1. Introduction to the Yellow Road Workshop

The main aim of the Yellow Road Workshop is to decide the fiscal envelope for 2014. The fiscal envelope sets the total amount of spending in the 2014 budget. It also shows how the Government will pay for this spending through domestic revenue, withdrawals from the petroleum fund, loans and use of any cash held in the Government's accounts.

There are four main issues that participants should consider when setting the fiscal envelope:

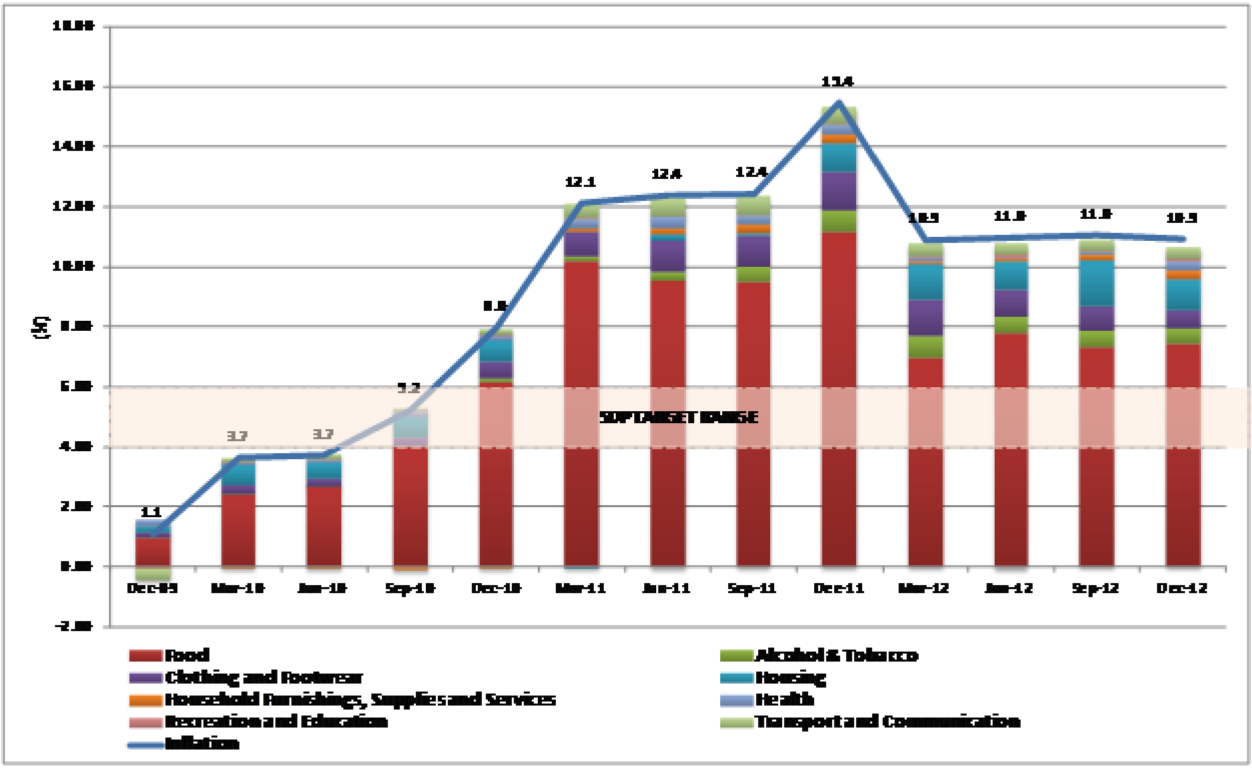
1. inflation
2. fiscal sustainability
3. budget execution
4. the amount of Infrastructure Fund spending needed to complete ongoing projects

This paper discusses each of these issues in turn. It then discusses fiscal rules and provides a recommended fiscal envelope for the 2014 budget.

2. Inflation

Inflation in Timor-Leste is currently 10.9% (see graph 1). This is higher than the SDP's target of 4% to 6% and also higher than most other countries in Asia. Inflation in Timor-Leste has now been above the rate targeted in the SDP for over two years.

Graph 1: Inflation – Overall Rate, Contribution by Type of Good and SDP Target



Consistently high inflation is harmful for two reasons.

First, high inflation reduces the amount of goods people can buy with their income. Inflation in Timor-Leste has been driven by increases in food prices. Because poor people spend most of their income on food, increases in food prices can increase poverty.

Second, inflation also increases costs for Timorese companies and makes them uncompetitive. Wages are already higher and labor productivity probably lower in Timor-Leste than other developing Asian countries.

International increases in the prices of commodities and depreciation of the USD contributed to inflation in 2010 and early 2011. More recently the USD has increased in value (theoretically making imports cheaper) and international food prices have stabilized, so these external factors cannot explain the recent high levels of inflation. Prices of goods produced in Timor-Leste have also increased faster than those of imported goods. This also suggests that inflation is not just being driven by external factors.

Growth in recurrent expenditure may also have contributed to inflation. At the risk of overly simplifying: when the Government takes money out of the petroleum fund and gives it to Timorese companies or residents, it is increasing the amount of money in the economy. More money chasing the same amount of goods can cause inflation. Increased inflation has also occurred at the same time that recurrent expenditure has sharply increased. There is some evidence that growth in recurrent expenditure above 6% a year may result in inflation above the 4% to 6% targeted in the SDP. This 6% is the maximum that recurrent expenditure should be increased by and it may be necessary to cut recurrent expenditure to ensure fiscal sustainability. Cutting recurrent expenditure in 2014 is consistent with low inflation.

3. Fiscal Sustainability

Timor-Leste is simultaneously in one of the strongest financial positions in the world and one of the weakest. On the one hand Timor-Leste has saved over $13 billion in the petroleum fund, enough to pay for the 2013 budget nearly eight times. On the other hand domestic revenue in Timor-Leste funds less than 9% of the budget. So if the petroleum fund ever runs out of money spending would have to be sharply and suddenly cut. This would in turn lead to a reduction in Government employment and salaries, massive disruption to public services and a sharp contraction in non-oil GDP.

The Government, therefore, calculates the Estimated Sustainable Income (ESI). This is the amount the Government can take out of the Petroleum Fund each year, forever, without the fund ever running out of money.

In some recent years the Government has withdrawn more than the ESI (known as 'excess withdrawals') to pay for infrastructure spending. This spending could lead to increased economic growth and domestic revenue collections, allowing withdrawals from the petroleum fund to fall back to the ESI level in the medium term.

The Government has recently undertaken a detailed fiscal sustainability analysis. An economic model was constructed to see whether it was possible to get back to the ESI through higher economic growth, stronger revenue collections and constrained growth in recurrent spending.

The fiscal sustainability analysis shows that in order to ensure fiscal sustainability with realistic rates of economic growth and domestic revenue collections the Government should ensure that total spending in 2013 does not exceed $1.3 billion.

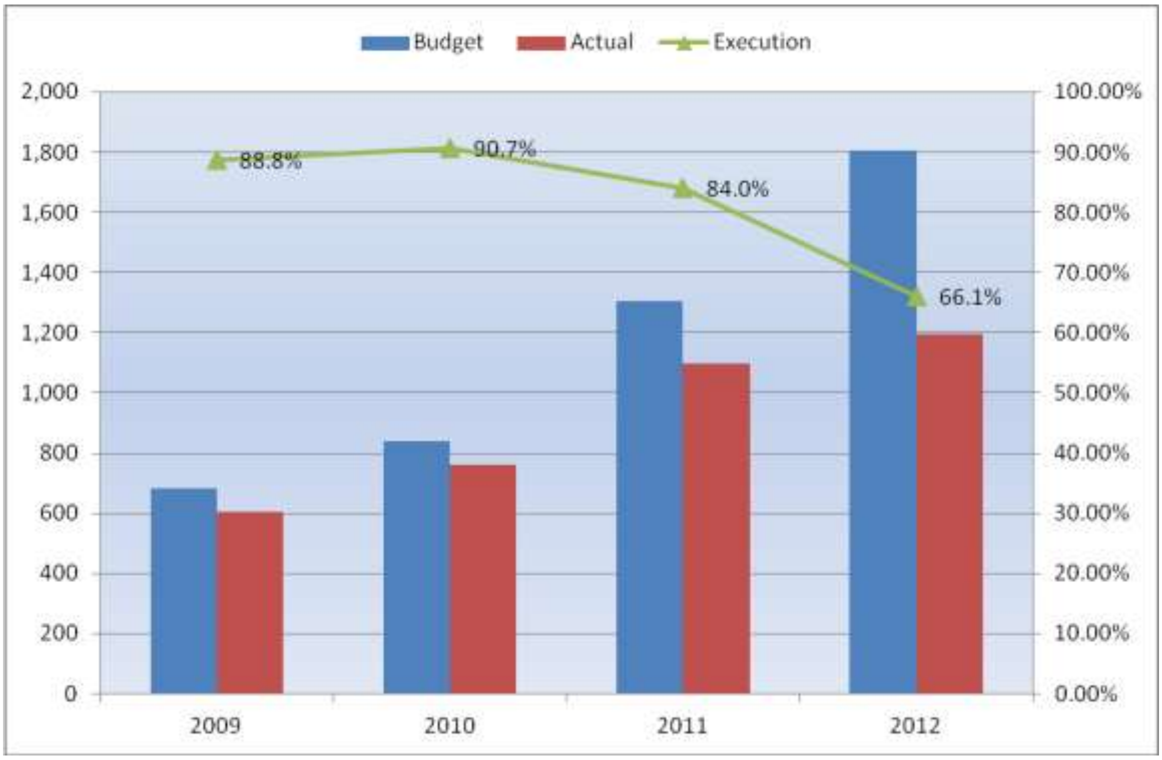
4. Budget Execution

Budget execution refers to the amount of the budget which is actually spent. Graph 2 shows budgeted, actual spending and execution (actual/budgeted) since 2008. The Government has sharply increased budgeted spending and actual spending has also increased. Because actual spending has not increased as quickly as budgeted spending execution has fallen from approximately 90% in 2009 to 66.1% in 2012.

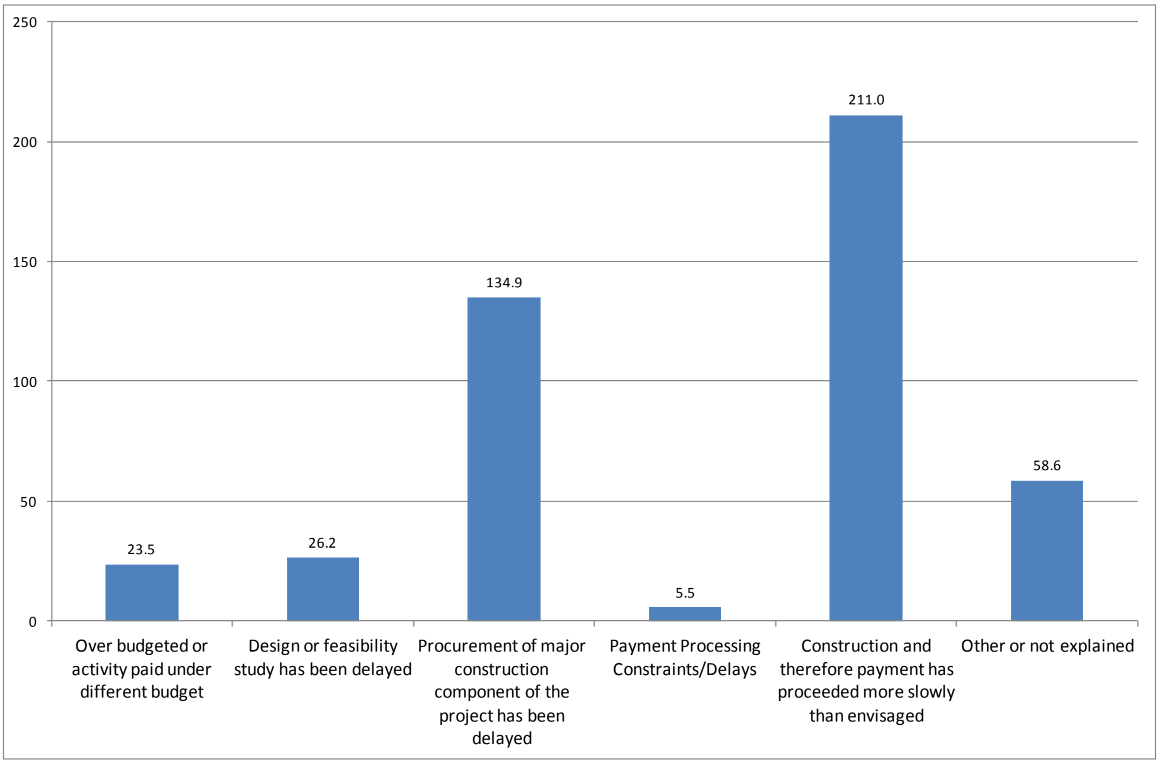
The main reason for the low overall rate of execution was low spending in the Infrastructure Fund. This fund had a budget of $832 million, but only $372 million was spent in 2012. This illustrates that there may be serious constraints on the fund’s ability to execute all projects which are currently included in its budget.

Graph 3 shows the reasons for low execution in the Infrastructure Fund in 2012. Delays in procurement and constructions were the two main reasons projects did not spend their budgets in 2012. The delays in procurement are often due to delays in line ministries drafting bid documentation and do not normally reflect delays by the Major Projects Secretariat or National Procurement Commission. The delays due to construction may indicate the limited capacity of the Timorese private sector to construct larger projects and the difficulties international construction companies face when working in Timor-Leste. These constraints may be difficult to resolve in the short term; meaning execution of the Infrastructure Fund is likely to be constrained over the medium term. This suggests that limiting the size of the Infrastructure Fund's new budget in 2014 may be necessary.

Graph 2: Budget, Actual and Execution 2009 to 2012 ($ million)



Graph 3: Reasons for under-spending in 2012 ($ million)



5. Infrastructure Fund Spending

The Infrastructure Fund is a multi-year fund. This means that if a project does not fully spend its budget in one year, its unspent balance will be rolled over to the next (with the approval of Parliament). This paper recommends that the unspent balance in 2013 is fully rolled over to 2014 so as to maintain the multi-year nature of the fund.

In addition to the rollover, the Infrastructure Fund can also be budgeted additional money in 2014. This new money may be needed to finance entirely new projects. But it may also be needed to finance spending in 2014 on existing projects which are not fully covered by the rollover.

The need for fiscal sustainability suggests that this additional budget for the Infrastructure Fund should be very small. The low rate of execution of the fund in 2012 also supports this. If the Infrastructure Fund receives a large additional budget which it cannot spend, this money will be held in its bank account. It would be better to keep these savings in the Petroleum Fund which has a well-developed investment management policy and achieves a higher rate of return on its savings.

On the other hand, giving the Infrastructure Fund an additional budget which is too small in 2014 might mean existing projects would have to be delayed. Delaying projects which are still in the design or feasibility stage has a relatively small cost. But delaying projects which have already started construction can have a high cost. These factors need to be considered when deciding the Infrastructure Fund's budget for 2014. The Ministry of Finance considered these factors when setting the recommended fiscal envelope for 2014 and believes that no existing projects with high economic rates of return will have to be cancelled if that fiscal envelope is adopted.

6. Fiscal and Economic Rules

There are three types of fiscal rules. These are rules based around fiscal sustainability, economic stability and the distribution of expenditure.

6.1 Fiscal Sustainability Rules

Fiscal sustainability rules aim to ensure that expenditure is set at an affordable level and that the Government is not going to run out of money. These rules are important because if the Government does run out of money, expenditure has to be sharply and suddenly cut, there is massive disruption to services and a sharp contraction in the economy.

Timor-Leste already has the ESI rule which is a well-developed rule to ensure fiscal sustainability. The ESI is the amount of money the Government can take out of the Petroleum Fund each year, forever, without the fund ever running out of money.

The Government has frontloaded expenditure in recent years to pay for Infrastructure Fund spending. Even with frontloading, total expenditure should not be above $1.3 billion in 2014 if the Government is aiming to return to the ESI in the medium term.

6.2 Economic Stability Rules

Macroeconomic stability rules aim to ensure that Government spending does not lead to high inflation, decreased competiveness or volatile economic growth. These rules have a different purpose to fiscal sustainability rules. It is possible that a certain level of spending can be fiscally sustainable, but still cause high inflation and a loss of economic competiveness.

There is some evidence that high levels of growth in recurrent expenditure in Timor-Leste have contributed to high inflation. This suggests that a rule to limit growth in recurrent expenditure might be useful. Increasing recurrent expenditure by more than 6% a year may contribute to inflation rates above the SDP's target range of 4% to 6%. Reducing expenditure growth by less than this, or even cutting it, would contribute to lower inflation.

Economic stability rules can also be based around the non-oil fiscal balance as a % of non-oil GDP. This measure is equal to domestic revenue minus total expenditure[1] divided by non-oil GDP.

This measure makes a distinction between expenditure financed from the petroleum fund and expenditure financed from domestic revenue. The reason for this is that spending financed from the petroleum fund increases the amount of money in the economy and therefore demand for goods and services. If domestic firms and labor cannot respond to this demand by increasing production then two things may occur. First, imports will increase and footloose international firms and workers will move to Timor-Leste to increase production. Second, if production still can't respond to demand, inflation will increase. In contrast, spending financed by domestic revenue is not as inflationary. This is because the increase in expenditure by the Government is matched by an increase in tax revenue and therefore a reduction in spending by consumers or businesses.

Determining the right level of the non-oil balance as a % of non-oil GDP requires more detailed work. There is, however, some evidence that in Timor-Leste non-oil balances as a % of non-oil GDP above 60% have coincided with high inflation. Preliminary analysis shows a non-oil deficit not above 70% and falling to 50% over time might be worth targeting.

The economic rules outlined in this section are in addition to and not instead of the ESI. In the medium term it is important to reduce excess withdrawals to 0 by constraining growth in expenditure.

6.3 Budget Distribution Rules

Distributional rules provide guidelines for the amount of the total ongoing budget that should be spent on different sectors or types of expenditure. Common international norms suggested for developing countries include:

- 20% of the budget should be spent on education

[1] In the future it might be wise to exclude international loan repayments from total expenditure in this equation. The reason for this is that international loan repayments do not contribute to domestic demand.

- 15% of the budget should be spent on health[2]
- 10% of the budget should be spent on agriculture

These rules are very problematic and are not recommended for Timor-Leste for four reasons.

First, it is the responsibility of democratically elected politicians to set priorities in line with the population's wishes. Priorities should not be predetermined by countries conforming to international norms.

Second, demographics need to be taken into account when determining the right amount of spending. A country with a young population might need to spend more on education and less on healthcare than a country with an older population.

Third, guaranteeing sectors a set percentage of the budget can remove the incentive for line ministries to put together detailed, costed plans for their spending and thus weaken the budget process.

Fourth, Timor-Leste has many programmes with multiple goals. For example the PDID program is mainly about district development and boosting the capacity of the Timorese public sector, but it also constructs education and health buildings. This means that the education sector's budget is not necessarily the same as the Ministry of Education's budget.

6.4 Fiscal and Economic Rules Conclusion

The next table summarizes fiscal and economic rules which warrant further discussion about what they would imply for expenditure in 2014.

Table 1: Summary of Economic and Fiscal Rules

Rule	What it means in practice for 2014	Advantages of rule
1: Estimated Sustainable Income	Reduce total 2014 budget (excluding rollover) to $1,020 million or less.	ESI has well thought out methodology.
2: Frontload in short term. ESI in medium term.	Do not spend more than $1.3 billion in 2014.	Fits Government policy.
3: Recurrent expenditure should not grow by more than 6% a year.	Recurrent expenditure not above $883 million. Lower recurrent expenditure would be beneficial.	Shows commitment of Government to low inflation.
4: Non-oil fiscal balance as a % of GDP	Should never be above 70% and should fall to 50% or less in the medium term.	Distinguishes between economic impact of expenditure financed by petroleum fund and domestic revenue.

Every year the rule which implies the least amount of total expenditure should be followed. This will lead to all the rules being met.

[2] See for example the Abuja, Maputo and Dakar declarations for health, agriculture and education respectively

7. Fiscal Envelope for 2014

Table 2 shows the recommended fiscal envelope for 2014. It is important to realize that the 2013 to 2014 rollover will be revised later in the year and thus the 2014 total will change. It is therefore the 2014 new column which will be binding based on decisions made now.

Table 2: Recommended Fiscal Envelope for 2014

	2011 Actual	2012 Actual	2013 Budget Final	2013to2014 Estimated Rollover	2014 New Binding	2014 Total
Total Expenditure	**1,096**	**1,194**	**1,647**	**241**	**1,059**	**1,300**
Recurrent	*508*	*692*	*841*	*0*	*765*	*765*
HCDF	17	32	42	0	25	*25*
Other	491	660	799	0	740	*740*
Capital	*588*	*502*	*806*	*241*	*294*	*535*
Infrastructure Fund	474	372	604	241	114	355
Other	114	130	202	0	180	180
Domestic Revenue	**109**	**137**	**146**	**N/A**	**N/A**	**163**
Non-Oil Balance	**-988**	**-1,057**	**-1,501**	**N/A**	**N/A**	**-1,137**
Financing	**988**	**1,057**	**1,501**	**203**	**0**	**1,137**
Loans	0	0	44	N/A	N/A	109
ESI	734	665.3	787	N/A	N/A	785
Excess Withdraws	321	829.6	0	N/A	N/A	40
Use of Cash Balance (- = saving)	-68	-438	671	203	N/A	203
Memorandum Item						
Non-Oil GDP $	975.9	1,292.70	1,507	N/A	N/A	1,769
Non-Oil Balance as % of Non-Oil	-101%	-82%	-100%	N/A	N/A	-64%
Growth in Recurrent Expenditure						-9%

The advantages of this envelope are:

1. it shows a cut in recurrent expenditure and is consistent with low inflation
2. it reduces the non-oil deficit compared to 2013 and is therefore consistent with stable economic growth
3. it includes sufficient additional Infrastructure Fund spending to complete ongoing projects
4. the level of expenditure it shows is consistent with reducing excess withdrawals to 0 in the medium term. It is also consistent with the expenditure targets shown in the SDP.

8. Questions for Discussion:

Conference delegates may wish to discuss:

1. The possible relationship between inflation and Government spending?

2. The advantages and disadvantages of frontloading expenditure?
3. Whether new fiscal rules in addition to the ESI would be useful?
4. The advantages and disadvantages of the recommended fiscal envelope?
5. Whether it would be useful to further reduce expenditure to reduce excess withdraws to 0 in 2014?