Viewing cable 07DILI166, NATIONAL BUDGET PLAGUED BY EXECUTION CHALLENGES AND

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SUBJECT: NATIONAL BUDGET PLAGUED BY EXECUTION CHALLENGES AND
POLITICAL UNCERTAINTY

REF: A) 2005 DILI 406, B) 2006 DILI 474

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Â¶1. Summary: During an informal briefing for donors last week, the International Monetary Fund's Resident Representative in East Timor painted a bleak picture of budget execution to date for the fiscal year (FY) 2006-2007. Of a $329 million budget, while $211 of it has been committed, only $84 million (about 25 percent) has actually been spent. The picture is worse regarding spending on capital development, the budget's single biggest category and a key component of the government's anti-poverty priorities, where only $3 million of $120 million budgeted has been spent. With large amounts of carryover from previous years still coming on line, the FY 06-07 numbers are not the whole picture, but nonetheless starkly demonstrate the barriers to progress on a development and anti-poverty agenda. Meanwhile, planning has begun for the FY 07-08 budget, but is overshadowed by preparation for elections and the uncertainty regarding the next government. Plans for the new budget are similar to FY 06-07, but some new categories as well as innovations to improve execution are being discussed. Available revenue from the Petroleum Fund to subsidize the next budget is expected to be around $330 million. Post expects that even if planned budget proposal preparation proceeds on schedule, the current parliament is unlikely to pass a budget prior to the end of its mandate. Operation on the resulting equivalent of a continuing resolution, however, would restrict the GOET's ability to begin new programs and commitments, delaying once again desperately needed progress on numerous issues. End summary.

Execution of 2006-2007 budget

Â¶2. During an informal briefing for donors last week, the International Monetary Fund's Resident Representative in East Timor painted a bleak picture of budget execution to date for the fiscal year 2006-2007. (The fiscal year ends on June 30.) While $211 million has been committed, and thus is counted as "executed" according to the government's accounting, actual cash expenditures stand at $84 million out of a $329 million budget. This is an improvement over this time last year when only $60 million had been spent, but most of this reflects increases in recurrent costs, such as salaries, that are the easiest categories to spend. The major focus of the 2006-2007 budget, a massive increase in capital development investment designed to address anti-poverty priorities, is where the inability to execute stands out. Of $120 million allotted for the year, only $3 million has been spent to date.

Â¶3. The gap between what the Timorese government defines as execution, i.e. the commitment of funds, versus the actual expenditure of those funds, has resulted in large amounts of each year's budget being carried over for spending in future fiscal years. In fact, the government still has carryover commitments on the books as far back as the FY02-03 budget.. At present the IMF reports a total of at least $150 million in outstanding carryover commitments from previous years, encompassing some 600 items. These carryovers are in many cases the source of larger spending currently taking place. For example, in contrast to only $3 million spent out of the FY 06-07 budget on capital development, carryover spending in this category is estimated to be around $12-15 million.

Planning for new budget

Â¶4. Development of next year's budget, which according to East Timor's current fiscal year cycle is due to begin July 1, formally commenced this week and ministries are now working on their respective proposals. These proposals are due to Ministry of Planning and Finance (MOPF) by May 7. MOPF plans to forward the draft to the Council of Ministers in early June in order to reach Parliament by June 15 so that it can be voted on and approved before the end of this parliament and before the start of the new fiscal year (parliamentary elections will be on June 30; the fiscal year runs from July 1 - June 30).

Â¶5. Observers at the IMF and the World Bank note that this is an

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extremely tight timeframe. The process is also overshadowed to a large extent by election-related activities-many ministers and ministry staff are taking regular leave to campaign-along with the uncertainty of the election outcome. Moreover, there remains significant disagreement regarding whether the existing Parliament legally can or should pass a budget for a government not yet in power. Separately, Post has also been informed that some political actors favor changing the fiscal year to align with the calendar year. How and whether this will impact budget planning and the date at which a new budget comes on line is unclear at this point.

Â¶6. Nonetheless, the process is moving forward and some aspects of what the new budget will likely include are emerging. An advisor in the MOPF relayed to Emboff that the present expectation is for the new budget to reflect similar anti-poverty priorities as the current budget. The advisor also noted that the current process is based on the expectation that recurrent funding (salaries, goods and services, minor capital, transfers) will remain at similar levels to FY 06-07, while capital development funding is to be reviewed to ensure its achievability and alignment with anti-poverty priorities. According to the IMF, this budget will incorporate some innovations particularly regarding the handling of carryovers from previous fiscal years. Specifically, most items that are committed but not obligated by the end of June 2007 will lapse and have to be re-appropriated to remain active. Obligated items will then be subject to deadlines for actual spending, by December 31, 2007 for most categories and by June 30, 2008 for capital development.

Â¶7. New items that are reportedly being proposed for the FY 07-08 budget include:
-- $45 million to the Millennium Challenge Account Program for Accelerated National Development (PAND), mostly for a hydropower project;
-- $28 million for new veterans' pensions;
-- increased electricity costs;
-- a ferry subsidy (for the ferry that provides the only public transportation between Dili and the Oecusse enclave as well as Atauro island);
-- food security;
-- and costs for a new career development and promotion regulation, the financial implications of which remain unclear.

Â¶8. If Parliament and the President are unable to agree on a budget before the start of the fiscal year on June 1, then the government will follow the 1/12th rule, which in absence of an approved budget allows ministries to spend 1/12 of the previous year's budget per month on current expenditures and minor and major capital that has already been obligated. The government cannot transfer monies from the Petroleum Fund without a budget, but this is unlikely to be a problem, as $200 million has just been transferred and another $60 million is expected to be transferred before the end of the fiscal year. Given the low rate of current spending and available cash on hand, government will not be running into a liquidity problem for some time.

Revenue status

Â¶9. The Petroleum Fund, the single largest source of revenue for the GOET, is currently increasing at a rate of approximately $100 million per month, with a current balance of $1.2 billion. The fall in oil prices means that the ceiling for withdrawal from the Petroleum Fund is slightly lower than last year, but the limit for FY 07-08, at approximately $330 million, still stands at more than the FY 06-07 budget. However, if a significant amount of unspent commitments need to be re-appropriated, and are thus incorporated in the FY 07-08 budget, budget demand could then exceed the amount available to be withdrawn from the Petroleum Fund. This could constrain the amount available for capital development, but should not be a major issue in light of the many projects in the pipeline. The prospect of Millennium Challenge Corporation (MCC) funds coming on line does not at this time appear to be included in calculations for the new fiscal year, as government officials

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now appear to understand that MCC's due diligence requirements will take significantly more time and that continued eligibility is not a foregone conclusion.

Comment

Â¶10. The GOET's ongoing dismal budget execution demonstrates the fundamental difficulties Timor faces in translating its cash riches into national development and prosperity for the wider population. Even with previous years' commitments coming on-line, the extreme shortfall on actual spending arguably represents East Timor's greatest barrier to effective development and poverty reduction. Regarding the prospect for the new budget, Post assesses that Parliament is unlikely to pass a budget by June 30 despite the current efforts underway. The more likely scenario is that the MOPF will move forward with preparing a budget proposal for consideration by the new government, but differences over the start of the budget year, spending priorities, and the June 30 parliamentary elections will result in no budget being enacted. After the end of the fiscal year June 30, the government would then operate under the rules that allow it to spend 1/12th of the previous year's budget on recurring expenses. The new government, once in place, would either accept the MOPF's proposal with limited changes or choose to operate for a sustained period without a new budget in order to develop a new proposal. Operation on the resulting

equivalent of a continuing resolution, however, would restrict the GOET's ability to begin new programs and commitments, delaying once again desperately needed progress on numerous issues. One further dynamic to watch will be the role of the new parliament. The current parliament, dominated by the ruling Fretilin party, has with few exceptions served as a rubber stamp on previous years' budget processes. The new parliament is expected to be far less dominated by any single party and so may introduce a much more interesting -if less efficient-budget approval process. End comment.
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