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EAST TIMOR PUBLIC ADMINISTRATION

PUBLIC EXPENDITURE MANAGEMENT AND ACCOUNTABILITY NOTE

THE WORLD BANK
EAST ASIA AND PACIFIC REGION
POVERTY REDUCTION AND ECONOMIC MANAGEMENT SECTOR UNIT
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Fiscal Year

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Abbreviations

BPA	Banking and Payments Authority
CAS	Central Administrative Services
CEP	Community Empowerment Project
CFET	Consolidated Fund for East Timor
CISPE	Civil Service and Public Employment Service
CPV	Commitment and Payment Voucher
ETPA	East Timor Public Administration
ETTA	East Timor Transitional Administration
FTP	First Tranche Petroleum
FY	Fiscal Year
GDP	Gross Domestic Product
MoF	Ministry of Finance
MTFF	Medium Term Fiscal Framework
NDP	National Development Plan
NGO	Non-Governmental Organization
OIG	Office of the Inspector General
TFET	Trust Fund for East Timor
UNTAET	United Nations Transitional Administration in East Timor

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The present East Timor Public Expenditure Management and Accountability Note was drafted by Adrian Fozzard (EASPR), with contributions from Rob Taliercio (EASPR), Sarah Cliffe (EAP) and Jose Braz (Consultant). Fieldwork for the preparation of the Note was undertaken in January and March 2002. The authors are grateful to the staff of the East Timor Public Administration, and the Ministry of Finance in particular, for their assistance in preparing the Note and reviewing early drafts.

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PURPOSE AND SCOPE OF NOTE

1. This study focuses on the implications of East Timor's transitions from United Nations administration to Independence, from reconstruction to development and from aid dependence to fiscal independence for public expenditure policy and management. Following an assessment of the existing systems and their constraints, it makes recommendations for improvements in the public expenditure management system as a tool for achieving:

- *Macro-Economic Stability and Growth,* by delivering a sustainable and productive application of resources;
- *Poverty Reduction,* by allocating resources to programs that benefit and meet the needs of the poor;
- *Value-for-Money* in the application of public funds, by focusing on economy, efficiency and effectiveness in public spending;
- *Good Governance,* by ensuring transparency in decision-making and expenditure management, and accountability within the public sector, to the legislature and ultimately to the public.

2. The note is intended first as a contribution to the Government's on-going reform strategy. Summary recommendations are presented at the end of this report. The note is also intended as a contribution to independent assessments of the Government's financial management system undertaken by external partners.

PUBLIC EXPENDITURE REVIEW

3. ***Revenues.*** Revenue yields, at $28 million in FY2001, 8% of GDP, are significantly lower than in most low income countries, reflecting the low level of formal economic activity. Oil and gas accounts for about half of current revenues. This share will increase to an estimated $215 million in FY2006, after the Bayu Undan field comes on stream, when oil and gas will account for approximately 90% of total revenues and 43% of non-oil GDP. Taxes on imports currently account for about half of non-oil taxes, income taxes and service taxes about one quarter. Domestic revenues are levied on an extremely narrow tax base: 11 taxpayers provided 68% of services tax collections and 13 taxpayers 84% of corporate income taxes up to August 2001. With economic growth and diversification the tax base should gradually widen. In the meantime, increases in tax yields will depend on tax hikes – particularly on excises – and improvements in administration – including cracking down on smuggling, reducing the range of exemptions, and improved information sharing between customs and revenue administrations. Major changes in the tax regime – such as the extension of the sales tax to domestic production, presumptive taxes on agriculture and property taxes – are only feasible once revenue administration capacity has improved and local government reforms have been implemented. The merits of such changes must be assessed against their impact on international competitiveness and private investment.

4. ***Trends in Aggregate Expenditure.*** Programmed public spending in FY2002 amounted to nearly $290 million, equivalent to 70% of non-oil GDP. Of this, 22% was channeled through the Consolidated Fund (CFET), 19% through the Trust Fund for East Timor, constituting the Government's capital program, 39% through bilateral projects and 19% through UN assessed contributions, covering some international staff and government operating expenditures. Over the FY2002 to FY2006 period, external financing is expected to drop from around 80% to 14% of public

spending as oil and gas revenues come on stream and the UN mission and bilateral projects wind down. While increased oil and gas revenues will allow the Government to cover programmed expenditures and generate substantial savings by the end of this period, total per capita spending will drop from $350 to just $140.

5. In this context, the challenge facing government is to set an appropriate level of expenditure that can be used productively, is sustainable when taking into account future revenue streams and can be financed in the short-term. Given the low levels of budget execution in recent years, implementation capacity will be the principal determinant of the appropriate level of spending in the short term. By channeling an increasing volume of resources through the Government's treasury system, as budgetary support, external partners can help to develop this capacity. At the same time, the Government can sustain grant financing over the longer-term by developing a coherent capacity building program, integrating both expatriate staffing and extensive training activities.

6. ***Sectoral Expenditures***. In FY2001, general public services accounted for about 35% of Consolidated Fund spending, mostly in capital outlays for the start-up of new institutions. Once start-up costs had been covered, general public services' share of CFET spending dropped to 16% in FY2002 and the social sectors' share increased from 29% in FY2001 to nearly 40% of programmed spending in FY2002. Education now accounts for one quarter of total CFET spending and health almost one-tenth. Spending on defense and public order has also increased, to 5% and 15% respectively of total programmed CFET expenditures in FY2002. Limited resources have been allocated to economic sectors. Although the sector accounted for around one-fifth of total CFET expenditures in FY2001 and FY2002, the bulk of these funds went to the power authority, which accounted for 16% of actual CFET spending in FY2001 and 11% of programmed CFET spending in FY2002. The overall pattern of spending, taking into account TFET, bilateral projects and UN technical assistance, is broadly consistent with the structure of CFET spending, though allocations for economic affairs (notably in agriculture, support to the private sector and investments in road infrastructure) and other social services (notably community development and water and sanitation) are slightly higher, reflecting substantial investments in these areas.

7. Total spending in the education and health sectors, at $57 and $32 per capita respectively, is comparable to many middle income countries. Although boosted by large post-conflict investments, external financing also supports operational costs. The challenge in both these sectors is to mobilize sufficient resources to support on-going operations and maintenance of programs as external financing declines and operating costs borne by TFET and bilateral projects are transferred to the CFET budget. The share of CFET spending allocated to health and education sectors–currently at $19 per capita for education and $7.5 for health–will have to increase in order to sustain these programs. For CFET health spending to reach the international $12 per capita benchmark, CFET spending would have to increase by 50% to over $9.6 million, with health's share of the budget rising from 10% to over 15%. At the same, owing to the winding down of TFET and bilateral projects, total spending in both sectors will decline, requiring careful prioritization to ensure that programs with the highest social returns and poverty reduction impact are protected.

8. ***Economic Composition of Expenditure***. Capital spending accounted for 42% of the FY2001 CFET budget, reflecting large set-up costs for administrative buildings and equipment. Although programmed capital expenditures dropped to 19% of total CFET spending in FY2002, the proportion of capital spending on administrative functions increased significantly. Government has now placed a moratorium on the acquisition of vehicles, which accounted for nearly half of capital spending. Over the next three years, the capital program will have to reformulated to allocate an increasing share of resources from minor capital for administrative purposes to development projects supporting service delivery and infrastructure.

9. Unlike most low income countries, personnel costs account for a relatively small share of the budget: 27% of actual expenditures in FY2001 and 34% of programmed expenditures in FY2002. The public sector payroll is modest, with a total payroll of 12,274, of which 3,300 are civil servants and 6,600 teachers, around 3% of the working age population. The administration has encountered considerable difficulty in recruiting qualified and experienced senior managers and professionals: in January 2002, 22% of grade 5 and 6 posts (of a 7 grade structure) were still vacant. In order to attract and retain these personnel, a strong case can be made for payroll decompression, whilst leaving salaries lower grades at their current levels. Greater flexibility is also needed, to allow finer differentiation between levels of skills and experience, and provide for within grade progression, through the introduction of salary steps.

10. Allocations for goods and services have increased from 31% of actual CFET expenditures in FY2001 to 47% of programmed CFET expenditures in FY2002. This is generous by low-income country standards. Although expenditure data suggests that the bulk of goods and services spending is on operational functions, administrative overheads have increased and may be expected to increase still further as logistical support provided by UNTAET, bilateral and TFET projects is reduced in the coming years. Again tight controls are warranted to ensure that administrative functions do not capture resources intended for service delivery.

11. A further area of concern is the extremely low level of spending on maintenance, which accounted for just 12% of goods and services spending in FY2001 and 6% of liquidated payments to February FY2002. This is significantly lower than required to maintain assets put in place through post-conflict reconstruction. Not only should maintenance allocations be increased but deconcentrated management systems will need to be put in place to ensure that these funds can be used in a timely and effective manner.

12. ***Budget Execution and Alterations.*** Execution has fallen short of programmed expenditures, with an execution rate of 86% in FY2001 and an annualized execution rate of 81% for FY2002. Although there are variations between sectors, the problem is widespread with annualized execution rates of less than 75% appropriations for 25 of the 36 agencies in FY2002. This is partly explained by delays in recruitment and the recent moratorium on minor capital expenditures. However, the principal bottleneck in CFET budget execution is in the liquidation of payments: by February, only 19% of goods and services and 20% of capital appropriations had actually been paid out to suppliers for goods and services rendered. This reflects delays in procurement and delivery by suppliers, particularly where goods have to be imported. Solutions to this problem lie in improved program costing and budgeting, and front-loading of expenditure releases so that agencies can commit funds earlier in the year.

13. ***Expenditure Deconcentration and Regional Distribution.*** Authority for the commitment and disbursement of funds is extremely centralized. In the period July to January FY2002, over 90% of CFET goods and services and capital spending was centrally executed and just 7% was executed at district level. If TFET and bilateral project spending were taken into account, the degree of deconcentration would be even lower. Deconcentration of spending would strengthen facility managers' role in expenditure management and provide opportunities for meaningful community participation in service delivery. However, the lack of banking facilities outside Dili represents a significant constraint.

14. In the absence of comprehensive expenditure data by district it is impossible to determine the regional allocation of public spending. Although, it is encouraging to note that well over 60% the personnel in the service delivery sectors – education, health, agriculture, roads and water and sanitation – are based outside the capital, further studies are needed to verify the share of spending that actually reaches field level service delivery units.

15. ***Public Spending and the Poor.*** The current sectoral structure of expenditures is broadly consistent with the immediate objectives of the pre-independence period: establishment and support to the core institutions of government – the executive, legislature, judiciary and public administration – and restoration of basic public services. However, there are two areas of concern as regards the pro-poor orientation of public spending: firstly, high levels of spending on power utility operating subsidies; and secondly, the proportion of health and education spending allocated to tertiary level services.

16. Data from the 2001 Household Survey suggests that the public spending on the power sector is strongly regressive (benefiting the rich more than the poor): 46% of households with mains electricity as the principal source of light are in the richest fifth of the population. Furthermore, power subsidies – 16% of actual CFET expenditures in FY2001 and at least 11% in FY 2002 – divert substantial volumes of resources that could be applied in poverty reduction programs.

17. Although 54% of CFET education spending was allocated to primary education in FY2002, the overall structure of education spending is regressive, with the richest quintile benefiting from 35% of education subsidies. This reflects the relatively high level of subsidies on and limited access for poorer families to secondary and tertiary education: the richest quintile benefits from 44% and 57% of spending on these services respectively. A similar pattern is found in the health sector, where spending on primary and secondary services is evenly shared across income groups, while the richest quintile benefits from 36% of tertiary service subsidies, leading to a regressive structure of spending for the sector as a whole. While it would be premature to draw policy conclusions from this preliminary analysis, it is clear that increased spending on primary education and health services is most likely to benefit the poor.

EXPENDITURE PLANNING AND BUDGETING

18. ***Economic Monitoring and Forecasting.*** Although routines for the preparation of consumer price indexes are already in place and the compilation of trade statistics has recently begun, monitoring of economic performance is hampered by the lack of regular statistical information on production. A medium-term strategy for the development of trade statistics is needed to address this gap. Forecasts prepared by the Ministry of Finance are designed to support the preparation of short to medium-term revenue estimates. These are based on assumptions regarding economic output and the impact of flows of external assistance on service industries and imports, which constitute the bulk of non-oil tax revenues. For other purposes, forecasts of key economic variables are prepared by the IMF. Development of national capacity for in economic forecasting should be considered a medium-term goal.

19. ***Budget Coverage and Structure.*** The revised FY2002 budget presents revenue, expenditure and financing aggregates in a consolidated budget, broadly following international conventions. Transparency would be improved by including a detailed listing of external financing agreements and their respective disbursements and details of the disposition of and income generated from oil and gas fund savings.

20. The budget follows a program structure that largely coincides with Ministry departments, with a crosscutting economic classification broken down into salaries, goods and services and capital expenditures. Improvements introduced in the FY2003 budget exercise include: a functional classification of expenditures; more detailed breakdowns of goods and services allocations, to facilitate expenditure control; estimates for capital projects, considering projects as cost-centers for the purposes of budget execution; and a breakdown of expenditures by districts, forcing agencies to consider the regional allocation of resources. In the medium term, agency budgets should be further broken down by cost center, so as to facilitate expenditure tracking to field level.

21. ***Budgeting, Expenditure Planning and Performance Management.*** In contrast to the FY2002 budget exercise, national staff have taken an active role in the preparation of agencies FY2003 budget proposals. Synchronization with the National Development Plan process has also helped to focus attention on agency priorities. However, the budget process is undermined by the failure to set hard expenditure limits early on, leading to the presentation of bids that greatly exceed to available financing envelope. A two-stage budget process is proposed as a technical solution to this problem, though this is no substitute for strong political commitment to expenditure control. Difficulties have also been encountered in giving meaningful content to the budget's performance orientation. A formal review of performance indicators is needed, bringing them in line with NDP goals and routine data collection. Periodic expenditure reviews would also help assess the policy consistency of expenditure and improve understanding of the link between expenditures and agency outputs. In the medium-term, Regulation 2001/13, should be revised to a establish a statutory the budget process at agency level and the institutional framework for performance management, particularly as regards institutional responsibilities for the negotiation and monitoring of performance targets.

22. ***Development and Poverty Reduction Planning.*** The National Development Plan, scheduled for completion in mid-April, should provide the broad framework for the Government's growth and poverty reduction policies over the medium-term, indicating the vision, goals and development strategies across eight thematic areas. The institutional arrangements for the planning function following Independence have yet to be defined. While a separate planning commission is one option, most countries now integrate planning and financial management functions under the Ministry of Finance. This approach is recommended for East Timor. The Government intends to undertake a review of the NDP process during the first quarter of FY2003. This should result in a road map for the planning system. A key feature of this system should be a rolling, medium-term strategic planning instrument – linked to the MTFF – that allows Government to update policies and programs regularly to reflect implementation, changing circumstances and improved information on policy options and impact.

23. ***Development Projects.*** While TFET has established procedures for development project management and supervision at the agency level, such systems do not yet exist for core government. These systems have to be put in place as TFET winds down and on-budget development expenditures increase. There are two key elements: firstly, procedures for the review and approval of development projects which ensure adequate standards of formulation and costing, and include simple criteria to verify consistency with the Government's poverty reduction objectives; and secondly, simple tracking systems that allow core agencies and the legislature to identify where project implementation is delayed and projects that are running over their lifetime budget. This basic system can be used to ensure effective management of both internally and externally financed projects.

24. ***Autonomous Agencies.*** Three autonomous agencies were created in FY2002: the Power Authority; the Airport Authority; and Dili Harbor Authority. While the Airport and Port Authorities are now self-financing, the Power Authority continues to rely heavily on budgetary subsidies to cover operating costs. By the end of February 2002 the Power authority had only recovered 19% of its revenue target, largely owing to poor enforcement of collections. An action plan to address structural and management deficiencies is urgently needed, including a realistic plan for cost recovery and the reduction of budgetary transfers over the medium-term. At the same time, an umbrella Public Enterprises Act, specifying internal and external governance structures, the basis for inter-governmental transfers, accounting and insolvency would provide a sounder framework for agency management.

25. ***Management of Financial Assets.*** Conservative estimates of the royalties and tax revenues generated by oil and gas production over the next twenty years exceed $2,000 million (about $2,500 per capita at current population). Estimates including prospective projects are considerably higher, at around $6,000 million ($7,500 per capita). Government has indicated that it intends to save a

substantial proportion of petroleum revenues over the coming decade, when yields will be relatively high, constituting a fund that can be drawn down in perpetuity, after oil and gas reserves are depleted. At present, the Government assigns tax revenues from Timor Sea production to the Consolidated Fund account to support current expenditures. Royalties (First Tranche Petroleum) are deposited on term. By FY2006 the Government will assign a large part of tax revenues to savings as well. Design of an appropriate statutory framework for the management of these savings can provide an important safeguard to ensure that funds are used productively, though is not a substitute for a sound expenditure management system for the budget as a whole. The key issues to be addressed by this statutory framework are: the basis for revenue assignment to savings; the institutional framework for fund management, ensuring transparency, accountability and freedom from political interference; a sound investment policy, balancing risk and the returns from alternative applications of funds; the basis for application of income, channeling funds through the budget system rather than parallel systems or earmarked allocations; and lastly, provisions allowing the use of funds for the purpose of expenditure smoothing.

BUDGET EXECUTION AND CONTROL

26. ***Budget Execution***. Treasury's centralized budget execution procedures ensure rigorous control of agency commitments and payments, backed up by a computerized payments and accounts information system. This system is now being rolled-out to agencies to allow them to monitor execution on-line. While budget execution procedures include multiple safeguards, they rely on a small number of gatekeepers to ensure probity and compliance with expenditure allocations. At present these gatekeepers are expatriates, with most national personnel engaged in data entry rather than supervisory functions. Transfer of management responsibilities to national personnel represents a significant challenge for the medium-term. While measures should be taken to gradually deconcentrate responsibility for budget execution closer to the field level, the centralized payments system – by which payments are executed by treasury or sub-treasuries – should be retained for administrative expenditures.

27. ***Liquidity Management***. Government does not have access to short-term borrowing for the purposes of in-year liquidity management. Consequently, Treasury relies on a rigorous cash-budgeting system, restricting funds release and commitments, to maintain an adequate balance of funds. This can undermine agency performance. A front-loaded disbursement profile for budgetary support would address this problem in the short-term, though it will ultimately have to be addressed by providing access to short-term financing for the purposes of expenditure smoothing, by, for instance, establishing procedures for the call-down and repayment of oil and gas trust funds. At the same time, criteria for the in-year prioritization of expenditures should be defined in order to protect high priority poverty reduction programs from cuts should the Government have to impose expenditure controls.

28. ***Accounting and Financial Reporting***. Comprehensive monthly, quarterly and annual expenditure reports are prepared on a modified cash basis within the specified period. Regulation 2001/13 provides for more complex accounting registers, including tax expenditures, accrual accounting and contingent liabilities. While it would be unreasonable to expect that these provisions can be applied in the near future, a strategy for their progressive application is needed, starting first with the progressive expansion of the coverage of reports, including TFET projects in the first instance, with the introduction of accrual accounting for autonomous agencies and registering of NGO tax expenditures following in the medium-term.

29. ***Personnel and Payroll Management***. Civil service management is centralized, with agencies' proposals for new posts, the selection and recruitment of new staff overseen by the Civil Service and Public Employment Service. Staffing levels are determined through the budget process, though in practice there is little analysis behind the staffing levels determined for each agency. Introduction of a

functional review process would strengthen this process. A Civil Service Code, currently in preparation, is urgently needed to regulate the basic personnel management functions, including appraisal, promotion, transfers, standards of conduct and disciplinary procedures.

30. Payroll control systems require agencies to verify staffing and attendance on a monthly basis. However, these systems are not necessarily effective in identifying absenteeism, which is more easily picked up when service users are required to verify attendance. Furthermore, verification of staffing levels is hampered by inconsistencies between Treasury payroll records and CISPE personnel records, arising from the incomplete institutional coverage of CISPE registers. Regular reconciliation of payroll and personnel records would reduce the risk of ghosting. In the medium-term the separate payroll and personnel databases should be integrated into one system. Tighter controls are also needed on the contracting of temporary employees, including statutory restrictions on the duration of contracts and the introduction of budget codes that enable Treasury to identify agencies' spending on temporary staff.

31. ***Procurement and Supply***[1]. Central Administrative Services manages the procurement and supply process on behalf of agencies, undertaking market consultation on the basis of agencies' specifications and contracting suppliers. Procedures have recently been introduced to ensure that the Public Works Department participates in the drawing up of specifications for and monitoring of works contracts. A computerized tracking system is now being introduced to ensure the risk of unauthorized procurements, bypassing central controls. Procurement policies are needed to prevent further proliferation of makes and models of equipment, such as computers and vehicles, ensuring that only appropriate equipment is purchased and reducing maintenance costs. Procedures for the reception of supplies should also be tightened up, so as to hold agencies responsible for verifying that goods comply with specifications. The divergent donor procedures present a more intractable problem, though many countries have made progress in harmonizing procedures on the basis of multi-donor agreements.

32. ***Asset Management.*** Although the Central Administrative Services does have an asset register, its coverage is incomplete, failing to record: buildings and land; assets of bilateral projects transferred to government; and assets directly procured by agencies. A comprehensive stock take is scheduled for before Independence and Treasury has recently introduced a computerized asset management module, that will automatically link asset registers with payments and procurement records. However, a regulation on asset management is also needed, setting out institutional responsibilities for asset management, providing for verification and laying out procedures for the disposal and transfer of assets, especially from projects.

33. ***Internal Audit, Inspection and Anti-Corruption Measures.*** An Internal Audit Unit, with just two staff, has been set-up in Treasury, carrying out four audits so far during FY2002. Additional staff are needed if the unit is to provide adequate management support across the public sector. An Inspector General's Office, currently subordinate to the Prime Minister, is broadly mandated to investigate cases of corruption and raise awareness on corruption issues. While statutory maximum penalties for abuse of public funds or position have been defined, they are difficult to apply in the absence of clearly defined procedures for carrying out investigations, graduated penalties, suspension and prosecution of public employees and recovery of funds. It is expected that this oversight will be transferred to an independent Ombudsman after Independence. Framework legislation should be put in place to ensure administrative autonomy and define the Ombudsman's competence.

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[1] This Note presents a preliminary review of procurement issues. A comprehensive World Bank Country Procurement Assessment is currently in preparation.

34. Further diagnostic work is needed to identify the extent and risk of corruption. This should lead to the formulation of a comprehensive anti-corruption strategy, identifying changes in management systems to reduce monopoly and discretionary powers and improve transparency throughout the public sector.

EXTERNAL PARTNERS, OVERSIGHT AND CONSULTATION

35. ***External Assistance Management.*** If it is to maximize the benefits from declining external assistance flows over the next three years, Government will have to put in place mechanisms to ensure that external financing is allocated in line with policy priorities. Although the NDP should provide the framework for Government-donor dialogue on policy priorities, a specific external assistance strategy will probably be needed to operationalize the plan for donors, identifying priority sectors and the preferred mechanisms for delivery of external assistance. Internal review and approval procedures should be put in place to ensure that external financing agreements are in line with policy priorities. Ministry of Finance approval should be required for all external financing agreements to ensure that agencies do not use external assistance to by-pass internal review. In order to enforce these procedures and integrate external assistance programming in the budget process, the external assistance management function is best placed in the Ministry of Finance.

36. ***Non-Governmental Organizations***. There is no specific legislation governing the constitution, governance and responsibilities of NGOs. However, NGOs can apply for charitable status and thereby benefit from exemptions from income tax and customs duties for goods imported for the purposes of humanitarian relief (broadly defined to include rehabilitation activities), education and health care. To January 2002, 111 applications have been approved. Government is currently reviewing options for financing service provision by NGOs, in particular religious organizations that currently provide a wide range of education and health services. Enabling legislation is needed to provide a framework for such partnerships, ensuring that transfers are transparent, equitable, efficient and effective.

37. ***Legislative Oversight***. The National Council (current Constituent Assembly), played an active role in the review and approval of the FY2002 budget. The Assembly's oversight function could be strengthened by: involving the legislature early on in budget process, as, for example, in the review of forward estimates prepared in a two-stage budget process; and adopting an appropriate committee structure, providing for review of the budget and accounts.

38. ***Audit***. ETTA's FY2001 Financial Report and Accounts were audited by a commercial auditor and endorsed without qualification. However, the Management Report did identify shortcomings in some internal control procedures. In future, the scope of review should be broadened to cover supporting systems such as personnel, asset management and procurement. The transfer of this function to an independent auditor, reporting to the Assembly, as foreseen in the Constitution, also needs to be planned. A crucial first step is the formulation of framework legislation, laying out the basic institutional structure, functions and competencies of the High Administrative, Tax and Audit Court.

39. ***Consultation and Participation in Expenditure Management***. The extensive consultations that accompanied the NDP process cannot be repeated on routine basis. Nevertheless, there is a need to establish mechanisms that ensure that stakeholders' and citizens' views are taken into account in the planning and budgeting. Design of a consultation strategy should be one of the key outputs of the review of the NDP process. At the same time, the Government can increase awareness of budgeting and expenditure management issues by, for instance, preparing popular guides. Development of participatory mechanisms will depend on local governance structure adopted. Preliminary studies and pilot initiatives are required to evaluate alternative models.

ACTION PLAN

40. ***Capacity Building.*** There is an acute shortage of qualified and experienced managers and professionals in East Timor, particularly so in financial management and accounting functions. Under UNTAET this problem was solved by hiring expatriate specialists. The challenge is now to transfer responsibility to national personnel, whilst ensuring adequate safeguards for the use of public funds. This will require an extended transition, with a phased substitution of expatriate personnel accompanied by substantial investments in training for national personnel at all levels, from post-secondary to post-graduate. Breadth is as important as depth, ensuring that all managers are familiar with the principles of expenditure management as well as procedures. This kind of training program is expensive and would require technical support in design and implementation, possibly through institutional twinning arrangements. An organizational structure, such as a cadre system, will be also needed to provide technical support as well as training to staff in financial management and planning functions across the public sector. If trained staff are to be used effectively they will have to be properly placed and progress monitored. This requires an adequately staffed personnel management function. The transition to national management will be all the faster where there is continuity in the basic systems and procedures, in the institutional framework for technical assistance delivery and individual personnel.

41. ***Proposed Prioritization***. Five priorities are identified for the immediate post Independence period:

- Capacity building in financial management, through the development of an integrated, long-term training and technical assistance program for the whole public sector.
- Strengthening of management controls, through the integration of payment, personnel, procurement and asset management information systems, issuing of complementary regulations and strengthening of internal audit capacity.
- Strengthening of governance structures, by ensuring budgetary transparency, engagement of the legislature in *ex ante* and *ex post* reviews, development of an independent audit function and design of an anti-corruption and transparency strategy.
- Focusing on service delivery, by introducing an operational planning instrument, establishing a statutory framework for performance management and facilitating the deconcentration of resources to the field level.
- Aligning external assistance with Government's development priorities, by increasing the volume of external assistance delivered as budgetary support, establishing appraisal and approval procedures for external financing agreements and establishing a policy framework for Government-donor dialogue.

1. INTRODUCTION

TRANSITIONS AND PUBLIC EXPENDITURE

1.1 This study focuses on public expenditure issues arising from East Timor's transition from United Nations administration to Independence, from reconstruction to development and from aid dependence to fiscal independence. All three of these transitions present opportunities and risks for public expenditure policy and management, all the more so because these transitions are unfolding virtually simultaneously.

1.2 After two and half years of UN administration, East Timor will become an independent country on 20 May 2002. This marks the end of progressive transfer of responsibility from a transitional administration headed by UN officials, through a transitional government led by East Timorese politicians and overseen by the UN, to a sovereign, independent state accountable to its citizens and their representatives. Withdrawal of the UN administrative umbrella requires national staff to assume increased management responsibility. Independent oversight institutions will have to be put in place, together with effective management controls, to reduce the risk of corruption and limit executive powers. Governance will come under the spotlight.

1.3 The transition from reconstruction to development has also been a gradual process. In the immediate post-conflict period, the priority was to put in place the core state institutions, rebuild infrastructure and deliver basic services. External agencies played a leading role in the management of the huge aid flows supporting reconstruction, often substituting for embryonic state institutions in order to deliver results quickly on the ground. Building on these foundations, attention has gradually turned to the need for capacity building, national leadership of the development process, and longer-term planning. While the institutional legacy of the reconstruction phase persists in the design of some external assistance programs, an increasing share of the external resources will be provided as budgetary support, channeled through national systems rather than standalone projects. Priorities will have to be redefined as external assistance flows decline, leading to a reduction in aggregate and sectoral expenditures. Resources will have to be shifted from capital projects to operations and maintenance, from institution building to service delivery. Management systems will have to be put in place to ensure efficiency and effectiveness in the application of scarce resources.

1.4 Unlike most low-income countries, for whom the transition from aid dependence to fiscal independence is a painfully long process, the exploitation of oil and gas reserves promises to provide East Timor with sufficient revenues to cover its expenditure requirements within four years. The track record of most mineral rich countries is poor. If East Timor is to benefit from its mineral windfall, institutional safeguards will have to be put in place to ensure that resources are used productively to benefit present and future generations. If East Timor is to avoid replacing aid dependence with oil dependence, resources will have to be invested in building up human capacity and economic diversification.

PURPOSE AND SCOPE OF THE NOTE

1.5 In addressing these issues, the present Public Expenditure Management and Accountability Note assesses and makes recommendations for improvement of the public expenditure management system as a tool for achieving:

- *Macro-Economic Stability and Growth*, by delivering a sustainable and productive application of resources;

- *Poverty Reduction*, by allocating resources to programs that benefit and meet the needs of the poor;
- *Value-for-Money* in the application of public funds, by focusing on economy, efficiency and effectiveness in public spending;
- *Good Governance*, by ensuring transparency in decision-making and expenditure management, and accountability within the public sector, to the legislature and ultimately to the public.

1.6 The Note is intended as a contribution to the Government's on-going reform and capacity building program. The study identifies areas where public expenditure management systems may require strengthening and makes recommendations for improvement. The study is not a check-list. Proposals should be reviewed critically in order to determine whether they are appropriate and viable. Particular attention should be paid to prioritization. Since Government capacity is limited not all of the actions can be implemented at once, some can be implemented shortly after Independence, others will take much longer. The last chapter proposes a prioritization of actions.

1.7 The Note is also directed at a wider audience of organizations interested in public expenditure management and accountability issues, foremost amongst them donors. The Note provides a frank assessment of the strengths and weaknesses of public expenditure management system that can serve as an input to their assessment of fiduciary risks. Donors may also use the report to identify areas where they may be able to provide technical or financial assistance. Other interested parties include Non-Governmental Organizations who may use the report as an input to their advocacy work.

1.8 The Note is presented in six Chapters, including this Introduction:

- Chapter 2 reviews public expenditure trends over the past two years, covering aggregate expenditure, structural and execution issues, and ending with an assessment of the distribution of the benefits of public spending in three sectors, power, health and education.
- Chapter 3 examines the institutional framework and process of planning and budgeting in core government, autonomous agencies and the arrangements for oil fund management.
- Chapter 4 assesses budget execution and control systems, including supporting systems for personnel, supply and procurement, and asset management.
- Chapter 5 examines the relationship between the core public expenditure management system and external partners, including donors and NGOs, and oversight institutions.
- Chapter 6 presents a brief overview of the capacity building challenges in the area of public expenditure management and proposes a prioritization of actions to address issues identified in the body of the report.

1.9 Throughout its preparation, the Public Expenditure Management and Accountability Note benefited from close collaboration of the various ministries and agencies of the East Timor Public Administration. In particular, the report benefited from the extensive discussions with the Ministry of Finance and the documentation and data that the Ministry made available. The report is based on data collected in March 2002 and consequently does not reflect the results of the FY2003 budget exercise.

2. PUBLIC EXPENDITURE REVIEW

RECENT DEVELOPMENTS

2.1 East Timor will become independent on May 20, 2002, following 25 years of conflict, a violent transition from Indonesian rule in September 1999 and two and half years of United Nations administration. The country now faces all the challenges of nation-building with very limited human resources, embryonic institutions, and high levels of poverty, particularly in the rural areas.

2.2 Significant progress has already been made. Constituent Assembly elections – the first in East Timor's history – concluded peacefully on August 30, 2001. The Assembly has recently approved a new Constitution, which is now subject to public review. A transitional cabinet has been sworn in. Presidential elections are scheduled for April 2002.

2.3 Destruction of much of the country's infrastructure and dislocation of the population led to a sharp decline in output in 1999. Since the restoration of public order in late 1999, the economy has made a strong recovery. It is only possible to give rough estimates of economic performance, owing to the scarcity of economic data, but these suggest that non-oil GDP grew by 15 percent in 2000 and 18 percent in 2001. Output, at $380 million, is now comparable to pre-1999 levels in real terms. Recovery has been strongest in the capital, Dili, driven by spending on services by the international military and civil administration. However, the rapid rehabilitation of rural roads, together with favorable weather conditions, has also elicited a strong response in rural areas. Production of most food crops has now recovered to pre-1999 levels, though rice production is still lower than in the mid-1990s – owing to the poor state of much of the irrigation infrastructure and competition from cheaper imports – and marketing of coffee, the main non-oil export, has recently been affected by low international prices.

2.4 Consumer prices rose sharply in late 1999 and early 2000 due to the disruption of imports and rural marketing. Since then prices have stabilized with inflation at 3 percent during 2001. In January 2000, the East Timor Transitional Administration adopted the US$ as the sole legal tender. Dollarization of the formal economy has proceeded rapidly, though the Indonesian Rupiah continues to circulate in rural areas. Two foreign commercial banks have opened delegations in Dili but there is still no access to banking services outside the capital. Bank deposits have increased, to $8.4 million as of September 2001, but commercial credit remains very limited, at just $1.8 million. On the external account, East Timor faces a huge trade deficit – with non-oil imports of goods estimated at US$210 million and non-oil exports of just US$8 million in 2001 – driven by public sector imports of capital goods for reconstruction and consumer goods to support the large international presence. The trade deficit is financed by inflows of official grants.

2.5 The withdrawal of the United Nations civil administration and winding-down of peacekeeping operations from early 2002 will lead to a significant drop in public spending and a sharp downturn in the service sector. Government anticipates that the economy will see no growth in output in 2002 and 2003: the IMF's forecasts are slightly more optimistic, suggesting that modest growth may resume in 2003. Non-oil related imports are also expected to tail off from $175 million in 2001 to US$117 million in 2003, whilst some increase in non-oil exports is anticipated, resulting in a narrowing of the non-oil trade deficit from US$167 million in 2001 to US$97 in 2003.

REVENUE TRENDS

2.6 East Timor has a narrow revenue base and low revenue yields. Total revenues amounted to US$28 million in FY2001, equivalent to 8% of GDP (see Table 2.1), as compared with an average of 14% for low income countries in 1999 (WDI, 2001).

Table 2.1: Fiscal Trends, FY2000 to FY2006

Source	FY01	FY02	FY03	FY04	FY05	FY06
Value US$						
Import Taxes	10	11	11	11	11	11
Services Tax	2	2	1	1	1	1
Income Taxes	1	4	4	4	5	5
Interest and Other	1	1	1	1	1	1
User Fees and Charges	1	1	2	2	2	2
Autonomous Agencies	1	6	6	7	9	11
Timor Sea non-FTP	10	6	15	32	52	164
Timor Sea FTP	3	6	2	1	30	50
Total US$	**29**	**37**	**42**	**59**	**111**	**245**
Structure %						
Import Taxes	34	30	26	19	10	4
Services Tax	7	5	2	2	1	0
Income Taxes	3	11	10	7	5	2
Interest and Other	3	3	2	2	1	0
User Fees and Charges	3	3	5	3	2	1
Autonomous Agencies	3	16	14	12	8	4
Timor Sea non-FTP	34	16	36	54	47	67
Timor Sea FTP	10	16	5	2	27	20
Total	**100**	**100**	**100**	**100**	**100**	**100**
% Non-Oil GDP						
Autonomous Agencies	0	2	1	2	2	2
Domestic Revenues	1	2	2	2	2	2
Trade Revenues	3	3	3	3	2	2
Oil Revenues	4	3	4	8	18	43
Total	**8**	**10**	**10**	**14**	**24**	**50**

Source: Ministry of Finance

2.7 In FY2001, royalties and taxes on oil production accounted for almost half of total revenue. This share is expected to drop slightly in FY2002 as oil production tails off and then increase rapidly as the Bayu Undan field begins production. By FY2006 oil and gas revenues from approved projects are expected to reach US$215 million, with oil and gas accounting for around 90% of total revenues and 43% of non-oil GDP. Forward estimates based on approved projects and the current tax regime, suggest that that the nominal value of petroleum revenues over a twenty year period are likely to be around $2 billion, with revenue streams heavily front-loaded in the first decade. These estimates will have to be revised to take into account dry gas production and, possibly, Sunrise Troubadour field production, once agreements have been finalized. Not only will revenue yields increase, probably to over $6 billion over twenty years in nominal terms, but dry gas production is also likely to result in a flatter revenue profile, with yields more evenly spaced across the project lifetime.

2.8 Import duties, excises and sales tax on imports account for over one third of total revenues and almost half of non-oil revenues, as compared with an average of 21% for low income countries in 1999 (WDI, 2001). This reflects the early stage of development of the fiscal system and the narrow base of domestic taxation. Since a uniform 5% tariff is applied, the nominal tariff structure is not distortionary, though the effective rate of taxation may be less uniform owing to the difficulties in valuing some imports – such as used vehicles. Excise rates range from 175% for alcohol, 23% on tobacco, 27% for cars and 10% on a wider range of products. Yields from excises account for about

20% of total non-oil revenue. Imports are also subject to a sales tax of 5%, which is effectively a supplementary duty since the tax is not levied on domestic production.

2.9 About 80% of imports are currently tax exempt, mostly imports for UNTAET and diplomatic missions, though registered charities also enjoy exemptions for education, health and humanitarian imports (see 5.10). There are anecdotal reports of the diversion of tax exempt goods to the local market. The scope for this kind of diversion will be reduced as the UN mission winds down. Application of duty to Government imports and, ideally, project imports financed by donors on behalf of Government, would further reduce opportunities for diversion, whilst having a neutral budgetary impact. Of course there is a risk that this would create a bureaucratic hurdle for project implementation, but streamlined procedures can be applied to expedite the dispatching of Government imports.

2.10 Smuggling across land and sea borders is rife. Much of the imported rice on the local market, for example, is thought to be smuggled. Although a concerted effort along the land border could reduce the volume of illegal imports, it is impossible to stamp out altogether. Furthermore, smuggling of excisables is likely to increase as the UNTAET mission winds down, reducing the supply of diverted exempt goods.

2.11 The main domestic revenue sources are corporate and personal income tax and a services tax, levied on hotels, food service establishments, telecommunications firms, and vehicle rental businesses. Together these taxes amounted to 15% of non-oil revenue and little more than 1% of GDP in FY2001. About half the income tax is collected from wage earners. Personal income is taxed on a two step progressive scale of 10-30%, above a threshold of $100 per month. The corporate income tax regime, with a three-step progressive scale with the same upper and lower limits, is free of distortionary tax incentives and exemptions. However, the base for these taxes is extremely narrow: 11 taxpayers provided 68% of services tax collections and 13 taxpayers 84% of corporate income taxes up to August 2001, with nearly all corporate taxes levied on enterprises in Dili (750 of the 822 tax-registered establishments in August 2001).

2.12 Government has a number of options for widening the revenue base through changes in the tax regime, but needs to consider also the implications of any tax-burden increase on the economy's competitiveness and on incentives for investment and employment-creation. In the short term, Government might consider: increases in excise rates; extension of the services tax to construction and financial institutions; increases in sales tax rates; additional user charges on public services, such as airport taxes, vehicle registration and immigration documentation. Over the medium-term, the tax base should grow as the economy becomes more diversified and robust. At a later date, the Government might consider more fundamental reforms, including extension of the sales tax to cover domestic transactions as well as imports, as provided for under existing tax regulations, and the introduction of a presumptive income tax on agriculture and construction. However, these measures are only practicable if there is a significant improvement in East Timor Revenue Service (ETRS)'s staffing and management capacity. Other medium-term measures might include the introduction of a property tax and fees for municipal services, though little progress can be expected in these areas until an appropriate legal and institutional framework is in place: property registration is a pre-requisite for the collection of a property tax, while both the property tax and municipal service fees are unlikely to be feasible without statutory local government structure and assignment of revenues.

2.13 Consequently, in the short-term, increases in non-oil revenue yields will depend on tax-rate hikes and improvements in revenue administration. It is expected that administrative measures – including the sharing ETRS and customs data sets, strengthening of audit capacity, rigorous review of tax exemptions, and establishment of an internal audit function – together with refinements in the existing tax regime, will offset the downturn in the economy in the immediate post-Independence period, as the UN mission winds-down. Yields from the service tax are expected to decline – since

these are levied on services that depend on spending by international personnel – but those from income taxes and import duties are expected to remain at current levels. Over the medium-term, oil and gas revenues will be the principal determinant of the Government's domestic resource envelope.

TRENDS IN AGGREGATE EXPENDITURE

2.14 Public sector spending in East Timor is disbursed through four distinct channels (see Table 2.2). The Consolidated Fund of East Timor (CFET), accounted for 22% of programmed expenditures in FY2002. It is financed from two sources: domestic revenues, which covered 39% of expenditures in FY2002, and budgetary support grants disbursed from a UNTAET Trust Fund, which covered the remaining 61%. Twenty two donors made voluntary contributions amounting to US$58 million for budgetary support in FYs 2000, 2001 and 2002. The Trust Fund for East Timor (TFET), also financed by a consortium of donors, supports programs in the agriculture, roads, water, education, health and community development sectors as well as activities in the areas of micro-finance and enterprise development (19% of programmed expenditures). This is, effectively, the Government's capital program, with funds channeled through project management units under the supervision of sector ministries and overseen by Treasury. Bilateral projects account for 39% of programmed expenditures. Most of these are standalone interventions, managed following donor-specific procedures; some are projects implemented by NGOs with only nominal Government involvement in management and oversight. Lastly, assessed contributions to the UN, covering some international staff and some government operating costs, account for 19% of programmed expenditures.

Table 2.2: Programmed Expenditures by Source of Funds FY2001 and FY2001

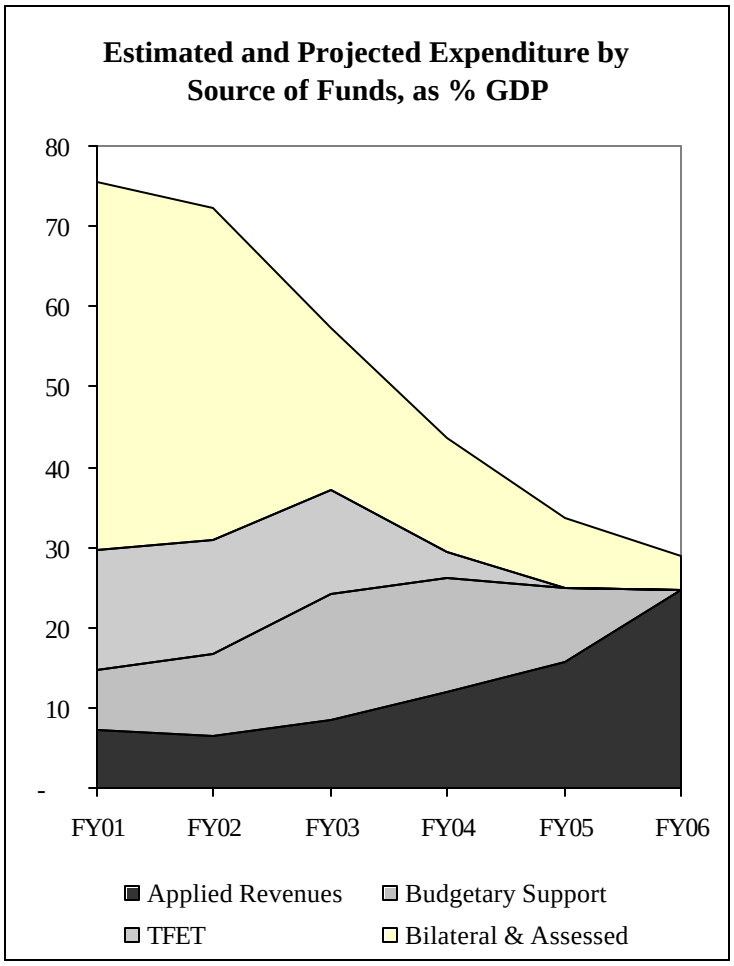
Source	FY2001		FY2002	
	$ Mn	%	$ Mn	%
Consolidated Fund	51.3	19	63.4	22
Trust Fund for East Timor	51.4	19	55.1	19
Bilateral	85.0	32	112.8	39
Assessed Contribution	80.3	30	55.2	19
Total	**268.1**	**100**	**286.6**	**100**

Source: Ministry of Finance

2.15 When considered together, the resources channeled through the public sector amount to over 70% of estimated non-oil GDP (see Figure 1, page 7). This is substantially higher than the share of public spending for low income countries, which averaged just 17% GDP in 1998 (WDI, 2001). However, such high levels of public spending are by no means unusual for post-conflict countries, owing to the low levels of private sector activity and substantial external support for reconstruction. Inevitably, public sector spending tails off as development programs come to predominate and private sector activity recovers. Forward estimates for East Timor show a similar trend, with total public sector financing dropping to under 30% of GDP by FY2006. Over the FY2002 to FY2006 period, per capita public spending is projected to drop from $350 to just $140.

2.16 If the trend of declining public spending is comparable to the experience of other post-conflict countries, the timing is not. Public spending is expected to drop off much faster than seen in, for example, Uganda and Mozambique. Furthermore, the decline in spending is due to reductions in earmarked external financing: again in contrast to Uganda and Mozambique, which continued to benefit from substantial external assistance a decade after conflicts had ended. Forward estimates for East Timor suggest that external financing will only amount to 14% of total public spending in FY2006, or 5% of GDP. Such a steep decline in external financing may be unrealistic, since major bilateral donors are likely to maintain programs over the medium-term. Nevertheless, external financing will decline sharply in the years shortly following Independence as the anticipated oil and

Figure 1



gas windfall comes on stream. The implications of this trend for public expenditure policy are assessed below.

2.17 ***An appropriate level of core budgetary spending***. As external financing declines, one of the most important decisions facing Government is to determine the appropriate level of core budgetary spending. This should reflect three considerations: firstly, the level of public spending that can be applied productively; secondly, the sustainable level of spending; and lastly, the volume of budgetary support that the Government can mobilize. Of these three considerations, the level of spending that can be applied productively is the key determinant of the appropriate level of spending in both the short and medium-term.

2.18 The volume of resources that the public sector can apply productively is largely a function of management capacity: the capacity to plan and budget an appropriate allocation of resources and capacity to implement the expenditure program efficiently and in compliance with statutory requirements. Although considerable progress has been made in establishing appropriate financial management systems, capacity remains weak, owing to the scarce human resources at the government's disposal and the embryonic nature of institutions. The most striking evidence of these capacity constraints is found in the low levels of budget execution seen across the public sector (see page 18), though this report also identifies weaknesses in budgeting, project and capital program management and oversight institutions. In this context, the most useful guide to the appropriate level of spending is the quality of the expenditure program. Programs that merit financing are based on sound policies, supported by a realistic, properly costed budgets, with a direct impact on service delivery, and are backed-up by a strong implementation record. Where programs fail to meet these criteria, increases in spending are unlikely to have the desired impact on public sector output.

2.19 A secondary consideration is the sustainable level of spending taking into account revenue streams over the medium to long-term. The Government's decision to balance inter-generational transfers from oil and gas revenues, by building up a stock of financial assets that can provide income in perpetuity, sets an expenditure constraint. This strategy requires the Government to accumulate substantial savings during the early years of the oil and gas boom. Projections – based on the revenue streams from approved oil and gas projects – indicate that an public expenditure path with CFET expenditures rising to around $120 million in FY2006 and thereafter growing at slightly less than non-

oil GDP, is sustainable, allowing expenditures to be fully financed from non-oil tax revenues and income from oil savings when oil and gas reserves are depleted in 2025. Higher levels of spending in the early years would undermine this strategy, particularly if these created long-term commitments for government. In practice, this constraint is significantly higher than the volume of resources that the Government can use productively in the short-term.

2.20 The third consideration in determining the appropriate level of spending is the volume of budgetary support that Government can mobilize. The Government presented a "high case" financing requirement at the December 2001 Oslo Donors' Conference amounting to $168 million over the three lean years until oil and gas revenues come on stream. This projected a 52% increase in the level of spending in FY2003, to around 25% of GDP, remaining at this level through to FY2006. Expansion of the capital program accounted for much of the programmed increase in spending (see Table 2.3).

Table 2.3: Actual and Projected Consolidated Fund Position

Component	FY01	FY02	FY03	FY04	FY05	FY06
Revenues $m	28	31	36	52	102	234
Expenditures $m	51	64	97	112	115	122
Recurrent	28	52	67	82	85	90
Capital	17	11	30	30	30	32
Oil and Gas Savings $m	3	6	2	1	30	112
Deficit/Financing $m	**(26)**	**(39)**	**(63)**	**(61)**	**(43)**	**-**
Expenditure GDP (%)	*15*	*17*	*24*	*26*	*25*	*25*
Expenditure Growth (%)		*25*	*52*	*15*	*3*	*6*

Source: Ministry of Finance.

2.21 This scenario will be revised downwards in the FY2003 budget and forward estimates. The FY2003 expenditure program is expected to focus on the consolidation of on-going programs, particularly as regards improvements in the efficiency of service delivery, with increases in recurrent spending broadly in line with existing forecasts. TFET will provide the bulk of programmed capital spending, financed from existing donor commitments. Some additional capital spending may be included for high priority projects, such as for the replacement of communications equipment withdrawn by UNTAET and the refurbishment of some administrative buildings. However, most of the new capital program is likely to be deferred pending the formulation of properly costed project proposals and the implementation of procedures for project management and monitoring within the Ministry of Finance (see page 34).

2.22 The Government is currently trying to reconcile agencies' spending proposals and expectations with short-term financing constraints and implementation capacity. Although bids for FY2003, amounting to $94 million, are much lower than received in previous budgetary cycles (see page 29), it is likely to prove more difficult to cut back on proposed expenditures in a collegiate, cabinet decision making process than was the case under UN administration, when decisions could be taken by administrative fiat. Nevertheless, a preliminary review suggests that core budgetary spending can be cut back to around $70 million in FY2003 by deferring proposed capital projects, cutting back on operating expenditures and bringing expenditure programs in line with demonstrated execution capacity. On this basis financing requirements are likely to be around $30 million in FY2003.

2.23 Following the modest increase in CFET spending in FY2003, expenditures would increase sharply in FY2004 to cover new capital projects and the expansion of service delivery. This does not imply a significant increase in the volume of spending channeled through government institutions, merely a shift from TFET projects to the CFET capital program. Combined TFET and CFET expenditures amounted to $119 million in FY2002, about 30% of GDP. By FY2006, total CFET

spending is programmed to have reached $115 million, about 25% of GDP. This suggests that the volume of CFET expenditures currently programmed for FY2004 and beyond is feasible, even if there is only a modest increase in total CFET spending in FY2003.

2.24 ***Mobilizing and managing external assistance during the transition***. Since early 2000, East Timor benefited from substantial external assistance inflows, amounting to around 60% of GDP, excluding the costs of peacekeeping. The volume of financing will drop sharply in the years immediately following Independence. TFET disbursements, currently at around $50 million, will drop to $13 million in FY2004, when the Trust Fund will close. The technical assistance program has been scaled back to 100 "core" posts, financed from assessed contributions, over a period of 24 months up to end-FY2004 with an additional 200 "development" posts to be financed from bilateral contributions. Bilateral programs, supporting projects implemented with Government or through non-governmental organizations, are expected to wind-down over a similar time frame.

2.25 Despite this downward trend, Government can still mobilize support if it presents a coherent external assistance strategy focusing on the one area that donors are likely to support: capacity building. At the same time, efforts should be made to bring externally financed capital spending on budget as soon as possible, so as to facilitate the transition to national management.

2.26 The substantial expatriate technical assistance effort, which currently absorbs over half of all external financing, will be phased out in FY2005. This is premature. Capacity constraints in East Timor's public sector are acute and unlikely to be addressed effectively in the two years immediately following independence. Withdrawal of key technical personnel before national personnel are ready to assume their functions, will undermine public sector performance and fiduciary controls. Besides, Government should be able to mobilize grant financing for a substantial and prolonged technical assistance program. After all, many middle income countries continue to benefit from substantial grant financing for this purpose. Botswana provides an example of a country that has successfully managed the nationalization of management posts over an extended period, drawing on expatriate technical assistance inputs during its transition from a low to middle-income country.

2.27 Clearly, the design of the technical assistance program is critical to its success, both in terms of delivering improvements in capacity and mobilizing the necessary financial support. East Timor's experience to date demonstrates that a coordinated program is preferable to dispersed bilateral assistance. Since Government is unlikely to assume responsibility for recruitment, this requires the support of an international partner with the requisite management systems: UNDP has offered to fulfill this role in FY2003. From the Government's perspective, the critical issues are prioritization of posts, design of terms of reference and the supervision and reporting of staff. The prioritization of "core" and "development" posts for FY2003 has been conducted outside the budget process. If subsequent programs are to be financed through an international partner, so that funds are not fungible, this is probably the most effective way to prioritize posts in future exercises. However, a core-government management structure is needed to appraise agency staffing proposals and monitor performance. Furthermore, appraisal and evaluation criteria will have to be specified, with greater emphasis on capacity building functions and how these will be implemented.

2.28 International experience has shown that technical assistance does not have a significant impact on capacity unless accompanied by a substantial training program to upgrade counterparts' basic skills. A training program of this kind is likely to be expensive and absorb a substantial part of the overall package. Formulation of this capacity building program should be priority for FY2003, so that a long-term program can be presented before oil and gas revenues come on stream.

2.29 At present, development and investment projects enjoy substantial technical assistance support and are closely monitored by external partners. Government has yet to put in place procedures for the management of a project portfolio and currently lacks sufficient resources to finance a program without recourse to projectized external assistance. This capacity has to be put in place before

FY2006, when Government will be able to finance a substantial capital program from oil and gas revenues. While TFET projects are already integrated into sectoral agencies' management structures, monitoring and oversight by core government, notably the Ministry of Finance, is often superficial. Efforts are now being made to integrate TFET into routine budgeting and financial management procedures, by, for instance, ensuring that TFET resources are programmed as part of the budget process and applying the Government's financial management information systems to all TFET projects.

2.30 It will prove more difficult to bring the bilateral project portfolio on-budget, since funds will continue to follow parallel disbursement and reporting channels. Nevertheless, progress can be made by putting in place systems for appraisal, approval, monitoring and tracking expenditures (see pages 34 and 52). What is important from the perspective of sound public expenditure management, is that the investment decision is brought within the budget process, so that external financing does not become a financing window for projects rejected by core Government.

Aggregate Expenditure: Recommendations

a) *Aggregate expenditures should be determined by the level of spending that can be used productively and sustainably, and by the volume of budgetary support that the Government can mobilize. This requires a rigorous budgetary process, leading to the presentation of a balanced budget, with all programmed expenditures covered by revenues, grants and financing.*
b) *Government should seek to increase the volume of external financing channeled through the budgetary and Treasury systems in the three years following Independence, by i) increasing the share of external assistance provided as budgetary and balance of payments support, and ii) putting in place appraisal, monitoring and programming procedures for donor financed capital and development programs.*
c) *In order to mobilize grant financing in the longer-term, priority should be given to the preparation of a coherent capacity building strategy across the public sector, covering both technical assistance and training.*

SECTORAL EXPENDITURES

2.31 Changing policy priorities are reflected in the sectoral composition of CFET expenditures. In the immediate post-conflict period, spending was geared to the establishment of core public sector institutions. In FY2001, general public services – including the financial management, central and district administration and oversight functions – absorbed about 35% of Consolidated Fund spending (see Table 2.4)[2]. About half of these expenditures were one-off payments for the capitalization of the Banking and Payments Authority, acquisition of office equipment and rehabilitation of offices for central agencies. Once start-up costs had been covered, general public services' share of CFET spending dropped to 16% in FY2002 and a larger share of CFET expenditures was allocated to service delivery functions. The social sectors' share of CFET spending increased from 29% of total CFET expenditures in FY2001 to nearly 40% of programmed spending in FY2002. Education now accounts

[2] The institutional structure used for budget and expenditure management purposes has changed three times since 2000. To allow comparison of expenditure allocations across the time series, expenditures have been mapped against the standard UN classification of the functions of government. The results of this mapping exercise should be interpreted with caution: where institutions or projects fulfill multiple functions, expenditures have been mapped against the primary function. Unallocated expenditures include contingency and other reserves and external financing that cannot be assigned to any one functional category.

for one quarter of total CFET spending and health almost one-tenth. Spending on defense and public order has also increased, to 5% and 15% respectively of total programmed CFET expenditures in FY2002, reflecting progress in the recruitment of the first battalion of the East Timor Defense Forces and cadets to the Police Services. In contrast, limited resources have been allocated to economic sectors. Although the sector accounted for around one-fifth of total CFET expenditures in FY2001 and FY2002, the bulk of these funds are allocated to the power authority – 16% of actual CFET spending in FY2001 and 11% of programmed CFET spending in FY2002 – and only a small proportion is allocated to transport and communications (5% in FY2002), agriculture (2%) and economic services (1%).

Table 2.4: Structure of Expenditure by Source of Funds and Sector (%)

Sectors	FY2001					FY2002				
	CFET	TFET	Bilat	UNA	Total	CFET	TFET	Bilat	UNA	Total
General Public Services	35	0	6	66	**29**	16	1	18	65	**23**
Defence	1	-	-	-	**0**	5	-	5	0	**3**
Public Order	13	-	8	16	**10**	15	-	3	16	**8**
Economic Affairs	22	46	39	13	**29**	20	50	21	12	**25**
Health	6	6	2	2	**3**	9	21	8	2	**9**
Education	20	21	27	1	**16**	25	13	21	2	**17**
Other Social	3	27	18	3	**12**	5	16	15	3	**11**
Unallocated	-	-	-	-	**-**	5	-	8	-	**4**
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: Ministry of Finance (Note: CFET data from FY02 Revised Budge; UNA, UN Assessed Contributions).

2.32 There are marked differences in the sectoral structure of spending between sources of financing. This is a legacy of the division of labor established between TFET and UNTAET in 2000. TFET spending has supported programs in the economic sectors (agriculture; roads and transport; and private sector development and micro finance), health, education and community development, constituting the Government's development and capital program. UNTAET technical assistance has been directed primarily the development of core public sector management functions, including the central and district administrations, oversight institutions and the judiciary. Bilateral assistance, in contrast, is more evenly spread, with substantial contributions to the social sectors, including projects in general public services, economic affairs, health, education, water supply and social protection, together with some support to general public services. The resulting pattern of total expenditure broadly follows the CFET sectoral structure. However, there are two areas where the share of total spending is significantly higher than the CFET allocations: economic affairs, notably in agriculture, support to the private sector and investments in road infrastructure; and the social services, notably community development and water and sanitation.

Table 2.5: Sectoral Expenditure by Source of Funds, FY2001 and FY2002

Sectors	FY2001					FY2002				
	CFET	TFET	Bilat	UNA	Total	CFET	TFET	Bilat	UNA	Total
General Public Services	24	0	6	70	100	15	1	30	54	100
Defence	100	-	-	-	100	36	-	63	2	100
Public Order	25	-	25	50	100	43	-	18	39	100
Economic Affairs	15	30	42	14	100	18	39	34	9	100
Health	35	33	18	15	100	22	42	32	3	100
Education	24	23	50	3	100	33	15	50	2	100
Other Social	5	41	46	7	100	10	28	56	5	100
Total	**20**	**19**	**31**	**31**	**100**	**22**	**19**	**39**	**19**	**100**

Source: Ministry of Finance (Note: CFET data from FY02 Revised Budge; UNA, UN Assessed Contributions).

2.33 Table 2.5 indicates the relative weight of these financing channels by sector. This provides a rough indication of those areas where the transition to on-budget financing is likely to prove most difficult, owing to the high levels of dependence on standalone external financing and technical assistance. Bilateral and assessed contributions account for more than 80% of programmed spending on general public services and more than half in the defense, public order, education and other social sectors.

2.34 CFET defense spending is significantly lower than seen in comparable countries, though the gap narrows when all sources of financing are taken into account (see Table 2.6). If peace-keeping operations were also included, the level of spending on defense would be significantly higher than seen in comparable countries.

Table 2.6: International Comparators, Sectoral Expenditure as % of GDP

Sector	CFET	Total	Low Income	Middle Income	East Asia Pacific
Defence	0.8	2.3	2.9	2.9	2.5
Education	4.1	12.4	3.4	3.8	2.5
Health	1.6	7.0	1.3	3.1	1.7

Source: Ministry of Finance (Note: CFET data from FY02 Revised Budget); World Development Indicators 2000/01 (Note: Education and Defense data refers to 1997; Health to 1990-98).

2.35 Spending on education as a share of GDP and in per capita terms is significantly higher than the average for comparator countries. FY2002 CFET spending on education amounted to $19 per capita, as compared with $11 per capita in Vietnam and $8 in Uganda. When all external financing is taken into account, per capita spending increases to $57. This is significantly higher than seen in many middle income countries (Philippines $36 per capita and Sri Lanka $28). The situation is similar in the health sector, where CFET expenditures are higher than low income countries, both as a share of GDP and on a per capita basis, with $7.5 for CFET spending as compared with $1 in Vietnam and $5 in Uganda, but lower than in middle income countries (Philippines $15 and Sri Lanka $12). CFET health spending is also significantly lower than the $12 per capita international estimate for a minimum package of health services, including public health. However, when all sources of financing are considered health expenditures are significantly higher than all comparators, at $32 per capita and 7% of GDP.

2.36 The high levels of external financing in both these sectors reflects inflows to support reconstruction and rehabilitation programs which will draw to a close in the next two to three years. Nevertheless, TFET and bilateral projects also finance sectoral operating costs, including essential consumables such as school books and medicines. These operating costs will be transferred to the CFET budget in the period to FY2006. To cover these costs and sustain on-going programs, the share of CFET spending allocated to health and education sectors will have to increase. This may entail capping lower priority sectors in order to release the necessary funds. For CFET health spending to reach the international $12 per capita benchmark, CFET spending would have to increase by 50% to over $9.6 million, with health's share of the budget rising from 10% to over 15%. At the same time, owing to the winding down of TFET and bilateral programs, total spending in both sectors will decline. Consequently, choices will have to be made regarding the prioritization of programs. As spending is cut back, this prioritization should favor those services with the greatest social returns and poverty reduction impact (see page 22).

2.37 Forward forecasts prepared by the Ministry of Finance before the National Development Plan and FY2003 budget exercises started – and so likely to be changed significantly in the coming months – suggest that it will prove difficult to respond to this challenge owing to competing claims on public spending. Health's share of total CFET spending is expected to remain at around 10% of total spending while education's share falls back to around 20% of spending over the medium term. At the same time, other sectors' share of spending is expected to increase. General public services' share of

spending is expected to increase in FY2003, owing to one-off investments arising and increase in operational costs due to the withdrawal of UN logistical support (see Box 2.1). Thereafter, spending on general public services is expected to remain at about 15% of total CFET expenditures. Spending on defense also increases to around 9% of total CFET expenditures as the armed forces and reserves are built up to full-compliment of 1,500 full-time soldiers. Infrastructure's share increases significantly, to over one quarter of total spending, largely due to increased costs of road maintenance, once rehabilitation has been completed and the routine maintenance costs are shifted to the budget. Clearly, considerable attention should be paid to the forward planning of expenditures in order to assess the future cost implications of policy decisions and ensure that sufficient resources are allocated to the Government's stated policy priorities. If the social services are to be adequately financed it may be necessary to cap spending on other sectors, starting first with the power sector, but also including administration and defense.

Sectoral Expenditures: Recommendations

a) As external assistance declines, an increasing share of resources will have to be assigned to the social sectors just to maintain current levels of service. In the health sector, budgetary spending will have to increase by 50% to reach the $12 per capita international benchmark for a basic package of health services.

b) The future cost implications of policies should be carefully assessed and programmed if the Government is to avoid crowding out of high priority social and poverty reduction programs in future budgets. Spending on low priority sectors may have to be capped.

c) Improvements in cost-recovery and hard budgetary constraints are urgently needed to curtail subsidies to the power authority, which accounted for 11% of CFET spending in FY2002 – more than the budgetary allocation for health.

ECONOMIC COMPOSITION OF EXPENDITURE

2.38 An appropriate balance between personnel, goods and services and capital expenditures is critical to public sector efficiency and the effectiveness of public services. East Timor is starting from a strong position. Unlike most low-income countries the level of spending on personnel is relatively low, at 34% of total budgetary expenditures, freeing a substantial share of resources for capital, operations and maintenance spending. The challenge is to contain personnel expenditures, whilst paying competitive salaries, particularly at the higher grades, and administrative overheads so that service delivery's share of resources is maximized.

Table 2.6: Economic Composition of Consolidated Fund Expenditure by Sector, FY2001 and FY2002 (%)

Sectors	FY 2001Actual				FY 2002 Revised Budget			
	S&W	G&S	Capital	Total	S&W	G&S	Capital	Total
General Public Services	5	13	82	100	26	44	30	100
Defence	39	49	11	100	24	69	7	100
Public Order	24	28	48	100	34	42	24	100
Economic Affairs	8	74	18	100	10	66	24	100
Health	48	31	20	100	40	51	10	100
Education	85	10	5	100	70	22	8	100
Other Social	12	59	29	100	11	66	22	100
Unallocated				-	-	67	33	100
Total	**27**	**31**	**42**	**100**	**34**	**47**	**19**	**100**

Source: Ministry of Finance

Capital Expenditures

2.39 During FY2001, CFET was heavily skewed towards capital expenditures, which accounted for 42% of total spending (see Table 2.6). The proportion of total spending on capital was particularly high for general public services (82%), largely owing the inclusion of a substantial one off charge for the capitalization of the Banking and Payments Authority, and public order (48%), owing to investments in equipment for the police service and buildings for the judiciary. Across the public sector the bulk of capital spending was used to set-up the administration, with acquisition of buildings accounting for 40% of total capital spending (excluding capitalization charges), vehicles and office equipment 25% and only 36% for plant and infrastructure, the category with closer links to service delivery (see Table 2.7).

Table 2.7: Composition of Consolidated Fund Capital Spending by Broad Sector, FY2001 and FY2002

Sector	FY2001				FY2002			
	Build-ings	Vehicle & Office	Plant & Infrastr-ucture	Total	Build-ings	Vehicle & Office	Plant & Infrastr-ucture	Total
General Public Services	53	17	30	100	9	77	14	100
Defence	12	78	11	100	0	100	0	100
Public Order	16	44	40	100	7	70	23	100
Economic Affairs	21	28	51	100	6	65	29	100
Health	10	29	61	100	0	0	100	100
Education	13	35	53	100	0	90	10	100
Other Social	51	43	6	100	15	52	34	100
Total	**39**	**25**	**36**	**100**	**6**	**74**	**19**	**100**

Source: Ministry of Finance (FY2001 actuals and FY2002 liquidated payments to February)

2.40 Although programmed capital expenditures dropped to 19% of total CFET spending in FY2002, with the share of total allocations falling in all sectors but economic affairs, the proportion of capital spending on administrative functions has increased significantly. Spending on buildings has dropped, but capital spending on office equipment and vehicles rose to nearly three quarters of the total, with nearly half of total capital spending allocated to vehicles. Government has now placed a moratorium on the acquisition of vehicles until UNTAET vehicles have been transferred to Government agencies.

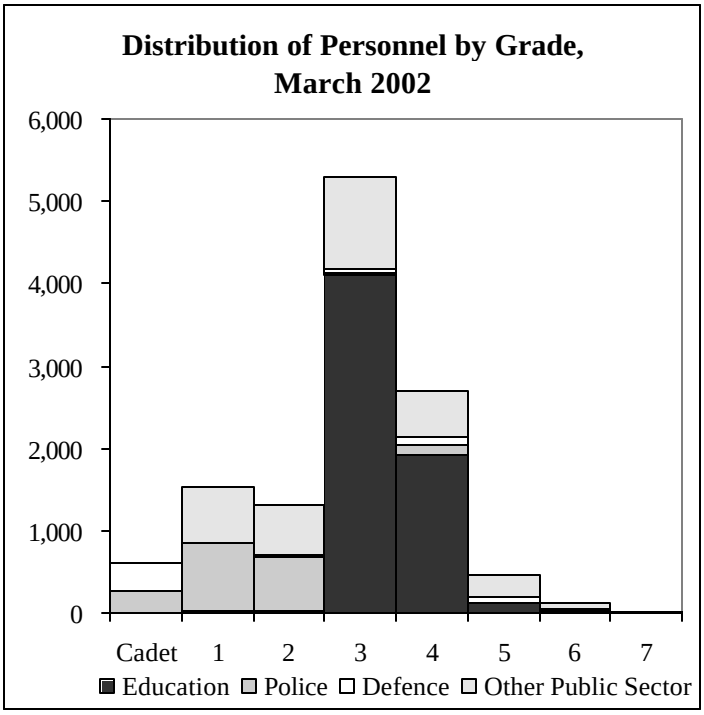
2.41 This pattern of capital spending reflects a division between minor capital spending, which has been financed by CFET, and development spending, which has been financed through TFET, complemented by bilateral projects. Consequently, CFET capital spending does not reflect the substantial investments in schools, health facilities, rural water supplies and transport infrastructure in recent years. This pattern will change as TFET winds down and development projects are brought onto the CFET budget. Nevertheless, the high levels of spending on the administration, particularly for consumables with high maintenance and operation costs, such as vehicles, indicates that there is still a need for tight controls on minor capital spending .

Personnel Expenditures

2.42 Unlike most low income countries, personnel costs account for a relatively small share of the budget: 27% of actual expenditures in FY2001 and 34% of programmed expenditures in FY2002. The public sector payroll is modest, with a total payroll of 12,274, of which 3,300 are civil servants and 6,600 teachers, around 3% of the working age population, as compared with an estimated 28,000 civil servants under Indonesian administration (see Figure 2). The education sector accounts for just over

half total payroll costs. Staffing levels have increased in FY2002, particularly in education, the police and defense forces and general public services, though most agencies are now at or near their programmed establishment limit. Despite the increases in staffing numbers, the share of sector spending allocated to payroll has actually fallen in key service delivery sectors, notably education and health, allowing an increase in spending on goods and services. This is a positive trend. However, there is considerable pressure to increase staffing numbers – the public sector is virtually the only source of formal salaried employment – and public sector salaries, in large measure provoked by artificially high salaries paid by international organizations. Faced with these pressures, high level commitment to a lean and cost-effective public service will be needed to contain payroll costs in the post-Independence period.

Figure 2



2.43 One of the features of the current staffing profile is the high proportion of staff in middle-grades and low staffing levels in senior grades. This structure is most pronounced in the education sector, where two thirds of staff have been recruited into Grade 3, as compared with one third of staff in other sectors (excluding defense and the police force). Senior professional and managerial staff (grades 5 and 6) account for just 5% of total public sector employment, and just 11% of core civil service. Considerable difficulty has been encountered in recruiting suitably qualified staff in these grades: in January 2002, 22% of grade 5 and 6 posts were still vacant. However, the skills shortfall is common to the whole public sector. Selection criteria have had to be relaxed in order to fill posts in the administration, for teachers and in technical fields.

2.44 The difficulties encountered in recruiting qualified staff for senior posts are, in part, a consequence of uncompetitive pay for senior grades: salaries for graduates in the private and NGO sectors are often double those paid for corresponding posts in the civil service. On the other hand, levels of pay for staff in levels 1 to 3 are fairly competitive. The compression rate of 4.4 – highest grade pay as a multiple of lowest grade pay – is significantly lower than the mean of 8.8 for developing countries. A strong case can be made for public sector pay reforms leading to decompression at the higher grades whilst leaving lower grades' salaries at their current levels. There is a danger that, in the absence of pay reform, civil servants' income will be increased through additional non-salary benefits. This would distort the pay structure, create perverse incentives and reduce transparency.

2.45 Introduction of within grade salary steps would provide greater flexibility in the pay structure, thereby allowing finer differentiation between levels of skills and experience, and providing for within grade progression. However, considerable care should be taken in the design of a revised pay structure since minor changes in salary structure could have a significant impact on the total wage bill. A revised salary structure leading to a 10% increase in the salaries of 50% of staff in each grade would

add $880,000 – almost 5% – to the annual wage bill, with 60% of this increase benefiting staff in grades 3 and below.

Operations and Maintenance Expenditures

2.46 Allocations for goods and services have increased from 31% of actual CFET expenditures in FY2001 to 47% of programmed CFET expenditures in FY2002 (see Table 2.6). Aggregate data is distorted by the huge allocations to the power authority: the authority accounted for nearly half of total government spending on goods and services in FY2001 and nearly 20% in FY2002. Nevertheless, most sectors' goods and services allocations are around half of total sector spending. This is generous by low-income country standards. Sectoral spending on goods and services is lowest in the education sector, at just 22% of total sectoral spending in FY2002, though this does not to take into account substantial TFET and bilateral expenditures on school materials and so underestimates total sectoral operational spending. Likewise operational spending is significantly higher than 50% in the health sector if external financing of medical supplies is taken into account.

Table 2.8: Composition of Consolidated Fund Goods and Services Spending (%)

	FY2001					FY2002				
Sector	**Administrative**	**Operat-ional**	**Routine Mainte-nance**	**Other Serv-ices**	**Total**	**Administrative**	**Operat-ional**	**Routine Mainte-nance**	**Other Serv-ices**	**Total**
General Public Services	13	33	1	52	100	40	24	3	34	100
Defence	3	96	0	0	100	9	90	0	1	100
Public Order	10	75	7	8	100	26	63	6	4	100
Economic Affairs	8	26	23	43	100	13	67	9	11	100
Health	3	76	1	20	100	18	51	4	27	100
Education	22	63	0	15	100	23	61	0	16	100
Other Social	13	29	52	7	100	71	11	4	13	100
Total	**11**	**49**	**12**	**28**	**100**	**20**	**60**	**6**	**14**	**100**

Source: Ministry of Finance (FY2001 actuals and FY2002 liquidated payments to February)

2.47 Although the classification of payments data is not always accurate, it does suggest that the bulk of goods and services spending is on operational functions rather than on administrative overheads (see Table 2.8). However, administrative overheads are increasing, particularly in general public services, and may be expected to increase still further as logistical support provided by UNTAET, bilateral and TFET projects is reduced in the coming years (see Box 2.1). Again tight controls are warranted to ensure that administrative functions do not capture resources intended for service delivery. This risk is particularly acute given the concentration of spending authority in central agencies (see page 21).

2.48 Also of concern is the relatively low share of spending on routine maintenance, which accounted for just 12% of goods and services spending in FY2001 and 6% of liquidated payments to February FY2002. In FY2001, over half of the water and sanitation sector's goods and services spending was on maintenance activities and one third of the fuel and road transport sectors'. Only the roads sector sustained this level of spending in FY2002. There is no maintenance spending in the education sector in either FY2001 or FY2002, surprisingly so given that an allocation of $500 per school was approved in the original appropriations. Spending on maintenance is also extremely low in the defense, health, public order and general public services sectors.

2.49 As a rule of thumb, expenditure on maintenance should be above 5% of the capital stock: current levels of maintenance spending are less than 1% of capital spending in FY2001 and FY2002, and are insignificant in relation to total public sector assets. Inevitably, this calls into question the sustainability of infrastructure program and equipment and buildings acquired by Government. While

Box 2.1: Estimating the Cost of Transition

Although the UNTAET mission and East Timor Public Administration are institutionally distinct, there are a number of shared and cross-subsidized services. UNTAET has prepared cost estimates for some of these services, amounting to at least $1.5 million a year. These include, on a monthly basis: electricity generation for government buildings ($10,000); internet and email services for personnel in Government offices ($15,000); computer consumables ($9,500); telephone communications ($12,000); and office supplies ($78,000). Some of these services will be discontinued and others cut back. Internet services, for instance, are likely to be restricted to a few key personnel and agencies, such as the Ministry of Finance.

The transfer of UNTAET assets – including accommodation units, 450 vehicles, 460 computers and furniture, communications equipment – will substitute for capital outlays, but it will also increase maintenance costs and demand for consumables such as fuel and office supplies. Concern has already been voiced regarding the condition of some of the assets to be transferred, particularly vehicles, since this is likely to increase maintenance costs.

Less tangible are the costs induced by the transfer of working practices. The civil service has become used to working in an environment where generous supplies of consumables and utilities are readily available, sometimes without direct costs. Similarly, relatively high daily travel allowances – at $11 a day equivalent to nearly two days' salary for Grade 3 staff – have inevitably created the perverse incentives seen in other low income countries.

The Government's decision not to mount air conditioning in Government offices indicates that it is prepared to reduce operating costs. So too do recent efforts to cut back on international and domestic travel and training events in agencies' FY2003 budget submissions. Nevertheless, much still needs to be done to inculcate cost awareness in the public sector.

increases in maintenance spending are clearly needed, the management challenge should not be underestimated. Maintenance requires many small, timely interventions by service delivery units to avoid deterioration of infrastructure and equipment. The most effective maintenance systems tend to be those that deconcentrate responsibility to the field level. Unfortunately, the current sectoral and public expenditure management systems are highly centralized, particularly so in sectors such as education where deconcentrated maintenance management is likely to be most effective.

Externally Financed Technical Assistance and Capital Spending

2.50 Rough estimates of programmed externally financed expenditures prepared by the Ministry of Finance suggest that around half of total programmed expenditure is allocated to technical assistance (see Table 2.9). Technical assistance's share of programmed spending is particularly high in general public services and the judiciary reflecting the large number of UNTAET personnel in core public institutions. Spending on technical assistance is higher than on CFET payroll in all sectors, including education, and is roughly four times the total CFET wage bill.

2.51 While this level of technical assistance financing cannot be sustained in the longer-term, it is likely to remain close to current levels in the two years after Independence if Government secures financing for the 100 "core" and 280 "development" posts that have been proposed. Given capacity constraints, the need for substantial technical assistance inputs will continue well in the next decade. Ideally, this assistance should be provided through a coordinated program: this allows the Government to prioritize the allocation of personnel and brings them under the direct supervision of national managers. The alternative, technical assistance provided through large numbers of standalone projects, has a poor track record in terms of skills transfer. However, the initiative for this kind of program rests

with Government. Bilateral donors will find it difficult to coordinate assistance unless Government puts in place an appropriate policy and management framework. This should be considered one of the highest priorities for FY2003.

Table 2.9: Composition of Total Programmed Expenditure , FY2002 (%)

Sectors	Personnel	Technical Assistance	Goods & Services	Capital	Total
General Public Services	4	75	7	14	100
Defence	9	23	25	43	100
Public Order	16	62	20	2	100
Economic Affairs	2	32	12	53	100
Health	9	42	12	37	100
Education	24	48	8	20	100
Other Social	1	6	3	90	100
Total	**8**	**46**	**11**	**35**	**100**

Source: Ministry of Finance

2.52 Although the classification of external assistance delivered as capital is fairly loose, including administrative and operational support as well as capital, it is clear that a substantial share of spending is allocated to capital activities, roughly one third of total public spending. Such high levels of investment cannot be sustained over the longer-term. As infrastructure is put in place, an increasing share of public spending will have to be transferred to the recurrent budget to support operations and maintenance. If resources are to be used productively, the level of capital investment should be driven by the resources available for recurrent financing, through a rigorous appraisal of the induced recurrent costs of all capital spending. This strengthens the case for a gradual transfer of capital spending from standalone, externally financed projects to the Government's capital program.

Economic Composition of Expenditure: Recommendations

a) *Tight controls on minor capital and administrative expenditures will be needed to prevent administrative capture, releasing funds for development projects as these are brought on budget and for operations expenditures in support of service delivery.*
b) *Decompression of salaries is justified in order to facilitate recruitment and retention of suitably qualified senior managers and technicians. Within-grade salary increments should be considered as a means of providing for finer differentiation based on qualifications and experience and allowing for within grade progression.*
c) *Maintenance spending should be increased significantly, accompanied by a deconcentration of responsibility for maintenance management so that resources are available closer to the field level.*
d) *Government should give high priority to the development of a coherent program of technical assistance and training to meet its capacity and capacity building requirements for the long-term.*

BUDGET EXECUTION AND ALTERATIONS

2.53 One of the key considerations in determining the viability of the public expenditure program is execution capacity. Execution fell slightly short of programmed expenditures in FY2001, with spending at 86% of total appropriations, broken down as 90% of capital appropriations, 87% of salaries and wages appropriations, and 81% of its goods and services appropriations (see Table 2.10). The higher rates of execution against capital appropriations in FY2001 reflect the priority given to the

acquisition of administrative buildings and equipment, but also the relative ease of acquiring equipment as compared to the execution of goods and services, which tends to be driven by activities. Relatively low execution rates for personnel are the result of difficulties in identifying and recruiting candidates and/or delays in the recruitment process. Annualized execution rates for FY2002 to February – based on commitments and liquidated payments – suggest a similar level of execution for personnel and goods and services at the aggregate level, though execution of capital appropriations is significantly lower than the previous year due to the Ministry of Finance's decision to defer commitments of capital expenditures until UNTAET mission equipment has been transferred to Government.

Table 2.10: Annual and Annualized Execution FY2001 and FY2002 (%)

Sector	FY 2001 Actual				FY 2002 Annualized Actual			
	W&S	G&S	Capital	Total	W&S	G&S	Capital	Total
General Public Services	67	75	97	92	79	49	70	63
Defence	69	52	92	61	78	102	130	98
Public Order	83	78	78	79	75	79	42	69
Economic Affairs	70	91	68	84	72	117	67	100
Health	82	84	100	86	90	99	140	99
Education	96	83	99	94	90	61	78	83
Other Social	76	67	80	71	70	103	66	91
Total	**87**	**81**	**90**	**86**	**85**	**84**	**63**	**81**

Source: Ministry of Finance (Note: CFET data from FY02 Revised Budget and annualized commitments and liquidated to February 2002).

2.54 Aggregate data hides considerable variation in budgetary execution between sectors. Annualized FY2002 execution rates for personnel and goods and services are lowest in general public services; health and agriculture sector spending has tended to be front loaded; while mid-year commitments and payments for the goods and services in the power sector have tended to exceed estimates, running at nearly double the FY2002 appropriation in mid-year. Agency level expenditure data reveals the extent of execution constraints (see Table 2.11). Of the 40 agencies in FY2001, 19 spent less than three-quarters of revised total appropriations. Annualized execution in FY2002 is even weaker, with 25 of the 36 agencies spendin g less than 75% of appropriations. Agency level execution of personnel and goods and services spending is particularly weak in both years, with more than one in four agencies spending less than half their appropriations.

Table 2.11: Agency Execution and Sequestrations FY2001

Execution Indicator	FY2002 Actual Execution 40 Institutions				FY2002 Annualized Execution 36 Institutions			
	S&W	G&S	Capital	Total	S&W	G&S	Capital	Total
No. Agencies Execution <75%	19	19	11	20	21	25	15	25
No. Agencies Execution <50%	11	12	3	3	12	16	9	13
No. Agencies sequestered	6	18	3	9	16	17	7	20
Sequestrations % total appropriations	4	32	7	16	4	13	5	8
Sequestrations % agencies' appropriations	7	38	44	23	13	18	8	10

Source: Ministry of Finance

2.55 Table 2.11 reveals extensive sequestrations of agency funds, reallocating resources from low-spending to high-spending agencies. In FY2001, almost half of the forty agencies had goods and services appropriations sequestered, with sequestrations amounting to more than one third of these agencies' appropriations. Sequestrations have also been proposed for FY2002, reducing total spending

from $64 million to $59 million, in order to bring appropriations in line with available financing. Although the sequestrations are extensive, a smaller proportion of total and agency appropriations have been withheld. Further sequestrations of agency appropriations may be required towards the end of the fiscal year.

2.56 Low levels of budget execution and the extent of in year alterations reveal deficiencies in budget formulation. Admittedly it is difficult for agencies to prepare realistic budgets: agencies do not have much of a track record on which to base their estimates and budgeting in times of change is always a hit and miss affair. Nevertheless, more attention needs to be paid to assessments of implementation capacity and actual costs if realistic budgets are to be prepared.

2.57 Data on the breakdown of expenditures by stage of payment provides some indication of the origin of bottlenecks in execution (see Table 2.12). Ministry of Finance expenditure releases to agencies are broadly on track, at around 68% of goods and services and 63% capital appropriations by mid-FY2002. There is some delay in the commitment of funds, at 56% of goods and services and 42% of capital appropriations by mid-year, which may result from poor programming of spending and, in the case of capital, withholding of commitments by the Ministry of Finance. (The power sector is an exception with 90% of annual appropriations committed by end of the February 2002). However, the principal bottleneck in CFET budget execution is in the liquidation of payments: by February, only 19% of goods and services and 20% of capital appropriations had actually been paid out to suppliers for goods and services rendered. Once commitments have been authorized, there are significant delays in the procurement process and delivery by suppliers, since most goods have to be imported.

Table 2.12: Expenditure by Stage of Payments as % of Appropriations, February 2002

Component	Released	Committed & Liquidated	Liquidated
Personnel	63	57	57
Goods and Services	68	56	19
Capital	63	42	20
Total	**65**	**54**	**32**

Source: Ministry of Finance

2.58 The low level of payment liquidation suggest that the current funds release profile is too conservative for the difficult procurement environment: if appropriations are to be spent by end of year, funds would have to be fully released by the end of the third-quarter at least and perhaps three-quarters of appropriations released by mid-year. This lends support to the argument for a heavily front-loaded profile for external partners' budgetary support, since the Ministry of Finance will be unable to authorize the release and commitment of funds unless it has confidence that expenditures have adequate coverage from revenues and financing.

Budget Execution and Alterations: Recommendations

a) *Low levels of budget execution are, in part, a reflection of deficient budgeting. Subsequent budgeting exercises should focus on improving program costing and assessment of agency implementation capacity.*
b) *Owing to the lengthy procurement process, funds release should be front-loaded to ensure that agencies have sufficient time to execute appropriations. For this to be feasible, external partners will have to front-load budgetary and balance of payments support to ensure that financing is available to cover Government expenditure commitments*

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EXPENDITURE DECONCENTRATION AND REGIONAL DISTRIBUTION

2.59 Authority for the commitment and disbursement of funds is extremely centralized. In the period July to January FY2002, over 90% of CFET goods and services and capital spending was centrally executed and just 7% was executed at district level. If TFET and bilateral project spending were taken into account, the degree of deconcentration would be even lower. The Community Empowerment Project is a notable exception, with almost half of programmed spending disbursed through communities.

2.60 It should be stressed that this data does not reflect the allocation of public spending, in terms of the geographical distribution of beneficiaries, merely the division of responsibility for budget execution. For example, most school and medical supplies, though distributed to the districts, are purchased centrally and recorded as such. Some attempt is made to distinguish expenditures made by central agencies for national programs – amounting to 16% of goods and services and 6% of capital – but this data is not recorded systematically and so underestimates the share of resources destined for field level programs.

2.61 Deconcentration is not necessarily efficient: routine maintenance of service delivery units for instance, is probably more efficient when deconcentrated, but purchase of medical supplies is not. Nevertheless, the degree of deconcentration is important, since it determines the extent to which district and service delivery unit managers are able to manage their budgets, and the extent to which communities can be meaningfully involved in service delivery management.

Table 2.13: Expenditure Deconcentration by Sector / Program (%)
(July to February FY2002)

Sector	Goods & Services				Capital			
	Dili	National	Districts	Total	Dili	National	Districts	Total
General Public Services	88	8	4	100	99	1	0	100
Defence	93	7	-	100	100	-	-	100
Public Order	92	4	4	100	90	7	3	100
Economic Affairs	70	26	4	100	71	17	12	100
Health	55	13	32	100	64	36	-	100
Education	99	1	0	100	100	-	-	100
Other Social	94	6	-	100	100	-	-	100
Total	**78**	**16**	**6**	**100**	**90**	**6**	**4**	**100**

Source: Ministry of Finance

2.62 Only the health sector has made significant progress in deconcentrating resources, with almost one third of goods and services spending executed by districts, mainly to regional hospitals. Only three sectors – agriculture, internal administration and road transport – have deconcentration rates above ten percent of total goods and services spending to February FY2002. For the rest of government, the level of deconcentration is negligible or none. Furthermore, the degree of sectoral deconcentration is not uniform across districts, with limited spending in a handful of districts and none in the majority.

2.63 Since about 85% of the population and 90% of the poor live outside the capital, the geographical distribution of public spending is critical in determining whether public spending is distributed equitably and is broadly pro-poor. In the absence of regionally disaggregated expenditure data, the distribution of personnel is perhaps the best indicator of the geographical allocation of resources. Table 2.14 indicates that around 40% of staff are based in the capital. The majority of these are employees of central agencies and so cannot be considered as representative of the share of spending on service delivery in the capital. Indeed, it is encouraging to note that well over 60% the personnel in the service delivery sectors – education, health, agriculture, roads and water and

sanitation – are based outside the capital, particularly when one considers the rudimentary conditions in many districts and difficulty encountered in out-placing qualified personnel.

Table 2.14: Distribution of Personnel by Districts, February 2002

Sectors	Number of Personnel				% Personnel			
	Dili	Baucau	Other Districts	Total	Dili	Baucau	Other Districts	Total
General Public Services	768	23	275	1,066	72	2	26	100
Defence	597	0	0	597	100	-	-	100
Public Order	1,095	188	997	2,280	48	8	44	100
Economic Affairs	304	29	157	490	62	6	32	100
Health	494	186	701	1,381	36	13	51	100
Education	1,535	681	4,056	6,272	24	11	65	100
Other Social	125	8	55	188	66	4	29	100
Total	**4,918**	**1,115**	**6,241**	**12,274**	**40**	**9**	**51**	**100**

Source: Ministry of Finance (Note: CFET data from FY02 Revised Budget).

2.64 Obviously the placement of personnel does not signify that financial and material resources follow. Further work is needed to understand the distribution of spending between levels of administration and its geographical allocation. The experience of other low-income – and some high-income countries – suggests that where resources and spending decisions are centralized, the administration tends to capture a substantial share of resources, even where these are nominally allocated for front-line service delivery and service delivery units are well-staffed. The share of resources that actually reaches service delivery facilities and benefits the rural population can be assessed through expenditure tracking studies, carried out in the context of periodic expenditure reviews (see page 29).

Budget Deconcentration and Regional Distribution: Recommendations

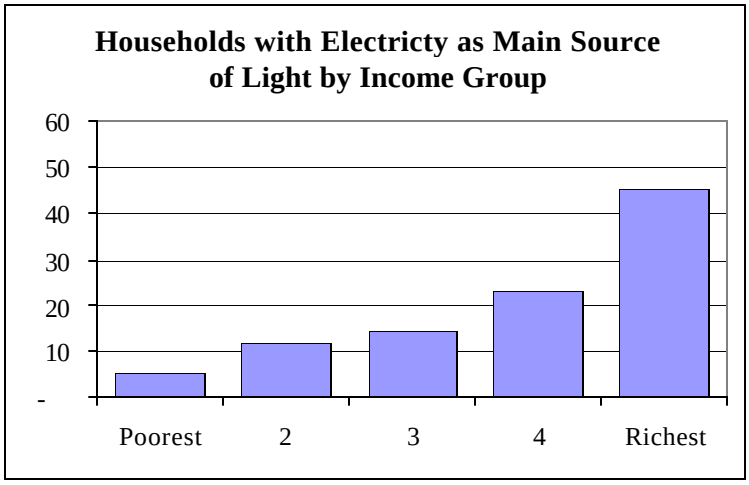
a) *Progressive decentralization of agency budget execution authority should be encouraged to improve efficiency in service delivery management and create opportunities for communities to influence resource allocation decisions. However, the constraints imposed by the lack of banking facilities in rural areas and the risks inherent in making large cash transfers to rural areas should be recognized.*
b) *Tracking studies should be implemented as part of public expenditure reviews to verify what proportion of resources allocated for service delivery actually reaches the intended beneficiaries.*

PUBLIC SPENDING AND THE POOR

2.65 The current sectoral structure of expenditures is broadly consistent with the immediate objectives of the pre-independence period: establishment and support to the core institutions of government – the executive, legislature, judiciary and public administration – and restoration of basic public services. Furthermore, the relatively high proportion of public spending on operational goods and services and the regional distribution of personnel do suggest that resources are being spent on service delivery. However, there are two areas of concern as regards the pro-poor orientation of public spending: firstly, high levels of spending on power utility operating subsidies; and secondly, the proportion of health and education spending allocated to tertiary level services.

2.66 Data from the 2001 Household Survey suggest that the public spending on the power sector is strongly regressive (benefiting the rich more than the poor): 46% of households with mains electricity as the principal source of light are in the richest fifth of the population (see Figure 3). The distribution of the subsidy between households by income group is difficult to calculate in the absence of consumption and payments data. On the one hand one would expect power consumption to increase with income. On the other, revenue collections are larger for wealthier households and tend to more rigorously enforced. However, it should be noted that only 650 households are classified as large domestic consumers, providing the bulk of domestic revenue collections, all of which are Dili residents, and these represent a small fraction of the richest quintile (comprising over 17,000 power consumers). Consequently, there can be little doubt that – aside from a small number of the wealthiest households who pay for electricity – power subsidies benefit the rich far more than they do the poor. Furthermore, the opportunity cost of power subsidies – 16% of actual CFET expenditures in FY2001 and at least 11% in FY 2002 – is huge, diverting resources that could be applied in poverty reduction programs. Clearly, continuation of substantial power subsidies is incompatible with a pro-poor spending program. Measures are urgently needed to enforce revenue collections and cap subsidies, first in Dili and then for district systems. These issues are examined in the context of the institutional arrangements for autonomous authorities (see page 35).

Figure 3



2.67 International experience suggests that one of the key determinants of the poverty–orientation of spending in the social sectors is the distribution of spending between levels of service delivery, with spending on lower level services, which are more accessible to the poor, tending to be progressive and spending on higher levels of service tending to be regressive. A similar pattern is found in East Timor.

Table 2.15: Education Spending by Source Funds and Program, FY2002 (%)

Sector/Program	CFET	TFET	Bilateral	Total
Early Childhood Education	1	-	-	0
Primary and Secondary, of which	77	90	29	57
Primary Education	54	90	3	39
Technical and Vocational	3	-	17	9
Non-Formal & Language	1	-	6	3
University	10	-	47	25
Administration & Management	7	10	2	5
Total	**100**	**100**	**100**	**100**

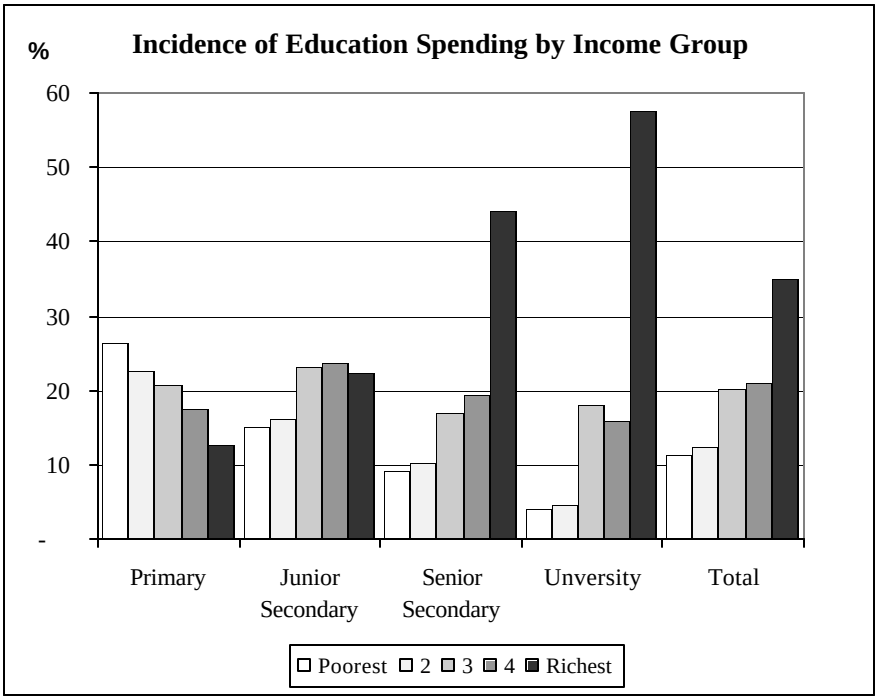
Source: Ministry of Finance

2.68 The revised budget for FY2002 indicates that 54% of CFET expenditures are allocated to primary education, 23% to secondary education and 10% to tertiary services (see Table 2.15). When external financing is taken into account, primary education's share of total spending drops

significantly, to 37% of total, while University education's share increases to 25%, both as support to the development of national institutions and scholarships abroad.

2.69 Figure 4 maps the per student subsidy from CFET spending on different levels of education across household income groups, using data from the 2001 Household Survey. Spending on public primary education is progressive, since more poor children attend public primary schools than children from wealthier families. This may be because children of wealthier families are more likely to attend private schools. It may also reflect the fact that children of poorer families are more likely to be outside their age cohort, attending school later than those in wealthier families and held back by higher repetition rates. At junior secondary school the distribution of subsidies begins to reverse, though the regressive nature of subsidies is most marked for secondary and tertiary education, where the richest quintile benefits from 44% and 57% of spending respectively. Owing to the relatively high share of education spending on secondary and tertiary services, the overall pattern of education spending is strongly regressive, with the richest quintile benefiting from 35% of education subsidies. Obviously, the regressive nature of education spending would be even more marked if external financing is taken into account, since this significantly increases the subsidy at University level.

Figure 4



2.70 Formulation of an appropriate policy response requires further analysis. The average incidence of spending hides the impact of changes in the volume of spending on different levels of services by income group. It is often found that increases in spending tend to benefit poor more than the average incidence would suggest. This is most likely to be the case for junior secondary schools. The determinants of attendance at different levels of service should also be assessed, since if the poor are deterred from attending secondary school by fees and incidental charges, increases in public spending will continue to benefit the wealthier income groups if these charges are not reduced. Notwithstanding these caveats, there is clearly a need for some reconsideration of the allocation of public spending between levels of education, with a larger share of spending allocated to primary and junior secondary education accompanied by measures intended to increase poorer children's' enrollment in secondary and university education. The policy response favored by most countries in these circumstances is to increase cost recovery from higher level services, while providing targeted subsidies to support students from poor families.

2.71 The program structure used in the health sector allows a rough breakdown of spending by level of service: unfortunately it is not possible to make this distinction for bilateral projects (see Table

2.16). Tertiary – hospital – services are allocated just under over half of CFET health sector spending. This pattern contrasts with the health policy objective, which is to restrain hospital spending to the range of 35-40% of CFET expenditures. The pattern of spending is even more skewed in favor of tertiary services when TFET spending is taken into account, rising around two-thirds of combined expenditure. However, the bulk of TFET spending on tertiary services are one-off payments for the rehabilitation and re-equipment of hospitals, rather than on-going operational costs.

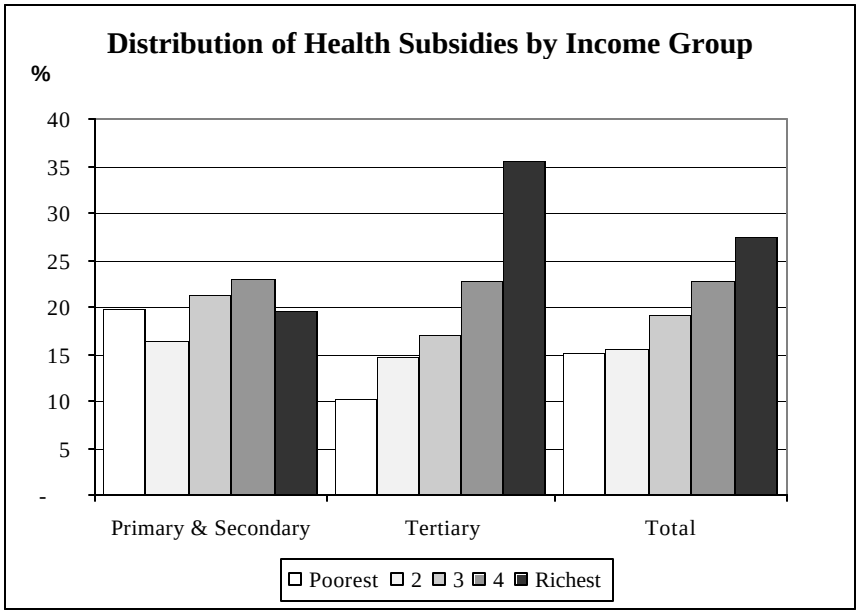
Table 2.16: Health Spending by Source of Funds, Program and Level of Service, FY2002 (%)

Program/Level of Care	CFET	TFET	Bilateral	Total
By Program				
Support Ongoing Service Delivery	68	17	25	32
Range and Quality of Service	25	66	35	48
Policy and Management	8	16	40	20
Total by Program	100	100	100	100
By Level of Care				
Primary and Secondary Care	51	34		39
Tertiary Care	49	66		61
Total by Level of Care	100	100		100

Source: Ministry of Finance and Ministry of Health

2.72 The 2001 Household Survey reveals that poorer households are more likely to attend primary health facilities than richer households. This is particularly true of the mobile clinics, where the richest quintile accounts for just 10% of attendance. In contrast, the richest quintile accounts for 38% of attendance at community clinics and 34% of attendance at public hospitals.

Figure 5



2.73 Calculation of the income group distribution of health subsidies is handicapped by shortcomings of the attendance and service data and the lack of public expenditure data disaggregated by level of service[3]. A crude breakdown of subsidies distinguishing primary and secondary services and tertiary services is presented in Figure 5. This confirms that the distribution of subsidies for primary and secondary services is broadly neutral across income groups, while tertiary spending is strongly regressive, with

[3] There are notable limitations to attendance data. Respondents indicated only whether or not they attended a particular kind of facility during the last thirty days. It is not possible to determine how many times they visited, nor the nature of the service they received.

the richest quintile benefiting from 36% of hospital subsidies. Owing to the high levels of spending on tertiary services, the overall pattern of health sector spending is also regressive. Again, despite the weakness of the underlying data, this preliminary analysis tends to support the case for a reallocation of public spending from hospitals to lower level services.

Public Spending and the Poor: Recommendations

a) *Preliminary analysis confirms that the impact of power subsidies is strongly regressive. A gradual reduction in subsidies is justified in order to release funds for services that benefit the poor.*

b) *Preliminary analysis also confirms that primary education and primary and secondary level health services tend to be progressive, whereas spending on secondary and tertiary education and hospitals is regressive. Although further analysis is required to determine an appropriate policy response, it is clear that increases in spending on lower level services are most likely to benefit the poor.*

3. EXPENDITURE PLANNING AND BUDGETING

ECONOMIC MONITORING AND FORECASTING

3.1 The Census and Statistics Department under Ministry of Economic Affairs and Development is responsible for the preparation of statistical surveys and bulletins. Major outputs include village and household surveys, which are now being used as the basis for a Poverty Assessment. The only economic data prepared on a routine basis is the Consumer Price Index, which has been tracked in Dili since July 2000 and is now available on a quarterly basis for each District.

3.2 The Department has recently begun to compile trade statistics, entering a backlog of 30,000 customs certificates, so as to constitute a time series following standard international classifiers dating back to January 2001. While trade statistics are primarily intended for monitoring purposes, it is important to note that donors providing budgetary financing in the form of balance of payments support may require this data as evidence of eligible imports by commodity and country of origin. Consequently, establishment of routines for the compilation of the import data and ensuring that the relevant supporting documentation is properly archived should be considered a priority.

3.3 Preliminary estimates of GDP by industrial origin and by expenditure account have been prepared for 2000, and will serve as a temporary baseline for subsequent GDP estimates[4]. However, there is no routine collection of production data. Estimates for agricultural production were prepared by the Ministry of Agriculture in June 2000 and a survey of manufacturing enterprises was conducted by MEAD's Department of Industry in May 2001, but this data has not been updated systematically. Although supplementary information on economic activity will be available from the Household Survey, this is no substitute for regular monitoring of sectoral production.

3.4 Although timely and reliable data on economic performance is critical if the Government is to formulate and monitor the impact of economic policies, given capacity constraints – the Statistics Department has only nine staff with limited technical skills and experience – the routine preparation of national accounts is a long term project. A useful starting point is the preparation of data sets on prices and trade, which are comparatively cheap and technically straightforward. These routine data collection exercises can be complemented by periodic surveys of key sectors.

3.5 A plan for the development of the statistics system is needed if progress is to be made. Key elements of this plan would include a short and medium term work program of routine and survey activities to be undertaken and supporting capacity building activities. To date, short-term technical support has been mobilized from the World Bank, on national accounts and the household survey, and long-term technical support from the IMF for the preparation of trade statistics. A comprehensive program of technical assistance over the long-term is needed.

3.6 In the absence of reliable output data it is difficult to monitor economic performance, evaluate the impact of economic policy or generate reliable forecasts. Forecasts prepared by the Ministry of Finance are designed to support the preparation of short to medium-term revenue estimates. These are based on assumptions regarding economic output and the impact of flows of external assistance on service industries and imports, which constitute the bulk of non-oil tax revenues (see page 3). For

Economic Monitoring and Forecasting: Recommendations

a) Routine compilation of trade statistics and maintenance of an archive of supporting documentation should be a priority, both for monitoring purposes and to satisfy fiduciary requirements for balance of payments support.

b) A medium-term development program for the statistics system is needed to ensure that necessary statistical information can be delivered in the longer-term and to mobilize financing for capacity building.

other purposes, forecasts of key economic variables are prepared by the IMF. In the medium-term, this function will have to be internalized in the Ministry of Finance through the recruitment and training of a national economist.

BUDGET COVERAGE AND STRUCTURE

3.7 The revised FY2002 budget presents revenue, expenditure and financing aggregates in a consolidated budget, broadly following international conventions. Autonomous agencies' revenues and off-shore oil royalties and their respective assignments are reflected on budget, though the disposition of financial assets was not shown. Given that Regulation 2001/13 (17.3 and 17.4) provides for the presentation of assets and considering projected size of oil and gas savings, this is a significant omission that should be corrected in the FY2003 budget.

3.8 Budget estimates are prepared for the fiscal year and three forward years, together with a staffing profile over the same time-frame. The budget follows a program structure that largely coincides with Ministry departments, with a crosscutting economic classification broken down into salaries, goods and services and capital expenditures. The number of programs has proliferated from 79 in the FY2002 budget to around 150 in agencies' FY2003 budget submissions. Often this is an attempt by agencies to break down the budget into meaningful cost centers which share the same programmatic objectives and activities. Problems arise where the program structure crosses institutional structures, as in the case of the health sector, since it becomes difficult to breakdown the structure of spending by levels of service and functional departments. The Ministry of Finance intends to rationalize the program structure during the budget process, establishing a program structure that can be applied over the medium-term.

3.9 Several innovations have been introduced during the FY2003 budget process:

a) Programs will be mapped against a functional classification so as to generate a standard structure that can be used to present budgetary data in time series.

b) Agencies will present detailed breakdowns of proposed goods and services and capital expenditures by line-item. This will facilitate the control of administrative and operational expenditures during budget execution (see page 46).

c) Agencies will indicate the proposed structure of spending by district. This should encourage agencies' to consider the regional allocation of resources. It is unclear as yet whether agencies have been able to provide a detailed regional breakdown for all program expenditures or whether they have only provided data on the funds to be deconcentrated for the purposes of budget execution. Although this marks a significant step forward, the budgetary discrimination of district allocations for programs is only meaningful if these constitute effective expenditure limits for the purposes of budget execution.

d) Agencies will present detailed estimates for capital projects, considering each project as a cost center for the purposes of budget execution. Although a preliminary review of submissions suggests that there is some confusion regarding the distinction between projects and programs, with many time-bound activities presented as on-going activities, and the coverage of externally financed projects continues to be weak, this is the essential first step in the formulation of an on-budget capital program.

3.10 Over the medium-term further discrimination of the budget by cost-centers should be considered. Although this significantly increases the number of budget units, thereby complicating the process of budget compilation, it strengthens the role of line managers in planning and budgeting and provides a basis for tracking actual execution to ensure that resources are actually delivered to service delivery units. This also creates opportunities for community participation in facility management.

3.11 Accurate information on budget allocations and outturns is only available for CFET and TFET funds, since only these funds pass through the Treasury system. Programmed bilateral projects, numbering some 520 projects in total, are mapped to agencies on the basis of data provided by donors, but there is usually insufficient information to break down their budgets by program or object of expenditure. Nevertheless, a rough breakdown of earmarked external financing by capital and technical assistance is presented for information purposes in budget documentation (see Table 2.9). Although some bilateral projects were identified in the FY2002 budget documentation, coverage was not systematic. Presentation of a summary list of projects on-going during the budget year as a memorandum item is recommended. This ensures transparency, both within government and to oversight institutions, regarding the source and duration of financing. It also facilitates coordination between government agencies and external partners.

3.12 Appropriations are approved at the agency level by broad expenditure category. For the purposes of budgetary management, however, allocations are controlled at the program level. The Ministry of Finance may authorize agencies to vire up to 10% of their appropriations, transferring funds between categories of expenditure and programs. More extensive budget alterations have be presented in a mid-year review or in supplementary appropriations which are subject to legislative approval. In-year administrative adjustments can also be made by drawing on the contingency reserve managed by the Ministry of Finance to meet urgent and unforeseen expenditures. Regulation 2001/13 limits the size of the reserve to 5% of total expenditures.

Budget Coverage and Structure: Recommendations

a) To ensure transparency budget documentation should present comprehensive data on financial assets and their disposition, including oil and gas fund savings.

b) Budget documentation should include a comprehensive list of development projects and their respective total cost, sources of financing and implementation dates presented in budget documentation for information purposes.

c) Agencies should present district allocations for all programs, with deconcentrated spending translated to cost-center structure for the purposes of expenditure execution, control and tracking. .

BUDGETING, EXPENDITURE PLANNING AND PERFORMANCE MANAGEMENT

3.13 The Ministry of Finance launched the FY2003 budget exercise with the dissemination of a Budget Circular to Departments in mid-February 2002. This provided guidance on budget coverage, expenditure limits for the forthcoming year and the presentation of submissions. Agencies were required to present forward estimates of expenditures by program and source of funds for the budget year and a further three years of the Medium-Term Fiscal Framework, together with key performance indicators for each program. Agency proposals were submitted at the end of March and then subject to prior review by the Ministry of Finance's budget department, in order to cut back proposals in line with resource constraints. The proposals will then be subject review by Cabinet's Budget Sub-Committee, chaired by the Minister of Finance. Following the proposed time-table, the budget will be finalized by Cabinet in May, before the scheduled Donors' Conference, and then submitted to the Constituent Assembly for approval in June. It is expected that the FY2003 budget will also be subject to a mid-year review, as carried out in November for the FY2002 budget exercise.

3.14 Whereas agency proposals for the FY2002 budget exercise were largely prepared by expatriate staff, there has been much stronger engagement of national staff and Ministers in the FY2003 budget. The longer time schedule has helped – the FY2003 exercise started a month earlier than the previous

exercise – so too has the synchronization of the budgeting and the National Development Plan processes, since this has helped focus agencies' attention on priorities. In most agencies, departmental heads have been closely involved in the preparation of their program budget proposals, which were subsequently reviewed internally and consolidated for submission to the Ministry of Finance. However, it is unclear how far down the line this participation goes, certainly in most agencies district and field level managers do not appear to have participated actively in the budgeting process.

3.15 While the budgeting process and – on the basis of a superficial review – agency proposals have improved markedly since the FY2002 exercise, the process remains loosely structured, left to the discretion of the Ministry of Finance and individual agencies. Creation of agency-level Budget Management Committees, including departmental and district managers, to oversee the preparation of budget proposals and in-year prioritization of expenditures, would help agencies make sure that budgets reflect operational needs and are consistent with delivery targets. Statutory budget procedures – within the framework of a revised Regulation 2001/13 – establishing a budget timetable and budget management structures, would guide and ensure continuity to the budget and planning process.

3.16 Although budget reviews are supposed to focus on policy consistency, efficiency and effectiveness, in practice there is little opportunity for detailed analysis, partly because the Government lacks much of the basic data needed to appraise policy options and agency proposals, but also because attention focuses on the reconciliation of agency proposals with aggregate resource constraints. Agency submissions for CFET 2001/02 totaled $112.6 million, double the agreed forward estimates, including a 34% increase in the number of civil servants to nearly 16,000 posts. Proposals were subsequently trimmed to $64.9 million by Cabinet. The mid-year budget revision also generated proposals for increases in spending amounting to approximately $15 million, though appropriations were actually revised downwards by just over $1 million. The FY2003 process has generated much more conservative bids, totaling $88 million against a projected final budget of $70 million. Nevertheless, some agency proposals are significantly off-track and will require substantial revision.

3.17 Rather than providing agencies with hard cash limits, resource constraints were defined loosely in terms of shares of aggregate spending. Consequently, alignment of agency proposals was deferred till late in the budget process when detailed bids have already been prepared and cuts are more difficult to negotiate. One solution is to introduce a two-stage policy review and budget process, whereby agencies present policy proposals and their budgetary implications in mid-year, so that they can be reviewed by the Budget Committee and cash limits set in February before budget call notices are distributed. In this way the major reallocations of resources are decided before the budget process begins, with subsequent Ministry of Finance and Cabinet reviews simply fine tuning the agency proposals. Excess proposals are discouraged by pressure from Cabinet colleagues. This two-stage process is much easier to implement where, as in the case of East Timor, medium-term expenditure estimates are available.

3.18 While the forward programming and performance orientation of the budget process are important features, accepted as international best-practice, difficulties have been encountered in giving these features meaningful content. Forward programming in the FY2002 exercise was often little more than a projection of budget year estimates and while most agencies managed to present Service Delivery Targets, the quality of formulation was patchy. Some improvement has been made in FY2003, particularly as regards bringing forward estimates in line with resource constraints, though difficulties are still encountered in the design and operationalization of the performance orientation:

a) Lack of an institutional framework for performance management. Regulation 2001/13 does not require the Government to present performance targets in the budget and actual implementation in interim and end-of-year reports, nor does it specify institutional responsibility for reporting, monitoring and evaluation of agency performance. A revised 2001/13 could resolve these problems by defining the basis of performance assessment, institutional responsibilities for the

Box 3.1: Promoting participation in the budget process?

Government Ministries tend to think they know best, yet they are distant from the communities that they are trying to help and cannot know their needs and priorities. So why not let the communities themselves decide how to spend money?

In recent years a large number of state and local governments in Latin America have done just that. Participatory budgeting allows communities to decide how to spend part of the budget and lets them know how the remainder of public funds will be used. Participatory budgeting starts with allocations for investment in public works and infrastructure which the communities are allowed to allocate by voting. Experience has shown that communities are responsible and tend to projects that benefit all their members rather than a few, the poor rather than the rich. In some Brazilian municipalities the experiment has been so successful that the whole budget is now subject to community consultation and decision-making.

East Timor's Community Empowerment Project follows a similar strategy. Community councils decide how to spend investment funds and then implement the projects. Since May 2000 the councils have implemented about 1,400 CEP project activities, valued at nearly $5 million – about the same amount as spent on power subsidies in the first six months of 2001/02. Not all of these projects have been a success, but experience has shown that communities can identify their development needs and priorities; communities can mobilize substantial resources, in labor and materials, significantly reducing the unit cost of infrastructure; communities have a vested interest in the maintenance of infrastructure and ensuring the service delivery standards are maintained; and community structures are able to oversee the use of funds, reducing the risk of corruption.

A strong case may be made for institutionalizing the CEP approach, whereby community grants are on budget and transferred directly to community accounts by Treasury, overseen by and with technical support from a Departmental structure within the Ministry of Internal Administration. However, if the community driven approach is to realize its full potential a number of issues will have to be addressed.

Firstly, the functional responsibilities of levels of government should be clarified, so that it is clear, for instance, that feeder roads will be the responsibility of beneficiary communities rather than central government. Secondly, government functional departments should be encouraged to respond to community initiatives by providing technical support, particularly in areas such as public works and agriculture. Thirdly, appropriate mechanisms should be put in place, backed up by incentives, to ensure transparency and accountability in the use of funds by communities and by sectoral agencies. Lastly, a system of territorial planning is needed to ensure a rational distribution of service delivery units and adequate coordination between community and government initiatives.

negotiation of performance targets and reporting within the executive and between the executive and the legislature.

b) Limited understanding of the nature and purpose of the performance measures and their measurement. Some agencies presented input indicators, others process indicators and only a few measurable output indicators. Many sectors are hampered by the lack of baseline data and systems for routine data collection. In the absence of adequate service costing information, particularly unit costs for deliverables and assessments of implementation capacity, the relationship between expenditure and performance indicators is poorly understood, making it difficult to set realistic targets. The Ministry of Finance has recently carried out a review of agency performance indicators with a view to standardization at the program level. While some progress may be made in key sectors – such as education and health – during the FY2003 budget

process, the formulation of appropriate indicators across government is likely to take several budget cycles. Ideally agency level indicators should be linked to the cross-government development goals identified in the National Development Plan.

c) Agency budget structures that do not facilitate a service delivery orientation. Resources are allocated between vertical programs, managed by central agencies, with no indication of the distribution of expenditures between levels of administration (see page 21). Consequently, it is difficult to determine what proportion of spending on, for example, primary education, will actually finance services in schools, how resources will be distributed geographically, or track expenditures to the field level during execution. The presentation of district allocations in the FY2003 exercise goes some way to resolving this problem, though more detailed breakdowns of allocations by cost centers will eventually be needed.

3.19 The more fundamental problem facing the budgeting system is the difficulty of integrating the policy, planning and budgeting systems so that the resource allocations reflect policy priorities and decisions are informed by an understanding of the impact of public expenditures. These issues cannot be addressed properly in the short time allowed for the preparation of the FY2002 and FY2003 budgets, even if a two-stage budget process is introduced. Annual routines have to be complemented by periodic expenditure reviews. These would: i) provide a better understanding of program cost structures and implementation constraints and thereby guide the annual target setting process; ii) focus attention on the budget base—ongoing expenditures—providing an opportunity for a critical analysis of public policy, including an assessment of the efficiency and effectiveness of alternative expenditure policies and alternative service providers; and iii) provide an opportunity to assess the impact of public spending. This requires analysis at the field level using a number of survey instruments: expenditure tracking, to assess how much public spending actually benefits front-line service delivery; service delivery surveys, to assess the effectiveness of the services provided; and client surveys, to assess client satisfaction with the services provided, clients priorities and identify problems such as illegal payments to service delivery personnel.

3.20 Although some countries carry out these reviews on an annual basis, a rolling, multi-year program which allows Government to focus on sectors every three to five years is probably a more useful approach. Expenditure reviews are usually undertaken in collaboration with external partners, providing a useful framework for dialogue on policy and expenditure priorities at the sectoral level.

Budgeting, Expenditure Planning and Performance Management: Recommendations

a) Revision of the statutory framework for the budget process (Regulation 2001/13) to: i) specify the budget timetable and agencies' internal budget process, ii) establish the institutional framework for performance management and reporting to core government and the legislature.

b) Introduction of a two-stage budgetary process, to strengthen policy engagement and facilitate the formulation of hard cash limits: i) Cabinet level policy review and setting of cash expenditure limits prior to the distribution of agency budget call notices, ii) review of agency submissions and alignment with agreed expenditure allocations.

c) Implementation of periodic sectoral expenditure reviews on a rolling basis, in collaboration with financing partners, focusing on: i) policy consistency ii) efficiency and effectiveness of expenditure; ii) impact of public spending, particularly as regards poverty reduction .

DEVELOPMENT AND POVERTY REDUCTION PLANNING

3.21 The National Development Plan process has been identified as the Government's highest priority in the pre-Independence period. The planning process was launched in October 2001 under the

supervision of a Planning Commission, comprising five ministers, chaired by the Chief Minister, a Secretariat to provide technical and managerial support, and a Consultative Commission of Civil Society, including five representatives from the NGO sector.

3.22 As the first step, each Ministry prepared a Status Report during November 2001. These provided the basis of a "State of the Nation" report, outlining the achievements made under the UN Transitional Administration and the situation as East Timor moves toward Independence. Subsequent activities included: i) broad consultations with NGOs, communities and focus groups, in order to generate a popular developmental vision; ii) formulation of a vision, goals and development strategies together with development targets at a cross-sectoral, thematic level, by eight thematic working groups, led by Ministers; and iii) preparation of agency development strategies linked to the MTFF and budget. The National Development Plan will be finalized in April.

3.23 Although it is too early to assess the content of the Plan, since only preliminary drafts for some thematic components were available for review, the process itself appears to have engaged national personnel in policy analysis and planning activities. Technical support has been provided by a team of international consultants, with additional inputs from technical specialists, including a preliminary Poverty Assessment based on the results of the Household Survey. These contributions do not appear to have dominated the process: there is a strong sense of Government ownership.

3.24 The institutional arrangements for the planning function following Independence have yet to be defined. The Planning Commission is a temporary institution established to prepare the National Development Plan and undertake donor coordination activities prior to Independence. While a separate Planning Commission is one option, most countries have consolidated the planning and resource management functions in the Ministry of Finance. This makes it easier to coordinate planning and budgeting, so that plans reflect resource constraints and budgets reflect the Government's development objectives.

3.25 The draft Constitution requires the Government to present a Government Program for its mandate which is debated and approved by the legislature. Presumably the Plan and Government Program will coincide. Mechanisms will also have to be put in place for operationalizing the plan, ensuring the policies and programs are updated regularly to reflect implementation, changing circumstances and improved information on policy options and impact. The linkage to budget process is crucial. This could be achieved through a rolling strategic planning exercise focusing on the Government's poverty reduction strategy as part of the MTFF process, allowing the Government to update policy and medium-term programming of development targets and activities on an annual basis. This would provide flexibility, whilst ensuring that operational plans are prepared taking into account resource constraints.

3.26 The Government intends to undertake a review of the National Development Plan process late in the first quarter of FY2003. This should indicate the way forward. The review will identify weaknesses and gaps in the planning process as regards: policy content; process and methodology; stakeholder consultation; information constraints and information use; and mechanisms for operationalizing the plan. On the basis of the review, the Government can then prepare a road-map for the next planning cycle, including: a program of data collection and policy analysis (providing an opportunity for Government to carry out substantial studies, such as beneficiary assessments, tracking studies, public expenditure reviews); a stakeholder consultation plan; and a training program. Improvements in the costing agency programs deserve particular attention in order to ensure that programs are realistic in terms of the outputs that they intend to deliver and sustainable over the longer-term.

3.27 The planning review, supported by the National Development Plan, could constitute an Interim-Poverty Reduction Strategy, identifying the major actions to be taken in preparation of a full Poverty Reduction Strategy in support of the FY2004 planning and budgeting exercise.

Development and Poverty Reduction Planning: Recommendations

a) Definition of the institutional framework for the development planning function after Independence, ensuring that development planning is linked to expenditure planning and budget process.

b) Implementation of a review of the National Development Plan process and preparation of a road map for the next planning cycle, focusing on improvements in policy analysis, stakeholder consultation and the technical formulation of agency programs, particularly as regards costings.

b) Introduction of a rolling multi-year planning instrument focusing on poverty reduction as part of the MTFF process.

DEVELOPMENT PROJECTS

3.28 The CFET capital program is basically a procurement plan for the budget year. Development projects, financed under TFET and from bilateral funds, are not consolidated into a comprehensive capital program for the public sector.

3.29 TFET projects have established project management systems at the Ministry level. Project management units are part of the agency structure, headed – for the most part – by project directors who are civil servants or contracted with CFET funds. Payments against project budgets are authorized by the Project Directors and Treasury. From April 2002, project funds will be managed using the Treasury's computerized commitments and payments system, so that Treasury will be able generate timely expenditure reports. However, oversight continues to rely heavily on World Bank and ADB mechanisms, such as the withdrawal applications and regular supervision missions. The logical next step is to develop internal systems that can assume the monitoring function and allow the Ministry of Finance to track progress on a routine basis.

3.30 Bilateral projects are more difficult to integrate into the Government system. They are usually managed by executing agencies, contractors or project management units that lie outside Government structures. Payments are often made off-shore and are not usually reported to Treasury. Some projects submit quarterly statements of receipts and payments, most do not. Progress reports may be available to Government but their primary audience is the donor. This presents numerous problems for Government. Lack of prior-expenditure controls on project accounts increases pressure for these to accommodate expenditures that cannot be covered from CFET, thereby increasing the burden of recurrent expenditures on nominally capital projects and subverting budget discipline. Even if agencies are fully informed regarding the commitments, expenditures and performance of these projects, core Government – the Ministry of Finance and Cabinet – is not.

3.31 Government must establish basic systems for project programming, management and monitoring before it begins to implement a substantial capital program financed through the Consolidated Fund (see page 6). The two key elements of such systems are: procedures for the appraisal of investment projects; and project tracking systems and procedures.

3.32 Although projects are reviewed as part of the budget process, the information agencies provide is usually superficial, without the support of detailed costings, procurement plans and implementation arrangements. To ensure that projects are properly appraised standards for the presentation of project proposals have to be set and enforced. Implementation costs deserve particular attention, since under-costed projects will either be delayed or require unprogrammed supplementary allocations. Similarly projects' recurrent cost implications should be reviewed to ensure that sufficient funds are available for operations and maintenance. Use of standard projects with predefined investment and recurrent

costs should be encouraged. Simple appraisal criteria should be formulated to allow technicians to assess whether projects are consistent with the Government's poverty reduction objectives.

3.33 A simple spreadsheet register of projects providing information on project programmed and actual completion dates and total cost is a powerful management tool, allowing budget analysts to identify whether projects are delayed and running over their lifetime budget. This alone is sufficient to identify poor performing projects. More complex reporting systems may be appropriate for line agencies but they are likely to overload the Ministry of Finance's limited capacity. Detailed reviews are more useful where projects are significantly delayed or over lifetime budget, when the review supports the decision to allocate additional funds. Where projects are identified as cost centers for budgetary management purposes, expenditure controls should be sufficient safeguard against in-year budgetary overruns. Public Works and Central Administrative Services are currently introducing a contract management system that ensures that payments are released against certified works progress. Basic information on the project portfolio should be presented in the budget documentation, including a list of major projects, their financing and programming dates

3.34 It should be noted that these basic systems are essentially the same as those required to ensure effective management of externally financed projects. In most countries these systems are integrated within a single investment program. Some adjustment to Regulation 2001/13 may be required to provide a statutory basis for the project management and monitoring systems. This may include: i) identification of projects as cost-centers within the overall departmental and program structure of the budget; ii) a requirement for agencies to report on programmed expenditures and disbursements against all sources of funding; and iii) a requirement for agencies to report on project implementation in budget submissions.

Development Projects: Recommendations

a) Definition of procedures for the appraisal of development projects as part of the budget process, including specification of minimum information requirement, particularly as regards costings, and simple criteria for project appraisal. .

b) Implementation of a project tracking system designed to identify project implementation and cost overruns, together with procedures for review of projects that are consistent poor performers or significantly over-budget.

AUTONOMOUS AGENCIES

3.35 Regulation 2001/13 established a legal framework for autonomous public agencies, providing for the capitalization of agencies from budgetary appropriations and financing of service delivery from earmarked revenues, thereby creating incentives for enhanced revenue collection. These provisions were applied to three public enterprises from the start of fiscal year 2001/02: the Power Authority, Dili Airport Authority, and Dili Harbor Authority.

3.36 The Airport and Harbor Authorities' revenue performance is on track, despite a gradual slowdown in cash inflows during the later months of 2001, with 150% and 77% respectively of annual target revenues collected by end-February 2002. Budgetary transfers were made for working capital during the first half of 2001/02, but these were wholly repaid by the end of 2001. Over the longer-term, additional transfers will probably be needed for capital investments.

3.37 In contrast, the Power Authorities' revenue performance has been poor (see Table 3.1). This is partly a consequence of pricing policies and partly a consequence of poor management. About one third of the power authority's operating costs arise from energy production and distribution outside Dili. No attempt is made to recover costs from these consumers. In Dili systematic billing only began

in August 2001 when a computerized billing system was installed. Since consumers receive their first 25kWh free other than for a $1 monthly connection fee, the vast majority of households connected have only minimal charges, which clients rarely pay and are not worth the trouble of enforcing. Cost recovery has focused on larger commercial and domestic consumers. From September to December 2001 some progress was made in recovering costs, though largely through the settlement of substantial arrears by a few large consumers. Although invoicing has increased, there was little improvement in revenue collections owing to poor enforcement. By the end of February, the power authority had recovered only 19% of its annual revenue target.

Table 3.1: Power Authority Revenue Performance, July – December 2001 (US$ 000)

Month	Net Production	Invoiced	Current Payments	Settlement of Arrears	Payments / Invoiced %	Payments / Production
July	1,087	32	4	-	2.9	0.3
August	1,087	50	3	-	4.6	0.3
September	804	70	30	536	8.7	3.7
October	885	464	35	168	52.4	4.0
November	1,067	570	83	4	53.4	7.8
December	1,370	618	52	-	45.1	3.8

3.38 These problems are aggravated by weak management controls. Even though the authority consumes about $6 million in fuel a year, it has not installed flow meters to verify whether the quantity of fuel purchased is actually delivered or whether fuel is stolen from storage tanks. It is hardly surprising then that budget disbursements have been far higher than originally programmed: by the end of February liquidated payments and outstanding payments amounted to 79% of annual appropriations. Supplementary appropriations will probably be needed to keep the power authority operational. The volume and regressive structure of these expenditures seriously undermines the poverty reduction impact of the Government's expenditure program (see page 22).

3.39 It is beyond the scope of this report to propose actions leading to a resolution of the poor revenue performance of the Power Authority. However, solutions will have to be found and action taken if the Government is to succeed in mobilizing substantial budgetary support over the medium-term.

3.40 Part of this solution entails resolving deficiencies in the institutional framework for autonomous public agencies, particularly with respect to the basis for budgetary transfers to autonomous agencies and the institutions' governance arrangements. This would require the preparation of an umbrella Public Enterprise Act to replace the scanty provisions in Regulation 2001/13. Such legislation would make provision for i) internal and external governance structures, including appointment and remuneration of board members; ii) criteria for determining the level of operating subsidies from Government, if any; iii) external audit, either by State audit institution or by commercial auditors; iv)

Autonomous Agencies: Recommendations

a) Formulation of an action plan to address the structural and management deficiencies of the Power Authority, including a realistic plan for cost recovery and the reduction of budgetary transfers over the medium-term.

b) Preparation of an umbrella Public Enterprises Act specifying internal and external governance arrangement, the basis for inter-governmental fiscal transfers, accounting and insolvency.

basis of accounting, providing for the application of commercial accounting standards; v) procedures for closure and insolvency. Specific provisions for each enterprise would be presented in Public Enterprise Enabling Acts which should be promulgated separately.

MANAGEMENT OF FINANCIAL ASSETS

3.41 Conservative estimates of the royalties and tax revenues generated by oil and gas production over the next twenty years exceed $2,000 million (about $2,500 per capita at current population). Estimates including prospective projects are significantly higher, at around $6,000 million ($7,500 per capita). Government has indicated that it intends to save a substantial proportion of petroleum revenues over the coming decade, when yields will be relatively high, constituting a fund that can be drawn down in later years as oil and gas reserves are depleted. At present, the Government assigns tax revenues from Timor Sea production to the Consolidated Fund account to support current expenditures. Royalties (First Tranche Petroleum) are deposited on term. By FY2006 the Government will assign a large part of tax revenues to savings as well.

3.42 The management of financial assets constituted from oil revenues has been the subject of several detailed studies over the past year. This Note does not introduce new material to on-going discussions. However, it is useful to reiterate some of the guiding principles and then focus on those issues that have important implications for public expenditure management.

3.43 Recent studies have advocated a trust fund arrangement, whereby revenues are statutorily assigned to a segregated account governed by specific regulations. These regulations will normally assign institutional responsibility for Trust Fund management, set parameters for fund investment policies, establish the basis for draw-down of income and, in some cases, principal, and define specific oversight arrangements. Funds are usually invested internationally in a diversified portfolio of financial products managed by professional fund managers, with the objective of maximizing risk-adjusted returns.

3.44 The rationale for trust funds is to safeguard assets for future generations, by maintaining the real value of the fund, whilst at the same time providing access to financing for the purposes of macro-economic management, by smoothing streams of revenue, and promoting economic growth, by financing viable investments in the non-oil economy. It should be stressed that the existence of a trust fund is not, in itself, a solution to the problems of fiscal management arising from revenue streams generated from resource endowments. The best safeguard is a well functioning budget process that enforces budget discipline and rigorous appraisal of proposed applications of public funds.

3.45 Where trust funds are established, care must be taken in the design of management structures, fund policies and in the application of trust income. Some of the key issues to be addressed are identified below:

a) ***Revenue assignment***. While present arrangements provide for separate treatment of tax revenues and royalties, with only the latter assigned to savings, this distinction is artificial and potentially destabilizing. From the perspective of inter-generational equity, both the tax and royalty revenues are products of the depletion of the resource endowment. From a revenue management perspective, tax revenues on profits and royalties are effectively interchangeable, the appropriate structure depending on the Government's revenue policy objectives. From a fiscal management perspective, taxes from resource depletion cannot be considered as regular revenue because the revenue source will eventually be exhausted and, in the meantime, will be subject to sharp price fluctuations. For these reasons, it is more appropriate to adopt a broad policy for revenue assignment to savings, covering all income from the depletion of East Timor Sea reserves.

b) ***Institutional Framework.*** Managerial independence, transparency and adequate oversight are essential if the East Timor Sea savings are to be safeguarded and used effectively. This requires an appropriate statutory framework for trust funds. Managerial independence would be assured by the appointment of a Board, possibly by the legislature, with fixed terms and including permanent representatives from the civil service (for instance BPA, Treasury). Day to day fund management would be contracted out to professional fund managers who would be responsible for executing fund investment policy. The Board would be required to submit regular reports on performance, ideally benchmarking performance against similar portfolios, and reports would be subject to independent audit. Failure to ensure independence from political interference, and failure to inform citizens about the arrangements that have been made, is potentially destabilizing: fiscally responsible Governments may save funds, creating a "honey-pot" that fiscally-irresponsible opponents may promise to distribute in order to win votes.

c) ***Investment policy.*** Investment policies should determine the balance between fund objectives, as regards investment selection and risk tolerance, and between the appropriate size of the fund, current and future income streams. Consideration should be given to the trade-offs between off-shore investments and the draw-down of funds to finance investments in East Timor: well selected investments in East Timor can generate equivalent or higher financial and economic returns than off-shore fund managers are likely to achieve. Consequently, simply setting a target fund size and withholding all income from assets until this target has been achieved is not necessarily the most efficient use of funds. Care should be taken to ensure that these policies are sufficiently flexible to adapt to changing circumstances, but sufficiently precise to avoid manipulation.

d) ***Application of funds.*** The appropriate mechanism and legal framework for making decisions regarding the application of drawn-down fund income is the budget process, with income surrendered to the Consolidated Fund alongside all other revenues. Assignment of income to particular applications – sectors, institutions, programs – should be avoided, as should extra-budgetary mechanisms for the allocation of these resources. While the application of a "golden rule", assigning income to the finance of investments, is attractive, this would constrain fiscal policy in times of fiscal stress.

e) ***Expenditure smoothing.*** A legitimate use of the trust fund is for expenditure smoothing. This is relatively easy where funds are drawn down for the purpose of in-year liquidity management, since the financing requirement is limited by appropriations, the sums involved are relatively small and funds must be repaid by the end of the fiscal year. This would address the liquidity constraint faced by Government owing to the absence of a ways-and-means facility with the BPA (see page 42). Financing of counter-cyclical expenditure smoothing is more complicated, since the sums involved would be relatively large and the provisions for repayment difficult to enforce. Some Central Banks facing similar problems restrict the amount of borrowing to a proportion of Government revenue over preceding years. Similar restrictions might be appropriate for the East Timor Fund. Some Commonwealth countries resolve the problems of repayment of Government debt by requiring servicing to be categorized as statutory payments, thereby withdrawing them from Government discretion.

3.46 It is beyond the scope of the present report to make specific recommendations regarding the issues identified above. However, it is important that these issues be addressed soon. Existence of substantial government savings will make it difficult for external partners to justify the provision of budgetary support unless the purpose of these savings is made explicit and appropriate institutional arrangements for managing the savings are put in place. While it may not be possible to address all of the issues identified above immediately, legislation establishing the management structure should be considered a priority, as should the administrative regulation of drawn-downs from and repayments to the fund for the purposes of expenditure smoothing. At the same time, the Government should set in

motion the studies and consultation needed to arrive at a definitive response to the issues identified above before substantial revenues come on stream.

Management of Financial Assets: Recommendations

a) Formulation of interim administrative directives establishing procedures for draw-down and repayment of funds for purposes of in-year expenditure smoothing.

b) Formulation of a statutory framework for management oil and gas savings, addressing: i) revenue assignment; ii) institutional framework; iii) investment policy; iv) application of funds; v) expenditure smoothing.

4. BUDGET EXECUTION AND CONTROL

BUDGET EXECUTION

4.1 CFET has a centralized budget execution and control system. Treasury authorizes the release of funds through quarterly Expenditure Authorization Notices (EAN). Quarterly funds release for capital appropriations is made against an annual capital program, approved by the Budget Department. Spending units initiate purchases by issuing requisitions and a Commitment and Payment Voucher (CPV) which is endorsed by the agency's Authorizing Officer and submitted to Treasury. Treasury's Certifying Officer verifies coverage and approves the commitment. The requisition and CPV are then sent to Central Administrative Services which either issues from stock or initiates procurement (see page 46). On delivery and invoicing, Agency Certifying Officers confirm receipt and endorse the CPV for payment. The Treasury Authorizing Officer verifies the CPV against the approved commitment and supporting documentation, issuing a Treasury Payment Order for liquidation by the Banking and Payments Authority (ETPA's banker), either by cheque or bank transfer. BPA submits daily statements to Treasury for reconciliation.

4.2 All transactions are processed on paper and then registered on a computerized Treasury payments and accounts system. This system is now being rolled out to agencies. Two agencies already have on-line, read-only access and the system should be available to all Ministries and central agencies by end of March 2002. There are plans to extend live access to district sub-Treasuries in a subsequent phase, followed by agency-level electronic payments processing.

4.3 The only CFET expenditures that escape centralized controls are petty cash payments. However, agencies' petty cash imprest accounts are limited to $5,000 and can only be used for direct procurements of less than $300. Total expenditures through this mechanism amount to just $700,000 a year – about 1% of total public spending. Much more significant are expenditures through bilateral projects which escape Treasury control and registration altogether.

4.4 Owing to the lack of banking facilities in rural areas, District Administrations' Finance Officers have to hold funds and make payments in cash. Treasury remits funds to sub-Treasuries, constituting an imprest account, on the basis of expenditure authorizations issued by line agencies in favor of their District offices. Monthly expenditure authorizations are largest for health, at approximately $5,000 per district, and public works, at around $3,000. Agencies' internal guidelines identify eligible expenditures for these funds. Payments are executed by the District Finance Officer, as approved by the agency's District Certifying Officer and the District Administrator as Authorizing Officer. Most payments are pre-authorized by the District Finance Officer to verify coverage and eligibility.

4.5 The payments system allows a small number of gatekeepers in Treasury and District sub-Treasuries to oversee and control budget execution by the whole of Government. From a governance perspective, gatekeepers represent a corruption risk. Treasury has sought to minimize this risk by ensuring that payments are processed by five different people in the agency and Treasury. At present, the gatekeepers are expatriates. Most of Treasury's national personnel are engaged in routine data entry and verification of CPVs. These tasks continue to be overseen by international personnel: CPV registers, for instance, are only executed in the ledger once they have been verified by expatriates, who correct any mistakes that are identified. This raises concerns regarding the level of recording and authorization errors should expatriate supervisors be removed too quickly.

4.6 Inevitably there will be pressure from agencies to dismantle the centralized payments system by delegating authority for payments execution to agency Finance Officers. While this may appear to streamline administrative procedures, the experience of other countries – Jamaica, Malawi and Mozambique – has shown that agency controls are often inadequate and the dismantling of the centralized payments system quickly leads to inconsistencies in accounting registers, overspending

Box 4.1: Controlling public spending from the top-down or from the bottom-up?

Public expenditure management in East Timor, like most countries, seeks to enforce good expenditure management practices from the top-down by controlling funds from the center and verifying compliance with rules and regulations throughout the system. This is not always the best way to control public spending.

It is important to recognize that the users of public services have the most to lose where funds are not used properly. By giving service users some authority in the management of service delivery units and informing them of how much money is to be made available, for what and when, they can assist the Government in overseeing the use of public funds. They can also influence the way that money is spent so as to better meet their needs.

School grants and management boards in the United Kingdom and Uganda provide a good example. By allocating resources to schools rather than education departments, and informing parents about the money made available, both countries have significantly increased the proportion of spending on education that has actually reached schools. By giving parents a meaningful role in school management, they have been able to hold teachers accountable for their performance. In Uganda, teacher attendance has improved and misuse of funds has decreased.

Public expenditure management systems can be designed so that mechanisms of top-down and bottom-up control complement each other. The decentralization of resource utilization decisions to service delivery points reduces the risk of administrative capture. When parents are informed – by public radio in Uganda – that funds have been released they can verify that funds are actually received. When parents are involved in running schools and their budgets they are more likely to see and denounce misuse of funds.

and the accumulation of uncovered arrears. Since the centralized payments system is critical to the maintenance of fiduciary controls attempts to dismantle the system would seriously undermine external partners' confidence in the public sector's ability to manage spending.

4.7 Agencies will also seek to subvert the centralized payments system by constituting separate funds, drawn from own-source revenues that are not surrendered to Treasury and externally financed projects. In principle, Treasury authorizes and acts as co-signatory to all project bank accounts. However, there may be instances where Treasury has not been notified that accounts have been opened. Rigorous control of agency bank accounts in commercial banks is needed if Treasury is to prevent a multiplication of accounts and dispersion of funds. Enforcement may require legislation holding commercial banks responsible for verifying whether account holders are designated government projects and obliging them to report on respective balances periodically.

Budget Execution: Recommendations

a) Consolidation of Treasury centralized budget execution to ensure that budgetary discipline is maintained.

b) Progressive rolling out of computerized budget execution system to agencies and, eventually, to districts.

c) Increased investments in capacity building to allow progressive transfer of supervisory and authorizing functions to national personnel.

d) Review of mechanisms for deconcentration of agency expenditure management to field level, focusing on education and health sectors, in order to strengthen community involvement of service delivery facilities.

LIQUIDITY MANAGEMENT

4.8 Government operates a single Consolidated Fund account, managed by the Banking and Payments Authority. Revenue accounts are held by a commercial bank but balances are swept into the Consolidated Fund account on a daily basis.

4.9 Since the Banking and Payments Authority cannot extend credit to the Government, under Regulation 2001/30, Government has no access to a ways-and-means facility. There is provision under Regulation 2001/13 for the Government to contract debt, including short-term debt, though each credit has to be approved by specific legislation. This option has not been exercised under the Transitional Administration. Government could draw down a temporary line-of-credit against the Petroleum Trust Fund to cover short-term shortfalls in revenues, but is reluctant to do so whilst regulations and safeguards governing the use of these funds have yet to be determined[5]. Consequently, Treasury is currently unable to raise funds to cover unanticipated short-falls in revenues and is forced to impose a rigorous cash-budgeting system, maintaining an adequate balance of funds by restricting funds release and commitments. Where this leads to unpredictable funds release and commitment authorization it can undermine agency performance.

4.10 Revenue streams are not particularly stable throughout the year, and a sharp drop may be anticipated in the first half of FY2003. However, the late release of donors' contributions to the UNTAET Trust Fund is the principal cause of unpredictability, with some contributions delayed by up to four months. This led to a sharp fall in cash balances during the first quarter of FY2002. To avoid a similar situation arising after Independence, Treasury intends to curtail expenditures during the last quarter of FY2002, so as to ensure that sufficient funds are carried over to FY2003, providing a safety cushion during the first months of the fiscal year. While this is a responsible policy, it is likely to result in lower than anticipated expenditure outturns across the year.

4.11 Information on Government's liquidity status should be provided in Treasury's quarterly expenditure reports, including forward cash-flows and an analysis of the principal sources of variance against the original cash plan. Care should be taken in the interpretation of this information, since substantial cash balances may be needed to cover outstanding commitments. Particular care is needed where cash balances are used as triggers for disbursements in individual donors' financing agreements, since this leads to an element of discretion on the timing of disbursements that may adversely impact on the Government's future cash position. For the purposes of disbursement profiling, budget execution and commitments may be a better guide than cash balances at any particular point in time.

4.12 A frontload disbursement profile for budgetary support would reduce the impact of volatility in cash flows by creating sufficient cash balances to cover delays. Regulation of the mechanisms by which the Government can call down on oil savings for the purpose of short-term liquidity management, provides a more permanent solution, though this is likely to depend on the formulation of a more comprehensive arrangements for fund management.

4.13 At the same time, Government should establish mechanisms and criteria for in-year expenditure prioritization where funds release and commitments have to be curtailed in order to bring expenditure in line with reductions in revenues. In most countries this process is overseen by the Cabinet's Budget Sub-Committee, which defines criteria for prioritizing funds release when resources are lower than anticipated. Priorities are usually defined by categories of spending, such as salaries and essential expenditures – such as hospital and prison food – though some countries have also defined priorities on a program basis so as to ring-fence poverty reduction spending from in-year cuts. Inevitably, this

[5] Funds were drawn down from the Petroleum Trust Fund during the first quarter 2001/02 to provide coverage when Consolidated Fund balances reached a critically low level of just over $1 million. However, these funds were not applied.

means the incidence of any cuts fall disproportionately on other programs, particularly administrative services and defense.

Liquidity Management: Recommendations

a) Presentation of information on Government's liquidity status in quarterly expenditure reports together with programmed cash flow would enable external partners to assess short-term financing requirements and identify the cause of deviation from cash plans.

b) In order to ensure that Government has adequate cash balances early on in the fiscal year and a float to cover delays in subsequent disbursements, budgetary support should be front-loaded.

c) Mechanisms for call-down and replacement of oil savings for the purpose of short-term liquidity management should be included in trust fund statutes. These mechanisms can be defined in administrative directives prior to legislation .

d) Criteria for prioritization of funds release should be defined at a policy level to safeguard high-priority expenditures and programs when in-year expenditure adjustments are required.

ACCOUNTING AND FINANCIAL REPORTING

4.14 Regulation 2001/13 (37.1.b) requires the preparation of detailed budget and reporting documents complying with international transparency standards. Financial statements are presented on a modified cash basis, indicating revenues received, liquidated payments and outstanding commitments. Final accounts are prepared by Treasury on the basis of registers in its computerized payments system. Agencies are supposed to keep parallel sets of accounts on spreadsheets, for the purposes of verifying outstanding balances available and verifying Treasury registers. In practice, most agencies have come to reply on information provided by Treasury for the purposes of budget management. This will be much easier when agencies have on-line, read-only access to the relevant registers in Treasury's payments system.

4.15 As required by Regulation 2001/13, monthly appropriation execution reports and quarterly financial reports are generated within days of the end-of-period, distributed within Government and made available to donors as well. Detailed expenditure reports are available on-line. The Ministry of Finance submitted its report and accounts on the 2000/01 Consolidated Budget within three months of the end of the fiscal year. The report has now been audited by an international firm and certified without qualification – though observations are made in an accompanying Management Report regarding the need to strengthen some supporting management systems (see page 56).

4.16 Regulation 2001/13 (17.3 and 17.4) provides for complex accounting registers, including tax expenditures (income forgone from tax exemptions), accrual accounting (assets and liabilities), including contingent liabilities (potential liabilities arising, for example, from loan guarantees). These provisions are not applied at present and it would be unreasonable to expect that they can be applied comprehensively in the near future. However, a strategy is needed to map out how full compliance with the Regulation's accounting provisions will be achieved.

4.17 The first step is to ensure that supporting systems are in place to manage the assets and outstanding commitments. Simultaneously, the coverage of Treasury reporting systems should be extended. At present, financial statements and interim execution reports cover only expenditures executed through the Treasury system: this includes Consolidated Fund expenditures and expenditures from Special Funds, comprising earmarked transfers from external partners. From FY2003, TFET expenditures will also be tracked and reported through the same systems. This will allow Treasury to present execution of TFET expenditures – a significant part of the Government's capital program – in consolidated financial reports and accounts. Bilateral donors' project expenditures and assessed

contributions, amounting to nearly 60% of total expenditures in FY2002, cannot be included since these disbursements are not channeled through the Treasury system.

4.18 In the medium-term, autonomous agencies' financial statements can be moved to an accrual basis, including presentation of profit and loss statements and balance sheets. By following commercial principles, the financial performance of autonomous agencies' can more readily be compared with alternative private sector providers. Some consideration should also be given to the compilation of tax expenditures, covering, in the first instance, the cost of tax exemptions for NGOs.

Accounting Financial Reporting: Recommendations

a) Consolidation of financial reporting system, ensuring timely and comprehensive reporting on Consolidated Fund transactions.

b) Formulation of a strategy for implementation of Regulation 2001/13's accounting and reporting provisions, including in the short-term i) development of supporting systems to manage assets and outstanding commitments; and ii) extension of Treasury reports to include TFET expenditures, thereby covering the Government's capital program. Over the medium term, iii) preparation of autonomous agencies' accounts on an accrual basis; iv) compilation of tax expenditures, starting with exemptions for NGOs.

PERSONNEL AND PAYROLL MANAGEMENT

4.19 Civil service personnel management is centralized. Agencies' proposals for new posts must be endorsed by the Civil Service and Public Employment Service (CISPE), which verifies job descriptions to ensure that there is not excessive duplication of functions. The number of establishment posts are then determined through the budget process.

4.20 In practice, there is little analysis behind the staffing levels chosen for each agency. Institutional mandates have not yet been clearly defined, though the National Development Plan process should help clarify agencies' missions and identify key programs. Translation of these mission statements and programs into concrete staffing proposals requires a functional review process, which relates missions to the agencies' internal structure and staffing requirements, taking into account medium-term financial constraints. Obviously there is insufficient capacity to carry out such reviews across government, though some reviews could be conducted in the context of future sectoral public expenditure reviews (see page 29).

4.21 CISPE oversees selection and recruitment of candidates, the majority of which are interviewed by joint CISPE and agency panels. CISPE prepares employment contracts which are signed by the Minister of the respective agency, and maintains a database of personnel registers for Ministry personnel. This covers 3,050 of 3,106 personnel with signed contracts. It does not include most teachers, many health workers, Defense Force and Police personnel. A more comprehensive summary register is kept on a spread sheet, but this too omits several large institutions and has not been kept up to date.

4.22 The basic framework for personnel management has yet to defined. While procedures are in place for recruitment, none have been specified for appraisal, promotions, transfers and redeployment of personnel, standards of conduct and disciplinary procedures. A Civil Service Code is in preparation, though it is unclear when the code will be finalized. It is urgently needed. Without regulations it is impossible to undertake basic personnel management functions.

4.23 New staff are entered on payroll against presentation of signed contracts, with the exception of teachers who are entered on the basis of a list prepared by the Ministry of Education. Each month, the

Treasury's Payroll Section distributes a draft payroll to each Ministry for updating and verification of attendance in the previous months, before executing payment. Payroll for district staff is drawn in cash in Dili and disbursed by the District Finance Officer. Staff must present photographic identification in order to collect payroll, either at BPA or the District office. Uncollected salaries are returned to Treasury.

4.24 While these systems provide rigorous administrative control of payroll and reduce the risk of ghosting, there are significant discrepancies between the CISPE registers of contracted staff and Treasury payroll. A preliminary assessment suggests that these discrepancies are the result of poor articulation of registers between Treasury and CISPE, originating from: i) incomplete institutional coverage of CISPE's registers; ii) CISPE's failure to update registers systematically; iii) inclusion on payroll of staff recruited before creation of CISPE whose contractual status has yet to be regularized; iv) inclusion of temporary workers not contracted through CISPE on payroll, particularly in the health sector.

4.25 Poor articulation between recruitment and payroll registers is a serious fiduciary risk. This problem could be resolved by integrating Treasury payroll and the CISPE personnel management databases using the Treasury's payroll management software, which is part of a larger human resources program. In the meantime, CISPE and Treasury registers of permanent employees should be reconciled on a monthly or quarterly basis. Action should be taken to regularize the contracts of temporary staff currently on payroll where it is intended that these personnel will become permanent employees.

4.26 Treasury relies on the agencies' verification of attendance records to ensure that staff are in place and have worked. There are anecdotal reports of widespread absenteeism. The extent of this problem is difficult to verify or resolve administratively. Local controls, where the beneficiaries of services – represented in school and health clinic boards – are required to endorse attendance records are much more likely to be effective. Of course, these measures are only viable where there have been governance reforms providing community representatives with oversight functions.

4.27 In addition to staff on payroll, agencies are able to contract temporary personnel, drawing funds from their goods and services appropriation. The present chart of accounts fails to distinguish these payments. Consequently there is no effective control over the number of temporary personnel, their contracting or duration of employment. These issues have to be addressed by specific policies and regulations to be put in place as soon as possible, setting a time-limit for individual contracts and their renewal so as to prevent long-term employment on temporary contracts, a practice that undermines budgetary controls on civil service numbers and subverts public sector recruitment procedures.

Personnel and Payroll Management: Recommendations

a) *A Civil Service Code, addressing standards of conduct and disciplinary procedures, is urgently needed for the Government to undertake basic personnel management functions.*

b) *The risks of ghosting can be reduced by integrating Treasury payroll and CISPE personnel management information systems and, as an interim measure, regular reconciliation of payroll and CISPE staffing registers.*

c) *Back-door increases in staffing through the recruitment of temporary staff can be controlled where the terms of temporary employment, particularly as regards duration of contracts, are regulated and the chart of accounts revised to identify payments for temporary employees in expenditure reports.*

d) *The contracts of temporary staff currently on payroll should be regularized where agencies intend to retain these staff as permanent employees.*

PROCUREMENT AND SUPPLY[6]

4.28 Agencies initiate procurement by submitting a Procurement Requisition and Commitment and Payment Voucher to Treasury. Treasury registers the commitment of funds (see page 40) and forwards documentation to Central Administrative Services' Commodity Cell. For goods held in stock, the requisition and CPV is transmitted to the CAS Supply Unit which releases goods from the ETPA warehouse and charges against agency budgets. The stock register includes frequently used items but also expensive equipment (computers, photocopiers and air conditioners) which can only be released against an approved agency capital program. Many expensive items remain in stores for months on end. Unallocated stores at the end of FY2001 were valued at $381,000, amounting to about 15% of annual expenditure on the broad category of items held in stock. Government is currently building four regional stores to facilitate distribution of supplies to districts.

4.29 For goods not held in stock, the requisition and CPV is transmitted to CAS's Procurement Unit, which is responsible for all public sector procurement other than items under $1,000 procured using agency imprest accounts. Procurements up to $50,000 are usually by request for quotation, procurements above this amount by invitation to bid or request for proposal. These limits are significantly lower than those established by Regulation 2000/10 which allows for request for quotations up to $200,000 for goods and $350,000 for works.

4.30 Each procurement process is logged, identified by the corresponding CPV and Commodities Number, and tracked in a spread-sheet register. Specifications are drawn up by the beneficiary agency while the Procurement Unit deals with market consultation and contracting. Contracts exceeding $100,000 are reviewed and approved by the Contracts Committee. Following award of contract, the Procurement Unit issues a purchase order/contract to supplier. Goods are received by the Supply Unit which issues a Receiving & Inspection Report, which, together with the CPV, is endorsed by the beneficiary agency and submitted to Treasury for payment.

4.31 Recently the Procurement Unit and Public Works Department reached agreement that all contracts for works should also pass through the procurement system. Specifications are drawn up by the Public Works Department and bids evaluated with the Procurement Unit and agency. Payments to contractors are made on the basis of works inspection reports endorsed by the Public Works Department.

4.32 In the absence of procurement policies, a wide range of equipment has been acquired, some unnecessarily expensive, some technically inappropriate. The range of vehicles and computers used by Government has proliferated. Procurement policies are urgently required for commonly used equipment in order to reduce capital costs, by ensuring that only appropriate equipment is acquired, and maintenance costs, by standardizing inventories.

4.33 Tighter controls on the procurement process are also needed. Some procurement in the public sector is deemed "unauthorized", where agencies have signed contracts without passing through the procurement system. While this may be negligible at present, it is likely to increase as the proportion of goods acquired locally increases, reducing the effectiveness of customs clearance as a control point. Treasury is now extending a module of its computerized expenditure management system to the Procurement Unit. This should reduce the scope for unauthorized procurements by linking all commitments and payments to the respective procurement process. Another problematic area is the poor formulation of specifications, aggravated by the superficial inspection of goods. Agencies should be required to nominate approved receiving officers, informing the Supply Unit of these signatories, who can be held accountable when goods are not properly verified on receipt.

[6] The Ministry of Finance and World Bank will undertake a separate assessment of procurement management leading to more comprehensive recommendations.

Box 4.2: How can the Ministry of Finance stop people stealing fuel? It can't but agencies can.

Many Governments suffer considerable losses owing to theft and waste of consumables. Fuel provides a good example.

In East Timor, provision of vehicle fuel is contracted out to a single supplier. A voucher system was introduced in October 2001 in order to curb abuse and theft. Agencies requisition books of vouchers for refueling up to 60 liters, these indicate the vehicle registration, mileage and the drivers name, details that are supposed to be verified by the supplier at the pump. Drivers are also supposed to log mileage and fuelling in a vehicle journey book. At the end of each month, vouchers submitted by the supplier are assigned to the respective agencies and the agencies' budgets debited. These controls, if enforced, are quite sufficient to prevent most cases of fraud and misuse.

Unfortunately, these basic controls are not properly enforced: drivers fail to log mileage; agencies fail to verify mileage against fuel consumption; and in some cases voucher books have been distributed to drivers rather than individual vouchers. While fuel bills have risen sharply since July 2002, this is partly accounted for by increasing numbers of vehicles. However, cases of abuse have been identified and are likely to multiply unless effective controls are put in place.

So why has enforcement been poor? Much of the problem lies in the fact that there is a soft budget constraint for fuel. Although spending on vehicle fuel can be identified in accounts, agencies only have expenditure limits for the broader category of goods and services. If spending on fuel increases it simply crowds out spending on other categories of goods services. Often spending on fuel and other administrative consumables ends up crowding out spending on services, contributing to the administrative capture of resources appropriated for service delivery.

By imposing a hard budget constraint on vehicle fuel, theft and abuse will quickly have an impact on management, who will have an incentive to enforce administrative controls. Budget constraints will also allow Treasury and internal auditors to monitor monthly expenditure returns against limits. The challenge then becomes for the budget department to set an appropriate budget limit.

4.34 Donor financed projects present a more intractable problem. Procurement is usually undertaken by the executing agency or project management unit, following donor specific procedures and policies, sometimes with country of origin requirements. This contributes to the proliferation of makes and models of equipment. While these donor specific systems may enforce fiduciary standards, they are poorly articulated with the Government supply and asset management systems, hindering control of the goods received. Parallel donor specific procurement procedures can also cause confusion in government, since institutions may be following various procedural guidelines at the same time. This

Procurement and Supply: Recommendations

a) *Procurement policies are urgently needed for high value items such as vehicles and computers to reduce capital and maintenance costs.*

b) *Installation of the procurement module of Treasury's expenditure management system should be completed as soon possible, with a view to the extension of the module to TFET projects.*

c) *Agencies should strengthen internal supply controls by nominating approved receiving officers for verification of goods and equipment on reception.*

d) *Expenditures for consumables – such as vehicle fuel, utilities and office supplies - should be monitored against original line item allocations and, where necessary, contained through funds release authorizations.*

is true of TFET too, where World Bank and ADB procedures – which differ in detail – are applied alongside those of Government. The solution lies firstly in an increase in the volume of external financing delivered as budgetary support, which are applied following government procedures, and secondly in the harmonization of donors' procedures. Some countries have made progress in this direction in the framework of an external assistance strategy (see page 52).

4.35 A more fundamental concern relates to the degree of centralization of the procurements system. A centralized procurement system serves much the same function as a centralized payments system: it ensures that all procurements are verified by a third-party, thereby reducing the risk of poor compliance and fraud. Inevitably, this process is irksome to agencies, which would often prefer to procure goods and services directly. However, delegation of the procurement function increases fiduciary risks – particularly where the internal audit function is weak, and so should be avoided for the time being.

ASSET MANAGEMENT

4.36 Central Administrative Service's Asset Management Cell has a spreadsheet register and supporting archive covering part of ETPA's assets – currently about 9,000 items valued at $17 million – procured with CFET funds, identifying the CPV, customs, and receipt and inspection registers associated with each asset, together with its bar code, location and value. The register is well organized, but it is incomplete. The Cell's current procedures only record assets purchased with CFET funds, cleared by customs and received and inspected through the supply system. Consequently the system fails to record, in probable order of magnitude: i) buildings and land; ii) assets of bilateral projects; iii) assets of bilateral projects formally transferred to agencies; iv) assets procured locally that do not necessarily pass through the supply unit; v) assets procured directly by agencies with CFET funds.

4.37 Although on-site inspections were carried out at the end of FY2001, the assets register has not been updated systematically. Some agencies have asset registers, but these are neither standardized nor cross-referenced with the central register. A dedicated asset management module of Treasury's IFMIS has recently been installed, automatically registering assets when agencies request the liquidation of payment. The Ministry of Finance intends to undertake a stock take before Independence and the transfer of assets from UNTAET. This transfer is a complicated task in itself, since the information provided by UNTAET makes it impossible to identify, locate or assess the condition of the assets that it is proposed to transfer.

4.38 There is an urgent need for a regulation on asset management, clarifying institutional responsibilities and procedures. This would: i) give agencies primary responsibility for the maintenance of asset registers, informing the Asset Management Cell of acquisitions, disposals and changes of status in order to update the central, computerized register; ii) require registers to be verified annually by a third party, given the limited internal audit capacity this may require the establishment of a board of survey comprising staff from asset management and other agencies; iii) put in place procedures for the disposal of assets and the transfer of assets from projects; iv) require agencies to hold suspense registers of bilateral and TFET project assets until these are transferred to Government.

Asset Management: Recommendations

a) Implementation of in situ verification of all agency asset registers prior to Independence.

b) Preparation of an asset management regulation defining institutional responsibility and procedures for maintenance of registers, verification and asset disposal.

INTERNAL AUDIT, INSPECTION AND ANTI-CORRUPTION MEASURES

4.39 Internal audit is primarily a management function, intended to strengthen management systems rather than identify and prosecute malfeasance. Only the Ministry of Finance has an internal audit unit, which was set-up in November 2001, staffed by one expatriate and one national. A manual presenting general principles has been prepared and a more detailed manual following ETPA procedures is in preparation. The unit has started four internal audits – CISPE, Ministry of Health, Civil Registry, and Power Service – focusing on compliance with financial and management controls. Additional staff are needed if the internal audit function is to play a useful role supporting line agency management and implement a systematic audit program.

Table 4.1: Statutory Maximum Penalties for Civil Servants

Offence	Institutional Scope	Criminal Penalty (Years)	Civil Penalty (Dollars)
Lack of due care and diligence	Public Sector		250,000
Improper use of position	Public Sector	5	250,000
Misuse of infromation	Public Sector	5	250,000
Receipt of money	Public Sector	7	
Reciveing money by another	Public Sector	7	
Deposit of money in non-official account	Public Sector	7	
Failure to deposit money promptly	Public Sector	2	
Purporting to act in an official capacity	Public Sector	12	
Improper application of public money	Public Sector	7	
Non-compliance with accounting practice	Autonomous	6 months	
Failure to keep informed	Autonomous	3 months	

Source: Regulation 2001/13

4.40 The Inspector General's Office (IGO), which currently reports to the Prime Minister, is broadly mandated to investigate cases of corruption and raise awareness on corruption issues . This function is likely to be transferred to the Ombudsman after Independence. IGO undertook twenty investigations in 2001, some relating to recruitment, payroll mismanagement at the field level, procurement and abuse of supplies. The Office has a drop-box at headquarters and in districts to allow individuals to post complaints. However, since citizens have little access to information regarding appropriate standards and behavior in the public service, or regarding finance, procurement and the supply or goods and services, it is difficult for them the identify let alone denounce cases of impropriety. When denunciations are made, investigations tend to be exhaustive and time consuming. Reports focus on improvements in control systems, with most cases of misconduct being dealt with administratively. Inspection reports are not published. Framework legislation is needed to define the scope of IGO/Ombudsman's powers of investigation and ensure is administrative autonomy.

4.41 Regulation 2001/13 identifies the specific sanctions for criminal use of public funds, including civil penalties and lengthy terms of imprisonment (see Table 4.1). Application of sanctions is limited by the lack of supporting directives for the supply and asset management process, even though these are areas where there is high risk of malfeasance. Furthermore, implementation of statutory penalties is hindered by lack of: clear procedural guidelines on reporting, registration and administrative investigation of suspected cases of impropriety; suspension of personnel involved; graduated administrative penalties depending on the extent of wrong-doing, ranging from fines to dismissal; transfer of responsibility to the Inspector General or criminal investigation and prosecution; recovery

Box 4.3: Combating Corruption

There is no perfect pill to vaccinate against corruption – instances of the abuse of public office for private gain occur in all countries, rich and poor. International experience does however point to several initiatives with proven impact in combating corruption.

Simple procedures and controls. Opportunities for corruption can be eliminated by avoiding situations where officials have a monopoly over a service, or too much discretion in how to administer the service. For example, if one official is responsible for making decisions on whether to exempt goods from import duty, detailed specification of the goods eligible for exemption and the posting of these rules publicly reduces the officials discretion. The division of responsibility for operational and control tasks is equally important – for example, the same staff should not sign prescriptions for pharmaceuticals and control the drug stock. Use of spot-checks rather than regular inspections is also more likely to identify corruption, since the latter have a potential to become a source of corruption rather than a control against it.

Transparency and Participation. The more information is publicly available, the easier it is for citizens to hold officials to account. Widespread publication of information allows ordinary citizens, the media and advocacy groups to assist in monitoring the use of public funds. A strong transparency strategy might include:

- An information campaign on citizen's rights to services, making clear which services are provided free of charge and the appropriate standards – waiting times, availability of medicines- and where to complain if the service provider tries to demand an illegal fee or services are below standard.
- Posting of project budget information, together with expenditure reports, procurement information and receipts at local community sites.
- Informing communities when funds or goods – text books for example – will be delivered to service delivery units and how they should be used.
- Involving communities in the management of services through school and clinic committees, or linking these to local councils, so that service users have a say in how facilities are managed and know what is supposed to be done.
- Disclosure of income and assets for political appointees and senior officials – Ministers have completed a declaration of interests but this is not available to the public.
- Publication of budget and accounts information, and training for journalists and advocacy groups in understanding and querying this information

Sanctions. The best way to send a credible signal throughout the civil service is to take rapid action to sanction guilty officials, and publicize these cases. In order to do this, clear guidance on complaints mechanisms, the process of investigation and rules for application of sanctions are necessary. Care should be taken that due process is followed to protect against unsubstantiated allegations, but criminals should be prosecuted. Dismissal is not a sufficient sanction where there has been criminal abuse of funds.

Paying the going rate. It is also important to ensure that officials are not trapped into a cycle of corruption through wages which are well below market wages. Paying market wages will not prevent corruption unless the additional factors above are addressed – but extremely low wages can create a breeding ground for corrupt practices.

of public funds. In the absence of such guidelines, there is a risk that agencies will tend to deal with cases of impropriety internally, without bringing cases to prosecution.

4.42 Key fiduciary systems vary in the attention given to anti-corruption safeguards. Treasury systems much stronger than other areas, with multiple approvals of each transaction (see page 40). While most payments are routine, there is still substantial scope for discretion where payments are of an extraordinary nature or are considered as priorities by Ministers. Consequently, even the Treasury system is vulnerable to corruption. At present, the system is overseen by highly-paid international gatekeepers and so the low benefits relative to international salaries diminish the risk. Supporting systems (customs, procurement, supply and asset management), registration and licensing functions (land and property, business and investment, pharmaceuticals) and services provided to the public require much more attention.

4.43 A credible anti-corruption strategy has to be based on a firm understanding of the scale of the problem and areas of risk. A diagnostic study would include a review of procedures in those areas vulnerable to corruption (police, tax, budget, treasury, asset management and disposal, customs, procurement, land and property, pharmaceuticals control, school attendance and examinations) and citizen surveys to identify particular services that are considered to be corrupt. On the basis of this diagnosis Government can develop an anti-corruption action plan, identifying procedures and management systems to be addressed – reducing monopoly or discretionary factors – and monitorable indicators that can be tracked to assess whether the environment is improving or deteriorating. An essential component of this strategy must be measures to improve transparency in the public sector, including translation of regulations into local languages, public information campaigns and disclosure measures (see Box 4.3). At the same time, external partners channeling funds through the Treasury system may seek a Government commitment to make public, prosecute and apply sanctions in those cases of corruption that are identified.

Internal Audit, Inspection and Anti-Corruption Measures: Key Recommendations

a) Staffing of internal audit function should be increased so that it can support agency managers and undertake a systematic audit program

b) Procedures for the processing and investigation of suspected cases of criminal or negligent misconduct are needed in order to apply the sanctions foreseen in Regulation 2001/13.

c) Framework legislation is required to establish the scope of the Inspector General/Ombudsman's investigative powers and administrative autonomy.

d) Implementation of diagnostic studies leading to the design of an anti-corruption and transparency strategy should be considered a priority, firstly to identify the level of corruption and formulate an appropriate response, secondly to send a message to all stakeholders that the Government does intend to tackle corruption before it becomes widespread.

5. EXTERNAL PARTNERS, OVERSIGHT AND CONSULTATION

EXTERNAL ASSISTANCE MANAGEMENT

5.1 The challenge for the immediate post-Independence period is to put in place an institutional framework for the management of external assistance that can maximize the benefits of a declining external financing over the following three years. Such a system must include two elements: firstly, a policy and institutional framework for dialogue between Government and external partners; secondly, appraisal, approval, programming and tracking mechanisms to ensure that external financing agreements are consistent with government expenditure priorities, and to ensure that resources are actually delivered.

5.2 ***Policy and Institutional Framework.*** Biannual Donors' Conferences have provided a forum for dissemination of information regarding financing requirements and implementation, and consultation between Government and donors as regards priorities and policy measures. Dialogue has been handicapped by the lack of a clear policy framework. An attempt was made to match donors with Government financing priorities by drawing up an "unfunded priorities list", comprising a pipeline of projects at various stages of formulation proposed by line Ministers and approved by the Council of Ministers. However, it proved difficult to mobilize donor support for individual projects without a broader policy rationale. The National Development Plan should now fill this gap. On-going dialogue would be strengthened by the introduction of a rolling, medium-term Poverty Reduction Strategy which would update policy priorities, strategies and targets (see page 32).

5.3 At the sectoral level, TFET has established a system of biannual Joint Donor Assessments for each project which allow representatives of financing agencies, collaborating agencies (such as NGOs) and government departments to assess progress and participate in the formulation of work plans. Government-donor dialogue has been successful at the sectoral level, where it is anchored on concrete issues of program design and implementation. As TFET winds down, Government-led sectoral working groups should take over this function.

5.4 Ideally, the Government's internal planning instruments should be complemented by an external assistance strategy. This would lay out sectoral and programmatic priorities, operationalizing the priorities laid out in the National Development Plan, and management framework for the delivery of external assistance, based on discussions with donors regarding alternatives. Tanzania's external assistance strategy provides a good example. Formulated through a consultative process, the strategy includes clear guidance on the priorities for external financing together with commitments by donors to untie aid, harmonize procedures and provide an increasing share of assistance as budgetary support. It also includes commitments on the Government's part to ensure transparency and accountability by, for example, conducting independent audits of Government institutions benefiting from budgetary support. Flexibility is important: external partners are constrained by their own fiduciary and programming requirements and may not be able to provide assistance through the mechanisms preferred by Government.

5.5 The Planning Commission's Donor Coordination Unit is currently the official contact point for donor agencies, supports the negotiation of external assistance programs and records commitments and disbursements. This arrangement is unlikely to continue after Independence. The donor coordination function may be transferred to the Prime Minister's Office, to Economic Affairs or to Finance. International experience suggests that there should be just one aid management entity responsible for all external assistance: programmatic budgetary and import support, sector programs, projects and technical assistance. Where there are multiple institutions involved information exchange is poor, resulting in policy drift and administrative confusion, both for Government agencies and

donors. Furthermore, bilateral donors and spending agencies tend to shop around until they find an institution that agrees to sponsor the program or project that they propose, irrespective of policy agreed by Government, thereby undermining budgetary discipline. Experience also suggests that aid management is most easily integrated into Government's internal decision-making process when responsibility for aid management lies with the Ministry of Finance.

5.6 ***Appraisal, Programming and Tracking.*** External financing should be programmed along with domestic resources through the Government's expenditure planning and budget process. Ideally, Cabinet would allocate external resources between institutions and programs by setting external financing limits for each agency, just as it does for domestic financing. This encourages agencies to assess the most economic, efficient and effective way of applying external resources since external assistance is no longer seen as free (selection of one project reduces the funding available for others) and decisions regarding the allocation of external financing are subject to the national decision making process led by Cabinet and ratified by the legislature. This degree of fungibility is only possible with budgetary support: most external financing is earmarked to projects.

5.7 Donors' country programs and individual project financing agreements should be subject to an internal review and approval process. In most countries, financing agreements above a threshold are subject to review by Cabinet's Budget Committee, with the remainder reviewed by the Ministry of Finance. In order to ensure that all financing agreements are subject to review by a third party – not the beneficiary institution – there is usually a statutory requirement that all financing agreements are signed by the Minister of Finance. This is not the case in East Timor, where administrative directives delegate this authority to all Cabinet Ministers. This undermines budget discipline since agencies can access donor funds and make financial commitments for Government without passing through the budget process.

5.8 Information on commitments and disbursements by financing agreements is needed to track implementation. This information should be consolidated with internal financing of development projects in a single capital program (see page 34) and summary information presented in published

External Assistance Management: Recommendations

a) *Institutional responsibility for external assistance management will have to be determined shortly after Independence. It is strongly recommended that this function is assumed by the Ministry of Finance in order to facilitate integration with the budget process and internal capital program management systems.*

b) *Formulation of an external assistance strategy, in consultation with external partners, would i) guide external partners' support for implementation of the National Development Plan; and ii) lay out the guiding principles and mechanisms for the delivery of external assistance in the post-Independence period.*

c) *Regulation 2001/13 should be revised to i) require Ministry of Finance review of all donor country programs and financing agreements, with Cabinet Budget Sub-Committee review above a threshold, so as to verify consistency with Government policy and budgetary coverage of financing commitments; ii) designate the Ministry of Finance as the sole authorized signatory of external financing agreements; iii) eliminate blanket duty and tax exemptions for externally funded imports; iv) establish budget registration as a requirement for payment of tax and duties for donor financed imports.*

d) *Information on programmed and actual disbursements and implementation schedules should be consolidated with information on CFET financed projects in a single capital program. Summary information on all financing agreements should be presented in published budget documentation.*

budget documentation. At present, the Planning Commission collects information on financial commitments and disbursements directly from donor agencies. A database has been set up to record this information, but coverage is incomplete and does use not the same classifications as the budget. The Ministry of Finance has a more comprehensive register of some 520 projects based on information presented in agencies' budget submissions. However, information from this source is also incomplete and, because external financing agreements are signed by the Transitional Administrator and retained by UNTAET, the Budget Unit is unable to verify aid flows reported by agencies against the original agreements.

5.9 Since both donors and beneficiary institutions have incentives to bypass the budget process, independent appraisal and budget registration of external financing agreements can only be enforced where there are sanctions for those institutions that fail to comply. The most effective way of creating incentives for budget registration is to eliminate blanket customs exemptions for donor financed imports, making budget registration of external financing agreements a requirement for payment of import duties by the Ministry of Finance. Budget registration can also be made a requirement for: i) opening of bank project and program accounts outside of the treasury system; and ii) issuing of work permits for long-term international personnel. In this way, agencies have to register projects and financing agreements in order mobilize and apply external financing.

NON-GOVERNMENTAL ORGANIZATIONS

5.10 There is no specific legislation governing the constitution, governance and responsibilities of Non-Governmental Organizations. However, NGOs can apply for charitable status and thereby benefit from exemptions from income tax and customs duties for goods imported for the purposes of humanitarian relief (broadly defined to include rehabilitation activities), education and health care. These imports amounted to about $600,000 in the second quarter FY2002.

5.11 Although Regulation 2001/13 provides for the registration of tax expenditures, this provision has not been implemented. This omission should be corrected in order to improve transparency, revealing the programmed and actual volume of Government subsidies and the beneficiary institutions. In this way the cost of tax exemptions to NGO programs can be assessed alongside other Government expenditures.

5.12 Applications for charitable status must be supported by the organizations' constitution, demonstrating that the organization is intended primarily for the benefit of third-parties without discrimination and does not undertake activities for profit. Organizations whose primary purpose is recreational or political are not eligible. To January 2002, 145 applications for registration as charitable organizations have been received, 91 from international and 54 from national organizations, 111 applications have been approved. Charitable organizations are required to present annual accounts six months after the fiscal year in which they register. Most NGOs have complied with this requirement within the due period, though, owing to lack of staff – only one person in the Tax Department manages the register – it has not been possible to review all the accounts or investigate organizations' operations in the field. A few organizations have been removed from the register where commercial activities have been identified.

5.13 NGOs are mostly involved in community level development activities, usually implementing projects financed by the major bilaterals. However, church organizations are also directly engaged in health and education service delivery. An emerging issue is the design of grant financing modalities that will allow the Government to contribute to financing of NGO service providers. While the basis and management of such transfers will vary from sector to sector, framework legislation is needed to ensure that such transfers are transparent, equitable, efficient and effective. In order to ensure transparency, transfers would have to be presented on budget, with each beneficiary institution identified. Beneficiary institutions should be required to meet appropriate accounting and reporting

standards, including the presentation of comprehensive annual financial reports within stipulated periods. Transfers should also be contingent on service delivery norms and standards (such as application of a national curriculum), verification of non-discriminatory access services and performance reviews. Open-ended commitments should be avoided since policies are subject to change.

5.14 A few civil society organizations also fulfill watchdog and advocacy function. An NGO forum has been established with 130 national members, many of them local community based organizations, and 117 international members. The NGO forum acts as a coordinating body, lobbies Government on NGOs' behalf and supports capacity building activities among national NGOs. One of the forum's focus issues is transparency in the public sector.

5.15 Government has sought to engage NGOs in the preparation of the National Development Plan, both through its oversight committee and through national consultations. It is not clear to what extent this consultation has influenced policy. Formal consultative mechanisms are required to ensure that NGOs are engaged in policy debate and coordinate with Government programs. Broad consultative exercises around the planning and budgeting process – such as those established for the National Development Plan exercise – provide one such mechanism. However, more detailed consultations are often needed at the sector level. This can be achieved by involving NGOs in sectoral working groups along with interested donors. Ideally, these consultative exercises should be mapped out in a consultation strategy as part of the road map for the FY2004 and subsequent planning process.

Non-Governmental Organizations: Recommendations

a) *Legislation providing a framework for contracting NGOs should be approved before the Government initiates subsidies for service provision. This legislation should uphold the principles of equity, transparency and efficiency in determining modalities and volumes of transfers.*

b) *Permanent consultative bodies should be put in place to facilitate NGOs' participation in the annual planning and budgeting process and consultative activities mapped out in the road map for the FY2004 and subsequent planning exercises.*

c) *Tax expenditures benefiting Non-Governmental Organizations should be programmed in budget documentation and reported in accounts.*

LEGISLATIVE OVERSIGHT

5.16 The Constitution affirms the legislature's authority to approve the budget and monitor budget execution. Regulation 2001/13 requires the Government to present its budget to the Constituent Assembly no later than June 15th. The FY2002 budget was submitted in May. Annual appropriations were analyzed and voted by the Council in plenary over a period of six weeks, leading to substantive alterations in some sectors' allocations. Revised appropriations were subsequently approved in November 2001. The Financial Statement for FY2001 was submitted to the legislature but this was not the subject of review or debate.

5.17 While the legislature has engaged in the budget process, the Constituent's Assembly's internal procedures do not favor detailed, critical analysis. In most countries the budget, state accounts and audit report are reviewed by specialist Parliamentary committees before being submitted to plenary debate and vote: the budget is usually reviewed by a Finance Committee, often chaired by the majority party; state accounts and the audit report are usually submitted by a Public Accounts Committee, which deliberates on the government and agencies' consolidated accounts, with authority

to call public officials to account and make recommendations intended to improve compliance. Often the Public Accounts Committee is chaired by a member of the opposition, so as to ensure critical analysis of Government reports.

5.18 Parliament is involved in the budget process at a relatively late stage, when detailed appropriations have already been prepared. OECD recommendations now call for the publication and review of pre-budget statements, as part of a two-stage budget process, before Government issues the budget circular (see page 29). This communicates Government policy and serves as the basis for public and parliamentary consultations on expenditure priorities. Presentation of an outline plan and budget before budget submissions were distributed in the FY2004 budget cycle could provide a framework for broader discussions, both with the legislature and wider civil society.

Legislative Oversight: Recommendations

a) *Establishment of Budget and Accounts Committees structure to ensure that budget proposals are subject to detailed review before approval, accounts are scrutinized and the executive is held to account for compliance and performance.*

b) *Presentation of a Budget White Paper early in the budget process, before distribution of the budget call circular, to serve as a basis for discussions with legislature and civil society.*

AUDIT

5.19 Regulation 2001/13 requires the administration to appoint an independent auditor, who will present a report by 31 December following the end of the financial year. ETTA's FY2001 Financial Report and Accounts were endorsed without qualification. Treasury intends to undertake an interim-audit in March, covering the first nine months of FY2002, up to just before Independence, which will include verification of compliance with the Management Report recommendations. A full audit of the FY2002 accounts and financial report will be carried out in August 2002.

5.20 Despite the unqualified opinion, the auditors' FY2001 Management Report did identify shortcomings in some internal procedures, including: incomplete asset registers; lack of internal audit function; lack of policies and procedures manual. However, the assessment underlying the Management Report was limited to the Ministry of Finance's internal controls. Some consideration should be given to the widening scope of commercial audits and making adequate financial provision. An understanding of the financial statements does require a review of supporting management and control systems (such as payroll, asset management, supply and procurement) and the confrontation of data from disparate sources. Separate provision should be made for the audit of autonomous agencies.

5.21 The Constitution establishes a High Administrative, Tax and Audit Court as the supreme audit body. The president of the Administrative Court will be nominated by the President from amongst the judges and ratified by Parliament. Framework legislation is needed to lay out the basic institutional structure, functions and competencies. This should follow INTOSAI (International Organization of Supreme Audit Institutions) principles. These include: safeguards of independence, such as fixed terms of appointment; a requirement for transparency; powers of investigation and a requirement for disclosure, backed up by sanctions for non-compliance. Although it may be several years before the Audit Court operates effectively with its own staff, since staff will have to be recruited and trained, there is some urgency in setting up the basic framework for the institution. At present the auditor is contracted by the Ministry of Finance. This is not an appropriate arrangement in the period after Independence. Consequently, framework legislation should be considered a priority, including provision for contracting of the audit function, to allow the Audit Court to assume its functions during FY2003.

Audit: Recommendations

a) Adequate financial provision should be made for the audit of State accounts, ensuring that supporting management control systems are properly assessed on a test basis, with separate provision for audits of autonomous agencies.

b) Framework legislation for the audit function should be prepared so as to guarantee independence of the auditor during FY2003.

CONSULTATION AND PARTICIPATION IN EXPENDITURE MANAGEMENT

5.22 Cabinet is currently carrying out a series of public hearings in various regional centers across East Timor, providing citizens with an opportunity to voice their concerns and priorities. The on-going National Development Plan also includes a nation-wide consultative exercise on developmental issues and priorities. However, owing to high costs involved – estimated at around $240,000 – this exercise will not be replicable in future years. It is unclear what mechanisms will be put in place to provide opportunities for consultation on a routine basis.

5.23 The centralized agency and budget structure makes it difficult to accommodate local consultations and participation into the planning and budget process. Several District Administrations have recently prepared District Plans, but it is unclear to what extent these were generated through a meaningful consultative process. A consultation strategy is one of the key outputs expected of the review of the FY2003 planning process (see page 32). At the same time, action can be taken to strengthen awareness of the budget process and its importance at relatively low cost. Uganda, South Africa, Philippines and many other countries have produced brochures explaining the budget process, how decisions are made and how citizens can go about trying to influence these decisions. Preparation of a guide to the budget and planning process could be sub-contracted to an NGO.

5.24 Obviously the appropriate mechanisms for consultation and participation will depend on the design of local governance structures. While it is unlikely that the Government will decide on a definitive local government structure in the immediate post-Independence period, it is important to begin analytical work so that an informed decision can be made when the Government is ready. Since the range of issues to consider is broad, and widespread consultation will be needed, an inter-Ministerial Working Group on Local Governance may provide an appropriate framework for preparatory work. Line agencies can play an important part in this process, notably those responsible for health, education, roads maintenance, water and agricultural services, since they can implement meaningful governance structures at the service delivery point without requiring a administrative superstructure at the district or regional level. Pilot programs can be used to test out different governance models.

Consultation and Participation in Expenditure Management: Recommendations

a) Consultation strategy prepared as part of review of FY2002 planning exercise and road map for FY2003.

b) The Ministry of Finance should increase public awareness of budget and planning process and its relevance to citizens as a crucial first step in developing meaningful dialogue. This can be achieved relatively inexpensively by working with NGOs and the media.

c) Preparatory studies on the options for and design of local governance structures should be launched as soon as possible after Independence, with a view to providing analytical basis for policy choices in the medium-term.

6. ACTION PLAN

CAPACITY AND CAPACITY BUILDING

6.1 ETPA has had considerable difficulty recruiting candidates with suitable technical qualifications and managerial experience: the approved establishment comprises 555 personnel at Grades 5 to 7, corresponding to professional and managerial posts, but Government has a pool of just 1,250 East Timorese with post secondary education on which to draw. Many formally qualified candidates have low quality formal training and limited management experience. The shortage of qualified and experienced accountants and economists is particularly acute. In January 2002, 25% of L5 to L7 posts were still unfilled, with over one third of the L6 posts still vacant. While the Ministry of Finance has managed to recruit its full complement of lower level staff it still has not managed to identify suitably qualified personnel to fill its two L7 posts. Most of the Ministry's senior management are expatriates, as are all the District Finance Officers and the majority of agency Finance Officers.

6.2 Training of East Timorese staff in the Ministry of Finance has mainly been geared to routine, procedural tasks, which continue to be overseen by expatriate personnel, rather than technical, managerial and supervisory functions. National staff have found it relatively easy to adapt to the routine procedures in Treasury, though the numbers of errors in data entry and drafting is still quite high. Adjusting to supervisory tasks which require judgment based on a firm understanding of accounting principles and procedures has proved more difficult. Most difficult of all have been the complex tasks involved in planning and budgeting which call for a wide range of analytical and numerical skills that are difficult to assimilate quickly. These problems have been exacerbated by the fact that the systems are continually evolving. In-service training has focused on the staff of the Ministry of Finance itself, rather than the agencies. Basic numerical, analytical and drafting skills are weak across the public sector. In some institutions, expatriate personnel have assumed virtually all financial management responsibilities, marginalizing national staff who have consequently had little opportunity to learn new skills.

6.3 The Government has secured funding from UN assessed contributions for 100 "core" posts and has requested bilateral support for a further 288 "development" posts in the period immediately after Independence. Of the 100 "core posts" 46 are in financial management or related support functions, including: Treasury (12 posts); Budget (2); Customs and Revenue (10); Banking and Payments Authority (8). These include a mixture of in-line and advisory positions, though most of those within finance are in-line functions that will eventually be assumed by national staff. The recent arrival of a Portuguese team of 21 technicians has significantly increased the number of international staff available to the Ministry of Finance, though it now appears likely that the Australian team will leave shortly after Independence. Efforts are now being made to ensure a successful hand-over. Nevertheless, the number of international personnel working in expenditure management functions for line agencies will drop sharply as these functions are handed over the national personnel. The same is true for districts, where the 13 UNV finance officers will be replaced by national staff and a single international post will be retained in a supervisory role at central level. As yet no coherent exit strategy been prepared, the terms of reference simply include a requirement for international staff to train counterparts.

6.4 The transition of planning, budget and control systems currently overseen by a small number of expatriate gatekeepers to national managers is a huge challenge. The Government must balance its legitimate desire to nationalize posts as quickly as possible with the need to maintain adequate safeguards for use of public funds. These goals can only be reconciled by the development of a comprehensive, long-term transition strategy for the core financial management functions of

government. Most countries with established formal education institutions are able to recruit staff with the requisite qualifications. East Timor does not have this luxury. While recruitment will be an important component of the capacity building strategy over the medium-term, the short-term strategy is to apply existing staff to the best advantage and upgrade their skills. Some of the key issues to consider in the design of this capacity building strategy are discussed below.

6.5 A ***long-term capacity building program*** is needed to train staff in core financial management disciplines – economics, accounting and public finance – as well as the routine procedures. Such training should be government-wide, encompassing staff of the Ministry of Finance, agencies and at district level, and should seek to provide a range of formal training opportunities from basic post-secondary to university level. In most countries, formal training is contracted out to specialist training institutions. In East Timor, this may be an appropriate strategy, though it is likely that some kind of twinning arrangement will be needed with training institutions in other countries to support curriculum development, training of trainers and classroom facilitation. University level training will be required to upgrade a smaller number of staff with the requisite academic qualifications and potential. Scholarships abroad – generally financed by bilateral donors – offer one solution, but this leads to the loss of staff over prolonged periods. An alternative is to combine classroom and distance learning while staff remain in post, an approach that has been used successfully in Mozambique. Again, this would require long-term twinning arrangements with specialist training institutions abroad. The set-up costs of this kind of formal training program are substantial and requires long-lead times: a needs assessment has to be undertaken, covering both institutional requirements and the profiling of prospective candidates; an appropriate curriculum has to be designed and graded for the purposes of academic equivalency; and trainers trained. At the same time, technical assistance can provide complementary on-the-job training, focusing on agency specific procedures. Such a complex mixture of training activities has to be managed and monitored. The Ministry of Finance should consider recruiting a training coordinator as a senior staff post. At the same time, the Ministry of Finance should seek long-term financing – over a three-year period at least – for a specific project as soon as possible.

6.6 Some countries have used a ***cadre system*** to provide technical support and training to staff with similar functional responsibilities throughout the public sector, though staff continue to report administratively to their line agency managers. In this way, accountants throughout the public sector are responsible to the Ministry of Finance on technical matters, the Ministry oversees standards, provides training and participates in promotions and rotations between institutions. Again, to be effective, a cadre system has to be properly managed, with an anchor team coordinating administrative and technical support. Effective personnel management is critical, so that scarce staff are assigned to the tasks to which they are best suited. Progress should be monitored, requiring a formal appraisal process, and line managers should have responsibility for staff development. This requires a properly staffed personnel management function at agency level.

6.7 The Ministry of Finance will need ***technical and managerial support*** for some time to come. Few national staff have reached the point where they master existing systems and procedures, the majority require close supervision. Some countries – Botswana and the Gulf States for instance, Mozambique too in the years immediately after Independence – have retained expatriate advisors into in-line positions over many years, whilst national personnel are trained and gain experience. This may be a more appropriate model than immediate adoption of the more traditional advisory function of technical assistance. The principal advantage to Government is that expatriate personnel are directly accountable to the senior national personnel, at Ministerial level if necessary, and follow the agency work plan, rather than specific activities designed within the framework of a project.

6.8 ***Continuity in the basic system design*** is critical if national staff are to become familiar with procedures and so assume supervisory and management responsibility more quickly than where there are fundamental changes. While there is a need to refine existing systems and introduce new systems

in a few key areas, there is no need to change the basic structure of the planning, budgeting and treasury systems. To date the Ministry has been successful in combining technical assistance from a range of countries into a single team, adapting international best practice to fit ETPA's specific requirements. This will continue to be a challenge in the years to come, requiring strong leadership from ministerial level so that technical assistance teams and individual advisers do not try to mould the existing system to fit the model with which they are most familiar. Continuity of technical support teams will also be important. High turnover rates amongst international staff are inefficient. Ideally, the Ministry of Finance would establish a long-term institutional twinning arrangement whereby there will be continuity in the teams, even if individual consultants are rotated, and the staffing levels can gradually be reduced as national capacity develops.

Capacity Building: Recommendations

a) Preparation of long-term capacity building strategy for public expenditure management, including i) basic skills and professional training across the public sector; ii) appointment of a training coordinator.

b) Strengthening of personnel management function in Ministry of Finance and across public sector, to ensure specialists receive technical support, possibly through cadre system, staff are appropriately placed and performance monitored.

c) Formulation of a long-term technical assistance strategy and financing strategy to support progressive transfer of skills and progressive substitution of expatriate personnel as skills are developed.

PROPOSED PRIORITIZATION

6.9 The basic elements of a modern public expenditure management system have already been put in place. Notable features include the performance orientation and medium-term perspective of the budget process, and a centralized payments system, supported by computerized information systems, that allows rigorous control of agency budget execution. However, it should remembered that the system, first established in early 2000, has yet to complete two budget cycles and is still evolving as weaknesses are identified and addressed. Current framework legislation was only promulgated in July 2001 and the complementary regulations needed to implement some elements of the system have not yet been put in place. Much of this preliminary work has been undertaken by expatriates, who continue to oversee most public expenditure management functions. National personnel have been recruited but – hardly surprisingly – have not yet fully assimilated the basic procedures, let alone the underlying principles of public expenditure management. Much remains to be done.

6.10 This section seeks to prioritize the areas for intervention in the immediate pre and post-Independence period. Five priorities are identified:

a) **Capacity Building**. Transfer of responsibility for the management and implementation of the public expenditure management system from expatriate to national personnel is a huge challenge and will be a lengthy and expensive process. If Government is to maintain adequate expenditure controls, a core of expatriate line managers will have to remain in post for several years to come. A long-term, extensive training program is needed to develop skills in the basic functions of planning, budgeting and accounting, as well as familiarity with procedures. MoF will also have to develop a personnel management function that is able to provide support to staff throughout the public sector in these critical areas.

b) **Strengthening Management Controls**. The core Treasury expenditure management system ensures adequate controls over agency spending. However, the linkages between expenditure

and other management controls are weak, leading to inconsistent records and opportunities for malfeasance. Particular weaknesses are encountered in personnel management, procurement, asset and supplies management. Solutions lie in:

- Integration of information systems, linking the payments, payroll, personnel, procurement and asset management under a single on-line system;
- Supplementary regulations on procedures and policies, particularly as regards civil service personnel management, employment of temporary staff, procurement standardization and asset management;
- Increased capacity for internal audits to identify weaknesses in systems and non-compliance; and
- Imposition of a hard budgetary constraint for consumables through the expenditure warrants.

c) **Strengthening Governance Structures**. Independent oversight institutions are needed to verify and enforce compliance, reducing the risks of corruption and abuse of executive authority. The draft Constitution establishes the basic governance framework, including an independent Administrative Court and an Ombudsman reporting to the legislature. However, the details of how these institutions will operate have yet to be decided and it is likely to be several years before these institutions have developed sufficient technical capacity to fully discharge their functions. Measures likely to strengthen governance in the short-term include:

- Budgetary transparency, by i) publishing a comprehensive budget, including full disclosure of oil revenues and movements in oil assets, and ii) promulgating legislation providing for disclosure of information in the public sector.
- Engagement of the legislature in public expenditure decision making and oversight, through early consultation in the budget process, before limits are approved, and establishment of appropriate committee structures to scrutinize the budget and state accounts;
- Independence of the auditor, assured through framework legislation, though in the next few years audits will continue to be undertaken by contractors, and a requirement for full disclosure of auditors' reports.
- Public information and consultation, ensuring that public is aware of government expenditure decisions and their basis, and the public has an opportunity to influence decision-making, through public hearings, local consultation and participatory planning activities;
- An Anti-Corruption Strategy, based on a comprehensive diagnosis of risks in the public sector, can send a strong message regarding standards of conduct, particularly where this is backed-up by a commitment to apply disciplinary procedures and prosecute in cases of misconduct.

d) **Focusing on service delivery and performance**. The purpose of public expenditure management is to support and facilitate the delivery of public services in line with Government policy. This requires that policy and planning is informed by feed-back on program implementation and impact, line mangers have sufficient autonomy to respond to locally identified needs and priorities, and communities are involved in decision-making and implementation. Actions to strengthen the service delivery and performance orientation of public spending include:

- Following-up the National Development Plan with an annual rolling, medium-term plan, providing for review and updating of the National Development Plan policy framework,

programs and targets. The first step in this process would be a critical review of the NDP planning process and a road map for FY2004 planning cycle.

- Improving the framework for performance management, by providing a statutory basis for agency reporting and reviewing agency indicators in order to ensure policy consistency and availability of information.
- Facilitating deconcentration of resources and decision-making, by encouraging agencies to establish budget management committees integrating line and district mangers, and provide indicative resource allocations for lower level administration and service delivery units.
- Monitoring of field level delivery through tracking studies and beneficiary assessments, as well as periodic fundamental expenditure reviews to examine the allocation of resources at sectoral level.
- Establishing local governance structures for public services, either by giving local councils a role in the oversight of services or by establishing specific committees for schools and health facilities. Proposals for bringing community grants for investment projects, as under the Community Empowerment Project, on budget merit consideration.

e) **Aligning external assistance with Government's development priorities**. The proliferation of standalone projects executed outside the Government's management systems leads to policy drift and undermines budgetary discipline. To reduce these risks, the allocation of external assistance should be subject to an internal review and monitoring. At the same time, there is a need to strengthen dialogue with donors so that resource allocation decisions reflect a consensus regarding policy priorities. To this end Government should consider:

- Increasing the share of external assistance delivered as budgetary and balance of payments support rather than as standalone projects.
- Bringing external assistance into the budget process by establishing reviews for externally financed projects by MoF Budget Department and Cabinet for larger projects, and requiring Ministry of Finance authorization of external financing agreements, within the framework of a revised Budget Framework Law (Regulation 2001/13). Incentives for registration of projects may include, restrictions on payments of import duties, work permits and project bank accounts.
- Setting up procedures and information systems for programming and monitoring development projects, covering projects with external and domestic financing, so as to track project implementation and disbursements.
- Establishing mechanisms for Government-Donor dialogue by formulating an External Assistance Strategy, laying out a policy and operational framework for aid delivery, and Working Groups for Macro-Economic Policy and at the sectoral level. Government-Donor Working Groups could usefully parallel the internal working groups set-up for the National Development Plan process.

ANNEX

SUMMARY RECOMMENDATIONS

PROPOSED ACTION PLAN ***KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners***			
Issue	***Immediate (FY2002)***	***Short Term (FY2003)***	***Medium to Long Term (FY2003 and beyond)***
EXPENDITURE POLICY			
Aggregate Expenditure	*¨ Presentation of balanced budget, with all programmed expenditures covered by revenues, grants and financing.*	*¨ Aggregate expenditures determined by the level of spending that can be used productively, is sustainable and the volume of budgetary support mobilized.* *¨ △ Increase the volume and share of external financing provided as budgetary and balance of payments support.* *¨ △ Preparation of a coherent capacity building strategy across the public sector, covering both technical assistance and training, as part of external assistance strategy.*	
Sectoral Expenditure		*● Future cost implications of policies assessed and programmed to avoid crowding out of high priority social and poverty reduction programs.* *¨ Spending on low priority sectors capped.*	*¨ Increasing share of resources assigned to the social sectors to maintain current levels of service*
Economic Composition of Expenditure	*● Tight controls on minor capital and administrative expenditures to prevent administrative capture.*	*¨ Maintenance spending increased significantly, accompanied by a deconcentration of responsibility for maintenance management.*	*¨ Decompression of salaries to facilitate recruitment and retention of qualified senior managers and technicians.* *¨ Within grade salary increments introduced to provide for progression .*
Budget Execution and Alterations	*¨ △ Negotiation of front-load budgetary and balance of payments support financing to cover Government expenditure commitments.*	*● Funds release front-loaded to ensure that agencies have sufficient time to execute appropriations*	*● Focus on improving program costing and assessment of agency implementation capacity in budget preparation.*
Expenditure Deconcen-tration and Regional Distribution		*● Tracking implemented as part of public expenditure reviews to verify proportion of resources actually reaching intended beneficiaries..*	*¨ Progressive decentralization of agency budget execution authority to improve efficiency in service delivery management and create opportunities community participation..*

PROPOSED ACTION PLAN KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners			
Issue	**Immediate (FY2002)**	**Short Term (FY2003)**	**Medium to Long Term (FY2003 and beyond)**
EXPENDITURE PLANNING AND BUDGETING			
Economic Monitoring and Forecasting	¨ Routine compilation of trade statistics and maintenance of an archive of supporting documentation should be a priority, both for monitoring purposes and to satisfy fiduciary requirements for BOP support.	¨ A medium-term development program for the statistics system developed to ensure that necessary statistical information available for economic and policy impact monitoring.	
Budget Structure and Coverage	● Budget documentation presents i) comprehensive data on financial assets and their disposition, including oil and gas fund savings; ii) a comprehensive list of development projects and their respective total cost, sources of financing and implementation dates. ● Agencies present district allocations for all programs, with deconcentrated spending translated to cost-center structure for the purposes of expenditure execution, control and tracking. .		
Budgeting, planning and public expenditure		■ Revision of the statutory framework for the budget process (Regulation 2001/13) to: i) specify the budget timetable and outline agencies' internal budget process, ii) define the institutional framework for performance management and reporting requirements to core government and the legislature. ¨ Introduction of a two-stage budgetary process, providing for policy review and setting of cash expenditure limits prior to the distribution of agency budget call notices.	● Implementation of periodic sectoral expenditure reviews on a rolling basis, in collaboration with financing partners, focusing on: i) policy consistency ii) efficiency and effectiveness of expenditure; ii) impact of public spending..
Development and Poverty	¨ Definition of the institutional framework for the development planning function after	¨ Implementation of a review of the National Development Plan process and preparation of a	¨ Introduction of a rolling multi-year planning instrument focusing on poverty reduction as part of

PROPOSED ACTION PLAN KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners			
Issue	**Immediate (FY2002)**	**Short Term (FY2003)**	**Medium to Long Term (FY2003 and beyond)**
Reduction Planning	Independence, ensuring that development planning is linked to expenditure planning and budget process.	road map for the next planning cycle, focusing on improvements in policy analysis, stakeholder consultation and the technical formulation of agency programs, particularly as regards costings.	the MTFF process.
Development Projects	● Comprehensive list of development projects and their respective total cost, sources of financing and implementation dates, presented in budget documentation.	● Definition of procedures for the appraisal of development projects as part of the budget process, including specification of information requirements, and simple appraisal criteria . ● Implementation of a project tracking system designed to identify project implementation and cost overruns, together with procedures for review of projects that are consistent poor performers or significantly over-budget.	
Autonomous Agencies	¨ Formulation of an action plan to address the structural and management deficiencies of the Power Authority, including a realistic plan for cost recovery and the reduction of budgetary transfers over the medium-term.		■ Preparation of an umbrella Public Enterprises Act specifying internal and external governance arrangement, the basis for inter-governmental fiscal transfers, accounting and insolvency.
Management of Financial Assets	¨ Formulation of interim administrative directives establishing procedures for draw-down and repayment of funds for purposes of in-year expenditure smoothing		■ Formulation of statutory framework for management of oil and gas fund, addressing: i) revenue assignment; ii) institutional framework; iii) investment policy; iv) application of funds; v) expenditure smoothing.
BUDGET EXECUTION AND CONTROL			
Budget Execution		● Consolidation of Treasury centralized budget execution to ensure that budgetary discipline is maintained. ● Progressive rolling out of computerized budget execution system to agencies on read only basis.	● Progressive rolling out of computerized budget execution system to agencies with electronic processing and extension to districts. ● Increased investments in capacity building to allow progressive transfer of supervisory and authorizing functions to national personnel. ¨ Review of mechanisms for deconcentration of agency expenditure management to field level, focusing on education and health sectors, in order to strengthen community involvement of service

PROPOSED ACTION PLAN KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners			
Issue	**Immediate (FY2002)**	**Short Term (FY2003)**	**Medium to Long Term (FY2003 and beyond)**
			delivery facilities.
Cash Management	● Presentation of information on Government's liquidity status in quarterly expenditure reports together with programmed cash flow. ¨ △Negotiation of front-loaded budgetary support to ensure that Government has adequate cash balances early on in the fiscal year and a float to cover delays in subsequent disbursements.	¨ Criteria for prioritization of funds release defined at a policy level to safeguard high-priority expenditures and programs when in-year expenditure adjustments are required.	■ Mechanisms for call-down and replacement of oil savings for the purpose of short-term liquidity management included in trust fund statutes..
Financial Reporting		● Consolidation of reporting system, ensuring timely and comprehensive of monthly and quarterly execution reports. ● Formulation of a strategy for implementation of the Regulation 2001/13's accounting and reporting provisions, including in the short-term i) development of supporting systems to manage the assets and outstanding commitments; and ii) extension of Treasury reports to cover TFET expenditures, thereby covering the Government's capital program.	¨ Preparation of autonomous agencies' accounts on a commercial basis. ¨ Compilation of tax expenditures, starting with exemptions for NGOs.
Personnel and Payroll Management	● Regular reconciliation of payroll and CISPE personnel registers. ¨ Contracts of temporary staff currently on payroll regularized where agencies intend to retain temporary staff as permanent employees. ● Chart of accounts revised to identify payments for temporary employees in expenditure reports.	¨ Preparation of Civil Service Code, addressing key personnel management functions, standards of conduct and disciplinary procedures. ¨ Regulation of terms of temporary staff particularly as regards duration of contract	● Integration of Treasury payroll and CISPE personnel computerized information systems. .
Procurement and Supply	● Installation of the procurement module of Treasury's expenditure management system to facilitate tracking of procurement process against payments.	¨ Procurement policies defined for high value items such as vehicles and computers to reduce capital and maintenance costs. ¨ Nomination of agency approved receiving officers for verification of goods and equipment on reception. ● Expenditures for consumables – such as vehicle	

PROPOSED ACTION PLAN ***KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners***			
Issue	***Immediate (FY2002)***	***Short Term (FY2003)***	***Medium to Long Term (FY2003 and beyond)***
		fuel, utilities and office supplies - monitored against original line item allocations and, where necessary, contained through funds release authorizations.	
Asset Management	*● Implementation of in situ verification of all agency asset registers prior to Independence.*		*¨ Preparation of an asset management regulation defining institutional responsibility and procedures for maintenance of registers, verification and asset disposal.*
Internal Audit, Inspection and Sanctions		*● Staffing of internal audit function increased and implementation of systematic audit program.* *¨ Procedures for the processing and investigation of suspected cases of criminal or negligent misconduct defined to permit application of sanctions foreseen in Regulation 2001/13.* *■ Framework legislation prepared defining Inspector General/Ombudsman's investigative powers and establishing its administrative autonomy.*	*¨ Implementation of diagnostic studies leading to the design of an anti-corruption and transparency strategy.*
EXTERNAL PARTNERS, OVERSIGHT, CONSULTATION AND CAPACITY BUILDING			
External Assistance Management	*¨ Institutional responsibility for external assistance management defined. It is strongly recommended that this function is assumed by the Ministry of Finance in order to facilitate integration with the budget process and internal capital program management systems.* *● Information on programmed and actual disbursements and implementation schedules consolidated with information on CFET financed projects in a single capital program.* *● Summary information on all financing agreements presented in published budget documentation.*	*¨ △ Formulation of an external assistance strategy, in consultation with external partners ,to i) guide external partners' support for implementation of the National Development Plan; and ii) lay out guiding principles and mechanisms for the delivery of external assistance in the post-Independence period.* *■ Regulation 2001/13 revised to i) require Ministry of Finance review of all donor country programs and financing agreements, with Cabinet Budget Sub-Committee review above a threshold, so as to verify consistency with Government policy and budgetary coverage of financing commitments; ii) designate the Ministry of Finance as the sole authorized signatory of external financing agreements; iii) eliminate blanket duty and tax exemptions for externally funded imports; iv)*	

PROPOSED ACTION PLAN KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners			
Issue	**Immediate (FY2002)**	**Short Term (FY2003)**	**Medium to Long Term (FY2003 and beyond)**
		establish budget registration as a requirement for payment of tax and duties for donor financed imports.	
Non-Governmental Organizations		■ Legislation providing a framework for contracting NGOs approved before the Government initiates subsidies for service provision, ensuring equity, transparency and efficiency in transfers.	¨ Permanent consultative bodies put in place to facilitate NGOs participation in the annual planning and budgeting process. ¨ Tax expenditures benefiting Non-Governmental Organizations programmed in budget documentation and reported in accounts.
Legislative Oversight		¨ Presentation of an outline plan and budget early in the budget process, before distribution of the budget call circular, to serve as a basis for discussions with legislature and civil society.	■ Establishment of Budget and Accounts Committees structure to ensure that budget proposals are subject to detailed review before approval, accounts are scrutinized and the executive is held to account for compliance and performance.
Audit	● Interim audit undertaken before Independence. ● Adequate financial provision made for the audit of State accounts, ensuring that supporting management control systems are properly assessed on a test basis, with separate provision for audits of autonomous agencies	■ Framework legislation for the audit function prepared so as to guarantee independence of the auditor during FY2003.	
Consultation and participation in expenditure management		¨ Consultation strategy prepared as part of review of FY2002 planning exercise and road map for FY2003.	● Increase public awareness of budget and planning process and its relevance to citizens, through targeted publications and collaboration with NGOs and the media. ¨ Preparatory studies on the options for and design of local governance structures launched as soon as possible after Independence, with a view to providing analytical basis for policy choices in the medium-term.
Capacity Building	● Measures taken to ensure a successful hand-over between technical assistance teams.	● Preparation of long-term capacity building strategy for public expenditure management, including i) basic skills and professional training across the public sector; ii) appointment of a training coordinator.	● ¨ Strengthening of personnel management function in Ministry of Finance and across public sector, to ensure specialists receive technical support, possibly through cadre system, staff are appropriately placed and performance monitored.

PROPOSED ACTION PLAN ***KEY: Level of competence ● Ministry of Finance ¨ Government ■ Legislature △ External Partners***			
Issue	***Immediate (FY2002)***	***Short Term (FY2003)***	***Medium to Long Term (FY2003 and beyond)***
		¨ △*Formulation of a long-term government-wide technical assistance strategy and financing strategy to support progressive transfer of skills and substitution of expatriate personnel as skills are developed.*	