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BACKGROUND NOTE

TIMOR-LESTE’S RECOVERY FROM THE 2006 CRISIS: SOME LESSONS

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**Introduction**

Timor-Leste’s request in May 2006 that Portugal, Malaysia, Australia and New Zealand send troops to restore order came just a year after the last UN peacekeepers had departed and four years into the country’s independence. The 2006 violence that claimed at least 37 lives and drove 155,000 people (15% of the population) from their homes sent shock waves through an already fragile polity.

The complex causes of the 2006 conflict have been treated in depth elsewhere. This note looks specifically at how the government used public finance management (PFM) policies to help address the enormous short-term challenges of a fragile situation in the aftermath of the 2006 crisis. The government capitalized on a rapid increase in oil revenues and through administrative measures that delegated more responsibility for spending decisions to line ministries, achieved a rapid increase in the rate of public spending on cash transfers, goods and services and public works. This note starts by summarizing the evolving challenges of the post-independence PFM system, the fragility of 2006/07, and the changed fiscal outlook following the surge in petroleum revenue. It then looks at the government’s PFM policies that helped it to address urgent demands and successfully restore short-term stability. The note concludes by drawing possible lessons from this period for other post-conflict situations.

**The Legacy of State Building**

When initiated in 1999, two months after the historic referendum in which the Timorese voted overwhelmingly for independence, the UN Transitional Administration in East Timor (UNTAET)\(^1\) was aware that it carried a heavy weight of expectation. The UNTAET chief, Sergio Vieira de Mello saw in Timor-Leste a “test case... even a laboratory case where we can transform utopia into reality” (CNN 2000). The performance of the UN-led effort between October 1999 and May 2002 has been widely debated, but was initially favorably reviewed.\(^2\) The UN managed a major humanitarian relief effort in 1999 to avert a crisis. By 2002, the country achieved important benchmarks including adoption of the constitution, national elections, and demobilization of resistance fighters.

Some early gains in capacity were sustained during the first four years of independence. The tax and customs service, established by UNTAET, is one example, as is the delivery of health services. The creation of a Petroleum Fund remains a major achievement. This has provided a critical instrument for promoting transparency and accountability in petroleum revenue management, particularly as the volume of resources and pressures to spend increased dramatically in 2007.

The UN’s Independent Special Commission of Inquiry into the 2006 crisis, however, noted several wider ‘governance failures’ in the post-independence period including the failure to follow legislative procedures; lack of restraint and respect for institutional channels in communication; the leadership styles of national figures; and the absence of systematic control over distribution of weapons within the security sector (UN 2006, see also CIGI 2009). Many have also argued that the international community
was responsible for “analytical and practical failings” in areas such as policing and security sector reform (Goldsmith and Dinnen 2007, 1092, 1098; cf. ICG 2009b). With these in mind, the current Minister of Finance, Emilia Pires and long time adviser Mike Francino, have remarked that the 2006 conflict “should not have come as a surprise” (Pires and Francino 2007, 144).

Others have argued that these difficulties reflect an inability to link state-building efforts with local governing traditions, and an over-reliance on imported institutional models. Timor-Leste was traditionally governed by a series of small clan-based polities that were remarkably resilient to years of foreign occupation and conflict (Traube 1986; McWilliam 2005). But whilst local traditions of social order and governance dated back four centuries, Timorese leaders were aware that these and the resistance structures developed during 24 years of independence struggle were ill-suited to governing an independent nation. Whilst the new government retained the legal framework installed during the Indonesian occupation, the Indonesian administrative structures were no longer intact, infrastructure and records had been destroyed and the only people with any understanding of the systems had fled. That expatriate state-builders perceived they faced an institutional ‘tabula rasa’ many believe predisposed foreign advisers and the Timorese leadership to adopt governance “models (that) were imported wholesale” from other countries (Bowles and Chopra 2008. See also Chopra 2000, 2002; Gunn 2007). Over time, the style of executive decision making became increasingly centralized and hierarchical.

The government faced a number of challenges on planning and financial management. Firstly, while the majority of international technical assistants between 1999 and 2005 focused on core functions of the state, relatively few were devoted to budget execution in line ministries responsible for service delivery. Secondly, the system was very fragmented. Aid effectiveness was constrained by the multiplicity of funding sources, confusion over mandates, conflicting and complex donor procedures – thus, “there were many cooks in the kitchen, all baking different kinds of cakes.” (Pires and Francino 2007, 131. See also Carnahan 2004, 52). In addition four languages – English, Tetum, Portuguese, Bahasa Indonesia – were daily woven into a myriad of cross-translated public finance operations. Bahasa, the language most familiar to the majority of national staff recruited in 2000/1, was the language least likely to be used in administrative instructions.

In addition, the public finance system was book-ended on one side by resource intensive medium-term planning, and on the other with centralized but fragmented fiduciary controls. Encouraged by donors, the government consulted extensively to craft a National Development Plan, underpinned by seventeen Sector Investment Plans and a medium term expenditure framework. The plan heavy architecture was a challenge to implement in the context. It was intended to ensure that resources were spent prudently on medium term development priorities. But these carried a high opportunity cost in terms of human resources and attention to short term spending priorities. By 2005, the number of expatriate TA declined rapidly, and the vacuum was filled by politically appointed administrative officials and a ‘shuffling up’ from the lower ranks of less experienced people. Administering the growing legacy of rules, systems and procedures would have perplexed the most experienced, astute and competent administrator.
With hindsight, the combined effects of this aid-focused planning and finance management architecture, along with a centralized and hierarchical leadership style amongst senior officials (Kaltenborn-Stachau 2008), are not surprising. As the World Bank and International Monetary Fund noted in 2005, a combination of “complex and over-centralized processes, and weak human resource and institutional capacity on the one hand, and a high level of commitment to fiduciary accountability on the other, results in very low levels of budget execution” (World Bank & IMF 2005, 8). Budget execution, particularly for Capital and Development projects that were critical for delivering tangible benefits to the population was very low (Table 1).

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Table 1: Spending of Recurrent and Capital Budgets (%, FY01-FY05), Consolidated Fund for East Timor

Sources: Budget documents and staff estimates

The 2006 crisis was rooted in complex issues. The performance of the PFM system is likely to have fuelled these through inability to stimulate economic activity, particularly for the youth who were increasingly concentrated in Dili. A relatively low share of public spending went on economic sectors since independence, notably infrastructure and agriculture. This will have had a major impact on economic wellbeing since the public sector has traditionally been the main diver of economic growth in Timor. The economic situation was further exacerbated by a scaling back of UN activities after 2004. Opportunities in Dili, where an estimated fifty percent of non-oil GDP was generated (Carnahan et al 2005), had contracted as a result.

**Challenges for the new Government**

When the government of Prime Minister Xanana Gusmão took office in August 2007, it faced a daunting task of maintaining order and stability. The economy in 2006 had contracted (-5.8% real non-oil GDP growth). Approximately 150,000 displaced people were scattered around the country and in temporary camps around Dili. The proportion of unemployed youth engaged in gang activities had increased. Wounds in the police and army were still fresh. Inflation was rising rapidly, peaking at around 11 percent in June 2008.

Two further factors also became evident to the government. Early results from what was later published as the Timor-Leste Survey of Living Standards revealed that poverty had increased sharply since 2001. By 2007, one out of two Timorese, around half a million people were living below the poverty line, a significant increase from just over one-third (36% - or around 266,000) in 2001. Second, Timor-Leste’s fiscal environment had been transformed. Petroleum receipts had jumped from $140 million in 2004 to a peak of $2.2 billion in 2008. The government was no longer dependent on aid to fund the state budget and projections indicated that aid flows would finance less than 10 percent of capital spending during the government’s five-year term of office.
Public awareness of this wealth meant pressure was steeply mounting to convert it into tangible dividends. Political commentary had become livelier, feeding off greater access to information. As important, the result of the 2007 election meant that the administration – predominantly loyal to Fretilin, the previous government - also had become an arena for coalitional politics. All this placed further pressure on the public finance system, which the government worried would be unable to convert sufficiently quickly the petroleum wealth into social and economic outcomes. The Government was convinced that radical change would be needed at the same time as the PFM system was being required to do exponentially more than ever before. Within weeks of taking office in August 2007, the new government followed up their 2007-2012 programmatic announcements with a new budget, announced to parliament that 2008 would be the “Year of Administrative Reform”, and quickly prepared a statement of National Priorities for 2008.\(^5\)

**Responding to Crisis: spending choices and administrative reforms**

Two aspects of the government’s response to political expectations are highlighted here. On the one hand the government made decisions that would rapidly increase the size of the budget and add a range of spending on public transfers, social protection and small scale public works. On the other hand, and partly to implement these decisions, administrative reforms would involve increasing delegation of spending and procurement authority to line ministries. Notably, these decisions could be made because the government was now almost entirely in control of its administration and spending decisions.

Within three months of taking office, the administration produced a half year budget for 2007 and a full budget for 2008. A budget revision in mid 2008 more than doubled budget outlays (to $788 million from $348 million, compared to actual spending of $160 million in FY06/07), and included a $240 million Economic Stabilization Fund for market subsidy in response to the commodity price crisis. The aim was to escalate rates of spending, in particular, by doubling the volume of cash transfers and by opening up...
a plethora of new spending lines, and to signal to the public that the government would mitigate the shocks of the commodity price crisis. Reinforcing the sense of urgency, the government demanded that administrators achieve “100% obligation” by the end of August 2008, less than two months after the mid-year budget revision had been approved. Figure 3 illustrates the shifts in volume and categories of public spending.

In addition to the above, there was also a shift in relative priorities as illustrated in Figure 4 below. These new priorities opened up the possibility of spending quickly to deliver economic benefits both population-wide and to key constituencies. Not only was there more spending in these areas but their share of total spending had also risen. For example, before 2007, government had on average spent less than one percent of its budget on current transfers and social protection payments. In 2008, current transfers (e.g. compensation for Internally Displaced People; support to Veterans; pensions; social protection for vulnerable women, children and the poor) amounted to 6 percent of spending (excluding the Economic Stabilization Fund set up to deal with commodity prices), and in 2009 around 18 percent. Spending on Economic Affairs increased to 30 percent in 2009, from an average of 26 percent before 2007. Allocations to general public services have remained high in light of the administrative reforms initiated by the new government. Most sectors had more resources in absolute terms (including health and education, which declined as a percent of total outlays), and there are implications for quality of spending and sustainability, as discussed below.
The pace of decision making, and thus of spending, was aided by a limited set of priorities and strong direction from the PM’s Office and senior levels in the Ministry of Finance. This was not entirely new, as noted earlier. But at the same time, the government dramatically increased the levels of delegated spending and procurement authority to line ministry executives, and simplified treasury processes. This impacted positively on execution of the capital and development budget, which increased from an average of 10 percent between FY04 and FY06 to nearly 80 percent in FY08, and on goods and services spending.

**Lessons and Implications: Difficult Choices and Trade Offs**

Two years on from the near-fatal shooting of President Jose Ramos-Horta and the assassination attempt on Prime Minister Xanana Gusmão, the government has been able to address several pressing threats to social stability through rapidly implemented shifts in spending priorities, new categories of spending, and administrative streamlining.

A positive account of this period shows a government trying to balance the need to deliver results with incremental reforms. Under popular pressure, the government has maintained the country’s strong petroleum revenue management framework, underpinned by the Petroleum Fund Act (2005). The framework continues to help guide annual budget ceilings. Revenue projections are based on conservative estimates of oil price and are reportedly free of political interference. Timor-Leste recently achieved compliance with standards for transparency under the Extractive Industries Transparency Initiative.
In addition to this there are ongoing investments to upgrade Financial Management Information Systems to improve the reliability and availability of financial information. In the absence of capacity to conduct independent audits, the government continues to commercially retain auditors to review its financial statements. A Vice Prime Minister has been appointed to oversee administrative reform and anti-corruption. Over the period of the present government, whilst the executive remains strong, parliament, oversight institutions and the Presidency, along with the media whilst comparatively weaker, now play a larger role in political affairs. Some possible lessons from this successful period of short-term stabilization include:

**Prioritize short-term needs to consolidate peace:** On taking office in August 2007, the Government faced an uncertain domestic peace, an expectant population, a civil service of questionable loyalty and a lack of confidence in donor advice. The government took strong ownership of its resources and priorities by investing heavily in public transfers, social protection, and infrastructure works. Critics argue that more effort is needed to address the underlying causes of conflict and the constraints to economic growth. However, by its many actions in 2008, the government sought first to re-establish trust as a way of achieving near term peace and building confidence. A number of studies have pointed to the significance of this kind of ‘social policy’ in post-conflict countries (e.g., Collier and Hoeffler 2002).

**Realistic expectations:** Timor-Leste is still in the early stages of post-conflict recovery. Reforms will be gradual and opportunistic, which could sit at odds with expectations of more linear and predictable implementation of development plans. This might involve taking measured risks to deliver results – whilst acknowledging the implications and putting in place mitigating measures. The government may also incur significant costs in the short-term – mistakes will be made and capacities will need to be substituted by international TA and short term measures. The counterfactual may be a risk of re-igniting conflict. Buying the peace through spending directed to particular interests or popular consumption must however be accompanied by more realistic expectations about the role government spending can play as it transitions from ‘recovery to development’.

**Demonstrate results:** The economy has started to recover with strong growth in 2008 and 2009. The National Priorities process, whilst not a substitute for a national development strategy, provides specific targets against which government holds itself to account in a transparent manner. These priorities set short-term expectations, with clear outputs. These of course tell only part of the story but provide the building blocks for monitoring outcomes in the future. For example, as budget execution becomes less chronic, it is important to gradually turn to quality and accountability measures.

**Maintain transparency and accountability:** Throughout the post-crisis period, the government has endeavored to operate within the broad framework of laws and institutions in place since Independence. Despite the urgency, government spending was mandated through budgets approved by Parliament, there were no off-budget expenditures, parameters set by the Petroleum Fund Law were respected, and there has been regular reporting on budget implementation. There is increased scrutiny of the budget and government spending by Parliamentary Committees and civil society, as more detailed information is produced (e.g. on resource allocations across districts). In addition, although capacity remains weak, there are more resources going to external oversight bodies.
The task going forward is to build on the important short-term achievements to sustain peace, growth and poverty reduction. The government is conscious of the governance challenges ahead around security sector reform, a weak justice system, and increased perceptions of corruption. It is starting to establish the systems and institutions, which are needed to tackle these challenges and other emerging priorities, and to avoid a situation where the drive for results is at the expense of fiduciary standards and sustainability.

It is fair to remark that these problems must be tackled, not least because they have been at the root of the instability facing Timor-Leste since independence. But the present government’s experience in many respects shows in exaggerated form – due to its oil revenue and the latitude this provides – the difficult trade-offs facing any regime in the aftermath of conflict. A high premium on medium term results, allocative efficiency in development spending and minimizing fiduciary risks where downstream spending systems are weak will make it difficult to respond to the ‘here and now’ pressures for immediate results. Reversing the equation, delegating to line ministries high degrees of responsibility for spending decisions and focusing on cash spending will likely, where spending controls remain similarly weak, enable rapid but less targeted and accountable spending.

Thus, the Government's policy of achieving a “transition from post-conflict to development” presents a series of PFM-related challenges:

**Quality of spending:** The administrative and expenditure innovations introduced since 2007 have not appreciably lessened the country’s dependence on international technical assistance, nor the underlying weaknesses in Timorese capacity to appraise, design and cost investments, manage internal controls or ensure audits. This is not surprising given how rapidly pressures have built up over the past three years on a limited capacity base. However, rapid delegation of authority is likely to have exacerbated the risks to quality of spending. The country is vulnerable to the destabilizing effects of corruption. The government is trying to tackle these through PFM reforms and the establishment of external oversight agencies. The continued commitment to delivering results demonstrated since the 2006/07 crisis should help to gradually shift the focus to quality of spending and development outcomes.

**Fiscal sustainability:** Government spending has understandably scaled up to help address major infrastructure, human capital and private sector capacity deficits. Some favor further scaling up given high returns to government spending and the opportunity cost of building up Petroleum Fund savings. Aside from the implications for quality of spending, income from hydrocarbon resources is volatile and finite. There may of course be significant untapped resources. But the non-oil fiscal deficit is high. Rapidly growing spending may mean less flexibility for future adjustments given the increase in non-discretionary expenditure (e.g., wage bill, now around 50% more than domestic non-oil revenue), growing contingent liabilities (e.g., civil service pensions) and the recurrent demands of infrastructure spending. Petroleum savings provide a strong buffer against potential shocks. The government commendably moderated spending growth in 2009 and 2010 based on macro-fiscal analysis. It has indicated its intention to borrow, which will require sound debt management capacity to ensure that Timor-Leste is not exposed to the past experiences of Heavily Indebted Poor Countries.
Government spending and employment generation: One challenge specifically worth highlighting in relation to spending priorities, is that of dealing with a rapidly growing labor force. There are around 15,000-20,000 new entrants to the labor force each year, most of whom are unprepared for work in a dynamic formal economy. This results in an excess supply of young workers, at a time when there is an excess demand for skilled and experienced workers. The demand gap is being filled by expatriate labor both in the public and the private sectors. Tackling the problem of unemployed youth is a high priority, not only for long-term development but also short-term stability. There are a number of steps that can be taken, some of which are already underway including: improving agricultural extension services; seeking labor market access agreements with countries in the region; institutionalizing the transfer of skills from foreign labor; compiling reliable labor market data to better understand the scope of the skills gaps; and using this to develop appropriate vocational training. In addition to these longer-term efforts, promoting labor-based infrastructure works, that create employment particularly for unskilled workers, can provide an important bridge for the short-term.
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UNTAE was established by Security Council resolution on October 25, 1999 less than two months after the Popular Consultation of August 30, 1999. The PC itself had taken place under the aegis of UNAMET.


Timor-Leste: Poverty in a Young Nation, November 2008

According to the 1990 census, the population of Timor-Leste stood at around 748,000. The UN tried to update this through a registration process, which estimated the population at around 738,000. The results of the 2004 census indicated that the population had grown to 925,000.


After the elections in 2007, the government changed the Fiscal Year from July-June to January-December. After this four Budgets had to be prepared in relatively quick succession: (i) Transitional Budget (July-Dec 2007); (ii) 2008 Budget (January-December); (iii) 2008 Mid-Year Review Budget (July-December); (iv) 2009 Budget (January-December).