



COMMONWEALTH OF PUERTO RICO
FISCAL UPDATE

July 11, 2006

Balanced Budget & Tax Reform Signed Into Law

On July 10th, Aníbal Acevedo-Vilá, Governor of Puerto Rico, signed into law the \$9.488 billion balanced budget approved by the Legislature, having previously, on July 4th, signed into law the new tax reform bill as passed by both the House and Senate.

With these steps, the Commonwealth of Puerto Rico:

- Reestablishes fiscal discipline with which it had struggled in recent years,
- Puts the Island on a path to live within its means, and
- Begins the important process of reducing the growth and cost of government while promoting a greater role for private enterprise in providing services and employment.

“The objective of fiscal and tax reform is not only to assure the continued investment grade ratings for our debt, as vital as that is,” said Alfredo Salazar, Chairman of the Board of the Government Development Bank, the Commonwealth’s fiscal agency, “it is also to usher in long term fiscal integrity so that our citizens can benefit from continuing economic growth and stability for generations to come. These actions represent a true and very promising beginning.”

Tax Reform

- The law authorizes a 7% sales tax, with the option, if expected revenues do not materialize, to raise it to 8% after December 2006. The 7% is distributed as follows:
 - 1.5% for the 78 city governments
 - 1.0% for the Urgent Interest Fund
 - 2.0% to substitute existing excise tax
 - 1.0% for Income tax relief to middle income tax payers
 - 1.5% to the General Fund (may be increased by 1%)
- Other non-recurring tax measures related to capital gains and stock options could generate approximately \$1 billion, according to the Legislature, to be spent over the next three years to supplement revenues and offset the Government’s structural operating deficit.

As provided by Act 91, approved in May, 1% of the sales tax will be dedicated to the payment of debt service on the \$6.4 billion of outstanding appropriation debt through a special fund. Through Executive Order, the Governor will create the Urgent Interest Fund as the vehicle for managing this debt.



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- The Tax Reform measure is expected to be amended to provide further tax relief to low and middle income tax payers in future legislative sessions, as the new Sales Tax is collected.
- The new bill withstood a last minute challenge by the House that was rejected by a 5 to 1 decision of the Supreme Court and moves Puerto Rico strongly towards the reforms and policies credit agencies and investors were advocating.

Fiscal 2007 Budget

- The Government's budget for FY 2007, which began July 1, 2006, authorizes expenditures of \$9.488 billion, and will be balanced with similar revenues.
- Last year's budget was carried over from the previous years as provided by the Constitution, because the Governor vetoed it due to an imbalance between revenues and expenditures. The result was a total expenditure of \$9.683 billion or \$738 million more than revenues. This amount was covered by a loan from GDB authorized by the legislature in May.

GDB's Assessment

- The new fiscal and tax reform laws puts the Government's finances on more solid footing, which, together with concerted administrative programs to reduce Government expenditures, is expected to reflect greater fiscal discipline.
- One of the immediate effects should be that Puerto Rico maintains its current investment grade ratings, and over time sees its credit standing improve.
- Current plans call for Puerto Rico to move forward with a \$1.043 billion General Obligation bond issuance, which will gauge market reaction to the improved financial and economic environment in the Commonwealth, and provide more liquidity to the Government Development Bank by reimbursing over \$600 million already advanced to the Public Improvement Fund.

Economic Outlook

- The Puerto Rico Planning Board has recently published revised real growth estimates of around 1.2% for GNP in fiscal 2006, compared to 2.2% previously estimated in January 2006, and 0.6% (4.6% nominal) for fiscal



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- 2007, versus 2.5% estimated earlier.
- The Planning Board stated the revisions reflect economic changes over the first six months of calendar 2006, including higher oil prices, increased interest rates and more moderate growth of the U.S. economy, as well as reduced exports and lower investment in construction, particularly public construction.
 - The revised projections also reflect the general uncertainty caused by Puerto Rico's fiscal condition, the partial shutdown of the Central Government, and the extended time taken to produce a tax reform that would provide tax relief, stimulate investment, and allow for more efficient revenue collections. Also, the downgrade of Commonwealth bond ratings had a dampening effect.
 - The impact of the revised economic growth rates may be reflected in lower revenues for fiscal 2007, since the Secretary of the Treasury had revised fiscal 2007 revenue projections downwards by \$200 million before enactment of the sales tax.
 - The Planning Board will now provide quarterly revisions based on the new Coincident Economic Activity Index (CEAI) which allows for monthly measurements of changes in the GNP growth rate. The next revision is scheduled for this coming September.

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