



COMMONWEALTH OF PUERTO RICO FISCAL UPDATE

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Tax Reform and Fiscal Programs to Eliminate Structural Budget Deficit on Track to Start in Fiscal 2006-2007

The Commonwealth of Puerto Rico is making steady progress toward achieving the tax reform and fiscal changes necessary to eliminate the structural deficit, as set forth in the historic Joint Resolution approved by the Legislature and signed by the Governor and Executive Order announced November 21, 2005.

Based on a far-ranging fiscal and tax reform program that the Legislature now has under consideration, the objective is to eliminate the current \$1 billion deficit within three years, starting with the fiscal year that begins July 1, 2006. In addition, the program is focused on changing many aspects of how the Government operates so that similar spending issues will be avoided in the future. The program also establishes a more equitable tax base to ensure maximum revenues.

The program is essentially embodied in November's Joint Resolution, which committed the Legislature to adopt tax reform in the current session now underway, and outline reform measures relating to expenditures. It also committed the Government to reduce unfunded pension liability. Following the Resolution's passage, an Executive Order implemented a number of the fiscal control measures.

As in all political processes, there will be some debate, but it is fully anticipated that the new budget, together with the necessary measures, will be approved on schedule by the Legislature. Over the last several days, all major Executive and Legislative leaders have issued public statements reaffirming their commitment to such an outcome. They have also conveyed the message this week in meetings with Standard & Poor's and Moody's Investors Service, the rating agencies covering the Commonwealth.

THE PROCESS IS UNDERWAY

Now, the process of fully addressing the Resolution is underway. A tax bill proposing a broad-based 7% sales tax, with few exemptions, resulting in a more just tax system and substantially improving the financial health of the Government, was submitted by Governor Aníbal Acevedo-Vilá on January 16, 2006. Among its key aspects are:

- Widening the tax base, making the distribution of income taxes and their rates fairer.
- Reducing tax evasion.

- Stimulating savings and work opportunities.
- Shifting the tax burden from income to consumption.
- Eliminating the excise tax in favor of a broad sales tax.

Ten days later the Government, which had already instituted a program to address cost savings, announced a comprehensive 18-point fiscal reform program designed to permanently restore fiscal balance and stability. Its key points call for:

- Legislation to keep public expenditure growth below growth in the economy, including a requirement that all new programs or appropriations authorized by law must identify the funds to cover such expenditures.
- The elimination of all vacant positions from the classification plans of agencies.
- Legislation to encourage, through economic incentives, retirement of eligible public employees, and the determination of the feasibility of similar early retirement programs for certain public corporations and agencies.
- Consolidation of agencies to reduce inefficiencies and redundancy, and wider use of not-for-profit entities that can more efficiently and inexpensively solve specific problems.
- Establishment of a permanent Sunset Commission comprised of eight members from the Executive, Legislative and Private Sector to periodically evaluate programs, incentives and agencies, to eliminate inefficiencies or those that are unnecessary.
- By Executive Order, an Oversight Committee representing all political views will be created to evaluate the budgetary management of the Education Department, which accounts for one-quarter of the total budget.
- Prohibiting use of public debt to cover operational deficits, and the mandatory amortization over a 10-year period of the accumulated deficit loans provided by the GDB.
- Legislation establishing financial integrity by assuring that within 90 days of the fiscal year-end agency and public corporation heads and their financial directors will have to certify every aspect of their financial statements.

THE NEXT STEP

The objective is to have the plan approved and in place by the beginning of the fiscal year 2007, which begins July 1.



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Towards that end, the House Ways and Means Committee will commence hearings on the program on February 6. It expects to conduct at least 70 hearings over a three month period during which a broad spectrum of Puerto Rico's business, financial, industrial, community, economic and government leaders will make presentations.

In March, the Governor expects to deliver a budget proposal for the Legislature's consideration covering the upcoming fiscal year 2007. It will incorporate many features of the proposed reform program. Tax reform is expected to yield approximately \$800 million in additional net revenues, resulting from a projected \$2.1 billion in sales tax revenues (on retail sales of \$32 billion), the excise tax elimination (\$0.6 billion) and middle income tax reductions (\$1.0 billion).

Although over the coming months, the Legislature and the Central Government will have to agree on the final details of the proposed tax reform and spending, the general consensus is that it will pass by the end of this Legislative session.

ACCOMPLISHMENTS TO DATE

The Government, as noted, has been engaged in reducing expenses and enhancing revenues. In one of the more historic accomplishments, the government headcount over the past 12 months has been reduced by 5,251 positions, or 2.5% – the first time in years that the Government work force has not grown and, in fact, has shrunk. Newly instituted control measures have resulted in a 6.9% reduction in expenditures for the first five months of the current fiscal year, and it appears that the increase in expenditures this fiscal year may rise just 2.6%, the lowest in four years, compared to 9% last year. As of December 2005, fiscal year 2006 revenues were \$34 million in excess of budget.

For the full fiscal year ending June 30, 2006, preliminary estimates are that the budget deficit will amount to \$519 million, approximately 84% of it accounted by payroll expenses. Revenues are estimated to exceed budget by \$100 million or more, while expenditures appear likely to total around \$9.5 billion, approximately \$36 million greater than anticipated. The figures do not take into account potential expenditures of roughly \$170 million related to the Health Insurance and Medical Service Administrations, and the Government Retirement System. Approximately \$435 million of the deficit is expected to be met through available reserves of approximately \$135 million, a proposed incentive to taxpayers that is anticipated to yield as much as \$300 million, and additional tax revenues due to economic growth (which last year in-

creased 2.3%) and increased collection efforts expected to generate approximately \$100 million.

THE FINANCING OUTLOOK

The currently anticipated offering calendar through the end of fiscal 2006 totals around \$1.2 billion of government financing. Included would be approximately \$384 million in refinancing notes and \$675 million of general obligation bonds. The GOs are on hold, however, pending the pace of progress in the development of the tax and fiscal reform measures. Among other issues is a GDB medium term note offering of approximately \$2.0 billion that would improve liquidity and reduce GDB's dependence on commercial paper. Of this amount, \$885 million were already placed this Wednesday in the Puerto Rico market. Also moving ahead is a \$430 million revenue issue (based on a room tax) for the newly inaugurated Puerto Rico Convention Center, a world class facility that is expected to enhance the attraction of Puerto Rico for business groups and tourism, and \$165 million for the year-old Coliseum, a multipurpose arena that is already hosting world-class entertainment acts and major professional sporting events, among others. An initial pension obligation issue of approximately \$500 million, still subject to legislative approval, could also come to market.

Meanwhile, GDB's liquidity continues strong, and will be buttressed by the anticipated scheduled repayment of Government debt under the soon-to-be-adopted tax and fiscal program. In fiscal 2005, GDB's total assets were \$10.4 billion, an increase of 13%. Net assets amounted to \$1.96 billion, off slightly from the prior year because of a one-time contribution of \$500 million from GDB's capital to the Special Communities Trust. Total deposits increased 27.8%, to \$4.9 billion, with the number of depositing clients increasing year-over-year from 48 to 85, including a 75% growth in private institutional clients.

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