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Out of the Ashes: Destruction and Reconstruction of East Timor

Abstract for chapter 17

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'Fiscal issues for a small war-torn Timor Loro Sa'e' considers the fiscal instruments that the devastated East Timorese economy needs in order to promote sustainable economic growth. The author also discusses the need to set priorities on expenditure, mobilise revenue, and seek international aid in the short-term.

Timor Loro Sa'e's fiscal policy and its likely effect on the long-term development of the country are discussed. Although internal revenue mobilisation is limited, Timor Loro Sa'e has the capacity to finance its current budget. With carefully planned revenue mobilisation – free of corruption – Timor Loro Sa'e should be able to provide budgetary support for basic education and health.

Keywords

Central Fiscal Agency (CFA), expenditure, fishing rights, gas, IMF, income, Interfet, National Consultative Council (NCC), oil, taxes, Timor Gap, UN Peace-Keeping Force (UNPKF), UNTAET, World Bank

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17

Fiscal issues for a small war-torn Timor Loro Sa'e

João Mariano Saldanha

Introduction

The magnitude of the destruction in Timor Loro Sa'e after the post-referendum ballot has been amply documented.[1] As a consequence, Timor Loro Sa'e has been left with no civil service, no fiscal institutions, and little means to gather revenues, to make expenditures and to receive international aid. The United Nations Transitional Administration in East Timor (UNTAET), which is administering the transition of Timor Loro Sa'e toward independence within two to three years, has created a Central Fiscal Agency (CFA) and a payment bureau as the embryos of a Ministry of Finance and a Bank of Timor, respectively. It is expected that the fiscal agency will move quickly to mobilise domestic revenue and to seek foreign aid to support the reconstruction needs and thus lay the foundations for long-term economic development. However, the payment bureau will only administer the payment system without conducting monetary policy because Timor Loro Sa'e has adopted the US dollar as legal tender.[2]

The role of fiscal policy is to correct market failure (its allocative

1 See World Bank (1999a) for a complete assessment of the destruction of East Timor.

2 For discussions on this issue see José Braz and João Mariano Saldanha (2000), 'Currency and exchange in East Timor: analysis and preliminary proposals'. Mimeo. OECD Development Centre, Paris.

role), to redistribute income (its distributive role), and to stabilise cyclical instability, unemployment, and inflation (its stability role).[3] The instruments of fiscal policy fall broadly into the three categories of taxation, expenditure and budget policy. Tanzi and Zee (1996) provide an exhaustive survey on how these instruments positively affect economic growth in the long run.

In countries devastated by destruction like Timor Loro Sa'e, fiscal policy plays an even more important role in recovery and transition toward sustained economic growth. Bevan and Pradhan (1994) argue that a post-war situation has profound budgetary consequences that can only be addressed through careful re-examination of expenditure patterns in conjunction with providing positive signals to the private sector in order to make investments possible. This poses enormous challenges to post-conflict governments in identifying priorities and establishing the basic conditions to encourage private sector participation in the reconstruction process. Haughton (1998) argues that introducing cash budgeting, setting up a payments system, seeking foreign aid for general budgetary purposes and revenue mobilisation are among the first generation issues of fiscal policy in post-conflict societies. Tax reform and decreasing the amount of foreign aid are among the second-generation issues of fiscal policy in reconstruction and recovery.

Howard (1992) argues that fiscal policy in small countries is constrained by economies of scale and limited possibilities of diversification. Therefore, a small economy needs foreign exchange and international aid for growth (de Vries 1975).

As a small war-torn economy, Timor Loro Sa'e needs to promote sustainable economic growth using fiscal instruments. It needs to set priorities of expenditure, mobilise revenue, and seek international aid in the short-term. In the medium-to-long-term perspective as international aid declines, Timor Loro Sa'e must develop like other small countries in the world. Therefore, Timor Loro Sa'e needs long-term fiscal sustainability. This is another critical area of fiscal policy that deserves closer analysis.

3 On the allocative, distributive, and stability roles of fiscal policy, see Musgrave (1959) who provides a conceptual framework of fiscal policy which remains useful to this day.

Internal revenue: short-term

Post-destruction conditions in Timor Loro Sa'e have reduced the capacity of the country to collect revenues. During the Indonesian occupation, 15 per cent of total revenues were raised internally.[4] Rough estimates by the IMF and the World Bank suggest that in fiscal year 2000, East Timor can raise $15 m from internal revenue sources.[5] This is an indication that there is potential for revenue mobilisation in Timor Loro Sa'e. Saldanha and da Costa (1999) identified six potential sources of internal revenue, namely from the exploitation of natural resources, particularly oil and gas; income and property taxes; exports of agricultural products (such as coffee, sugar, livestock and fish produce); tourism; remittances from abroad; and profits from state-owned enterprises. Additional sources of revenues could come from fishing rights, home industries, such as traditional clothing and craft products linked with the development of the tourism sector.

What kind of tax should UNTAET or the future Timor Loro Sa'e government collect? Easterly and Rebelo (1993) argue that developing countries tend to rely more on indirect taxes than on direct taxes because income levels are low. This is even more so in poor countries, especially those emerging from destruction like Timor Loro Sa'e. Governments are unlikely to collect both income and property taxes because politically these direct taxes are contentious and bureaucratically hard to collect. However, indirect taxes such as import duties, excise taxes and other levies can be collected as soon as the capacity to collect taxes is in place. Indirect taxes can often be the only source of revenue in post-conflict societies. However, even in peacetime, indirect taxes constitute a substantial proportion of total revenue, ranging from 40-60 per cent in small countries of the Caribbean (Howard 1992).

4 This number was underestimated because it only accounted for revenues collected by the provincial government such as levies and dues. East Timor Loro Sa'e only received a small percentage of tax and non-tax collected in the territory. See Pemerintahan Daerah TK I Timor Timur: *Anggaran Pendapatan dan Belanja Daerah 1999/2000*.

5 Unfortunately, data on how this figure was estimated is not available. This amount is cited in a footnote in a document prepared by UNTAET and the World Bank for the donors' meeting in Tokyo. See United Nations and World Bank, 'Overview of External Funding Requirements for East Timor', December 1999.

TABLE 1: *Timor Loro Sa'e: Projected revenues, 2000-2005 (US$m)*

Source of revenue	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
I. Internal revenue	14.90	17.33	20.09	23.02	41.13	47.20
1.1. Oil and gas[a]	3.60	3.96	4.36	5.00	20.00	23.00
1.2. Import duty (5 per cent)[b]	3.50	4.03	4.63	5.33	6.13	7.05
1.3. Export license fees (5 per cent)[c]	1.00	1.15	1.32	1.52	1.75	2.01
1.4. Sales tax (15 per cent)[b]	3.70	4.26	4.90	5.64	6.49	7.46
1.5. Excise tax[e]	2.80	3.64	4.73	6.15	6.77	7.45
1.6. Levies (15 per cent)[d]	0.26	0.29	0.32	0.35	0.39	0.43
1.7. Royalties of fishing rights	-	-	-	-	-	-
1.8. Remittance from abroad	-	-	-	-	-	-
II. International grants[f]	81.80	141.90	83.50	-	-	-
Total	96.70	159.23	103.79	23.44	41.33	47.51

Notes: Yet to be estimated. The projections are based on the following assumptions:

a. 10 per cent annual growth from 2000-2003 and jumps in 2003 before growing 15 per cent annually.
b. 10 per cent annual growth rate.
c. 15 per cent annual growth. Excise tax is comprised of liquor ($1.5/ltr), cigarettes ($15/kg), and fuel ($0.05/ltr).
d. Major components of these levies are port fees, landing fees, departure tax, and vehicle registration fees. It is expected they grow at 10 per cent annually.
e. 30 per cent growth from 2000-2003 and 10 per cent growth afterwards.
f. UNTAET and the World Bank (1999).

Source: Internal revenues are estimated by the author based on assumptions on breakdown of each category of revenues and the respective rates of taxes and levies.

For Timor Loro Sa'e, at least in the medium term (3-4 years), it would be advisable to avoid reliance on income and property taxes to allow people to rebuild their lives, find jobs, and rebuild their homes before starting to pay income or property taxes. In the short-run, Timor Loro Sa'e will have to rely on revenues from oil and gas, indirect taxation, and international transfers (grants). Expenditures from 2000 through 2002 have been secured at least on paper from the international community although there is no guarantee of full disbursements.

Table 1 presents some projections of revenues for 2000 through 2005. Aside from international grants, there are six categories of revenues, i.e. oil and gas, import and export duties, sales taxes (cars,

TABLE 2: *Timor Loro Sa'e: Share of oil in internal revenue, 2000-2005 (per cent)*

Year	*Oil share*	*Non-oil share*
2000	24.2	75.8
2001	23.1	76.9
2002	21.9	78.1
2003	21.7	78.3
2004	48.6	51.4
2005	48.7	51.3

Source: As for Table 1.

mobile phones, hotels and restaurants), excise taxes (fuel, liquor and cigarettes), and levies (port, airport and landing fees, departure tax and vehicle registration). In the year 2000, Timor Loro Sa'e can collect revenues of about $14.5 m, of which oil and gas, sales tax, import duties and excise taxes would be the major sources of revenue. From 2000 through 2003, their share in total domestic revenues is likely to be well over 90 per cent of revenue, and from 2004 to 2005, this share may even increase to around 97 per cent of revenue.

By spring 2000, revenue from oil and gas of $3.6 m in terms of royalties from the Timor Gap Joint-Exploration is guaranteed, if and when Timor – or more specifically UNTAET representing Timor Loro Sa'e – replaces Indonesia in the Treaty with Australia.[6] There have been different estimates on the potential revenues from Timor Gap exploitation. One estimate is that once it has been fully exploited, royalties for Timor Loro Sa'e could be around $88 m per year, which would amount to US$2.2 billion in 25 years.[7] Other sources mention A$800 m over the course of 20 years or around US$28 m per year.[8] Such figures need to be accepted with caution. There are no contending estimates to dismiss these optimistic estimates.

It is only by 2004 that commercial production will begin. So it is reasonable to assume that revenue from oil and gas from the Gap

6 Australian Associated Press, 28 February 2000, 'New oil and gas pact agreed to by Australia and East Timor'. For an overview of Timor Gap issues, see Saldanha (1994) and East Timor Relief Association (1999).

7 Williams (1999) and Australian Labor Party Press Release, 13 January 1999, available on Regeasttimor.

8 'East Timor, Australia eyes revenue from offshore developments', Dow Jones, 20 January 2000 and 'Woodside's Timor Sea oil field surprises on up side', Dow Jones, 20 January 2000.

will be around US$20 m to $23 m in 2004 and 2005, respectively (Table 1). If this is the case, then the share of oil and gas will constitute 50 per cent of the total revenue in those years (Table 2). This could have a significant impact on the local economy. On the positive side, Timor Loro Sa'e will be able to pay its bills, at least the recurrent budget which is estimated to be around $30 m in 2000 (UN and the World Bank 1999). The major component of this expenditure would be the wage bills and goods and services of the public sector. On the negative side, a dominant oil economy could have a 'Dutch disease' effect whereby increased spending in the non-tradeable sector, induced by the increase in oil revenues, would tend to reduce output in the importable sector. The negative effect of increased spending would not be sustained if revenue from oil decreases due to a decline in prices on the international market. Thus it is advisable that the expansion of revenue from the oil sector from 2004 onwards not be fully spent. Rather a substantial proportion of these revenues could constitute offshore reserves to smooth public expenditure in case there is a disruption in the oil industry.

In February 2000, the National Consultative Council (NCC), on the advice of the IMF, promulgated laws levying taxes. An import duty of five per cent was introduced across the board with additional sales tax of 15 per cent on items such as cars, mobile phones, and perfumes. Other components of sales tax would come from retail sales, hotels and restaurants. It is expected that sales tax will be extended as taxable items are identified and when the capacity of the Central Fiscal Agency to collect taxes improves. One positive indication of the potential for such taxes is the growing number of businesses, restaurants and hotels. By the end of February 2000, the UN had issued certificates of business registration for more than 2000 domestic, foreign or joint ventures.[9] Excise taxes of $1.5/litre on alcoholic beverages, of $15/kilogram on tobacco and cigarettes, and of 5 cents/litre for fuel have been levied. The estimates of sales and excise taxes in Table 1 employ these rates. It may be possible that when the UN leaves in 2-3 years, excise taxes may decrease but this seems unlikely because economic activity will increase, thus driving demand upward.

9 See 'Open for business, but a while before good times roll', *Sydney Morning Herald*, 7 March 2000.

Revenues from levies would also increase as taxable items increased along with economic activity and the capacity of the Central Fiscal Agency improved.

The National Consultative Council (NCC), on the advice of the IMF, has agreed to levy taxes on exports, especially coffee. This decision was hotly debated within the NCC in the face of pressure from the IMF.[10] Some felt that it was premature to levy export fees on coffee because this might discourage attempts to expand production as well as diversification away from exporting only coffee beans. Assuming five per cent taxes on coffee exports, the revenue from exports is only $1.0 m or 6.6 per cent of the total internal revenue in 2000 (Table 1). It is premature to levy export fees on coffee exports because this levy may discourage attempts to expand production as well as diversification away from exporting only coffee beans. It is not too late to put on hold the implementation of this policy for coffee.

Two other important sources of revenues that need to be tapped in the short-term are remittances from abroad and fishing rights around the Timor Sea. Since the presence of the UNTAET in October 1999, only a few weeks after Interfet had landed, there has been a substantial inflow of remittances from Australia, Macau and Portugal. The amount of these remittances is not known but they could be a source of potential revenue for Timor Loro Sa'e. Royalties associated with fishing activities in the waters around Timor could also be another source of revenue. Japanese and Taiwanese fishermen have been reported to be operating illegal trawling in eastern Indonesian waters, including those of Timor Loro Sa'e, but they have never been required to contribute a share of their revenue. It may be all right to continue such fishing but the revenues associated with it ought to be shared with Timor Loro Sa'e as the owner of these resources. One of the immediate tasks of UNTAET is to initiate negotiations to share revenues of fishing activities in the Timor Sea.

Overall, collecting indirect taxes constitutes a great challenge for the Central Fiscal Agency. It is desirable that UNTAET develop guidelines for a collection system and the mechanisms for collections which are free of corruption. This mechanism must be enforced impartially. Such fiscal guidelines, mechanisms of enforcement, with impartiality of enforcement could be the great legacy of UNTAET for Timor Loro Sa'e.

10 See 'Timor ire at coffee tax', *Sydney Morning Herald*, 29 February 2000.

Internal revenue: medium-to-long-term

In the medium-to-long-term, there are a number of potential sources of revenues that the Timor Loro Sa'e government can collect. Three major sources of revenue could be telecommunications and the Internet, the leasing of the Baucau airport, and the development of either Atauro or Jaco islands as major resort areas.

Telecommunications and Internet: The role of telecommunications and Internet in economic development is yet to be fully understood. But there are ample indications that telecommunications, especially the Internet business, will become the engine of economic growth in developed countries, especially in the US electronic businesses based on e-trade (trade through the Internet) such as Amazon.com and eBay are flourishing in the United States. Small countries like Guyana, Moldavia and Netherlands Antilles now rent their telephone codes to major industries in developed countries. Guyana's revenue from telecommunications traffic is a startling 40 per cent of GDP.[11]

Timor Loro Sa'e could tap into this sector to raise revenue. Once a telecommunications system has been established, an aggressive move to lease phone codes for customer services (1-800-numbers) of major companies could be an important source of revenue. The potential market would be large or even medium-sized companies in the United States, Australia, New Zealand, Europe and Japan, where customer services and technical assistance for their customers can take hours, thus becoming a burden on their budget. This implies that the rates offered by Timor Loro Sa'e must be competitive. Guyana, Moldavia and Netherlands Antilles offer their services for sex chats but Timor Loro Sa'e does not need to take that road. There are plenty of companies around the world that provide post-sale services for their customers at low telephone costs. More research would need to be done to identify a market but these are the companies to which Timor Loro Sa'e could possibly offer its services.

Leasing the Baucau airport: Another potential source of revenue to consider would be to lease the airport at Baucau for international companies, like UPS, Federal Express or DHL as a hub for their

11 See *The Economist*, 3 January 1998. 'Little countries: small but perfectly formed' for discussions on the advantages of small countries and the role of telecommunications in shaping their economic growth.

Asia-Pacific operations. The Philippines leased Clark Air Base to UPS for several years before it moved to the new Hong Kong airport. This kind of a lease could raise revenues of a couple million dollars annually for Timor Loro Sa'e. The period of the lease could be for five to ten years with a review at the end of the period. This would leave Timor Loro Sa'e with options in the future if other attractive offers emerged both commercially and strategically. Again the lease option would need to be studied carefully.

Timor Loro Sa'e has enough capacity to operate the airport of Dili for its public and commercial purposes. The Dili airport can accommodate medium-sized jets, such as Fokker-100s or an Airbus, which have the capacity to carry up to 200 passengers. Operating both the Dili and Baucau airports would be an enormous cost to the government and a drain on its budget. The government of Timor Loro Sa'e does not have the luxury to waste resources.

Politically, leasing the airport would provoke a heated debate but the reasons for doing so would be to mobilise revenues in order to provide decent livelihoods for its citizens. In other words, leasing the airport to raise revenues would help the people of Timor Loro Sa'e to realise their dreams. Although the revenue from leasing would not constitute a large proportion of the budget, it would help to put more children into schools and provide basic health cover to the poor.

Atauro as a tourism island: There has been much discussion about developing tourism as one of the major foreign exchange generators in Timor Loro Sa'e. Saldanha and da Costa (1999), da Costa (1999), Saldanha (forthcoming), and Pedersen and Arneberg (1999) discuss the possibility of tourism being a major source of foreign exchange for Timor Loro Sa'e. Whereas ideas for ecotourism (da Costa 1999) and backpacker accommodation (Saldanha and da Costa 1999) have been advanced, there are other options that need to be considered. One of them is designating either Atauro Island (north of Dili) or Jaco Island (at the eastern tip of Timor Loro Sa'e) as an exclusive tourist destination with resort hotels that might also offer the possibilities of gambling. These two islands, especially Jaco, are isolated from the mainland and therefore the negative effects that may arise from such tourism could be neutralised. Atauro Island has a population of less than 10 000 people while there is no settlement on Jaco. Atauro might be more attractive because of its closeness to Dili and the availability of basic infrastructure which would need to be further developed. Jaco, on the other hand, is isolated and would need an entire infrastructure to persuade people to live there. This might not be difficult once development started there. One of the positive issues of tourism development on these islands is that they would create jobs that will attract labour. Of course, these ideas need further study before proceeding with any serious attempt of implementation.

The competitor for either Atauro or Jaco is Christmas Island to the south of the island of Java where wealthy Indonesians with their private jets commute, especially at weekends to gamble. Another competitor is Darwin which has a casino and a far better infrastructure. Providing good incentives to build Atauro or Jaco as a modern tourist destination might make a difference. Going to Macau takes longer and is more expensive than flying to Dili and taking a helicopter or boat to Atauro.

This initiative would face strong resistance from the Catholic church but if approached properly, that resistance might soften over time. After all, Timor Loro Sa'e needs to develop all its potentials to create welfare and provide a decent life for its people who have suffered so much.

Expenditure: short-term

Bevan and Pradhan (1994) argue that the budgetary consequences of the transition from war to peace is a change in public expenditure patterns toward the civilian sector, and within the civilian sector, toward economic infrastructure and social spending. This implies that expenditures need to be shifted away from defence by giving priority to infrastructure, health, education, and to kick-start the economy through productive sectors such as agriculture and small scale trade activities.

An important element in the transition to peace in Timor Loro Sa'e, or in other transitions from war to peace economies, is the heavy presence of international agencies and international aid (Bevan and Pradhan 1994; Haughton 1998). Timor Loro Sa'e has both. Since October 1999, public expenditure in Timor Loro Sa'e has been funded by the international community. This expenditure is divided into four categories, namely the defence expenditure of Interfet and the UN peacekeeping force, humanitarian expenditure (appeal crisis), UN personnel expenditure, and expenditure on reconstruction and development, including governance and capacity-building. Since these expenditures have varying effects on Timor Loro Sa'e's economy, it is worth exploring each of them briefly with a focus on reconstruction and development.

Australia bore the bulk of the defence expenditure for the International Force in East Timor (Interfet). This budget was to restore order so it does not belong to the expenditure as described by Bevan and Pradhan. Although the expenditure had an effect on the local economy, this effect was relatively marginal because most consumption goods were imported. Interfet was replaced by the UN Peace-Keeping Force (UNPKF) in February. It is possible that the operation of the peace-keeping force will have a greater impact on the local economy because it is an operation that will last at least two years compared to Interfet's five months. The troops may hire some local staff for language translation and demand local products, especially agricultural produce.

The humanitarian budget, which runs from October 1999 through to June 2000 was allocated the task of supplying food and carrying out the resettlement of internally displaced people and of refugees returning from West Timor. About four per cent out of a budget of US$209.7 m was spent in West Timor where around 100 000 people are still stranded.

UN personnel's budget in terms of salaries, plus compensation for working in a dangerous country, is quite sizeable but contributes little directly to the economy because of a heavy reliance on imported goods and services with limited domestic supply. Large UN missions typically bring about a phenomenon called 'Dutch disease' in small countries. With the additional demand for urban services and other non-traded goods and services, labour costs increase, hampering the competitiveness of the economy and leaving it without a sector capable of earning or saving foreign exchange (World Bank 1999a:7). Timor Loro Sa'e may, however, only suffer limited effects of this 'Dutch disease' because most of the goods and services will be imported. This will mitigate against such effects (Bevan and Pradhan 1994). UN personnel do not even stay on land but instead they have been provided with two floating hotels (Olimpya and Amos W). Their economic activities are delinked from the local economy since many of their goods and services are imported, except low scale labour of the local Timorese. Most goods for infrastructure in the reconstruction programs are also imported.

TABLE 3: *Timor Loro Sa'e: Summary of external financing requirements 2000-2002 (US$m)*

Sector	*2000*	*2001*	*2002*	*Total*	*Percentage*
Community empowerment	9.2	10.9	9.8	30.9	10.5
Education	14.8	25.6	17.4	57.8	18.8
Health	7.5	17.0	15.7	40.2	13.1
Agriculture	7.1	14.3	3.0	24.4	7.9
Infrastructure	21.1	49.3	22.7	93.1	30.3
Economic management	4.3	6.5	5.4	16.2	5.3
Civil service	16.6	16.6	9.3	42.5	13.8
Judiciary	1.2	1.6	0.2	2.9	0.9
Total	81.8	141.9	83.5	307.2	100.6

Source: World Bank (1999b).

The negative effects of imported goods for consumption and infrastructure are distributional in nature. There are allegations that the UN presence and its reconstruction efforts do not favour the local economy because few local East Timorsese have been hired to work with UNTAET. Reconstruction in infrastructure and other sectors will rely on foreign contractors and even foreign labour. In addition, a high proportion of the budget is allocated to technical assistance, which may create resentment among the locals.

These are delicate issues that need to be addressed through compensatory policies, one of which would be to encourage companies to hire local people if they are capable and to use as much local materials as possible for construction and infrastructure. This would create some linkages that will stimulate the local economy on the one hand and lead to a more participatory reconstruction process on the other.

The budget for the civilian sector, which is one of the foci of this chapter, is presented in Table 3. The budget was estimated by the World Bank-led Joint Assessment Mission (JAM) and was subsequently submitted to the Donors Conference on Timor Loro Sa'e in Tokyo in December 1999. At that conference, the donors pledged to contribute US$261.7 m for reconstruction and development in infrastructure, agriculture, health, education and macroeconomics. An additional US$56.1 m was allocated for governance and capacity-building, which brings the total amount of funding allocated for reconstruction to US$317.8 m. This is a figure that is slightly higher than that in Table 3.

The budget allocated for the reconstruction and development is likely to get Timor Loro Sa'e moving because it will rebuild both shattered infrastructure and shattered institutions. There are three points, however, that I would like to discuss in relation with this reconstruction budget.

First, expenditure for the civil service, which targets the recruitment of 12 000 civil servants over the course of three years, raises the purchasing power of the economy, although only one small proportion of the population is involved. Almost 14 per cent of the budget in the transitional period has been allocated to the civil service. This will define the patterns of recurrent expenditure for Timor Loro Sa'e in the future. Timor Loro Sa'e has few options except to maintain this level of civil servants in the future since it is a more sustainable level than the 28 000 civil servants during the Indonesian occupation.

Second, expenditure for education, health and infrastructure sets the right direction for reconstruction. However, when one looks closely at the specific projects that have been designed, the education sector needs a review. Early childhood education, adult education and distance learning are luxuries that a country like Timor Loro Sa'e can hardly afford. Priority should be given to primary, secondary and university students in the country. In addition, a priority should be given to help those students of Timor Loro Sa'e who were studying in Indonesian universities to finish their studies.

Third, the budget for reconstruction also provides opportunities to kick-start the economy through the agricultural sector and micro-financing (micro-enterprise credit for start-up ventures and revolving credit for small and medium enterprises). Although this sector was not destroyed as was construction and trade, expenditure on cash crop production, especially rice and maize, will help reduce the food deficit. Directing more resources into the agricultural sector provides linkages to other sectors in terms of labour absorption, food sufficiency and balancing reconstruction programs that are heavily biased toward urban centres.[12] More spending in agriculture also restrain the urban sector tendency to draw limited productive labour force from rural areas to urban areas. Unfortunately, this sub-sector was not considered a priority. The agriculture budget only receives

12 For an extensive discussion of the agricultural sector in Timor Loro Sa'e, see Saldanha and da Costa (1999); also Pedersen and Arneberg (eds) (1999), especially the chapter on production.

eight per cent of the reconstruction budget. Therefore, it needs to be reviewed as far as implementation is concerned.

Expenditure: medium-to-long-term

Expenditure on education, health and infrastructure is important during the transition period (Bevan and Pradhan 1994) as well as in peacetime. Education and health are the two core sectors in human capital development that in the long-term contribute to economic growth (Tanzi and Zee 1996). Human capital development is even more important in small countries because they have a smaller reservoir of trained talent than larger countries, so they must depend more on technical assistance (de Vries 1975). Expenditure on infrastructure, especially transport and communications, also have a significant effect on economic growth (Easterly and Rebelo 1993). Therefore, the priorities of expenditure, in the medium-to-long-term, should continue to focus on developing infrastructure, education and health.

Timor Loro Sa'e may seem set to depend eternally on foreign aid, given its limited natural resources. However, the prospects are not that gloomy. At least as indicated in Table 1, Timor Loro Sa'e will have the capacity to finance its civil servants and provide the basic needs for its people. The government should concentrate on a few areas where it can perform well or where the private sector cannot afford to do so.

To avoid large budget deficits and debt, public expenditure in an independent Timor Loro Sa'e must achieve a trade-off between maintaining basic public services (civil servants and police) and infrastructure with the development of human capital (education and health), agriculture and tourism. Providing rural health clinics and access to schooling (up to high school) will possibly deter mass movements into urban areas, especially Dili. Control of growth in the public sector, especially the number of civil servants and their wages is equally important. Public expenditure also can be directed to stimulate the development of the agricultural sector from which almost 80 per cent of the people of Timor Loro Sa'e derive their income and livelihood. In addition, the tourism sector also deserves significant attention as one of the sectors that will generate foreign exchange in the future.

Although there is a great temptation for elected officials and their allies in the bureaucracy to provide perks for their constituents, government needs to be cautious of becoming too involved in the economy, thus crowding out the private sector. Therefore, the state needs to avoid creating state-owned enterprises, such as telecommunications, transport and communications because they may be the source of fiscal difficulties. Thus it may be more sensible to focus on water, postal and power management.

One question is whether the government will run budget deficits or borrow from abroad. Budget deficits can be financed in two ways. First, by selling government bonds to the public or asking the central bank to print more money. By adopting the US dollar as legal tender, Timor Loro Sa'e has given up its option to finance budget deficits through printing more money, at least during the transition process. One solution to the budget deficit problem would be to borrow from abroad. In any case, Timor Loro Sa'e will have to support a debt because international aid (grants) can not go on indefinitely. Therefore, the question is what kind of borrowing Timor Loro Sa'e needs to undertake and with what conditions attached to this borrowing?

International aid

After its destruction, Timor Loro Sa'e was left to the mercy of the international community for both its recurrent and reconstruction budget during the transition to independence. The initial reaction of the international community was positive. At the Tokyo Donors Conference on Timor Loro Sa'e in December 1999, the donor countries pledged $520 m for humanitarian, governance and reconstruction purposes to be given over a three-year period from 2000 to 2002. The question is whether these pledges will actually be translated into disbursements. Pledges do not automatically translate into disbursements (Haughton 1998; Heininger 1994; and Kadhr 1999). Disbursement can be as low as six per cent, as in Cambodia (Heininger 1994:59-61) or at best 40 per cent as in Palestine (Kadhr 1999:147). In Kosovo, the percentage of disbursement of pledged international aid is currently around 25 per cent. It is not clear whether Timor Loro Sa'e will have the same experience but precautionary measures need to be taken and the people of Timor Loro Sa'e should lower their expectations because there is a limit to international aid.

During the transitional period, the task of persuading the donors is supposedly entrusted to the Central Fiscal Agency working together with the World Bank and other multilateral agencies, such as the IMF and the Asia Development Bank. This task requires competence and a good working relationship with these institutions.

Although funds were pledged toward the end of 1999, it was not until the completion of the visit to East Timor by the president of the World Bank, James Wolfensohn, on 22 February 2000, that the first World Bank funds became available in the form of a US$7 m grant for an initial six-month period to support a community empowerment and local governance project, which will eventually receive US$21.5 m. Following election of local councils, communities are to receive US$15 000 each to support locally-determined projects. Additional funding will be provided by the Japanese government (US$1.5 m) and the Asian Development Bank (US$1 m).[13]

Conclusion

This chapter has discussed fiscal policy and its likely effect on the long-term development of Timor Loro Sa'e. Although internal revenue mobilisation is limited, Timor Loro Sa'e has the capacity to finance its recurrent budget. With carefully planned revenue mobilisation, which is not distortive, and implementation of a collection system, which is free of corruption, Timor Loro Sa'e may even be able to provide budgetary support for basic education and health.

Therefore, the fiscal strategy for the long-term will be to control the growth of both the number of civil servants and their wages and to limit government expenditures to education, health, agriculture and tourism, leaving other sectors to the private sector by creating the appropriate environment for the private sector to grow. Within this context, it may be a good idea to offer tax incentives in terms of tax holidays in certain industries or accelerated depreciation of capital that is attractive. In addition, it should be a priority to promulgate an investment law that can send the proper signals to long-term investors interested in Timor Loro Sa'e. The challenge for this purpose is land ownership, which is a delicate issue.

International aid will continue to be a substantial component of

13 'Rebuilding East Timor at the local level', The World Bank, 22 February 2000, available at east-timor.cig.apc.org.

Timor Loro Sa'e's budget. However, there is a limit to international aid and Timor Loro Sa'e will be better off mobilising its domestic revenues before contemplating whether to borrow or not. If Timor Loro Sa'e does borrow, it is imperative that the borrowing be limited to soft loans to complement internal revenue.

The idea would be to streamline expenditures and let the development and modernisation (or industrialisation) of Timor Loro Sa'e take its own course without overburdening future generations with debt because of the irresponsibility of their predecessors.

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