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14 December 2010

Mr. Holger van Eden
International Monetary Fund
700 19th Street, N.W., Washington, D.C. 20431 USA

Dear Mr. Van Eden,

We wish to thank you and your team very much for the two reports the IMF Fiscal Affairs Department released last month about Timor-Leste's state finances. Both the *Public Financial Management Performance Report* (PFMPR) (10-341) and the *Report on Observance of Standards and Codes (ROSC)—Fiscal Transparency Module* (10-340) provide invaluable insights and information about public financial management in Timor-Leste.[1]

As the reports point out, there are some strengths and many weaknesses in budgetary and planning processes here. We appreciate your frank discussion of these issues, especially regarding the shortcomings in accountability and planning.

Unfortunately, since your team visited last January, a number of things have deteriorated. The situation in Timor-Leste changes quickly, and the past ten months have seen a mid-year budget revision, a shortened calendar for enacting the annual state budget, and a reduction in the amount of information shared with the public. Several imminent legislative and budgetary actions – including extra-budgetary funds, new autonomous institutions, and revisions to the Petroleum Fund Law – will further undermine fiscal transparency and accountability if they are enacted.

We are writing to update you about what has changed from a civil society perspective, especially in light of the in-process Article IV Consultation and discussion of Timor-Leste's General State Budget for 2011.

In June and July 2010, Timor-Leste enacted a mid-year budget adjustment, increasing expenditures from $683 million to $838m, and the amount withdrawn from the Petroleum Fund from $502m to $811m, almost 97% of total expenditures. The process made Timor-Leste more dependent on oil export revenue and violated what the IMF considers good practice.[2]

Since it will be impossible to execute the entire budget during 2010 (as of 12 November cash expenditures were 52.1% of the $838 million appropriated), but the entire $811m is being withdrawn from the Petroleum Fund this year, one could say that more than 100% of state expenditures in 2010 will come from the Fund.[3] The leftover cash balance will help finance the 2011 budget although, as La'o Hamutuk discussed with the

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1 Although these reports have probably circulated privately for months, La'o Hamutuk first saw them when they were published to the IMF website on 24 November, after the Article IV team had returned to Washington. Since the IMF no longer has an office in Timor-Leste, it is difficult for civil society here to engage with it directly.

2 See ROSC paragraph 7, footnote 4. Also, footnote 13 to ROSC para 33 is no longer correct as the rectification increased capital appropriations (excluding donors) from $217 to $253 million. ROSC paragraphs 32 and 54 understate the reliance on mid-year budget increases, and the shortened, information-starved, consultation-limited process that accompanies them.
Paragraph 54 and footnote 18 leave out that the Court of Appeals ruled that the 2008 mid-year budget rectification was illegal and the ESF was unconstitutional.

3 As of 12 November, $437m had been spent and another $197m obligated, for a total of $634m. The Ministry of Finance transferred $600m from the Fund between January and November 2010, and has requested the BPA to transfer $211m more in December.

Article IV team, it would be more in keeping with the spirit of the Petroleum Fund Law if it were returned to or not withdrawn from the Fund.

The processes of transparency and public consultation have gotten worse than the IMF reports indicate. For example, the many items listed as available to the public in the Summary[4] have not been made available. In fact, until today the Ministry of Finance website did not contain a single document about the mid-year budget that was promulgated last July or about the 2011 budget currently being discussed in Parliament. La'o Hamutuk has partially filled this gap by scanning and OCRing barely-legible photocopies of documents we got from Members of Parliament, but the Ministry has been totally uncooperative.[5]

Parliament acquiesced to the Government's request for an extra month to prepare the budget, further reducing the time for Parliament and the public to analyze it.[6] November and December contain about ten holidays, so the number of working days is much fewer. This budget will not be promulgated until well into 2011, undercutting the principles of last year's Budget and Financial Management law.[7]

The proposed special funds[8] (including nearly one-third of the 2011 appropriations) circumvent planning and discussion, as the Government full power to change line items and delay expenditures to future years. The Special Funds also allow virements[9] without prior Parliamentary notice, approval or oversight, and are not restricted to stay within a category, Ministry or year. The Capital allocation in the consolidated state budget (CFTL) has been reduced by 65% compared with the mid-year 2010 budget, although the total capital budget has grown by 62%, with $317 million reassigned to the infrastructure fund.

In addition, the imminent establishment of several new independent agencies (including the PETRONATIL national oil company, the Institute for Petroleum and Geology and the National Development Agency) by decree-law evades budgetary accountability, transparency and democracy, as the budgets for these agencies will be outside the state budget and not subject to Parliamentary approval or oversight.[10] Those in the petroleum sector also contravene the Petroleum Fund by intercepting oil income before it is deposited into the Fund.[11]

The expansion of the Decentralized Development Package (PDD) further erodes accountability and oversight. Budgeting and procurement is proliferating both above and below ministries.[12]

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4 ROSC Table 2, paragraph 93. In addition, the URL for the Banking and Payment Authority should be www.bancocentral.tl.

5 ROSC para 35 overstates the limited time and space that has been available for public consultation during 2010. Paragraph 72 says that all budget information is provided to the public in English and Portuguese; this is rarely true. Today, 14 December 2010, one day before the Parliamentary standing committees have to submit their reports, the Ministry finally posted Portuguese and English versions of Budget Books I, IV and V to its website. However, the website has been nonfunctional for most of the afternoon. According to the Parliamentary calendar of budgetary hearings, 76 events took place before the electronic documents were posted, and only four more are scheduled before the plenary discussion of the budget starts on January 10.

6 ROSC paras 16 and 32 (and Box 5), PFMPR paras 42 and 95.

7 PFMPR paragraph 44.

8 ROSC paragraph 2.

9 ROSC paragraph 51.

10 ROSC paragraph 3 (transfers not explicit, although PETRONATIL gets $2 million in GSB 2011), 10, 19, 28 (limited public consultation) and 66 (outside the state budget). La'o Hamutuk discussed two of the proposed agencies in submissions to SERN on PETRONATIL (http://www.laohamutuk.org/Oil/PetRegime/NOC/LHSubPetronatil24Nov2010En.pdf) and IPG (http://www.laohamutuk.org/Oil/PetRegime/NOC/LHSubIPG25Nov2010En.pdf).

11 ROSC paragraph 19.

12 ROSC paragraph 83.

The amount of information provided in the state budget has declined significantly. In particular, there is no information on costs of new initiatives,[13] and multi-year capital projects are not costed beyond the current year. Although the Government secretly increased the contract cost of the national electricity grid from $367 million to $629 million last September,[14] they did not inform Parliament of this and the budget documents ignore it. The Annual Action Plans in 2011 Budget Book 2 say nothing about the cost of each item, and the Ministry no longer provides a list of multi-annual capital projects which had been Annex 4 to Budget Book 1 in past years.

As the IMF recognizes,[15] medium-term forecasting is extremely limited. In fact, projected expenditures for 2013-2015 in the 2011 budget document appear to come from a simple percentage model, based on a projected inflation rate of 4%. For example, the amounts to be transferred annually into the infrastructure fund from 2013 to 2015 are each precisely 4.00% more than the previous year, with no thought as to actual costs of projects or whether the completion of some projects might reduce the needed money. Similarly the CFTL budget is projected to increase 4.00% per year with no consideration of new government agencies or programs, expanded levels of service, decentralization, managing new infrastructure, etc.

The 2011 GSB proposes a contingency reserve of $27 million. Since the Special Funds are outside of the main budget and inherently flexible, this should be seen as part of the Consolidated Fund, of which it is 4.2% (if autonomous agencies are included), or 4.6% without them, far above the 3% the IMF considers good practice.[16]

Budgetary proposals increasingly erode or avoid the principles underlying the Petroleum Fund,[17] and a pending revision of the Petroleum Fund Law[18] will exacerbate this trend, reducing safeguards discussed in your reports, including independence of the operational manager and Investment Advisory Board.

The 2011 budget uses imprudent oil price assumptions (not the EIA low case) to increase the sustainable income estimate by 46%. In 2009 and 2010, the government transferred more than the ESI[19] to the state budget, and proposes to do so again in 2012-2015, even though ESI estimates have been increased.[20] The legal requirement for a "detailed explanation" before overspending the ESI [21] is rarely observed in reality, and wasn't even attempted for the 2010 mid-year rectification. Your report should also explain that the Petroleum Fund cannot be used to guarantee debt repayment.[22]

Petroleum companies have had difficulty complying with their tax obligations,[23] and the Ministry of Finance has not effectively enforced them until recently. Fortunately, the Ministry's Petroleum Tax Division has just collected $32 million in taxes which were evaded years ago, and further investigation and audits are likely to

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13 ROSC paragraph 40.

14 See http://laohamutuk.blogspot.com/2010/12/heavy-oil-project-delayed-over-budget.html for more information.

15 ROSC paragraph 39.

16 ROSC paragraph 55.

17 ROSC paragraphs 41 and following, PFMPR para 11. There was no transfer in 2005/6 as PFMPR paragraph 11 says, but spending was above ESI in 2009 and 2010.

18 See ROSC para 18, box 4. For information and analysis on the proposed revisions, including our submission to the Ministry of Finance see http://www.laohamutuk.org/Oil/PetFund/revision/10PFRevision.htm

19 PFMPR para 22 is misleading. Although only $512m was transferred from the Petroleum Fund in 2009 (instead of the $589m authorized by Parliament), it was $104m above ESI. The Prime Minister justified going over ESI to spend $87m in 2009 on the power plant, which was later deferred and the money rechanneled to Pakote Referendum.

20 These assumptions are clear, as ROSC paragraphs 38 and 44 describe, but they have little bearing on the budget.

21 ROSC paragraph 43.

22 ROSC paragraph 69.

23 ROSC paras 20, 58; PFMPR para 57.

yield more.[24] Your report observes that tax compliance in the petroleum sector is "very high,"[25] but we do not yet know if this is true, since meaningful audits and investigation only started a few months ago.

In addition to the information above, we would like to call your attention to some errors and omissions in the two reports:

- ROSC para 7: Petroleum revenues are far more than 200% of non-oil GDP. In 2009, non-oil GDP was $557.8 million and petroleum revenues (including interest on the Petroleum Fund) were $1,918.4, 344% of non-oil GDP.[26] The latest IMF preliminary forecast for 2010 puts them at 328%.
- ROSC paras 17 and 29: All Production Sharing Contracts signed after 2005 for both the Joint Development Area and Timor-Leste's Exclusive Area are legally required to be published. However, they do not appear on any current Government website, as the sites that used to host them have been allowed to die.[27]
- ROSC para 52, Box 6: The FreeBalance financial information management system may eventually provide comprehensive, timely information to stakeholders, but its public portals are not yet operational. Last week the Ministry organized workshops to publicize their promises.
- ROSC para 54 and footnote 18 regarding mid-year budgets: The ESF in 2008 was ruled unconstitutional. The rice import/subsidy/resale program continues (it's budgeted through 2015), with frequent changes in methodology and widespread allegations of mismanagement and corruption; it also undercuts the domestic market for local agricultural productions.
- ROSC para 59 (box 8) and PFMPR para 41 (table 6): The BPA's quarterly reports on the Petroleum Fund are given to the Ministry 20 days after each quarter; Parliament and the public receive them after 40 days. The consolidated report of Audited Annual Accounts planned for April 2010 still has not been issued, nor has the Annual Report from the Ministry of Finance for 2009, although article 45.1(b) of the Budget and Financial Management Law says it should have been published by the end of September.
- ROSC para 61 and PFMPR para 41 (table 6): Unfortunately, draft budget documents are often not published on the MoF website, and the approved budget has been late. In fact, the 2010 mid-year approved budget only appeared on the MoF website today, five months after it became effective,[28] and drafts were never published.
- ROSC para 89: The external auditors' management letters for2007-8 and 2009 still have not been published.
- ROSC para 91: The ANP 2009 Annual Report did include an external audit of activities both in the TLEA as well as the JPDA.
- ROSC para 76: Fiscal risks and hidden subsidies continue and will get worse. Some of the subsidies (such as for electricity infrastructure) are concealed in special funds, and Annex III to the budget law, which purportedly shows subsidies for autonomous agencies, is misleading.
- ROSC para 70: Although the civil service pension system has not yet been created (it will be soon), the state has non-debt liabilities for pensions for ex-office-holders, ex-Parliamentarians, veterans and others.

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[24] See http://www.laohamutuk.org/Oil/tax/10BackTaxes.htm.

[25] PFMPR para 55.

[26] Source: RDTL proposed 2011 GSB Book 1.

[27] La'o Hamutuk has made them available at http://www.laohamutuk.org/Oil/PSCs/10PSCs.htm.

[28] The promulgated budget law was published in the *Jornal da Republica*, like all legislation, but only in Portuguese and without any supporting documents.

We would like to make a few suggestions regarding ROSC paragraph 95, recommendations:

- Short-term on budget process: the MoF should provide much more information on full costs of capital projects
- Medium-term on budget process: The timeline for budget preparation should include making preliminary information public and soliciting consultations.
- Financial management: The IMF would like to remove quasi-fiscal requirements on Petroleum Companies. We disagree; such companies must be obliged to be socially responsible, including local content, environmental and safety precautions, and other measures to protect Timor-Leste's people, environment and economy. By making these legal requirements, the costs of such activities are shared with the company, rather than coming entirely out of Timor-Leste's revenues. However, they should be directly related to the companies' activities.

Thank you very much for your attention, and we are happy to discuss any of these issues further.

Sincerely,

Juvinal Dias Charles Scheiner
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Cc: IMF Article IV Consultation team leader Werner Schule, RDTL Minister of Finance Emilia Pires, La'o Hamutuk website, media, and others in Timor-Leste government and civil society.