

# **Background Paper for the Timor-Leste and Development Partners Meeting**

Dili, 18-19 May 2004



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## EXECUTIVE SUMMARY

*Timor-Leste has made impressive progress in implementing the NDP.*

*Although projections of the financing gap have been reduced, in the face of uncertain oil and gas revenues the Government asks development partners to extend the Transition Support Program through FY06 and FY07.*

*Sector Investment Programs will be finalized by August, 2004.*

*Government has identified a range of measures to strengthen good governance.*

*Exit strategies are needed for areas vulnerable to the reduced international presence.*

Since the last Timor-Leste and Development Partners Meeting (TLDPM) in December, ***Timor-Leste has made commendable progress in implementing the National Development Plan.*** Among the most notable achievements are the adoption by Parliament of the Organic Law for the Provedor dos Direitos Humanos e Justiça and the Public Service Statute, both key to building a transparent and accountable public sector. The Government has also implemented a host of measures to improve the efficiency of public spending. With the installment of 7,500 prepaid electricity meters, it has made a breakthrough in cost recovery in the power sector; this is a considerable achievement for an area that has been very problematic.

***The projected financing gap for the next 4 years has been reduced from USD 126 million to about USD 30 million***, as the result of Government efforts, and a projected increase in oil and gas revenues. A small portion of this reduced gap (USD 1.7 million) comes from increased contributions from development partners, including exchange rate changes. The Government has improved tax administration and proposes much reduced growth in expenditures, together contributing about USD 40.5 million to the reduced gap. Bayu-Undan oil and gas production has accelerated, and combined with a surge in oil prices, this results in projected oil and gas revenues that are about USD 53.8 million higher than those presented at the December TLDPM. However, ***oil and gas revenues are subject to tremendous uncertainties*** in the range of USD 100 million, both on the upward and the downward side. Hence a low and high case scenario for FY05-08 are associated with a financing gap of USD 138 million and a surplus of USD 90 million, respectively. In face of these uncertainties, ***the Government would like to maintain its request for extending TSP to FY06 and 07 at levels similar to the current contributions by development partners.***

The Government would like to ***align the combined sources budget fully to the NDP.*** To this end, it is preparing ***Sector Investment Programs*** (SIPs) for fourteen sectors, clarifying sector goals, policy and strategy, and medium term expenditure programs. The SIPs will be finalized by August and presented at the December 2004 TLDPM.

Timor-Leste's Constitution provides for essential checks and balances, safeguards and citizen's rights, and separation of powers. Progress has been made in adopting the legislative framework associated with this governance architecture. It is now crucial to translate this into well-functioning and fully autonomous institutions. It is equally important to address emerging problems of corruption and mismanagement before they become entrenched.

UNMISSET has been extended until May 20, 2005, and will wind down with a much smaller mission; thus, it will be important to ***identify those areas that will be especially vulnerable to the continued reduction in international presence, and actively identify exit strategies linked to medium-term institution and capacity building plans.*** These areas include law and order (for which an extensive strategy is already being prepared), public resource management, justice and road transport.

## DEVELOPMENTS SINCE LAST MEETING AND PLANS FOR THE FURTHER IMPLEMENTATION OF THE NATIONAL DEVELOPMENT PLAN

*Considerable progress has been made since December 2003, with major achievements in public expenditure management.*

*Priority actions for the coming fiscal year have been included in the action matrix for TSP III, the third annual budget and balance of payments support program totaling USD 30 million.*

*The economy declined by an estimated 2 percent in 2003, implying a drop in per capita gross national income of 5 percent.*

*Inflation declined to 3 percent in March 2004; the trade deficit has narrowed but remains large.*

Since the last Timor-Leste and Development Partners Meeting, the Government has squarely maintained its focus on implementing the NDP. Achievements have been made across the board. Consistent with the Government's announcements during the December TLDP, considerable efforts have been made in improving public expenditure management<sup>1</sup>, including in the electricity sector. This is a major achievement. The challenge of sustaining poverty reduction while maintaining good governance is daunting, and the Government is especially aware of the short window of opportunity for critical action.

In addressing the challenges over the next fiscal year, agencies will be steered by their FY05 Annual Action Plans (AAP), which are based on the NDP. Progress against the AAPs is monitored by the Quarterly Reporting Matrix (QRM). The most pressing among the AAP actions are collected in the action matrix of the Third Transition Support Program and constitute the basis for a USD 30 million budget and balance of payments support program. As with its predecessor programs, TSP III will be financed entirely on the basis of grants provided by Australia, Canada, Finland, Ireland, New Zealand, Norway, Portugal, Sweden, the United Kingdom, the United States of America, and the World Bank, and is supported by technical assistance from these same development partners as well as the Asian Development Bank, China, Japan, Malaysia, UNMISSET, UNDP and UNICEF. The status of progress of actions under TSP II is reported in Annex I, and the proposed action matrix for TSP III is presented in Annex II.

### Macro-economic Developments and Outlook

Following a moderate increase of 2 percent in real GDP in 2002, *the economy is estimated to have declined by 2 percent in 2003, implying a reduction in Gross National Income per capita of about 5 percent from 2002 to USD 430.*<sup>2</sup> The slowdown of economic growth is the expected consequence of the winding down of UNMISSET, the associated decline in international presence and the dwindling pace of reconstruction activities. Urban areas are impacted most by the economic downturn, as it affects predominantly the services and construction sectors. The unemployment rate is at least 20 percent among urban males, and reaches at least 43 percent among urban male youth.

On a year on year basis *inflation* declined to 3 percent in March 2004, and is expected to vary between 2 and 3 percent in the medium-term. While the *trade deficit* remains large, it has narrowed to about 50 percent of GDP. Total exports for 2003 are estimated at USD 7 million,

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<sup>1</sup> For details, see the section on resource utilization and mobilization, pages 10-17.

<sup>2</sup> GDP has not been measured since 2000, and the first population census will be launched in mid 2004. Hence estimates of GDP and GDP per capita are tentative.

up from USD 6 million in 2002. Imports have declined substantially from USD 261 million in 2001 to USD 174 million in 2003.

*Real GDP is expected to increase modestly in 2004.*

Looking toward the future, ***real GDP is expected to increase modestly by 1 percent in 2004***, largely on account of the recovery of the agriculture sector, which in aggregate is expected to compensate for the further winding down of the international presence. The development of the Bayu-Undan petroleum field has accelerated since December, and the liquids phase is expected to be in full production by the end of 2004. The Government has just completed the first round of ***negotiations on the maritime boundaries*** with Australia, with the next round scheduled for September. To safeguard Timor's future, it is important that these negotiations conclude swiftly and fairly, and that in the interim no actions be taken that might prejudice the rights of either party.

### **Financial and Private Sector Development, Job Creation, Agriculture and Infrastructure**

To make a significant dent in income poverty and unemployment, GDP growth rates need to rise well above current levels and must exceed the population growth rate, currently estimated at 3 percent. Fostering private sector investment, enhancing food security, encouraging private initiative in the agriculture sector, and ensuring access to power and well-maintained roads are all crucial in achieving this goal.

*The expansion of the financial sector continues*  
...

***The expansion of the financial sector continues***, and bank deposits have now reached approximately USD 74 million, up from USD 65 million in December 2003. More importantly, bank lending has almost tripled over the same period, with a loan portfolio amounting to about USD 30 million and loan sizes averaging between USD 1,000 and 10,000. Financial services outside of the capital are still largely lacking. The Instituição de Microfinanças de Timor-Leste and five other micro-finance institutions active in various districts have deposits and outstanding loans totaling about USD 1 million. The size of the individual loans issued by micro-finance institutions is often below USD 100 and seldom reaches above USD 1,000.

*... and significant progress has been made in preparing the enabling legislation for the private sector ...*

To allow more of Timor-Leste's sizeable savings to be re-invested in the economy and to attract foreign investment, the country needs a transparent private sector regulatory framework. Significant progress has been made in preparing the ***enabling legislation for the private sector***, of vital importance to future job creation. The Law on Commercial Societies was promulgated, and draft domestic and foreign investment laws have been tabled to the Council of Ministers. Draft laws on insurance and bankruptcy have been prepared. Yet the business registration system appears to have become less transparent and more lengthy, and may constitute a significant impediment to accelerated investment. In the context of the implementation of the Law on Commercial Societies, the Government will need to review the business registration process. It may also want to conduct an analysis of bureaucratic impediments to doing business. Following the promulgation of the Law on the Juridical Regime on Immovable

*... although the business registration system appears to have become more lengthy and less transparent.*

Property in early 2003, draft laws for the leasing of private and Government property as well as draft law for land and property dispute mediation are being analyzed by the Council of Ministers. The Government intends to launch a forum of dialogue with the private sector, which will meet every six months.

*Business training and mentoring was launched, preparations for an emigrant workers program continue, and the community based roads maintenance program is expected to be re-started soon.*

A program of **business training and mentoring** was launched in four Business Development Centers in Dili, Baucau, Maliana and Oecussi. Since January 2004, a total of 250 people attended training in entrepreneurship development and market management. Among the participants, 30 percent were under 30 years old, and 29 percent were women. The Government continues to pursue an **emigrant workers program**, and hopes to send a first group of 500 workers to Malaysia in the course of FY05, with contacts being established in South Korea as well. The **community based roads maintenance program** created around 500 annualized jobs in the first half year. It was unfortunately interrupted in January but is expected to be launched again soon.

*A policy and strategic framework for agriculture, fisheries, and forestry is under discussion.*

In **agriculture, fisheries, and forestry**, the Government has prepared a policy and strategic framework as a precursor to the finalization of the SIP. The policy is under discussion by the Council of Ministers and focuses on food security and the capturing of high-valued export or import substitution markets, which may include coffee, vanilla, coconut oil, and cattle fattening. The Government has continued its highly successful livestock vaccination program with the completion of the 2003 hemorrhagic septicemia campaign for cattle and buffalo, implemented by 190 private livestock workers who received their second round of training. The Government also adopted a decree law allowing the piloting of fisheries licensing in the next fiscal year.

*Installment of pre-paid electricity meters gained momentum, and the tender process of fuel acquisition is expected to result in further savings and reduced subsidies to the power sector.*

A management contractor for the **Power** Authority began functioning in March 2004. The installment of 10,000 pre-payment meters gained considerable momentum following a successful information campaign, with 7,500 meters installed by the end of April. The Government has also launched a call for expressions of interest for a fuel acquisition tender, which is expected to result in a marked reduction in the fuel purchasing price, and further reductions in the subsidies to the power sector. It is expected that these achievements will have a considerable effect on the financial position of the Power Authority and will allow for a gradual reduction in the highly regressive Government subsidies to the sector. However, to match these results it is important that Government agencies set an example by settling their electricity bills in a timely fashion. Additionally, two pilot projects are to be launched to use on-shore oil and gas for power production, allowing Timor-Leste to explore earning carbon-credits under the Kyoto agreements.

*Concerns are high regarding road maintenance, and this warrants increased attention in FY05.*

Considerable **concerns have arisen regarding road maintenance** in view of the imminent departure of the Japanese Engineering Group, and compounded by the unfortunate interruption of the community based roads maintenance program. This is an area that warrants increased attention over the next fiscal year.

## Health, Education, and Veterans and Ex-Combatants

*Several critical pieces of legislation for the health sector have been adopted.*

*Health service delivery systems are showing results including improved immunization rates and an increase in attended births, although there is variability in service outputs across districts.*

*The national education policy is under discussion*  
...

*... but budget execution in the sector is poor and needs attention.*

*The national registration process for armed veterans and ex-combatants was completed by the two commissions (CAAC and CAVF), and the final report will be presented to the President in May 2004.*

Following the adoption by the Council of Ministers of the overall **health** policy framework in early 2003, several important pieces of legislation have been adopted, including the Organic Law of the Ministry of Health, the Basic Law for Health, and the Law creating the Autonomous System for Drugs and Health Equipment. In March 2004 quarterly vaccination rates for DPT3 and measles reached 71 and 66 percent, respectively, compared to 59 and 55 percent in March 2003. In the same period, births attended by qualified personnel increased from 42 to 45 percent, and outpatient visits per capita from 1.6 to 2.15.<sup>3</sup> While these achievements are most encouraging, the utilization rate for public health services remains low by regional standards and there is a wide variability in service outputs among districts. In overcoming these challenges the SIP will be an important instrument in keeping the assistance of all health sector donors focused on the sustainable delivery of priority services.

In **education**, the Ministry has focused on drafting a National Education Policy following the National Education Congress held at the end of October 2003. The policy is currently under discussion in the Council of Ministers and will be the basis for an Education Law and SIP. This is a very critical step forward, as a clearly articulated policy will allow for much improved donor coordination in the sector. However, the Ministry urgently needs to address slow budget execution. At the end of March 2004, actual expenditures and commitments in goods and services for the Ministry of Education added up to only 41 percent of their annual budget appropriation, compared to 63 percent for the Government as a whole. At the same time, schools are operating without learning materials and are introducing school fees to cover some costs. The Ministry has indicated its intention to take pro-active steps on budget execution; further, the Ministry will pilot a program of block-grants to schools, allowing them to be directly responsible for part of the sector's expenditures.

Two commissions created by the President with the full support of Government, one for ex-combatants of the 1975-79 period (CAAC) and one for Falintil veterans from the 1981-99 period (CAVF), have completed a **national registration process for all armed veterans and ex-combatants**. Over 36,000 veterans and ex-combatants were registered and identified. Claims were verified by posting lists of names, and then receiving complaints, corrections and counter-claims in December 2003 and January 2004. Public debates on the criteria for definition as a veteran were held in 25 locations across the country during the month of February 2004. The Commissions will present a final report, including recommendations for criteria accompanied by a database and provisional list, to the President by mid-May 2004. It will

<sup>3</sup> The accuracy of the health indicators may suffer from inaccurate measurement of the crude birth rate, a data problem that can only be addressed after the completion of the Census scheduled to be launched in mid-2004. Nevertheless, it is clear that there is an improving trend for all indicators.

*A similar process for the “cuadro civil” and “clandestinos” may be considered.*

then be important to decide who will produce the final list, what will be the ultimate institutional home and future uses of the database, and how people may correct personal data or appeal exclusion from the final list. This will be followed by the definition of a policy of recognition, commensurate to the country’s resources. Timor-Leste may consider a similar registration, identification, and policy definition process for the recognition of the “cuadro civil” and the “clandestinos”, not in the least because these categories of resistance fighters include many women and youth who were – by virtue of its mandate – not captured by the CAAC-CAVF process.

## **Governance**

*Government has taken important steps to complete the architecture of governance as set out in the Constitution . . .*

The Government underlined its commitment to good governance and to minimizing corruption by requesting the preparation of a ***governance issues paper***, which is attached to this document as Annex III and has served as a basis for dialogue on governance issues in the preparation of TSP III. Timor-Leste’s Constitution provides for essential checks and balances, safeguards and citizen’s rights, and separation of powers. Considerable progress has been made in preparing and adopting the legislative framework associated with the Constitutional governance architecture. It is now important to translate this legislation into well-functioning and fully autonomous institutions. In order to achieve the checks and balances envisioned in both the Constitution and the NDP, Government may wish to consider measures ensuring that independent institutions have statutory budgets approved by Parliament; maintaining proper channels of communication; respecting the separation of powers; and creating an enabling environment for media, civil society and business. Leadership will be critical to the credibility of good governance and anti-corruption efforts, especially in a context where not all independent constitutional powers are fully effective yet. Hence it is important that Government’s resolve to stamp out mismanagement and corruption be backed up by demonstrating that members of Government make decisions that are free from conflict of interest and are subject to the same standards of performance and disciplinary procedures applied to the rest of the administration.

Since the last TLDPM, the Government has taken important steps to ***complete the governance architecture set out in the Constitution***. The Law on Political Parties was promulgated. The Organic Law for the Provedor dos Direitos Humanos e Justiça was approved by Parliament and is expected to be promulgated imminently, as was the Organic Law on the Office of the Presidency; the latter paves the way for the establishment of the Superior Council of Defense and Security and the Council of State. The Organic Law for the Prosecutor General has been submitted to the Council of Ministers, and a Defense Act is under preparation. It will be important that these legislative steps be completed and that the independent institutions being created be sufficiently well resourced to fulfill their important functions.

Given the very limited availability of human resources in the justice sector, the Government wants to focus first on the improved functioning

... although severe constraints on human resources in the Justice sector require a delay in the creation of the higher courts.

Government is finalizing the laws that create the basic framework for accountability for the use of public resource ...

... and these will be complemented by laws specifically governing the oil and gas sector.

The broad framework for public sector management is laid out in the Public Service Statute, adopted recently by Parliament ...

... and Government is preparing legislation and regulations governing disciplinary actions.

of the courts of first instance and the court of appeals to ensure access to justice in the districts. In this context the creation of the higher courts provided for in the Constitution, such as the Supreme Court and the High Administrative, Tax and Audit Court, is considered premature. Nevertheless, it would be important to consider whether some of the functions of the higher courts, such as the independent audit of Government accounts, could be established under transitional arrangements.

With respect to **public expenditure management**, the Government is finalizing the Budget and Financial Management Law and expects to submit it to Parliament together with the FY05 Budget Law. The Government is also finalizing a Procurement Decree Law. These legislative pieces are crucial for establishing the **basic framework for transparency and accountability in the use of public resources, including oil and gas revenues**.

These laws will be complemented by a set of **laws specifically governing the exploitation of petroleum and the use of oil and gas revenues**, expected to be submitted to Parliament in the course of FY05. These will include: the Petroleum Mining Code and the associated model production sharing contract for the Joint Petroleum Development Area; a code and model contract for the petroleum production areas outside the JPDA; the Petroleum Taxation Law; and the Petroleum Fund Law. The Petroleum Fund Law will establish a savings policy and governance arrangements for a savings fund. It will be important to hold broad-based consultations on the mechanisms through which the nation's petroleum revenues will be managed and saved for the benefit of future generations. Timor-Leste is already applying sound principles to the management of oil and gas revenues; the Government has indicated its support of the **Extractive Industries Transparency Initiative (EITI)** and participated in the London EITI Conference on June 17<sup>th</sup> 2003. The Government is currently adhering to EITI guidelines in its financial reporting, and may wish to become one of the first countries to receive assistance under the initiative.

In the area of **public sector management**, the Public Service Statute was adopted by Parliament and is expected to be promulgated soon. The Statute lays out the broad framework for disciplinary regulations, and, as a priority, the Ministry of State Administration intends to issue supplementary legislation laying out the disciplinary procedures for serious infractions. It will also be important to clarify certain concepts and principles such as the prohibition on gifts, and conflict of interest clauses, especially with respect to the acceptable involvement of public servants in political activities. This will allow a consistent application of disciplinary action and will protect Government from perceptions of political partisanship in enforcement of discipline. The Government may want to consider an options study for the declaration and registration of assets and income applicable to members of Government, Parliament, and other appointees in sovereign institutions, as well as high-level civil servants. Implementing such declarations would help to reassure the

public that no-one is benefiting improperly from office, and to effectively implement conflict of interest rules.

The Ministry of State Administration has made a commendable effort to build a **filing system for Government personnel**. So far 3,500 out of a total of about 17,000 files have been constituted but progress is very slow. The lack of a comprehensive and computerized personnel registry constitutes a serious fiduciary risk for the Government and will require urgent attention over the next fiscal year.

*The draft Organic Law for the Office of the Inspector General is being discussed ...*

With respect to **internal control**, a draft Organic Law for the Office of the **Inspector General** has been prepared. Its finalization will strengthen the OIG by, among others, clarifying procedures for the referral of alleged criminal cases to the Prosecutor General. The Office has also indicated its willingness to resume publishing summary reports on its investigations and on the implementation of its recommendations, with appropriate treatment of cases *sub judice*. Both the Office of the Inspector General and the Internal Audit unit of the Ministry of Planning and Finance have identified alleged cases of criminal mismanagement, and three such cases were referred to the Office of the Prosecutor General by the Office of the Prime Minister. According to the Office of the Inspector General, **areas of high risk to corruption or mismanagement** include customs, procurement, public works, petty cash management, and recruitment. Other areas vulnerable to corruption are business registration and natural resource exploitation. Timor-Leste signed the UN Convention against Corruption in December 2003, and it is important that the convention be ratified in a timely fashion to launch its implementation. Timor-Leste may also want to consider surveys to better document the scope and magnitude of the current corruption problem and help establish a baseline against which future process can be gauged.

*... and the Organic Law for the Provedor has been passed by Parliament and is being promulgated.*

The imminent promulgation of the Organic Law of the Provedor dos Direitos Humanos e Justiça is an important step in **creating a framework to safeguard public integrity and human rights**. Once created it will be crucial that the Office of the Provedor be adequately resourced to fulfill its important mandate throughout the territory. While Timor-Leste currently lacks the human resources needed to create a full-fledged High Administrative, Tax and Audit Court, the Government may want to undertake an options study to identify a path allowing a transition to independent auditing arrangements. Currently the Government's accounts are audited by a private external auditor recruited by the Ministry of Planning and Finance. Similar arrangements under the supervision of a State institution independent from Government would better reflect the spirit of the Constitution.

*The Suco Elections Law was promulgated, and phased elections are expected to be launched around October 2004.*

In view of **legitimizing community authorities**, a Suco Elections Law was promulgated, and the associated National Electoral Commission was sworn in. Accompanying legislation on the composition and competencies of Suco Councils has been promulgated as well, establishing the councils' role in community development. Electoral registration is scheduled to start around mid-year, followed by phased

elections starting with the border districts around October. Following the completion of a **local government** options study and a comparative analysis of Uganda and Cape Verde, the Ministry of State Administration is preparing a report identifying two options, after which it would be desirable to plan a gradual and phased introduction of local administrative structures starting with the elaboration of a policy which can serve as the basis for broad-based consultation.

*The Superior Council for the Judiciary is in operation, and the direct administration of budgets by courts and prosecutors will begin in FY05.*

In **justice**, the Superior Council for Judiciary (SCJ) continues its operations. Starting with fiscal year 2004-05 the budgets for the courts and the prosecution will be administered directly by the SCJ and the Office of the Prosecutor General, respectively; this is expected to improve budget execution and reduce administrative delays. Despite some progress, the Justice system remains the weakest branch of Timor-Leste's governance architecture. All justice institutions remain understaffed, the capacity of the actors remains limited, and essential case management and administration systems are not in place.

*Despite progress, the justice system remains the weakest branch of Timor-Leste's governance architecture.*

It will be important to process soon the Organic Law for Public Defenders and Public Prosecution, allowing for the creation of the Superior Council for Prosecutors. The appointment of a Judge Secretary and Inspector will allow the SCJ to function adequately and to commence inspections. Most of all there is an urgent need to reduce the backlog of cases. Several factors are important in this context, including the definition of a clear policy on which cases should proceed; the establishment of a case management system; the opening of the district courts in Suai and Oecussi; and the improved administration of the courts and the Public Prosecutors' office.

*The final handover of law and order responsibility to the national police force will occur on May 20, 2004.*

On May 20, 2004, executive authority will be transmitted from UNPOL to PNTL, completing the handover of **law and order** services to the national police force. The UNMISSET successor mission is expected to bring continued support to security services through 42 military liaison officers, 157 civilian police advisors, an infantry battalion of 310 peacekeeping forces, and an intervention force of 125 police officers. Recurrent tensions between the police and army, most recently during a confrontation in Los Palos in January, underscores that long term security will require a clear definition of the role and mandate of the police and army, and sustained capacity building of both forces.

*Long-term security requires a clear definition of role and mandate of the police and the army, and immediate priorities will require considerable bilateral assistance.*

Priorities for next fiscal year include the implementation of the recently adopted Organic Law, the development of a policy on policing, including broad-based consultation over the policy, as well as the continued enhancement of the relationship between the police and the community, and the implementation of an effective liaison mechanism with the public prosecutor. PNTL will benefit from planned bilateral assistance in these areas. It will also be important to provide for independent civilian oversight of the police and the armed forces, in the context of their respective Organic Laws.

*Gender issues are being mainstreamed through the public administration, and were introduced in the TSP discussions.*

Timor-Leste has chosen to address **gender** issues by mainstreaming them throughout the administration. Gender mainstreaming has been introduced in the TSP III dialogue, especially for health and education, along with specific measures to fight gender-based violence. Over the next fiscal year special attention will be paid to the passage of the Law on Domestic Violence, fully harmonized with the Penal Code, to the reduction of the backlog of judicial cases pertaining to gender based violence, and to improved gender and domestic violence awareness among police officers.

*The new Government Information Office may provide a mechanism for a pro-active approach to information outreach.*

The Government has been exceptionally open with **information** to development partners, especially in the context of the TSP dialogue. The recent launching of the Government Information Office may allow for a pro-active outreach approach to the entire population. Further work on **media** legislation, in collaboration with representatives from the local media, is planned as well. Studies show that good governance and control of corruption are strongly related to freedom of the press. In this light, the recent decision of the Council of Ministers to reintroduce the criminalization of defamation may unduly intimidate a national press with very low capacity and limited skills in investigative journalism.

*Activating the long-planned High Level Mechanism for oversight of NDP implementation could help advance a partnership with civil society.*

Finally, to build a partnership with **civil society** for the implementation of the NDP it is hoped that the High Level Mechanism will be pursued further, and civil society considers it important that the legislation on associations be finalized.

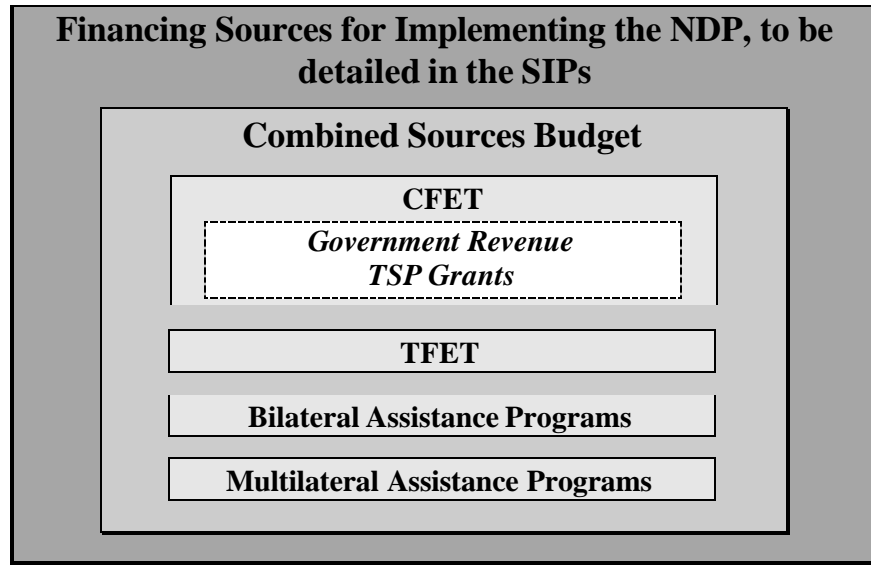
## **RESOURCE UTILIZATION AND MOBILIZATION**

*A comprehensive system of planning underlies the preparation of Timor-Leste's Combined Sources Budget.*

The Government of Timor-Leste has developed a system of planning underpinning the preparation of the Combined Sources Budget. In the medium-term this is guided by the **Road Map for the Implementation of the National Development Plan**, which includes the **Stability Priorities** issued in early 2003, structured around governance (law and order, justice and the legitimization of local authorities); employment creation; and service delivery for poverty reduction.

The Government is now in the process of preparing Sector Investment Programs (SIPs) with a view to refining the Road Map and improving Combined Resources Budgeting, which comprises CFET (supported by TSP), the undisbursed balances of TFET, and other multilateral assistance and bilateral assistance programs (see figure 1).

Figure 1: The NDP and its Road Map Guide the Combined Sources Budget



#### CFET Budget Execution in FY04

At end-March 2004, Timor-Leste's FY04 *budget execution is characterized by higher than expected revenues and slower than projected expenditures*. A considerable surplus will result in an increase in CFET balances of about USD 12 million.

*Domestic revenues are higher, helped by improved administration in both tax and customs service . . .*

At the time of the Mid-Year Budget Update (MYBU) presented at the December TLDPM, the Government estimated total **revenue** for FY04 to reach USD 45.1 million, with domestic revenues contributing USD 20.3 million, and Timor Sea revenues contributing USD 24.8 million. The Government is now expecting FY04 revenues to reach USD 57.4 million, with domestic revenues totaling USD 26.1 million, and Timor Sea revenues USD 31.3 million.

*. . . and several factors that have boosted Timor Sea revenues as well.*

Several factors have contributed to this development. First, **domestic revenues** benefited considerably from improved administration in both the revenue and customs services, the latter helped by the installment of ASYCUDA. Second, Timor Sea revenues have benefited from an acceleration in the production at Bayu-Undan following successful drilling strategies, a surge in oil prices, a deferral of the starting date of depreciation for Timor Sea companies, and improved administration of taxes. While some improvements in tax administration have had a one-time effect through the collection of arrears, a sustained impact on revenues is expected as well.

The FY04 budget has a **strong pro-poor focus** which is confirmed by the execution of the budget (Tables 1 and 2).

**Table 1: FY04 CFET Spending by Ministry**

Ministries/Programs	FY04	Budget Execution	
	MYBU	as of March 31, 2004	
	US \$	US \$	%
Office of the President	400,000	211,697	53%
National Parliament	1,167,000	766,954	66%
Government Structures, <i>not including Defense</i>	2,201,550	1,437,184	65%
Defense	6,118,850	3,897,878	64%
State Administration	2,637,535	1,588,880	60%
Interior, <i>not including Police</i>	1,359,000	883,297	65%
Police	8,528,700	5,432,388	64%
Justice	2,319,775	1,264,985	55%
Development and Environment	526,000	183,660	35%
Trade and Industry	150,400	97,550	65%
Agriculture, Forests, and Fisheries	1,644,000	1,020,950	62%
Education Culture Youth and Sports, <i>of which</i>	15,940,260	10,174,821	64%
<i>Salaries and Wages</i>	11,343,000	8,130,922	72%
<i>Goods and Services</i>	3,966,150	1,621,463	41%
<i>Minor Capital Expenditure</i>	566,110	422,437	75%
<i>Capital Development</i>	65,000	0	0%
Health	8,852,850	6,077,483	69%
Labor and Solidarity	574,300	329,211	57%
Foreign Affairs and Cooperation	1,154,000	835,059	72%
Planning and Finance	4,237,900	2,667,305	63%
Transport Communications Public Works, <i>of which</i>	16,541,350	10,711,944	65%
<i>Salaries and Wages</i>	1,243,000	678,013	55%
<i>Goods and Services</i>	10,309,350	5,815,070	56%
<i>Minor Capital Expenditure</i>	412,000	344,041	84%
<i>Capital Development</i>	4,577,000	2,289,407	50%
Public Broadcasting Service	261,600	121,565	46%
<b>Total</b>	<b>74,615,078</b>	<b>47,702,821</b>	<b>64%</b>

Source: FY04 MYBU data from Mid-Year Budget Update December 2003; Budget Execution data from Budget Execution Report March 2004.

*The FY04 budget was strongly pro-poor in its structure, and budget execution also has been pro-poor.*

*Budget execution as of March 31, 2004, shows a continuing consistency with the principles of the TSP, including priority on education and health and restraint on policing and defense . . .*

Health and education made up 35 percent of the core CFET budget, and 36 percent of spending at end-March. More than 45 percent of the core CFET education budget is allocated to primary education; as of March 31, spending on primary education comprised 60 percent of actual education sector spending.

Less than 40 percent of the core CFET health budget is allocated to hospitals; actual spending reached 41 percent by the end of March. Police and defense make up 19 percent of the core CFET budget, and comprised 20 percent of actual spending at end-March.

**Table 2: FY04 CFET Budget Execution by Expenditure Category**

Category	Budget MYBU		Execution	
	Appropriation	Structure	end Mar	Structure <sup>1</sup>
	USD m	%	USD m	%
Recurrent expenditure (Core CFET)				
Wages and salaries	26.07	35%	17.92	69%
Goods and services	38.05	51%	23.96	63%
Minor Capital expenditure	3.39	5%	2.74	81%
Capital Development expenditure	7.11	10%	3.08	43%
<b>Total</b>	<b>74.62</b>	<b>100%</b>	<b>47.7</b>	<b>64%</b>

<sup>1</sup> Structure = expenditure as of March 31 as a % of Appropriation

*... but budget execution overall is slow, with particular problems appearing in education, and transport and public works.*

Tables 1 and 2 point to **slow budget execution** overall, with particular problems in key ministries. At end-March overall budget execution was only 64 percent. Among expenditure categories, capital development expenditures have reached only 41 percent of appropriations at end-March, indicating low capacity in planning and executing capital development activities. Moreover, the goods and services and capital development budgets of the Ministry of Education, Culture Youth and Sports, and the Ministry of Transport, Communications and Public Works are being executed at a particularly slowly rate, despite covering expenses that are of crucial importance to service delivery in the districts. A multi-sector committee has been established in the Prime Minister's Office to address budget execution issues.

*Government plans to specifically assess problems that are hindering service delivery in districts.*

At the district level, budget execution is hindered by problems with central procurement, operation of imprest accounts, availability of fuel, and maintenance of vehicles. These are contributing to interruptions in services such as medicine stock-outs. The Government is planning a Service Delivery Impact Survey to fully assess these problems and identify solutions.

*Government has strengthened the compliance environment and improved value-for-money in public spending.*

**The Government has made considerable progress in strengthening the compliance environment and value-for money in spending** by implementing the measures laid out in the FY04 MYBU and presented at the December 2003 TLDPM. The temporary requirement for all Commitment and Payment Vouchers to be endorsed by the Minister of Planning and Finance resulted in a more rigorous control over agency spending. It did however also introduce a centralization of expenditure authorization and delays in budget execution.

Travel expenditures have been severely restricted. In view of the UNMISSET handover of about 230 vehicles between February and November 2004, vehicle purchases for FY04 were prohibited at MYBU and no vehicle purchases have been budgeted for FY05. Government is establishing procedures for the sale of redundant vehicles. It has enhanced compliance with its vehicle use policy and introduced measures to avoid the abuse of the voucher system for fuel consumption.

Revenue collection in the power sector has improved dramatically . . .

Most prominently, *revenue collection in the power sector has increased markedly*. This constitutes tremendous progress in an area that has been problematic since the first days of the transition. Average monthly collections from Government and non-Government power customers reached USD 270,000 for the first 10 months of FY04 in comparison with USD 233,000 for FY03. Over the past 4 months, the period coinciding with the arrival of the contract manager and the accelerated installation of the pre-paid power meters, the average monthly collections totaled USD 314,000.

. . . and prospects are good for further reductions in the subsidy to the power authority.

Assuming this level is maintained throughout the rest of the fiscal year, revenue collections will reach USD 3.33 million in FY04, compared to USD 2.87 million in FY03 and a MYBU target of USD 4.3 million. In addition, if all Government agencies clear their outstanding arrears with EDTL by the end of FY04, the annual revenue would reach USD 4.2 million, quite close to the MYBU target. It is expected that the FY04 subsidy to EDTL will remain contained at USD 6.8 million, which represents about 9 percent of budget, compared to 16 percent in FY01. The *subsidy to the Power Authority will gradually be reduced* to USD 5.65 million in FY05, 4.1 million in FY06, and 3.4 million in FY07.

### The Proposed FY05 Budget

The proposed FY05 budget is conservative and pro-poor.

The Government proposes a FY05 budget conservatively set at about USD 75 million, slightly higher than the FY04 MYBU aggregate.

**Table 3: Proposed FY05 CFET Spending by Ministry**

Ministries/Programs	FY04	FY04	FY05
	Budget	MYBU	Proposed
	US \$	US \$	US \$
Office of the President	400,000	400,000	380,000
National Parliament	1,167,000	1,167,000	930,000
Government Structures, <i>not including Defense</i>	2,306,000	2,201,550	1,384,000
Defense	6,585,000	6,118,850	5,994,000
State Administration	2,729,000	2,637,530	2,722,000
Interior, <i>not including Police</i>	1,379,000	1,359,000	1,307,000
Police	9,110,000	8,528,700	7,989,000
Justice	2,554,000	2,319,770	2,142,000
Development and Environment	531,000	526,000	480,000
Trade and Industry	174,000	150,400	177,000
Agriculture, Forests, and Fisheries	1,783,000	1,644,000	1,573,000
Education Culture Youth and Sports	16,648,000	15,940,260	16,488,000
Health	9,071,000	8,852,850	9,725,000
Labor and Solidarity	589,000	574,300	490,000
Foreign Affairs and Cooperation	1,205,000	1,154,000	2,436,000
Planning and Finance	4,304,000	4,237,900	4,295,000
Transport Communications Public Works	19,618,000	16,541,350	16,235,000
Public Broadcasting Service	360,000	261,600	350,000
<b>Total</b>	<b>79,113,000</b>	<b>74,615,070</b>	<b>75,097,000</b>

Health and education make up 35 percent of proposed spending . . .

. . . while combined defense and police allocations remain at about 19 percent.

Source: FY04 data from Budget Paper of June 2003; MYBU data from Mid Year Budget Update, November 2003; and FY05 data from Draft Budget, May 2004.

The budget maintains a strong pro-poor focus. Health and education make up 35 percent of the proposed spending, with primary education more than 45 percent of the education budget and hospital spending less than 40 percent of the proposed spending on health. The combined defense and police allocations remain at about 19 percent. On the other hand, the proposed budget for Foreign Affairs and Cooperation has doubled from last year's allocation.

### **The Medium Term CFET Outlook and Financing Options**

*The financing gap for FY05 – FY08 has been revised downward to approximately 30 million USD ...*

*... but very large uncertainties in oil and gas revenues mean that the situation could vary substantially.*

At the time of the December TLDPM it was projected that there would be a financing gap of about USD 126 million over FY05-07, and the Government issued a call to donors for augmented TSP support in FY05 as well as an extension of TSP support to FY06 and 07. Due to several developments, and assuming that all oil and gas royalties will continue to be saved, ***the financing gap for FY05-08 has now been revised downward to about USD 30 million*** in the base case scenario (Table 4). However, oil and gas revenues are subject to ***very large uncertainties*** related to potential variations in both price and production, ***illustrated by a “low case” scenario with a deficit of USD 138 million to a “high case” scenario generating a surplus of USD 90 million***. Hence, while programmed TSP support for FY05 will be sufficient to finance the deficit, mindful of the magnitude of uncertainties, the Government maintains its request to donors for an extension of TSP financing to FY06 and FY07 at levels similar to the current annual TSP financing.

*Several factors have contributed to the reduced financing gap.*

Several factors are contributing to the reduced financing gap. First, ***projected oil and gas tax revenues have increased*** for FY05-08, reaching USD 158 million, as opposed to USD 104 million at the time of the FY04 MYBU. Forward estimates for the price of oil have increased since December, and average about USD 24 per barrel for the next four years. Moreover, production is expected to reach 15.5 million barrels of petroleum in 2004, as opposed to 12 million barrels as projected in December. Two additional factors are also expected to have a positive effect on oil and gas revenues over the next four years: a delay in the scheduled depreciation of taxable capital assets, and improved tax administration.

*Government has made impressive efforts to constrain expenditure growth and to increase domestic revenue.*

Second, ***the Government has made impressive efforts to reduce the financing gap both by increasing domestic revenue and by constraining expenditure growth***. These efforts amount to a total reduction in the projected deficit of about USD 40.5 million. Following improved administration of customs and other domestic taxes, domestic revenue forecasts have been revised upward from USD 88 million to USD 98 million for the FY05-FY08 period. Moreover, the Government proposes to follow a very conservative expenditure path, with proposed CFET spending totaling USD 320 million as compared to USD 350 projected at MYBU. It will focus on consolidating and improving existing services with increased funding directed only to the highest NDP priorities. It will also seek more efficiency in spending, for

*The proposed reduction in expenditures over the medium term is large, and any further reductions would be damaging to Timor-Leste's sustainable development.*

example by improving the procurement of fuel for the power sector. The proposed cut in expenditure growth is large and any further reductions in projected expenditures would be detrimental to Timor-Leste's sustainable development. In fact, Government may wish to consider whether the proposed reduction in expenditure growth would jeopardize achieving the highest NDP priorities, especially the delivery of services most urgently needed in districts and rural communities.

**Table 4: Medium-Term Financing Gap (US\$ 'm)**

	MYBU Dec 03	FY2004 estimated actual	FY2005	FY2006	FY2007	FY2008
<b>Revenue</b>	<b>45.1</b>	<b>57.4</b>	<b>67.1</b>	<b>86.4</b>	<b>110.7</b>	<b>103.9</b>
Domestic Revenues	20.3	26.1	23	23.8	25	26.6
Timor Sea Revenues	24.8	31.3	44.1	62.6	85.7	77.3
<i>Tax Revenues</i>	<i>17.1</i>	<i>26.7</i>	<i>18.3</i>	<i>35.2</i>	<i>56.4</i>	<i>47.7</i>
<i>FTP Royalties &amp; Interest</i>	<i>7.7</i>	<i>4.6</i>	<i>25.8</i>	<i>27.4</i>	<i>29.3</i>	<i>29.6</i>
<b>CFET Expenditures</b>	<b>74.6</b>	<b>74.6</b>	<b>75.1</b>	<b>78.9</b>	<b>81.9</b>	<b>84.2</b>
Recurrent	67.6	67.6	66.7	69.6	71.7	73.2
<i>Salary and Wages</i>	<i>26.1</i>	<i>26.1</i>	<i>28.2</i>	<i>28.9</i>	<i>29.5</i>	<i>30</i>
<i>Goods and Services</i>	<i>38.2</i>	<i>38.2</i>	<i>36.7</i>	<i>37.9</i>	<i>39.4</i>	<i>40.3</i>
<i>Minor Capital</i>	<i>3.4</i>	<i>3.4</i>	<i>1.8</i>	<i>2.8</i>	<i>2.8</i>	<i>2.9</i>
Capital Development	7.0	7.0	8.4	9.3	10.1	10.9
<b>Overall Balance (-deficit)</b>	<b>-29.5</b>	<b>-17.2</b>	<b>-8.0</b>	<b>7.5</b>	<b>28.8</b>	<b>19.7</b>
<b>FTP Transfers</b>		<b>4.6</b>	<b>25.8</b>	<b>27.4</b>	<b>29.3</b>	<b>29.6</b>
<b>Financing</b>						
Donor Support (grants)		35.7	30.8	0	0	0
Change in CFET Balances (-increase)		-13.9	2.9	0	0	0
<b>Financing "Gap"</b>		<b>0</b>	<b>0</b>	<b>-19.9</b>	<b>-0.5</b>	<b>-9.9</b>
Memorandum:						
Balances at end of period						
Consolidated Revenue Fund		30.0	27.1	27.1	27.1	27.1
Timor Sea FTP Account		14.0	39.8	67.2	96.5	126.1

*NOTES: All data from Ministry of Finance and Planning.*

*Dramatic risks mean great uncertainty for oil and gas revenues over the next four years.*

It is important to underline that **tremendous upward and downward risks may affect medium term oil and gas revenues**. First, as the Bayu-Undan project is in its start up phase, small changes in the price can have a very large effect on revenues since profit taxes disappear below a certain price level. In other words, changes in price do not always have a proportional effect on tax revenues. Second, there are considerable technical risks especially for a country that relies on one project only, Bayu-Undan, and hence production volumes are uncertain.<sup>4</sup> Finally, there are marketing risks.

<sup>4</sup> As an illustration of production uncertainties, in 2001 it was estimated that the 2004 Bayu-Undan production would reach 33 million barrels of petroleum. At the time of the FY04 budget presentation the expected production was 22 million barrels. In December 2004, following protracted drilling problems production estimates were

*High and low case scenarios illustrate the substantial uncertainty . . .*

These uncertainties are best illustrated by presenting *high and low case scenarios for revenue projections* (Table 5). The *high case scenario* assumes an average world oil price of USD 28 per barrel as well as production levels that are about 18 percent higher than those for the base case. Under the high case scenario, there is no longer a financing gap over the medium term, but rather a surplus of USD 90 million. As oil prices have been well above USD 30 for several months recently, this case is not implausible. The *low case scenario* is based on an average world oil price of USD 22 per barrel, and production levels that are about 16 percent lower than those for the base case. In the low case scenario, the projected deficit is USD 138 million, which would be extremely difficult for Timor-Leste to absorb given that there is no room for further cutting projected expenditures. Again, this scenario is not implausible; oil prices averaged USD 19 per barrel from 1985 to 2000.

**Table 5: Fiscal Gap Under Different Scenarios (\$m)**

	2004-05	2005-06	2006-07	2007-08	Total
Central Case (FY05 Budget)	0.0	-19.9	-0.5	-9.9	-30.3
High Case	10.7	11.2	33.4	34.7	90.0
Low Case	-2.8	-47.0	-44.4	-43.9	-138.1

In line with the updated medium term fiscal framework, and cognizant of the tremendous uncertainties surrounding projected oil and gas revenues, the Government would like to update its request to development partners for additional TSP support. The currently committed levels of TSP financing are sufficient to cover the programmed financing gap in FY05 – hence, there will not be a need for the extra USD 10 million in TSP support for FY05 proposed in late December. However, given the magnitude of the uncertainties for FY06-08, *the Government would like to maintain its request for extended TSP support in FY06 and FY07, at annual levels roughly similar to the annual TSP support provided now.*

*. . . and an extension of TSP support through FY06 and FY07 is an appropriate response to these risks.*

*An extension of TSP financing is an appropriate response to the significant risks in projected Timor Sea revenue flows.* These risks are so large that revenues could possibly fluctuate as much as USD 100 million above or below the “central case” estimate of USD 158 million in total tax revenues from FY05 to FY08. Extended TSP financing would allow the Government to maintain a cushion of Consolidated Fund reserves to accommodate revenue variability. Adequate reserves allow Government to avoid abrupt changes to the current savings policy until the Petroleum Fund and appropriate governance arrangements have been put in place and are fully functioning. The Government holds the option of concessionary loans in reserve but defers a decision until it will have had the time to analyze a feasibility study on concessionary

again revised downward to 12 million barrels. Today 2004 production is expected to reach about 15.5 million barrels.

loans which is under preparation. In view of its request for extended TSP financing the Government may wish to analyze its projected expenditure path and evaluate whether the proposed cuts in expenditure growth represent lost opportunities for better service delivery in NDP priority areas. In the context of the SIPs it may want to identify priority expenditures that could be implemented through CFET.

### **The Medium Term Combined Sources Budget and the SIPs**

The Government's Medium Term Combined Sources budget consists of CFET, the un-disbursed parts of TFET, the UN Assessed Contribution for technical assistance posts, and bilateral and multilateral assistance. The Government would like to **align the combined sources budget fully to the NDP**, as is currently the case for CFET. To this end, it is preparing **Sector Investment Programs (SIPs)** for fourteen sectors, clarifying sector goals (including national Millennium Development Goals), policy and strategy, and medium term expenditure programs covering both investment and recurrent expenditures. The fourteen sectors covered are: education; health; agriculture, fisheries and forestry; natural resources and environment; private sector development; power; communications and transport; water supply and sanitation; public sector management; local government and civil society; rights, equality and justice; security, peace building and reconciliation; and external relations.

*Fourteen Sector Investment Programs, or SIPs, are in varying stages of preparation . . .*

The fourteen SIPs are in a varying state of preparation. For some sectors, such as agriculture and education, no clear policy and strategy statement was available at the start of the SIP process, and hence these are being elaborated before future programs are identified and costed. **All fourteen SIPs are expected to be finalized by August 2004**, including a revision by the Council of Ministers of intra- and inter-sector priorities in the context of a combined medium term resource envelope. As part of TSP III, the SIPs will then form the basis for elaborating a comprehensive Combined Sources Budget and Medium Term Expenditure Framework, starting with the budget for FY06. In view of its request for the extension of TSP to FY06 and 07, the Government may also wish to analyze how the CFET budget could absorb some of the SIP expenditures to ensure funding for priority expenditures in lieu of the efficiency cuts that were made to the FY05-07 expenditure path.

*. . . and these SIPs will form the basis for detailing a comprehensive Combined Sources Budget and Medium Term Expenditure Framework beginning with the FY06 budget.*

### **CHALLENGES**

Despite the impressive progress made in the first two years since the restoration of independence, Timor-Leste faces daunting challenges in building a State with fully functional institutions in the face of very limited capacity. As UNMISSET is winding down with a much smaller successor mission until May 20, 2005, it will be important to **identify those areas that will be left vulnerable to the reduction in international presence and will require a strategy to address gaps and needs**. These areas include law and order, public resource management, justice and road transport.

*Daunting challenges remain as Timor-Leste seeks to build a state with fully functional institutions.*

It would be useful to define future institution and capacity building programs with a long term view and in the context of sector programs, recognizing that some positions may require international presence for a considerable time, while carefully planning the training of Timorese skilled personnel and their succession into the administration. It will also be important to define the “critical” and “most critical” UN and UNDP posts, which are very short term positions, with a view to focusing on the areas of highest risk, as well as coordinating with medium and long term support initiatives.

*Law and order services will require both UN and bilateral support, which must be fully coordinated to effectively build capacity.*

**Law and order services** are expected to continue to benefit from the presence of 157 civilian UN advisors and a 125 person intervention unit. In addition, a major bilateral assistance program is expected to begin in early FY05. It will be important that the UN and bilateral support initiatives are fully coordinated with a view to bringing coherent support to capacity building.

*Timor-Leste’s planning and management of public resources is vulnerable to the reduction in international technical assistance, and medium- to long-term capacity building is still needed.*

**Public resource management** is an area that is particularly fragile. Timor-Leste has established core planning and resource management functions that are effective, transparent, and compare very favorably with those of other low income countries. However, this area has benefited disproportionately from the presence of international technical assistance and is thus especially vulnerable to the departure of international advisors. Medium to long term technical assistance and capacity building in planning and monitoring, budgeting, budget execution – both on the expenditure and revenue side – and in personnel management will be necessary to maintain the current standards of public resource management and to implement sustainable improvements.

*In the justice sector, assistance in information systems, administration, and case management is urgently required.*

Several multilateral and bilateral technical assistance programs have benefited the **justice sector**, particularly public defense and prosecution services as well as some private legal aid organizations. A multilateral assistance program is providing a range of inputs to the justice sector. Despite these ongoing programs, much remains to be done. Of particular urgency are the areas of information systems, administration and case management.

*Finalization and financing of a sustainable program for road maintenance should be a priority.*

The **roads system is expected to suffer considerably** from the scheduled departure of PKF engineering units, and the slow execution of the CFET budget for road maintenance and rehabilitation. This is likely to have a significant impact on service delivery and economic activity. The finalization and financing of a sustainable program for road rehabilitation and maintenance should therefore be considered a priority.