 2001, the Commonwealth authorized the issuance, on a delayed basis, of \$501,565,000 aggregate principal amount of its Public Improvement Refunding Bonds, Series 2002 (the "Forward Delivery Bonds"). The

Forward Delivery Bonds have been sold and will be delivered in April of 2002. A portion of the proceeds of the Forward Delivery Bonds will be invested in guaranteed investment contracts instead of United States Treasury obligations. The bonds to be refunded with the proceeds of the Forward Delivery Bonds are considered outstanding for purposes of calculating the Commonwealth's 15% constitutional debt limitation.

In October 2001, the Commonwealth expects to issue approximately \$455 million of its Public Improvement Bonds of 2002, Series A, \$20 million of its Public Improvement Bonds of 2002, Series B and \$837,960,000 of its Public Improvement Refunding Bonds, Series 2002 A (the "2002 Bonds"). If and when these Bonds are issued, the Official Statement for such Bonds will be available from Government Development Bank upon request by contacting the persons listed in the eighth paragraph in *Introductory Statement*.

Without giving effect to the 2002 Bonds, future maximum annual debt service for the Commonwealth's outstanding general obligation bonds will be \$556,325,000 in fiscal year ending June 30, 2002, after giving effect to the issuance of the Forward Delivery Bonds. This amount, plus the amount paid by the Commonwealth in respect of the PRASA Guaranteed Bonds in fiscal 2001 (\$33,473,000), is equal to 8.39% of \$6,634,417,500, which is the average of the adjusted internal revenues for the two fiscal years ended June 30, 2000 and June 30, 2001.

The Notes are not subject to the above described constitutional debt limitation.

#### *Estimated Note Revenues*

The Commonwealth estimates that the taxes and revenues available for deposit in the Note Fund for fiscal 2002 will be approximately \$5.5 billion. For fiscal 2001, taxes and revenues which would have been available for deposit in the Note Fund were approximately \$5.0 billion.

#### **Debt Limitation with Respect to Additional Parity Notes**

The aggregate principal amount of notes issued under the Act with respect to any fiscal year and outstanding at any time shall not exceed \$800,000,000. The Act provides that any notes issued thereunder shall mature on such date or dates not exceeding 30 days after the close of the fiscal year in which such notes are issued. The Commonwealth previously has issued notes under the Act, which notes have since matured and been paid in full. No notes of the Commonwealth are currently outstanding under the Act.

Under the Note Resolution, the Secretary of the Treasury covenants not to issue additional obligations payable on a parity with the Notes except for additional notes issued under the Act. Any additional notes issued under the Act during fiscal 2002 may not mature prior to July 30, 2002 pursuant to the Note Resolution. Unless said Notes are retired before June 30, 2002 (an eventuality not currently contemplated by the Commonwealth), the Act will preclude the issuance of additional notes because the principal amount of the Notes offered hereby is \$800,000,000.

#### **Payment Record**

The Commonwealth has never defaulted on the payment of principal of or interest on any of its debt.

### **PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES**

The Secretary of the Treasury has custody of the funds of the central government of the Commonwealth and is responsible for the disbursement and investment of and accounting for such funds. Central government funds are grouped into three major categories or "types" of funds, as follows: (i) Governmental Fund Types, which include the General, Special Revenue, Debt Service (also referred to herein as Redemption) and Capital Project Funds;

(ii) Proprietary Fund Types, which include the Enterprise and Internal Service Funds; and (iii) Fiduciary Fund Types, which include the Trust and Agency Funds. These funds do not include funds of the municipalities because the municipalities are governmental entities with independent treasuries.

The General Fund is the primary operating fund of the Commonwealth. General Fund revenues are broadly based and include revenues raised internally as well as those from non-Commonwealth sources. Internal revenues consist principally of income taxes and excise taxes. Revenues from non-Commonwealth sources are derived from federal excise taxes and customs duties returned to the Commonwealth. The primary expenditures of the Commonwealth through the General Fund are for grants and subsidies and personal and other services.

### **Summary and Management Discussion of General Fund Results**

The following table presents the Commonwealth revenues and expenditures of the General Fund on a cash basis for fiscal 1998 through fiscal 2001 and the Commonwealth's estimated revenues and budgeted expenditures for fiscal 2002. The information through fiscal 2000 is based on actual fiscal year-end results. The information relating to fiscal 2001 is subject to audit adjustments. The information relating to fiscal 2002 is based on (i) revised revenue estimates made by the Secretary of the Treasury in September 2001 and (ii) expenditures included in the approved budget for fiscal 2002, adjusted upward by the Office of Management and Budget in September 2001 to incorporate the revised costs of the health insurance program as determined after completion of negotiations with the health insurance companies. The revenue estimates do not take into account any possible revenue reduction resulting from any adverse economic impact arising from the recent terrorist attacks in the United States.

To improve the presentation of the following table, the Department of the Treasury has eliminated the use of line items identified as "Operating Transfers In" and "Operating Transfers Out" in the financial statements of the Commonwealth and has assigned the amounts previously listed under these two categories to the following revenue and expenditure line items according to the purpose and amount of each transfer: "Other Income", "Other Expenditures", "Capital Outlays and Other Debt Service" and "Transfers to Agencies". Amounts listed under "Other Income" represent recurring General Fund revenues not appropriately attributable to other revenue line items such as repayment of General Fund advances to municipalities and government agencies and funds. "Other Expenditures" represent recurring General Fund expenditures not appropriately attributable to other expenditures line items such as advances to government agencies and municipalities which advances are to be reimbursed to the General Fund by law. Amounts listed under "Capital Outlays and Other Debt Service" represent debt service on obligations and capital expenditures for which the Legislature has by resolution agreed to appropriate funds. "Transfers to Agencies" represent moneys appropriated for the operation of the Health Facilities and Services Administration. General Fund revenues, expenditures and transfers as presented in the table differ from the General Fund revenues, expenditures and transfers as presented in the financial statements of the Commonwealth, as the latter statements reflect an expanded General Fund entity in accordance with generally accepted accounting principles.

**Commonwealth of Puerto Rico**  
**General Fund Revenues, Expenditures and Charges in Cash Balance**  
**(in thousands)**

	1998	1999	2000	2001(P)	Estimated 2002 (1)
Beginning cash balance	\$ 127,477	\$ 340,771	\$ 474,759	\$ 287,055	\$ 184,556
Revenues from internal sources:					
Income Taxes:					
Individuals	2,026,612	2,244,376	2,352,066	2,348,042	2,595,000
Corporations	1,527,415	1,653,762	1,781,862	1,696,766	1,724,000
Partnerships	4,404	2,087	2,339	3,026	3,000
Withheld from non-residents	192,463	369,384	557,276	696,835	670,000
Tollgate taxes	170,953	114,533	111,130	49,511	36,000
Interest	11,406	10,666	11,674	14,781	15,000
Dividends	39,616	38,996	39,664	58,580	40,000
Total income taxes	<u>3,972,869</u>	<u>4,433,804</u>	<u>4,856,011</u>	<u>4,867,541</u>	<u>5,083,000</u>
Commonwealth excise taxes					
Alcoholic beverages	238,118	243,464	236,374	237,512	242,000
Cigarettes	111,094	119,105	115,157	119,135	119,000
Motor vehicles	350,004	411,573	389,995	406,252	429,000
Other excise taxes	613,500	699,685	668,820	579,596	661,000
Total Commonwealth excise taxes	<u>1,312,716</u>	<u>1,473,827</u>	<u>1,410,346</u>	<u>1,342,495</u>	<u>1,451,000</u>
Property taxes	5,673	2,214	1,131	287	-
Inheritance and gift taxes	1,380	1,811	3,109	7,475	2,000
Licenses	66,167	70,848	73,801	76,335	79,000
Other:					
Lottery	57,986	59,206	63,779	57,482	62,000
Electronic Lottery	54,681	53,013	70,209	69,912	61,000
Miscellaneous	158,568	176,669	169,246	199,676	427,000
Total other	<u>271,235</u>	<u>288,888</u>	<u>303,234</u>	<u>327,070</u>	<u>550,000</u>
Total revenues from internal sources	<u>5,630,040</u>	<u>6,271,392</u>	<u>6,647,632</u>	<u>6,621,203</u>	<u>7,165,000</u>
Revenues from non-Commonwealth sources:					
Federal excise taxes	200,260	217,296	245,750	286,890	280,000
Customs	72,206	61,355	50,231	43,152	40,000
Total revenues from non-Commonwealth sources	<u>272,466</u>	<u>278,651</u>	<u>295,981</u>	<u>330,042</u>	<u>320,000</u>
Sub-total revenues	5,902,506	6,550,043	6,943,613	6,951,245	7,485,000
Proceeds from special funds	50,253	-	-	-	57,000
Total Revenues	<u>5,952,759</u>	<u>6,550,043</u>	<u>6,943,613</u>	<u>6,951,245</u>	<u>7,542,000</u>
Other income (refunds) (2)	482,120	2,570	64,325	58,651	98,870
Transfers to Redemption Fund (3)	(368,544)	(320,240)	(410,046)	(297,944)	(314,636)
Proceeds of notes and other borrowings (4)	601,892	600,000	778,863	825,703	1,072,007
Repayment of notes and other borrowings (5)	(617,775)	(611,410)	(787,155)	(683,913)	(1,201,084)
Adjusted revenues	<u>6,050,452</u>	<u>6,220,963</u>	<u>6,589,600</u>	<u>6,853,742</u>	<u>7,197,157</u>
Expenditures:					
Grants and subsidies	2,118,266	2,392,018	2,864,215	2,997,704	2,164,701
Personal services	2,197,903	2,470,456	2,737,159	2,859,387	3,717,935
Other services	698,446	723,563	745,194	655,053	889,707
Materials and supplies	84,451	99,404	109,081	91,653	258,648
Equipment purchases	31,626	52,993	56,404	38,381	46,080
Capital outlays and other debt service	253,962	166,841	101,178	33,102	26,327
Transfers to agencies	131,174	181,700	164,073	280,961	-
Other expenditures	321,330	-	-	-	268,000
Total expenditures	<u>5,837,158</u>	<u>6,086,975</u>	<u>6,777,304</u>	<u>6,956,241</u>	<u>7,371,398</u>
Adjusted revenues less expenditures	<u>213,294</u>	<u>133,988</u>	<u>(187,704)</u>	<u>(102,499)</u>	<u>(174,241)</u>
Ending cash balance	<u>\$ 340,771</u>	<u>\$ 474,759</u>	<u>\$ 287,055</u>	<u>\$ 184,556</u>	<u>\$ 10,315</u>

(P) Preliminary.

(1) Budget, as revised on September 7, 2001 by the Office of Management and Budget and the Secretary of the Treasury.

(2) Consists of reimbursement of certain advances to agencies to cover expenses, revenue from General Fund's non budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.

(3) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly to the Redemption Fund from non-General Fund revenues.

(4) Consists of proceeds of borrowing from Government Development Bank and proceeds from Commonwealth's Tax and Revenue Anticipation Notes.

(5) Consists of repayment of borrowing from Government Development Bank and repayment of Commonwealth's Tax and Revenue Anticipation Notes.

Source: Department of Treasury

### *Estimated Fiscal 2002 Compared to Preliminary Fiscal 2001*

As of September 7, 2001, it was projected that General Fund total revenues for fiscal 2002 (excluding proceeds from special funds) would be \$7,485 million, representing an increase of \$534 million, or 7.6%, from fiscal 2001 revenues. The major changes from fiscal 2001 are expected to be: projected increases in income taxes from individuals of \$247 million and in corporate income taxes of \$27 million, a projected increase in Commonwealth excise taxes of \$109 million, a projected increase in miscellaneous revenues of \$227 million and a projected decrease in income taxes withheld from non-residents, tollgate taxes and dividend taxes totaling \$57 million.

The revenue estimates for fiscal 2002 were based on the following assumptions: (i) the economy of Puerto Rico will continue a moderate growth pattern until at least the fourth calendar quarter of 2002 (nominal growth of the economy during fiscal 2002 was expected to be between 5% and 6%); (ii) tax collections will continue to grow in excess of the 2% growth registered in fiscal 2001, which was an election year and a year in which the last phase of a previously legislated tax rate reduction became effective; (iii) the price of crude oil will average \$25 per barrel; (iv) rum excise tax collections will decrease as the amount of excise tax that is returned to Puerto Rico is reduced from \$13.25 to \$10.50 per gallon effective on January 1, 2002 (see "Relationship with the United States" in *Introduction* in the Commonwealth Report); and, (v) there will be some income tax revenue reductions as a result of the recently enacted Commonwealth tax legislation designed to stimulate economic activity.

One of the largest components of the expected increase in tax collections (\$180 million) is based on special administrative actions which the Treasury Department expects to implement during fiscal 2002. These involve stronger enforcement actions in the collection of excise taxes and an aggressive campaign to collect income taxes which are past due. The success of these actions is uncertain. The Secretary of the Treasury expects to collect an additional \$20 million in income taxes by increasing the required tax withholding on professional services contracts from 7% to 10%. This increase requires legislation.

For the first two months of fiscal 2002, actual tax collections were in excess of the estimated amount by approximately 7%.

It is too early to determine with any certainty the impact that the terrorist attacks, which occurred in the United States on September 11, will have on economic activity in Puerto Rico and on revenues of the General Fund. It is possible that there will be a short term reduction in economic activity with an adverse impact on revenues. The Commonwealth government is in the process of formulating measures to restore confidence to consumers and the business community and proposes to accelerate its capital investment program to help counteract the possible adverse effect of these recent events.

Total estimated expenditures for fiscal 2002 are \$7,371 million, an increase of \$415 million, or 6.0%, from fiscal 2001 expenditures. The ending cash balance for the General Fund for fiscal 2002 is estimated to be \$10.3 million, a decrease of \$174.2 million from fiscal 2001. This decrease resulted principally from the repayment during fiscal 2002 from General Fund moneys of short-term borrowings incurred in fiscal 2001 and not repaid in said fiscal year. It is not possible at this time to determine whether the September 11, 2001 terrorist attacks will cause General Fund expenditures to increase. For a comparison of budgeted expenditures and estimated expenditures, see "*Fiscal 2002 Budget*" in the Commonwealth Report.

### *Preliminary Fiscal 2001 Compared to Fiscal 2000*

General Fund total revenues for fiscal 2001 are currently estimated at \$6,951 million, an increase of approximately \$8 million from fiscal 2000. The major changes for fiscal 2000 are: a decrease of \$85 million in corporate income taxes; a decrease of \$62 million in tollgate taxes; a decrease of \$89 million in other excise taxes; an increase in income tax withheld from non-residents of \$140 million; and an increase in federal excise taxes of \$41 million. The decrease in corporate income taxes was due to the effects of the economic slowdown in the United States and Puerto Rico. The reduction in tollgate taxes and the increase in withholding taxes to non-residents are the result of continuing conversions

of corporations to controlled foreign corporation tax status and the payment of withholding taxes on royalties paid to U.S. affiliates. The reduction in local excise taxes allocated to the General Fund was attributable principally to a reduction in the tax on crude oil (which varies inversely with the price of crude oil) and a transfer of certain excise taxes from the General Fund to other funds of the Commonwealth as required by recent Commonwealth legislation. Federal excise tax revenues rose due to growing exports of rum products. For fiscal 2000 the amount of the rum excise tax that is returned to the Treasury of Puerto Rico increased from \$10.50 to \$13.25 per gallon, but for the second half of fiscal 2002, the rum excise tax will return to \$10.50 per gallon. See “Major Sources of General Fund Revenues” below.

The budget for fiscal 2001 had estimated that revenues would be \$7,505 million, whereas actual revenues were only \$6,951 million. This difference was attributable to: (i) the effect of slower than anticipated economic growth; (ii) the impact of the Section 936 and 30A phase out on corporate tax revenues (offset by increases in withholding taxes on royalty payments); (iii) the increase in the price of crude oil, which affects economic growth and excise tax collections; and (iv) the previously legislated tax rate reduction which became effective in fiscal 2001.

Total expenditures for fiscal 2001 were \$6,956 million, an increase of \$179 million, or 2.6%, over fiscal 2000. Expenditures grew primarily in the areas of education, health and public safety. This growth is attributable in part to the rising cost of services and expanding programs. For a comparison of budgeted expenditures and actual expenditures, see “Fiscal 2001 Budget” under *Budget of the Commonwealth of Puerto Rico* in the Commonwealth Report. The ending cash balance for the General Fund for fiscal 2001 is estimated to be \$185 million, a decrease of \$102 million from fiscal 2000. This decrease in the ending cash balance, together with moneys raised by the Commonwealth from short-term borrowings that were not repaid in full prior to the end of fiscal 2001, enabled the Commonwealth to cover expenses in said year in excess of the amounts budgeted therefor and in the face of a decline in the General Fund revenues. General Fund deposits to the Redemption Fund in fiscal 2001 were \$113 million less than in fiscal 2000 because the last four monthly deposits in fiscal 2001 were made from the proceeds of a short-term loan from GDB which loan was repaid in early fiscal 2002 from the proceeds of general obligation bonds issued in June 2001.

In lieu of issuing tax and revenue anticipation notes in fiscal 2001 to meet seasonal differences in the timing of revenues and expenses, the Commonwealth borrowed from GDB \$825.7 million. Of this amount \$661.4 million has been repaid.

#### *Fiscal 2000 Compared to Fiscal 1999*

General Fund total revenues for fiscal 2000 were \$6,944 million, an increase of \$394 million, or 6.0%, over fiscal 1999. The major changes were: an increase in revenues obtained from income taxes of \$422 million and a decrease in Commonwealth excise taxes of \$63 million.

Total expenditures for fiscal 2000 were \$6,777 million, an increase of \$690 million, or 11.3%, over fiscal 1999. The ending cash balance for the General Fund for fiscal 2000 was \$287 million, a decrease of \$188 million from fiscal 1999.

#### *Fiscal 1999 Compared to Fiscal 1998*

General Fund total revenues for fiscal 1999 were \$6,550 million, an increase of \$597 million, or 10.0%, over fiscal 1998. Major changes were: an increase in income taxes of \$461 million and an increase in excise taxes of \$161 million.

Total expenditures for fiscal 1999 were \$6,087 million, an increase of \$250 million, or 4.3%, from fiscal 1998. The ending cash balance for the General Fund for fiscal 1999 was \$475 million, an increase of \$134 million from fiscal 1998.

## Major Sources of General Fund Revenues

### *Income Taxes*

The Commonwealth's income tax law, the Internal Revenue Code of 1994, as amended (the "PR Code"), imposes a tax on the income of individual residents of Puerto Rico, trusts, estates, and domestic and foreign (if engaged in a trade or business in Puerto Rico) corporations and partnerships. A withholding tax is imposed on certain payments made to non-residents of Puerto Rico.

*Individuals.* Resident individuals are subject to tax on their taxable income from all sources. Prior to January 1, 2000, the PR Code had five tax brackets for individuals with tax rates of 8%, 12%, 18%, 31% and 33%. As a result of legislation enacted in 1999, the first four brackets were reduced to 7.5%, 11%, 16.5% and 29.5% for the taxable year commencing on January 1, 2000, to 7%, 10%, 15% and 28% for taxable year commencing on January 1, 2001, and 6%, 9%, 14% and 27% for the taxable years commencing on and after January 1, 2002. Dividend income from Puerto Rico corporations and certain qualifying foreign corporations is taxed at a rate of 10%.

Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a rate of 20% or 10% if the capital asset consists of certain property located in Puerto Rico sold or exchanged after December 31, 2000. Gains realized by Puerto Rico resident individuals, trusts and estates from the sale of stock of certain Puerto Rico corporations in an initial public offering made prior to December 31, 2000 are subject to a special capital gains rate of 7%. Legislation has been introduced to extend the eligibility date from December 31, 2000 to December 31, 2007.

Interest income in excess of \$2,000 on deposits with Puerto Rico financial institutions is taxed at a rate of 17%; the first \$2,000 of interest income from such institutions is exempt from taxation. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident individuals, trusts and estates qualifies for a special 17% tax rate.

*Corporations and Partnerships.* Puerto Rico corporations and partnerships are subject to tax on income from all sources; foreign corporations and partnerships that are engaged in a trade or business in Puerto Rico are subject to tax on their income from Puerto Rico sources and on income from sources outside Puerto Rico that is effectively connected with the conduct of their trade or business in Puerto Rico. Unless a corporation or partnership qualifies for partial exemption from corporate income and other taxes under the industrial incentives program (see "Tax Incentives" under *The Economy* above), it is subject to tax at graduated rates.

The PR Code provides for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to taxable income in excess of \$275,000. Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a maximum rate of 25% or 12.5% if the capital asset consists of certain property located in Puerto Rico sold or exchanged after December 31, 2000.

Certain corporations and partnerships covered by the tax incentives acts continue to be subject to a maximum tax rate of 45% on their taxable income. Corporations and partnerships covered by the Puerto Rico Tourism Incentives Act of 1993, as amended, are subject to a maximum tax rate of 42% on their taxable income. The PR Code also provides for an alternative minimum tax of 22%. Corporations and partnerships operating under a new grant of tax exemption issued under the 1998 Tax Incentives Act are subject to a maximum income tax rate of 7%.

The PR Code imposes a branch profits tax on resident foreign corporations less than 80% of whose gross income qualifies as income effectively connected with a Puerto Rico trade or business. The branch profits tax is 10% of an annual dividend equivalent amount, and it applies without regard to the Puerto Rico source of income rules.

Interest from Puerto Rico sources paid to non-resident non-affiliated corporate recipients is not subject to any income or withholding tax. Interest paid to certain related non-resident recipients continues to be subject to a

withholding tax of 29%. Dividends paid to non-resident corporate recipients are subject to a withholding tax of 10%. Dividends distributed by corporations (including Section 936 Corporations) operating under new grants of tax exemption issued under the 1998 Tax Incentives Act are not subject to Puerto Rico income tax. The basic tax on dividends paid to foreign corporate shareholders of Section 936 Corporations operating under grants of tax exemption issued under prior incentives laws is 10% but is subject to reduction with respect to dividends paid from profits invested in certain eligible instruments for specified periods of time.

Payments in excess of \$1,000 during a calendar year made by the Commonwealth and persons engaged in a trade or business in Puerto Rico in consideration of the receipt of services rendered in Puerto Rico are subject to a 7% withholding tax. The Secretary of the Treasury proposes to introduce legislation increasing the withholding tax to 10%.

#### *Excise Taxes*

The PR Code imposes a tax on articles and commodities that are imported into or manufactured in Puerto Rico for consumption in Puerto Rico and a tax on certain transactions, such as hotel occupancy, public shows, and horse racing. The excise tax on certain articles and commodities, such as cigarettes and petroleum products, is based upon the quantity of goods imported. The excise tax on motor vehicles is based on its suggested retail price. The PR Code imposes a tax at an effective rate of 6.6% of the F.O.B. factory price for imported goods and 3.6% of the sales price of goods manufactured in Puerto Rico, except sugar, cement, cigarettes, motor vehicles and certain petroleum products, which are taxed at different rates. Goods to be used by the government, except for motor vehicles and construction equipment, are not exempt. Exemptions apply to certain articles, such as food and medicines, and to articles designated for certain users.

#### *Other Taxes and Revenues*

Motor vehicle license plate and registration fees comprise the major portion of license tax receipts.

Non-tax revenues consist principally of lottery proceeds, documentary stamps, permits, fees and forfeits, proceeds of land sales and receipts from public corporations in lieu of taxes.

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of alcoholic beverages from the island to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth.

On April 26, 2001, legislation was introduced in the United States House of Representatives to repeal the return to the Treasury Department of Puerto Rico of the federal excise taxes on shipments of alcoholic beverages from Puerto Rico. The Commonwealth will vigorously oppose the enactment of any such repeal. No assurance can be given at this time as to the likelihood of the passage of such repeal.

#### **Collections of Income and Excise Taxes**

The Department of the Treasury has continued its program of improving tax collections which began in fiscal 1986. The program has consisted, in part, of sponsoring and implementing tax reform, particularly in the areas of excise taxes and income taxes, in order to decrease the incidences of nonpayment of taxes and expand the taxpayer base. The program has also included: (a) improving the methods by which delinquent taxpayers are identified, primarily through the use of computer analyses, (b) computerizing the processing of tax returns, and (c) identifying and eliminating taxpayer abuses of existing tax laws.

#### **Transfers to General Obligation Redemption Fund**

These consist of transfers from the General Fund to the Redemption Fund for the amortization of the principal of and interest on general obligation bonds and notes of the Commonwealth.

## **Components of General Fund Expenditures**

### *Grants and Subsidies*

This category includes grants and contributions to municipalities, public corporations with independent treasuries and contributions to charitable institutions. It also includes items for or included in court awards, damage awards for personal injury or property damage as well as payment of taxes and payment in lieu of taxes.

### *Personal Services*

This category includes compensation paid for personal services rendered to the Commonwealth and its public instrumentalities by individuals or firms in the form of salaries, wages, per diems, fees, commissions or other forms of compensation.

### *Other Services*

This category includes the payment of services other than the services referred to above, including advertising, printing, communications, legal expenses, utilities, building and equipment rental and maintenance expenses, insurance premiums and miscellaneous services.

### *Materials and Supplies*

This category includes all articles which ordinarily have short life and durability, lose their characteristic identity in the process of use, have only nominal value (\$25 or less) or are not otherwise chargeable as equipment.

### *Equipment Purchases*

This category includes items which have three special characteristics which distinguish them from materials; durability, long useful life and high unit cost. In addition, these items are subject to centralized inventory control as fixed assets.

### *Capital Outlays and Other Debt Service*

Capital outlays are made primarily for acquisition of land or interests in land, construction of buildings, roads, bridges and other structures, as well as permanent improvements and additions. Other debt service includes payments on notes issued to Government Development Bank to be paid from General Fund moneys and payments for the amortization of the principal of and interest on non-general obligations payable from Commonwealth appropriations.

### *Transfers to Agencies*

Includes repayment of loans and advances to other funds, certain refunds, advances from other funds and other receipts, repayment of advances from other funds, grants and contributions to other funds under the custody of the Secretary of the Treasury and other items. The major portion of grants and contributions in recent fiscal years has consisted of transfers to the Health Facilities and Services Administration to cover the costs of health reform and advances to the municipalities.

### *Other Expenditures*

This category represents recurring General Fund expenditures not appropriately attributable to other expenditures line items, such as advances to government agencies and municipalities, which advances are to be reimbursed to the General Fund by law.

## **Inter-fund Borrowings**

The Commonwealth historically has used inter-fund borrowing to meet temporary imbalances of receipts and disbursements in the General Fund. Act No. 147 of the Legislature of Puerto Rico, approved June 18, 1980, provides that in any fiscal year where revenues of the General Fund are not sufficient to meet approved appropriations for such year, the Governor may authorize the Secretary of the Treasury to borrow funds from Government Development Bank and, if necessary, from any funds of the Commonwealth under his custody, on such terms and conditions as the Secretary of the Treasury deems advisable. Funds available for this purpose do not include public pension funds and funds of public employees' associations. Monies so borrowed must be repaid as soon as there is sufficient money in the General Fund to do so. Monies borrowed and repaid by the General Fund are accounted for as "Operating Transfers In" and "Operating Transfers Out", respectively, on the financial statements of the Commonwealth and included in certain revenue and expenditure line items in the table entitled "General Fund Revenues, Expenditures, and Changes in Cash Balance" in "Summary and Management Discussion of General Fund Results" under *Puerto Rico Taxes, Other Revenues and Expenditures*. As of August 31, 2001, funds aggregating approximately \$367 million under the custody of the Secretary of the Treasury were available for inter-fund borrowings, if necessary. In addition, the Commonwealth has available for this purpose a \$800 million line of credit with Government Development Bank.

## **General Fund Monthly Cash Flow for Fiscal 2001 and Fiscal 2002**

The tables which follow set forth the actual monthly cash flow for the General Fund for fiscal 2001 and the estimated monthly cash flow for fiscal 2002. The monthly cash flow for fiscal 2001 is preliminary and does not take into account any audit adjustments.

The monthly cash flow estimates for fiscal 2002 are based upon the General Fund budget for fiscal 2002 and upon historical experience as adjusted to reflect economic conditions, statutory and administrative changes and anticipated payment dates for grants and subsidies, personal and other services, materials and supplies, equipment, capital outlays, debt service and transfers. These estimates are based on present circumstances and currently available information and are believed to be reasonable. Such estimates may be affected by numerous factors, including the continuing validity of the assumptions underlying the estimates, and there can be no assurance that such estimates will be achieved.

**Commonwealth of Puerto Rico**  
**Preliminary General Fund Cash Flows**  
**Fiscal Year 2001**  
**(in thousands)**

	July	August	September	October	November	December	January	February	March	April	May	June	Total
<b>Beginning cash balance</b>	\$ 287,055	\$ 88,061	\$ (107,453)	\$ (90,644)	\$ (82,469)	\$ (52,163)	\$ 71,852	\$ (69,563)	\$ (32,386)	\$ 75,108	\$ 495,399	\$ 248,021	\$ 287,055
<b>Receipts:</b>													
Income taxes	238,802	292,694	408,423	278,781	278,032	612,733	362,287	346,957	338,627	826,830	356,952	526,423	4,867,541
Property taxes												287	287
Commonwealth excise taxes	110,428	106,013	103,475	114,938	122,436	124,475	111,936	90,048	114,588	118,127	110,011	116,020	1,342,495
Inheritance and gift taxes	199	1,217	2,283	792	908	206	85	122	227	123	1,268	45	7,475
Licenses	4,055	4,259	9,023	18,106	6,343	5,916	5,549	4,380	4,820	4,563	4,608	4,713	76,335
Other internal sources	18,245	21,203	17,700	29,623	16,577	27,346	21,098	18,809	19,883	26,248	23,845	86,493	327,070
Non-Commonwealth sources	23,215	28,002	34,446	25,890	27,498	39,771	29,493	25,453	23,736	23,800	19,679	29,059	330,042
SubTotal receipts	394,944	453,388	575,350	468,130	451,794	810,447	530,448	485,769	501,881	999,691	516,363	763,040	6,951,245
Other income (refunds) (1)	20,349	(332)	19,198	29,185	30,901	32,277	38,345	(5,861)	(7,730)	(12,810)	(96,555)	11,684	58,651
Transfers to Redemption Fund (2)	(37,243)	(37,243)	(37,243)	(37,243)	(37,243)	(37,243)	(37,243)	(37,243)	0	0	0	0	(297,944)
Proceeds of Notes and other borrowings (3)	0	0	80,000	120,000	100,000	0	86,481	100,000	175,000	164,222	0	0	825,703
Repayment of Notes and other borrowing (4)	0	0	0	0	0	(5,576)	(2,403)	0	0	(230,000)	(100,000)	(345,934)	(683,913)
Total available cash from operations	378,050	415,813	637,305	580,072	545,452	799,905	615,628	542,665	669,151	921,103	319,808	428,790	6,853,742
<b>Disbursements:</b>													
Grants and subsidies	305,873	264,938	302,941	244,818	239,630	263,433	257,980	187,469	229,658	206,949	257,467	236,548	2,997,704
Personal services	156,370	242,273	249,292	252,212	223,178	324,867	248,068	245,544	254,256	230,250	247,018	186,059	2,859,387
Other services	78,278	84,264	33,046	53,496	37,618	44,487	196,373	30,779	38,390	27,101	18,991	12,230	655,053
Materials and supplies	5,070	5,414	9,088	14,205	11,195	9,985	7,686	7,952	5,453	3,995	7,739	871	91,653
Equipment purchases	1,923	2,239	5,167	2,739	2,590	8,436	1,849	3,509	976	2,815	4,371	1,767	38,381
Other debt service and capital outlays	22	2,634	302	5	6	401	7,386	2,603	1,887	95	7	17,754	33,102
Transfers to (from) other agencies	29,508	9,565	20,660	4,422	928	24,282	37,701	27,632	31,037	29,606	31,593	34,027	280,961
Total disbursements	577,044	611,327	620,496	571,897	515,145	675,891	757,043	505,488	561,657	500,811	567,186	492,256	6,956,241
<b>Total available cash less transfers and disbursements</b>	(198,994)	(195,514)	16,809	8,175	30,307	124,014	(141,415)	37,177	107,494	420,292	(247,378)	(63,466)	(102,499)
<b>Ending Cash Balance</b>	<b>\$ 88,061</b>	<b>\$ (107,453)</b>	<b>\$ (90,644)</b>	<b>\$ (82,469)</b>	<b>\$ (52,163)</b>	<b>\$ 71,852</b>	<b>\$ (69,563)</b>	<b>\$ (32,386)</b>	<b>\$ 75,108</b>	<b>\$ 495,399</b>	<b>\$ 248,021</b>	<b>\$ 184,556</b>	<b>\$ 184,556</b>

(1) Consists of revenues from General Fund's non budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.

(2) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly to the Redemption Fund from non-General Fund revenues.

(3) Consists of proceeds of borrowing from Government Development Bank.

(4) Consists of repayment of borrowing from Government Development Bank.

Source: Department of Treasury

**Commonwealth of Puerto Rico**  
**Estimated General Fund Cash Flows**  
**Fiscal Year 2002**  
**(in thousands)**

	July	August	September	October	November	December	January	February	March	April	May	June	Total (1)
<b>Beginning cash balance</b>	\$184,556	(\$268,479)	(\$436,700)	(\$566,357)	(\$115,931)	\$117,973	\$405,164	\$351,392	\$226,569	\$232,185	\$373,732	\$65,304	\$184,556
<b>Receipts:</b>													
Income taxes	254,000	308,500	402,600	324,100	297,400	578,100	417,800	291,000	424,300	798,400	466,700	520,100	5,083,000
Commonwealth excise taxes	109,200	110,400	105,500	120,500	123,400	139,900	121,300	104,800	130,200	127,300	123,000	135,500	1,451,000
Inheritance and gift taxes	200	100	100	100	200	100	200	200	200	200	200	200	2,000
Licenses	3,800	4,500	6,600	21,000	7,900	6,400	5,200	4,500	4,900	4,900	4,600	4,700	79,000
Other internal sources	34,500	35,800	33,600	36,900	32,700	76,100	39,000	35,800	37,600	40,800	43,500	103,700	550,000
Non-Commonwealth sources	25,000	30,800	36,800	27,300	29,500	41,900	25,000	21,000	20,600	20,400	17,000	24,700	320,000
Proceeds from Special Funds						57,000							57,000
Sub Total receipts	426,700	490,100	585,200	529,900	491,100	899,500	608,500	457,300	617,800	992,000	655,000	788,900	7,542,000
Other income (refunds) (2)	13,700	17,100	25,100	25,100	31,200	31,200	31,200	18,100	1,300	39,600	(95,700)	(39,030)	98,870
Transfers to Redemption Fund (3)	(35,970)	(35,970)	(35,970)	(35,970)	(21,345)	(21,345)	(21,345)	(21,345)	(21,345)	(21,345)	(21,345)	(21,345)	(314,636)
Proceeds of notes and other borrowings (4)	-	-	-	804,007	268,000	-	-	-	-	-	-	-	1,072,007
Repayment of notes and other borrowings (5)	(164,220)	-	-	(217,996)	-	-	-	-	-	(272,956)	(272,956)	(272,956)	(1,201,084)
Total available cash from operations	240,210	471,230	574,330	1,105,041	768,955	909,355	618,355	454,055	597,755	737,299	264,999	455,569	7,197,157
<b>Disbursements:</b>													
Grants and subsidies	304,239	217,926	253,640	239,391	143,150	185,617	164,172	134,822	136,996	132,617	123,320	128,812	2,164,701
Personal services	244,392	250,343	299,608	271,085	282,168	359,222	347,272	333,252	339,615	357,465	343,664	289,849	3,717,935
Other services	67,690	105,174	70,011	63,761	36,133	50,485	136,748	75,755	77,681	67,154	73,930	65,185	889,707
Materials and supplies	9,096	10,652	22,442	22,338	16,945	18,732	19,803	27,954	32,167	33,151	27,696	17,672	258,648
Equipment purchases	1,790	1,553	3,195	2,483	2,319	4,171	4,088	5,876	4,528	4,099	4,739	7,238	46,080
Other debt service and capital outlays	12,437	204	1,491	1,959	738	3,937	45	1,218	1,152	1,267	78	1,802	26,327
Prior year disbursements	53,600	53,600	53,600	53,600	53,600	-	-	-	-	-	-	-	268,000
Total disbursements	693,245	639,451	703,988	654,615	535,052	622,164	672,128	578,878	592,140	595,753	573,427	510,559	7,371,398
Total available cash less transfers and disbursements	(453,035)	(168,221)	(129,657)	450,426	233,903	287,191	(53,772)	(124,822)	5,616	141,546	(308,427)	(54,990)	(174,241)
<b>Ending Cash Balance</b>	<b>(\$268,479)</b>	<b>(\$436,700)</b>	<b>(\$566,357)</b>	<b>(\$115,931)</b>	<b>\$117,973</b>	<b>\$405,164</b>	<b>\$351,392</b>	<b>\$226,569</b>	<b>\$232,185</b>	<b>\$373,732</b>	<b>\$65,304</b>	<b>\$10,315</b>	<b>\$10,315</b>
<b>Ending cash balance without considering TRANS</b>	<b>(\$268,479)</b>	<b>(\$436,700)</b>	<b>(\$566,357)</b>	<b>(\$919,938)</b>	<b>(\$686,034)</b>	<b>(\$398,843)</b>	<b>(\$452,615)</b>	<b>(\$577,438)</b>	<b>(\$571,822)</b>	<b>(\$156,632)</b>	<b>(\$191,417)</b>	<b>\$27,237</b>	

- (1) Budget, as revised on September 7, 2002 by the Office of Management and Budget and the Secretary of the Treasury.
- (2) Consists of revenues from General Fund's non budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.
- (3) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly to the Redemption Fund from non-General Fund revenues.
- (4) Consists of proceeds of borrowing from Government Development Bank and proceeds from Commonwealth's Tax and Revenue Anticipation Notes (net of \$950,311 of underwriters' discount and \$730,500 of costs of issuance).
- (5) Consists of repayment of borrowing from Government Development Bank and repayment of Commonwealth's Tax and Revenue Anticipation Notes.

Source: Department of Treasury

## TAX MATTERS

The Internal Revenue Code of 1986, as amended (the “Code”), includes requirements regarding the use, expenditure and investment of Note proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, which the Commonwealth must continue to meet after the issuance of the Notes in order that interest on the Notes not be included in gross income for federal income tax purposes. The Commonwealth’s failure to meet these requirements may cause interest on the Notes to be included in gross income for federal income tax purposes retroactive to their date of issuance. The Commonwealth has covenanted to comply, to the extent permitted by the Constitution and the laws of the Commonwealth, with the requirements of the Code in order to maintain the exclusion from gross income for federal income tax purposes of interest on the Notes. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth which would prevent the Commonwealth from complying with the requirements of the Code.

In the opinion of Bond Counsel, subject to continuing compliance by the Commonwealth with the tax covenant referred to above, under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, interest on the Notes will not be includable in gross income for federal income tax purposes. Interest on the Notes is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations; however, interest on the Notes will be includable in the computation of the alternative minimum tax on corporations imposed by the Code. No opinion is rendered by Bond Counsel as to the exclusion from gross income of the interest on the Notes for federal income tax purposes on or after the date on which any action is taken under the Note Resolution or any other instrument relating to the Notes upon the approval of counsel other than Bond Counsel. Bond Counsel is further of the opinion that, under the provisions of the Acts of Congress now in force, the Notes and the interest thereon are exempt from state, Commonwealth and local income taxation.

Ownership of tax-exempt obligations may result in collateral federal income tax consequences to certain taxpayers, including, without limitation, financial institutions, property and casualty insurance companies, certain foreign corporations, certain S Corporations with excess passive income, individual recipients of Social Security or Railroad Retirement benefits, taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations and taxpayers who may be eligible for the earned income tax credit.

Ownership of tax-exempt obligations may also result in collateral income tax consequences under Puerto Rico law to financial institutions doing business in Puerto Rico.

Prospective purchasers of the Notes should consult their tax advisors as to applicability and impact of any collateral consequences.

Legislation affecting municipal securities is constantly being considered by the United States Congress. There can be no assurance that legislation enacted after the date of issuance of the Notes will not have an adverse effect on the tax-exempt status of the Notes. Legislative or regulatory actions and proposals may also affect the economic value of tax exemption or the market price of the Notes.

### **Note Premium**

The excess, if any, of the original tax basis of a Note to a purchaser (other than a purchaser who holds such Note as inventory, stock in trade or for sale to customers in the ordinary course of business) who purchases such Note as part of the initial offering over the amount payable at maturity of such Note is “Note Premium.” Note Premium is amortized over the term of such Note for federal income tax purposes. No deduction is allowed for such amortization of Note Premium; however, United States Treasury regulations provide that Note Premium is treated as an offset to qualified stated interest received on such Note. Owners of such Notes are required to decrease their adjusted basis in such Notes by the amount of amortizable Note Premium attributable to each taxable year such Notes are held. Owners of such Notes should consult their tax advisors with respect to the precise determination for federal income tax purposes

of the treatment of Note Premium upon sale or other disposition of such Notes and with respect to the state, Commonwealth and local income tax consequence of owning and disposing of such Note.

### **LEGAL MATTERS**

The proposed form of opinion of Sidley Austin Brown & Wood LLP, Bond Counsel, is set forth in *Appendix II* to this Official Statement. Certain legal matters will be passed upon for the Underwriters by McConnell Valdés, San Juan, Puerto Rico.

### **LEGAL INVESTMENT**

The Notes will be eligible for deposit by banks in Puerto Rico to secure public funds and will be approved investments for insurance companies to qualify them to do business in Puerto Rico, as required by law.

### **UNDERWRITING**

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Notes from the Commonwealth at an aggregate premium of \$5,688,000 from the initial offering price of the Notes. The obligations of the Underwriters are subject to certain conditions precedent, and the Underwriters will be obligated to purchase all the Notes, if any Notes are purchased. The Underwriters may offer to sell the Notes to certain dealers and others at prices lower than the initial public offering prices, and such offering price may be changed, from time to time, by the Underwriters.

Banc of America Securities LLC (“BAS”) has entered into a written agreement with Oriental Financial Services Corporation (“OFS”) pursuant to which OFS has agreed to act as a consultant to BAS in connection with BAS’ provision of underwriting and investment banking services to the Commonwealth with respect to the Notes. Pursuant to this agreement, the existence of which has been disclosed to the Commonwealth and Government Development Bank, OFS will be entitled to receive a portion of BAS’ actual net profits, if any, in connection with the underwriting of the Notes. Other similar agreements with respect to the sharing of underwriting net profits have been entered into and disclosed to the Commonwealth and Government Development Bank by: Morgan Stanley & Co. Incorporated and Popular Securities, Inc., Goldman, Sachs & Co. and FirstBank Puerto Rico, Merrill Lynch & Co. and Santander Securities Corporation, First Union National Bank and Doral Securities Inc., and ABN Amro Financial Services, Inc. and Prudential Securities Incorporated.

### **GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

As required by Act No. 272 of the Legislature of Puerto Rico, approved May 15, 1945, as amended, Government Development Bank has acted as financial advisor to the Commonwealth in connection with the Notes.

As financial advisor, Government Development Bank participated in the selection of the Underwriters of the Notes. The Underwriters have been selected by Government Development Bank to serve from time to time as underwriters of its obligations and the obligations of the Commonwealth, its instrumentalities and public corporations. Certain of the Underwriters or their affiliates participate in other financial transactions with Government Development Bank.

## RATINGS

Moody's Investors Service Inc. and Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., have given the Notes ratings of MIG-1 and SP-1+, respectively. The ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency.

Such rating agencies were provided with materials relating to the Commonwealth and the Notes and other relevant information, and no application has been made to any other rating agency for the purpose of obtaining a rating on the Notes.

There is no assurance that such ratings will remain in effect for any given period of time or that they will not be revised downward or withdrawn entirely by either or both of such rating agencies, if in the judgment of either or both, circumstances so warrant. Any such downward revision or withdrawal of such ratings, or either of them, may have an adverse effect on the market price of the Notes.

## CONTINUING DISCLOSURE

In accordance with the requirements of Rule 15c2-12, as amended (the "Rule"), promulgated by the Securities and Exchange Commission (the "SEC"), the Commonwealth has covenanted in the Note Resolution for the benefit of the Underwriters and the Beneficial Owners as defined in such resolution and generally the tax owners of the Notes:

To file, in a timely manner, with each NRMSIR or with the MSRB and with any Commonwealth state information depository ("SID"), notice of the occurrence of any of the following events with respect to the Notes, if material:

- a. principal and interest payment delinquencies;
- b. non-payment related defaults;
- c. unscheduled draws on debt service reserves reflecting financial difficulties;
- d. unscheduled draws on credit enhancements reflecting financial difficulties;
- e. substitution of credit or liquidity providers, or their failure to perform;
- f. adverse opinions or events affecting the tax-exempt status of the Notes;
- g. modifications to rights of the holders (including Beneficial Owners) of the Notes;
- h. note calls;
- i. defeasances;
- j. release, substitution, or sale of property securing repayment of the Notes; and
- k. rating changes.

Events (c), (d), (e), (h) and (i) are included pursuant to a letter from the SEC staff to the National Association of Bond Lawyers, dated September 19, 1995. However, such events may not be applicable, since the terms of the Notes do not provide for "debt service reserves", "credit enhancements" or "credit or liquidity providers" or for redemption and the Note Resolution does not contain any "defeasance" provisions. For a description of the Notes, see "*The Notes*". In addition, with respect to the following events:

Events (d) and (e). The Commonwealth does not undertake to provide any notice with respect to credit enhancement added after the primary offering of the Notes, unless the Commonwealth applies for or participates in obtaining the enhancement.

Event (f). For information on the tax status of the Notes, see "*Tax Matters*".

As of August 31, 2001, there is no Commonwealth SID, and the name and address of each NRMSIR is: Bloomberg Municipal Repository, 100 Business Park Drive, Skillman, New Jersey 08558; Standard & Poor's J.J. Kenny Repository, 55 Water Street, 45<sup>th</sup> Floor, New York, New York 10041; FT Interactive Data, Attn: NRMSIR, 100 William Street, New York, New York 10038; and DPC Data Inc., One Executive Drive, Fort Lee, New Jersey 07024.

The Commonwealth may from time to time choose to provide notice of the occurrence of certain other events in addition to those listed above if, in the judgment of the Commonwealth, such other events are material with respect to the Notes, but the Commonwealth does not undertake to provide any such notice of the occurrence of any material event except those events listed above.

The Commonwealth acknowledges that its undertaking described above is intended to be for the benefit of the Beneficial Owners of the Notes, and shall be enforceable by any such Beneficial Owner, provided that the right to enforce the provisions of its undertaking shall be limited to a right to obtain specific enforcement of the Commonwealth's obligations hereunder. The Commonwealth has represented to the Underwriters that it has not failed to comply with any similar undertaking under the Rule.

No Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenant (the "Covenant") or for any remedy for breach thereof, unless such Beneficial Owner shall have filed with the Commonwealth written notice of any request to cure such breach, and the Commonwealth shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan, Puerto Rico, for the equal benefit of all Beneficial Owners of the outstanding Notes benefitted by the Covenant, and no remedy shall be sought or granted other than specific performance of the Covenant. Moreover, Proceedings filed by Beneficial Owners against the Commonwealth may be subject to the sovereign immunity provisions of Section 2 of Act No. 104, approved June 19, 1955, as amended (32 L.P.R.A. § 3077 and § 3077a), which governs the scope of legal actions against the Commonwealth, substantially limits the amount of monetary damages that may be awarded against the Commonwealth and provides certain notice provisions, the failure to comply with which may further limit any recovery.

The Covenant may only be amended if:

(1) the amendment is made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature, or status of the Commonwealth, or type of business conducted; the Covenant, as amended, would have complied with the requirements of the Rule at the time of award of the Notes, after taking into account any amendments or change in circumstances; and the amendment does not materially impair the interest of Beneficial Owners, as determined by parties unaffiliated with the Commonwealth; or

(2) all or any part of the Rule, as interpreted by the staff of the SEC at the date of the adoption of such Rule, ceases to be in effect for any reason, and the Commonwealth elects that the Covenant shall be deemed amended accordingly.

Any assertion of beneficial ownership must be filed, with full documentary support, as part of the written request described above.

The Covenant has been made in order to assist the Underwriters in complying with the Rule.

## MISCELLANEOUS

The foregoing summaries of or references to the various acts, the Notes, the Note Resolution and the summaries of or references to the various acts contained in the Commonwealth Report, are made subject to all the detailed

provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

Appended to and constituting a part of this Official Statement is the Commonwealth Report (*Appendix I*) and the proposed form of opinion of Bond Counsel (*Appendix II*).

The information included in this Official Statement and incorporated herein by reference, except for information pertaining to DTC and the information appearing in *Underwriting*, was supplied by certain officials of the Commonwealth or certain of its agencies or instrumentalities, in their respective official capacities, or was obtained from publications of the Commonwealth or certain of its agencies or instrumentalities, and is included or incorporated by reference in this Official Statement on the authority of such officials or the authority of such publications as public official documents. The information pertaining to DTC was supplied by DTC.

This Official Statement will be filed with each NRMSIR and with the MSRB.

**COMMONWEALTH OF PUERTO RICO**

By:           /s/ Juan A. Flores Galarza            
Secretary of the Treasury  
of the Commonwealth of Puerto Rico

**COMMONWEALTH OF PUERTO RICO**

**Financial Information and  
Operating Data Report**

**September 25, 2001**

COMMONWEALTH OF PUERTO RICO  
 Financial Information and Operating Data Report  
 September 25, 2001

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# COMMONWEALTH OF PUERTO RICO

## Financial Information and Operating Data Report September 25, 2001

### INTRODUCTION

#### Geographic Location and Demography

Puerto Rico, the fourth largest of the Caribbean islands, is located approximately 1,600 miles southeast of New York City. It is approximately 100 miles long and 35 miles wide.

According to the United States Census Bureau, the population of Puerto Rico was 3,808,610 in 2000, compared to 3,522,000 in 1990. As of 1999, the population of San Juan, the island's capital and largest city, was approximately 439,000.

#### Relationship with the United States

Puerto Rico was discovered by Columbus in 1493, and shortly thereafter the island was conquered and settled by the Spaniards. It remained a Spanish possession for four centuries.

Puerto Rico came under United States sovereignty pursuant to the Treaty of Paris, signed on December 10, 1898, which ended the Spanish-American War. Puerto Ricans have been citizens of the United States since 1917. In 1950, after a long evolution toward greater self-government for Puerto Rico, the Congress of the United States enacted Public Law 600, which is "in the nature of a compact" and which became effective upon its acceptance by the electorate of Puerto Rico. It provides that those sections of existing law which defined the political, economic and fiscal relationship between Puerto Rico and the United States would remain in full force. It also authorized the people of Puerto Rico to draft and adopt their own Constitution. The Constitution was drafted by a popularly elected constitutional convention, overwhelmingly approved in a special referendum by the people of Puerto Rico and approved by the United States Congress and the President of the United States, becoming effective upon proclamation of the Governor of Puerto Rico on July 25, 1952. Puerto Rico's relationship with the United States is referred to herein as commonwealth status.

The United States and the Commonwealth of Puerto Rico (the "Commonwealth") share a common defense, market and currency. The Commonwealth exercises virtually the same control over its internal affairs as do the fifty states. It differs from the states, however, in its relationship with the federal government. The people of Puerto Rico are citizens of the United States but do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives but no vote. Most federal taxes, except those such as Social Security taxes which are imposed by mutual consent, are not levied in Puerto Rico. No federal income tax is collected from Puerto Rico residents on income earned in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries. A portion of the federal excise taxes imposed on shipments of alcoholic beverages from Puerto Rico and other rum producing countries and other taxes on shipments of tobacco products from Puerto Rico to the mainland are returned to the Treasury Department of Puerto Rico. See "Major Sources of General Fund Revenues - Other Taxes and Revenues" under *Puerto Rico Taxes, Other Revenues and Expenditures* for a discussion of a current federal legislative proposal relating to the elimination of the rebate of federal excise taxes on shipments of alcoholic beverages.

The official languages of Puerto Rico are Spanish and English.

## **Governmental Structure**

The Constitution of the Commonwealth provides for the separation of powers of the executive, legislative, and judicial branches of government. The Governor is elected every four years. The Legislature consists of a Senate and a House of Representatives, the members of which are elected for four-year terms. The highest court within the local jurisdiction is the Supreme Court of Puerto Rico. Puerto Rico constitutes a District in the Federal Judiciary and has its own United States District Court. Decisions of this court may be appealed to the United States Court of Appeals for the First Circuit and from there to the Supreme Court of the United States.

Governmental responsibilities assumed by the central government of the Commonwealth are similar in nature to those of the various state governments. In addition, the central government assumes responsibility for local police and fire protection, education, public health and welfare programs, and economic development.

Sila M. Calderón was sworn in as Governor of Puerto Rico on January 2, 2001. She obtained a Bachelor's degree in Political Science from Manhattanville College in New York and undertook graduate studies at the School of Public Administration of the University of Puerto Rico. Since 1973, she has worked in the public sector as Executive Assistant to the Labor Secretary, Special Assistant to the Governor of Puerto Rico, Chief of Staff of the Governor of Puerto Rico and Secretary of State. In the private sector, she was an executive in charge of Business Development for Citibank, N.A., President of Commonwealth Investment Company Inc., and a member of the Board of Directors of BanPonce, Banco Popular de Puerto Rico and Pueblo International, Inc. From 1996 until taking office as Governor, she served as elected Mayor of the municipality of San Juan.

Juan A. Flores Galarza, Secretary of the Treasury, took office on January 2, 2001. He is a certified public accountant and a graduate of the University of Puerto Rico, Mayagüez Campus, where he obtained a Bachelor's degree in Business Administration. Prior to his appointment as Secretary of the Treasury, he worked in a manufacturing company and as an auditor for a large accounting firm.

Melba Acosta, Director of the Office of Management and Budget, took office on January 3, 2001. She is a graduate of the University of Puerto Rico, where she obtained a Bachelor's degree in Business Administration and a Juris Doctor degree. She obtained a Master's degree in Business Administration from the Harvard Graduate School of Business. She is a certified public accountant and has six years of experience as a tax consultant and corporate attorney in the private sector. Prior to her appointment as head of the Office of Management and Budget, she served for four years in the public sector.

Juan Agosto Alicea, President of Government Development Bank for Puerto Rico ("Government Development Bank" or "GDB"), took office on January 2, 2001. He obtained a Bachelor's degree in Business Administration from the University of Puerto Rico and has been a licensed certified public accountant since 1966. He has worked as an auditor for Arthur Andersen & Co., Puerto Rico Industrial Development Company, Peat Marwick & Mitchell, and the Federal Department of Housing and Urban Development. From 1985 to 1988 he served as Secretary of the Treasury, and was chairman of the Board of Directors of Government Development Bank. From 1995 to 1996, he was Administrator of the Municipality of San Juan. He is a former president of the Puerto Rico College of CPAs and the Board of Directors of United Way of Puerto Rico.

## **Political Trends**

For many years there have been two major views in Puerto Rico with respect to the island's relationship with the United States: one favoring commonwealth status, represented by the Popular Democratic Party, and the other favoring statehood, represented by the New Progressive Party. The following table shows the percentages of the total vote received by the gubernatorial candidates of the various parties in the last five elections by voter preference with respect to commonwealth status, statehood, and independence. While the electoral choices of Puerto Rico's voters are not based solely on preferences regarding the island's relationship with the United States, candidates who support a continuing relationship between Puerto Rico and the United States have prevailed in elections for many years.

	<u>1984</u>	<u>1988</u>	<u>1992</u>	<u>1996</u>	<u>2000</u>
Popular Democratic Party	48.5%	48.7%	45.9%	44.5%	48.6%
New Progressive Party	45.5	45.8	49.9	51.1	45.7
Puerto Rico Independence Party	3.9	5.4	4.2	3.8	5.2
Others	2.1	0.1	--	0.6	0.5

With the results of the 2000 election, control of the executive and legislative branches is now under the Popular Democratic Party. The composition of the Senate and House by political party is as follows:

	<u>Senate</u>	<u>House</u>
Popular Democratic Party	19	29
New Progressive Party	8	20
Puerto Rico Independence Party	1	1
Independent	<u>-</u>	<u>1</u>
	28	51

The next general election (gubernatorial, municipal, and legislative) in Puerto Rico will be held in November 2004. Voter participation in Puerto Rico is substantially higher than in the United States, averaging 83% since 1972.

## **THE ECONOMY**

### **General**

The Commonwealth has established policies and programs directed principally at developing the manufacturing and service sectors of the economy and expanding and modernizing the island's infrastructure. Domestic and foreign investment has been stimulated by selective tax exemption, development loans, and other financial and tax incentives. Infrastructure expansion and modernization have been to a large extent financed by bonds and notes issued by the Commonwealth, its public corporations and municipalities. Economic progress has been aided by significant increases in the levels of education and occupational skills of the island's population.

The economy of Puerto Rico is fully integrated with that of the United States mainland. During fiscal 2000 (July 1999 through June 2000), approximately 88% of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 56% of Puerto Rico's imports. In fiscal 2000, Puerto Rico experienced an \$11.4 billion positive merchandise trade balance.

The dominant sectors of the Puerto Rico economy are manufacturing and services. The manufacturing sector has undergone fundamental change over the years as a result of increased emphasis on higher wage, high technology industries, such as pharmaceuticals, electronics, computers, microprocessors, professional and scientific instruments, and certain high technology machinery and equipment. The services sector, including finance, insurance, real estate, wholesale and retail trade, and hotel and related services, also plays a major role in the economy. It ranks second only to manufacturing in contribution to the gross domestic product and leads all sectors in providing employment.

### *Fiscal 1996 to 2000*

Puerto Rico's almost two decades-long economic expansion continued throughout the five-year period from fiscal 1996 through fiscal 2000. Almost every sector of the economy participated, and record levels of employment were achieved. Factors behind this expansion included government-sponsored economic development programs, periodic declines in the exchange value of the United States dollar, increases in the level of federal transfers, the relatively low cost of borrowing and low oil prices.

Gross product in fiscal 1996 was \$30.4 billion and gross product in fiscal 2000 was \$41.4 billion (\$34.8 billion in 1996 prices). This represents an increase in gross product of 36.3% from fiscal 1996 to 2000 (14.7% in 1996 prices). Since fiscal 1985, personal income, both aggregate and per capita, has increased consistently each fiscal year. In fiscal 2000, aggregate personal income was \$38.2 billion (\$34.6 billion in 1996 prices)\* and personal income per capita was \$9,870 (\$8,925 in 1996 prices).

Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total federal payments to Puerto Rico, which include transfers to local government entities and expenditures of federal agencies in Puerto Rico, in addition to federal transfer payments to individuals, are lower on a per capita basis in Puerto Rico than in any state. Transfer payments to individuals in fiscal 2000 were \$7.6 billion, of which \$5.7 billion, or 75.1%, represented entitlements to individuals who had previously performed services or made contributions under programs such as Social Security, Veterans' Benefits, Medicare and U.S. Civil Service retirement pensions.

According to the Labor Department's Household Employment Survey, average employment increased from 1,092,000 in fiscal 1996 to 1,159,470 in fiscal 2000. Average unemployment decreased from 13.8% in fiscal 1996 to 11.0% in fiscal 2000.

The following table shows the gross product for the five fiscal years ended June 30, 2000.

### Commonwealth of Puerto Rico

#### Gross Product

	Fiscal Year Ended June 30				
	1996	1997	1998	1999	2000(p)
Gross product - \$ millions	\$ 30,357	\$ 32,343	\$ 35,161	\$ 38,297	\$ 41,366
Real gross product - \$ millions (1996 prices)	30,357	31,390	32,401	33,750	34,812
Annual percentage increase in real gross product (1996 prices)	3.3%	3.4%	3.2%	4.2%	3.1%
U.S. annual percentage increase in real gross product (1996 prices)	2.8%	4.0%	4.4%	3.9%	5.2%

(p) Preliminary.

Sources: Planning Board and Data Resources Inc.

Since the 1950s, the Planning Board has prepared a complete set of macroeconomic measures like those prepared for the United States by the Bureau of Economic Analysis ("BEA") of the Department of Commerce. In contrast with the BEA, which computes the economic accounts on a quarterly basis, the Planning Board computes the economic accounts on an annual basis. Like the BEA, the Planning Board revises the macroeconomic numbers on a regular basis. The Planning Board has always classified the latest annual numbers as preliminary until they are revised and made final in conjunction with the release of new data each year. At present, all macroeconomic accounts for fiscal 2000 are preliminary until the revised figures are released.

#### Fiscal 2001 and 2002

According to the Labor Department's Household Employment Survey, during fiscal 2001 total employment decreased 0.1% from fiscal 2000. Total monthly employment averaged 1,157,850 during fiscal 2001, compared to 1,159,466 in fiscal 2000. During the first two months of fiscal 2002, total monthly employment averaged 1,142,000

\*Different price deflators are used for gross product and personal income statistics.

compared to 1,178,000 in the same period of fiscal 2001, representing a decline of 3.1%. As a result, the unemployment rate increased from 10.5% to 11.7% during the first two months of fiscal 2002. The Planning Board's gross product forecast for fiscal 2001 and fiscal 2002, made in March 2001, projected an increase of 2.2% for fiscal 2001 and an increase of 2.0% for fiscal 2002.

The performance of the economy during fiscal 2002 will depend primarily on the performance of the United States economy, the level of oil prices and the level of interest rates. In the past, Puerto Rico has been heavily dependent on oil imports for its energy needs. As a result of the construction of two cogeneration plants, however, one of which burns liquefied natural gas and is now operational and the other of which will burn coal and is expected to become operational during 2002, Puerto Rico's dependence on oil imports for its energy needs will be reduced by approximately 30%.

As a result of the terrorist attacks in the United States on September 11, at present there is uncertainty as to the expected level of economic activity in Puerto Rico during the remainder of fiscal 2002. It is possible that these recent events will cause a temporary loss in consumer and business confidence, thus triggering a reduction in the level of economic activity in Puerto Rico and a decrease in General Fund revenues from those estimated in the fiscal 2002 budget. It is not possible at this time to predict with certainty how the Puerto Rico economy will be affected. One of the sectors expected to be affected immediately is tourism, as the level of leisure and business travel is reduced. Although tourism has been one of the sectors which has demonstrated consistent growth during the last decade, total visitors' expenditures represented only 3.8% of gross domestic product for fiscal 2000. It is too early to estimate what long term impact, if any, the terrorist attacks will have on the economy of Puerto Rico. The information appearing in this Report with respect to periods subsequent to August 2001 does not consider the effects, if any, of these recent events.

The Commonwealth government is in the process of formulating measures to reduce the economic impact of these recent events. The Governor has met with business leaders to discuss how the government and the private sector can work together to restore consumer and business confidence. One of the steps the government proposes to take is to accelerate its capital investment program in order to stimulate economic activity.

### **Economic Development Program**

The Commonwealth's current economic development program is based on the following four initiatives: (i) the enactment of laws in Puerto Rico providing tax benefits that will promote foreign investment and increased economic activity; (ii) the acceleration and simplification of the local permitting process; (iii) the reduction of the costs of doing business in Puerto Rico; and, (iv) the amendment of Section 956 of the United States Internal Revenue Code of 1986 (the "Code") to incorporate new Federal income tax benefits that enhance the attractiveness of establishing operations in Puerto Rico.

#### *Puerto Rico Legislation*

One of the benefits enjoyed by the Commonwealth is that corporations operating in Puerto Rico (other than corporations organized in the United States) and individuals residing in Puerto Rico generally are not subject to Federal income taxes. This enables the Commonwealth to utilize local tax legislation as a tool for stimulating economic development in Puerto Rico. See "Tax Incentives" below.

In this regard, the Commonwealth recently enacted legislation extending certain benefits of its most recent tax incentive law, Act No. 135 of December 2, 1997 (the "1998 Tax Incentives Act"), to all eligible businesses operating under previous tax incentives laws. These benefits include a 200% deduction for research and development expenses and worker training expenses, the ability to deduct as a current expense investments in machinery and equipment, and the ability to claim a tax credit equal to 25% of the purchase price of a product manufactured in the Commonwealth (in excess of a base amount) or 35% of the purchase price of a locally manufactured recycled product.

The 1998 Tax Incentives Act was also amended to allow a credit against the Puerto Rico income tax liability of investors that acquire the majority of the stock, partnership interests or operational assets of an exempted business that is in the process of closing operations in Puerto Rico. A credit against the Puerto Rico income tax liability is also provided to investors that contribute cash to such exempted business for the construction or improvement of its physical facilities and the purchase of machinery and equipment. The amount of the credit is equal to 50% of the cash invested for such purposes.

The Commonwealth has also recently enacted legislation which (i) reduces the capital gains tax from 20% to 10% in the case of individuals and estates and trusts, and from 25% to 12.5% in the case of corporations and partnerships organized under the laws of the Commonwealth or engaged in trade or business in the Commonwealth, for gains from the sale of eligible Commonwealth investments; and, (ii) allows income tax credits for extraordinary investment in housing infrastructure.

In addition, legislation has been submitted for the purpose of: (i) amending the 1998 Tax Incentives Act to provide special income tax rates ranging from 0% to 2% to companies that establish operations in Puerto Rico in “core pioneer industries” which utilize innovative technology not previously used in Puerto Rico; (ii) granting tax credits with respect to eligible investments made in the construction or substantial rehabilitation of housing units to be rented to low income families; (iii) reducing to 7% the capital gains rate applicable to gains realized on the sale of shares of stock of Puerto Rico corporations sold in an initial public offering made prior to December 31, 2007 or acquired in public offerings made prior to December 31, 2007; (iv) granting income tax exemption to the fees received by financial institutions in connection with guaranteeing the payment of debt issued to finance tourism development projects; and (v) granting exemption to qualified associations administering timesharing rights or vacation clubs and to owners’ associations of areas designated as tourism enhancement districts.

Legislation has also been proposed for the purpose of granting tax credits to Puerto Rico businesses that acquire products manufactured in Puerto Rico for exportation.

#### *Acceleration and Simplification of Local Permitting Process*

Another of the government’s initiatives to promote economic activity is to simplify the regulatory process for obtaining government permits in order to accelerate the granting of permits and reduce the costs of the permitting process. As part of this initiative, the government is establishing a multi-agency center that will handle in a coordinated way the permitting process and allow the filing of a single application for all government permits required for a project. When public hearings are required by various government agencies, the government is also developing a procedure to allow them to be conducted simultaneously by the various government agencies.

#### *Reduction of the Costs of Doing Business*

The government believes that to make Puerto Rico more competitive and foster investment it needs to reduce the cost of doing business in Puerto Rico. As part of this initiative, PRIDCO is conducting a thorough evaluation of the cost of doing business in Puerto Rico in order to develop new proposals to reduce those costs.

The high cost of energy in Puerto Rico has been identified as one of the costs of doing business that particularly affects the manufacturing industry. The government has sought to lower this cost by reducing Puerto Rico’s dependence on oil for energy production through the development of the cogeneration plants mentioned above. In addition, Puerto Rico Electric Power Authority has commenced a hedging program with respect to oil prices to lessen the impact of the volatility of oil prices on the cost of electricity.

## Federal Legislative Proposal

In order to enhance the attractiveness for United States companies of establishing operations in Puerto Rico, the Commonwealth government is seeking to have Section 956 of the Code amended to provide a new and permanent tax regime applicable to U.S. based businesses that have operations in the Commonwealth or other U.S. possessions. This proposed regime is based on the tax rules generally applied to U.S. companies with international operations, but with certain modifications intended to promote employment both in the Commonwealth and the United States. For a discussion of the bill which has been introduced in the U.S. Congress incorporating the Commonwealth's proposed amendment, see "Proposed New U.S. Tax Regime for Companies Doing Business in Puerto Rico - Section 956 of the Code" under "Tax Incentives" below.

### Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal 2001 averaged 1,157,850. Unemployment, although at relatively low historical levels, remains above the United States average. Average unemployment decreased from 13.1% in fiscal 1997 to 10.5% in fiscal 2001, the lowest level since 1970. The moderate increase in employment in the last few years, along with a drop in the participation rate, resulted in a decline in the unemployment rate.

The following table presents annual statistics of employment and unemployment for fiscal 1997 through fiscal 2001, and monthly statistics for July and August 2001.

<u>Fiscal Years Ended June 30</u>	<b>Commonwealth of Puerto Rico Employment and Unemployment (1)</b>			<b>Unemployment Rate<sup>(2)</sup></b>
	<u>Labor Force<sup>(1)</sup></u>	<u>Employed<sup>(1)</sup></u>	<u>Unemployed<sup>(1)</sup></u>	
	<b>(Annual Average)</b>			
1997 .....	1,298	1,128	170	13.1%
1998 .....	1,317	1,137	179	13.6
1999 .....	1,310	1,147	163	12.5
2000 .....	1,303	1,159	143	11.0
2001 .....	1,293	1,158	135	10.5
	<b><u>Fiscal 2002</u></b>			
	<b>(Seasonally Adjusted)</b>			
July .....	1,276	1,135	140	11.0%
August .....	1,311	1,149	162	12.4

(1) Thousands of persons 16 years of age and over. Totals may not add due to rounding.

(2) Unemployed as percentage of labor force.

Source: Department of Labor and Human Resources - Household Survey

### Economic Performance by Sector

Puerto Rico has a diversified economy. During the period between fiscal 1996 and 2000, the manufacturing and services sectors generated the largest portion of gross domestic product. Three sectors of the economy provide the most employment: manufacturing, services and government.

The following table presents annual statistics of gross domestic product by sector and gross product for the five fiscal years ended June 30, 2000.

**Commonwealth of Puerto Rico**  
**Gross Domestic Product by Sector and Gross Product**  
(in millions at current prices)

	<b>Fiscal Year Ended June 30</b>				
	<b><u>1996</u></b>	<b><u>1997</u></b>	<b><u>1998</u></b>	<b><u>1999</u></b>	<b><u>2000(p)</u></b>
Manufacturing	\$18,467	\$19,302	\$22,976	\$26,637	\$27,442
Services <sup>(1)</sup>	17,470	18,956	20,723	22,333	24,036
Government <sup>(2)</sup>	4,841	5,220	5,251	5,526	5,478
Transportation, communication and public utilities	3,563	3,751	3,979	3,951	4,057
Agriculture, forestry and fisheries	376	466	437	336	450
Construction <sup>(3)</sup>	1,077	1,257	1,483	1,645	1,863
Statistical discrepancy	<u>(452)</u>	<u>(765)</u>	<u>(714)</u>	<u>(388)</u>	<u>(176)</u>
Total gross domestic product <sup>(4)</sup>	45,341	48,187	54,133	60,039	63,150
Less: net payment abroad	<u>(14,984)</u>	<u>(15,844)</u>	<u>(18,973)</u>	<u>(21,742)</u>	<u>(21,783)</u>
Total gross product <sup>(4)</sup>	<u><u>\$30,357</u></u>	<u><u>\$32,343</u></u>	<u><u>\$35,161</u></u>	<u><u>\$38,297</u></u>	<u><u>\$41,366</u></u>

(p) Preliminary.

(1) Includes wholesale and retail trade, finance, insurance and real estate, hotel and related services, and other services.

(2) Includes the Commonwealth, its municipalities and the federal government; excludes public corporations.

(3) Includes mining.

(4) Totals may not add due to rounding.

Source: Planning Board

The following table presents annual statistics of average employment by sector for the six fiscal years ended June 30, 2001.

**Commonwealth of Puerto Rico**  
**Average Employment by Sector**  
(thousands of persons age 16 and over)

	<b>Fiscal Year Ended June 30</b>					
	<b><u>1996</u></b>	<b><u>1997</u></b>	<b><u>1998</u></b>	<b><u>1999</u></b>	<b><u>2000</u></b>	<b><u>2001(p)</u></b>
Manufacturing	167	162	161	159	159	159
Services <sup>(1)</sup>	527	551	573	578	587	584
Government <sup>(2)</sup>	246	261	244	246	249	251
Transportation, communication and public utilities	61	59	59	59	55	56
Construction <sup>(3)</sup>	59	64	69	78	85	87
Agriculture, forestry and fisheries	<u>32</u>	<u>31</u>	<u>31</u>	<u>27</u>	<u>24</u>	<u>22</u>
Total <sup>(4)</sup>	<u><u>1,092</u></u>	<u><u>1,128</u></u>	<u><u>1,137</u></u>	<u><u>1,147</u></u>	<u><u>1,159</u></u>	<u><u>1,158</u></u>

(p) Preliminary.

(1) Includes wholesale and retail trade, finance, insurance and real estate, hotels and related services, and other services.

(2) Includes the Commonwealth, its municipalities and the federal government; excludes public corporations.

(3) Includes mining.

(4) Totals may not add due to rounding.

Source: Department of Labor and Human Resources - Household Survey

## Manufacturing

Manufacturing is the largest sector of the Puerto Rico economy in terms of gross domestic product. The Planning Board estimates that in fiscal 2000 manufacturing generated \$27.4 billion, or 43.5% of gross domestic product. The manufacturing sector employed 136,037 workers as of March 2001 (as reported in the Department of Labor and Human Resources - Benchmark on Employment Hours and Earnings). Most of the island's manufacturing output is shipped to the United States mainland, which is also the principal source of semifinished manufactured articles on which further manufacturing operations are performed in Puerto Rico. The United States minimum wage laws are applicable in Puerto Rico. As of May 2001, the average hourly manufacturing wage rate in Puerto Rico was 65.5% of the average mainland United States rate.

Manufacturing in Puerto Rico is now more diversified than during the earlier phases of the industrial development program. In the last three decades, industrial development has tended to be more capital intensive and more dependent on skilled labor. This gradual shift in emphasis is best exemplified by the heavy investment in the pharmaceuticals, scientific instruments, computers, and electrical products industries in Puerto Rico over the last decade.

The following table sets forth gross domestic product by manufacturing sector for the five fiscal years ended June 30, 2000.

**Commonwealth of Puerto Rico**  
**Gross Domestic Product by Manufacturing Sector**  
(in millions at current prices)

	<b>Fiscal Year Ended June 30</b>				
	<b><u>1996</u></b>	<b><u>1997</u></b>	<b><u>1998</u></b>	<b><u>1999</u></b>	<b><u>2000(p)</u></b>
Pharmaceuticals	\$ 9,570	\$10,354	\$13,192	\$15,569	\$15,810
Machinery and metal products:					
Machinery, except electrical	904	925	1,131	2,036	2,349
Electrical machinery	1,490	1,496	1,506	1,582	1,687
Professional and scientific instruments	1,361	1,334	1,596	1,646	1,782
Other machinery and metal products	266	300	350	413	455
Food products	2,167	2,086	2,052	1,908	1,783
Other chemical and allied products	524	590	941	1,184	1,223
Apparel	645	622	610	616	671
Other <sup>(1)</sup>	<u>1,539</u>	<u>1,595</u>	<u>1,597</u>	<u>1,682</u>	<u>1,683</u>
Total gross domestic product of manufacturing sector <sup>(2)</sup>	<u>\$18,467</u>	<u>\$19,302</u>	<u>\$22,976</u>	<u>\$26,637</u>	<u>\$27,442</u>

(p) Preliminary.

(1) Includes petroleum products; petrochemicals; tobacco products; stone, clay and glass products; textiles and others.

(2) Totals may not add due to rounding.

Source: Planning Board

The following table sets forth manufacturing employment by industry group as of March 31 for the last five years.

**Commonwealth of Puerto Rico**  
**Manufacturing Employment by Industry Group\***  
**(persons age 16 years and over)**

<u>Industry Group</u>	<u>As of March 31</u>				
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Apparel and related products	21,750	19,039	18,349	16,770	15,617
Food and related products	19,949	17,816	16,852	15,182	14,305
Electrical machinery, equipment and supplies	24,671	22,728	20,254	19,394	18,167
Chemicals and related products (includes pharmaceuticals)	27,235	27,524	26,899	28,714	29,509
Professional and scientific instruments	14,914	15,105	14,542	14,818	15,174
Machinery, except electrical and transportation equipment	3,755	3,068	3,790	3,593	3,297
Petroleum refining and related industries; rubber and miscellaneous plastic products	5,768	5,994	5,970	6,197	5,985
Leather and leather products	6,566	5,834	4,749	3,982	2,730
Paper and related products; printing, publishing and related industries	7,441	8,698	9,418	9,536	9,524
Metal products	5,683	6,159	6,390	6,719	6,623
Stone, clay and glass products	4,972	5,217	5,509	5,929	5,920
Lumber and wood products; furniture and fixtures	3,352	3,538	3,446	3,343	3,205
Textile mill products	3,627	3,282	2,827	2,010	1,930
Tobacco products	1,206	1,285	1,297	1,254	1,438
Miscellaneous manufacturing industries	<u>2,384</u>	<u>3,558</u>	<u>3,125</u>	<u>3,114</u>	<u>2,613</u>
Total	<u>153,273</u>	<u>148,845</u>	<u>143,417</u>	<u>140,555</u>	<u>136,037</u>

\*The manufacturing employment figures presented in this table are based on the Current Employment Statistics Survey (establishment survey) and are lower than the manufacturing employment figures presented in the "Average Employment by Sector" table above, which is based on the Current Population Survey (household survey). There are numerous conceptual and methodological differences between the household and establishment surveys. The establishment survey reflects information collected from payroll records of a sample of business establishments, while the household survey is based on responses to a series of questions by persons in a sample of households.

Sources: Department of Labor and Human Resources, Census of Manufacturing, except for March 1999, 2000 and 2001, which information was derived from the "benchmark" on Employment, Hours and Earnings

While total employment in the manufacturing sector decreased by 17,236 from March 1997 to March 2001, other indicators of the manufacturing sector suggest that manufacturing production increased. Average weekly hours worked increased 4.1% from fiscal 1997 to fiscal 2001. The reduction in manufacturing employment occurred during a period of significant expansion in real manufacturing output, as reflected in the growth of exports. This trend suggests a significant increase in manufacturing productivity. Most of the decreases in employment have been concentrated in labor intensive industries, particularly apparel, textile and tuna manufacturing.

**Leading United States and Foreign Companies with Manufacturing Operations in Puerto Rico**

**Employment 2,500 and over**

Baxter International  
Sara Lee Corp.

**Product**

Pharmaceuticals  
Apparel

Dabco Industries  
Dexter Shoe  
Johnson and Johnson  
Loclite Corp.  
Merck & Co.  
Ortho-Tain Enterprises Inc.  
Pharmacia UpJohn Co.  
SmithKline Beecham  
Storage Technology Corp.  
Stryker Corp.

Mechanical Products  
Footwear  
Pharmaceuticals  
Chemicals  
Chemicals  
Orthodontic Products  
Pharmaceuticals  
Pharmaceuticals  
Electronic  
Surgical and Medical  
Instruments  
Food  
Electrical Instruments  
Leather

**Employment 1,500 to 2,499**

Abbott Laboratories Inc.  
American Home Products  
Bristol-Myers Squibb  
Eaton Corp.  
General Electric Co.  
Hubell Incorporated  
Integra Lifesciences Corp.  
International Bagle  
Monsanto  
Ocular Science-American Hydron  
Warner-Lambert Co.

Pharmaceuticals  
Pharmaceuticals  
Pharmaceuticals  
Electronic Instruments  
Electrical Instruments  
Electrical Instruments  
Surgical Medical  
Devices  
Food  
Pharmaceuticals  
Ophthalmic Products  
Pharmaceuticals

Suiza Foods  
Thomas & Betts  
Timberland Company (The)

**Employment 300 to 499**

Atlantron Inc.  
Avon Products Inc.  
Becton-Dickinson & Co.  
Cardinal Health Inc.  
Coating Co.  
Coleman Co.  
Colgate-Palmolive Co.  
Dupont (E.I.) de Nemours  
Ecolab  
Eli Lilly and Co.  
Grupo Pacifico S.A.  
Industrial Dielectrics Inc.  
International Molders

**Product**

Communications  
Costume Jewelry  
Scientific Instruments  
Packaging Products  
Litographic  
Platemaking  
Luggage  
Consumers Products  
Chemicals  
Electronics  
Pharmaceuticals  
Paper Products  
Glass and Plastics  
Apparel Related  
Products  
Medical Equipment  
Surgical and Medical  
Instruments  
Medical Devices  
Envelopes  
Glass and Plastics  
Food and Cigarretes  
Signs Products  
Services  
Apparel

**Employment 1,000 to 1,499**

Ingersoll-Rand Co.  
MacAndrews & Forbes Holdings  
Medtronics

Electrical Instruments  
Tobacco Products  
Surgical and Medical  
Instruments  
Filters  
Pharmaceuticals  
Electronic Components  
Electronic Components  
Food  
Pharmaceuticals  
Pharmaceuticals  
Apparel  
Scientific Instruments

Pall Corp.  
Schering-Plough Corp.  
Sensormatic Electronics  
Solectron Corp.  
Start Wu  
Pfizer  
Procter & Gamble Co.  
Propper International  
U.S. Surgical Corp.

Ivax Corporation  
Mafcote Industries Inc.

Nypro  
Oles Inc.  
Owens Illinois  
R.J.R. Nabisco  
Signal Transformer Co.  
Swiss Air Services Co.  
Wacoal Corp.

**Employment 500 to 999**

Allergan  
Astra Zeneca Group PLC  
Conagra

Pharmaceuticals  
Pharmaceuticals  
Food

*Source:* PRIDCO, Office of Economic Research (as of July 2001)

## Services

Puerto Rico has experienced significant growth in the services sector (including finance, insurance, real estate, wholesale and retail trade, hotels and related services and other services) in terms of both income and employment over the past decade, showing a favorable trend as compared with certain other industrialized economies. During the period between fiscal 1996 and 2000, the gross domestic product in this sector increased at an annual average rate of 6.6%, while employment increased at an annual average rate of 2.2%. The development of the services sector has shown a strong interaction among the following important sectors: manufacturing, tourism, construction, and agriculture. The services sector in Puerto Rico has a diversified base.

The high degree of knowledge, skills, and expertise in professional and technical services available in Puerto Rico places the island in a favorable competitive position with respect to Latin America and other trading countries throughout the world.

The services sector ranks second to manufacturing in its contribution to gross domestic product, and it is the sector with the greatest employment. In fiscal 2000, services generated \$24 billion of gross domestic product, or 38.1% of the total. Service employment grew from 526,720 in fiscal 1996 to 587,438 in fiscal 2000, a cumulative increase of 11.5%, which increase was greater than the 6.2% cumulative growth in total employment over the same period. During fiscal 2001, however, employment in the services sector decreased to 583,900. Wholesale and retail trade, finance, insurance and real estate experienced significant growth in the fiscal 1996 to 2000 period, as measured by gross domestic product. Gross domestic product in wholesale and retail trade increased from \$6.3 billion in fiscal 1996 to \$8.4 billion in fiscal 2000. In finance, insurance and real estate, gross domestic product increased from \$6.2 billion in fiscal 1996 to \$8.9 billion in fiscal 2000. There are sixteen commercial banks and trust companies currently operating in Puerto Rico. Total assets of these institutions as of December 31, 2000 were \$54.8 billion.

The following tables set forth gross domestic product for the services sector for the five fiscal years ended June 30, 2000 and employment for the services sector for the six fiscal years ended June 30, 2001.

**Commonwealth of Puerto Rico**  
**Gross Domestic Product by Service Sector**  
**(in millions at current prices)**

	<b>Fiscal Year Ended June 30</b>				
	<b><u>1996</u></b>	<b><u>1997</u></b>	<b><u>1998</u></b>	<b><u>1999</u></b>	<b><u>2000(p)</u></b>
Wholesale and retail trade	\$6,281	\$ 6,724	\$ 7,287	\$ 7,896	\$8,437
Finance, insurance and real estate	6,164	6,917	7,672	8,327	8,920
Other services <sup>(1)</sup>	<u>5,025</u>	<u>5,314</u>	<u>5,763</u>	<u>6,110</u>	<u>6,679</u>
Total <sup>(2)</sup>	<u>\$17,470</u>	<u>\$18,955</u>	<u>\$20,723</u>	<u>\$22,333</u>	<u>\$24,036</u>

(p) Preliminary.

(1) Includes hotel and related services.

(2) Totals may not add due to rounding.

Source: Planning Board

**Commonwealth of Puerto Rico**  
**Average Employment by Service Sector**  
**(thousands of persons age 16 and over)**

	<b>Fiscal Year Ended June 30</b>					
	<u><b>1996</b></u>	<u><b>1997</b></u>	<u><b>1998</b></u>	<u><b>1999</b></u>	<u><b>2000</b></u>	<u><b>2001(p)</b></u>
Wholesale and retail trade	218	228	236	229	239	242
Finance, insurance and real estate	39	38	40	43	42	40
Other services <sup>(1)</sup>	<u>270</u>	<u>285</u>	<u>297</u>	<u>306</u>	<u>307</u>	<u>302</u>
Total	<u>527</u>	<u>551</u>	<u>573</u>	<u>578</u>	<u>587</u>	<u>584</u>

(p) Preliminary.

(1) Includes hotels and related services.

Source: Department of Labor and Human Resources Household Survey

*Hotels and Related Services - Tourism*

Total visitors' expenditures accounted for 3.8% of the island's gross domestic product in fiscal 2000, compared to 3.6% in fiscal 1999. Visitors' expenditures and the number of visitors to the island had grown consistently from 1985 to 1998, reaching \$2.2 billion, and more than 4.6 million, respectively, in fiscal 1998. In fiscal 1999, however, the number of visitors to the island decreased to 4.2 million and visitors' expenditures decreased to \$2.1 billion, a decrease of 4.2% compared to fiscal 1998, due in part to the effect of Hurricane Georges, which struck the island in September 1998. During fiscal 2000, the number of visitors to the island increased to 4.6 million and visitors' expenditures increased to \$2.4 billion, an increase of 8.2% and 11.7%, respectively, compared to fiscal 1999.

The number of persons registered in tourist hotels during fiscal 2000 increased 1.3% over the number registered during fiscal 1999. The average occupancy rate in tourist hotels during fiscal 2000 was 74.3% compared to 75.4% in fiscal 1999. The average number of rooms rented in tourist hotels increased 1.7% during fiscal 2000 compared with fiscal 1999. These increases are due in part to increased marketing by the Commonwealth, trends in the U.S. economy and increased hotel usage by Puerto Rico residents.

During fiscal 2001, the number of persons registered in tourist hotels was 1,598,619, an increase of 10.3% over the number registered during fiscal 2000. The average occupancy rate in tourist hotels during fiscal 2001 was 70.3% compared to 74.4% in fiscal 2000. The average number of rooms rented in tourist hotels increased 1.2% during fiscal 2001 compared with fiscal 2000. The average number of rooms available in tourist hotels increased 8.0% during fiscal year 2001 compared with fiscal 2000. As of June 30, 2001, the total number of hotel rooms was 12,353.

San Juan has become the largest homeport for cruise ships in the Caribbean and the fourth largest homeport for cruise ships in the world.

The following table presents data relating to visitors to Puerto Rico and tourist expenditures for the five fiscal years ended June 30, 2000.

**Commonwealth of Puerto Rico  
Tourism Data**

<u>Fiscal Year Ended June 30</u>	<u>Number of Visitors</u>				<b>Total Visitors' Expenditures (in millions)</b>
	<b>Tourist Hotels(1)</b>	<b>Cruise Ship</b>	<b>Other (2)</b>	<b>Total</b>	
1996 .....	828,251	1,045,104	2,236,805	4,110,160	\$1,898.3
1997 .....	906,706	1,107,913	2,335,068	4,349,687	2,046.3
1998 .....	1,030,500	1,274,700	2,365,600	4,670,800	2,232.9
1999 .....	1,042,000	1,197,200	1,982,100	4,221,300	2,138.5
2000(p) .....	1,050,100	1,224,600	2,291,300	4,566,000	2,387.9

(p) Preliminary.

(1) Includes visitors in guesthouses.

(2) Includes visitors in homes of relatives, friends, and in hotel apartments.

Sources: Puerto Rico Tourism Company and the Planning Board

*Government*

The government sector of Puerto Rico plays an important role in the economy. In fiscal 2000, government accounted for \$5.5 billion of Puerto Rico's gross domestic product, or 8.7% of the total. The government is also a significant employer, providing jobs for 249,213 workers, or 21.5% of total employment in fiscal 2000. Government sector employment does not include employment by public corporations, which is included in the employment statistics of other sectors. These public corporations include significant employers such as the Electric Power Authority and the Aqueduct and Sewer Authority. The government's (including the central government, the public corporations and the municipalities) share of payroll employment, measured according to the payroll survey, has diminished from 34.9% in fiscal 1981, to 33.6% in fiscal 1990, and to 26.5% in fiscal 2000.

On February 25, 1998, legislation was enacted permitting the unionization of government employees (excluding municipal employees). Under this law, government employees are given collective bargaining rights subject to a number of limitations. Among those limitations are: employees are prohibited from striking; annual salary increases are limited; employees cannot be required to become union members and pay union dues; and, collective bargaining negotiations cannot occur in an election year. Negotiations of non-economic conditions with government employees pursuant to this law commenced in fiscal 2000, and negotiations of economic conditions commenced in fiscal 2001.

*Transportation*

Thirty-four shipping lines offer regular ocean freight service to eighty United States and foreign ports. San Juan is the island's leading seaport, but there are also seaport facilities at other locations on the island including Arecibo, Culebra, Fajardo, Guayama, Guayanilla, Mayagüez, Ponce, Vieques, and Yabucoa.

Luis Muñoz Marín International Airport is currently served by twenty-six United States and international airlines. At present, there is daily direct service between San Juan and New York, Chicago, Dallas, Los Angeles, Miami, Atlanta, Boston, and numerous other destinations within the United States. There is also regularly scheduled service between Puerto Rico and other Caribbean islands and major Latin American and European cities. A major

United States airline uses San Juan as a hub for its intra-Caribbean airline service. Several smaller airports serve intra-island traffic.

The island's major cities are connected by a modern highway system, which, as of December 31, 2000, totaled approximately 4,610 miles.

### *Construction*

The construction industry has experienced substantial real growth since fiscal 1987. Although it represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic activity.

During the period from fiscal 1996 through fiscal 1999, construction investment increased 62%. In fiscal 2000, investment in construction rose to a record level of \$7.0 billion, an increase of 7.3% from \$6.6 billion in fiscal 1999, and the total value of construction permits increased 52.1%. The strength of public investment has been an important component in the significant expansion of construction investment. During fiscal 2000, approximately 41% of the total investment in construction was related to public projects. While sales of locally produced cement for fiscal 2000 decreased 3.5% in comparison with fiscal 1999, the government believes that total sales of cement for fiscal 2000 increased slightly from fiscal 1999 because of an offsetting increase in sales of imported cement. In fiscal 2000, the average employment in the construction sector was 84,886, an increase of 9.2% over fiscal 1999.

During fiscal year 2001, the total value of construction permits increased 25.3%. Total sales of locally produced cement decreased 6.7% in comparison with fiscal 2000, which decrease was offset by increases in imported cement. The average employment in the construction sector during fiscal 2001 was 84,890.

### *Agriculture*

The Department of Agriculture and related agencies have directed their efforts at increasing and improving local agricultural production, increasing efficiency and quality of produce, and stimulating import substitution where economically feasible. During fiscal 2000, gross income from agriculture was \$810.1 million, an increase of 13.5% in comparison with fiscal 1999. Agriculture gross income consists of the total value of production in the principal agricultural sectors, which include traditional crops, livestock and poultry, grains, vegetables, fruits, and other products. Recently, non-traditional crops and livestock and poultry have contributed a higher percentage of the sector's income.

The Commonwealth supports agricultural activities through incentives, subsidies, and technical and support services, in addition to income tax exemptions for qualified income derived by bona fide farmers. Act No. 225, approved on December 1, 1995, increased the tax benefits available to bona fide farmers. The Act provides a 90% income tax exemption for income derived from agricultural operations, an investment tax credit equal to 50% of the investment in qualified agricultural projects, and a 100% exemption from excise taxes, real and personal property taxes, municipal license taxes and tariff payments. It also provides full income tax exemption for interest income from bonds, notes and other debt instruments to be issued by financial institutions to provide financing to agricultural businesses. Subsequent legislation imposed an aggregate annual limit of \$15 million on the investment tax credits available under Act No. 225.

Since fiscal 1995, the Commonwealth has sold to private entities various agricultural operations previously conducted by governmental entities. These include certain assets of the pineapple processing operation and a mango growing facility. The Commonwealth has transferred to local private sugarcane growers the sugar processing facilities formerly operated by the Sugar Corporation.

Policy changes are expected to be implemented to promote employment and income generated by the agricultural sector. The policy initiatives being considered include a restructuring of the Department of Agriculture,

an increase in government purchases of local agricultural products, and a new system of agricultural credits and subsidies for new projects.

### Higher Education

During the four decades from 1950 to 1990, Puerto Rico made significant advances in the field of education, particularly at the college and graduate school level. The transformation of Puerto Rico during the 1950s and 1960s from an agricultural economy to an industrial economy brought about an increased demand for educational services at all levels. During the 1970s and 1980s, certain higher wage, higher technology industries became more prominent in Puerto Rico. More recently, employment in the services sector has increased significantly. This has resulted in an increased demand for workers having a higher level of education and greater expertise in various technical fields. During the same time period, enrollments in institutions of higher learning rose very rapidly due to growth in the college-age population, and the increasing proportion of college attendance by such population. Since the 1980s, college attendance has remained relatively stable as a percentage of the college age population, generally following the trend in the United States.

The following table presents comparative trend data for Puerto Rico and the United States with respect to college age population and percentage of such population attending institutions of higher learning.

#### Commonwealth of Puerto Rico Trend in College Enrollment

<u>Academic Year</u>	<u>Commonwealth of Puerto Rico</u>			<u>Mainland United States</u>		
	<u>Population 18-24 Years of Age<sup>(1)</sup></u>	<u>Higher Education Enrollment<sup>(2)</sup></u>	<u>Percent<sup>(3)</sup></u>	<u>Population 18-24 Years of Age<sup>(1)</sup></u>	<u>Higher Education Enrollment<sup>(2)</sup></u>	<u>Percent<sup>(3)</sup></u>
1970 .....	341,448	57,340	16.8%	23,714,000	8,580,887	36.2%
1980 .....	397,839	130,105	32.7	30,022,000	12,096,895	40.3
1990 .....	417,636	156,147	37.4	26,961,000	13,819,000	51.3
1997 .....	478,028	173,608	36.3	24,979,000	14,345,000	57.4
1998 .....	480,775	175,633	36.5	25,476,000	14,608,000	57.3
1999 .....	483,028	175,449	36.3	26,011,000	14,881,000	57.2
2000(e) .....	470,660	174,550	37.1	26,748,000	15,072,000	56.3

(e) Estimated.

(1) 1970, 1980 and 1990 based on enumerated population as of April 1; other years based on estimated population as of July 1.

(2) For some small college level institutions, the data for 1998 and 1999 was estimated.

(3) Number of persons of all ages enrolled in institutions of higher education as percent of population 18-24 years of age.

Sources: United States Bureau of the Census (Mainland United States Population), United States National Center for Education Statistics, Planning Board (Puerto Rico Population) and Council on Higher Education of Puerto Rico

The University of Puerto Rico, the only public university in Puerto Rico, includes eleven campuses located throughout the island. Total enrollment of the University was 69,773 students during academic year 2000-2001. The Commonwealth is legally bound to appropriate annually to the University an amount equal to 9.60% of the average annual revenue from internal sources for each of the two fiscal years immediately preceding the current fiscal year.

In addition to the University of Puerto Rico, there are 37 private institutions of higher education located in Puerto Rico. Such institutions have current enrollment in excess of 100,000 students and provide programs of study in liberal arts, education, business, natural sciences, technology, secretarial and computer sciences, nursing, medicine, and law. Degrees are offered by these institutions at the associate, bachelor, master, and doctoral levels.

## **Tax Incentives**

One of the factors that has promoted and continues to promote the development of the manufacturing sector in Puerto Rico has been the various local and federal tax incentives available, particularly those under Puerto Rico's Industrial Incentives Program and, until recently, Sections 30A and 936 of the Code. Tax and other incentives have also been established to promote the development of the tourism industry. These incentives are summarized below.

### *Industrial Incentives Program*

Since 1948, Puerto Rico has had various industrial incentives laws designed to stimulate industrial investment in the island. Under these laws, companies engaged in manufacturing and certain other designated activities were eligible to receive full or partial exemption from income, property, and other local taxes. The most recent of these industrial incentives laws is the 1998 Tax Incentives Act, a law aimed at attracting and retaining foreign investment in Puerto Rico.

The benefits provided by the 1998 Tax Incentives Act are available to new companies as well as companies currently conducting tax exempt operations in Puerto Rico which choose to renegotiate their existing tax exemption grant. The activities eligible for tax exemption include manufacturing, certain designated services performed for markets outside Puerto Rico, the production of energy from local renewable sources for consumption in Puerto Rico and laboratories for scientific and industrial research. For companies qualifying thereunder, the 1998 Tax Incentives Act imposes income tax rates ranging from 2% to 7% for periods ranging from 10 to 25 years. In addition, it grants 90% exemption from property taxes, 100% exemption from municipal license taxes during the first three semesters of operations and between 80% and 60% thereafter, and 100% exemption from excise taxes with respect to raw materials and certain machinery and equipment used in the exempt activities. The 1998 Tax Incentives Act also provides various special deductions designed to stimulate employment and productivity, research and development and capital investment in Puerto Rico.

Under the 1998 Tax Incentives Act, companies can repatriate or distribute their profits free of Puerto Rico dividend taxes. In addition, passive income derived from the investment of eligible funds in Puerto Rico financial institutions, obligations of the Commonwealth and other designated investments are fully exempt from income and municipal license taxes. Individual shareholders of an exempted business are allowed a credit against their Puerto Rico income taxes equal to 30% of their proportionate share of the exempted business's income tax liability. Gain from the sale or exchange of shares of an exempted business by its shareholders during the exemption period is subject to a 4% income tax rate.

### *Tourism Incentives Program*

For many years Puerto Rico has also had incentives laws designed to stimulate investment in hotel operations on the island. The most recent of these laws, the Tourism Incentives Act of 1993, provides partial exemptions from income, property, and municipal license taxes for a period of up to ten years. In addition, it provides certain tax credits for qualifying investments in hotel development projects.

As part of the incentives to promote the tourism industry, the Commonwealth established the Tourism Development Fund as a subsidiary of GDB with the authority to make investments in or provide financing to entities that contribute to the development of the tourism industry. The Fund was initially capitalized with \$50,000,000 and was authorized to provide financial guarantees for financing hotel development projects. To date the Fund has provided financial guarantees to private entities issuing bonds or borrowing funds to finance the development of thirteen hotel projects that provided approximately 3,000 new hotel rooms.

### *Incentives under the Code*

United States corporations operating in Puerto Rico have been subject to special tax provisions since the Revenue Act of 1921. Prior to enactment of the Tax Reform Act of 1976, under Section 931 of the Code, United States corporations operating in Puerto Rico (and meeting certain source of income tests) were taxed only on income arising from sources within the United States.

The Tax Reform Act of 1976 created Section 936 of the Code, which revised the tax treatment of United States corporations operating in Puerto Rico by taxing such corporations on their worldwide income in a manner similar to that applicable to any other United States corporation but providing such corporations a full credit for the federal tax on their business and qualified investment income in Puerto Rico. The credit provided an effective 100% federal tax exemption for operating and qualifying investment income from Puerto Rico sources.

As a result of amendments to Section 936 made in 1996 (the “1996 Amendments”), the tax credit is being phased out over a ten-year period for companies that were operating in Puerto Rico in 1995 and is no longer available for corporations that establish operations in Puerto Rico after October 13, 1995. The 1996 Amendments also eliminated the credit previously available for income derived from certain qualified investments in Puerto Rico.

Section 30A. The 1996 Amendments added Section 30A to the Code. Section 30A permits a “qualifying domestic corporation” (“QDC”) that meets certain gross income tests to claim a credit (the “Section 30A Credit”) against the federal income tax imposed on taxable income derived from sources outside the United States from the active conduct of a trade or business in Puerto Rico or from the sale of substantially all the assets used in such business (“possession income”). The Section 30A Credit will not be available for taxable years commencing after 2005.

The Section 30A Credit is limited to the sum of (i) 60% of qualified possession wages as defined in the Code, which includes wages up to 85% of the maximum earnings subject to the OASDI portion of Social Security taxes plus an allowance for fringe benefits of 15% of qualified possession wages, (ii) a specified percentage of depreciation deductions ranging between 15% and 65%, based on the class life of tangible property, and (iii) a portion of Puerto Rico income taxes paid by the QDC, up to a 9% effective tax rate (but only if the QDC does not elect the profit-split method for allocating income from intangible property).

In the case of taxable years beginning after December 31, 2001, the amount of possession income that qualifies for the Section 30A Credit is subject to a cap based on the QDC’s possession income for an average adjusted base period ending before October 14, 1995 (the “income cap”).

Section 936. Under Section 936 of the Code, as amended by the 1996 Amendments, United States corporations that meet certain requirements and elect its application (“Section 936 Corporations”) are entitled to credit against their United States corporate income tax the portion of such tax attributable to income derived from the active conduct of a trade or business within Puerto Rico (“active business income”) and from the sale or exchange of substantially all assets used in the active conduct of such trade or business.

Under Section 936, a Section 936 Corporation may elect to compute its active business income, eligible for the Section 936 credit, under one of three formulas: (i) a cost-sharing formula, whereby it is allowed to claim all profits attributable to manufacturing intangibles and other functions carried out in Puerto Rico provided it makes a cost sharing payment in the amount required under Section 936; (ii) a profit-split formula, whereby it is allowed to claim 50% of the combined net income of its affiliated group from the sale of products manufactured in Puerto Rico; or (iii) a cost-plus formula, whereby it is allowed to claim a reasonable profit on the manufacturing costs incurred in Puerto Rico.

The Section 936 credit is now only available to companies that were operating in Puerto Rico on October 13, 1995, and had elected the percentage of income credit provided by Section 936. Such percentage of income credit is equal to 40% of the federal income tax otherwise imposable on the Puerto Rico active business income or derived from the sale or exchange of substantially all assets used in such business.

In the case of taxable years beginning on or after 1998, the possession income subject to the Section 936 credit will be subject to a cap based on the Section 936 Corporation's possession income for an average adjusted base period ending on October 14, 1995. The Section 936 credit is eliminated for taxable years commencing after 2005.

#### *Controlled Foreign Corporations*

Because of the credit limitations and impending phase out of Sections 30A and 936, a large number of corporations previously operating thereunder have reorganized their operations in Puerto Rico to become controlled foreign corporations ("CFCs"). A CFC is a corporation which is organized outside the United States and is controlled by United States shareholders. In general, a CFC may defer the payment of federal income taxes on its trade or business income until such income is repatriated to the United States in the form of dividends or through investments in certain United States properties. The Puerto Rico Office of Industrial Tax Exemption has received notification of over sixty corporations that have converted part or all of their operations to CFCs. These include most of the major pharmaceutical, instrument and electronics companies manufacturing in Puerto Rico.

CFCs operate under transfer pricing rules for intangible income that are different from those applicable to corporations operating under Section 936 and 30A. In many cases, they are allowed to attribute a larger share of this income to their Puerto Rico operation, but must make a royalty payment "commensurate with income" to their U.S. affiliates. Section 936 companies were exempted from Puerto Rico withholding taxes on any cost sharing payments they might have opted to make, but CFCs are subject to a ten percent Puerto Rico withholding tax on royalty payments. The recent increase in Commonwealth revenues attributable to withholding taxes on royalty payments suggests that a significant share of the net income previously reported by corporations operating under the profit split method of Section 936 has been transferred to CFCs.

#### *Proposed New U.S. Tax Regime for Companies Doing Business in Puerto Rico - Section 956 of the Code*

One of the elements of the Commonwealth's new economic development plan involves amending the Code to provide a new tax regime applicable to U.S.-based businesses that have operations in Puerto Rico or other U.S. possessions.

On July 18, 2001 a bill sponsored by various members of the House Ways and Means Committee was introduced in the United States House of Representatives to amend the Code as follows: (i) Sections 30A and 936 would be allowed to expire according to their terms; (ii) Section 956 would be amended to exclude from current U.S. tax 90% of the otherwise taxable investments in certain U.S. property made by a "Qualified CFC" out of its "Qualified Income"; (iii) as an alternative to the Section 956 exclusion, Section 245 would be amended to allow an 85% dividends received deduction with respect to dividends paid out of Qualified Income by the Qualified CFC; (iv) transition rules would be provided for companies now conducting operations in Puerto Rico (i.e., existing Section 936 and 30A credit claimants); and (v) the investment in U.S. properties by the Qualified CFC out of its Qualified Income will not be subject to the imputation of interest nor to treatment as a constructive dividend.

A "Qualified CFC" would be defined under the Code as a controlled foreign corporation which is created or organized under the laws of, or engaged in the active conduct of a trade or business within, the Commonwealth or a possession of the United States. "Qualified Income" would be limited to that portion of the CFCs post-2001 foreign source income that is derived from the active conduct by the CFC of a trade or business in Puerto Rico (or a possession of the United States) or from the sale or exchange of substantially all the assets used by the CFC in the active conduct of such a trade or business. The proposed Section 956 exclusion would be applicable only to income that is eligible for deferral under general U.S. tax principles. Thus, for example, passive income received by the CFC could not be converted from income that is currently taxable under Subpart F of the Code into income eligible for deferral by the investment of such amounts in U.S. property pursuant to the proposed amendment to Section 956.

It is proposed that the new Section 956 exclusion and the related transition rule be effective for taxable years of CFCs beginning after December 31, 2001.

The legislative process for this bill is in the early stages and, thus, it is not possible at this time to determine whether the bill will be enacted into law or what amendments, if any, may be made to the bill.

## **DEBT**

### **Public Sector Debt**

Public sector debt comprises bonds and notes of the Commonwealth, its municipalities, and public corporations (“notes” as used in this section refers to certain types of non-bonded debt regardless of maturity), subject to the exclusions described below. Direct debt of the Commonwealth is supported by Commonwealth taxes. Debt of municipalities, other than bond anticipation notes, is supported by real and personal property taxes and municipal license taxes. Debt of public corporations, other than bond anticipation notes, is generally supported by the revenues of such corporations from rates charged for services or products. See *Public Corporations*. However, certain debt of public corporations is supported, in whole or in part, directly or indirectly, by Commonwealth appropriations or taxes.

On June 7, 2001, the Commonwealth authorized the issuance, on a delayed basis, of \$501,565,000 aggregate principal amount of its Public Improvement Refunding Bonds, Series 2002 (the “Forward Delivery Bonds”). The Forward Delivery Bonds have been sold and will be delivered in April 2002.

The following table presents a summary of public sector debt as of June 30, 2001, as adjusted for the issuance of the Forward Delivery Bonds and the refunding of the bonds refunded thereby. The bonds that are being refunded with the proceeds of the Forward Delivery Bonds that are invested in guaranteed investment contracts are excluded from the table below even though such bonds are considered to be outstanding under its authorizing resolution and for purposes of calculating the Commonwealth’s 15% debt limitation. Also excluded from the table is debt not primarily payable from either Commonwealth or municipal taxes, Commonwealth appropriations or rates charged by public corporations for services or products, except as otherwise noted in footnote 4 to the table below. Also excluded from this table is debt the inclusion of which would reflect double counting, including, but not limited to, \$1,021,050,000 of bonds outstanding by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and \$1,517,430,000 of obligations of GDB issued to purchase certain Commonwealth public sector debt and for other purposes, of which \$267,000,000 is guaranteed by the Commonwealth.

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**Commonwealth of Puerto Rico  
Public Sector Debt  
(in thousands)**

	June 30, 2001	As Adjusted by the Issuance of the Forward Delivery Bonds
Puerto Rico direct debt <sup>(1)</sup> .....	\$ 5,837,909	\$ 6,044,541
Municipal debt .....	1,632,170	1,632,170
Public corporations debt		
Puerto Rico guaranteed debt <sup>(2)</sup> .....	603,334	603,334
Debt supported by Puerto Rico appropriations or taxes <sup>(3)</sup> .....	12,091,422	12,091,422
Other non-guaranteed debt <sup>(4)</sup> .....	<u>6,539,423</u>	<u>6,539,423</u>
Total public corporations debt .....	<u>19,234,179</u>	<u>19,234,179</u>
Total public sector debt .....	<u>\$26,704,258</u>	<u>\$26,910,890</u>

- (1) Includes a \$21,415,921 loan from GDB to the Department of the Treasury to settle certain property tax claims of the municipalities (the "GDB Tax Claims Loan") and \$78,820,000 of certain indebtedness originally issued by the Urban Renewal and Housing Corporation that was transferred to the Commonwealth by virtue of Act No. 134 of the Legislature of Puerto Rico, approved on December 13, 1994 ("Act No. 134 of 1994") (such indebtedness is referred to as "Transferred CRUV Debt").
- (2) Consists of bonds issued by the Housing Bank and Finance Agency and the Aqueduct and Sewer Authority. Excludes \$1,562,493,219 of Public Buildings Authority bonds and notes, which are primarily payable from Commonwealth appropriations and \$267,000,000 of GDB bonds payable from available moneys of GDB.
- (3) Represents, among others, bonds and notes issued by the Aqueduct and Sewer Authority, the Highway and Transportation Authority, the Public Buildings Authority, the Public Finance Corporation, the Infrastructure Financing Authority and the Housing Bank and Finance Agency and notes of the Health Facilities and Services Administration which were assumed by the Department of Health.
- (4) Includes \$1,092,550,000 of Infrastructure Financing Authority bonds which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company, and \$397,005,000 of The Children's Trust Fund bonds which are payable solely from a portion of the payments to be received pursuant to the tobacco litigation settlement.

*Source:* Government Development Bank

No deductions have been made in the above table for debt service funds and debt service reserve funds. The table above and the amounts shown throughout this section as representing outstanding debt include outstanding capital appreciation bonds at their respective original principal amounts and do not include any accretion thereon.

**Debt Service Requirements for Commonwealth General Obligation Bonds and Certain Guaranteed Debt**

The following table presents (A) debt service requirements for (i) Commonwealth general obligation bonds outstanding on June 30, 2001, adjusted to exclude debt service on the bonds being refunded by the Forward Delivery Bonds; (ii) the Forward Delivery Bonds; and (iii) bonds of the Aqueduct and Sewer Authority which were outstanding on June 30, 2001 for which debt service payments are being made under the Commonwealth guaranty; and (B) total debt service on all general obligation bonds, adjusted for the issuance of the Forward Delivery Bonds and the refunding of the bonds refunded thereby, and on the Aqueduct and Sewer Authority bonds. The table excludes debt service on the bonds being refunded with the proceeds of the Forward Delivery Bonds invested in guaranteed investment contracts notwithstanding that such bonds are considered to be outstanding under its authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. With respect to other debt of the Aqueduct and Sewer Authority, see *Public Corporations*. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

**Commonwealth of Puerto Rico**  
**Debt Service Requirements\***  
(in thousands)

Fiscal Year Ending June 30	Outstanding Bonds			Forward Delivery Bonds		PRASA Bonds Debt Service	Grand Total
	Principal	Interest	Total Debt Service <sup>(1)</sup>	Principal	Interest		
2002 .....	\$ 234,824	\$ 277,472	\$512,296	\$ 0	\$ 6,385	\$ 33,542	\$552,223
2003 .....	194,314	324,520	518,834	11,070	26,421	32,745	589,069
2004 .....	166,550	315,591	482,140	13,045	25,867	30,125	551,178
2005 .....	231,637	236,986	468,623	23,640	25,215	30,127	547,605
2006 .....	187,208	248,412	435,620	32,815	24,033	30,121	522,589
2007 .....	140,329	255,044	395,372	54,450	22,392	30,126	502,341
2008 .....	117,493	220,191	337,684	53,105	19,670	30,131	440,589
2009 .....	138,615	192,476	331,091	44,090	17,014	30,123	422,318
2010 .....	148,305	183,378	331,682	45,885	14,700	29,984	422,251
2011 .....	143,027	174,483	317,510	61,975	12,291	29,928	421,704
2012 .....	149,705	160,780	310,485	65,370	8,882	30,127	414,864
2013 .....	140,550	152,251	292,801	68,970	5,287	30,128	397,185
2014 .....	152,753	164,999	317,751	27,150	1,493	30,125	376,519
2015 .....	188,150	158,431	346,580	0	0	30,126	376,706
2016 .....	196,830	149,678	346,508	0	0	30,121	376,629
2017 .....	206,162	140,517	346,679	0	0	30,122	376,800
2018 .....	215,660	130,921	346,581	0	0	30,126	376,706
2019 .....	220,976	104,114	325,090	0	0	30,125	355,214
2020 .....	241,790	84,428	326,218	0	0	0	326,218
2021 .....	211,695	71,874	283,569	0	0	0	283,569
2022 .....	200,325	61,200	261,525	0	0	0	261,525
2023 .....	187,150	51,093	238,243	0	0	0	238,243
2024 .....	173,315	41,425	214,740	0	0	0	214,740
2025 .....	159,245	32,234	191,479	0	0	0	191,479
2026 .....	143,285	23,816	167,101	0	0	0	167,101
2027 .....	121,530	16,419	137,949	0	0	0	137,949
2028 .....	94,130	10,189	104,319	0	0	0	104,319
2029 .....	67,890	5,402	73,292	0	0	0	73,292
2030 .....	<u>37,520</u>	<u>1,923</u>	<u>39,443</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>39,443</u>
	<u>\$4,810,960</u>	<u>\$3,990,246</u>	<u>\$8,801,205</u>	<u>\$501,565</u>	<u>\$209,648</u>	<u>\$ 547,952</u>	<u>\$10,060,370</u>

\* Totals may not add due to rounding.

<sup>(1)</sup> Debt service requirements on all general obligation bonds outstanding on June 30, 2001, as adjusted to exclude debt service on bonds to be refunded by the Forward Delivery Bonds.

Sources: Government Development Bank and Department of the Treasury

## **Commonwealth Guaranteed Debt**

As of June 30, 2001, \$12,505,000 of Commonwealth guaranteed bonds of the Housing Bank and Finance Agency was outstanding. These bonds were originally issued by the Urban Renewal and Housing Corporation and refinanced in fiscal 1992 by the Housing Bank and Finance Agency. These bonds were paid on October 1, 2001, their final maturity date.

As of June 30, 2001, \$1,562,493,219 of Commonwealth guaranteed bonds of the Public Buildings Authority was outstanding. Maximum annual debt service on these bonds is \$160,698,186 in fiscal year ending June 30, 2002, with their final maturity being July 1, 2027. No payments under the Commonwealth guaranty have been required to date for bonds of the Public Buildings Authority.

As of June 30, 2001, \$267,000,000 of Commonwealth guaranteed obligations of GDB were outstanding. No payments under the Commonwealth guaranty have been required for any obligations of GDB to date.

As of June 30, 2001, the Commonwealth had guaranteed the outstanding Series 1995 revenue bonds of the Aqueduct and Sewer Authority in the aggregate principal amount of \$361,590,000. On January 2, 1997, the Commonwealth began to make debt service payments under the Commonwealth guaranty and expects to make all debt service payments required on these revenue bonds.

In addition, in April 2000, the Commonwealth extended its guaranty to all of the outstanding bonds issued by the Aqueduct and Sewer Authority to the United States Department of Agriculture, Rural Development, and to all of the outstanding loans by the State Revolving Funds for the benefit of the Aqueduct and Sewer Authority. The extended guaranty will also cover any additional bonds and loans that may be issued until June 30, 2005. As of June 30, 2001, aggregate principal amounts outstanding on these obligations were \$126,872,000 and \$102,376,000, respectively. No payments under the Commonwealth guaranty have been required to date for these obligations of the Aqueduct and Sewer Authority.

## **Trends of Public Sector Debt**

Historically, the Commonwealth has maintained a fiscal policy that provides for a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. During fiscal 1996, 1997 and 1998, however, public sector debt increased at a greater rate than the growth of gross product due to an increase in the amount of debt incurred to finance certain key infrastructure projects that were important to the development of the economy and were expected to produce long-term economic benefits, and debt incurred to refinance outstanding debt, enabling Puerto Rico to benefit from historically low levels of interest rates and realize debt service savings. During fiscal 1999 and 2000, the growth of public sector debt was below the growth of gross product. Public sector debt increased by 12.1% during fiscal 2001. Corresponding information about the growth of gross product during fiscal 2001 is not yet available. The increase in the rate of growth of public sector debt during fiscal 2001 is in part due to the issuance during such fiscal year of \$1,092,550,000 of bonds of the Infrastructure Financing Authority and \$397,005,000 of bonds of the Children's Trust Fund, both of which are payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations derived from services or products. Excluding these bond issues, the rate of growth of public sector debt for fiscal 2001 was 5.9%.

As of June 30, 2001, outstanding short-term debt, relative to total debt, was 10.8%.

The following table shows the trends in gross product (in current dollars) and public sector debt for the five fiscal years ended June 30, 2001:

**Commonwealth of Puerto Rico**

**Public Sector Debt and Gross Product**  
(dollars in millions)

<u>June 30</u>	<u>Public Sector Debt</u>					<u>Gross Product(1)</u>	
	<u>Long Term</u>	<u>Short Term(2)</u>	<u>Short Term as % of Total</u>	<u>Total*</u>	<u>Rate of Increase</u>	<u>Amount</u>	<u>Rate of Increase</u>
1997 .....	\$17,865	\$1,642(3)	8.4%	\$19,507	10.7%	\$32,343	6.5%
1998 .....	20,759	1,563(3)	7.0	22,322	14.4	35,161	8.3
1999 .....	20,905	1,772(3)	7.8	22,677	1.6	38,297	8.9
2000 .....	21,620	2,202(3)	9.2	23,822	5.0	41,366(p)	8.0
2001 .....	23,833	2,871(4)	10.8	26,704	12.1	N/A	N/A

\* Totals may not add due to rounding.

(p) Preliminary.

(1) In current dollars.

(2) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.

(3) Does not include the tax and revenue anticipation notes that were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.

(4) Includes a \$164 million line of credit from Government Development Bank to the Secretary of the Treasury whose proceeds were applied to pay debt service on general obligation bonds in lieu of funds available therefor in the General Fund.

Source: Government Development Bank

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 2001.

**Commonwealth of Puerto Rico**

**Public Sector Debt by Major Category**  
(dollars in millions)

<u>June 30</u>	<u>Commonwealth</u>			<u>Municipalities</u>			<u>Public Corporations(1)</u>			<u>Total*</u>		<u>Grand Total*</u>
	<u>Long Term</u>	<u>Short Term(2)</u>	<u>Total*</u>	<u>Long Term</u>	<u>Short Term(2)</u>	<u>Total*</u>	<u>Long Term</u>	<u>Short Term(2)</u>	<u>Total*</u>	<u>Long Term</u>	<u>Short Term(2)</u>	
1997 .....	4,512	0(3)	4,512(4)	843	51	894	12,509	1,590	14,100	17,865	1,642(3)	19,507(4)
1998 .....	4,819	0(3)	4,819(4)	973	57	1,030	14,967	1,506	16,473	20,759	1,563(3)	22,322(4)
1999 .....	5,097	0(3)	5,097(4)	1,215	60	1,275	14,593	1,713	16,306	20,905	1,772(3)	22,678(4)
2000 .....	5,349	0(3)	5,349(4)	1,396	68	1,464	14,875	2,133	17,008	21,620	2,202(3)	23,822(4)
2001 .....	5,674	164(5)	5,838(4)	1,468	164	1,632	16,691	2,543	19,234	23,833	2,871	26,704(4)

\* Totals may not add due to rounding.

(1) Includes Commonwealth guaranteed debt.

(2) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.

(3) Does not include the tax and revenue anticipation notes which were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.

(4) Includes the GDB Tax Claims Loan and the Transferred CRUV Debt.

(5) Includes a \$164 million line of credit from Government Development Bank to the Secretary of the Treasury whose proceeds were applied to pay debt service on general obligation bonds in lieu of funds available therefor in the General Fund.

## PUBLIC CORPORATIONS

In Puerto Rico, many governmental or quasi-governmental functions are performed by public corporations. These are governmental entities created by the Legislature with varying degrees of independence from the central government. Public corporations are generally created to perform a single function or a limited number of related functions. Most public corporations obtain revenues from rates charged for services or products, but many are subsidized to some extent by the central government. Most public corporations are governed by boards appointed by the Governor with the advice and consent of the Senate, but some public corporations are subsidiaries of departments of the central government. Capital improvements of most of the larger public corporations are financed by revenue bonds under trust agreements or bond resolutions or notes under loan agreements. The following table presents the outstanding bonds and notes of certain of the public corporations as of June 30, 2001 ("notes" as used in this section refers primarily to certain types of non-bonded debt regardless of maturity). Debt of certain other public corporations is excluded from this table because such debt is payable primarily from the Federal government or is payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations, or is payable from revenues derived from services or products, such as industrial development bonds. Also excluded from this table is debt of certain public corporations the inclusion of which would reflect double counting. No deductions have been made in the table for debt service funds and debt service reserve funds. More detailed information about the major public corporations is presented in the following sections.

### Commonwealth of Puerto Rico Outstanding Debt June 30, 2001 (in thousands)

	Bonds			Notes			Total Bonds and Notes		
	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total
Aqueduct and Sewer Authority	\$ 487,429	\$ 0	\$ 487,429	\$ 0	\$ 969,052 <sup>(1)</sup>	\$ 969,052	\$ 487,429	\$ 969,052 <sup>(1)</sup>	\$1,456,481
Electric Power Authority	0	4,308,388	4,308,388	0	125,000	125,000	0	4,433,388	4,433,388
Health Facilities and Services Administration <sup>(2)</sup>	0	0	0	0	654,041	654,041	0	654,041	654,041
Highway and Transportation Authority	0	3,897,434	3,897,434	0	340,788	340,788	0	4,238,222	4,238,222
Housing Bank	12,505	526,166	538,671	0	92,195	92,195	12,505	618,361	630,866
Industrial Development Company	0	176,433	176,433	0	53,379	53,379	0	229,812	229,812
Infrastructure Financing Authority	0	2,069,295 <sup>(3)</sup>	2,069,295	0	21,692	21,692	0	2,090,987	2,090,987
Public Finance Corporation	0	1,577,736 <sup>(4)</sup>	1,577,736	0	0	0	0	1,577,736 <sup>(4)</sup>	1,577,736
Ports Authority	0	102,670	102,670	0	257,397	257,397	0	360,067	360,067
Public Buildings Authority	1,562,493	0	1,562,493	0	230,723	230,723	1,562,493	230,723	1,793,216
Sugar Corporation	0	0	0	0	66,641	66,641	0	66,641	66,641
University of Puerto Rico	0	469,728	469,728	0	656	656	0	470,384	470,384
Others	0	397,005 <sup>(5)</sup>	397,005 <sup>(5)</sup>	0	835,333	835,333	0	1,232,338	1,232,338
Total <sup>(6)</sup>	<u>\$2,062,427<sup>(7)</sup></u>	<u>\$13,524,855</u>	<u>\$15,587,282</u>	<u>\$ 0</u>	<u>\$3,646,897</u>	<u>\$3,646,897</u>	<u>\$2,062,427<sup>(7)</sup></u>	<u>\$17,171,752</u>	<u>\$19,234,179</u>

- 
- (1) Principal of and interest on this debt is reimbursed from Commonwealth appropriations.
  - (2) This is debt incurred by the Health Facilities and Services Administration prior to its dissolution on June 30, 1999, which debt was assumed by the Department of Health.
  - (3) \$1,092.6 million of this amount is payable from interest earnings on \$1.2 billion deposited in the Puerto Rico Infrastructure Development Fund which represent a portion of the proceeds received by the Commonwealth from the sale of its controlling interest in the Puerto Rico Telephone Company in 1999.
  - (4) Payable primarily from Commonwealth appropriations.
  - (5) On November 15, 2000, the Children's Trust issued its Tobacco Settlement Asset-Backed Bonds, Series 2000, in the total principal amount of \$397,005,000. Said bonds will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Other Public Corporations" below.
  - (6) Does not include accretion of interest from the respective issuance dates on capital appreciation bonds.
  - (7) Authorization for Commonwealth guarantee of debt as of June 30, 2001 was \$3,891,000,000.

Source: Government Development Bank

### **Government Development Bank for Puerto Rico**

The principal functions of GDB are to act as financial advisor to and fiscal agent for the Commonwealth, its municipalities and public corporations in connection with the issuance of bonds and notes, to make loans and advances to public corporations and municipalities, and to make loans to private enterprises to aid in the economic development of Puerto Rico.

As of June 30, 2001, \$1,249,969,000 of bonds and notes of GDB were outstanding. As of said date, GDB also had \$3,710,506,000 in loans to local public corporations and municipalities. Act No. 12 of May 9, 1975, as amended, provides that the payment of principal of and interest on specified notes and other obligations of GDB, not exceeding \$550,000,000, may be guaranteed by the Commonwealth, of which \$267,000,000 were outstanding as of June 30, 2001.

GDB has the following principal subsidiaries:

*Housing Finance Corporation* was created in November 1977 to provide needed rental housing units and stimulate the construction industry under federally subsidized programs. The Corporation has issued tax-exempt revenue bonds and notes to finance the construction of housing units approved for federal rental subsidies and to finance home ownership of single family housing units, which bonds and notes are limited obligations of the Corporation payable solely from revenues collected in respect of such housing units. The Federal Housing Administration has insured mortgages on certain of the housing units. As of June 30, 2001, \$891,664,827 of bonds of Housing Finance Corporation was outstanding. In August 2001, the Corporation issued \$127,075,000 of its Home Mortgage Revenue Bonds and Notes.

On August 11, 2001, the Governor signed legislation creating the Puerto Rico Housing Finance Authority as the successor to the Corporation and transferring to the Authority all powers and duties of the Housing Bank and Finance Agency and dissolving the Housing Bank and Finance Agency. The legislation becomes effective 180 days after the Governor's signature thereon.

*Tourism Development Fund* was created in November 1993 to promote the hotel and tourism industry of Puerto Rico, primarily by making available guarantees to secure the payment of private financing used for new hotel development projects. The Tourism Development Fund is also authorized to make capital investments and provide direct financing to tourism related projects. As of June 30, 2001, the Tourism Development Fund had outstanding guarantees with respect to the financing of thirteen hotel projects totaling \$603,125,000. The owner of one of these projects with a guaranty for \$84,740,000 recently filed for bankruptcy. The Tourism Development Fund has commenced foreclosure proceedings in another project for which the guaranty is \$27,130,000.

*Development Fund* was created in 1977 to provide an alternate source of financing to private enterprises in Puerto Rico that have difficulties in obtaining financing from traditional sources. The Development Fund may also guarantee obligations of these enterprises and invest in their equity securities.

*Capital Fund* was created in November 1993 for trading in debt obligations and publicly traded shares of domestic and foreign corporations.

*Public Finance Corporation* was created in December 1984 to provide agencies and instrumentalities of Puerto Rico with alternate means of meeting their financing requirements. In June 1995, the Corporation issued \$296,393,974 of bonds to purchase from GDB certain debt of the Maritime Shipping Authority. In April 1996, the Corporation issued \$192,108,735 of bonds to purchase from GDB a portion of a debt of the Secretary of the Treasury relating to advances made by the Secretary to the municipalities to settle certain property tax claims. In June 1998, the Corporation issued \$383,225,000 of bonds to purchase from GDB the debt which had been incurred by the Office for the Improvement of Public Schools in connection with its public schools repair and improvement program. In January 1999, the Corporation issued \$618,085,149 of bonds to purchase from GDB a portion of the outstanding indebtedness of Health Facilities and Services Administration (“AFASS”). All of these bonds of the Corporation are payable from Commonwealth appropriations.

In February 1999, the Corporation issued \$228,318,000 of bonds to refund a GDB line of credit utilized by the Corporation to purchase certain property tax debts from the Municipal Revenues Collection Center and the Department of the Treasury. Said bonds are limited obligations payable solely from collections of the property tax debts purchased by the Corporation.

As of June 30, 2001, the Corporation had \$1,577,736,000 aggregate principal amount of bonds outstanding.

In August 2001, the Corporation issued \$390,000,000 of bonds to purchase from GDB certain debt of Aqueduct and Sewer Authority relating to the construction of the North Coast Superaqueduct (discussed below). These bonds are also payable from Commonwealth appropriations.

A description of certain other affiliates of GDB is provided in “Other Public Corporations.”

### **Other Public Corporations**

*Aqueduct and Sewer Authority* owns and operates the Commonwealth’s system of public water supply and sanitary sewer facilities. Capital expenditures are financed by revenues of the system, debt issuances, and federal and Puerto Rico grants. Debt service on revenue bonds is payable from net revenues of the system after payment of current expenses.

Facilities and operations of the Authority’s system are subject to regulation under numerous federal and Puerto Rico environmental laws, including the federal Clean Water Act and the Safe Drinking Water Act administered by the United States Environmental Protection Agency (“EPA”). The Authority has embarked on an extensive capital improvement program for the five-year period ending June 30, 2005, that is estimated to cost approximately \$1.7 billion. A portion of the capital improvement program is designed to enable the Authority to comply with federal and Commonwealth laws and regulations.

The Authority needs to make a substantial investment in infrastructure and a major overhaul of its operations to maintain the viability of the existing system and to finance its expansion for new users. Funds for this investment are expected to be provided through a combination of bond issues, legislative appropriations and federal grants. Due to the Authority’s financial difficulties (discussed below) and its inability to access the bond market, Act No. 45 was enacted in July 1994 to provide a Commonwealth guaranty of the principal and interest payments to the bondholders of all outstanding debt previously issued by the Authority which, at that time, amounted to \$388 million, and to also guarantee all future bonds or any other similar obligations incurred by the Authority to refinance such debt. In December 1995, the Authority issued \$400,340,000 of its Refunding Bonds, Series 1995 (the “Series 1995 Bonds”), to refund all of the Authority’s outstanding revenue and revenue refunding bonds. The Series 1995 Bonds are guaranteed by the Commonwealth pursuant to Act No. 45. On January 2, 1997, the Commonwealth began making all debt service payments under said guaranty in respect of the Series 1995 Bonds. In addition, Act No. 45 was amended

on April 24, 2000, to extend the payment guaranty of the Commonwealth to all of the outstanding bonds issued by the Authority to the United States Department of Agriculture, Rural Development, and to all of the outstanding loans granted by the Clean Water and Drinking Water State Revolving Funds for the benefit of the Authority. The extended guaranty will cover any additional issuance of these obligations until June 30, 2005.

The Authority has reported net losses of \$55.2 million, \$94.9 million, \$130 million and \$100.7 million during fiscal years 1997, 1998, 1999 and 2000, respectively. The estimated net loss for fiscal 2001 is \$176 million. These losses, which the Authority has financed with lines of credit from Government Development Bank, reflect the continuing financial and operating difficulties that the Authority has experienced in recent years. The outstanding principal amount of these lines of credit was \$865,652,000 as of June 30, 2001. These losses were aggravated in recent years by extraordinary items, including the required adoption of new government accounting requirements relating to required expense reserves, the posting of previous years' non-registered entries and adjustments, employees' salary increases and early retirement bonuses, non-budgeted or underestimated expenses relating to the PSG Agreement (described below), increased maintenance costs and additional non-budgeted reserves. Legislation was approved in July 1994 providing for annual Commonwealth appropriations to the Authority to pay a portion of the principal of and interest on the Authority's indebtedness, cover capital improvements and defray a portion of the Authority's operating and maintenance expenses, as follows: \$20 million for fiscal 1995, \$25 million for fiscal 1996, \$30 million for fiscal 1997, and \$35 million for fiscal 1998. Additional legislation was approved in August 1997 providing for annual Commonwealth appropriations of \$35 million annually through fiscal 2008. Additional annual appropriations are made to cover debt service on the Public Finance Corporation bonds issued to finance the North Coast Superaqueduct.

On May 26, 1995, the Authority and Professional Services Group, Inc. ("PSG") entered into a five-year agreement (the "Agreement") for the operation, management, repair and maintenance of the Authority's public water supply and sanitary sewer systems, and for its customer service systems (the "Authority Systems"). PSG, which is headquartered in Houston, Texas, is a subsidiary of Air Water Technologies Corporation ("AWT"), which in turn is a subsidiary of Compagnie Générale des Eaux-SAHIDE ("CGE"), a member of the Vivendi Group, a French based international conglomerate of environmental, utility, energy, construction and communication companies. CGE guaranteed PSG's performance obligations under the Agreement. PSG commenced management of the Authority Systems in September 1995. Under the Agreement, all employees remained employees of the Authority, and the Authority retained management responsibilities for the capital planning, construction and environmental compliance departments. The management of certain departments, such as finance and management information systems, was shared by the Authority and PSG.

In September 1998, the Authority, PSG, AWT and CGE entered into an amendment to the Agreement (the "Amended Agreement"), that assigned all of PSG's obligations under the Agreement to CGE and AWT, with CGE being primarily responsible. The Amended Agreement extended the term of the Agreement by one year until August 31, 2001, transferred the management responsibility for the shared departments to CGE, and modified certain terms and conditions of the Agreement. The Amended Agreement includes performance incentives and penalties in the event that CGE fails to operate the Authority Systems within specified parameters, and establishes a contract administrator to oversee and monitor CGE's performance under the Amended Agreement. The annual fees payable to CGE may be adjusted to provide for certain unforeseen events and circumstances, such as additional operations expenses due to hurricanes, and for adding facilities to the Authority Systems. The Amended Agreement gave the Authority the right to terminate the Amended Agreement, without cause or penalty, at the end of the fifth contract year.

On March 1, 1999, the Authority entered into a further amendment to the Amended Agreement, which transferred to CGE responsibility of the departments that had remained under the Authority's control. In connection with such amendment, the fees and costs payable to CGE were adjusted to reflect the additional responsibilities assumed by CGE and the hoped for increased efficiencies of a private management company.

On August 31, 2001, the Authority extended the Amended Agreement for nine months and requested proposals from CGE and other multinational companies for a new agreement (or more than one agreement if the island is divided into two areas of operation) covering the operation, management, repair and maintenance of the Authority Systems.

The Authority expects to select one or more operators and enter into one or more new contracts by the end of the nine-month extension period.

The Authority entered into an agreement with Thames-Dick Superaqueduct Partners, Inc. for the planning, design, construction, operation and maintenance of the North Coast Superaqueduct to supply additional potable water to certain municipalities, mainly in the San Juan Metropolitan Area. The total cost of the North Coast Superaqueduct was approximately \$390 million. GDB provided interim financing for this Project. Permanent financing was provided in August 2001 through the issuance of \$390,000,000 of bonds of Public Finance Corporation, payable from Commonwealth appropriations. The North Coast Superaqueduct started operations during January 2000.

*Economic Development Bank* was created in July 1985 to engage primarily in granting small direct loans, providing loan guarantees to private enterprises, and making equity investments in such enterprises. Its initial capital was provided by a transfer of loans in the principal amount of \$15,000,000 previously administered by a now inactive subsidiary of GDB. As of June 30, 2001, Economic Development Bank had outstanding debt of \$85,806,000.

*Electric Power Authority* owns and operates the island's electric system. The Capital Improvement Program for the five-year period ending June 30, 2005, is estimated to cost approximately \$2.0 billion and is financed primarily by borrowed funds, supplemented by internally generated funds. The Authority's bonded debt consists of Power Revenue Bonds, secured by a lien on net revenues of the electric system. As of June 30, 2001, the Authority had \$4,308,388,000 in bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As a means of reducing its dependency on oil, the Authority has entered into power purchase contracts relating to the construction of certain cogeneration plants that will use fuels other than oil. These two cogeneration projects consist of EcoElectrica's 507 megawatts liquefied natural gas plant at Guayanilla and a 454 megawatts clean coal facility at Guayama to be built and operated by an affiliate of Applied Energy Systems ("AES"). EcoElectrica's plant started commercial operations in March 2000. Construction of AES' plant began in November 1999, and the plant is expected to be in service during calendar year 2002. It is expected that these two cogeneration plants will initially provide approximately one-third of the Authority's energy needs.

*Health Facilities and Services Administration* was created by Act No. 26 of November 13, 1975, as amended, for the principal purpose of developing and operating public hospitals and other health facilities and providing health services. In connection with the revamping of the island's public health system and as part of a health reform program that has the effect of changing the public health system from one in which the government provides health services to low income persons to one in which medical services are provided by the private sector and the government provides comprehensive health insurance cover to such persons, the Administration was dissolved on June 30, 1999, and its administrative responsibilities, agreements and claims were transferred to the Department of Health. As part of the health reform, the government sold to private companies several of the public health facilities that were operated by the Administration.

The operations of the Administration had been funded substantially by Commonwealth appropriations and lines of credit provided by GDB. Aggregate outstanding indebtedness to GDB as of June 30, 2001, relating to such lines of credit was \$654,041,000. Such indebtedness is expected to be paid principally from Commonwealth appropriations.

*Health Insurance Administration* was created in 1993 to implement the health reform by negotiating and contracting for the provision of comprehensive health insurance coverage for qualifying (generally low income) Puerto Rico residents. Under this system, the government selects, through a bidding system, one private health insurance company in each of several designated regions of the island and pays such insurance company the insurance premium for each eligible beneficiary within such region. The health insurance system covers all of the municipalities and approximately 1.7 million persons were covered by the system as of June 30, 2001.

The government has recently completed the negotiations of the contracts with health insurance providers for fiscal 2002. The cost to the General Fund of the health insurance program for fiscal 2002 will be \$1,237 million, compared to \$1,302 million for fiscal 2001. This cost exceeds the amount budgeted for fiscal 2002 by \$238 million.

*Highway and Transportation Authority* is responsible for highway construction in Puerto Rico. Such construction is financed by debt (interim notes and revenue bonds), revenues of the Authority, and federal and Puerto Rico grants. Debt service on the Authority's revenue bonds constitutes a first lien on its gross revenues, which consist currently of all the proceeds of the gasoline tax; one-half of the proceeds of the tax on gas oil or diesel oil; all the proceeds of the excise taxes on crude oil, unfinished oil and derivative products, up to \$120 million per fiscal year; highway toll revenues; and, the gross receipts of \$15.00 per vehicle per year from certain motor vehicle license fees. Such revenues (except for toll revenues) may be applied first to the payment of debt service on general obligation bonds and notes of the Commonwealth and payments required to be made by the Commonwealth under its guarantees of bonds and notes to the extent that no other revenues are available for such purpose. The Commonwealth has never applied such revenues for such payment. As of June 30, 2001, the Highway and Transportation Authority had \$3,897,434,000 in bonds outstanding.

The Authority has under construction the first phase of a new mass transit system, known as Tren Urbano, to serve a portion of metropolitan San Juan. The first phase of Tren Urbano is being constructed under several design/build contracts, including a design/build/operate contract covering the design and construction of the system and the operation of Tren Urbano for five years with an additional five-year option at the Authority's election. The cost of the first phase is estimated to be \$1.9 billion, which cost will be financed by Federal Transit Administration grants, other federal funding sources and the Authority's own resources. On August 4, 2000, the Authority entered into a loan agreement with the United States Department of Transportation Federal Transit Administration evidencing a long-term loan to the Authority in the amount of \$300,000,000. This loan was used by the Authority to pay a portion of the costs related to the first phase of this project. An extension of the first phase of Tren Urbano to serve the area of Minillas Government Center is currently in the planning stage.

The Authority is a party to a concession agreement under which a private company designed, constructed and currently is operating a toll bridge spanning the San José Lagoon. The toll bridge was financed with special facility revenue bonds of the Authority payable by the private company principally from toll revenues. The concession is for a term of 35 years, subject to earlier termination or extension. The bridge opened for traffic in February 1994. In certain circumstances as described in the concession agreement, including where toll revenues are insufficient to generate certain rates of return to the private operator, the private company may require the Authority, among other things, to assume the private company's obligations with respect to the special facility revenue bonds. Some of those circumstances, including low toll revenues, exist at this time, but the Authority does not currently anticipate that the private company will exercise its remedy against the Authority.

*Housing Bank and Finance Agency* has been engaged in insuring mortgages and servicing mortgages originated by Urban Renewal and Housing Corporation and has issued bonds and notes to provide interim and permanent financing for low-income housing projects and single-family home ownership programs. The Agency obtained funds from legislative appropriations, sales of mortgages, mortgage repayments and other sources.

As of June 30, 2001, the Agency had outstanding \$538,670,818 of bonds (of which \$12,505,000, originally issued by the Urban Renewal and Housing Corporation, are guaranteed by the Commonwealth) issued to pay obligations of the Commonwealth under law, otherwise payable from Commonwealth appropriations, to fund certain payments of the Commonwealth under its mortgage subsidy program for low and moderate income families, to guarantee certain insurance obligations of the Agency under certain programs, and to refund bonds originally issued by Urban Renewal and Housing Corporation to carry out activities related to the provision of low-cost housing for moderate income families, federally aided public housing for low income families, and urban renewal, housing and related activities. These bonds are payable principally from appropriations in substantially the amount that the Commonwealth would otherwise have been bound to appropriate for such purposes.

The Agency will be dissolved and all of its powers and duties transferred to the newly-created Housing Finance Authority (successor to the Housing Finance Corporation), effective 180 days from August 11, 2001. The outstanding bonds of the Agency will become obligations of the Housing Finance Authority.

*Industrial Development Company* participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to manufacturers. The Company was merged with the Economic Development Administration in January 1998. Rentals derived from the leasing of specified facilities of the Company are pledged to the payment of the Company's revenue bonds. As of June 30, 2001, the Company had \$176,433,000 in bonds outstanding.

*Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority* ("AFICA") was created in June 1977. The Authority has issued revenue bonds to finance industrial, tourist, pollution control, medical, and educational facilities in Puerto Rico for the use of private companies, non-profit entities, or government agencies. The bonds are payable solely from payments to be made to the Authority by such private companies, non-profit entities, or government agencies, and do not constitute a debt of the Commonwealth or any of its other public corporations or municipalities. As of June 30, 2001, \$3,425,000,000 of the Authority's bonds were outstanding.

*Infrastructure Financing Authority* was created in June 1988 by virtue of Act No. 44 of June 21, 1988, as amended ("Act No. 44"), to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations and governmental instrumentalities of Puerto Rico authorized to develop infrastructure facilities and to establish alternate means for financing infrastructure facilities. The Authority is authorized to issue bonds and provide loans, grants and other financial assistance for the construction, acquisition, repair, maintenance and reconstruction of infrastructure projects by public corporations and instrumentalities of the Commonwealth. Act No. 44 also established the Puerto Rico Infrastructure Fund, funded in the amount of \$30 million during fiscal 1989 and \$40 million for each of the following twenty-nine fiscal years with the first proceeds of federal excise taxes imposed on rum and other articles produced in Puerto Rico and sold in the United States which are transferred to Puerto Rico pursuant to the United States Internal Revenue Code of 1986, as amended. On July 7, 1997, Act No. 44 was amended to increase to \$60 million for fiscal year 1998 and \$70 million for each subsequent year until fiscal year 2028 the amount of federal excise taxes transferred to the Authority. The increased level of appropriations was used by the Authority to provide financial support to aqueduct and sewer projects. The Authority had \$2,069,295,000 in bonds outstanding as of June 30, 2001.

In January 1998, the Authority expanded the assistance given to Aqueduct and Sewer Authority to include assistance covering the design and construction of various strategic regional water and sewer projects intended to provide improved services to targeted regions throughout the island, the implementation of an immediate action plan to address a number of small water and sewer rehabilitation projects, and legal and technical assistance in achieving compliance with certain environmental laws and in establishing a prioritized capital program. The Authority is undertaking such projects at the request of the Aqueduct and Sewer Authority.

In June 1998, Act No. 44 was amended to establish the Infrastructure Development Fund, a permanent trust fund to be utilized by the Authority for the purpose of financing infrastructure projects. The Infrastructure Development Fund was initially funded in March 1999 with \$1.2 billion of proceeds received by the Telephone Authority from the sale of a controlling interest in Puerto Rico Telephone Company ("PRTC"). This initial amount will remain permanently deposited in a segregated, perpetual account, denominated the "corpus account," and must be invested exclusively in U.S. government or U.S. government-backed obligations. The income from such investment may only be used to finance infrastructure projects related to the Commonwealth's water and sewer systems. Other moneys in the Infrastructure Development Fund not attributable to the corpus account or the investment income thereon may be used for other infrastructure projects. The Authority is the custodian and administrator of the Infrastructure Development Fund. On October 11, 2000, the Authority issued \$1,092,550,000 of bonds payable from and secured by a pledge of the interest received by the Authority from the investments of the Infrastructure Development Fund. The proceeds of this bond issue are being used to finance certain aqueduct and sewer infrastructure development projects.

*Maritime Shipping Authority* commenced operations in 1974 upon the acquisition of three shipping lines serving Puerto Rico and the United States mainland. On March 3, 1995, the assets and operations of the Maritime Shipping Authority were acquired by an investor group headed by BTIP, a subsidiary of Bankers Trust New York

Corporation, under the terms and conditions approved by the Legislature of Puerto Rico and signed by the Governor on September 27, 1994. The remaining debt of the Authority was refinanced, as allowed under Act No. 113 of September 27, 1994, through the issuance of bonds by Public Finance Corporation, a subsidiary of GDB. The aggregate principal amount of such bonds as of June 30, 2001, was \$271,878,974 (not including accreted values of capital appreciation bonds outstanding). The bonds are payable from funds to be appropriated annually by the Legislature of Puerto Rico.

*Municipal Finance Agency* was created in 1972 as a municipal “bond bank” for Puerto Rico. The Agency is authorized to issue bonds to purchase general obligation bonds and notes of Puerto Rico municipalities and to fund a debt service reserve. Debt service on the Agency’s bonds is payable from debt service payments on municipal bonds held by the Agency and from the debt service reserve, including investment income thereon. The Commonwealth has agreed to pay such amounts to the debt service reserve as may be necessary to maintain it at its required level, subject to appropriation by the Legislature, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of June 30, 2001, the Agency had \$1,021,050,000 of bonds outstanding.

*Ports Authority* owns and operates the major airport and seaport facilities in Puerto Rico. The Authority derives revenues from a variety of sources, including charges on airplane fuel sales, air terminal space rentals, landing fees, wharfage, dockage and harbor fees, and rentals for the lease of seaport equipment and property. The Authority had total net losses of approximately \$70 million during fiscal years 1993 and 1994 and, as a result, was not in compliance with its rate covenant with bondholders. After reducing its operating losses through a comprehensive rate revision process, including the implementation of annual (instead of triennial) rate revision analyses, the Authority is currently in compliance with its rate covenant. The Authority is implementing a plan to restructure its operations which, among other things, encompasses revisions to its capital improvement program, measures to increase collections from certain users of its facilities, and proposals to improve the efficiency of its operations. Act No. 1 of January 1, 2000 authorized the transfer of the Authority’s unprofitable maritime ferry operations to Puerto Rico Maritime Transportation Authority, a newly created government agency. The Authority reported net losses during the fiscal years ended June 30, 1997, 1998 and 1999 of \$11.3 million, \$28.8 million and \$6.5 million, respectively. The Authority reported a net income of \$15.3 million for fiscal year 2000 and expects its net income for fiscal 2001 to be \$28.2 million. As of June 30, 2001, the Authority had \$102,670,000 in bonds outstanding.

*Public Buildings Authority* is authorized to construct, purchase or lease office, school, health, and social welfare facilities for lease to departments, public corporations, and instrumentalities of the Commonwealth. Bonds that have been issued by the Authority to finance such facilities (through retirement of interim notes or otherwise) are payable from lease payments, which are largely derived from legislative appropriations and are further secured by the Commonwealth’s guaranty. The Authority is authorized by Act No. 17 of 1968, as amended, to have outstanding at any one time up to \$2,100,000,000 of bonds guaranteed by the Commonwealth. As of June 30, 2001, \$1,562,493,219 of such bonds of the Authority was outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). The Authority has four lines of credit for its capital improvement program totaling approximately \$562,138,430, of which \$230,724,033 was outstanding as of June 30, 2001.

The Authority is undertaking a program to construct additional correctional facilities to be completed by July 2002 at an estimated cost of \$187,000,000. The Authority has previously issued \$126,972,552 in bonds to finance the construction of three correctional facilities, which are being operated by private companies.

At present, several officers of the Commonwealth are defendants in a lawsuit filed in United States District Court in which they are charged with violating the constitutional rights of correctional system inmates as a result of severe overcrowding in the island’s correctional system. Fines to assure compliance with minimum space standards have been assessed in the past against the defendants, such fines being paid by the Commonwealth. Most of these fines have been earmarked for improving the conditions of inmates but not for construction of additional correctional facilities to alleviate prison overcrowding. The Commonwealth can give no assurance that additional fines will not be levied in connection with this lawsuit.

*Sugar Corporation* was created in 1973 to consolidate ownership and management of the Commonwealth's interests in Puerto Rico's sugar industry. Until February 27, 1998, Sugar Corporation owned or leased and operated virtually all the sugar production facilities on the island. Sugar Corporation bought all cane grown by private growers, processed the cane, and sold crude and refined sugar and molasses. For many years, its operations produced substantial operating deficits.

On September 5, 1996, the Governor of Puerto Rico signed into law Act No. 189, as amended, which authorized the transfer, for a nominal sum, of certain assets and liabilities of the Corporation to entities created by the sugar cane growers. Pursuant thereto, as of December 31, 2000, the Commonwealth had transferred the operations of the Corporation to certain entities formed by sugar cane growers. The Corporation retained substantially all its liabilities. For fiscal 2001, appropriations of approximately \$10,000,000 were made to cover its operating deficit. As of June 30, 2001, the total debt of the Corporation was \$66,641,000. Of this amount, \$62,856,000 is payable from Commonwealth appropriations.

*Telephone Authority* was created in July 1974 when the Commonwealth purchased PRTC from International Telephone and Telegraph Corporation. PRTC operates the principal telephone system in Puerto Rico.

On March 2, 1999, the Telephone Authority sold a controlling interest in PRTC to a consortium led by GTE International Telecommunications Incorporated, which has recently been acquired by Verizon Communications, Inc. The net proceeds of the sale received at closing were applied to defease outstanding bonds of the Authority in the principal amount of \$756 million, to make a \$1.2 billion deposit to the Infrastructure Development Fund held by the Infrastructure Financing Authority and to pay certain benefits to PRTC employees. The Government retained a 43% stock participation in PRTC. The proceeds from the future sale of such participation will be applied to reduce the unfunded pension benefits obligations of the Employees Retirement System of the Commonwealth and its instrumentalities.

*University of Puerto Rico*, with 69,773 students during academic year 2000-2001, is by far the largest institution of higher education on the island. Government appropriations are the principal source of University revenues, but additional revenues are derived from tuition, student fees, auxiliary enterprises, interest income, federal grants, and other sources. University capital improvements have been financed mainly by revenue bonds of which \$469,728,000 was outstanding as of June 30, 2001.

On December 21, 2000, AFICA issued its \$86,735,000 Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) for the purpose of financing the construction of additional student housing and parking and office space for the University. The project is being built and will be operated by Desarrollos Universitarios, Inc., a Puerto Rico not-for-profit corporation, and will be leased to the University for a term equal to the term of the bonds with lease payments being of sufficient amounts to pay debt service on said bonds as they become due.

*Children's Trust Fund* (the "Trust") is a not-for-profit corporate entity created by the Commonwealth under Act No. 173 of July 30, 1999. The Trust is a public instrumentality of the Commonwealth. Pursuant to Act No. 173, the Commonwealth has transferred to the Trust all of its rights, title and interest under the tobacco litigation Master Settlement Agreement ("MSA"), including the Commonwealth's right to receive initial, annual and strategic contribution fund payments to be made by the participating cigarette manufacturers under the MSA.

The Trust issued \$397,005,000 aggregate principal amount of Tobacco Settlement Asset-Backed Bonds, Series 2000 on November 15, 2000. The Series 2000 Bonds and any other additional series of senior bonds will be secured by a statutory pledge of certain tangible and intangible assets of the Trust, including its right to receive 50% of Puerto Rico's portion of the initial payments, annual payments, and strategic contribution fund payments under the MSA.

*Public corporations*, in addition to those mentioned above, have outstanding debt in the aggregate amount of \$726,739,000 as of June 30, 2001. Debt service on \$674,394,000 of such outstanding debt is being paid from legislative

appropriations. However, the Commonwealth is not obligated to make any such appropriations. Additional legislative appropriations are made to enable certain of such corporations to pay their operating expenses.

### **INSURANCE MATTERS**

Government-owned property is insured through policies obtained by the Secretary of the Treasury and through self-insurance, except for property owned by the Electric Power Authority and the Aqueduct and Sewer Authority, which is insured through arrangements and policies obtained by the respective Authorities. Personal injury awards against the Commonwealth are limited by law to \$150,000 per occurrence.

### **RETIREMENT SYSTEMS**

Public employees of the Commonwealth and its instrumentalities are covered by five retirement systems: the Employees Retirement System of the Commonwealth and its instrumentalities (the "Employees Retirement System"), the Annuity and Pension System for the Teachers of Puerto Rico (the "Teachers Retirement System"), the Commonwealth Judiciary Retirement System (the "Judiciary Retirement System"), the Retirement System of the University of Puerto Rico (the "University Retirement System"), and the Employees Retirement System of Puerto Rico Electric Power Authority (the "Electric Power Authority Retirement System").

The University Retirement System and the Electric Power Authority Retirement System apply to employees of the University of Puerto Rico and Electric Power Authority, respectively. The Commonwealth is not required to contribute directly to those two systems, although a large portion of University revenues is derived from legislative appropriations.

The Teachers Retirement System covers primarily public school teachers, the Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth, its municipalities and instrumentalities. As of June 30, 2000, the total number of active members of the three systems was as follows: Employees Retirement System, 158,000; Teachers Retirement System, 48,122, and Judiciary Retirement System, 343. The three systems are financed by contributions made by employers (the Commonwealth, public corporations, or municipalities), employees, and investment income. The central government is responsible for approximately 66% of total employer contributions to the Employees Retirement System, and the other 34% is the responsibility of public corporations and municipalities. The central government is also responsible for 100% and 99% of total employer contributions to the Judiciary and Teachers Retirement Systems, respectively. Retirement and related benefits provided by the systems and required contributions to the systems by employees are determined by statute. Required contributions to the systems by employers are determined by statute with respect to the Teachers Retirement System and, with respect to the Employees and Judiciary Retirement Systems, by the Administrators of the Systems.

According to the most recent actuarial valuation of the Employees Retirement System and Judiciary Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2000, the total pension benefit obligation for the Employees Retirement System and Judiciary Retirement System was \$9,459,300,000 and \$135,800,000, respectively. The unfunded pension benefit obligation of the Employees Retirement System and Judiciary Retirement System for the same period was \$7,417,500,000 and \$53,000,000, respectively, representing a funding ratio of 22% and 61%, respectively. This funding ratio does not take into account the recent significant decline in the equities market and the resulting reduction in the value of the equity portfolio.

The most recent actuarial valuation was completed in accordance with the "Projected Unit Credit" method. An investment return of 8.5% per year, a salary increase of 5% per year, and a post-retirement benefit increase of 3% every third year were assumed. In the case of the Employees Retirement System, Act No. 10 of May 21, 1992 provided three benefit increases of 3% each. The first 3% increase was granted to retirees who had been receiving their annuities for three or more years as of that date. The second 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1995. This increase is being financed by additional contributions from

the employers. The third 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1998. This third increase is being partially funded with additional contributions from some of the employers. On June 13, 2001, the Legislature approved a law providing another 3% increase, effective as of January 1, 2001, in post-retirement annuity payments granted on or prior to January 1, 1998. Subsequent increases will depend upon the explicit approval of the System's Board of Trustees and the Legislature. In the case of the Judiciary Retirement System, Act No. 41 of June 13, 2001 provides a 3% increase in annuity payments, commencing on January 1, 2002 and every three years thereafter, to retirees who have been receiving their annuities for three or more years as of that date.

On February 1, 1990, the Legislature of Puerto Rico enacted Act No. 1 amending the organic act of the Employees Retirement System to reduce the future pension liabilities of the Employees Retirement System. Among other provisions, the legislation increased the level of contribution to the System and limited the retirement benefits for new employees by increasing the length of time for the vesting of certain benefits and reducing the level of benefits in the case of early retirement. The legislation also reduced the level of occupational disability benefits and death benefits received by new employees.

Act No. 305 of September 24, 1999 further amended the organic act of the Employees Retirement System to change it, prospectively, from a defined benefit system to a defined contribution system. This amendment provides for the establishment of an individual account for each employee hired by the Government after December 31, 1999 and for those current employees who elect to transfer from the existing defined benefit system. The individual account of each current employee is credited initially with an amount equal to his aggregate contributions to the Employees Retirement System, plus interest. Current employees who do not elect to transfer to the new defined contribution system will continue accruing benefits under the current defined benefit system. The individual account of each participant of the new defined contribution system is credited monthly with the participant's contribution and is credited semiannually with a rate of return based on either of two notional investment returns. Such accounts are not credited with any contribution by the Government. Instead, Government contributions will now be used completely to reduce the unfunded accumulated pension liability of the Employees Retirement System.

The law approving the sale of a controlling interest in PRTC to a consortium led by GTE International Telecommunications Incorporated (subsequently acquired by Verizon Communications Inc.) provides that any future proceeds received by the government from the sale of its remaining 43% stock ownership in PRTC will be transferred to the Employees Retirement System to reduce its accumulated unfunded pension benefit obligation. Verizon has an option to purchase an additional 15% of the stock of PRTC for \$172 million, which option expires in March 2002. The government expects that Verizon will exercise this option.

The Employees Retirement System expects its disbursements of benefits during fiscal 2002 to exceed the expected contributions and investment income for such year. The Employees Retirement System proposes to finance the cash shortfall with a short-term loan from a private bank, which is expected to be repaid from the proceeds of the sale of the 15% stock ownership to Verizon upon its exercise of its stock option described above.

According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 1999, the accrued actuarial liability of the system was \$2,904,195,938, the value of assets amounted to \$2,509,490,000, representing a funding ratio of 79.67%, and the resulting unfunded accrued liability was \$590,465,938, a decrease of \$194,037,629 from the prior valuation made as of June 30, 1998. This funding ratio does not take into account the recent significant decline in the equities market and the resulting reduction in the value of the equity portfolio. As of June 30, 1999, the remaining amortization period for the unfunded liability is 21 years. The actuarial valuation assumed an investment return of 8% per year and salary increases of 5% per year. Act No. 43 of January 27, 2000 increased the amount of the employee contribution from 7% to 9%, effective immediately. This will result in an increase of employee contributions of \$1.5 million per month.

The following table presents, in summary form, the income and expenses of the retirement systems for the fiscal years ended June 30, 1999 and June 30, 2000, and estimates for the fiscal year ending June 30, 2001. The

investment income figures presented in the table for fiscal 1999 and 2000 include unrealized gains and losses. Income for fiscal 2001 is estimated as of December 31, 2000 and does not reflect the significant decline in the equities market that has occurred since December 2000. It is expected that the net income for fiscal 2001 will be significantly lower than the estimate shown as of December 31, 2000.

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**Commonwealth of Puerto Rico  
Retirement Systems  
Income and Expenses  
(in thousands)**

	<u>Employees Retirement System</u>	<u>Judiciary Retirement System</u>	<u>Teachers Retirement System</u>
<b><u>Fiscal Year Ended June 30, 1999</u></b>	<b><u>Actual</u></b>	<b><u>Actual</u></b>	<b><u>Actual</u></b>
Income:			
Employers' contributions	\$274,658	\$ 5,744	\$ 91,155
Employee contributions	217,179	2,115	67,807
Investment income	<u>244,025</u>	<u>7,489</u>	<u>242,198</u>
Total	<u>735,862</u>	<u>15,348</u>	<u>401,160</u>
Expenses:			
Benefit payments	515,993	7,099	206,397
Administrative and other expenses	<u>33,956</u>	<u>1,074</u>	<u>16,469</u>
Total	<u>549,949</u>	<u>8,173</u>	<u>222,866</u>
Net Income	<u>\$185,913</u>	<u>\$ 7,175</u>	<u>\$178,294</u>
<b><u>Fiscal Year Ending June 30, 2000</u></b>	<b><u>Actual</u></b>	<b><u>Actual</u></b>	<b><u>Actual</u></b>
Income:			
Employers' contributions	\$309,097	\$ 5,222	\$ 86,246
Employee contributions	218,342	2,094	68,864
Investment income	<u>296,842</u>	<u>11,075</u>	<u>286,507</u>
Total	<u>824,281</u>	<u>18,391</u>	<u>441,617</u>
Expenses:			
Benefit payments	605,465	7,705	219,886
Administrative and other expenses	<u>28,651</u>	<u>1,372</u>	<u>31,755</u>
Total	<u>634,116</u>	<u>9,077</u>	<u>251,641</u>
Net Income	<u>\$190,165</u>	<u>\$ 9,312</u>	<u>\$189,976</u>
<b><u>Fiscal Year Ended June 30, 2001(1)</u></b>	<b><u>Projected</u></b>	<b><u>Projected</u></b>	<b><u>Projected</u></b>
Income:			
Employers' contributions	\$310,000	\$5,500	\$ 90,000
Employee contributions	220,000	2,200	95,000
Investment income	<u>200,000</u>	<u>8,500</u>	<u>100,000</u>
Total	<u>730,000</u>	<u>16,200</u>	<u>285,000</u>
Expenses:			
Benefit payments	626,000	8,800	242,000
Administrative and other expenses	<u>34,000</u>	<u>1,800</u>	<u>32,000</u>
Total	<u>660,000</u>	<u>10,600</u>	<u>274,000</u>
Net Income	<u>\$ 70,000</u>	<u>\$ 5,600</u>	<u>\$ 11,000</u>

(1) Projected figures as of December 31, 2000. Does not reflect the decline in the equities market since December 2000.

Sources: Employees Retirement System, Judiciary Retirement System and Teachers Retirement System

## COMMONWEALTH FINANCIAL STATEMENTS

Since fiscal 1990, the complete financial statements of the Commonwealth have been audited. For fiscal 2000, such financial statements were audited by Deloitte & Touche LLP, whose report thereon is dated December 29, 2000. Preparation of the audited financial statements of the Commonwealth involves the collection and combination of audited financial statements from fifty separate reporting entities.

The Comprehensive Annual Financial Report of the Commonwealth for fiscal 2000 prepared by the Department of the Treasury, which includes the general purpose financial statements of the Commonwealth for fiscal 2000, has been filed by the Commonwealth with each nationally recognized municipal securities information repository.

### PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES

The Secretary of the Treasury has custody of the funds of the central government and is responsible for the accounting, disbursement and investment of such funds. Central government funds are grouped into three major categories or “types” of funds, as follows: (i) Governmental Fund Types, which include the General, Special Revenue, Debt Service (also referred to herein as Redemption), and Capital Project Funds; (ii) Proprietary Fund Types, which include the Enterprise and Internal Service Funds; and (iii) Fiduciary Fund Types, which include the Trust and Agency Funds. These funds do not include funds of the municipalities, because the municipalities are governmental entities with independent treasuries. The Special Revenue Fund was incorporated into the General Fund commencing in fiscal 1993.

The General Fund is the primary operating fund of the Commonwealth. General Fund revenues are broadly based and include revenues raised internally as well as those from non-Puerto Rico sources. Internal revenues consist principally of income taxes and excise taxes. Revenues from non-Puerto Rico sources are derived from federal excise taxes and customs duties returned to the Commonwealth. The primary expenditures of the Commonwealth through the General Fund are for grants and subsidies, and personal and other services.

#### Summary and Management’s Discussion of General Fund Results

The following table presents the Commonwealth revenues and expenditures of the General Fund on a cash basis for fiscal 1998 through fiscal 2001 and the Commonwealth’s estimated revenues and budgeted expenditures for fiscal 2002. The information through fiscal 2000 is based on actual fiscal year-end results. The information relating to fiscal 2001 is subject to audit adjustments. The information relating to fiscal 2002 is based on (i) revised revenue estimates made by the Secretary of the Treasury in September, 2001 and (ii) expenditures included in the approved budget for fiscal 2002, adjusted upward by the Office of Management and Budget in September, 2001 to incorporate the revised costs of the health insurance program as determined after completion of negotiations with the health insurance companies. The revenue estimates do not take into account any possible revenue reduction resulting from any adverse economic impact arising from the September 11 terrorist attacks in the United States.

To improve the presentation of the following table, the Department of the Treasury has eliminated the use of line items identified as “Operating Transfers In” and “Operating Transfers Out” in the financial statements of the Commonwealth and has assigned the amounts previously listed under these two categories to the following revenue and expenditure line items according to the purpose and amount of each transfer: “Other Income,” “Other Expenditures,” “Capital Outlays and Other Debt Service” and “Transfers to Agencies.” Amounts listed under “Other Income” represent recurring General Fund revenues not appropriately attributable to other revenue line items, such as repayment of General Fund advances to municipalities and government agencies and funds. “Other Expenditures” represent recurring General Fund expenditures not appropriately attributable to other expenditures line items, such as advances to government agencies and municipalities, which advances are to be reimbursed to the General Fund by law. Amounts listed under “Capital Outlays and Other Debt Service” represent debt service on obligations and capital expenditures for which the Legislature has by resolution agreed to appropriate funds. “Transfers to Agencies” represents moneys appropriated for the operation of the Health Facilities and Services Administration. General Fund revenues, expenditures and transfers as presented in the table differ from the General Fund revenues, expenditures and transfers as presented in the financial statements of the Commonwealth, as the latter statements reflect an expanded General Fund entity in accordance with generally accepted accounting principles.

**Commonwealth of Puerto Rico**  
**General Fund Revenues, Expenditures, and Changes in Cash Balance**  
(in thousands)

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001(p)</u>	<u>2002(1)</u>
Beginning cash balance	\$ 127,477	\$ 340,771	\$ 474,759	\$ 287,055	\$ 184,556
Revenues from internal sources:					
Income Taxes:					
Individuals	2,026,612	2,244,376	2,352,066	2,348,042	2,595,000
Corporations	1,527,415	1,653,762	1,781,862	1,696,766	1,724,000
Partnerships	4,404	2,087	2,339	3,026	3,000
Withheld from non-residents	192,463	369,384	557,276	696,835	670,000
Tollgate taxes	170,953	114,533	111,130	49,511	36,000
Interest	11,406	10,666	11,674	14,781	15,000
Dividends	39,616	38,996	39,664	58,580	40,000
Total income taxes	<u>3,972,869</u>	<u>4,433,804</u>	<u>4,856,011</u>	<u>4,867,541</u>	<u>5,083,000</u>
Commonwealth excise taxes					
Alcoholic beverages	238,118	243,464	236,374	237,512	242,000
Cigarettes	111,094	119,105	115,157	119,135	119,000
Motor vehicles	350,004	411,573	389,995	406,252	429,000
Other excise taxes	613,500	699,685	668,820	579,596	661,000
Total Commonwealth excise taxes	<u>1,312,716</u>	<u>1,473,827</u>	<u>1,410,346</u>	<u>1,342,495</u>	<u>1,451,000</u>
Property taxes	5,673	2,214	1,131	287	-
Inheritance and gift taxes	1,380	1,811	3,109	7,475	2,000
Licenses	66,167	70,848	73,801	76,335	79,000
Other:					
Lottery	57,986	59,206	63,779	57,482	62,000
Electronic Lottery	54,681	53,013	70,209	69,912	61,000
Miscellaneous	158,568	176,669	169,246	199,676	427,000
Total other	<u>271,235</u>	<u>288,888</u>	<u>303,234</u>	<u>327,070</u>	<u>550,000</u>
Total revenues from internal sources	<u>5,630,040</u>	<u>6,271,392</u>	<u>6,647,632</u>	<u>6,621,203</u>	<u>7,165,000</u>
Revenues from non-Commonwealth sources:					
Federal excise taxes	200,260	217,296	245,750	286,890	280,000
Customs	72,206	61,355	50,231	43,152	40,000
Total revenues from non-Commonwealth sources	<u>272,466</u>	<u>278,651</u>	<u>295,981</u>	<u>330,042</u>	<u>320,000</u>
Sub-total revenues	5,902,506	6,550,043	6,943,613	6,951,245	7,485,000
Proceeds from Special Funds	50,253	-	-	-	57,000
Total Revenues	<u>5,952,759</u>	<u>6,550,043</u>	<u>6,943,613</u>	<u>6,951,245</u>	<u>7,542,000</u>
Other Income (refunds) <sup>(2)</sup>	482,120	2,570	64,325	58,651	98,870
Transfers to Redemption Fund <sup>(3)</sup>	(368,544)	(320,240)	(410,046)	(297,944)	(314,636)
Proceeds of notes and other borrowings <sup>(4)</sup>	601,892	600,000	778,863	825,703	1,072,007
Repayment of notes and other borrowings <sup>(5)</sup>	(617,775)	(611,410)	(787,155)	(683,913)	(1,207,084)
Adjusted revenues	<u>6,050,452</u>	<u>6,220,963</u>	<u>6,589,600</u>	<u>6,853,742</u>	<u>7,197,157</u>
Expenditures:					
Grants and subsidies	2,118,266	2,392,018	2,864,215	2,997,704	2,164,701
Personal services	2,197,903	2,470,456	2,737,159	2,859,387	3,717,935
Other services	698,446	723,563	745,194	655,053	889,707
Materials and supplies	84,451	99,404	109,081	91,653	258,648
Equipment purchases	31,626	52,993	56,404	38,381	46,080
Capital outlays and other debt service	253,962	166,841	101,178	33,102	26,327
Transfers to agencies	131,174	181,700	164,073	280,961	-
Other expenditures	321,330	-	-	-	268,000
Total expenditures	<u>5,837,158</u>	<u>6,086,975</u>	<u>6,777,304</u>	<u>6,956,241</u>	<u>7,371,398</u>
Adjusted revenues less expenditures	213,294	133,988	(187,704)	(102,499)	(174,241)
Ending cash balance	<u>\$ 340,771</u>	<u>\$ 474,759</u>	<u>\$ 287,055</u>	<u>\$ 184,556</u>	<u>\$ 10,315</u>

(p) Preliminary

(1) Approved budget, as revised on September 7, 2001 by the Office of Management and Budget and the Secretary of the Treasury.

(2) Consists of reimbursement of certain advances to agencies to cover expenses, revenue from the General Fund's non budgetary funds and a reserve for future tax refunds reduced by estimated tax refunds.

(3) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly to the Redemption Fund from non-General Fund revenues.

(4) Consists of proceeds of Commonwealth tax and revenue anticipation notes and borrowings from Government Development Bank.

(5) Consists of repayment of Commonwealth tax and revenue anticipation notes and borrowings from Government Development Bank.



### *Estimated Fiscal 2002 Compared to Preliminary Fiscal 2001*

As of September 7, 2001, it was projected that General Fund total revenues for fiscal 2002 (excluding proceeds from special funds) would be \$7,485 million, representing an increase of \$534 million, or 7.6%, from fiscal 2001 revenues. The major changes from fiscal 2001 are expected to be: projected increases in income taxes from individuals of \$247 million and in corporate income taxes of \$27 million, a projected increase in Commonwealth excise taxes of \$109 million, a projected increase in miscellaneous revenues of \$227 million and a projected decrease in income taxes withheld from non-residents, tollgate taxes and dividend taxes totaling \$57 million.

The revenue estimates for fiscal 2002 were based on the following assumptions: (i) the economy of Puerto Rico will continue a moderate growth pattern until at least the fourth calendar quarter of 2002 (nominal growth of the economy during fiscal 2002 was expected to be between 5% and 6%); (ii) tax collections will continue to grow in excess of the 2% growth registered in fiscal 2001, which was an election year and a year in which the last phase of a previously legislated tax rate reduction became effective; (iii) the price of crude oil will average \$25 per barrel; (iv) rum excise tax collections will decrease as the amount of excise tax that is returned to Puerto Rico is reduced from \$13.25 to \$10.50 per gallon effective on January 1, 2002 (see "Relationship with the United States" in *Introduction*); and, (v) there will be some income tax revenue reductions as a result of the recently enacted local tax legislation designed to stimulate economic activity.

One of the largest components of the expected increase in tax collections (\$180 million) is based on special administrative actions which the Treasury Department expects to implement during fiscal 2002. These involve stronger enforcement actions in the collection of excise taxes and an aggressive campaign to collect income taxes which are past due. The success of these actions is uncertain. The Secretary of the Treasury expects to collect an additional \$20 million in income taxes by increasing the required tax withholding on professional services contracts from 7% to 10%. This increase requires legislation.

For the first two months of fiscal 2002, actual tax collections were in excess of the estimated amount by approximately 7%. It is possible, however, that as a result of the terrorist attacks, which occurred in the United States on September 11, revenues for subsequent months may be adversely affected.

It is too early to determine with any certainty the impact that such attacks will have on economic activity in Puerto Rico and on revenues of the General Fund. It is possible that there will be a short term reduction in economic activity with an adverse impact on revenues. The Commonwealth government is in the process of formulating measures to restore confidence to consumers and the business community and proposes to accelerate its capital investment program to help counteract the possible adverse effect of these recent events.

Total estimated expenditures for fiscal 2002 are \$7,371 million, an increase of \$415 million, or 6.0%, from fiscal 2001 expenditures. The ending cash balance for the General Fund for fiscal 2002 is estimated to be \$10.3 million, a decrease of \$174.2 million from fiscal 2001. This decrease resulted principally from the repayment during fiscal 2002 from General Fund moneys of short-term borrowings incurred in fiscal 2001 and not repaid in said fiscal year. It is not possible at this time to determine whether the September 11, 2001 terrorist attacks will cause General Fund expenditures to increase. For a comparison of budgeted expenditures and estimated expenditures, see "Fiscal 2002 Budget" in *Budget of the Commonwealth of Puerto Rico*.

### *Preliminary Fiscal 2001 Compared to Fiscal 2000*

General Fund total revenues for fiscal 2001 are currently estimated at \$6,951 million, an increase of approximately \$8 million from fiscal 2000. The major changes from fiscal 2000 are: a decrease of \$85 million in corporate income taxes; a decrease of \$62 million in tollgate taxes; a decrease of \$89 million in other excise taxes; an increase in income tax withheld from non-residents of \$140 million; and an increase in federal excise taxes of \$41 million. The decrease in corporate income taxes was due to the effects of the economic slowdown in the United States and Puerto Rico. The reduction in tollgate taxes and the increase in withholding taxes to non-residents are the result

of continuing conversions of corporations to controlled foreign corporation tax status and the payment of withholding taxes on royalties paid to U.S. affiliates. The reduction in local excise taxes allocated to the General Fund was attributable principally to a reduction in the tax on crude oil (which varies inversely with the price of crude oil) and a transfer of certain excise taxes from the General Fund to other funds of the Commonwealth as required by recent Commonwealth legislation. Federal excise tax revenues rose due to growing exports of rum products. For fiscal 2000 the amount of the rum excise tax that is returned to the Treasury of Puerto Rico increased from \$10.50 to \$13.25 per gallon, but for the second half of fiscal 2002, the amount of the rum excise tax returned to the Treasury of Puerto Rico will return to \$10.50 per gallon. See “Major Sources of General Fund Revenues” below.

The budget for fiscal 2001 had estimated that revenues would be \$7,505 million, whereas actual revenues were only \$6,951 million. This difference was attributable to: (i) the effect of slower than anticipated economic growth; (ii) the impact of the Section 936 and 30A phase out on corporate tax revenues (offset by increases in withholding taxes on royalty payments); (iii) the increase in the price of crude oil, which affects economic growth and excise tax collections; and (iv) the previously legislated tax rate reduction which became effective in fiscal 2001.

Total expenditures for fiscal 2001 were \$6,956 million, an increase of \$179 million, or 2.6%, over fiscal 2000. Expenditures grew primarily in the areas of education, health and public safety. This growth is attributable in part to the rising cost of services and expanding programs. For a comparison of budgeted expenditures and actual expenditures, see “Fiscal 2001 Budget” in *Budget of the Commonwealth of Puerto Rico*. The ending cash balance for the General Fund for fiscal 2001 is estimated to be \$185 million, a decrease of \$102 million from fiscal 2000. This decrease, together with moneys raised by the Commonwealth from short-term borrowings that were not repaid in full prior to the end of fiscal 2001, enabled the Commonwealth to cover expenses in said year in excess of the amount budgeted therefor and on the face of a decline in General Fund Revenues. General Fund deposits to the Redemption Fund in fiscal 2001 were \$113 million less than in fiscal 2000 because the last four monthly deposits in fiscal 2001 were made from the proceeds of a short-term loan from GDB which loan was repaid in early fiscal 2002 from the proceeds of the 2001 general obligation bonds issued in June 2001.

In lieu of issuing tax and revenue anticipation notes in fiscal 2001 to meet seasonal differences in the timing of revenues and expenses, the Commonwealth borrowed from GDB \$825.7 million. Of this amount \$661.4 million has been repaid.

#### *Fiscal 2000 Compared to Fiscal 1999*

General Fund total revenues for fiscal 2000 were \$6,944 million, an increase of \$394 million, or 6.0%, over fiscal 1999. The major changes were: an increase in revenues obtained from income taxes of \$422 million and a decrease in Commonwealth excise taxes of \$63 million.

Total expenditures for fiscal 2000 were \$6,777 million, an increase of \$690 million, or 11.3%, over fiscal 1999. The ending cash balance for the General Fund for fiscal 2000 was \$287 million, a decrease of \$188 million from fiscal 1999.

#### *Fiscal 1999 Compared to Fiscal 1998*

General Fund total revenues for fiscal 1999 were \$6,550 million, an increase of \$597 million, or 10.0%, over fiscal 1998. Major changes were: an increase in income taxes of \$461 million and an increase in excise taxes of \$161 million.

Total expenditures for fiscal 1999 were \$6,087 million, an increase of \$250 million, or 4.3%, from fiscal 1998. The ending cash balance for the General Fund for fiscal 1999 was \$475 million, an increase of \$134 million from fiscal 1998.

## Major Sources of General Fund Revenues

### *Income Taxes*

The Commonwealth's income tax law, the Internal Revenue Code of 1994, as amended (the "PR Code"), imposes a tax on the income of individual residents of Puerto Rico, trusts, estates, and domestic and foreign (if engaged in a trade or business in Puerto Rico) corporations and partnerships. A withholding tax is imposed on certain payments made to non-residents of Puerto Rico.

*Individuals.* Resident individuals are subject to tax on their taxable income from all sources. Prior to January 1, 2000, the PR Code had five tax brackets for individuals with tax rates of 8%, 12%, 18%, 31% and 33%. As a result of legislation enacted in 1999, the first four brackets have been reduced to 7.5%, 11%, 16.5% and 29.5% for the taxable year commencing on January 1, 2000, to 7%, 10%, 15% and 28% for taxable years commencing on January 1, 2001, and 6%, 9%, 14% and 27% for the taxable years commencing on and after January 1, 2002. Dividend income from Puerto Rico corporations and certain qualifying foreign corporations is taxed at a rate of 10%. A recent amendment to the PR Code provides an income tax exemption to REITs and imposes a 17% tax on taxable dividends distributed by such entities during the first ten taxable years of the REIT.

Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a rate of 20% or 10% if the capital asset consists of certain property located in Puerto Rico sold or exchanged after December 31, 2000. Gains realized by Puerto Rico resident individuals, trusts and estates from the sale of stock of certain Puerto Rico corporations in an initial public offering made prior to December 31, 2000 are subject to a special capital gains rate of 7%. Legislation has been introduced to extend the eligibility date from December 31, 2000 to December 31, 2007.

Interest income in excess of \$2,000 on deposits with Puerto Rico financial institutions is taxed at a rate of 17%; the first \$2,000 of interest income from such institutions is exempt from taxation. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident individuals, trusts and estates qualifies for a special 17% tax rate.

*Corporations and Partnerships.* Puerto Rico corporations and partnerships are subject to tax on income from all sources; foreign corporations and partnerships that are engaged in a trade or business in Puerto Rico are subject to tax on their income from Puerto Rico sources and on income from sources outside Puerto Rico that is effectively connected with the conduct of their trade or business in Puerto Rico. Unless a corporation or partnership qualifies for partial exemption from corporate income and other taxes under the industrial incentives program (see "Tax Incentives" under *The Economy* above), it is subject to tax at graduated rates.

The PR Code provides for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to taxable income in excess of \$275,000. Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a maximum rate of 25% or 12.5% if the capital asset consists of certain property located in Puerto Rico sold or exchanged after December 31, 2000. The special tax rate applicable to dividend distributions of REITs also applies to dividends received by corporations.

Certain corporations and partnerships covered by the tax incentives acts continue to be subject to a maximum tax rate of 45% on their taxable income. Corporations and partnerships covered by the Puerto Rico Tourism Incentives Act of 1993, as amended, are subject to a maximum tax rate of 42% on their taxable income. The PR Code also provides for an alternative minimum tax of 22%. Corporations and partnerships operating under a new grant of tax exemption issued under the 1998 Tax Incentives Act are subject to a maximum income tax rate of 7%.

The PR Code imposes a branch profits tax on resident foreign corporations less than 80% of whose gross income qualifies as income effectively connected with a Puerto Rico trade or business. The branch profits tax is 10% of an annual dividend equivalent amount, and it applies without regard to the Puerto Rico source of income rules.

Interest from Puerto Rico sources paid to non-resident non-affiliated corporate recipients is not subject to any income or withholding tax. Interest paid to certain related non-resident recipients continues to be subject to a withholding tax of 29%. Dividends paid to non-resident corporate recipients are subject to a withholding tax of 10%. Dividends distributed by corporations (including Section 936 Corporations) operating under new grants of tax exemption issued under the 1998 Tax Incentives Act are not subject to Puerto Rico income tax. The basic tax on dividends paid to foreign corporate shareholders of Section 936 Corporations operating under grants of tax exemption issued under prior incentives laws is 10% but is subject to reduction with respect to dividends paid from profits invested in certain eligible instruments for specified periods of time.

Payments in excess of \$1,000 during a calendar year made by the Commonwealth and persons engaged in a trade or business in Puerto Rico in consideration of the receipt of services rendered in Puerto Rico are subject to a 7% withholding tax. The Secretary of the Treasury proposes to introduce legislation increasing the withholding tax to 10%.

#### *Excise Taxes*

The PR Code imposes a tax on articles and commodities that are imported into or manufactured in Puerto Rico for consumption in Puerto Rico and a tax on certain transactions, such as hotel occupancy, public shows, and horse racing. The excise tax on certain articles and commodities, such as cigarettes and petroleum products, is based upon the quantity of goods imported. The excise tax on motor vehicles is based on its suggested retail price. The PR Code imposes a tax at an effective rate of 6.6% of the F.O.B. factory price for imported goods and 3.6% of the sales price of goods manufactured in Puerto Rico, except sugar, cement, cigarettes, motor vehicles and certain petroleum products, which are taxed at different rates. Goods to be used by the government, except for motor vehicles and construction equipment, are not exempt. Exemptions apply to certain articles, such as food and medicines, and to articles designated for certain users.

#### *Other Taxes and Revenues*

Motor vehicle license plate and registration fees comprise the major portion of license tax receipts.

Non-tax revenues consist principally of lottery proceeds, documentary stamps, permits, fees and forfeits, proceeds of land sales and receipts from public corporations in lieu of taxes.

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of alcoholic beverages from the island to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth. The excise tax on shipments of alcoholic beverages from Puerto Rico and other rum producing countries is \$13.50 per gallon. Of this amount, \$13.25 per gallon was returned to the Treasury of Puerto Rico during the period from October 1, 1999 to December 31, 2001. Effective on January 1, 2002, the amount returned will be \$10.50 per gallon.

On April 26, 2001, legislation was introduced in the United States House of Representatives to repeal the return to the Treasury Department of Puerto Rico of the federal excise taxes on shipments of alcoholic beverages from Puerto Rico. The Commonwealth will vigorously oppose the enactment of any such repeal. No assurance can be given at this time as to the likelihood of the passage of such repeal.

#### *Property Taxes*

Personal property, which accounts for approximately 55% of total collections of taxable property, is self-assessed. Real property taxes are assessed at 1958 values. No real property reassessment has been made since 1958, and construction taking place after that year has been assessed on the basis of what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual market value. Also, an exemption on the first \$15,000 of assessed valuation in owner-occupied residences is available.

On August 30, 1991, legislation was adopted in Puerto Rico providing a municipal reform program, which also involved the creation of the Municipal Revenues Collection Center (“CRIM”) to collect property taxes. The program transferred the previous functions of the Department of the Treasury with respect to real and personal property tax assessment, notification, determination, and collection to the CRIM, as of July 1, 1993. The special 1.03% tax on the assessed value of all property (other than exempted property) imposed by the Commonwealth for purposes of paying the Commonwealth’s general obligation debt continues to be deposited in the Commonwealth’s Redemption Fund.

**Commonwealth of Puerto Rico**  
**Assessed Valuations and Real and Personal Property Taxes**  
**(Commonwealth and Municipalities Combined)**  
**(in thousands)**

<u>Fiscal Year Ended June 30</u>	<u>Assessed Valuations</u> <sup>(1)</sup>	<u>Taxes Levied</u>	<u>Collections of Current Year</u>	<u>Collections of Previous Years</u>	<u>Total</u>
1996	\$13,052,524	\$416,881	\$400,207	\$70,571	\$470,778
1997	17,499,974	533,362	437,178	82,435	519,613
1998	19,272,428	619,343	510,999	90,311	601,310
1999	20,042,738	642,555	523,886	47,309	571,198
2000	20,514,014	704,568	594,151	64,812	658,963
2001 <sup>(2)</sup>	21,114,019	736,667	605,834	77,963	683,797

(1) Valuation set as of July 1 of each fiscal year.

(2) Preliminary.

*Source:* Municipal Revenues Collection Center

During 1997, legislation was enacted authorizing the CRIM to sell past-due property taxes on residential, commercial and industrial properties to persons who, after payment of the purchase price to the CRIM, would then be responsible for collecting such taxes from the delinquent property taxpayers. Pursuant to this legislation, in February 1999 the Government securitized eligible property tax debts of the CRIM by issuing non-recourse bonds of Public Finance Corporation payable solely from the collection of such past due property taxes. The proceeds of the securitization were paid to the CRIM for the benefit of the Commonwealth and the municipalities of the Commonwealth.

As of July 2001, all payments of debt service on such bonds had been made. CRIM has received notice that it is not in compliance with certain requirements concerning the continuing eligibility of certain past-due accounts in the securitized pool and requesting CRIM to substitute other eligible past-due tax accounts for the pool. The Legislature recently approved a law authorizing CRIM to borrow funds for the purpose of enabling CRIM to comply with the above requirements. The funds borrowed by CRIM may be utilized to purchase the outstanding bonds of Public Finance Corporation issued to securitize the property tax debts of the CRIM.

**Collections of Income and Excise Taxes**

The Department of the Treasury has continued its program for improving tax collections, which began in fiscal 1986. The program has consisted, in part, of taking the initiative in sponsoring and implementing tax reform, particularly in the areas of excise taxes and income taxes, in order to decrease the incidences of nonpayment of taxes and to expand the taxpayer base. The program has also included (a) improving the methods by which delinquent taxpayers are identified, primarily through the use of computer analyses, (b) computerizing the processing of tax returns, and (c) identifying and eliminating taxpayer abuses of the existing tax laws.

## **Transfers to General Obligation Redemption Fund**

These consist of transfers from the General Fund to the Redemption Fund for the amortization of the principal of and interest on general obligation bonds and notes of the Commonwealth.

## **Components of General Fund Expenditures**

### *Grants and Subsidies*

This category includes grants and contributions to municipalities, public corporations with independent treasuries, and charitable institutions. It also includes items for or included in court awards, damage awards for personal injury or property damage, and payment of taxes and payments in lieu of taxes.

### *Personal Services*

This category includes compensation paid for personal services rendered to the Commonwealth and its public instrumentalities by individuals or firms in the form of salaries, wages, *per diems*, fees, commissions, or other forms of compensation.

### *Other Services*

This category includes compensation for services other than the services referred to above, including advertising, printing, communications, legal expenses, utilities, building and equipment rental and maintenance expenses, insurance premiums and miscellaneous services.

### *Materials and Supplies*

This category includes all articles that ordinarily have a short life and durability, lose their characteristic identity in the process of use, have only nominal value (\$25 or less), or are not otherwise chargeable as equipment.

### *Equipment Purchases*

This category includes items that have three special characteristics distinguishing them from materials: durability, long useful life, and high unit cost. In addition, these items are subject to centralized inventory control as fixed assets.

### *Capital Outlays and Other Debt Service*

Capital outlays are made primarily for land acquisition or interests in land, construction of buildings, roads, bridges and other structures, and permanent improvements and additions. Other debt service includes payments on notes held by GDB to be paid from the General Fund and payments for the amortization of the principal of and interest on non-general obligations payable from Commonwealth appropriations.

### *Transfers to Agencies*

Includes repayment of loans and advances to other funds, certain refunds, advances from other funds and other receipts, repayment of advances from other funds, grants and contributions to other funds under the custody of the Secretary of the Treasury and other items. The major portion of grants and contributions in recent fiscal years has consisted of transfers to the Health Facilities and Services Administration to cover the costs of health reform and advances to the municipalities.

*Other Expenditures*

This category represents recurring General Fund expenditures not appropriately attributable to other expenditure line items, such as advances to government agencies and municipalities, which advances are to be reimbursed to the General Fund by law.

**Federal Grants**

Puerto Rico receives grants under numerous federal programs. The following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Department of the Treasury.

**Commonwealth of Puerto Rico  
Federal Grants  
(in thousands)**

	<b>Fiscal Year Ending June 30</b>				
	<b>1998</b>	<b>1999</b>	<b>2000(p)</b>	<b>2001(e)</b>	<b>2002(e)</b>
Education	\$ 504,296	\$ 571,758	\$ 675,876	\$ 734,494	\$ 741,563
Social Services	1,592,402	1,548,876	1,579,453	1,685,563	1,694,593
Health	399,790	362,905	298,980	304,068	310,690
Labor and Human Resources (1)	161,272	308,699	263,263	335,158	337,073
Public Works and Transportation(2)	0	0	0	0	0
Crime	25,726	27,552	24,836	17,700	11,623
Housing(3)	224,787	232,359	232,359	232,359	236,931
Drug and Justice	10,909	9,841	14,424	14,712	11,062
Agriculture and Natural Resources	6,771	6,898	7,307	9,949	6,820
Contributions to Municipalities	64,911	58,865	58,865	56,809	59,191
Other	<u>6,337</u>	<u>5,914</u>	<u>4,915</u>	<u>6,116</u>	<u>6,965</u>
<b>TOTAL</b>	<u><b>\$2,997,201</b></u>	<u><b>\$3,133,667</b></u>	<u><b>\$3,160,278</b></u>	<u><b>\$3,396,928</b></u>	<u><b>\$3,416,511</b></u>

(p) Preliminary.

(e) Estimated.

(1) Amounts include grants to the Right to Work Administration and to the Occupational Development and Human Resources Council.

(2) Amounts of federal grants to the Highway and Transportation Authority are not included in the Public Works and Transportation area.

(3) Amounts include grants to the Public Housing Administration.

Source: Office of Management and Budget

**BUDGET OF THE COMMONWEALTH OF PUERTO RICO**

**Office of Management and Budget**

The fundamental objective of the Office of Management and Budget (“OMB”) is to improve and strengthen the relationship between policy formulation and budgetary and fiscal management. The law creating OMB also strengthened budgetary controls and created an Operational Audit Division with the primary function of evaluating government operations and programs.

## **Budgetary Process**

The fiscal year of the Commonwealth begins each July 1. The Governor is constitutionally required to submit to the Legislature an annual balanced budget of capital improvements and operating expenses of the central government for the ensuing fiscal year. The annual budget is prepared by OMB, working with the Planning Board, the Department of the Treasury, and other government offices and agencies. Section 7 of Article VI of the Constitution provides that “The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law.”

The annual budget, which is developed utilizing elements of program budgeting and zero-base budgeting, includes an estimate of revenues and other resources for the ensuing fiscal year under (i) laws existing at the time the budget is submitted, and (ii) legislative measures proposed by the Governor and submitted with the proposed budget, as well as the Governor’s recommendations as to appropriations that in her judgment are necessary, convenient, and in conformity with the four-year investment plan prepared by the Planning Board.

The Legislature may amend the budget submitted by the Governor but may not increase any items so as to cause a deficit without imposing taxes to cover such deficit. Upon passage by the Legislature, the budget is referred to the Governor, who may decrease or eliminate any item but may not increase or insert any new item in the budget. The Governor may also veto the budget in its entirety and return it to the Legislature with the Governor’s objections. The Legislature, by a two-thirds majority in each house, may override the Governor’s veto. If a budget is not adopted prior to the end of the fiscal year, the annual budget for the preceding fiscal year as originally approved by the Legislature and the Governor is automatically renewed for the ensuing fiscal year until a new budget is approved by the Legislature and the Governor. This permits the Commonwealth to continue to make payments of its operating and other expenses until a new budget is approved.

## **Financial Control and Adjustment Procedures**

Revenue estimates for budgetary purposes are prepared by the Department of the Treasury, except for estimates of federal grants, which are prepared by OMB and various departments and other recipients of such grants. Revenue and federal grant estimates are under continuous review and, if necessary, are revised at least quarterly during the fiscal year. Fiscal control over expenditures is exercised severally by the Governor, through the Director of OMB, and the Secretary of the Treasury. Quarterly reviews and expenditure cut-off procedures are designed to prevent expenditures in excess of appropriations.

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures to reduce expenses and submit to both houses of the Legislature a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislature for new taxes or authorize borrowings under provisions of existing legislation or take any other necessary action to meet the estimated deficiency. Any such proposed adjustments shall give effect to the “priority norms” established by law for the disbursement of public funds in the following order of priority: first, the payment of the interest on and amortization requirements for public debt (Commonwealth general obligations and guaranteed debt for which the Commonwealth’s guarantee has been exercised); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit and good faith of the Commonwealth; third, current expenditures in the areas of health, protection of persons and property, education, welfare and retirement systems; and fourth, all other purposes.

A Budgetary Fund was created by Act No. 147 of June 18, 1980, as amended (the “Budgetary Fund Act”), to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to honor the public debt, and to provide for unforeseen circumstances in the provision of public services. The Budgetary Fund Act was amended in 1994 to require that an annual legislative appropriation equal to 0.33% of the total budgeted appropriations for each fiscal year be deposited in the Budgetary Fund. In 1997, the Budgetary Fund Act was further amended to increase the annual legislative appropriation required to be deposited in the Budgetary Fund to 1% of the

total revenues of the preceding fiscal year, beginning in fiscal year 2000. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. As of June 30, 2001, the amount on deposit in the Budgetary Fund was \$26.7 million.

### Appropriations

Appropriations in the central government budget of Puerto Rico consist of the following:

(i) General Fund appropriations for recurring ordinary operating expenses of the central government and for contributions to public corporations, municipalities, and private organizations. Such appropriations are made by a single annual law known as the Joint Resolution of the General Budget.

(ii) General Fund appropriations for special operating expenses and for capital expenditures. Such appropriations are authorized by separate laws for one or more years for special programs or activities, which may be permanent or transitory.

(iii) Disbursements of Special Funds for operating purposes and for capital improvements. For the most part, such disbursements do not require annual legislative authorization, because they are authorized by previous legislation or by the United States Congress. Federal grants constitute the major part of the resources of the Special Funds.

(iv) Bond Fund appropriations for capital expenditures financed by bonds. Such expenditures may occur in one or more years.

In Puerto Rico, the central government has many functions, which in the fifty states are the responsibility of local government, such as providing public education and police and fire protection. The central government also makes large annual grants to the University of Puerto Rico, Aqueduct and Sewer Authority and to the municipalities. In the summaries of the budgets of the central government presented below, grants to the University of Puerto Rico are included in current expenses for education and debt service on general obligation bonds is included in current expenses for debt service. Debt service on Sugar Corporation notes paid by the Commonwealth is included in current expenses for economic development, and debt service on Urban Renewal and Housing Corporation bonds and notes and on Housing Bank and Finance Agency mortgage subsidy bonds paid by the Commonwealth is included in current expenses for housing.

Approximately 25.2% of the General Fund is committed for payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, contributions to the Aqueduct and Sewer Authority, and rental payments to the Public Buildings Authority, among others, including debt service on direct debt of the Commonwealth.

### Fiscal 2001 Budget

The following table presents a summary of the Commonwealth budget for the fiscal year ending June 30, 2001.

**Commonwealth of Puerto Rico  
Summary of Central Government Annual Budget  
Fiscal Year Ended June 30, 2001  
(in thousands)**

	<u>General Fund</u>	<u>Bond Fund</u>	<u>Special Funds</u>	<u>Total</u>
Revenues from internal sources:				
Property taxes	\$ -	\$ -	\$ 101,371	\$ 101,371

	<b><u>General Fund</u></b>	<b><u>Bond Fund</u></b>	<b><u>Special Funds</u></b>	<b><u>Total</u></b>
Personal income taxes	2,729,000	-	-	2,729,000
Income tax withheld from non-residents	525,000	-	-	525,000
Corporate income taxes	1,767,000	-	-	1,767,000
Partnership income taxes	3,000	-	-	3,000
Tollgate taxes	94,000	-	-	94,000
17% withholding tax on interest	13,000	-	-	13,000
10% withholding tax on dividends	40,000	-	-	40,000
Inheritance and gift taxes	2,000	-	-	2,000

	<b>General Fund</b>	<b>Bond Fund</b>	<b>Special Funds</b>	<b>Total</b>
Excise taxes:				
Alcoholic beverages	258,000	-	-	258,000
Motor vehicles and accessories	441,000	-	-	441,000
Cigarettes	119,000	-	-	119,000
Special excise tax on certain petroleum products	70,000	-	-	70,000
General 5% excise tax	599,000	-	-	599,000
Slot machines and machines for entertainment	-	-	-	-
Other	97,000	-	117,020	214,020
Licenses	78,000	-	-	78,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	58,000	-	-	58,000
Electronic lottery	63,000	-	-	63,000
Registration and document certification fees	147,000	-	-	147,000
Other	<u>53,000</u>	<u>-</u>	<u>191,850</u>	<u>244,850</u>
Total revenues from internal sources	7,156,000	-	410,241	7,566,241
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	291,000	-	-	291,000
Federal grants	-	-	3,396,928 <sup>(1)</sup>	3,396,928
Customs	<u>58,000</u>	<u>-</u>	<u>-</u>	<u>58,000</u>
Total revenues from non-Commonwealth sources	<u>349,000</u>	<u>-</u>	<u>3,396,928</u>	<u>3,745,928</u>
Total revenues	<u>7,505,000</u>	<u>-</u>	<u>3,807,169</u>	<u>11,312,169</u>
Other:				
Balance from previous year	106,220	-	348,027	454,247
Bonds authorized	<u>-</u>	<u>425,000</u>	<u>-</u>	<u>425,000</u>
Total other sources	<u>106,220</u>	<u>425,000</u>	<u>348,027</u>	<u>879,247</u>
Total resources	<u>7,611,220</u>	<u>425,000</u>	<u>4,155,196</u>	<u>12,191,416</u>
Appropriations:				
Current expenses:				
General government	841,537	-	56,959	898,496
Education	2,337,485	-	796,260	3,133,745
Health	1,263,702	-	328,567	1,592,269
Welfare	382,807	-	2,049,875	2,432,682
Economic development	171,151	-	68,599	239,750
Public safety and protection	1,264,612	-	61,324	1,325,936
Transportation and communications	72,446	-	11,324	83,770
Housing	20,892	-	117,395	138,287
Contributions to municipalities	300,380	-	2,047	302,427
Special pension contributions	46,410	-	-	46,410
Debt service	446,920	-	92,455	539,375
Other debt service	<u>436,585</u>	<u>-</u>	<u>19,000</u>	<u>455,585</u>
Total appropriations-current expenses	7,584,927	-	3,603,805	11,188,732
Capital improvements	<u>25,915</u>	<u>425,000</u>	<u>160,896</u>	<u>611,811</u>
Total appropriations	7,610,842	425,000	3,764,701	11,800,543
Year-end balance	378	-	390,495	390,873
Total appropriations and year-end balance	<u>\$7,611,220</u>	<u>\$425,000</u>	<u>\$4,155,196</u>	<u>\$12,191,416</u>

(1) Does not include grants received by agencies whose accounting systems are not centralized in the Department of the Treasury.

*Sources:* Department of the Treasury and Office of Management and Budget as reported on March 29, 2001

In the fiscal 2001 budget, revenues and other resources of all budgetary funds total \$11,312,169,000, excluding balances from the previous fiscal year and general obligation bonds authorized. The estimated net increase in General Fund revenues in the fiscal 2001 budget, as compared to the fiscal 2000 budget, was accounted for by increases in personal income taxes (up \$215,934,000), corporate income taxes (up \$14,138,000), Federal excise taxes on off-shore shipments (up \$45,250,000), general excise tax of 5% (up \$73,438,000), excise tax on motor vehicles and accessories (up \$51,005,000), special excise tax on certain petroleum products (up \$45,214,000), registration and documentation fees (up \$21,144,000), excise tax on alcoholic beverages (up \$21,626,000), and decreases in tollgate taxes (down \$17,130,000) and income tax withheld from non-residents (down \$32,276,000).

Current expenses and capital improvements of all budgetary funds total \$11,800,543,000, an increase of \$760,761,000 from fiscal 2000. The major changes in General Fund expenditures by program in fiscal 2001, as compared to the fiscal 2000 budget, were: increases in education (up \$240,844,000), general government (up \$129,339,000), public safety and protection (up \$95,263,000), health (up \$55,602,000), debt service (up \$36,874,000), other debts (up \$30,460,000), contributions to municipalities (up \$6,567,000), special pension contributions (up \$6,908,000), housing (up \$1,306,000), and decreases in transportation and communications (down \$5,294,000), welfare (down \$6,257,000), and economic development (down \$43,481,000).

Although General Fund Revenues were budgeted at \$7,611 million, including a \$106 million balance from the previous year, actual revenues collected were only \$7,056 million (including such beginning balance), representing a reduction of \$555 million from the amount budgeted. The reasons for this reduction in revenues is explained in "Summary and Management Discussion of General Fund Results - Preliminary Fiscal 2001 Compared to Fiscal 2000" in *Puerto Rico Taxes, Other Revenues and Expenditures*. General Fund Expenditures were budgeted at \$7,611 million, but were actually \$7,775 million, or \$164 million higher. The excess expenditures from the budgeted amounts were mainly in the areas of education, health and the correctional system. The difference between revenues and expenditures of approximately \$718 million was covered by: (i) measures taken by OMB to reduce expenditures and apply available surpluses which together are estimated at \$176 million, (ii) the financing of certain deposits to the Redemption Fund (ordinarily made from General Fund moneys) in the amount of approximately \$164 million, and (iii) loans from GDB.

The general obligation bond authorization for the fiscal 2001 budget was \$425,000,000.

## Fiscal 2002 Budget

The following table presents a summary of the Commonwealth budget for the fiscal year ending June 30, 2002:

<b>Commonwealth of Puerto Rico</b>				
<b>Summary of Central Government Annual Budget</b>				
<b>Fiscal Year Ending June 30, 2002</b>				
<b>(in thousands)</b>				
	<b>General Fund</b>	<b>Bond Fund</b>	<b>Special Funds</b>	<b>Total</b>
Revenues from internal sources:				
Property taxes	\$ 0	\$ -	\$ 104,412	\$ 104,412
Personal income taxes	2,687,000	-	-	2,687,000
Retained non-resident income tax	670,000	-	-	670,000
Corporate income taxes	1,612,000	-	-	1,612,000
Partnership income taxes	3,000	-	-	3,000
Tollgate taxes	36,000	-	-	36,000
17% withholding tax on interest	15,000	-	-	15,000
10% withholding tax on dividends	40,000	-	-	40,000
Inheritance and gift taxes	2,000	-	-	2,000

	<b>General Fund</b>	<b>Bond Fund</b>	<b>Special Funds</b>	<b>Total</b>
Excise taxes:				
Alcoholic beverages	242,000	-	-	242,000
Motor vehicles and accessories	414,000	-	-	414,000
Cigarettes	119,000	-	-	119,000
Special excise tax on certain petroleum products	20,000	-	-	20,000
General 5% excise tax	580,000	-	-	580,000
Slot machines and machines for entertainment	-	-	-	-
Other	76,000	-	126,320	202,320
Licenses	79,000	-	-	79,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	56,000	-	-	56,000
Electronic lottery	61,000	-	-	61,000
Registration and document certification fees	143,000	-	-	143,000
Other	<u>70,000</u>	-	<u>212,566</u>	<u>282,566</u>
Total revenues from internal sources	6,925,000	-	443,298	7,368,298
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	280,000	-	0	280,000
Federal grants	-	-	3,416,511 <sup>(1)</sup>	3,416,511
Customs	<u>40,000</u>	-	<u>0</u>	<u>40,000</u>
Total revenues from non-Commonwealth sources	<u>320,000</u>	-	<u>3,416,511</u>	<u>3,736,511</u>
Total revenues	<u>7,245,000</u>	-	<u>3,859,809</u>	<u>11,104,809</u>
Other:				
Other Income	220,328	-	0	220,328
Balance from previous year	378	-	390,495	390,873
Bonds authorized	<u>-</u>	<u>475,000</u>	<u>-</u>	<u>475,000</u>
Total other sources	<u>220,706</u>	<u>475,000</u>	<u>390,495</u>	<u>1,086,201</u>
Total resources	<u>7,465,706</u>	<u>475,000</u>	<u>4,250,304</u>	<u>12,191,010</u>
Appropriations:				
Current expenses:				
General government	917,704	-	55,986	973,690
Education	2,289,782	-	819,428	3,109,210
Health	1,016,035	-	335,710	1,351,745
Welfare	365,907	-	2,092,769	2,458,676
Economic development	180,440	-	64,949	245,389
Public safety and protection	1,258,927	-	53,915	1,312,842
Transportation and communications	69,980	-	14,948	84,928
Housing	19,853	-	122,046	141,899
Contributions to municipalities	342,857	-	2,095	344,952
Special pension contributions	50,181	-	0	50,181
Debt service	469,636	-	104,412	574,048
Other debt service	<u>484,404</u>	-	<u>19,000</u>	<u>503,404</u>
Total appropriations-current expenses	7,465,706	-	3,685,258	11,150,964
Capital improvements	<u>-</u>	<u>475,000</u>	<u>165,019</u>	<u>640,019</u>
Total appropriations	7,465,706	475,000	3,850,277	11,790,983
Year-end balance	<u>-</u>	<u>-</u>	<u>400,027</u>	<u>400,027</u>
Total appropriations and year-end balance	<u>7,465,706</u>	<u>475,000</u>	<u>4,250,304</u>	<u>12,191,010</u>

(1) Does not include grants received by agencies whose accounting systems are not centralized in the Department of Treasury.

*Sources:* Department of the Treasury and Office of Management and Budget as reported on June 28, 2001

In the fiscal 2002 budget, revenues and other resources of all budgetary funds total \$11,325,137,000, excluding balances from the previous fiscal year and general obligation bonds authorized. Total General Fund revenues in the fiscal 2002 budget are \$7,245,000,000 compared to \$7,505,000,000 in the fiscal 2001 budget. However, total General Fund revenues in the fiscal 2002 budget are higher than the actual General Fund revenues for fiscal year 2001, which were \$6,951,245,000. The net decrease in General Fund revenues in the fiscal 2002 budget, as compared to the fiscal 2001 budget, is accounted for principally by decreases in corporation income taxes (down \$155,000,000), tollgate taxes (down \$58,000,000), special excise tax on certain petroleum products (down \$50,000,000), personal income taxes (down \$42,000,000), excise taxes on motor vehicles and accessories (down \$27,000,000), general excise tax of 5% (down \$19,000,000), customs revenues (down \$18,000,000), excise taxes on alcoholic beverages (down \$16,000,000) and federal excise taxes on off-shore shipments (down \$11,000,000). These decreases are partly offset by increases in withholding taxes to non-residents (up \$145,000,000) and increases in other miscellaneous non-tax revenues (up \$17,000,000).

Current expenses and capital improvements of all budgetary funds total \$11,790,983,000, a decrease of \$9,560,000 from the fiscal 2001 budget. The major changes in General Fund expenditures by program in fiscal 2002, as compared to the fiscal 2001 budget, are: increases in general government expenditures (up \$76,167,000), other debt service (up \$47,819,000), contributions to municipalities (up \$42,477,000), debt service (up \$22,716,000) and economic development (up \$9,289,000) and decreases in health (down \$247,667,000), welfare (down \$16,900,000) and education (down \$47,703,000). The increase in the general government category is mainly due to increases in salaries and benefits of public employees. General Fund expenditures of \$7,465.4 million in the fiscal 2002 budget are \$309.8 million lower than the actual amounts for fiscal 2001 (without considering the higher than budgeted health insurance costs discussed below). The principal areas where the government expects to reduce costs are education, health, welfare and public safety and protection.

In September 2001, the government announced that, based on negotiations with the several insurance companies that provide health insurance coverage to low income individuals, the projected savings for fiscal 2002 of \$300 million in the cost of health insurance, as compared to fiscal 2001, that were included in the budget will not be achieved. The government expects, however, to achieve savings of \$63 million and to cover the remaining shortfall in the budget of \$238 million through a series of initiatives, among which are the refinancing and restructuring of debt of the Commonwealth at lower interest rates, transfers to the General Fund of available surpluses in various special funds, including a transfer of \$25 million from the Emergency Fund, and increasing the applicable withholding tax for services rendered in Puerto Rico from 7% to 10%. The transfer of moneys from the Emergency Fund and the increase in withholding taxes require the enactment of legislation. See "Summary and Management Discussion of General Fund Results - Estimated Fiscal 2002 Compared to Preliminary Fiscal 2001" in *Puerto Rico Taxes, Other Revenues and Expenditures*.

The general obligation bond authorization proposed for the fiscal 2002 budget is \$475,000,000.

### **Differences between Budget and General Purpose Financial Statements**

Revenues and expenditures, as reported by the Department of the Treasury in its General Purpose Financial Statements, may differ substantially from resources and appropriations in the annual budget for a number of reasons, including the following:

- (i) The budgetary accounts are on a cash basis, while the financial statements prepared by the Department of the Treasury include accruals and other adjustments as required by government accounting standards.
- (ii) Expenditures for current purposes in a particular fiscal year may include amounts appropriated for earlier periods but not previously expended and, conversely, may exclude amounts appropriated for such fiscal year but not expended until later periods.

(iii) Bonds are authorized by the Commonwealth in accordance with a four-year capital improvement program. Since bond sales are determined by bond market conditions and other factors, the amount of bonds sold in any year does not necessarily equal the amount of bonds authorized in the budget for that year. Expenditures for capital improvements are financed by advances from the General Fund to the Capital Projects Fund, which are later reimbursed from proceeds of bond or note sales.

## LITIGATION

The Commonwealth is a defendant in numerous legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of the Legislature of Puerto Rico, approved on June 25, 1955, as amended (“Act No. 104”), persons are authorized to sue the Commonwealth only for causes of actions specified in said Act. The Commonwealth may be liable under Act No. 104 for damages up to a maximum amount of \$75,000 or \$150,000 if the suit involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as provided in Act No. 9 of the Legislature of Puerto Rico, approved on November 26, 1975, as amended (“Act No. 9”), the Commonwealth may provide its officers and employees, including directors of public corporations and government instrumentalities and mayors of the municipalities of the Commonwealth, with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the amount of the judgment that may be paid under Act No. 9.

With respect to pending and threatened litigation, as of June 30, 2000, the Commonwealth included in its financial statements reported liabilities of approximately \$350 million for awarded and anticipated unfavorable judgments. This amount represented the amount estimated at the time as a probable liability or a liability with a fixed or expected due date, which would require future available financial resources for its payment. This amount includes approximately \$200 million of accrued liabilities related to the fines described below. The Commonwealth believes that the ultimate liability in excess of amounts provided in the financial statements, if any, would not be significant.

The Commonwealth is a defendant in approximately three hundred related lawsuits in which the plaintiffs allege a tort claim and violation of their civil rights in connection with the preparation by the government of dossiers on certain individuals. The lawsuits are still in the discovery stage. A petition to certify these claims as a class action has been denied, and such denial has become final. The aggregate amount of damages claimed by the plaintiffs exceeds \$50 billion. The Commonwealth has accepted liability for the claims without renouncing the limitations, immunities and defenses available to it under Act No. 104. The Commonwealth believes that the amount of damages claimed is exaggerated and that the outcome of this litigation will not materially affect the revenues and expenditures of the Commonwealth. The Commonwealth’s financial statements for the fiscal year, which ended June 30, 2000, did not include any provision for liability with respect to these lawsuits.

Several officers of the Commonwealth are defendants in a class action lawsuit filed in 1979 in the United States District Court for the District of Puerto Rico by various inmates who alleged that their constitutional rights were being violated because of overcrowding and lack of adequate healthcare in the island’s correctional system. In 1980, the United States District Court issued a preliminary injunction and required the defendants to provide additional capacity for the cells of the correctional facilities and to improve the healthcare services available to inmates. Fines in the amount of \$280 million have been assessed against the defendants in order to assure compliance with the space and healthcare requirements imposed by the United States District Court. Of the fines imposed, \$150 million have already been paid by the Commonwealth.

# SIDLEY AUSTIN BROWN & WOOD LLP

CHICAGO  
DALLAS  
LOS ANGELES  
SAN FRANCISCO  
SEATTLE  
WASHINGTON, D.C.

875 THIRD AVENUE  
NEW YORK, NEW YORK 10022  
TELEPHONE 212 906 2000  
FACSIMILE 212 906 2021  
www.sidley.com  
FOUNDED 1866

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October 17, 2001

Hon. Juan A. Flores Galarza  
Secretary of the Treasury of Puerto Rico  
San Juan, Puerto Rico

Dear Sir:

We have examined Act No. 1 of the Legislature of Puerto Rico, approved June 26, 1987 (the "Act"), and certified copies of the legal proceedings and other proofs submitted relative to the issuance and sale of the following described notes (the "Notes"):

**\$800,000,000**

## **COMMONWEALTH OF PUERTO RICO**

### **Tax and Revenue Anticipation Notes of the Commonwealth of Puerto Rico Series 2002**

**Dated: Date of Delivery.**  
**Maturing: July 30, 2002.**  
**Interest Rate: 3%.**

The interest on the Notes is payable on July 30, 2002. The Notes are issuable as registered notes in denominations of \$5,000 and any multiple thereof in the manner and in accordance with the terms and conditions of the resolution of the Secretary of the Treasury authorizing the issuance of the Notes (the "Note Resolution"). The Notes are not subject to redemption.

We have also examined one of the Notes as executed and authenticated.

From such examination we are of the opinion that:

1. The Act is valid.

2. Said proceedings have been validly and legally taken.

3. The Notes have been duly authorized and issued to fund a portion of the Commonwealth of Puerto Rico's projected cash requirements for the remainder of the fiscal year ending June 30, 2002, which requirements result from timing differences between expected disbursements and receipts of revenues, and are valid and binding obligations of the Commonwealth of Puerto Rico payable solely from the special fund created by the Act designated "Special Fund for the Redemption of Tax and Revenue Anticipation Notes", to the credit of which Fund the Secretary of the Treasury of Puerto Rico is required by and in the manner set forth in the Note Resolution to deposit all taxes and revenues required to be deposited in the General Fund of the Commonwealth of Puerto Rico received after March 31, 2002 and on or prior to June 30, 2002 plus any balance in the General Fund on April 1, 2002 in respect of taxes and revenues received by the General Fund after the date hereof (and if certain coverage requirements are not met, taxes and revenues so deposited prior to April 1, 2002), subject to certain prior applications as specified therein, sufficient to pay the principal of and interest on the Notes. The full faith, credit and taxing power of the Commonwealth of Puerto Rico are not pledged to the payment of the Notes.

4. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and judicial decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), and the Note Resolution regarding use, expenditure and investment of Note proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the Notes is not includable in gross income for federal income tax purposes, and (ii) the Notes and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation.

Interest on the Notes is not a specific item of tax preference for the purpose of computing the alternative minimum tax on individuals and corporations imposed by the Code. Such interest will, however, be includable in the computation of the alternative minimum tax on corporations imposed by the Code. The Code contains other provisions that could result in tax consequences, upon which we express no opinion, as a result of (a) ownership of the Notes or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is excluded from gross income. No opinion is rendered by us as to the exclusion from gross income of the interest on the Notes for federal income tax purposes on or after the date on which any action is taken under the Note Resolution or any other instrument relating to the Notes upon the approval of counsel other than ourselves.

The Commonwealth of Puerto Rico has covenanted in the Note Resolution to comply, to the extent permitted by the Constitution and laws of the Commonwealth of Puerto Rico, with the requirements of the Code and the regulations promulgated thereunder so that interest on the Notes will remain exempt from existing federal income taxes to which it is not subject on the date of the issuance of the Notes. We are not aware of any provisions in said Constitution and laws that would prevent such compliance.

Respectfully submitted,