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EAST TIMOR
POLICY CHALLENGES FOR A NEW NATION
Country Economic Memorandum

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CURRENCY EQUIVALENTS

Currency Unit: US Dollar

FISCAL YEAR

July 1 - June 30

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

ADB - Asian Development Bank
ARP - Agricultural Recovery Project
AusAID - Australian Agency for International Development
BE - Business Environment
BPA - Banking and Payments Authority
CA - Constituent Assembly
CEP - Community Empowerment Project
CFA - Central Fiscal Authority
CFET - Consolidated Fund for East Timor
CGIAR - Consultative Group on International Agricultural Research
CPO - Central Payments Office
EEZ - Exclusive Economic Zone
ETTA - East Timor Transitional Administration
EIRP - Emergency Infrastructure Rehabilitation Project
FAO - Food and Agriculture Organization
FDI - Foreign Direct Investment
FIAS - Foreign Investment Advisory Service
FTP - First Tranche Petroleum
GDP - Gross Domestic Product
IAS - International Accounting Standards
ILO - International Labor Organization
ITPT - Information, Technology, Post and Telecommunications
JAM - Joint Assessment Mission
JICA - Japanese International Cooperation Agency
JV - Joint Venture
LPU - Land and Property Unit
MAFF - Ministry of Agriculture, Fisheries and Forestry
NCC - National Consultative Council
NGOs - Non-Governmental Organizations
OECD - Organization of Economic Cooperation and Development
SEP - Small Enterprise Project
TFET - Trust Fund for East Timor
TLSMS - Timorese Living Standard Measurement Survey
USAID - United States Agency for International Development
UNTAET - United Nations Transitional Administration in East Timor
VAT - Value Added Tax
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EXECUTIVE SUMMARY

- East Timor is due to become the first new state of the 21st century on May 20, 2002 after more than four centuries of colonial rule and a quarter century of occupation and conflict. Following the tragic events of 1999, East Timor, with generous financial and technical assistance from the donor community, has made enormous progress in rehabilitating its economy, reconstructing its infrastructure, reintegrating its refugees, and building key elements of a sustainable political process in an environment marked by internal peace—the latter in sharp contrast with other post-conflict societies.

- Since 1999, when real GDP may have fallen by about a third, economic recovery has been strong—a working assumption of over 15 percent average annual GDP growth during 2000 and 2001 has been used. While output was primarily boosted by the presence of the large expatriate community and donor-financed reconstruction efforts, the recovery was not limited to the urban sector; agricultural output over the past two years is also estimated to have recovered significantly. Overall growth is, however, expected to slow sharply in 2002 and 2003 as large numbers of expatriate personnel leave the country.

THE CHALLENGES AHEAD

- The main challenge facing East Timor is how to reconcile a simultaneous existence of acute poverty and severe shortage of human management skills with solid prospects of future flows from the country’s natural resource wealth. Policies to meet these two priorities—sustained poverty reduction and sound management of natural resource wealth—are the focus of this report.

- **Transitional Issues.** A pressing concern in the next two years is that of managing the economic transition from UNTAET administration, which will involve the departure of much of the expatriate community and the associated loss of employment and income for Timorese citizens—and the loss of critical technical expertise. In the short term, East Timor will not have the option of allowing its exchange rate to depreciate in response to the adverse demand shock of departing expatriates, given the use of the U.S. dollar as the official currency. A further transitional issue is how to manage public resources to bridge the period until adequate offshore revenue can be realized.

- **Wealth Creation.** In the medium term, the expected increase in offshore revenue constitutes an added threat to the competitiveness of the non-oil traded goods sector. In order to develop an economy not wholly dependent on aid and oil, the nation needs to enhance the private investment climate, foster agricultural incomes and productivity, promote a sustained improvement in human development, and ensure that the nation’s natural resource wealth is invested wisely. The impediments to improve the business environment are serious given East Timor’s historical legacy of conflict and isolation and the enormous gaps this has created with the rest of Southeast Asia in terms of infrastructure, institutions, legal framework, education and productivity. The manner
in which these gaps are reduced will be key to raising employment and productivity and reducing poverty.

- **Human Development.** In a situation of multiple demands competing for limited resources, the importance of raising human development standards for the quality and pace of long-term growth cannot be overstated. Basic education and training needs are formidable and together with core health services must remain the predominant claimant of public resources in any development strategy. The design of effective and affordable measures to assist the poor is also essential; hence the need to better understand the characteristics of poverty and the capacity of families to pay for some services.

- **Governance and Public Sector Management.** Post-colonial and post-conflict experience amongst poor countries is unfortunately replete with examples of resource misallocation, mismanagement and corruption. Heavy reliance on aid and natural resources exacerbates these concerns. In East Timor’s case, a limited number of qualified personnel to tackle the institutional challenges of building a nation from scratch compounds these risks. The ability to formulate and adhere to effective means of allocating resources towards high priority development objectives will be critical. Initially, the honesty and dedication of the small core of existing leaders will be essential; over time, a larger cadre of capable civil servants must be developed. Building and sustaining effective governance will thus require a range of institutional reforms, which will be difficult.

- **Poverty Reduction.** Preliminary results from the recently completed household survey (TLSMS) indicate a 40 percent poverty incidence in 2001. The incidence of poverty is lower in urban areas (25 percent) than in rural areas (44 percent). Poverty is overwhelmingly a rural phenomenon: 85 percent of all the poor live in rural areas. Poverty incidence is lowest in Dili/Baucau (14 percent) and highest in the rural center and the rural west (49 percent). Agriculture, not surprisingly, is the primary occupation for the population and particularly so among the poor. In East Timor as elsewhere, there is a strong correlation between consumption poverty and low levels of education. Ownership of assets, including access to land, is also correlated with lower poverty.

- Estimates from a survey conducted in all the country’s villages (sucos) show a significant destruction of the housing stock and loss of livestock. Among the more striking results of the suco survey is the extent of food insecurity: over 40 percent of sucos report not having enough to eat between November and February. This share peaks in January, when 80 percent of sucos report facing food shortages.

**A STRATEGY FOR GROWTH AND POVERTY REDUCTION**

- The Timorese authorities are well aware of the challenges they face: following the August 30, 2001 Constituent Assembly elections, a process to design a medium-term strategic framework to articulate and implement development objectives has been initiated, and a Planning Commission has been established to coordinate this
work, with the objective of producing a National Development Plan by independence. A key objective of an earlier draft of this report was to serve as an input into that effort.

○ The objective of sustained growth and poverty reduction would clearly be facilitated by fostering a business environment that is conducive to private investment and through continued agricultural rehabilitation and assistance to farmers in the form of capital, knowledge and marketing expertise—thereby generating greater private employment and higher rural productivity and incomes. At the same time, there are serious impediments to building a significant manufacturing base, and the prospects for rapid agricultural growth on a sustained basis are also uncertain.

○ These factors highlight the importance of continued donor support in the short term, sound management of East Timor’s oil and gas wealth over the long term, and the effectiveness with which aid and offshore wealth can be channeled towards poverty reduction, in particular to build the human capital base. This in turn requires: the development of sound savings and investment strategies to extend the benefits of offshore wealth beyond the windfall revenue period; the adoption of transparent public expenditure management and budgeting tools to utilize aid and revenues effectively; the development of an efficient and service-oriented civil service; and fostering a culture of accountability and results orientation that minimizes the scope for corruption.

Addressing Distortions from the Large Expatriate Presence and Urban Bias

○ The presence of the large and wealthy expatriate community has raised wages and prices well above those in neighboring regions or in countries with comparable levels of productivity despite the prevalence of widespread underemployment. This has already constrained the development of small-scale enterprise and tourism and reduced employment in other productive activities (e.g., in coffee processing), nonetheless raising Dili’s population significantly from its pre-1999 ballot level of 120,000. As the expatriate community begins to depart, it is essential not to embed through regulation or legislation a price structure that reflects the current artificial dual economy, but instead to allow the flexibility that would be conducive to private sector development and associated job creation. The risk of wage and price rigidity is heightened by the inability to allow the exchange rate to depreciate in response to the demand shock of departing expatriates. With little capacity to manage its own exchange rate or monetary policy in the short term, the option of East Timor adopting its own currency would appear ill-advised in the near term.1

○ The combination of higher than sustainable wages and exchange rate rigidity implies that wages and prices must be allowed to adjust in response to economic conditions rather than bureaucratic regulation. Given the artificial nature of current urban conditions, a floor should not be set for minimum wages, at least until the impact of the expatriate departure has been fully felt. This would not preclude promoting other aspects of labor market regulation, although special effort will be needed to align such regulation

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1 Under UNTAET, the US dollar was adopted as East Timor’s official currency, though the Indonesian rupiah continues to circulate in the rural economy.
to the realities of East Timor’s prospective labor market situation following the expatriate departure.

- The large but temporary expatriate presence can have significant economic and social costs, for example, in terms of encouraging unsustainable rural-urban migration and misallocated investment to service expatriate needs. The incentive to remain in agriculture and rural areas will depend most importantly on income prospects and the quality of rural life. The report addresses these objectives through highlighting the importance of maintaining the prevailing effort at raising farm incomes and productivity, improving the quality of rural education and health facilities, and promoting an appropriate governance structure at the community level. The donor community itself can mitigate the repercussions of its departure by phasing the withdrawal of UNTAET staff—ensuring also that skills that are difficult to replace locally are not abruptly withdrawn—and providing favorable severance packages to local staff made redundant, which could facilitate startup of small-scale enterprise.

- Tax policy can also play a role to avoid exacerbating urban bias:
  - High priority needs to be accorded to connecting urban customers with electricity and water meters and enforcing utility payments, thereby removing the free use that has prevailed through most of the UNTAET period.
  - Taxation of urban services (hotels and restaurants) will need to be maintained and taxation of rural commodities should be avoided.

**Improving the Business Environment**

- East Timor’s current development has been dominated by donor-financed projects, but fostering an extended period of labor-intensive growth will require sustained private investment, both domestic and foreign. Yet, there are major impediments to private sector development reflecting: the violence in 1999 which destroyed power generation capacity, telecommunications infrastructure, real estate and land records; the severance of the legal and regulatory system from that of Indonesia in 1999; as well as longstanding deficiencies in the legal framework for land ownership, broader legal environment and judicial capacity. Business services have also suffered from the exodus in 1999 of Indonesians and Chinese who dominated these fields, whereas local entrepreneurial capability has suffered due to the historical legacy.

- Capacity and resource constraints imply that not all impediments to investment can be resolved at once; priorities thus need to be defined. High on the list of priorities is to resolve the complex set of conflicting land claims, originating from the Portuguese and Indonesian periods, that has already inhibited commercial activity and investment and spawned various forms of land fraud. Lack of clarity over ownership of land and real estate assets also cuts off the most important source of collateral that could be used for commercial lending. Work on establishing a formal land administration system that confirms ownership of registered land should hence proceed with urgency, with priority given to urban areas where conflicting claims and disputed ownership are most acute and pressures for security of tenure are greatest.
The inability to collateralize assets also reflects the lack of a functioning Company Law, which inhibits creditors from making enforceable claims against corporate assets, and the lack of a legal framework for bankruptcy. Rectifying these gaps is needed to facilitate lending (at their own risk) by the existing two foreign banks to commercial and individual clients, and to encourage prospective foreign banks to begin operations in East Timor. Given the nascent bank supervisory capacity and inability to insure deposits or respond to bank runs, the authorities should avoid granting commercial banking licenses to local investors, and limit future licenses to respectable foreign banks that are subject to regulation and backed financially by their own regulatory authorities.

Microfinance programs could play an important role in developing both the private and rural sectors. In recognition of this, several programs have been established with the support of donors, though start up has been slow. Moreover, the focus has been on the general business sector due to that sector’s relatively greater loss of physical capital following the 1999 destruction. None of the available credit programs however tailor lending to the particular needs of farmers. There is thus a need to ensure that farmers and rural-based enterprises have sufficient access to credit, offered in conjunction with technical initiatives and training in responsible use of credit.

There is now clear recognition within government of the importance of an effective and efficient telecommunications system for the business sector and indeed for the broader objectives of economic development: the recently adopted approach has been to bundle into one contract all the major required system elements, and expressions of interest from international telecommunications companies have been sought and received. It is essential that the coming transition from the current UNTAET-supported telecommunications arrangements to the proposed private structure occur with minimum disruption—hence the need to expeditiously tender the telecommunications network contract.

A stable supply of power provided at competitive rates is also an important consideration for potential investors. While electric power generation has recovered to 90 percent of its pre-referendum operating capacity, the period since the 1999 referendum has been marked by severe power shortages and outages, substantial losses by the Power Authority and consequent claims on the budget, delayed introduction of metering, and a relatively high cost structure. Current objectives of attaining financial self-sufficiency for the Power Authority through careful rate setting, increased metering and lowering the billing threshold, are appropriate.

The road network is extensive relative to the size of the economy, but constructed with low standards of design and material—the cost of maintenance and upgrading the network has been estimated at $24 million per year, which is larger than the Government’s onshore revenue in FY02. Moreover, the roads department faces a severe shortage of qualified local staff, necessitating the continued use of foreign staff. Hence difficult decisions are needed to clarify the maintenance responsibility of central government; in such prioritization, commercial and social factors both need to be incorporated.
Raising Agricultural Incomes and Productivity

Prior to the 1999 referendum, agriculture and its support activities employed more than 75 percent of the population, contributed 32 percent of GDP, and accounted for 90 percent of foreign exchange. With most farmers engaged in subsistence agriculture often involving multiple crops, enhancing farm incomes and productivity is clearly central to any poverty reduction strategy and to the goal of food security. Yet agriculture was not spared from the destructive frenzy of 1999; in the aftermath of the 1999 referendum, starvation was perhaps only avoided through the tradition of solidarity and sharing in communities, the availability of traditional standby crops (cassava) and wild foods (sago) and the free distribution of rice, cooking oil and other food supplies (often by helicopter into remote areas).

Agricultural production is estimated to have recovered significantly during 2000 and 2001 for most crops—aided by concerted rehabilitation and reconstruction efforts and the provision of extension services by the donor community and NGOs, and despite the departure of many farmers of Indonesian origin. The recovery has occurred in conjunction with major adjustments. The previous Indonesian practice of regulated prices for inputs and outputs, control over the distribution of inputs, and government purchase of surplus production ended abruptly—reflecting the sudden departure of the overseeing bureaucracy—and was replaced by exposure to international prices (with imports subject to an across-the-board 10% tariff). At the same time, farmers have benefited from a level of external assistance that will be difficult to maintain indefinitely.

The adjustment for rice farmers appears to have been particularly traumatic, or at least better publicized. Though rice production in 2001 is estimated to have recovered to about 90 percent of its 1998 level and well exceeds production in 1999 or 2000, farmers have faced difficulties in selling their surplus, as distribution networks and marketing for imported rice in Dili and upland communities appear better developed. Local rice producers face difficulties in accessing markets due in particular to a lack of post harvest processing, especially packaging for transport, and unfamiliarity with distribution and marketing given the previous regulated system. Lack of stores to purchase inputs and inadequate access to credit also represent significant hurdles. By contrast, the price of imported rice at the retail level does not appear to be lower than local prices—though this may reflect higher mark-ups and profits for distributors of imported rice—and free donated rice does reduce the ability of local farmers to sell their surplus.

A sustainable policy response should include addressing the specific problems ailing rice farmers—post harvest processing, packaging, marketing, credit access, and facilitating the availability of inputs coupled with tariff exemption. But these problems cannot be resolved instantaneously, giving rise to considerable pressure for increased protection in the form of higher tariffs on rice. Such a policy could perhaps be warranted if the higher tariff was modest and temporary—to allow a reasonable time frame for the above adjustments to be developed.
But there are also serious drawbacks to raising the tariff on rice that need to be carefully considered before any decision is reached. First, rice farmers comprise some 26 percent of households (not all of whom are net sellers of rice); any boost to their incomes from higher protection must be weighed against the loss of purchasing power to the rest of the population, in particular the reduced consumption of rice by poor consumers in urban and upland areas (the latter is where poverty is most acute). Second, as it is a basic consumer good, raising rice prices would exacerbate the problems with competitiveness noted earlier. Third, even if a higher tariff is intended to be temporary, international experience indicates that reversing the higher protection would be difficult in practice. This in turn could promote shifts in cropping patterns not necessarily beneficial or sustainable in the long term. These factors suggest that a hasty decision on higher protection should be avoided, and any such decision should be preceded by developing feasible means to assist poor rice consumers.

Beyond rice policy, East Timor will need to decide on the broad policy framework it wishes to follow for agriculture. This report’s assessment is that after a transition period, the country would be best served by allowing maximum flexibility to farmers in production and marketing decisions, with the government’s role focused on supervising and financing its own agricultural investments, establishing and enforcing a regulatory framework and providing services, research and education. This limited role (relative to the Indonesian era) is suggested not only because of the government’s limited capacity to intervene more aggressively and its scarcity of resources for doing so on an ongoing basis, but especially because of evidence from other small economies of the benefits of relying on market signals and international prices for guiding farmer decisions.

Food security. In the long term, food security will be achieved when households are productive enough to grow or purchase adequate food for their families. But short-run food contingencies are better dealt with by establishing a buffer fund instead of aiming for self-sufficiency in food production through managing public stocks, which in other countries has distorted farmer incentives and proved expensive and difficult to sustain. A buffer fund would be earmarked to provide assistance directly to the most needy (in cash or vouchers) during exceptionally poor harvests, thus obviating the need for government to purchase staples, store grain or control prices itself.

Coffee is East Timor’s major onshore export and an important source of livelihood for an estimated 40,000 families. Despite the current very low level of world prices, there still appears to be considerable scope for increasing farmer income from coffee. Particular benefits can derive from improvements in the processing of coffee beans and several alternatives for increasing the value added in East Timor need to be explored. It is also important to provide assistance to farmers in improving the coffee tree stock (replanting coffee and shade trees and pruning) and in organizing more competitive marketing facilities. The organic nature of East Timor’s coffee is a factor that can give it a premium over the average world coffee price and needs to be safeguarded in effective and cost-efficient ways.
Addressing Human Development Needs

- A core feature of any poverty reduction strategy must include efforts to ensure everyone—particularly the poor—has effective access to an affordable basic education and package of essential health care services. A healthy and educated population will enable a more productive workforce to respond to the changing environment and develop a population better able to contribute to the cost of services.

- The Indonesian Legacy. While provision of education and health services was significantly expanded under Indonesian rule, East Timor nonetheless inherits poor education and health outcomes relative to either Indonesia or the region more generally. Overall illiteracy remains high—about 50 percent of the population—and even universal primary education has not been achieved. Net enrolment rates in 2001 (i.e. the proportion of the relevant age cohort attending each level of schooling) were only 74 percent for primary aged children, 22 percent for junior secondary aged children and 16 percent for senior secondary school aged children. Rural-urban, income and sex inequalities in access and completion of school are also evident.

- Health outcomes during the late 1990s remained unacceptably poor. Life expectancy remained very low, by one estimate below 50 years. The infant mortality rate was very high at 135 per 1000 live births in 1995, the reproductive health status of the population was of serious concern, and the total fertility rate was 4.43 (compared to 2.78 in Indonesia). The natural rate of population increase—of about 2.2 percent is thus fairly high. Further, with only 22 percent of births in 1998 attended by a doctor or midwife, maternal mortality rates were also very high. Malaria and TB constitute the two most serious diseases. But despite high shares of outpatient visits linked to malaria and TB, outpatient visits were very low at just over 1 visit per capita.

- Transitional Strategy. UNTAET and the donor community have accorded very high priority to education and health services. Considerable effort has been directed at improving the efficiency of public expenditure on health and education by dealing with chronic overstaffing issues, increasing the previously low civil service wages, replacing infrastructure only where there is a demonstrated need, ensuring needed quality inputs are financed and trying to focus attention on service delivery and outcomes. Both sectors have had to confront massive skill shortages caused by the departure of Indonesian secondary school teachers, doctors and administrators.

- Aggregate school enrolment rates were restored by 2000, although junior secondary and senior secondary enrolments remain below pre-disturbance levels. Planned investments will ensure capacity for junior secondary school enrolments to rise above pre-disturbance levels. The secondary school and tertiary education system, however, face significant skill shortages, creating the need for in-service training.

- In health, efforts were made to reestablish district health services and essential inpatient services while establishing a central health authority and a capacity to develop human resources. From the outset, there was a recognition of the need to redevelop the health system within a sustainable policy framework. From a
programmatic perspective, emphasis was placed on the delivery of a core program that met the major public health problems facing the country—prevention, immunization, TB control, basic clinical care (including for malaria) and the development of a referral mechanism for emergency care.

Towards a Medium-Term Framework. The FY02 combined sources budget and the forward projections for the operating budget for the period to FY05 constitute important steps towards placing the budget within a medium-term public expenditure framework. There remains some uncertainty, however, as to whether all the medium-term pressures on the education and health budgets—which comprise 38 percent of the total CFET budget—have been captured. To ensure an appropriate public expenditure planning process, it is crucial that a “whole of policy costing approach” is established for all expenditure, however financed. It is also vital that sustained operating costs are clearly identified and fully incorporated before decisions are made to implement new policy. This has significant repercussions for donors and how they cooperate with government. The accountability process within agencies and the associated procurement, accounting and auditing procedures also require ongoing focus.

Medium-Term Issues Facing Education. A crucial question is how fast to expand each level of education. Given resource and teacher supply constraints and the relative benefits of expanded education, a commitment to ensuring that all children complete at least primary school should be the top education priority—and is achievable in the first years of independence. Achieving universal junior secondary education in the medium term will be more difficult in light of added costs and the limited supply of trained teachers. Thus increasing the skills and competencies of the teaching force should be given high priority; the pace at which junior secondary schooling can be expanded will depend on this and the availability of additional resources, while maintaining current continuation rates for senior secondary schooling appears appropriate. Private returns to tertiary education are likely to be very high in the short term, and the reintroduction of fees for families who can afford them is warranted. Generous donor support will continue to be required; but it is important that such support is optimized to meet the immediate skill and educational needs of the economy; and that education and training capacity is developed consistent with long-term needs.

Medium-Term Issues Facing Health. The Ministry of Health has made significant advances in the development of a program budget for FY2001-02 consistent with the principles of public expenditure planning. The range of issues where attention will need to be focused in the medium term include finalizing: a hospital development strategy that contains hospital costs to 35-40 percent of the total health budget; the transition of responsibilities for district health programs and the implementation of district health plans to district health management teams; a human resource development strategy including the development of a nurse practitioner cadre to partially replace some of the activities performed by doctors; a health policy framework including a pricing policy which takes account of the needs of the poor; and a need to continue to refocus resources and efforts on the core health care package which can have the greatest impact on health outcomes—immunization, communicable and vector-borne diseases including
malaria, TB and HIV/AIDS, child health, reproductive health and preventive health programs.
Managing Timor Sea Oil and Gas Revenue

In July 2001, East Timor negotiated an arrangement with Australia, which is subject to ratification by the East Timor and Australian parliaments, on the division of oil and gas resources from the Joint Petroleum Development Area (JPDA) of the Timor Sea, with 90 percent accruing to East Timor. Subsequently, a tentative agreement on the development of the Bayu Undan LNG project in the JPDA was reached, which could yield revenue to East Timor over a 20-year period beginning in 2004. Negotiations on the development of another large field (Greater Sunrise) are ongoing, and production is not expected to begin before the second half of the decade. While the legal basis of these agreements remains to be finalized and their revenue impacts are subject to uncertainty, the prospect that East Timor will be able to drastically reduce its dependence on external assistance within three years appears promising.

Based on the experience of other natural resource-rich countries, the prospect of a significant oil and gas revenue windfall can be a mixed blessing as there are many dangers and pitfalls. For example, over-spending by governments during the boom can raise the relative price of non-traded goods and draw resources away from the non-oil traded goods sector, retarding its development. Government spending can easily exceed absorptive capacity, reducing investment efficiency, increasing waste, and bequeathing unsustainable recurrent expenditure. Volatility of revenues promotes unstable investment patterns making the entire economy more prone to business cycles. Finally, corruption and poor governance have been closely associated with oil-exporting developing countries.

To avoid the past errors of other oil exporters and to ensure that offshore wealth is wisely invested for the benefit of current as well as future generations, a strategy on the sustainable use of this wealth needs to be developed before revenues begin to exceed desired spending levels. Two key elements of this strategy are: (i) devising guidelines for saving versus spending the revenue windfall—to permit smoothing of government expenditure to extend beyond the windfall period; and (ii) ensuring that investment of the financial savings accumulated is managed in a transparent manner and entrusted to top-rated international fund managers who can maximize the financial returns to East Timor consistent with well defined investment objectives.

There are no unique rules for smoothing and a precise government spending strategy cannot be finalized before the status of commercial agreements is clear. Moreover, assumptions regarding prices, production and rates of return on accumulated savings will need to be updated on a regular basis. Nevertheless, it is important to develop the capacity to rigorously assess the implications of alternative scenarios, to accurately inform the public debate and to develop reliable parameters for fiscal policy.

Allocating a constant nominal stream in perpetuity to government expenditure once fiscal surpluses are attained is a useful starting point in the analysis of utilizing the revenue windfall. Depending on assessments of absorptive capacity, investment needs, prospects for the development of the non-oil economy and the extent of availability of concessional financing, the authorities may wish to either increase or
decrease the pace at which the oil revenue windfall is utilized. Whatever strategy is chosen, a rules-based approach to smoothing government spending can serve as an essential tool to avoid the pitfalls from windfall revenues that so many other countries have succumbed to. It will also be important to make available accurate information about revenue flows to foster a transparent savings formulation process, and to minimize the scope for diverting resources from public priorities.

**Maintaining Prudent Fiscal Policy**

- In the medium term, East Timor’s public finances will be heavily shaped by the extent of Timor Sea revenues, which, while subject to considerable uncertainty, will be by far the largest revenue source. But until more significant oil and gas revenue comes on stream, the nation will remain heavily dependent on donor financing: in the current fiscal year, for example, projected revenue of $31 million (including offshore revenue) comprises less than 60 percent of Consolidated Fund expenditure and only 14 percent of overall expenditure including spending financed by multilateral and bilateral agencies.

- Developing robust, non-corrupt administrative systems for collecting taxes is an important discipline from the outset. At the same time, the temptation to raise taxes to reduce a massive budget deficit in the short term will have to be tempered by the poverty and lack of purchasing power of the bulk of the population, the paucity of private enterprise, the scarcity of skilled administration officials (and hence their high opportunity cost), and the high cost (relative to collection proceeds) of maintaining an effective tax administration. In practice this may call for a regime of modest taxation of productive activity, at least during an initial phase as an incentive for the establishment of such activity. By contrast, additional effort is needed to address the problem of poor collection of user fees and charges—not only to reduce subsidies for utilities, but also to promote economic use of scarce resources and avoid waste. And administrative vigilance will need to be maintained in the collection of import tariffs, which account for more than half of onshore revenue.

- East Timor will continue to require significant levels of funding from donors to finance its budget deficits in FY03-FY05. In large measure, this reflects the recurrent cost repercussions of investment projects financed by the donors themselves, the cost of a substantially pared-down civil service and the need to maintain essential capital expenditure. With little productive activity and income to tax in the short term, no means of deficit financing domestically (through money or debt finance) and unlikely access to external commercial finance, there is little alternative but for the donor community to continue its generous level of financial and technical assistance.

- Continued donor support for the next three years is made more palatable by the prospect of a rapidly diminishing need for such support thereafter—when donor assistance can be limited primarily to technical assistance and possibly some concessional lending. While considerable uncertainty remains regarding offshore oil and gas revenue, current estimates suggest that East Timor will be able to meet its public expenditure requirements after FY05 from its own resources, primarily offshore revenue.
flows, and fiscal surpluses would grow significantly by the end of the decade. Effective management and oversight over public expenditures will need to be maintained, however, particularly if reliance on debt-creating flows is to be minimized as intended by the authorities.

**Ensuring Effective Public Expenditure Management**

- ETTA has put in place the key elements of a transparent, performance oriented public expenditure management system applying international best practice. The principal features of the present system are: an annual budget process that generates forward estimates of expenditures at agency level, linked to performance targets, and reconciles these proposals with hard aggregate resource constraints; a centralized payment system that requires Treasury authorization of most financial commitments and executes most payments from the Consolidated Fund on the agencies’ behalf; and a centralized recruitment process for establishment posts and payroll management system that relates staffing to budget limits. This system has allowed rigorous expenditure control and timely reporting on core government expenditures. Final accounts on the 2000/01 Consolidated Budget have been audited by an international firm and certified without qualification.

- Six challenges are identified for the future to a system that is naturally at an early stage of development:

  - **Development of a medium-term framework for expenditure management, consistent with macroeconomic stability, that can allocate resources in line with priorities and deliver a predictable flow of resources to agencies.** This requires a formal expenditure policy review as part of the budget process, supported by periodic fundamental reviews of public expenditure policy and its impact. To support this policy process, further work is needed in determining appropriate service delivery standards and analysis of unit costs.

  - **Strengthening the performance and service delivery orientation of management systems.** Budget regulations should ensure that line and district managers are involved in the formulation of agency budgets. Ideally, budgets would specify allocations at the district level, so as to track and facilitate the transfer of resources towards the field. A strong case may also be made for the institutionalization of a system of community grants, to ensure the longer-term sustainability of community empowerment initiatives.

  - **Maintenance of expenditure controls, to ensure that resources are applied in line with policy directives and comply with expenditure limits.** This can best be achieved by retaining the centralized expenditure execution and civil service recruitment system. Pressures are likely to build for a more decentralized—but potentially weaker—management system, particularly if the performance of the centralized systems deteriorate.

  - **Creation of governance structures that guarantee transparency and hold the executive to account for its performance.** An independent auditor, reporting to the legislature, is crucial to ensure adequate oversight over the executive. Ideally,
expenditure reporting mechanisms should be complemented by reporting on performance against agreed service delivery targets at the agency level.

- **Formulation of realistic, resource constrained plans to guide decision-making throughout government.** East Timor is in the process of preparing a National Development Plan, supported by wide-ranging consultations with civil society. An important element of this plan will be a visioning exercise that will identify priorities, long-term developmental goals and strategies. An appropriate institutional and procedural framework is required to ensure that this process supports the annual operational planning and the budget process.

- **Development of an external assistance management system that will align external resources with Government's developmental priorities and facilitate sound expenditure management.** Existing systems provide ample opportunity for donor-government consultation but do not include mechanisms that enable the government to manage external financing effectively. Coordination could be improved by the formulation of an external assistance strategy, laying out the broad principles for aid delivery. Basic systems for tracking disbursements against commitments should also be put in place, together with controls to ensure that agencies’ register all external assistance on budget.

- In the immediate post-Independence period, the maintenance and efficient operation of existing, Treasury expenditure control mechanisms should be considered a priority. This will require both political commitment to budgetary discipline and considerable investment in experienced expatriate personnel and capacity building. Where countries have tried to delegate responsibility for expenditure control to agencies, discipline has often weakened, leading to excess expenditures, arrears and un-programmed deficits.

- It should be stressed that these expenditure control mechanisms are not incompatible with deconcentration and decentralization within the public sector. Close coordination between territorial and sectoral planning, the involvement of district managers in agency budget formulation and the identification of district allocations within agency budgets, can strengthen the role of local administrations in budgetary decision making. A system of block grants direct to communities, such as those implemented through the Community Empowerment Projects (CEP), can provide an important channel for financing local initiatives.

**Building an Effective Civil Service**

- An honest, efficient and service-oriented public administration will be essential to maintain confidence in the government and the goodwill of the donor community. Key issues in this context relate to the size, composition, compensation and training needs of the civil service that will support the objective of sound administration while remaining consistent with fiscal constraints.

- Much progress has in fact occurred in building the civil service and restoring its functions following the departure of its upper echelon in 1999. The authorities intend to maintain the size of the civil service to less than half its pre-
referendum level, and staffing is also modest relative to comparator countries. But the civil service is afflicted by two major problems: significant shortfalls at higher grades (particularly Levels 5 and 6); and the recruitment of middle-to-higher level staff, apart from teachers and nurses, whose qualifications and experience are lower than required. These problems warrant decompression of salaries of Levels 5 through 7 and Level 4 excluding education and medical personnel relative to a shadow wage for lowest skilled employees, and mapping staff at the decompressed salary levels into appropriate salary scales. Any decompression would, however, need to remain consistent with fiscal constraints. To the extent that recruitment problems reflect the shortage of qualified staff, expatriate staff with the requisite skills will need to be retained, possibly for an extended period.

- An important parallel response to the problem of qualifications and experience is the availability of relevant training. The UNTAET Civil Service Academy provides a good basis for developing appropriate training programs, which could, however, be enhanced following a comprehensive training needs analysis.

**Promoting Effective Governance and Reducing Corruption Opportunities**

- Fostering a culture of accountability and results orientation within the civil service and judicial and bureaucratic efficiency are important objectives that can be enhanced through the active involvement of civil society. The promotion of transparent and accountable structures that avoid the development of corrupt practices hence merit careful consideration.

- Administrative priorities include:
  
  - Enhance citizen monitoring and complaint mechanisms for monitoring of and reporting on government performance such as in the delivery of public services.
  - Build citizen input into the public service commission to improve transparency and integrity in public service recruitment.
  - Enhance administrative transparency through requiring publication in the Official Gazette as a precondition before a regulation or directive can come into legal effect.
  - Review procurement rules and practices to ensure strong compliance and enforcement.

**Community Empowerment as a Means to Enhance Service Delivery**

- A potentially important decision with repercussions for both governance and service delivery relates to the extent of administrative decentralization. There is no off-the-shelf model of local government that can be recommended; rather, the solution most appropriate to East Timor should emerge from an assessment of cost, effectiveness and capacity to provide public services at the central versus local levels. The issue of local government is one of the themes for discussion in the context of a consultative process that will provide input for the nation’s first National Development Plan. A number of studies are underway and should provide guidance on the extent of appropriate
decentralization. Given there may be significant budgetary repercussions, decisions should not be rushed. It is preferable to start with a simple structure and expand it gradually if needed, as it is easier to create new civil service positions later than to reduce them if an initial structure proves to be unnecessarily burdensome.

○ To the extent that strong local government institutions become a reality, it may be possible to rethink the structures of public service formulation and provision in ways that enhance their quality and cost-effectiveness. The initial experience with the Community Empowerment Projects suggests that empowering local communities—the end-users of the services concerned—can achieve significant benefits in terms of governance and cost-efficiency of service delivery. If the debate on decentralization were to point to the establishment of representative community councils with decision-making responsibilities, for example, it would be possible to focus the role of the central ministries on setting standards and overall policy, rather than service delivery. Local community involvement could also mobilize revenues that are harder to collect by central government—including community contributions in kind.