

March 17, 2008

Puerto Rico's Proposed Budget: Improved Expenditure Controls, But Balance Remains Elusive

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DALLAS (Standard & Poor's) March 17, 2008--The general obligation rating of 'BBB-/Stable' on the debt of the Commonwealth of Puerto Rico is not immediately affected by Gov. Anibal Acevedo Vilá's projection of a \$1 billion structural imbalance in his proposed fiscal 2009 budget. In our downgrade of the commonwealth's GO rating to 'BBB-' from 'BBB' in May 2007 we cited the continuing difficulties with reducing the accrued deficit, and our expectation that the commonwealth's goal of a structurally balanced budget by fiscal 2010 would be difficult to achieve. We anticipated structural imbalance persisting.

From a credit perspective, the most important element of the budget proposal--the updated financial projections for the current 2008 fiscal year--estimates a general fund structural deficit of \$556 million, or about 6% of general fund expenditures. The projected structural deficit is primarily the result of an underperformance in revenues (mostly income tax revenues), which are projected to end the year \$406 million below budget. The commonwealth is planning to close the gap by collecting approximately \$287 million in pending reimbursements from the U.S. Department of Education, and by increasing efforts to collect back taxes of up to \$60 million. The budget

says the remaining \$209 million gap will be covered by additional budget cuts, cash management strategies, and a potential refunding of outstanding debt to generate debt service savings.

PERSISTENT RECESSION WILL AFFECT REVENUE GROWTH

While having chronic budget deficits is not new for Puerto Rico, the nature of the deficit in the past two fiscal years has been substantially different from years prior. In the late 1990s and early 2000s the budget deficit was primarily the result of lax expenditure controls and a ballooning payroll. However, since the budget impasse that led to the government shutdown and the adoption of the Fiscal Reform Law of 2006, expenditure controls have improved, while revenue projections have been off due to the island's economic recession.

The fiscal 2009 budget marks the third consecutive year in which budgeted expenditures are below the fiscal 2006 level. However, the commonwealth's efforts to achieve fiscal balance have come at a price. Given the dominant role that public spending has on the island's economy, the reduction in government spending coupled with the implementation of a sales and use tax and significant increases in fees for public services triggered the island's current recession. The prospect of continued high energy prices and a recession in the continental U.S. don't bode well for Puerto Rico either, particularly if the recession affects sectors that had remained relatively stable such as tourism and services. We expect the Puerto Rico Planning Board to revise downward by a significant margin its Gross National Product (GNP) growth projections, which indicated a 0.8% decline for fiscal 2008. The economic stimulus package recently approved by the U.S. Congress is expected to inject almost \$1.2 billion into the commonwealth's economy. The commonwealth has also adopted its own local economic incentive package, which includes roughly \$243 million in income tax relief in fiscal 2009, and \$220 million in tax credits on the purchase of new homes. These measures will provide some relief, but might not be enough to avoid a decline in revenue targets for fiscal 2009.

The \$1 billion revenue gap in the proposed fiscal 2009 budget can be largely attributed to slower tax revenue growth, particularly in income tax receipts, which are budgeted to be approximately \$464 million lower (9.2%) than the fiscal 2008 budgeted level. The budget shows recurring general fund revenues reaching \$8.8 billion dollars, or roughly 2.7% below the fiscal 2008 budget. Commonwealth officials attribute the economic recession largely to the implementation of the sales and use tax (SUT). However, from a fiscal perspective, the SUT has performed better than anticipated. For the first six months of the current fiscal year, SUT collections reached \$486.5 million, or approximately 2% above budget. The fiscal 2009 budget estimates SUT collections of \$977 million, 7.2% above estimates for fiscal 2008. Gov. Acevedo is expected to introduce legislation that would suspend the 4.5% general fund SUT and substitute it with a 6.6% excise tax. The extent to which the proposed shift in taxes meets the long-term revenue generating potential of the existing SUT will determine the impact, if any, that this proposed legislation would have on the commonwealth's budget and credit quality.

FILLING THE GAP

The proposed fiscal 2009 budget includes two non-recurring revenue measures to fill the \$1 billion projected gap. The administration is planning to obtain up to \$500 million in financing secured by delinquent taxes receivable. The treasury department has identified approximately \$1.3 billion in receivables that are less than five years past due. The second proposed revenue source is the concession of the electronic lottery, which is expected to generate an additional \$500 million in revenues in fiscal 2009. The proposed concession is expected to generate up to \$3 billion in lease/concession proceeds. The approval of the concession requires legislative approval.

Given the commonwealth's limited flexibility in cutting expenditures below existing levels, recurring revenues will be the credit focus in fiscal 2009, along with the extent to which the recession or an inadequate tax structure forces commonwealth officials to seek non-recurring revenue measures or increased borrowing to balance the budget.

PUERTO RICO'S STRUCTURAL BUDGET GAP

	FY2006	FY2007	FY2008	FY2009
Recurring revenues	8,545	8,621	8,671	8,488
Recurring expenditures	9,964	9,367	9,227	9,488
Structural gap	1,419	746	556	1,000

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