Background Paper for Donors' Meeting on East Timor

Dili, 14-15 May 2002

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EXECUTIVE SUMMARY

The May donors meeting will focus on the three-year post-independence development programme

The Donors' Meetings for East Timor have played an important part in maintaining pace and coordination in support of the independence transition. This role is even more critical in May 2002, when donors will come together a mere four days before the independence handover to discuss support for the program of the newly created Democratic Republic of East Timor.

At the Canberra and Oslo Donors' Meetings, Government put forward the idea of developing a strategic plan for the transition from reconstruction to national development at the time of the independence celebrations. This was widely supported by donor countries. In the intervening period, Government has made extremely fast progress in completing the National Development Plan and associated budget framework. This Background Paper provides a brief commentary on the plan and budget.

Strong progress has been made on the national development plan

The National Development Plan is exceptional in the speed of its development and the intensive consultative process followed with civil society. It should be noted that this has been achieved during a eight month period when the Government has also gone through two fundamental institutional transformations, first to an elected transitional Government in September 2001, and now to an independent state. The plan lays out a strong framework for post-independence development: it does not operationalize all of the priorities identified, but this is to be expected in a compressed process. More time will be needed after independence to fully operationalize the priorities laid out in the plan, and to address the more complex policy issues.

Supported by a pro-poor budget with an external financing requirement of USD 90 million over 3 years

The Plan has been supported by a multi-year fiscal framework which provides for fiscal sustainability. The Budget presented by Government is in general pro-poor in its orientation, with particularly high allocations over the medium term to the social sectors. The Budget lays out total expenditure of USD 256 million over three years, and an external financing requirement of USD 90 million dollars. This represents a reasonable balance of investment in critical social and economic areas, together with awareness of capacity constraints in execution, reflected through a gradual increase in capital projects execution.

Now is the time to signal continued engagement from the donor community in support of a strong poverty reduction strategy

Large challenges remain for the execution of the Plan and Budget. The plan is ambitious in its scope, although technical and management capacity remains weak in several sectors. Continued assistance by the donor community, in support of the Plan and its associated technical assistance requirements will be critical to maintain the gains made in social and economic recovery since the destruction of 1999. Now is the time to ensure that the recovery which we have all supported since 1999 is sustained and strengthened in the critical period after independence.

THE NATIONAL DEVELOPMENT PLAN

The National Development Plan has been completed in record time

After eight months of intensive work under the leadership of the Planning Commission and an intensive consultative process with all stakeholders, the Government published its first National Development Plan (NDP) on May 3, 2002. A popular version of the plan entitled "Our Nation, Our Future" was released simultaneously and will be made available to every East-Timorese household.

The process was strongly Timorese-driven and included wide-ranging community consultations

The NDP planning process was launched with a Poverty Assessment drawing on the results of three surveys: a Suco Survey, a Household Expenditure Survey and a Participatory Potential Assessment. This was complemented by an analysis of constraints, summarized in the State of the Nation Report. Subsequently, eight technical working groups chaired by the concerned Ministers worked for three months to develop sector programs - on macroeconomics; political development, foreign relations, defense and security; rural and regional development; social and human development: education and health; agriculture, fisheries and forestry; natural resources and environment; industry trade and the private sector; and infrastructure. The Civil Society Consultative Commission organized consultations with almost 40,000 people nationwide. The process concluded with a two-day workshop allowing stakeholders to provide feedback on a draft of the NDP.

The NDP proposes a development plan for the first five years of independence within a twenty year perspective. Part I provides an overview of the twenty-year vision, goals, challenges, the poverty reduction strategy and the capacity development needs. Part II presents the monitoring, evaluation and review arrangements as well as the macro-economic framework and medium-term economic and financial outlook. Part III is dedicated to the sector development plans prepared by the sector working groups.

The Plan is particularly strong on consultation process, vision, poverty reduction focus and medium term economic outlook…

…although insufficient time was available to address all policy issues and develop an operational sequencing for priorities

The NDP's most prominent strengths are the impressive consultations undertaken for its preparation, the vision for development distilled from these consultations, the clear focus on poverty reduction as the priority for development, and the detailed and comprehensive medium term economic and financing outlook. An area where the NDP could be enhanced over the coming period is the consistency between the vision and the proposed macroeconomic framework on the one hand and the proposed sector programs on the other hand. Some issues, especially property rights and decentralization would also benefit from a more comprehensive treatment. Finally, to make the NDP into a tool for the implementation of a Poverty Reduction Strategy, it would be useful to reflect upon the sequencing and prioritization of the comprehensive development program presented in the NDP, to rely more explicitly on the wealth of data already available in East Timor, especially the Poverty Assessment, and to strengthen links with the budget process.

The ***consultative process*** included the Government, civil society and about 40,000 people throughout the territory, which represents nearly 10 percent of East Timor's adult population. These nationwide consultations enabled the people to participate directly in the NDP planning exercise, to present their own vision and expectations for the next twenty years, and to outline their own priorities. The population invariably identified education and health as its two top priorities for progress. For the ranking of other priorities there are regional differences. The economy, agriculture, roads and bridges, power and water and sanitation rank high in several rural districts, while employment is an important priority in Dili. Several districts list democracy and governance, reconciliation, peace and security, and helping vulnerable groups as important priorities. In Viqueque and Liquica for example, reconciliation is the fourth priority. The consultative process for review and implementation of the NDP could be made even stronger by including the private sector and its associations in the discussions on areas of interest to them.

The popular consultations identified education and health as the top priorities

The vision is clear and comprehensive…

The ***vision for East Timor in 2020*** distilled from the participatory process is both succinct and comprehensive. It envisages a democratic, prosperous, fair and safe East Timor, where the rule of law and human rights are respected, and the environment, traditions and customs are preserved. It projects a market economic system with a strong role for the private sector and strategic and regulatory roles for the Government, including the provision of basic services and safety nets. It portrays a Government that pursues efficiency and transparency, that is accountable to its constituency and free of corruption and nepotism.

….with a direct poverty reduction focus

The program presented in the NDP clearly states ***poverty reduction*** as the ***primary objective for development***: "the people of East Timor determined that the overriding goals for the development of their country are to reduce poverty in all sectors and regions, and to promote rapid, equitable and sustainable growth that reduces poverty and improves the well-being of all people".

The macroeconomic framework focuses on sustainable fiscal policy, an open economic regime and prudent and transparent management of oil and gas revenues

The ***macro-economic policy framework and the medium term economic and financing outlook*** is comprehensive and detailed. It outlines a policy framework for high, sustainable and broadly based growth, consistent with both macro-economic stability and poverty reduction. It describes a multi-year fiscal framework which is sustainable and provides for a pattern of public expenditures that is pro-poor and allocates a high percentage of expenditures to education and health. It also presents a proposal for prudent management of East Timor's future oil and gas revenues aiming to provide a secure stream of dividends and interest income that will benefit both present and future generations.

…and insufficient time was available to address in-depth some key policy issues, such as property rights and

On the other hand, ***some issues would benefit from a more in depth treatment, once more time is available****.* The issue of property rights and land claim adjudication, which will be key for both investment and political stability, is not addressed in detail. Similarly, there is a need to deepen the approach to decentralization. An important priority for future study could therefore be to examine options for the roles and *subnational government structures*

structures of subnational government and local communities in a way that facilitates cost effective and efficient delivery of services while strengthening transparency and fostering grassroots democracy. The governance section also provides scope to develop a more detailed description of measures that will ensure an efficient, transparent and accountable public sector that focuses on basic service delivery. These are likely to emerge during discussions for the Civil Service Statute which Government intends to adopt during FY2003.

Finally, while the NDP's comprehensiveness and long-term view is one of its strengths, it could also hamper the use of the NDP as an effective tool for implementation of the poverty reduction strategy if not carefully managed. Two major risks will likely need to be addressed in this regard to ensure the NDP's successful implementation.

Further sequencing will be needed to facilitate implementation and operationalize the plan

First, as outlined above, the NDP's comprehensiveness and long-term perspective pose a considerable challenge for implementation. Without ***further sequencing and prioritization***, the government will run the risk of spreading itself thinly over too many programs at once. It may then lose the focus on the principal goal – poverty reduction on the basis of rapid and sustainable growth - and thus forego the chance of making a dent in poverty reduction quickly. To achieve results in the short term, it is important that the plan be implemented in phases, focusing first on the most urgent issues and constraints to poverty reduction. To make the plan operational it will be necessary to sequence and prioritize the proposed policy/action program and to clearly articulate it with available resources in the context of the MTFF. The sequencing proposed in the education section of the NDP presents a good example of how this can be approached, guided by a focus on poverty reduction on the basis of the Poverty Assessment.

Successful implementation will also depend closely on the success of capacity-building efforts

Second, successful implementation of the plan critically depends on improved ***capacity at the management and technical level***, both in the Government, the private sector, civil society and the communities. The plan commits to building on the governance and capacity development framework prepared with the support of UNDP. Accelerating progress on this regard will be key to the achievement of the ambitious targets laid out in the plan.

The Plan compares very favorably with I-PRSPs from other countries

Both in process and scope the NDP goes well beyond what is traditionally expected in an Interim Poverty Reduction Strategy Paper (I-PRSP), and contains almost all of the elements present in a full PRSP. Once Government has had time to review the recently completed planning process, identify gaps in the process and scope, and determine a brief road map for future updates of the Plan, it would therefore be worthwhile considering the use of the plan as an I-PRSP or even as a full PRSP. Entering the PRSP process would help structure the updating of the National Development Plan and would open doors to technical assistance grant funding for training and studies linked to the plan.

…and would need very little review to submit as an I-PRSP (or even full PRSP) next year.

Government also intends to establish a monitoring system during FY2003 to monitor implementation of the plan and assist in updating for the following financial year. The Government has requested donors' assistance to provide further training during FY2003 to strengthen this process. Such training will be an important pre-requisite to assist departments in operationalising the plan and improving plan and budget submissions for next year.

THE MEDIUM TERM FISCAL FRAMEWORK

Government released its FY2002/03 budget and medium term fiscal framework on May 6th.

Oil revenues will provide an exit strategy from dependence on external aid for the budget by 2006, but are unlikely to allow for substantial savings until the end of the decade

Revenue Trends

Owing to changes in the oil and gas projects' tax regime, the oil and gas revenue profile is now likely to be backloaded, with significant increases in revenues starting in FY2010 rather than FY2006. Conservative estimates for oil revenues have been used to program the MTFF resource envelope, discounted by 25% to accommodate price and volume risks. On this basis, oil revenues are expected to rise from $21.3 million in FY2003 to $76.4 million in FY2006 (as compared with $17 and $214 million respectively in previous estimates).

Non-oil revenues will increase slightly in FY2003, owing to the implementation of minor increases in the sales, excise and services taxes, which should more than offset the downturn in the economy as the UN mission winds down. Thereafter, the share of non-oil revenues is expected to stabilize as a share of GDP over the period to FY2006. Further changes in the domestic tax regime should be considered carefully to assess the trade-off between impact on the aggregate revenue profile against administrative cost, impact on competitiveness and the Government's investment promotion objectives.

Trends in Aggregate Expenditures

Expenditure estimates are lower than those presented at Canberra and Oslo

Changes in the revenue profile have important implications for public expenditure policy. Rather than substantial surpluses following FY2006, allowing a expansionary stance in the immediate post-independence period, the Government will now have to pursue a more conservative expenditure program if it is to balance its budget over the FY2006 to FY2009 period and reduce its dependence on external budgetary support.

Low execution rates in part reflect capacity constraints and in part freezes imposed due to uncertainty about cashflow

Expenditure estimates have also been lowered to reflect the demonstrated absorptive capacity. CFET execution rates have now been revised downwards to $54 million, comprising $52 million of programmed expenditures against appropriations – corresponding to an execution rate of 80% - and police, defense and general services expenditures that have been brought forward (Table 2). These low execution rates are largely a consequence of a freeze on recruitment during the first half of the year and a freeze on minor capital spending during the second half, together with the coverage of some budgeted expenditures by UNTAET (utilities and office supplies) and TFET (medical supplies). Execution rates are expected to be much higher in FY2003, particularly if front loaded budgetary support allows the Government to commit funds earlier in the year.

At the same time, the Government is keenly aware that it will have to expand the coverage and quality of services now if it is to have an impact on poverty reduction over the medium-term. The revised medium-term expenditure program seeks to balance these conflicting pressures.

Core expenditures for FY2003 increase over FY2002 primarily to accommodate recruitment and the assumption of services provided by UNTAET

Core expenditures for FY2003 increase to $67.2 million, reflecting a substantial increase in recruitment against approved posts – mainly in education, the police and defense forces – and increases in administrative overheads, as the Government assumes responsibility for support services formerly provided by the UNTAET mission. Minor capital spending falls in relation to FY2002, owing to a continued freeze on the acquisition of vehicles and office equipment, with agencies' requirements being met from equipment transferred from the UNTAET mission. The core budget also provides for a small development program, amounting to $3 million, mainly comprising critical administrative infrastructure.

Table 1: Consolidated Fund Accounts and Estimates, FY2001 to FY2006 ($ million)

Component	Actual FY01	Est. FY02	Core FY03	Rev. FY03	Projections FY04	FY05
Revenues	**28.5**	**31.3**	**42.1**	**42.1**	**52.8**	**97.7**
Consolidated Fund	25.5	25.3	41.3	41.3	46.2	73.5
Timor Sea Fund	3.0	6.0	0.8	0.8	6.6	24.2
Expenditure	**51.3**	**53.9**	**67.6**	**77.2**	**82.9**	**96.3**
Salaries and Wages	13.9	19.8	25.8	25.9	27.4	28.3
Goods and Services	15.7	23.5	33.9	35.0	40.6	42.7
Capital	21.7	10.6	4.9	9.3	4.9	5.3
Development	-	-	3.0	7.0	10.0	20.0
Savings (FTP)	**3.0**	**6.0**	**0.8**	**0.8**	**6.6**	**24.2**
Deficit/Surplus	**(25.8)**	**(28.6)**	**(26.3)**	**(35.9)**	**(36.7)**	**(22.8)**
Net Financing	25.8	28.6	26.3	35.9	36.7	22.8
CFET Reserves	(3.4)	15.0	5.1	5.1	-	-
Timor Sea Fund	-	-	-	-	-	-
External Financing	29.2	13.6	21.2	30.8	36.7	22.8
Expenditure % GDP	14.5	14.2	18.9	22.0	23.6	26.0

Source: Ministry of Finance *Note: For reserves: (-) designates increase.*

A supplementary budget of USD 10 million contains primarily capital expenditures…

The Government has also presented a proposed supplementary budget of $10 million, including some additional goods and services spending –

such as school books – though mostly consisting of an expanded on-budget development program, including capitalization of the Banking and Payments Authority, administrative buildings and additional spending on road maintenance. Execution of this program is to be deferred till second quarter FY2003, pending the presentation of fully costed project proposals. The Government is likely to require assistance from bilateral donors and IFIs for project design and management capacity building.

…intensive capacity-building in capital project management would likely be necessary to execute the full supplementary during FY2003

Total spending for FY2003 and subsequent years is significantly lower than the forward estimates presented at the December 2001 Donors Conference. This is largely due to the trimming back of the capital program, from $90 million over the three years immediately following Independence, to a graduated program totaling just $40 million.

Recurrent expenditure for FY2003 (USD 64 million of the core budget of USD 67 million) is only slightly lower than the estimates presented at the Oslo Donors' Conference. The subsequent growth path, however, is much more conservative, with expenditures rising to $76 million in FY2006, as compared with $90 million in earlier projections.

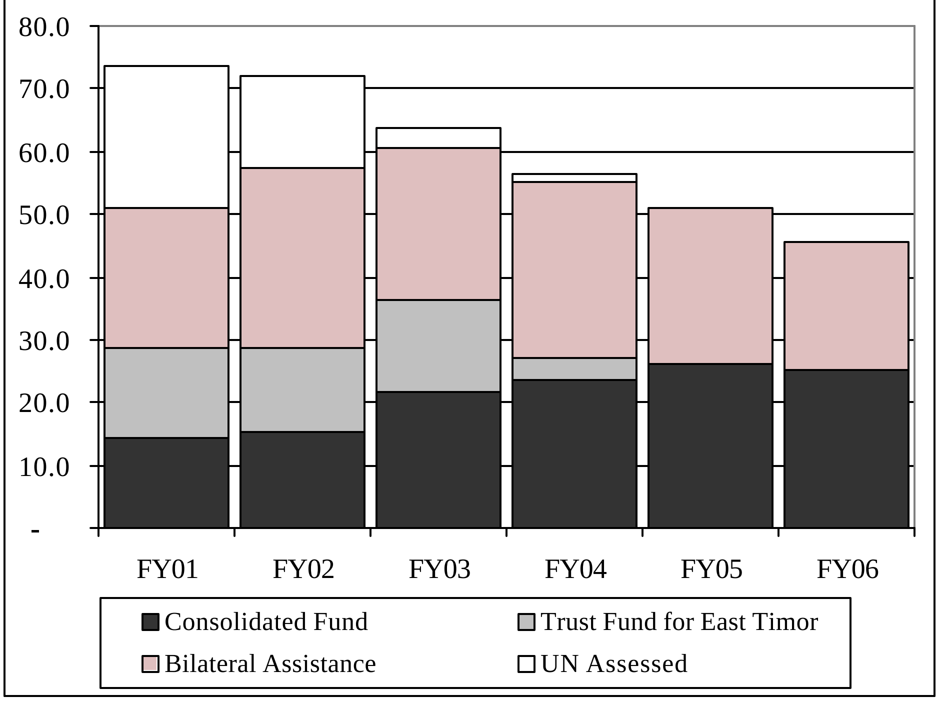
The deficit of USD 90 million over three years is sustainable…and allows for the accumulation of some savings to cushion against future shocks

The proposed expenditure program – including both core and supplementary budgets for FY2003 – yields a financing gap of $90 million over a three-year period, with external financing requirements peaking at $37 million in FY2004. This level of external financing is sustainable, taking into account the projected oil revenue path. There is little scope, however, for increases above the current levels if the Government is to balance its budget in the period up to FY2009, when substantial oil and gas revenues are expected to come on stream.

Whilst the three-year deficit is large, total external financing is projected to drop sharply over the period

This strategy should be seen in the context of the broader pattern of public spending and external financing. The Ministry of Finance estimates suggest that total public spending will drop sharply over the next four years, from just over to 70% of GDP in FY2002 to around 45% in FY2006. This corresponds to a drop in per capita spending from $263 in FY2002 to $240 in FY2003 and $173 in FY2006 (Figure 1). As UN Assessed and TFET spending declines, Consolidated Fund expenditures gradually increase from around 15% to around 25% of GDP. With the exception of FY2003 – when a decline in GDP inflates public spending's share – most of this increase merely compensates for the winding down of the Trust Fund for East Timor, with total spending through Government departments remaining at approximately the same level.

Figure 1: Expenditure as % GDP by Source of Funds



Changing Patterns of Expenditure

The forward projections provide for an increase in the development budget, timed to match a build-up in capacity for project management and the decrease in TFET disbursements

The program anticipates a gradual change in the structure of expenditure, with the share of spending allocated to development projects rising to nearly one quarter of total spending by FY2006. Most of these funds are tentatively programmed for the expansion of periodic infrastructure maintenance programs, capitalization of BPA, capacity building and expansion in service delivery.

This fulfils an immediate development purpose, by providing funds in investment in infrastructure and human capital. It partially compensates for the winding down of TFET projects in FY2004. It also serves a capacity building function, by channeling an increased share of spending through the budget and treasury, allowing Government to test and strengthen development project management systems. This capacity will be critical once the increased flows of oil revenues come on stream. After all, a substantial part of these revenues will be allocated to investments in infrastructure and human capital.

Percentage allocations to wages and salaries fall over time

As the development program expands, the share of spending on wages and salaries gradually falls from 37% in FY2002 to 29% by FY2006, spending on goods and services falls slightly, while spending on minor capital drops to replacement levels (Table 2). These are broadly positive trends, suggesting that operational and development activities will benefit from much of the increase in programmed expenditure.

Table 2: Structure of Consolidated Fund Spending, FY2002 to FY2006 (%)

Consolidated Fund Structure	Actual FY01	Est FY02	Core FY03	Projections FY04	FY05	FY06
Salaries and Wages	27.0	36.7	38.2	33.1	29.4	28.6
Goods and Services	30.7	43.6	50.1	49.0	44.3	42.1
Capital	42.3	19.7	7.2	5.9	5.5	4.5
Development	-	-	4.4	12.1	20.8	24.7
Total Programmed Expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Ministry of Finance

Civil service staffing remains lean, offering future potential for reform of the salary structure

Government continues to exercise restraint with regard to civil service numbers, which are still just under 12,000 in FY2003, and with regard to civil service pay, which is not expected to increase in the coming year. Increases in the size of the defense force proceed as previously programmed, with the recruitment of a second battalion. However, there are significant increases in the size of Border Patrol (200 additional officers) and Police Force (180 officers for Special Police Units). Total payroll, including defense and police, will exceed 16,000 in FY2003. It is important that the Government exercise continued restraint in recruitment to allow flexibility for future salary reforms and adequate goods and services allocations.

Allocations to the National Development Plan's priority poverty reduction sectors, health and education, increase significantly in

FY2003. Spending on social services increases from 33% of the FY2002 final budget to 39% in FY2003 and 48% of total programmed spending in FY2006. This is well above allocations in other countries in the region, and is a concrete reflection of East Timor's commitment to these sectors.

The allocation to the social sectors is amongst the highest in the world

Table 3: Actual and Projected CFET Expenditure by Sector, FY2003-FY2006 (%)

Function	Actual	Projections				
	FY01	FY02	FY03	FY04	FY05	FY06
Core Government	**49**	**41**	**40**	**39**	**38**	**39**
General Public Services	35	15	15	13	13	14
Defence	1	7	7	10	9	9
Public Order and Safety	13	19	18	16	16	16
Economic & Infrastructure	**25**	**25**	**20**	**17**	**16**	**13**
Economic Affairs	22	21	16	14	13	9
Environmental Protection	-	0	0	0	0	0
Housing & Community Dev.	3	4	4	4	3	4
Social	**26**	**33**	**39**	**43**	**45**	**48**
Health	6	9	11	17	18	19
Education	20	23	27	25	27	28
Social Protection	-	1	1	1	1	1
Recreation, Culture, Religion	-	-	0	0	0	0
Total Programmed Expenditure	**100**	**100**	**100**	**100**	**100**	**100**

Source: Ministry of Finance

Per capital spending in the health sector will be USD 15 by FY2006

Primary health care is prioritised

Health sector allocations increase from 9% of FY2002 final allocations to 11% of programmed spending in FY2003 and 19% by FY2006. Additional spending on goods and services accounts for the bulk of this increase, most of which is allocated to purchases of pharmaceuticals and medical supplies. Per capita spending more than doubles, from $6.5 to $15, over this period, exceeding the international benchmark of $12 per capita for a minimum package of health services from FY2004. The Government is committed to capping the share of health spending allocated to hospitals at 40%, thereby releasing funds for the services used by the poor. Unfortunately, it is not possible to determine whether the FY2003 meets this criteria using the present program classification of spending: a revised classification is in preparation.

Junior secondary and vocational education allocations are set to increase..

Spending on education increases at a slower pace, from 23% of FY2002 final allocations to 27% in FY2003, leveling out thereafter. Junior secondary and post-secondary education – mainly vocational training – benefits most from the increase in the CFET education budget (see Table 4). Junior secondary increases are probably appropriate in the medium term appropriate, since low enrolment rates at this level create a potential bottleneck in skills development. Spending on senior secondary education has stabilized, while spending on the University has dropped. So too has the share of primary education, which falls from 60% in FY2002 to around 51% in FY2003 and the following years, notwithstanding the fact that primary education is identified as the priority in the National Development Plan and spending on these services is most likely to benefit the poor.

Table 4: Structure of CFET Education Spending, FY2002 to FY2006 (%)

Sub-Function	Actual	Est.	Core	Projected		
	FY01	FY02	FY03	FY04	FY05	FY06
Primary and Pre-School	55	60	53	50	51	51
Junior Secondary	13	15	18	17	18	18
Senior Secondary	10	9	9	9	9	9
Post-Secondary	3	0	4	5	4	4
Tertiary Education	10	11	8	8	8	8
Other Education	1	2	3	4	4	4
Other Education Services	8	3	6	7	6	6
Total Education	**100**	**100**	**100**	**100**	**100**	**100**

Source: Ministry of Finance

..but the goods and services budget for primary education is low

This is partly a consequence of existing high enrollment rates and the shortage of qualified teachers, which restrict the expansion of primary education. However, there is also very little increase in allocations for goods and services to primary education, with its share of primary education spending remaining at around 14% over the whole period. This reflects the substitution effect of projectized external financing, with the bulk of the primary school textbooks and other teaching materials being provided off-budget. Inevitably, this will increase pressure on the education budget when these projects wind-down and the recurrent expenditures have to be financed from domestic sources. These expenditures should be brought on-budget in the near future so that adequate provision can be made over the longer term.

Defense and police increase in FY2003 but plateau thereafter

The share of spending on defense increases slightly in FY2002 in relation to original appropriations (rising from 5% to 7%), owing to the carry forward of some goods and services expenditures, as does public order and security's share (rising from 15% to 19%). However, the share of spending on public order declines thereafter, while defense's share plateaus at around 9% of programmed CFET spending by FY2005 (see Table 3). General public service's share of programmed CFET spending declines in FY2003, despite the start-up costs of new institutions – such as the Presidency, the Ombudsman – and the increased administrative costs due to the closure of cross-subsidized UNTAET services.

The scenario for cost recovery in the power sector is over-optimistic given current management capacity…

Economic affairs' share of programmed CFET expenditures also declines in FY2003 and thereafter. This is largely due to cuts in programmed transfers to the Power Authority, from $6.8 million in FY2002 (12% of CFET spending) to $4 million in FY2003 (6.5%), with these transfers phased out by FY2006. Despite the recent improvement in the Power Authority's revenue collections, and measures programmed to enforce cost-recovery, this scenario appears optimistic.

…and the agriculture and road transport allocations appears too low to ensure proper maintenance of existing investments

Allocations for agriculture and other economic support services remain insignificant, at around 4% of spending (around $3 million a year) in FY2003 and thereafter. Similarly, road transport's share of programmed CFET spending remains at around 4% from FY2003 to FY2006. This is clearly insufficient to sustain the agricultural and road maintenance programs currently financed under TFET and on-going bilateral projects. These sectors, and road maintenance in particular, should be considered as priorities under the Government's on-budget development program if the investments undertaken during reconstruction are to be sustained.

Risks to the Expenditure Program

Principal risks to the expenditure programme include:

..absorptive capacity, in particular for capital projects

The expenditure program is optimistic as regards ***absorptive capacity***, particularly in FY2003. In FY2001 and FY2002, execution rates were lowest for minor capital and goods and services, largely owing to an capital spending freeze and delays in the procurement and supply process. This risk can be mitigated by adopting a front-loaded expenditure profile in FY2003, whereby around three quarters of annual appropriations are released by mid-year and the remainder during the third quarter. However, this strategy is only feasible if donors' budgetary support disbursements are similarly front-loaded so as to ensure that funds release is adequately covered.

It will not be possible to front-load funds release for the development projects proposed under the supplementary budget, since these projects will be approved in the second quarter at the earliest. Consequently, there is a strong chance that there will be carry-overs to reserves against these allocations. Similarly, the proposed staffing profile for teachers, police and defense forces assumes that the majority of the new personnel will be in place at the beginning of the fiscal year. This is unlikely, considering the difficulties encountered in identifying suitable candidates and processing recruitment in previous years. Again, part of these allocations may be carried over.

… transition issues after the UNTAET handover

These difficulties are likely to be aggravated by ***capacity constraints*** as the UNTAET mission winds down. The withdrawal of management personnel in line and core agencies is likely to delay payments and procurement processing, as well as the implementation of agencies' programs, both of which will result in slower budget execution. Fiduciary risks will also increase as expatriate gatekeepers are replaced with less experienced national personnel: relaxation of expenditure controls has already been identified as a problem at district level, following the withdrawal of UNVs in recent months. Difficulties should also be anticipated where there is lack of continuity in technical assistance teams, particularly where those that are recruited are not familiar with the systems that have been put in place.

…lack of management capacity in the power sector

Subsidies to the ***power sector*** are much lower than one might anticipate given current levels of cost recovery. Admittedly, there has been considerable improvement under current administration, with monthly collections rising from nil to $130,000 in six months. However, this is still a far cry from the $400,000 a month that the agency must collect to meet its FY2003 targets. Improved performance will depend on putting in place an experienced management team, establishing an institutional framework that guarantees management autonomy, and increases in maintenance spending to keep the power station operational. With these elements in place, the prospects for further increase in cost-recovery are good. Even so, it would be wise to anticipate additional transfers during FY2003, over and above the proposed appropriations of $4 million.

…pressures for increased staffing

Over the longer-term, changes in ***wages and employment policy*** represent an important risk to the current expenditure program. Government has managed to resist pressures to increase staffing levels, keeping the number of civil servants under the 12,000 mark, though the total public sector payroll – including civil servants, police and defense force – now exceeds 16,000. Further increases are not warranted, other than for front line service delivery functions. Care will have to be taken in the design of local government structures to ensure that this does not lead to a multiplication of administrative posts.

Government has announced that it will maintain current salary levels during FY2003. Thereafter, changes in public sector pay scale should primarily seek to improve within grade differentiation across the pay scale and decompression at grades five and above, so as to facilitate recruitment and retention of experienced managers and professionals. This should be seen as part of an overall package of personnel management measures, including the approval of a Civil Service Statute, strengthening of the personnel management function, integration of personnel management and payroll information system, and administrative directives to control contracting of temporary personnel.

Uncertainties over grant revenues in FY2003-5 would undermine execution of the plan and budget…

…the strong progress made by Government warrants equally strong continued support from the international community

Lastly it is important to note the uncertainties regarding the overall ***resource envelope*** for FY2003 and the subsequent years. Oil and gas revenues are the key variable in the longer term. Government has sought to accommodate downside risks by discounting projected revenue streams by 25%. In the short-term, certainty over grant flows is critical. Unless adequate three-year pledges are realized at the May 2002 Donors Meeting, there is a risk that uncertainty over cashflow will undermine planning and budget execution. Considerable progress has been made in completing the National Development Plan in record time and in designing an action-oriented program for FY2003. This warrants strong continued support from the international community.