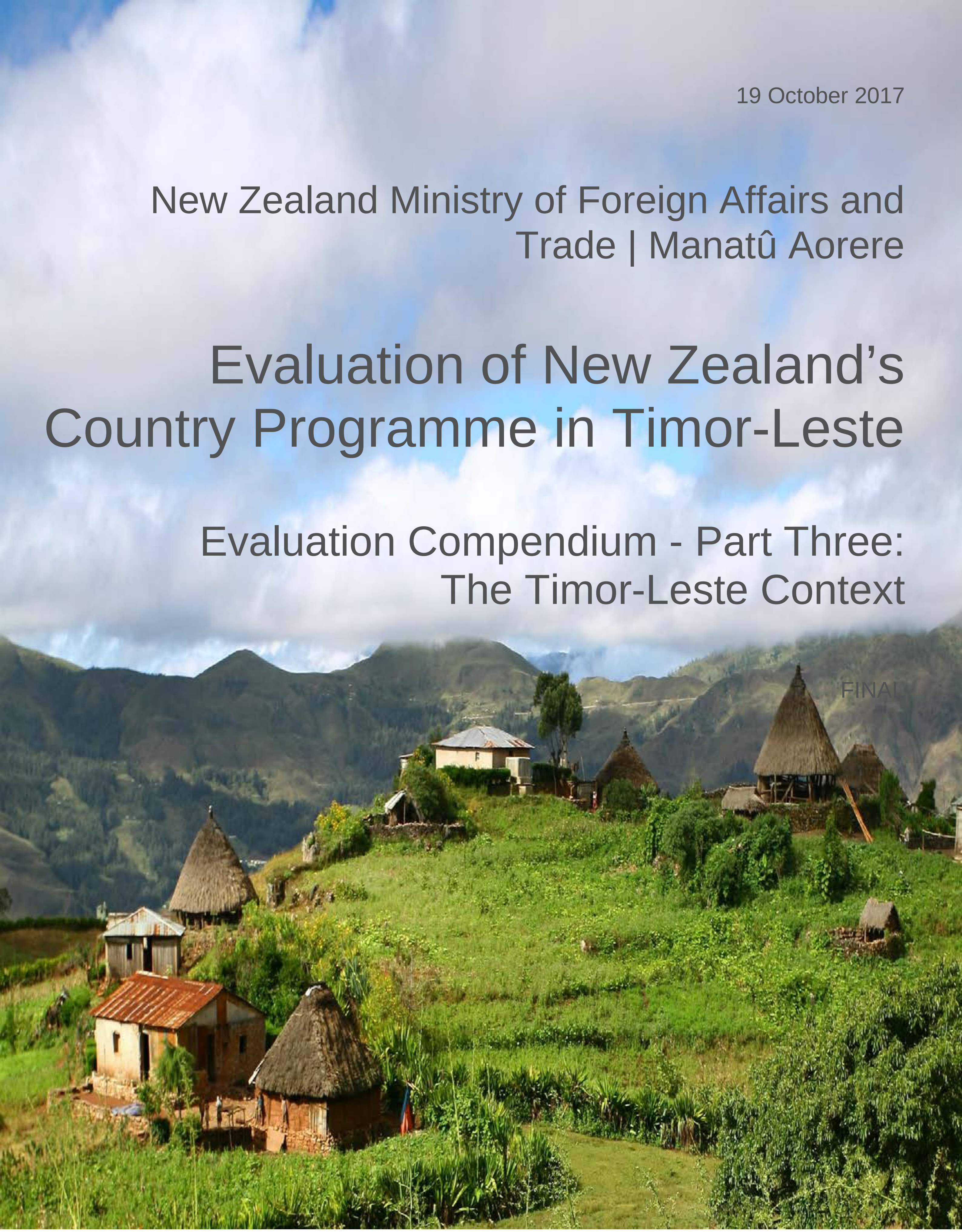


19 October 2017

New Zealand Ministry of Foreign Affairs and Trade | Manatû Aorere

Evaluation of New Zealand's Country Programme in Timor-Leste

Evaluation Compendium - Part Three: The Timor-Leste Context

FINAL

Adam Smith International

Evaluation Compendium

The Timor-Leste Country Programme Evaluation was commissioned by the New Zealand Ministry of Foreign Affairs and Trade (MFAT) to strategically assess New Zealand's bilateral engagement with Timor-Leste. This evaluation covers recent activities, particularly those under the Timor-Leste *Strategic Framework for Development 2012-2015* (MFAT, 2012), and includes their implications for current and future activities under the *Joint Commitment for Development 2016-2020* (MFAT, 2016b) and beyond. This is one of several strategic evaluations that are currently being undertaken to examine the results and impacts of New Zealand's country partnerships.

The evaluation commenced in April 2017 and has involved a range of detailed assessments that if combined would make for a long and complex report. The findings have therefore been made more accessible by presenting the evaluation as a compendium of five products crafted to meet the needs of different stakeholders.

These products are:

1. **Part One: The Summary Findings** which includes two subsections:
   - The Key Points: a double page infographic outlining the evaluation's main findings and key lessons.
   - The Executive Summary: a five-page summary of the main findings.
2. **Part Two: Country engagement and strategic outcomes.** This is a thirty-page discussion of the relevance of New Zealand's bilateral engagement with Timor-Leste, including the development context, how the programme is evolving, and the strategic implications for MFAT's future development assistance. This higher-level assessment focuses on the needs of MFAT's development managers and other state actors engaged in Timor-Leste.
3. **Part Three: The Timor-Leste Context.** This is a compilation of four papers that assess the current development environment and socioeconomic status of Timor-Leste. These papers provide a resource for MFAT staff, and a contextual basis for the upcoming strategic planning processes:
   - Paper 1: Economic and Social Development.
   - Paper 2: Public sector issues in Timor-Leste.
   - Paper 3: Private Sector Development.
   - Paper 4: International Integration.
4. **Part Four: The Detailed Assessments of Development Activities.** This is a compilation of eleven papers that assess the current New Zealand development activities against the OECD DAC criteria. These papers provide a resource for those MFAT programme managers, implementation teams, and development partners who are interested in particular activities. They also frame important issues that may warrant further investigation as part of the dedicated review processes planned for each activity.
   - Paper 1: Scholarships, Short-term, and English Language Training Opportunities.
   - Paper 2: Alternative Pre-school Education.
   - Paper 3: The HANDS programme (*Halimar, Aprende, no Deskobre; Susesu*).
   - Paper 4: Lafaek Education Media.
   - Paper 5: Coffee.
   - Paper 6: Aquaculture.
   - Paper 7: Tourism.
   - Paper 8: Community Policing.
   - Paper 9: Human Rights.

- Paper 10: Partnerships.
- Paper 11: Volunteers.

5. **Part Five: The Evaluation Process** outlines the evaluation plan, the evaluation team, the people consulted, and the findings from both the scoping mission and the main mission.

Part Three: The Timor-Leste Context

Contents

Paper 1: Economic and Social Development

By Robert Warner[1]

Timor-Leste is a new nation formed after a violent separation from Indonesia and a long period of non-developmental colonisation by Portugal. Access to earnings from off-shore oil resources has created a paradoxical situation of a nation that has levels of per capita income (and government revenue) that are at variance with the human development status of most of its population. The legacy of neglect and occupation are reflected in the struggle that the country has undergone to rapidly create the institutions of national government, and the entrepreneurial base to drive private sector development that is not linked to use of oil revenues.

In a little over 15 years, Timor-Leste has, however, made enormous progress in establishing a democratic government and many of the associated legislative, executive and judicial functions of a modern state. Successive governments have invested in infrastructure to provide power and connectivity to much of the country's urban and rural population. But capacity – in the public and private sectors - is extremely limited, and it is proving difficult to extend the supply of public goods and services to all the population, and to enable the development of business-led economic diversification. Progress has been made in improving access to education and, to a much lesser degree, health services. There have been steady improvements in access to improved water supplies, particularly in urban areas, although progress in access to improved sanitation has been much more limited.

Timor-Leste shares many development and cultural characteristics with the small island states of the Pacific, but is geographically aligned with Asia and has considerable potential for political and economic engagement with its ASEAN neighbours. While the stability of the country has been threatened by internal disruption, particularly in 2006, the country remains a strong and open democracy, which stands in contrast with many members of ASEAN, and the quality of governance is relatively high for a supposedly 'fragile state'.

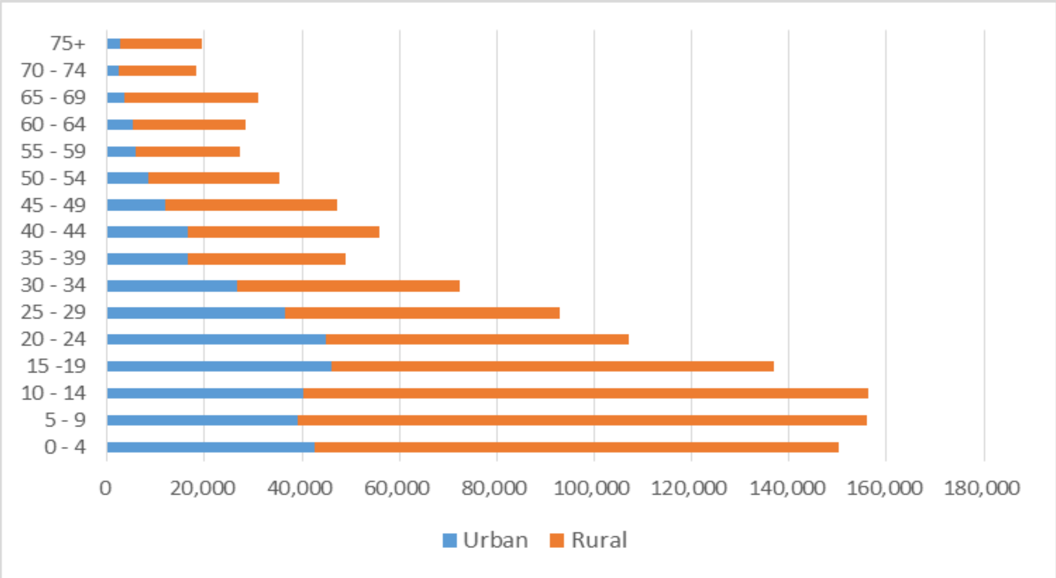
Some development partners, for example the ADB, manage interactions with Timor-Leste as part of their engagement with Pacific Island Countries (PICs), others, such as MFAT and DFAT, manage interactions from parts of the organisation that deal with South-East Asia or larger, non-Pacific groupings of countries. Where relevant, this annex uses PICs and ASEAN member countries as comparators for Timor-Leste.

The people and their human development

The population of Timor-Leste stood at just under 1.2 million in 2015. Just over half were under 19, and 60 per cent were under 24 years of age (Figure1.1). Seventy per cent of the population lived in rural areas, and the capital, Dili, accounted for 70 per cent (around 245,000) of the urban population. Since independence, the population has grown by 36 per cent: but according to the latest census the rate of population growth has started to fall (to 1.8 per cent per annum for the period 2010-2015, compared to 2.4 per cent for the period 2004-2010).

[1] Visiting Fellow, Development Policy Centre, Crawford School of Public Policy, Australian National University, Canberra ACT 0200 Australia

Figure 1: Population by age and location



Data source: Ministry of Finance, 2016b

Timor-Leste's people are mainly of Malayo-Polynesian and Melanesian-Papuan descent. Just over 30 indigenous languages are spoken in the country, as well as Portuguese, Bahasa Indonesia, English Malay and Chinese. According to the 2015 census, 37 per cent of the population speak Tetun (one of the two official languages) as their mother tongue, and 0.1 per cent have Portuguese (the other official language) as mother tongue. In all 88 per cent of the population speak Tetun as mother tongue or first or second language, 6 per cent speak Bahasa Indonesia, 5 per cent speak Portuguese and 2 per cent English (Ministry of Finance, 2016b).

Timor-Leste's human development is ranked 133 in the world, according to the United Nation's Human Development Indicator (Table 1.2). For each indicator in the table, there is an ASEAN and a Pacific Island country with a lower measure or poorer score than Timor-Leste. What perhaps distinguishes Timor-Leste from the member countries of ASEAN is that it has relatively low indicators *and* is also part of a small island with a small population: other ASEAN member countries with low indicators, such as Lao PDR, Cambodia and Myanmar have rather larger populations (and are part of the South-East Asian mainland). (Brunei Darussalam, the smallest, island member of ASEAN with a population of just 420,000, has an HDI ranking of 30.)

Table 1.2 Illustrates one of the important achievements of the Government of Timor-Leste – the fact that the expected years of schooling for the young people of the country are now nearly 3 times the average schooling that people over 25 have received[2]. In contrast, the table also demonstrates the country's relatively poor performance on human health, with the highest incidence of childhood malnutrition, and infant and maternal mortality of all the ASEAN and Pacific Island countries for which there are indicators.

Poverty

The proportion of the population estimated to be living under the national poverty line has fallen since 2007, but is still above the figure at independence (Figure 1.3). The poverty gap, which measures the depth of poverty as the average distance of the poor from the poverty line, is now back at the 2000 level. (When the poverty headcount is measured using the international poverty line of US$1.90 adjusted for purchasing power parity, a more significant drop in poverty between 2007 and 2014 of 16 percentage points is estimated to have occurred (Figure 1.3).)

[2] The 2015 census reports that 31 per cent of the population aged 15 and older have never been to school – and that 10 per cent of people aged 15-19 have never been to school, so the country still has a large cohort of people with very low levels of education.

Table 1: Population and human development indicators, ASEAN, PICs and Timor-Leste

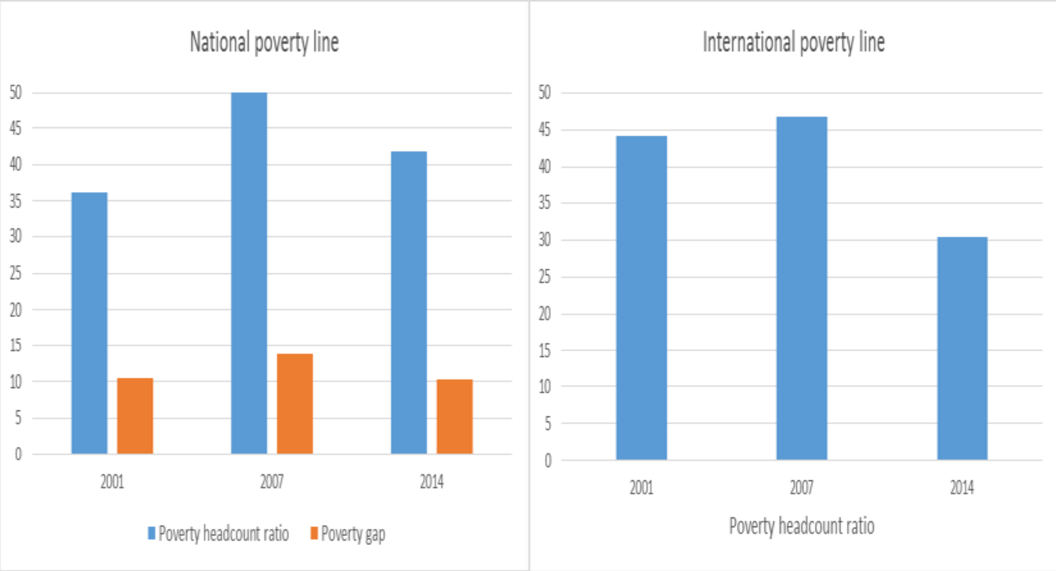
	Population	***HDI***		***Life expectancy at birth***	***Expected years of schooling***	***Per capita GNI***
	millions	Index	Ranking	Years	Years[a]	US$[b]
ASEAN maximum	257.56	0.925	145	83	15.4	78,162
ASEAN minimum	0.42	0.556	5	66	9.1	3,095
PIC maximum	7.62	0.788	156	74	15.3	13,771
PIC minimum	0.02	0.515	60	63	9.6	1,561
Timor-Leste	**1.18**	**0.605**	**133**	**69**	**12.5**	**5,371**

	Dependency ratio[c]		***Mortality***		***Malnutrition***	***Literacy rate***	***Mean years of schooling***
	Young	Old	infant[d]	Maternal[e]	Stunting[f]	Adult [g]	Years[h]
ASEAN maximum	56.6	16.1	50.7	197.0	43.8	96.8	11.6
ASEAN minimum	50.3	7.2	22.2	114.0	30.3	96.3	9.3
PIC maximum	69.1	10.2	44.5	215.0	49.5	99.5	12.3
PIC minimum	43.9	5.0	14.2	30.0	7.5	64.2	4.3
Timor-Leste	**81.5**	**10.7**	**44.7**	**215**	**50.2**	**67.5**	**4.4**

[a] Number of years of schooling a child of school entrance age can expect to receive if prevailing patterns of age-specific enrolment persists through the child's life
[b] 2011 purchasing power parity US$
[c] Per 100 people ages 15-64
[d] Per 1000 live births
[e] Deaths per 100,000 live births
[f] Moderate or severe stunting, per cent under age 5
[g] Per cent ages 15 and older
[h] Average number of years of education received by people ages 25 and older
Source: UNDP 2017

The incidence of poverty for women is very like that for men (41.2 per cent compared to 42.3 per cent). However, the incidence of poverty is much greater for young people than it is for older people (49 per cent for people under 15, compared to 40.3, 36.4 and 26.8 per cent for people aged between 35 and 44, between 45 and 60, and 61 and above, respectively). People under 15 comprise 47.3 per cent of the poor. The incidence of poverty is greater in rural Timor-Leste (47.1 per cent) than in urban areas (28.3 per cent), and about 80 per cent of people living below the poverty line are in rural areas.

Figure 2: Changes in poverty 2000 to 2014[a]

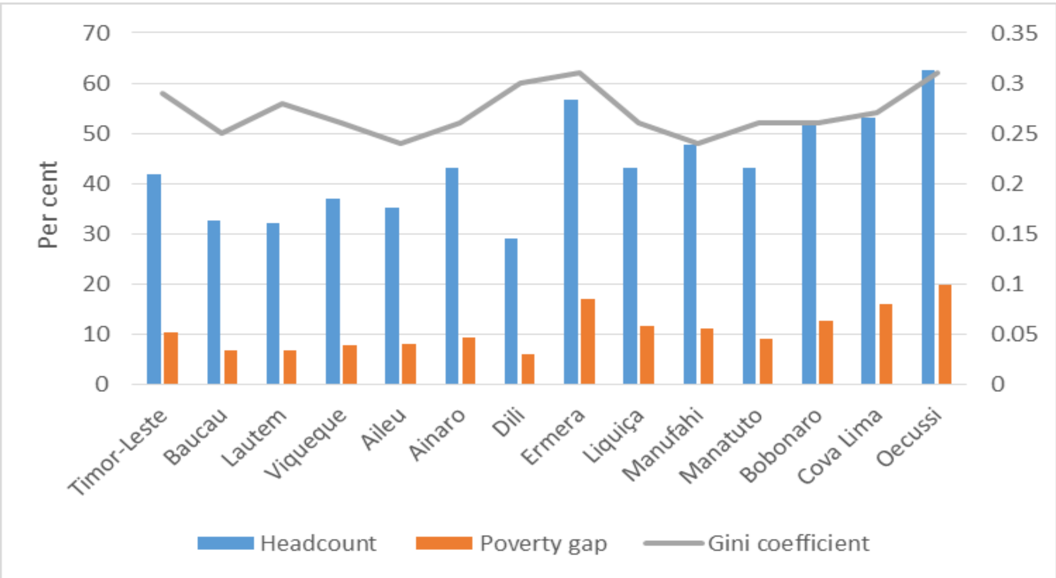


[a] Note: the international poverty line is U1.90 at 2011 Purchasing Power Parity

Data source: World Bank 2017a, Ministry of Finance and World Bank, 2016

The incidence of poverty varies considerably across the nation's districts/municipalities. Just under 63 per cent of the people in Oecussi live below the poverty line, compared to 29 per cent in Dili (Figure 1.4). The level of consumption inequality, as measured by the Gini coefficient varies somewhat over the municipalities, but is not exceptionally high (Figure 1.4)

Figure 3: Poverty by district, 2014



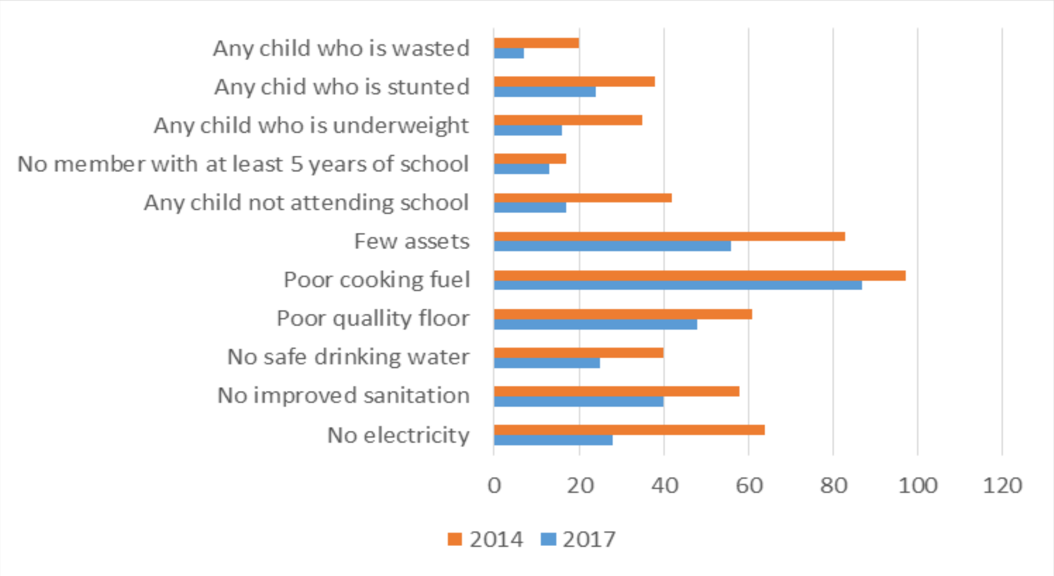
Data source: Ministry of Finance and World Bank, 2016

Along with improvements in consumption based indicators of poverty, Timor-Leste has achieved considerable reductions in the incidence of other measure of deprivation between 2007 and 2014. For example, the estimated percentage of households:

- with no electricity has fallen from 64 to 28;
- without access to improved sanitation has fallen from 58 to 40;
- without access to safe water has fallen from 40 to 25; and

› with any child not attending school has fallen from 42 to 17 (Figure 1.5).

Figure 4: Multi-dimensional indicators of deprivation 2007 and 2014[a]



[a] The chart shows the estimated proportion of households exhibiting the various signs of deprivation

Data source: Ministry of Finance and World Bank, 2016

The economy

Oil

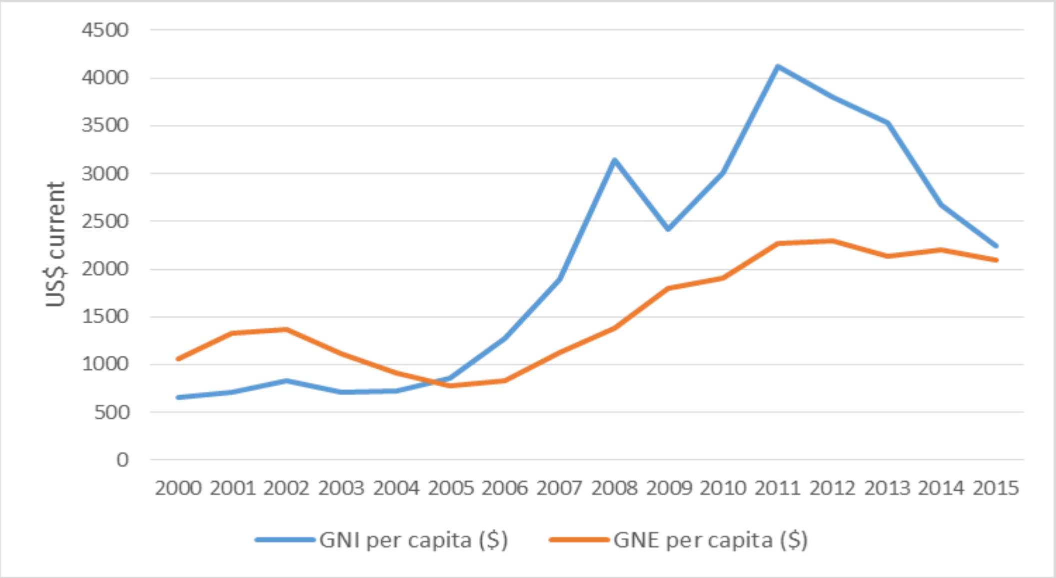
Timor-Leste is often described as one of the most oil-dependent economies in the world, and oil and gas revenues have certainly been a major source of revenues for the government. But unlike many other countries that have access to oil revenues, oil and gas production in Timor generates very little in direct on-shore economic activity, and there are few domestic activities, other than government, that have immediate linkages with oil production.

Oil and gas revenues from fields in the Joint Petroleum Development Area (JPDA) shared with Australia began to flow in 2004, shortly after independence, and Timor-Leste's agreed 90 per cent share of production led to a sharp increase in national income (Figure 1.6). As production in the Bayu Undan and Kitan fields in the JPDA has declined, the nation's income has begun to fall quite sharply. Since the government has been saving a large share of the revenues in a sovereign wealth fund, the impact of increases and decreases in production have had a much less marked effect on national

Timor Sea Dispute

The Timor Sea holds significant gas and oil reserves in several fields, most of which lie north of the midpoint between Australia and Timor-Leste. Since its independence, Timor-Leste's rights to these fields have been contested by Australia. In 2002, the two countries signed the *Timor Sea Treaty* which saw royalties from the existing fields (Bayu-Undan and Kitan) shared 90:10 in favour of Timor-Leste. The treaty deferred, however, the designation of a clear maritime boundary regarding future fields. In 2006, the countries signed the *Certain Maritime Arrangement in the Timor Sea (CMATS)* which proposed equal sharing of revenues from the yet-to-be-developed, and much larger, 'Greater Sunrise field'. However, amidst ongoing tensions, Timor-Leste withdrew from CMATS, and as of 2017 is seeking to clarify its Maritime Boundary by forcing Australia to undertake compulsory conciliation at the International Court of Justice in The Hague. Private Sector development of new fields has been delayed until the maritime boundary and the associated royalty dispute is settled expenditures. However, as discussed in Paper 2, the rate of withdrawals from the fund is such that, without significant change, the fund is likely to be exhausted in ten years or less[3].

Figure 5: Per capita Gross National Income and National Expenditure a - the impact of oil



[a] In current US dollars

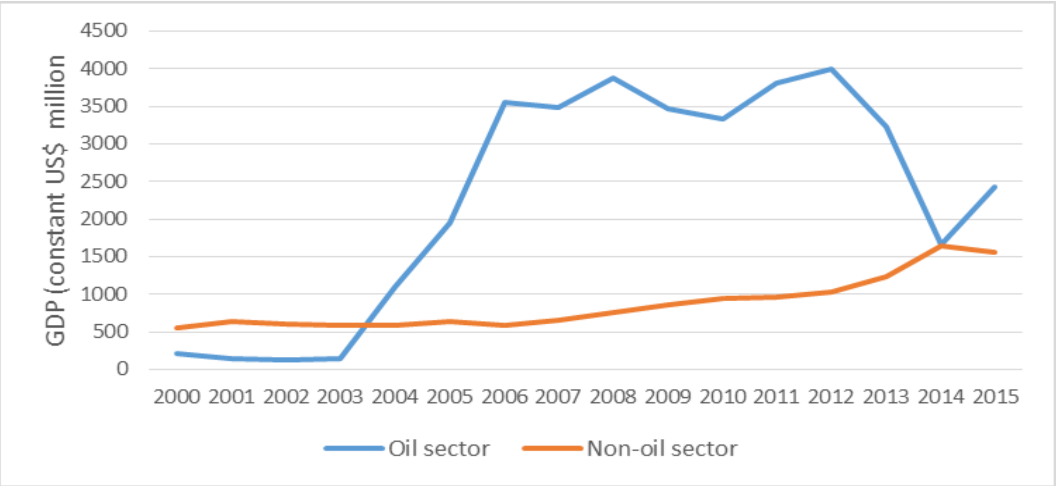
Data source: Ministry of Finance, 2015, 2016a

This means that if Timor-Leste is to avoid a significant contraction in aggregate living standards, significant progress will have to be made in diversifying the economy away from oil-funded government spending.

The rest

Since independence, the non-oil sector of the economy has been growing at an average of 7.2 per cent a year, a steady growth which has been rather over-shadowed by the rapid changes in oil and gas production (Figure 1.7).

Figure 6: Real oil and non-oil GDP 2000-2015[a]



[a] In constant 2010 prices, with data for 2010-2015 interpolated using data at 2015 prices

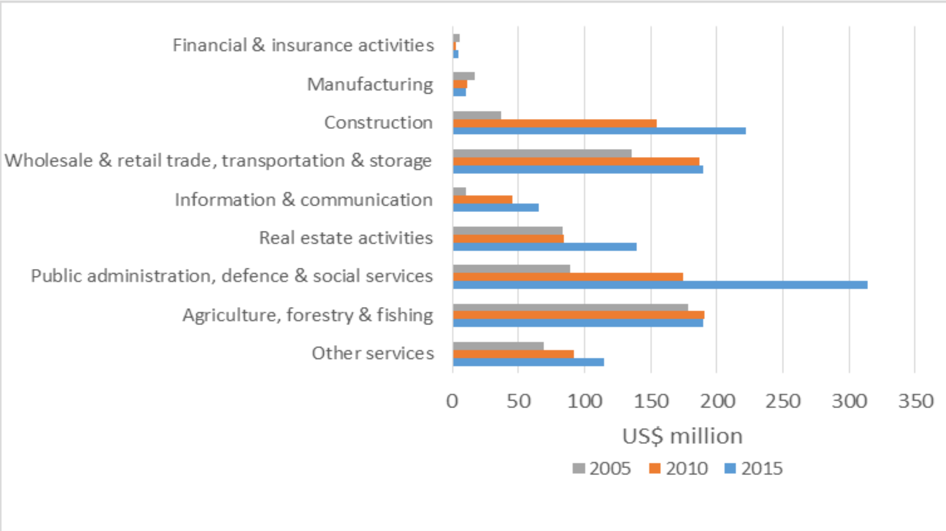
[3] There are other hydrocarbon resources that might generate income for Timor-Leste in the future, but they are unlikely to come on-stream in a time frame that would spare the country a significant drop on income over the next decade (see Paper 2).

Data source: Ministry of Finance, 2015, 2016a

The problem from a diversification perspective is that much of the expansion in non-oil GDP has been driven by increases in government spending, on public administration and on construction contracts for public investment – both of which have been made possible by oil revenues, and both of which may have to contract as oil revenues contract. Real value added in the Public administration, defence and social services sector grew by just over 250 per cent between 2005 and 2015, and the Construction sector grew by 500 per cent (Figure 1.8). Together, these two sectors accounted for 43 per cent of non-oil GDP in 2015. In contrast, output of the agriculture, forestry and fishing sector, where most Timorese make their livelihoods, grew by just 7 per cent over the period (when rural population grew by over 20 per cent), and the manufacturing sector contracted by nearly 40 per cent.

In 2015, services accounted for 84 per cent of non-oil GDP. Given the dominant role that oil plays in generating foreign exchange revenues for the country – and funding domestic expenditures, it is not surprising that the traded goods sector – exporting and import-competing – is so small in Timor-Leste.

Figure 7: Changes in real value added by sector[a] , 2005 to 2015



[a] In constant 2010 prices, with data for 2010-2015 interpolated using data at 2015 prices

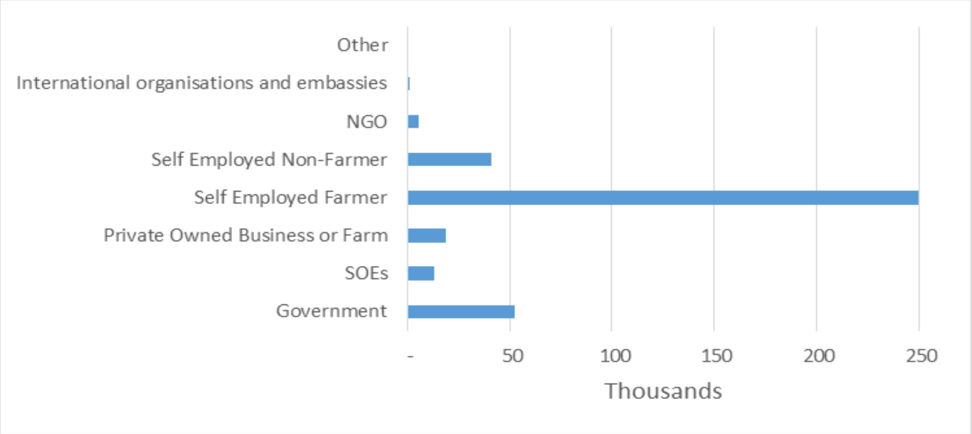
Note: Wholesale & retail trade, transportation and storage also includes accommodation and food services

Data source: Ministry of Finance, 2015, 2016a

Employment

The 2015 census reported that 45 per cent of the population aged 10 and over were in employment: the rest were unemployed (2 per cent) or economically inactive (53 per cent). Of the people who were employed, 250,000 or 64 per cent were classified as self-employed farmers (Figure 1.9). The government sector accounts for 38 per cent of the employed population who are not self-employed farmers.

Figure 8: Employment by sector[a]



[a] Sector of employment of employed population over 10 years of age.

Data source: Ministry of Finance, 2015, 2016

The 2 per cent unemployment figure in the census is not supported by data from the Labour Force Survey, which suggests that 11 per cent of the labour force was unemployed in 2013 (Ministry of Finance, 2015). And in practice, many people reporting as being engaged as self-employed farmers may well be chronically under-employed, especially young people, and many of those reporting as economically inactive may be 'discouraged' workers rather than people who are not interested in have gainful employment. This would suggest that the country is facing a significant employment generation problem with security as well as social and economic implications.

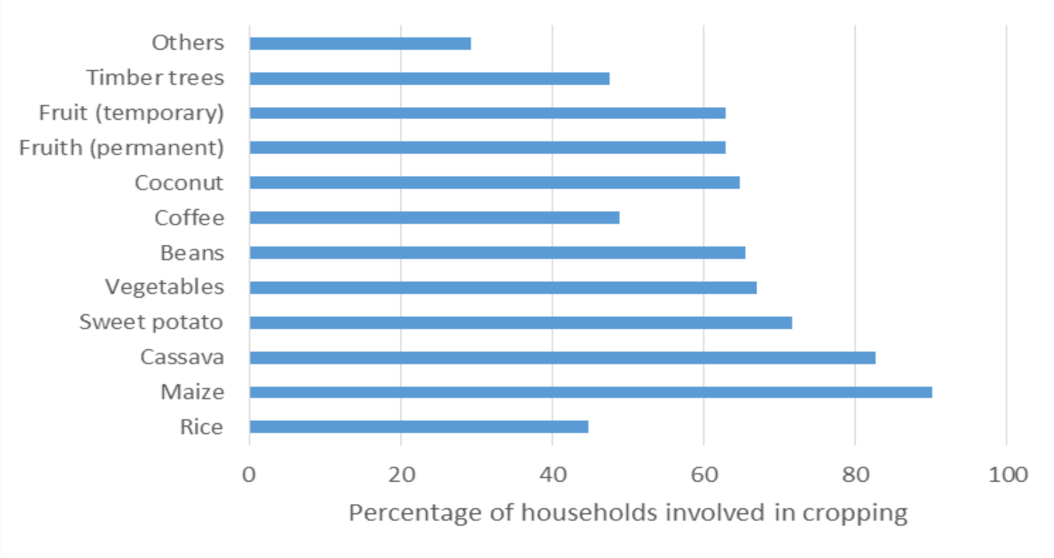
Agriculture

Agriculture systems in Timor-Leste are argued to be among the least productive in the world (ADB, 2016a). Subsistence production dominates the sector. In the 2015 census, only 3 per cent of the households that reported being engaged in some agricultural activity were involved primarily in production for sale. The remaining 97 per cent were producing in their back yards, or mainly for their own consumption with a small level of sales. Agricultural production is typically small scale – 62 per cent of rural households cultivate less than one hectare, and only 9 per cent cultivate more than 5 hectares.

Ninety per cent of households involved in cropping grew maize in 2015, 82 per cent grew cassava and 72 per cent grew sweet potato, while just 45 per cent grew rice (Figure 1.10). The Government has invested heavily in rehabilitating large-scale irrigation projects for rice production since 2005, but rice production has stagnated, and irrigation is not widespread – only 6 per cent of households reported using irrigation in 2015[4]. Just under half of all households (49 per cent) report growing coffee, which is the most important cash crop, and which accounted for 97 per cent of non-oil exports in 2015. Small scale livestock rearing is also widespread, with just over 70 per cent of all private households raising chickens and pigs: but only a quarter raise cattle.

[4] The irrigation technology is very expensive, with high maintenance costs, and generous social transfer schemes which raise the reservation wage of rural labour, combined with government subsidies for imported rice explain some of this outcome (ADB, 2016).

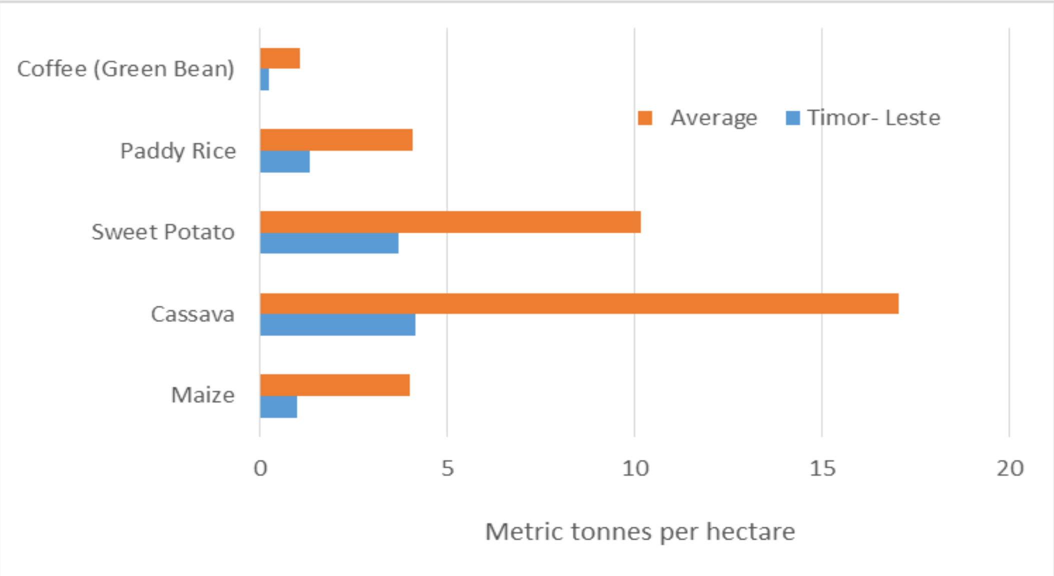
Figure 9: Households reporting production of crops in main or second season



Data source: Ministry of Finance, 2016b

Crop productivity in Timor-Leste is very low – in 2007 the rural population produced just over 220 kilograms of staple foods, about a third of what counterparts in Asia produced (ADB 2016a). Across the main crops, Timor-Leste's yields are between 21 and 36 per of those achieved in Cambodia, Thailand, China, Viet Nam, Indonesia and Lao PDR (Figure 1.11).

Figure 10: Comparison of crop yields, 2007 – Timor-Leste and selected Asian countries[a]



[a] The average yield shown in the chart is across production in Cambodia, Thailand, China, Viet Nam, Indonesia and Lao PDR
Data source: World Bank 2011

The low productivity in Timor-Leste's agriculture sector is attributed to inconsistent policy frameworks and lack of effective extension services – public or private to support adoption of alternative systems, poor infrastructure, and incomplete or absent markets, combined with the high level of risk-aversion evidenced by subsistence farmers. These all exacerbate the constraints to competitiveness from the macroeconomic impacts of high levels of government domestic expenditure financed from oil revenues.

Access to infrastructure and other services

Up to 85 per cent of Timor-Leste's (quite limited) infrastructure was destroyed in the violence that followed the independence referendum in 1999. Successive governments of the new country have invested heavily in rebuilding infrastructures, and there have been some significant improvements in access to power, transport, water and sanitation services, as well as public provision of social services.

Energy

Timor-Leste, through its electric utility, Electricidade de Timor-Leste (EDTL), has prioritized power sector development as a key driver of economic growth and poverty reduction. While the government's 2015 SDP target of 100% electrification was not achieved, the EDTL has still made extraordinary progress. Since 2008, the government has invested nearly US$1 billion in the generation, transmission and distribution of electricity in the country. As a result, access to electricity has increased significantly.

According to the ADB, network coverage increased from 22 to 71 per cent of households between 2003 and 2014 (ADB, 2017), while the World Bank's World Development Indicators show that the proportion of the population that has access to electricity increased from 27 to 45 per cent over this period (with access of the rural population increasing from 3 to 37 per cent, and urban access falling from 74 to 63 per cent). The ADB estimates that Timor-Leste currently possesses sufficient installed capacity to connect all households and meet peak residential, commercial, and industrial demand for the coming decade.

This development however levies considerable fiscal burdens on the state for recurrent operational and maintenance costs. The government currently spends approximately US$100 million per year to cover about 85 per cent of operating costs in the power sector – most of this money is spent on imported diesel. Revenue generation is very poor and about 60 per cent of the electricity generated is not billed to consumers (ADB, 2017). EDTL remains a department within the Ministry of Public Works, Transport and Communications and lacks the commercial focus to address the operational and developmental challenges that it faces.

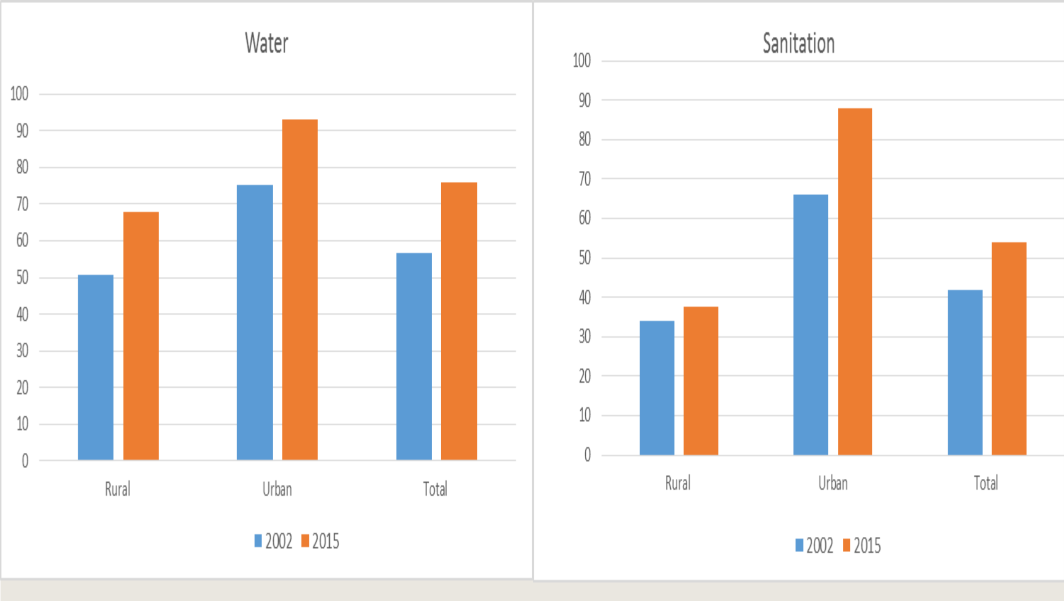
The ABD and Timor-Leste propose a new programme (*Electricity System Strengthening and Sustainability Investment Program*) to improve the sustainability of electricity supplies by improvements to service reliability, system losses, revenue generation and introducing natural gas in place of some of the current diesel generation plants (and thus reduce operating costs by 50%).

Given that one of the principle weaknesses of the power sector is generation, the ADB has assessed alternative energy options. While the ADB/GoTL's new programme plans to focus on natural gas options in the medium term, renewable energy options offer considerable supplementary potential particularly for more remote areas. This aim is reflected in the SDP which identified the need to upgrade generating capacity through development of renewable energy and onshore natural gas processing. ADB prefeasibility studies have already identified potential to generate 450MW from wind, solar and hydropower (ADB, 2016b).

Water and sanitation

The Joint Monitoring Programme data show that between 2002 and 2015, the proportion of the population with access to an improved water source increased from 57 to 76 per cent, with improvements in access for rural (51 to 68 per cent) as well as urban people (75 to 93 per cent) (Figure 1.12). This said, only 42 per cent of the population has access to piped water. The story on sanitation is not so impressive, with the proportion of rural people with access to improved sanitation increasing only from 34 to 38 per cent (Figure 1.12).

Figure 11: Access to improved water and sanitation, 2002 to 2015



Data source: Joint Monitoring Programme for Water Supply and Sanitation, 2017

Transport infrastructure

Roads

The Government is investing heavily in roads (see Paper 2), but significant expenditures have yet to translate into major improvements in rural roads, with 60 per cent or more of district and core rural roads in poor or bad condition. In rural areas, vehicle ownership is low and public transport infrequent, so that children walk and average of 30 minutes to school. A key issue is that very limited budget is allocated to road maintenance. The poor quality of the road system exacerbates the problem of market access that limits the opportunities for rural people to expand beyond subsistence agriculture.

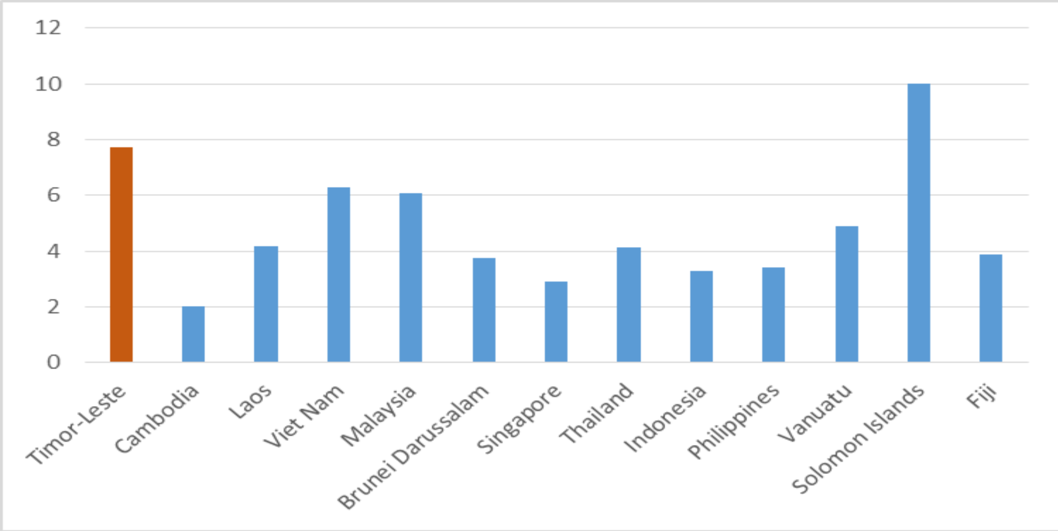
Water transport

Timor-Leste has only one international port, Dili, whose limited capacity leads to recurrent congestion, adding to the costs of importation of the goods which play an important role in local consumption. Subsidised ferry services provide the main means of connectivity between the Oecusse enclave and the rest of the country, and there is a ferry connection to the island of Atauro. The Government recently entered into its first public-private partnership to design, build and operate a new port at Tibar, close to Dili. Construction of the port, which is estimated to cost US$490 million, commenced earlier this year. The Government also has plans for port facilities on the south coast and Oecusse (see Paper 2).

Education

Timor-Leste has made significant progress in basic education, with the net enrolment rate reaching 96 per cent in 2014, up from 77 per cent in 2008 (World Bank 2017a). Secondary net enrolment reached 56 per cent in 2014, up from 34 per cent in 2008, with a slightly higher figure for females than males (60 per cent compared to 52 per cent). Government expenditure on education is a larger share of GDP than for any member of ASEAN for which data is available, and is only exceeded by Solomon Islands (Figure 1.13).

Figure 12: Government spending on education as a share of GDP, 2010 to 2014



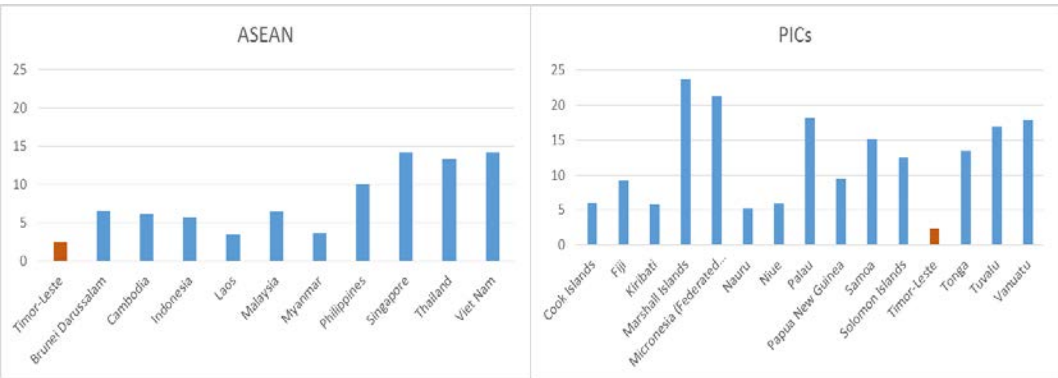
Data source: UNDP 2017

Despite these achievements, there are problems of quality and performance in the education sector. The ADB reports that 25 per cent of grade 1 students repeat the year, and nearly 5 per cent of students drop out each year in grades 1-4, and the net enrolment rate for pre-secondary education is low at 34 per cent (ADB, 2016a). Nearly one-third of primary school-age children in rural areas have never attended school, and many primary students show poor literacy and numeracy skills.

Health

As Table 1.2 shows, health sector performance in Timor-Leste is particularly poor, with the country having some of the worst health outcomes in South East Asia and the Pacific. Across ASEAN and the Pacific Island countries, the only country that has fewer physicians per 100,000 people than Timor-Leste is Papua New Guinea. As Figure 1.14 shows, the Government of Timor-Leste spends less of its budgetary resources on health than any member of ASEAN or and Pacific Island country for which there is data.

Figure 13: Comparison of government spending on health[a]



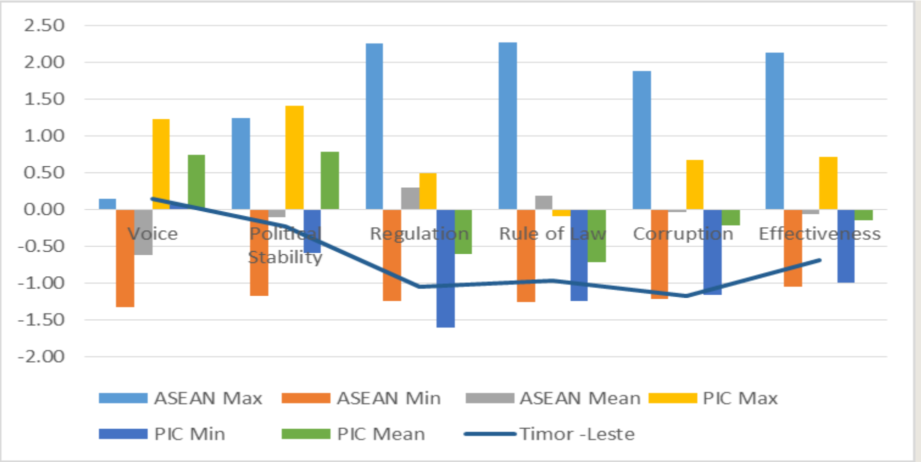
a Percentage of total government spending devoted to health.

Data source: WHO 2017

Government

As indicated in the introduction, Timor-Leste is a new country, with a state that is in the earliest stages of development. Capacity is limited, and many of the instruments – legal and institutional - of state functionality, are yet to be perfected. As Figure 1.15 indicates, the performance of the government and the overall institutions of governance are far from best practice, with regulatory quality, rule of law and control of corruption the areas where performance is rated particularly poorly. All the same, amongst Timor-Leste's neighbours in ASEAN, and comparators in the Pacific, there are countries with worse ratings in each dimension of performance.

Figure 14: Quality of governance[a]



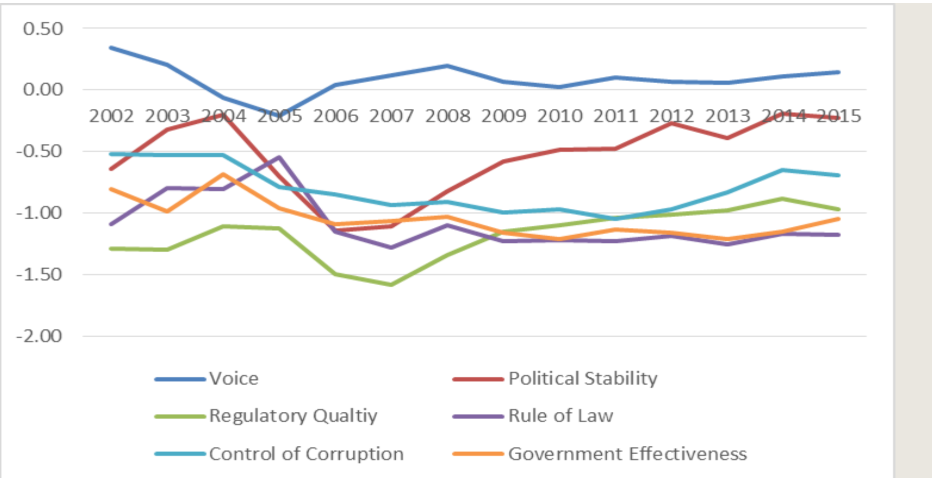
[a] As measured by the World Bank's World Governance Indicators

Note: the chart shows maximum, mean and minimum indexes for 10 ASEAN, 12 Pacific Island Countries and the indexes for Timor-Leste, where 2.5 is the best possible value, and -. 2.5 the worst, for 6 areas of governance: Voice and Accountability, Political Stability and Absence of Violence, Regulatory Quality, Rule of Law, Control of Corruption and Government Effectiveness.

Data source: World Bank, 2017b

Some of the aspects of government performance are discussed in some more detail in the annexes on the public and private sectors (Papers 2 and 3). As Figure 1.16 shows, most indicators suggest a marked improvement in the quality of governance after the disturbances of 2006.

Figure 15: Changes of over time in the quality of governance[a]



[a] As measured by the World Bank's World Governance Indicators

Data source: World Bank, 2017b

Development strategy

In 2011, the Parliament of Timor-Leste approved the Strategic Development Plan for the period 2011-2030. The plan aims to establish Timor-Leste as an upper middle-income country by 2030, eradicating extreme poverty and establishing a diversified economy. It is built on three pillars: social capital, infrastructure development and economic development for a non-oil economy. The plan also has a cross-cutting pillar addressing the institutions and macro-economic foundations for implementation. The World Bank has summarised the essence of the SDP as follows (World Bank, 2013).

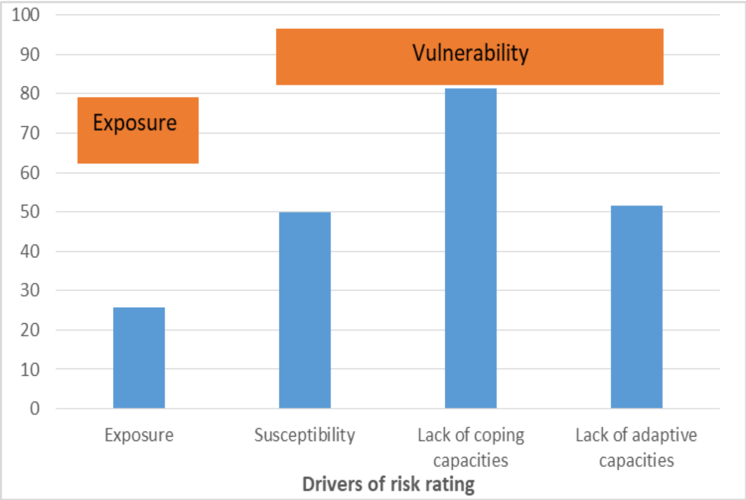
- Investing in human capital through improved access and quality of health, education and skills development while protecting the vulnerable. The plan outlines a strategy of investments in education and health infrastructure and developing standards to improve service quality, and prioritises social inclusion with specific targets for women, youth vulnerable family access to services.
- Using natural resource wealth to fund catalytic infrastructure. The plan proposed investments in roads, water and sanitation, seaports and airports, and further liberalisation of the telecommunications sector.
- Encouraging private sector investment, and diversifying the economy to sustain growth and employment. The plan envisaged large-scale investments in downstream petrochemical processing as the centre-piece of its growth strategy, accompanied by investments in agriculture and tourism development.
- Expanding the foundations of good governance and institutional effectiveness. The plan prioritised civil service and public financial management reforms and improving service delivery through decentralisation, as well as strengthening institutions for oversight and combatting corruption and instruments to ensure transparency and accountability.

Implications for New Zealand

New Zealand has been supporting Timor-Leste's development since the independence referendum in 1999. Despite the country's access to oil revenues, the development case for continued support has not greatly changed, particularly given the human capacity and poverty challenge the country still faces, and the impermanence of its oil revenue flows. However, as discussed in Papers 2 and 3, there are elements of the country's development strategy that are problematic, especially the focus on physical infrastructure and capital intensive industrial development at the expense of investment in human capabilities and development of a local private sector. At a broader level, the security risks from a growing pool of disaffected young people migrating to urban areas but not finding gainful employment cannot be ignored. And Timor-Leste is particularly vulnerable to disasters – natural and man-made with a limited capacity to address them (see annex A). New Zealand may want to use its acknowledged special relationship to find ways of working with the Government and other development partners, to find ways of addressing risks in the development strategy, and also to buttress the institutions that help address the country's fragility.

Annex A: Disaster risk management

The World Risk Report ranks Timor-Leste as the 12th (out of 171) most disaster-prone country in the world (UNU-EHS, 2016). As the chart shows, the main driver of the country's high ranking is its lack of coping capacities.

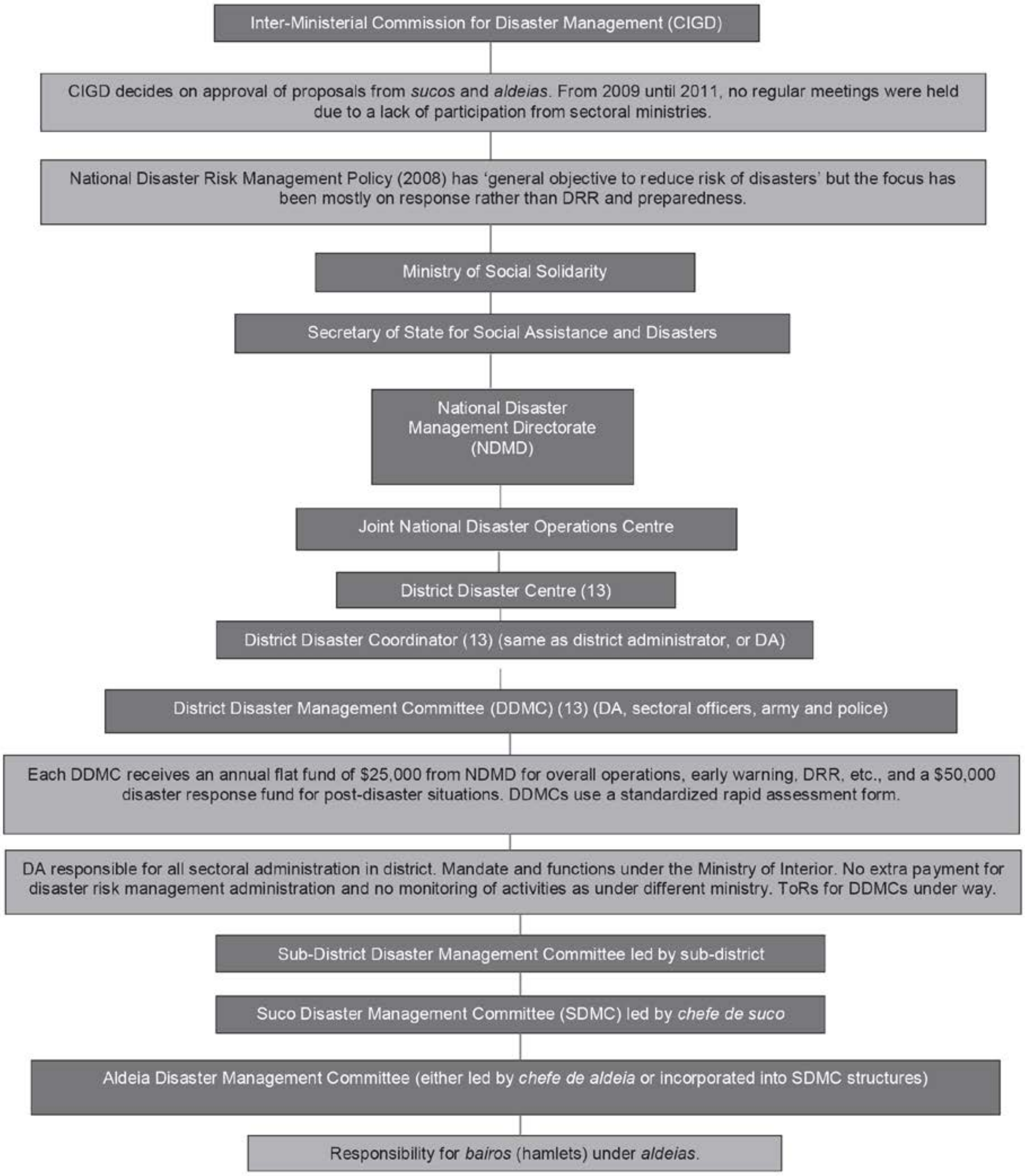


Timor-Leste is particularly exposed to severe and recurrent drought, flooding and landslides which impact on food security and connectivity. The country is also exposed to earthquakes and tsunamis and is very susceptible to the impact of El Niño and La Niña climate events. Sea levels have been rising by 9mm a year since 1993, significantly faster than the global average, compounding climate change related occurrence of extreme rainfall events, hotter dry seasons and shorter wet seasons (CFE-DM, 2016). Prevailing agricultural techniques combined with destruction of natural forests during Indonesian occupation have contributed to significant deforestation with attendant consequences for soil erosion and vulnerability to landslides and flooding. Timor-Leste is also at high risk of the spread of infectious diseases, such as Hepatitis A, Malaria and Typhoid, cause in part by limited access to safe water and sanitation.

With help from international agencies, the Government of Timor-Leste has worked on disaster assessments, management policies and plans. They include

- a National Disaster Contingency Plan of for Flooding (2006);
- the National Disaster Risk Management Policy (2008) (which, in line with the Hyogo Framework for Action aims to move beyond disaster response modes to proactive disaster risk reduction);
- the National Disaster Operations Centre manual (2009);
- a National Adaptation Program of Action for Climate Change (2010);
- a National Hazard, Vulnerability and Risk Assessment (2013); and
- an Emergency Response and Preparedness Plan (2014)

The Government has developed an organisational structure for disaster management that includes an Inter-Ministerial Commission for Disaster Management, coordinated by a Vice-Prime Minister, and a National Disaster Management Directorate and a National Disaster Operation Centre within the Ministry of Social Solidarity. At the District level, the structure envisages that District Administrators have their mandates extended to include the function of District Disaster Coordinators, supported by a committee that can draw on sectoral officers, the armed forces and the police force, representatives of churches and mosques and NGOs. These structures are meant to be replicated at sub-district level, and suco chiefs and village leaders are responsible for emergency and disaster risk reduction activities, expected to interact with sub-districts if they require assistance. While decision making during disasters is decentralised to district committees, given lack of resources and capacity, decisions are still direct back through the Directorate and the Ministry of Social Solidarity (see chart, from Mercer et al 2014).



The National Disaster Risk Management Policy lays out plans for Community-based Disaster Risk Management, and highlights the importance of partnerships with NGOs and other actors to help bolster community level capacity. Early warning systems are in place in every district, but not at the village level. District disaster management committees rely on police radio and existing networks to inform communities about impending dangers. And Timor-Leste relies on collaboration with Australian, Japanese, Indonesian and United States meteorological and geophysical services for information on climate, cyclone, earthquake and other hazards.

While Timor-Leste has a policy and notional institutional structure to address the different aspects of disaster management, capacity is extremely limited, and horizontal and vertical coordination across all agencies with a role to play is challenging. The various assessments of national approaches all observe that there is a high level of government commitment to improving disaster risk management, but that with the competing demands on scarce mid-level capacity, the institutional structures to deliver management and to respond to disasters are very weak (GFDRR, 2009, Mercer et al 2014).

The recent CFE-DM handbook suggested some critical areas in need of attention, including:

- ensuring that ongoing infrastructure investments do not add to existing risks and that they are risk resilient – in this regard it is interesting to note that the World Bank has supported a community based approach to disaster risk management with the Dilil-Anairo road project.
- strengthening inter-ministerial coordination,
- raising public awareness on disaster risk reduction through media campaigns,
- providing professional and formal education, and
- expanding integrated community-based disaster risk management and adaptation with a focus on the participation and needs of women.

The handbook argues that ‘more effective integration of disaster risk considerations into sustainable development policies, planning and programming at all levels, with a special emphasis on disaster prevention, mitigation, preparedness and vulnerability reduction is needed for Timor-Leste’ and that ‘institutions, mechanisms and capacities at all levels, in particular at the community level, that can systematically contribute to building resilience to hazards need to be strengthened. Risk reduction approaches need to be incorporated into the design and implementation of emergency preparedness, and into the response and recovery programs in the reconstruction of affected communities’.

There is a large donor presence in the disaster management space, which has not assisted in improving coordination of activities and efficient allocation of resources, nor of encouraging adequate allocation of national budgetary resources to this area. Even so, there are some areas where assistance would be useful, especially facilitating learning from other small island developing states (SIDS) with respect to vertical and horizontal governance and communication, tapping and making better use of available information, especially local knowledge, and improving integration of disaster risk reduction and climate change adaptation - again learning from the experience of other SIDS (Mercer et al, op cit).

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Paper 2: Public sector issues in Timor-Leste

By Robert Warner and David Swete Kelly

As a newly independent country, Timor-Leste has had to establish all the basic legislative, judicial and executive structures of government in an extremely short period. At the same time, its government has tried to move rapidly to address the development aspirations of its people and deal with the legacy of its difficult separation from Indonesia. These processes have been assisted - but also complicated - by Timor-Leste's access to oil revenues. And, even more than many other small-island developing states, Timor-Leste is trying to deliver the range of state functions with limited human and institutional capacity.

For the near future, the Government of Timor-Leste (GoTL) faces what could amount to a fiscal crisis, as oil revenues are set to fall rapidly. Perhaps more importantly, the quality and nature of spending from the oil revenues – in the past and projected into the future - pose longer term challenges for fiscal sustainability, and may represent a lost opportunity to lay the basis for a higher standard of living for the majority of Timorese in the future.

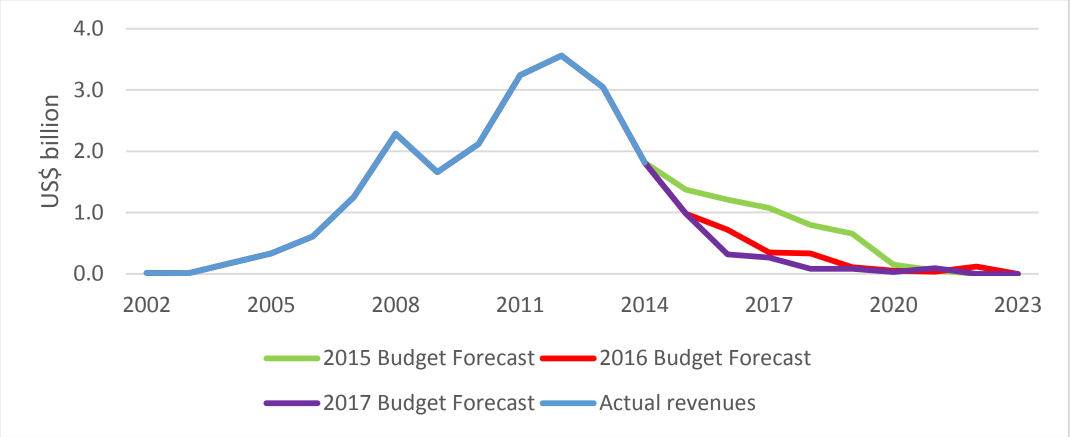
The pending fiscal and expenditure challenge

GoTL's oil revenues derive from Timor-Leste's share of proceeds from the Bayan Undan and Kitan offshore oil fields. The earnings flow into a 'state-of the art' Petroleum Fund, which uses the Norwegian petroleum sovereign wealth fund as a model. The law establishing the Fund sets a framework for how its resources should be invested, and for determining an Estimated Sustainable Income (ESI) to inform withdrawals in a way that would protect GoTL revenues from price and production variability, and allow for continued appropriations at the same level in the future (IMF, 2009, McKechnie, 2013).

Timor-Leste's oil revenues peaked in 2012 (at US$ 3.5 billion), and have fallen away rapidly from that peak. According to the 2017, revenues had fallen to an estimated US$ 317 million in 2016, and are estimated to terminate altogether in 2022 (Figure 2.1).

While there are other offshore hydrocarbon deposits that may be developed (principally the Greater Sunrise natural gas field) they are unlikely to be generating any revenues for GoTL before 2027 at the earliest, given the uncertainties created by the maritime boundary dispute with Australia, and differences regarding the optimal way to process gas from the field.

Figure 2.1: Actual and projected oil revenues 2002 to 2023 [a]



[a] Excludes Petroleum Fund earnings

Data source: ADB 2016a, Ministry of Finance 2016

The implications of this projected termination of revenues are exacerbated by the decisions of successive governments to draw much more than the ESI from the Petroleum Fund.

Under a strategy of 'frontloading' infrastructure, GoTL has been – and plans to continue – drawing large amounts from the Fund to finance outlays on several large infrastructure projects. Between 2017 and 2021, the Government plans to draw nearly 2.5 times the cumulative ESI for the period (Figure 2.2). Because of these planned withdrawals, the balance in the Petroleum Fund in 2021 would be 25 per cent lower than its 2014 peak. (A local commentator estimates that if current spending plans are carried out, the Fund could be fully depleted by 2027 (La'o Hamutuk, 2016a).

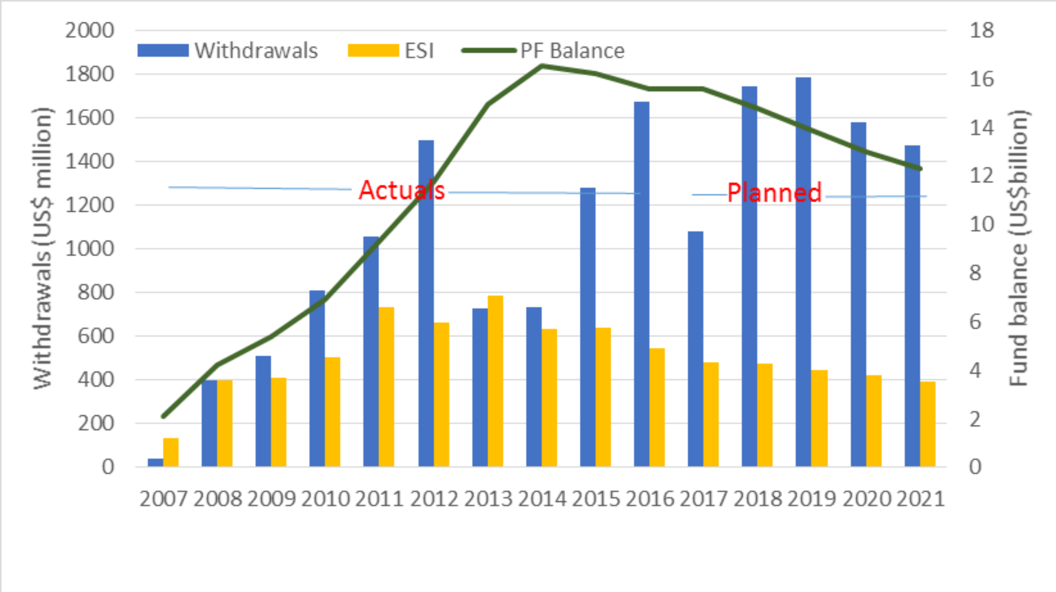
The Law establishing the Fund clearly allows for Parliament to approve withdrawals more than the ESI, if a justification is presented, so the excess withdrawals are consistent with current practice. Further, some commentators have suggested that rules like that determining the ESI, adopted from the Norwegian example, are far too conservative for a developing economy that should have potential investments with high social rates of return (Collier et al 2009).

The problems with what is proposed lie in:

- the absence of any alternative revenue instrument that can pick up the slack when the Fund ceases to sustain current rates of withdrawal;
- the questionable social and economic value of the infrastructure that is being built;
- the implications for expenditure in other areas if fiscal retrenchment is required: it may be politically and contractually difficult to curtail proposed infrastructure spending, and this spending may bring with it significant ongoing operational and maintenance cost obligations;
- the potential impacts on other initiatives being undertaken to improve service delivery and accountability.

In addition, high levels of government local spending impact on the cost of labour and other non-tradeables, crowding out and reducing the competitiveness of all other internationally exposed sectors (such as tourism and horticulture). This reduces the economy's ability to generate much needed private sector jobs and incomes.

Figure 2.2: Petroleum Fund: Estimated Sustainable Income, withdrawals and balance



Data source: La'o Hamutuk, 2016a, Ministry of Finance 2016

Revenues

Withdrawals from the Petroleum Fund financed 87 per cent of public spending in the period 2007-2015: non-oil revenues have been derived mainly from personal and company income taxes, import duties, final withholding taxes on government contracts and excise duties.

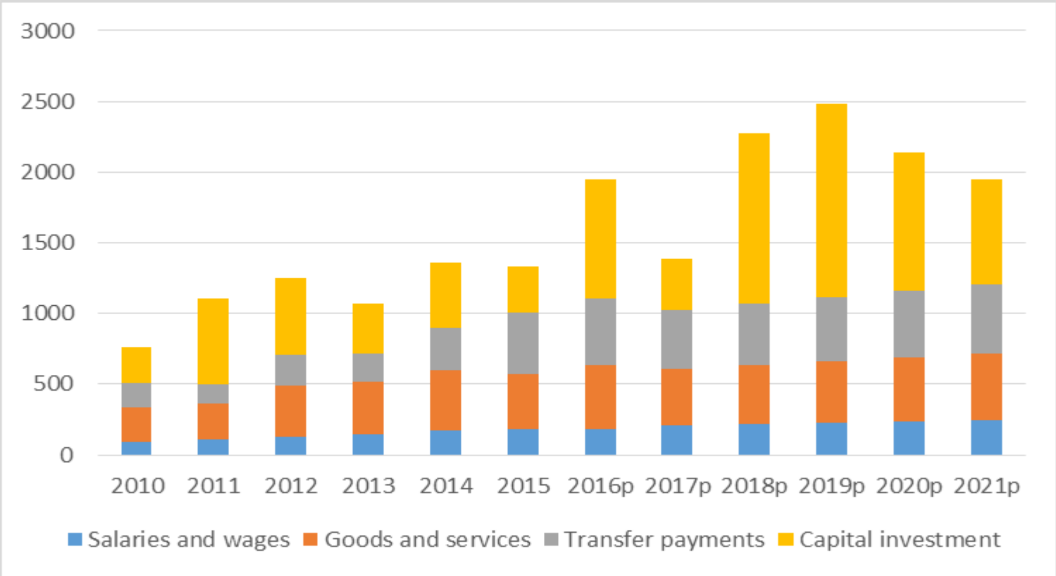
Import duties are low (2.5 per cent across the board, accompanied by a sales tax of 2.5 per cent on the customs value) and there is currently no generalized tax on consumption such as a Value Added tax (VAT)[5]. So non-oil revenues are very much dependent on collection of direct taxes from formal business and wages and salaries. Since so much of the formal business activity that occurs in the country is driven by government spending (especially construction), and most people paying personal income tax work for government or these businesses, a very large share of non-oil government revenues is directly or indirectly driven by oil income, leaving the funding of public spending exceptionally dependent on oil.

Infrastructure expenditures

As Figure 2.3 shows, GoTL has been devoting an unusually large share of its resources to capital investment. Over the 7 years 2010 to 2016, 38 per cent of total appropriated spending was on capital investment: and over the coming five years, GoTL plans to devote around $4.6 billion to capital expenditure, just over 45 per cent of planned spending. Another salient feature is the relatively large allocations to transfers, which account for around 22 per cent of actual and projected spending from 2010 to 2021. These transfers include amounts allocated to the Special Administrative Region in the Oecusse enclave, where significant public-sector investments in infrastructure are planned to establish a Special Zone of Social Market Economy.

[5] Timor-Leste imposes a 5 per cent service tax on hotel, restaurant, bar and telecommunications services

Figure 2.3: Actual and projected government spending, by type, 2010 to 2021



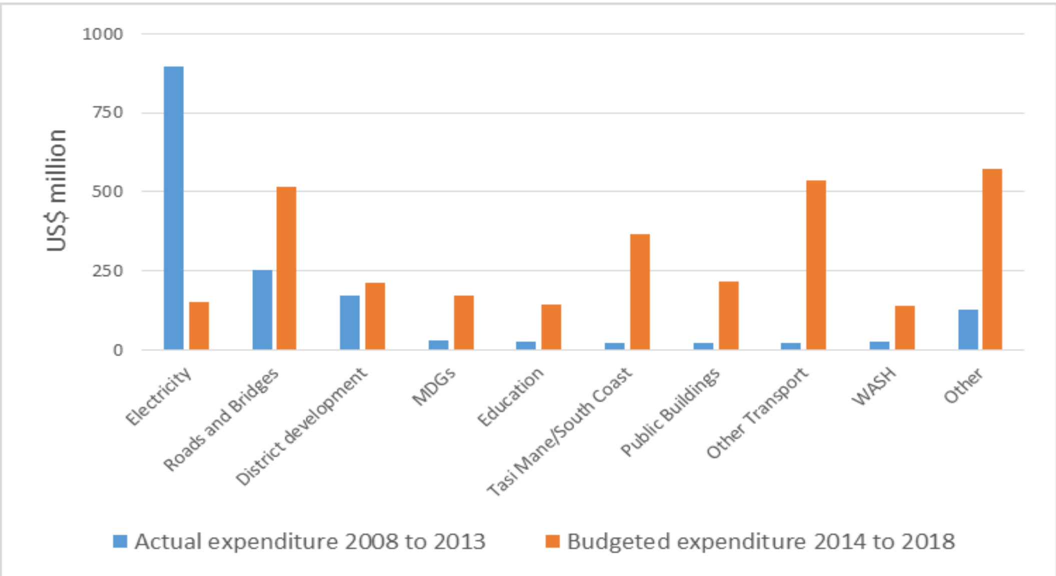
p = projection in 2017 budget papers

Data source: ADB 2016

Investment

According to a World Bank/Ministry of Finance report on investment expenditure, Timor-Leste has one of the highest rates of infrastructure spending in the world (World Bank/Ministry of Finance 2015). In 2016, budgeted capital spending amounted to 57 per cent of non-oil GDP. Until 2013, investments in electricity dominated the infrastructure budget (Figure 2 4): but with the main expenditures on generation completed, emphasis is shifting to other areas, particularly roads and other transport infrastructure and the Tasi Mane South Coast Development programme.

Figure 2.4: Total capital expenditure by programme – actual and planned 2008-2018



Note: MDGs – Millennium Development Goals, mainly Community Housing: WASH – Water, Sanitation and Health

Data source: World Bank/Ministry of Finance 2015

To date, the output performance of spending has been mixed

- The investments in electricity addressed major damage in the pre-independence upheavals, and led to a large increase in generation capacity, and, importantly a large increase in access: by 2014, 45 per cent of the population had access to electricity, compared to 26 per cent in 2001. However, the investments in generation have created considerable excess capacity, and the operational costs of diesel generation are very high – leading to a financial problem for the electricity authority that is exacerbated by the fact that a large number of connections are not metered. (In 2012, the costs of low tariffs (less than cost recovery), unaccounted losses and poor collection amounted to nearly 6 per cent of GDP).
- The past and planned spending on roads does not allocate sufficient funding to operations and maintenance, and is biased towards uneconomical road construction or reconstruction. The World Bank reports that the overall condition of the road network deteriorated over the period 2009 to 2012, despite an increase in road spending from US$23 million to US$89 million over the period (World Bank/Ministry of Finance op cit). The same report argues that if the existing road network is rehabilitated to a maintainable standard, Timor-Leste will have a larger network than the non-oil economy could support – this does not take into account plans for construction of new roads[6].

But the bigger risks may lie in a number of large scale projects

Tasi Mane

- The centrepiece of GoTL's development strategy is a corridor of petroleum and gas related infrastructure on the southwest coast – Tasi Mane. According to La'o Hamatuk (La'o Hamatuk 2016b), the vision is for three industrial clusters:
    - A 'supply base' at Suai, including an airport and industrial estates;
    - A refinery and petroleum complex at Betano; and
    - An LNG plant complex at Beacu.
- Significant spending has already been made on elements of this project: the 2017 budget envisages that GoTL will spend just under US$2 billion by 2021 – but this does not include the LNG and refinery/petrochemical plant
- The Tasi Mane project is predicated on an assumption that the Greater Sunrise gas field will be developed in the near term, and that the gas will be piped onshore for processing. At this point in time, both assumptions are questionable, and even if they were not, it is not clear that the GoTL investment makes good use of what will become increasingly scarce public funds.

Oecusse ZEESM

- Recent legislation has placed the administration of the Oecusse enclave under a Special Authority, and laid the foundation for creation of a Social Market Economy Zone (ZEESM). The Authority receives transfers from the state budget – in 2017, US$172 million was earmarked for spending on infrastructure and other items in the Zone. A situation analysis prepared For GoTL estimated government outlays of US$ 1.5 billion over a 20-year period to build the ZEESM, including power stations, a commercial port, and an airport (ZEESM, 2014)[7].
- A special World Bank study of Oecusse's development and trade potential argued for a much less ambitious development strategy for the enclave, pointing out the inherent disadvantages for becoming a logistics hub, a centre of manufacturing or a minerals processor, and suggesting that a focus on agriculture had the best prospects for increasing local incomes.

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[6] The report also examines investment in irrigation infrastructure – finding that significant effort has been expended to rehabilitate systems that fell into disrepair before independence, but that most government projects have ex ante negative rates of return because of inappropriate technology and disincentives built into current rice policies.

[7] Unfortunately, the budget book that presents information on planned allocations to ZEESM is only available in Tetum, so it has not been possible to explore future spending plans.

Tibar Port

- Last year, GoTL signed a concession contract for construction of a new container port at Tibar Bay, close to Dili. The total costs of the project are not entirely clear, but GoTL has committed to pay the concessionaire US$129 million. There appear to be questions about the economic viability of the port, given other planned port investments in the country (including Oecusse and Tasi Mane).

Ongoing implications of current spending commitments

The front-loading of infrastructure spending brings risks: not only of low social and economic returns from inappropriate project choice, but also from the recurrent costs which will be required to keep investments operational. If GoTL has to implement expenditure retrenchment in the face of declining oil revenues, it may prove contractually difficult –and costly – to terminate or slow down spending on some of the larger projects. And given the centrality of projects such as Tasi Mane to the nation's development strategy, it may be politically difficult to cut spending.

Even if future investment spending is cut, GoTL will face a significant burden in operations and maintenance expenditure to keep the current stock of capital functioning. The World Bank/Ministry of Finance report warns that a culture of 'build, neglect, rebuild' is emerging in the road sector, and budgetary allocations to operations and maintenance expenditure have historically been low.

- Using a rough accounting rule of thumb that maintenance spending should be about 5 per cent of the value of capital stock, and assuming that cumulative capital spending is a plausible estimate of that value, maintenance expenditure in 2017 should have been around US$ 170 million – compared to the actual allocation of US$ 9.6 million, plus $US54.9 million for fuel, operation and maintenance of the two new power plants. If planned infrastructure spending occurs in the future, the maintenance spend would be of the order of US$400 million in 2021, about a third of planned recurrent spending.
- GoTL has also embarked on a programme of borrowing to finance infrastructure, and has plans to borrow more than $1.4 billion over the next five years (La'o Hamatuk, 2106a). Repayment of these loans is estimated to cost around $135 million a year from 2026 onwards (La'o Hamatuk, op cit).

The Government has also committed itself to quite generous politically sensitive welfare payments to veterans. In 2017, the allocation is just over $100 million, around 10 per cent of total recurrent spending, compared to US$60 million for health[8].

These factors will make it even more difficult for Timor-Leste to meet its targets for improved coverage and quality of public services. As the Government's 2014 report on the Millennium Development Goals admitted, despite the rapid increases in overall recurrent spending, none of the eight goals were likely to be achieved by 2015 (Ministry of Finance 2014). To a significant extent, this failure was due to insufficient – and poorly directed – spending on key social services. Redressing these shortcomings will be quite difficult unless more headway can be made in future budgets for better spending on education, water, sanitation and health.

Other risks

There are a number of other sources of fiscal risk that may make it difficult to make an adequate adjustment to a reduced resource envelope.

A large risk lies in the absence of legal and regulatory frameworks to manage SOEs and Autonomous Public Agencies (APAs).

[8] These transfers are much more generous than other forms of social assistance, and provide recipients with incomes considerably larger than prevailing wages (Kent and Wallis, 2014)

- Timor Leste has 5 SOEs and about 50 APAs: until 2016 almost all of these operated as government departments with no financial and managerial autonomy. According to the ADB, SOEs and APAs accounted for over 90 per cent of budgeted public investment and nearly 40 per cent of budgeted recurrent expenditure for the period 2016-2020[9] (ADB, 2016b). This share could increase if responsibility for electricity supply is transferred to an autonomous entity. And these entities were expected to collect over 60 per cent of non-tax revenues in 2016.
- The Government is moving to increase the autonomy of these entities. Without stronger regulation of fees and charges collected by these entities, and better provisions for governance, performance and accountability, there could be serious consequences for service delivery and cost recovery.

Another risk lies on the Government's plans for decentralization.

- The Ministry of State Administration has been working towards territorial de-concentration of public administration, including decentralization of decision making and resource management powers to municipalities and deconcentrating central structures and public services to the municipalities (the establishment of the Oecusse SAR was one part of this process). According to a law passed in 2016, autonomous municipal authorities will be established in the 4 largest municipalities, and non-autonomous administrations in the others (ADB op cit). All will be funded through the national budget, but may be able to retain revenue from provision of specific public functions.
- At the Government's own admission, central agencies are weak in results and performance based governance, and find it difficult to sustain an establishment of suitably qualified, motivated and performing staff (Soares, 2015). It may therefore prove difficult to transfer significant responsibilities to lower levels of government without incurring considerable risks.

Addressing the challenge – current reform initiatives

Parts of GoTL are clearly very aware of the risks that are currently being run, and a number of initiatives are underway to come to grips with the challenges. At the political level, the Government has acted to improve ministerial level coordination of economic, social and state administration affairs by creating the position of coordinating Ministers of State. At the more technocratic level, GoTL is working on revenue and expenditure management reforms, and efforts to increase the professionalism and capability of the civil service.

On the revenue front, GoTL has established a Fiscal Reform Commission under the Minister of Finance. The Commission has worked with other parts of Government and development partners to:

- draft a VAT law, and revisions to tax and customs laws;
- coordinate modernization of customs administration; and
- develop a legal framework for improved management of government business, including State Owned Enterprises and Autonomous Public Agencies, including legal and governance frameworks for fees and charges. As the 2017 Budget papers indicate, this work 'sits at the cross-roads of Tax and Expenditure Reform, as it aims to simultaneously rationalize costs through more efficient service delivery in sectors such as electricity, water and sanitation, as well as to advance towards cost recovery in these sectors' (Ministry of Finance, 2016). (The 2017 budget spells out intentions to roll out meters for electricity consumers and take other steps to reduce the implicit subsidy in the sector).

On the expenditure front, after some rather less than successful and overly ambitious attempts at Public Finance Management Reform, the Office of the Prime Minister and the Ministry of Finance are now working on an agenda that:

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9 This is explained in part by GoTL's decision to convert the Infrastructure Fund, which manages most infrastructure investment, into an APA.

- ‘includes measures geared towards increasing financial controls on public expenditure, eliminating wasteful and superfluous spending, improving the links between planning and budgeting to focus public expenditure on the development objectives outlined in the SDP [Strategic Development Plan], introducing an effective system for jointly monitoring and evaluating both the quantity and quality of Public Expenditure, and increasing the progressivity of public expenditure’ (Ministry of Finance, 2016).

The Government has sought the help of the Organization for Economic Cooperation and Development (OECD) to develop a Roadmap for Budgetary Governance reform

- A key feature of this road map will be to lay out a pathway for adoption of programme based budgeting to better link plans to resource allocation, moving towards medium-term expenditure planning (which, in particular will try to get handle on recurrent cost implications of capital expenditures), and improving overall budgetary governance (including, but not limited to adopting ways to impose fiscal constraints in budgeting processes, and improving procurement.
- Efforts to date have led to adoption of a ‘programme-informed’ input based system, which is being implemented in ten line ministries and five APAs in the 2017 financial year.

These more technocratic reforms are being accompanied by significant efforts to build the capabilities of the state, especially the civil service. Through the Civil Service Commission, efforts are underway to:

- revise the regulatory framework governing recruitment, selection and promotion of staff and to create an appropriate career regime;
- restructure the service, based on a diagnosis of skill and capacity levels;
- improve working culture;
- improve human resource management; and
- reorganise public service agencies with a view to achieving better human resource management (Ministry of Finance, 2106).

Implications for New Zealand

The impending fiscal crisis, and questions about the quality and sustainability of current and projected government spending have important implications for New Zealand.

First, there is a risk, already being foreshadowed, (see Paper 6) that the Government will reduce its commitments to funding in sectors – particularly early childhood education - where New Zealand is providing support. This may require New Zealand to consider re-calibration of programmes to continue to target the overall objectives. It may also generate political risks to the programme (in New Zealand) if cuts in counterpart spending occur while other, less defensible, expenditures are maintained.

Second, other development partners consider that New Zealand’s rather special relationship may put it in a stronger place to engage with the Government in the delicate task of promoting fiscal consolidation. The recent request for New Zealand to help with accrual accounting might provide an entry point for such an engagement, depending perhaps on the upshot of the recent election. At the least this might suggest that MFAT should inform itself about current initiatives in the public finance management area so that it can act if an opportunity arises and an initiative appears to be desirable.

Third, if the Government does not engineer an efficient and equitable ‘soft landing’, the public expenditure ‘glue’ that has helped patch over political differences and avoid outbreaks of social unrest may well be eroded. New Zealand and other partners may need to think about contingency plans to assist Timor-Leste if unrest threatens stability.

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Paper 3: Private Sector Development

By Robert Warner and David Swete Kelly

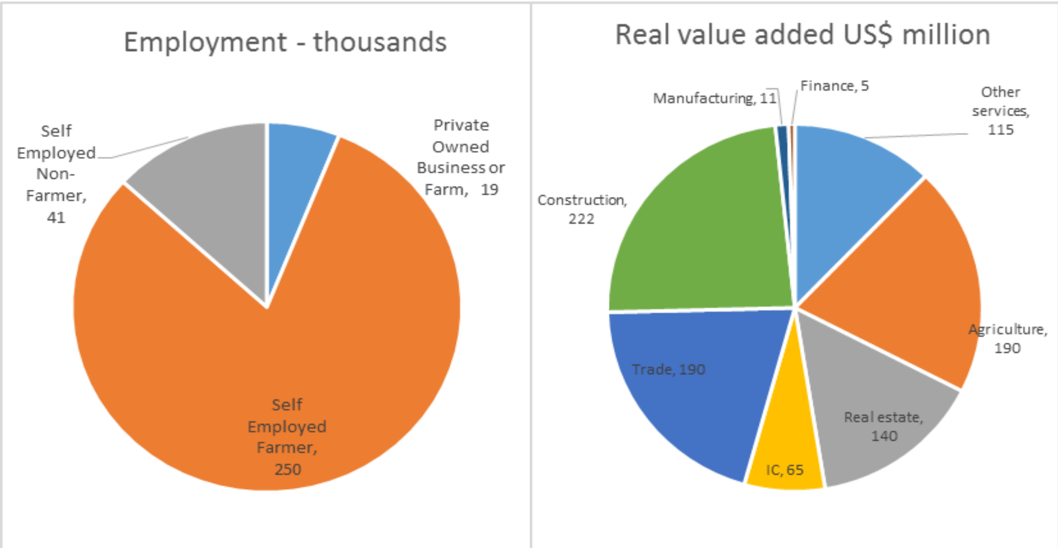
As a newly independent country, Timor-Leste has had to establish all the basic legislative, judicial and executive structures of government in an extremely short period. At the same time its government has tried to move rapidly to address the development aspirations of its people and deal with the legacy of its difficult separation from Indonesia. Understandably, and necessarily, given the fragility of formal and informal institutions in the country, the public sector has taken a major role in this task to date, a role facilitated by Timor-Leste's access to oil revenues. But in the face of an expected decline in oil incomes (see Paper 2), the country needs to create space for the development of private sector initiative to expand income and employment opportunities for its rapidly growing population.

This Paper briefly documents the current status of the private sector, and summarises some of the assessments that have been made of issues that need to be addressed to enable a private sector led diversification of the economy.

The private sector – current status

The majority (around 80 per cent) of people who work in the non-government sector in Timor-Leste are self-employed farmers (Figure 3.1). As discussed in Paper 1, most of these farmers are engaged in quasi-subsistence farming, with coffee the only significant cash crop. The low productivity of the agriculture sector is exemplified by the fact that the 80 per cent of the workforce that works in agriculture creates only 20 per cent of non-government value added (Figure 3.1).

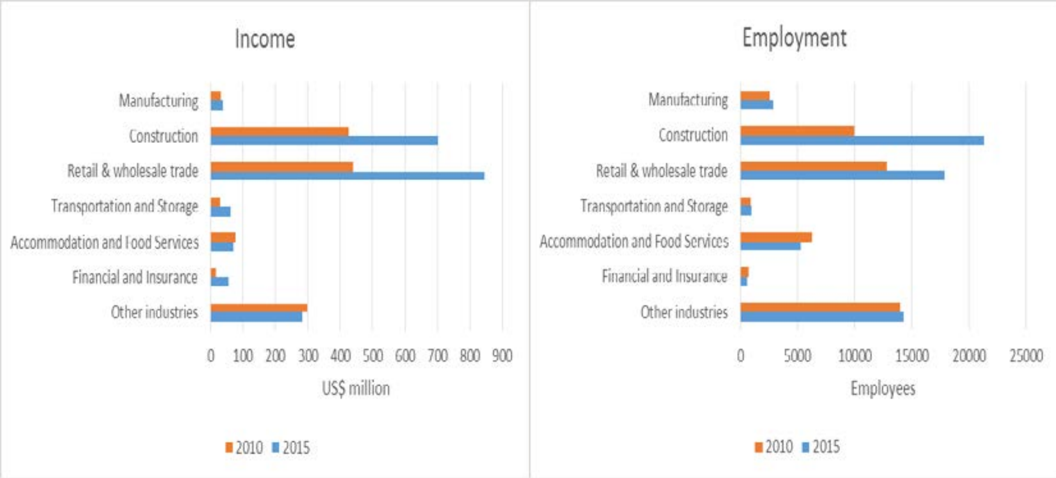
Figure 3.1: Employment and real value added in the non-government sector, 2015



Data source: Ministry of Finance, 2016a, 2016b

The formal market-focused private sector in Timor-Leste is quite small, and is dominated by construction contracting and wholesale and retail trade, sectors that have been growing quite strongly in recent years (Figure 3.2). Activity is heavily concentrated in Dili, which accounts for 95 per cent of business income and 82 per cent of employment.

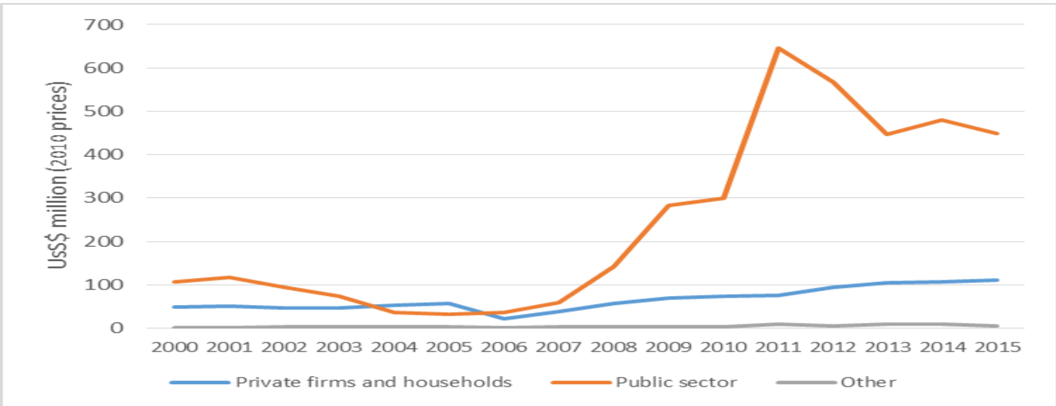
Figure 3.2: Income and employment in the formal private sector, 2010 and 2015



Data source: Ministry of Finance, 2016a

Real private investment has been growing by about 7 per cent per annum since independence, but it has been dwarfed – and to some degree crowded out – by investment by the government and state-owned enterprises (Figure 3.3).

Figure 3.3: Private and public sector investment [a], 2000 to 2015



[a] Real gross fixed capital formation

Data source: Ministry of Finance 2015, 2016a

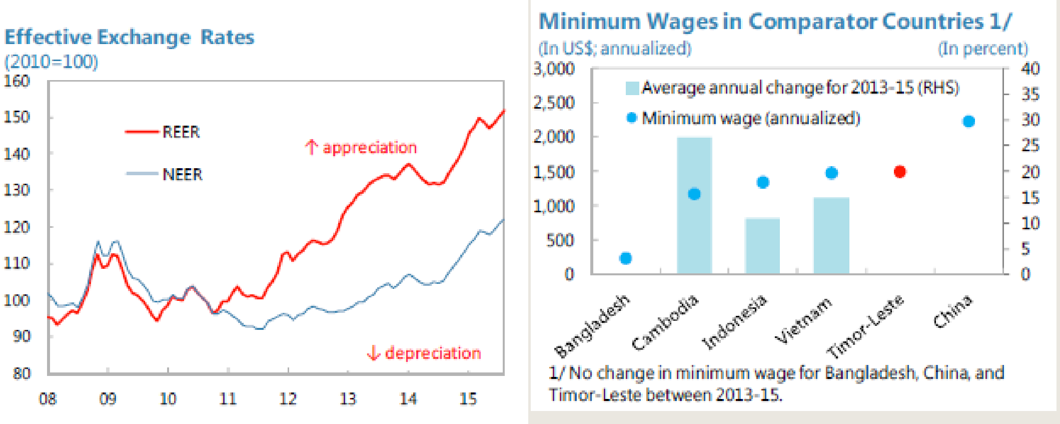
The environment for private sector development

The degree of under-development of the private sector is perhaps not surprising given Timor-Leste's history, but there are several factors, besides the dominant role of the public sector in economic activity, that are holding the private sector back.

Macroeconomic factors

It is important to recognize the impact that government spending on local services has on the competitiveness of exporting and import competing activities in the economy. Because Timor-Leste uses the US dollar, the impact of government spending from its oil revenues tends to be manifested in increase in the costs of local services and factors of production – particularly labour. This can compound the effect on competitiveness of a strengthening of the US dollar against other currencies that has nothing to do with development in the Timorese economy. The IMF's recent Article IV consultation report documents the appreciation of the real effective exchange rate – by approximately 50 per cent since 2010 (Figure 3.4).

Figure 3.4: Indicators of competitiveness



Data source: IMF, 2016

Government policy has also influenced competitiveness through its effects on wage rates. As the Figure 33.4 shows, Timor-Leste's minimum wage is relatively high, although changes in mandated minimum wages in Cambodia, Indonesia and Viet Nam have narrowed the gap. (Timor-Leste's minimum wage level has been estimated to be 91 per cent of per capita GDP, which compares to levels like 44 per cent for Thailand, 54 per cent for Viet Nam, 22 per cent for Malaysia (Wikipedia, 2017).

The impact of minimum wage policy on the competitiveness of exporting and import-competing activities has been compounded by the provision of relatively generous social security payments, particularly pensions for veterans, which have almost certainly raised the reservation wage for unskilled labour (see Paper 2). The daily cash rate for rural labour of US$5 a day is double that in the neighbouring Indonesian province of West Timor (Porter and Requena, 2017)

Legacy issues

Other constraints lie in the historical legacy of the country. These include the poor quality of infrastructure, particularly infrastructure that would enable the rural majority to connect with markets, shortages of all kinds of skills and the low levels of education of much of the population (as Paper 1 points out, nearly a third of all adults are illiterate, and 31 per cent of people aged 15 and more have never been to school).

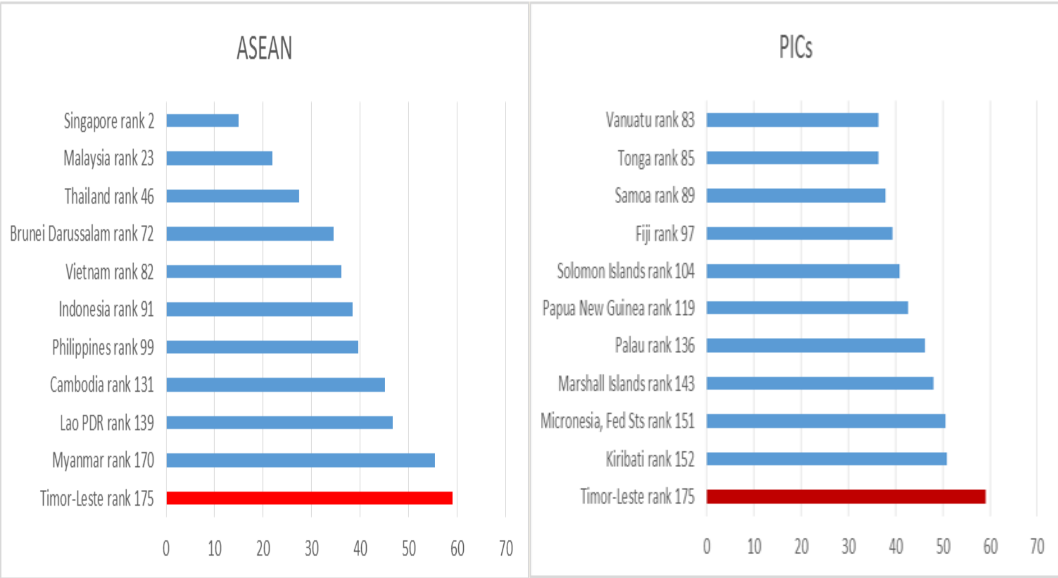
In addition, the negative effect of the country's violent separation from Indonesia and intermittent political conflict work against the development of trust across and within communities. Without trust, the formation of contracts that lie at the heart of business activity is seriously hindered. And if there are high levels of uncertainty, people will be reluctant to invest scarce time and money in adopting new technologies and new ways of doing business. Particularly in rural Timor-Leste, it appears that people are quite logically risk averse, and helping them develop more appetite for, and ways of managing, risk should be an important goal of the state.

Similarly, the formal private sector looks to the state to create the legal, regulatory and judicial underpinnings of market-oriented activity, and to create confidence in the capability of the state to deliver the related functions. To date, the political leadership in Timor-Leste has embraced a rather statist development paradigm. This has led to limited efforts to foster local entrepreneurship, outside of providing preferential access to government contracts. In agriculture, it has also fostered a culture of reliance on government subsidies and discouraged commercial initiatives in areas such as input supply. This approach may also explain the limited appetite for effective government-business dialogue (an issue highlighted in a number of assessment of Timor-Leste's investment climate (see, for example, ADB, 2015).

The legal and regulatory enabling environment

Currently the formal enabling environment for the private sector in Timor-Leste is very weak. Cross-country comparisons of key elements of this environment show that Timor-Leste lags best practice and is some way behind its ASEAN neighbours and Pacific island comparators. The World Bank's Doing Business indicators rank Timor-Leste 175 out of 190 countries, and suggest that the country is further away from the best practice frontier across all measured dimensions[10] than any ASEAN or Pacific island country (Figure 3.5). Difficulties in enforcing contracts, registering property, resolving insolvency and getting credit all loom large in shaping the country's ranking.

Figure 3.5: Doing Business – distance from the frontier



Data source: World Bank, 2017

An important factor contributing to Timor-Leste's low ranking is that the legal system is still being developed. The penal and civil codes that replaced Indonesian laws were promulgated in 2009 and 2011 respectively, and many of the lower level legal instruments to give effect to these codes are still to be put in place. Portuguese is the language of the legal system, which poses challenges for the citizens, civil servants, the legal profession and the judiciary. Further, there remains considerable lack of clarity with respect to which laws are actually operative in the country[11].

A further complication is the challenge of resolving land tenure, which has an important effect on the ability of business to access finance. And more broadly the financial system is quite limited in coverage. The lending environment is high risk, because of constraints on collateralization, enforcing contracts and accessing credit information, and the private sector has limited capacity to develop quality proposals. The payment system is still very cumbersome, and access to financial services more generally is limited.

The ADB's 2015 Private Sector Assessment of Timor-Leste provided a list of areas where action was desirable to improve the policy and regulatory environment for the private sector (ADB, 2015). The list included (but was not limited to):

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[10] The indicators cover processes involved in starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency.

[11] The ADB's Private Sector Development Initiative gives one example – bankruptcy law - where statutes based on the then Indonesian law were utilized during the period of United Nations transitional administration: these statutes have not been officially translated into Portuguese, and it is unclear if they are currently operative.

- introducing land legislation to provide a way to settle land disputes and determine original title, and building the institutional capacity to implement the law (the 2017 budget statement indicates that the government had prepared a new land law before the recent election);
- strengthening contract enforcement, by among other things building the capacity in the judicial system to deal with commercial cases, and introducing alternative dispute resolution methods;
- developing a framework for regulating provision of infrastructure services and promoting competition in the economy, and developing a framework for management of State-Owned Enterprises;
- improving functioning of the financial system, by, inter alia, introducing a secured transactions framework, an effective insolvency and bankruptcy regime, and encouraging financial sector competition (subject to effective licensing criteria and oversight); and
- taking greater steps to encourage foreign investment, by making the investment approval process more transparent, certain and responsive to investors, and addressing aspects of the legal and regulatory system that may deter investors. (This said, a review of the environment for investment in Timor-Leste by the United States Department of State finds limited evidence of discrimination against foreign investors in the legal system (US DOS, 2017).

Human capacity issues

A recent report on private sector development in Timor-Leste highlighted the critical importance of promoting learning and developing human capacity in fostering development in an ‘infant’ economy (Inder and Cornwell, 2016). This issue was also prioritised in the ADB Assessment.

The focus is not just on formal education – even though this is of critical importance given the poor levels of basic literacy and numeracy in the country – but also on fostering a learning culture, and the development of structures that stimulate the sharing of knowledge. Inder and Cornwell argue in favour of:

- Pursuing a top class formal education system at all levels from pre-primary to tertiary – this will require increasing government attention to secondary education, and fostering increased business input into the national training system, so that formal education provides students with skills that will equip them for productive work, as well as addressing the quality of training delivered by training institutions;
- Prioritising skills development within the public service and development partners, since these both provide an excellent environment for developing workplace and other skills that can be used in the private sector;
- Expanding business development services as a means of facilitating information flows, and supporting institutions that help businesses learn from each other;
- Adopting agricultural extension models that focus on localised learning and productivity
- Working on building an entrepreneurial culture and mindset, including addressing cultural obstacles to entrepreneurship.

An important challenge is to reduce constraints to increasing women’s contribution to the formal private sector. The ADB argues that this will involve addressing a range of issues, including high fertility rates, pervasive gender-based violence, educational disadvantage, and gender discrimination in land tenure systems. These are issues that reflect prevailing social norms as much if not more than government policy, but government leadership is important if progress is to be made.

Sectoral issues

Diagnostic work carried out by the government with development partners has identified a set of sectoral issues that will need to be addressed to facilitate diversification and private sector development. These include infrastructure and education, which are domains for direct government action, but also include agriculture and tourism, and perhaps manufacturing, where the focus must be more on putting in place enabling sector policies that complement work on the broader enabling environment.

For infrastructure and education, a key priority is to better focus public expenditures in areas with high social returns – this issue is discussed in more detail in Paper 2.

For agriculture, there is an urgent need to increase farm productivity if the living standards of the 70 per cent of the people living in rural areas are to improve, since job opportunities in other sectors will take time to emerge. There is clear potential to develop a range of agricultural products for the domestic, and in some cases, the export market, but as Paper 1 and Paper 7 have demonstrated, yields of the main cash and food crops are currently very low. There are some successes, with recent work by donors supporting integrated value chains for fresh vegetables resulting in good productivity and returns. While this opportunity is largely focused on peri-urban farmers the uptake is now rapid and has led to a significant replacement of imports. However, it required between 7 and 10 years of dedicated support to help local farmers and businesses develop the skills, systems, networks and vision for the vegetables value chain (USAID, 2013).

The ADB's Private Sector Assessment points to the absence of integrated, locally based strategies to develop agricultural markets and to link farmers to these markets as an underlying reason why productivity has not improved. It identifies obstacles such as: infrastructure deficiencies, limited access to productive inputs, uncertain land tenure, limited financial literacy and access to credit in farming households, lack of local storage facilities, absence of traders and wholesalers to bring together farmers and final consumers, and strong risk aversion and cultural preference for social rather than economic investment.

The situation calls for integrated, value chain approaches and programmes such as the US AVANSA and Australia's TOMAK. Past government programmes aimed at increasing food crop production – especially rice –have not proved successful, due in part to promotion of inefficient irrigation technologies and conflicting policies towards subsidisation of food consumption. Government based extension services have been neither well-funded nor well-targeted, and it would make much more sense to focus attention on alternative, market driven, ways of providing information services to farmers and a more diverse range of inputs.

As outlined in Paper 9, Tourism provides an important opportunity to create income earning opportunities in Timor-Leste, but realizing the potential requires a more nuanced approach than the government has adopted to date, recognising the need for effective partnerships between the public and private sectors. International connections to Timor-Leste are limited and expensive, road transportation services are poor, and the development of accommodation and activity services outside of Dili is in its earliest stages. Tourism development is also constrained by the lack of skills and understanding of what kind of services international tourists expect.

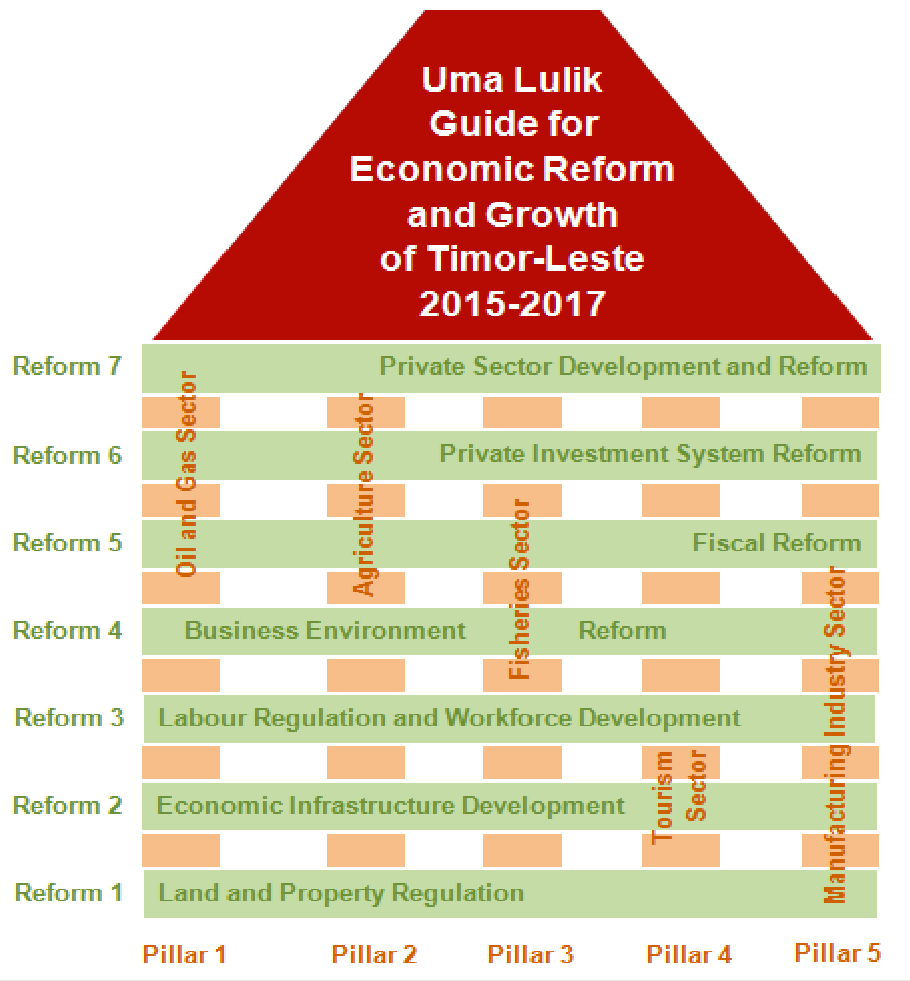
Through New Zealand's support, the Ministry of Tourism has now produced a Tourism Policy, which is an important starting point, but this needs to be accompanied by development of an action plan that recognizes the limits on what direct government provision can achieve, and addresses some of the enabling environment issues that constrain foreign investment in the sector.

Current initiatives

The Government has recognized the importance of economic reform to stimulate job creation. The Office of the Minister of State, Coordinating Minister of Economic Affairs (MECAE) has been working its 'Uma Lulik' programme for economic reform and growth since 2015 (Figure 3.6). The programme envisages reforms in land and property regulation, development of economic infrastructure, labour regulation and workforce development, business environment reform, fiscal reform, private investment system and development (Ministry of Finance, 2016c).

To date, as a result of the work on the reforms, the following laws have been approved by the Council of Ministers: a Private Investment Law, a Law of Commercial Companies, a Law of Certificates of Origin, and an Export Promotion Law.

Figure 3.6: Uma Lulik Guide for Economic Reform and Growth



Data source: Ministry of Finance 2016c

In agriculture, MECAE has in conjunction with Ministry of Agriculture and Fisheries developed sectoral investment plans in the coffee sector and forestry sector. In tourism, MECAE worked with the Ministry of Tourism on the Tourism Policy. In the manufacturing sector, MECAE is developing an Industrial Policy in conjunction with the Ministry of Commerce, Industry and the Environment. MECAE is also working to reform the business environment by improving the operation of the Services for Registration and Verification of Entrepreneurs (SERVE) which manages business registration processes business, and reforming government's approach to investment promotion and facilitation and drafting policies and laws on competition, bankruptcy and insolvency and a commercial code.

The government has also recently (2015) established a Legislative Reform and Justice Sector Commission which is charged with recommending law reform, evaluating how laws are being implemented, and harmonizing legislation. The commission is expected to review and improve the legal instruments ensuring protection of rights, liberties and guarantees, as well as access to the law.

Implications for New Zealand

Facilitating development of a private sector that is not dependent on oil-funded government spending is a major priority for Timor-Leste. But as this Paper has tried to demonstrate, making progress on this priority through top-down reform requires working across a large spectrum of policy, institutional and infrastructural issues. New Zealand (and New Zealand Inc) may from time to time find nimble, niche interventions to assist with the work, but it is not positioned to make a significant, long term bilateral commitment to address critical issues. However, ongoing New Zealand support for the ADB's Private Sector Development Initiative is warranted given its constructive support on the enabling environment.

However, waiting for all these changes to eventuate is not feasible and the private sector must identify ways of working that are functional despite the constraints. New Zealand's key role is in working with the private sector and farming households directly to improve value chain function within the current environment. These initiatives must leverage off the solid on the ground support to value chain function, by supporting sector advocacy with relevant line agencies to increase their focus on enabling systems and policies, and significantly reduce Government's predilection for direct market interventions.

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Paper 4: International Integration

By Robert Warner

The Government of Timor-Leste (GoTL) has initiated the processes of becoming a member of the Association of South East Asian Nations (ASEAN) and the World Trade Organization (WTO)[12]. This annex examines some of the implications of membership of these two organizations, and what the process of accession might mean for legal and institutional development in the country.

Membership of both organizations, especially ASEAN, has important political and strategic implications: but this annex focuses on the likely effects on economic policies and the institutions that deliver these policies, as well as the possible direct effects on the economy. These effects depend to a certain degree on the current nature of Timor-Leste's engagement with the international economy, its policies towards international trade and investment, and how accession to the two organizations may bring about change. The next section provides a quick survey of the current situation, providing context for the discussion of WTO and ASEAN accession, and the following sections summarize what accession to each organization might imply, and possible implications for New Zealand.

Timor-Leste's external policies and interaction with the regional and global economy

Trade and investment

By most objective standards, Timor-Leste is an open economy[13]. It has a low (2.5 per cent), uniform tariff on imports, no quantitative barriers to trade in goods, and applies no restrictions or taxes on exported goods (World Bank, 2011). Timor-Leste appears to have few formal barriers to foreign investment (although some investment incentives discriminate between domestic and foreign investors, and a limited number of activities are closed to foreign investment[14]).

Despite the relative absence of formal constraints to international trade and investment, Timor-Leste is not an easy place for foreigners (or locals, for that matter) to do business, reflecting the fragmented and incomplete condition of the legal and institutional underpinnings of commercial activity, and the limited capacity in most institutions of state. Timor-Leste is ranked 175 out of 190 countries in the World Bank's Doing Business indicator series, although in areas related to trade, it rates better than some current members of ASEAN. (As Figure 4.1 shows, Timor-Leste is closer to the 'best-practice' frontier for indicators of trading across borders than Indonesia, Myanmar, Lao PDR and Brunei Darussalam.)

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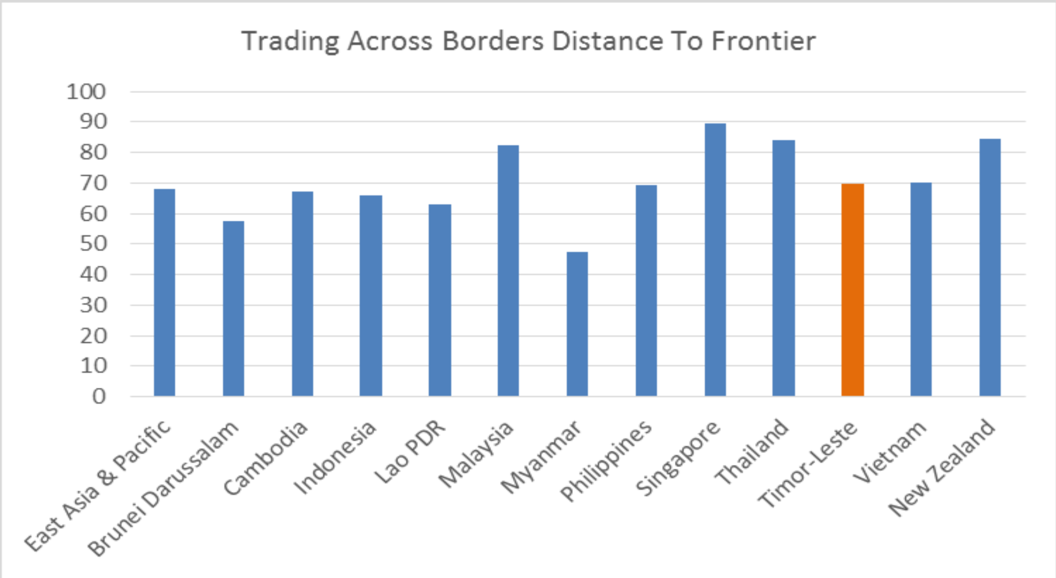
[12] GoTL formally applied for membership of ASEAN in March 2011, and for the WTO in April 2014. A Working Party for Timor-Leste's accession to the WTO was established in December 2016.

[13] The 2010 Diagnostic Trade Integration Study for Timor-Leste, prepared for the Integrated Framework, argued that Timor-Leste has one of the most liberal trade policy regimes in the world. (World Bank, 2011)

[14] These include land transport and some tourism-related activities. The Parliament of Timor-Leste approved a new Private Investment Law in April 2017, which was intended to bring national legislation into line with the legislation of ASEAN member countries – it may have removed these discriminations.

Figure 4.1: **Doing Business rating of trading across borders** [a]

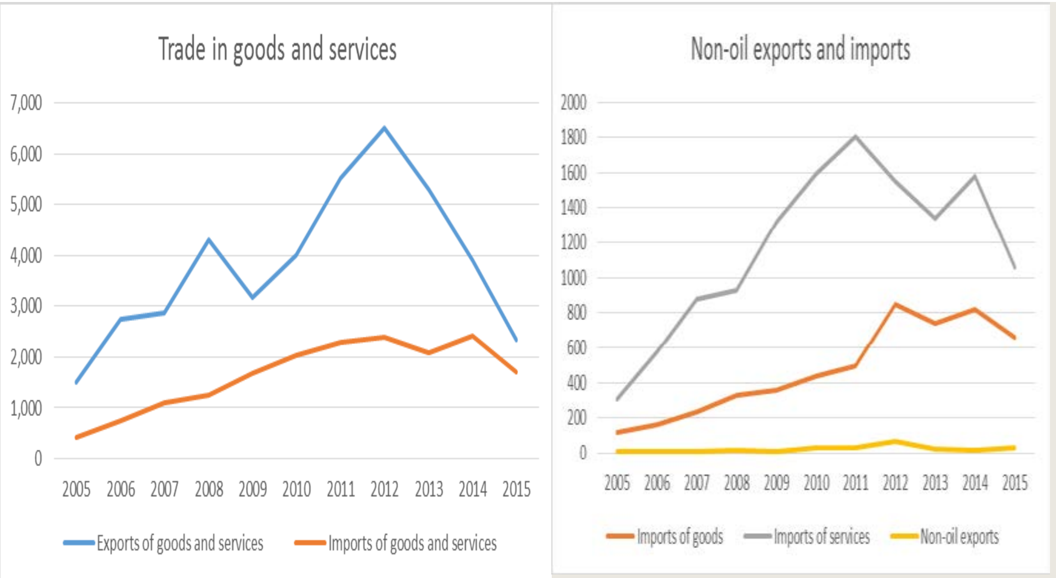


[a] The distance to frontier measures how close countries are to international best practice, aggregated across a collection of measures related the cost and time taken to process exports and imports.

Data source: World Bank 2017

In the recent past, Timor-Leste's oil income has facilitated a significant reliance on imported goods and services, although as Figure 4.2 shows, the value of imports has been slowing. [15] This appears to be a result, in part, of a decline in imports of services, which are mainly related to construction, maintenance and repairs and government services (Figure 4.3). (As Figure 4.3 shows, Timor-Leste's goods imports are dominated by fuel, machinery and vehicles).

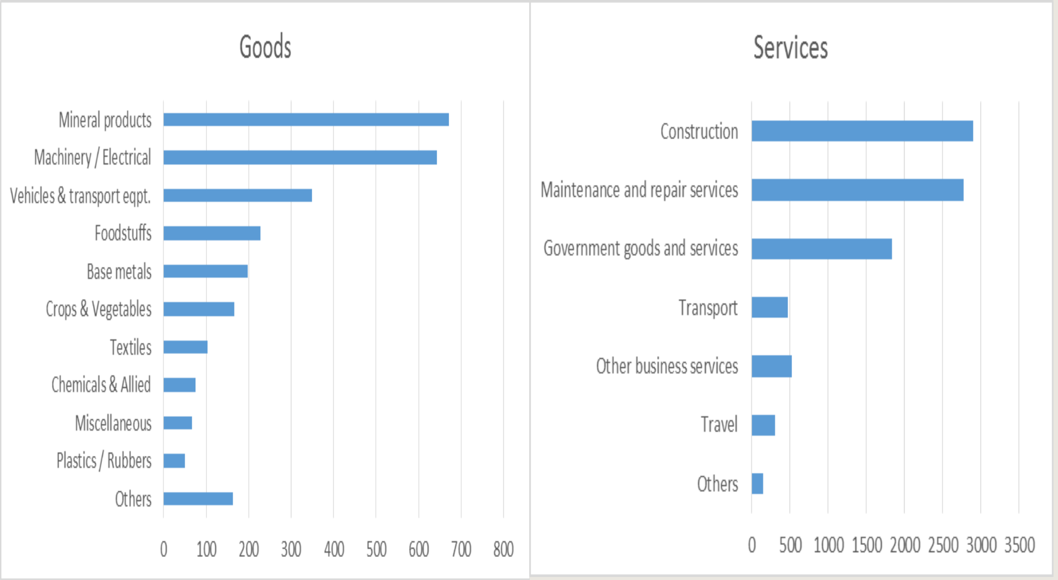
Figure 4.2: **Timor-Leste's trade in goods and services (US$ million)**



Data source: Ministry of Finance 2015, 2016a

[15] It is important to note that while the national accounts records Timor-Leste's export of oil and gas, the revenue from these exports, which come from an offshore area shared with Australia, accrue as an income stream that pass into the Petroleum Fund. Thus, there is not an immediate economic link between oil exports and capacity to import. As discussed in Annex 3, withdrawals from the Fund, which finance government imports of goods and services, have not tracked closely the trajectory of export income.

Figure 4.3: **Composition of imports 2010-2015 (US$ million)**



Data source: Ministry of Finance 2015, 2016a

Indonesia is the main source of Timor-Leste's imported goods (Table 4.4), and in 2015, ASEAN countries supplied 65 per cent of the country's imports. Non-oil exports, primarily of coffee, appear to go mainly to the United States and Germany[16]. As the table shows, Timor-Leste's trade with New Zealand is a very small part of its overall trade. (According to the New Zealand Ministry of Foreign Affairs and Trade, New Zealand's exports to Timor-Leste amounted to $NZ 2.7 million in 2016, comprising mainly meat, motor vehicles and cheese: imports from Timor-Leste amounted to $NZ 0.3 million, with the top commodities being coffee, motor vehicles and woven fabrics (MFAT, 2017)).

Table 4.4: **Direction of trade 2015**

Non-oil exports		***Imports***	
Country of destination	***Value ($'000)***	***Country of Origin***	***Value ($'000)***
United States of America	5,150	Indonesia	146,445
Germany	2,295	Singapore	97,104
Belgium	669	China, Peoples Republic of	53,151
Japan	529	Hong Kong	33,835
Australia	534	Malaysia	25,909
Canada	302	Viet Nam	31,734
Portugal	376	Finland	22,495
Indonesia	209	Australia	15,138
Korea Republic of	245	Thailand	11,986
Taiwan	166	Portugal	7,462
Spain	96	Brazil	7,768
New Zealand	160	Korea Republic of	6,962
Georgia	109	Japan	6,932

16 Although Timor-Leste's trade publications suggest the bulk of the country' coffee exports are exported to the United States, data on US imports do not seem to bear this out. This may be because a large share of Timor-Leste's coffee is purchased by an American company, but may be shipped to other countries

Hong Kong	53	Taiwan	6,098
Singapore	95	United States of America	4,207
Others	85	Others	14044
Total Exports	**11,073**	**Total Imports**	**491,270**
Memo item			
New Zealand share of total (per cent)	**1.4**		**0.2**

Note: The balance of payments for Timor-Leste treat oil revenues as an income flow, rather than a trade flow
Source: Ministry of Finance, 2016b

There does not appear to be any readily available data on the country of origin of foreign investment into Timor-Leste. (An undistributed ADB analysis of approved investments with expected employment over 100 people between 2006-2013 showed that approved investments came from Australia, Spain, Vietnam, Papua New Guinea, India, Indonesia and the Philippines. Most were investments in the service sector.)

Currently, most of Timor-Leste's non-oil exports enter into their destination markets duty free, in part because they are eligible for preferences that many countries accord to Least Developed Countries (Table 4.5).

Table 4.5: **Duties faced by Timor-Leste's exports**

Major market	*Year*	*Imports from Timor-Leste*	*Simple MFN average of traded tariff lines*	*Weighted MFN average of traded tariff lines*	*Weighted margin of preference*	*Tariff lines which were duty free*
		US$ million	*Per cent*	*Per cent*	*Percentage points*	*Per cent*
Agricultural products						
1.European Union	2014	16	5.5	0.0	0.0	100.0
2.Canada	2014	3	2.6	0.0	0.0	100.0
3.Australia	2014	1	0.0	0.0	0.0	100.0
4.Japan	2014	1	5.8	0.0	0.0	100.0
5.Korea, Republic of	2014	1	6.0	2.0	2.0	100.0
Non-agricultural products						
1.Korea, Republic of	2014	87	3.1	3.0	1.1	87.5
2.Japan	2014	18	0.9	0.0	0.0	100.0
3.Singapore	2014	1	0.0	0.0	0.0	100.0
4.Australia	2014	1	20.4	0.6	0.6	100.0
5.Zimbabwe	2014	1	0.0	0.0	0.0	100.0

Source: WTO, 2017a

International organizations

Timor-Leste is increasing its interactions with organizations and arrangements that foster integration or economic cooperation. Timor-Leste has been a member of the Community of Portuguese Language Countries (CPLP) since just after independence, and has observer status at the WTO and ASEAN. It also interacts with a number of Pacific regional bodies that are pursuing different kinds of economic cooperation and integration. It is, for example, a development partner of the Pacific Islands

Development Forum and the Melanesian Spearhead Group, as well as being Special Observer of the Pacific Island Forum, and is seeking membership of the Secretariat of the Pacific Community. At the bilateral level, in addition to the treaty arrangements determining the sharing with Australia of revenues from the Joint Petroleum Development Area, Timor-Leste participates in the Seasonal Worker Program, which offers the possibility of sending people to undertake seasonal work in Australia's agriculture, accommodation and tourism sectors[17].

WTO accession

The process of accession to the WTO is complex, time-consuming[18] and places heavy demands on the capacity of government institutions, not least with respect to inter-agency coordination across a wide range of issues that are the responsibility of separate government ministries. It is therefore important for Governments that embark on the accession process to have a clear idea of what they may gain from membership, what costs may be encountered, and hence how rapidly they should push through the accession process.

The process

The process of accession has three substantive phases. These involve:

- preparation of a Memorandum on the Foreign Trade Regime describing in detail policies and institutions that have a bearing on the conduct of international trade (Timor-Leste has already submitted a first version of its Memorandum);
- the members' fact-finding phase; and
- the negotiation phase, when existing members seek market access commitments from the aspiring member.

In the last two phases, the applicant is faced with meeting the requirements and provisions of the WTO agreements and demands from its existing members. A Working Party, established after the country has presented a formal request for accession, negotiates the conditions of entry with the applicant. These conditions set out the policy, legal and structural changes needed to comply with WTO rules, along with timelines for implementation. At the same time, the country has bilateral negotiations with WTO members, which lead to commitments that are automatically applicable to all other members. These processes lead to a draft accession package adopted by the Working Party, which is sent for approval to the General Council of the WTO. Upon approval, it is up to the applicant government to notify its acceptance of the terms of accession.

Benefits

The literature on the WTO argues that there are three main benefits from WTO membership for developing countries:

- improvements in the ease and security of market access to major export markets[19];
- strengthening of domestic policies and institutions for the conduct of international trade in both goods and services which is needed before accession into the WTO can be accomplished (it is often argued that because the policies and institutions are embedded in formal agreements, membership has a strong 'signalling' effect with respect to a countries commitment to maintaining WTO-sanctioned policy and institutional regimes); and

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[17] Between 2012-12 and 2015-16, Timor-Leste sent 487 workers to Australia under the Program.

[18] The fastest accession was that of Kyrgyzstan, which took just 3 years, but in the countries that have acceded in the period 2007 to now, the average time taken was 14 years.

[19] The WTO argues that WTO membership is cost-effective, since it means that countries do not have to negotiate rules to govern trade bilaterally – the accession process enable a country to reach agreement with all members on a single set of rules (WTO, 2017b)

- access to a dispute settlement mechanism for trade issues (Michalopoulos, 2001).

For new states, or those that have been subject to periods of embargo and exclusion from international fora, membership of one of the largest grouping of states is also seen as an important symbol of recognition.

Market access

The market access benefits for Timor-Leste are in the immediate term likely to be very limited. Generally, these benefits arise because membership means that all other WTO members will grant permanent and unconditional Most Favoured Nation status. However, most major trading countries currently grant Timor-Leste preferential treatment under their systems of trade preferences for Least Developed Counties. Therefore, MFN status will not lead to more favourable treatment of Timor-Leste's exports as long as it remains eligible for preferences.

Policies and institutions

For many developing countries, one of the more useful consequences of WTO accession is having to introduce 'the laws and institutions for the operation of private enterprises and markets free from government controls other than those explicitly provided under WTO regulations regarding for example, standards, sanitary and phytosanitary provisions intellectual property rights and state trading practices' (Michaloupolos, op cit).

Because the various agreements that members accede to when joining the WTO are legally binding, membership is also likely to lead to greater stability in commercial policy, and offer greater certainty to potential investors and trade partners with regard to the openness of the trade and investment regime. The agreements thus allow governments to 'lock-in' the gains from an open trade and investment regime.

Some commentators argue that a downside of this situation is that acceding members reduce their 'room to manoeuvre' with respect to strategies to foster development of local industries, including the use of strategies that existing members used in the past. For Timor-Leste, the more important question is whether the policy and institutional development required to accede to the WTO is consistent with its needs and priorities at this stage in its development (see below).

Dispute settlement

Access to an impartial and binding dispute settlement mechanism whose decisions have a significant chance of being enforced is argued to be an important potential benefit for small trade-dependent economies (Michalopoulos, op cit). (This said, there are questions about the philosophy underlying the WTO dispute resolution process, not least that it is only open to governments, not firms, to mount cases, and, perhaps more importantly, because the remedies it typically allows are trade harming rather than trade enhancing.)

Access to the WTO dispute settlement process is unlikely to provide significant benefits in the short term to Timor-Leste, given the nature of its current engagement with international markets.

Costs

For a small, open, new and fragile state such as Timor-Leste, the costs of membership lie mainly in the way in which scarce managerial and intellectual skills may be diverted from working on other issues with higher social and economic returns. Moving to implement the various WTO agreements will require establishing institutions that would otherwise be accorded a much lower priority because of their limited contribution to addressing immediate development objectives.

The agreements that new WTO members accede to fall into six main categories: an umbrella agreement, agreements on trade in goods, services and intellectual property, dispute settlement and reviews of trade policies (Figure 4.6). Within these 6 categories, however, there are some 60 agreements, annexes, decisions and understandings. For trade in goods, for examples, there are annexes covering: agriculture, sanitary and phytosanitary matters, product standards, investment measures, anti-dumping measures, customs valuation, pre-shipment inspection, rules of origin, import

In a nutshell

The basic structure of the WTO agreements: how the six main areas fit together — the umbrella WTO Agreement, goods, services, intellectual property, disputes and trade policy reviews.

Umbrella	**AGREEMENT ESTABLISHING WTO**		
	Goods	Services	Intellectual property
Basic principles	**GATT**	**GATS**	**TRIPS**
Additional details	Other goods agreements and annexes	Services annexes	
Market access commitments	Countries' schedules of commitments	Countries' schedules of commitments (and MFN exemptions)	
Dispute settlement	**DISPUTE SETTLEMENT**		
Transparency	**TRADE POLICY REVIEWS**		

licensing, subsidies and counter measures, and safeguards.

Figure 4.6: The WTO agreements

Source: WTO 2015

Because of its relatively open trade and investment regime, Timor-Leste will probably not have much problem complying with key WTO principles such as granting MFN and national treatment to other WTO members, limiting the use of non-tariff barriers and binding low tariff duties. Where it will encounter more challenges is with respect to those agreements where Timor-Leste currently has no or limited laws and un-developed mechanisms for their enforcement. It may also encounter challenges with respect to those agreements that deal with the treatment of state-owned businesses, since Timor-Leste currently has a very poorly developed framework for management of state run commercial activities.

WTO members may also look closely at Timor-Leste's land laws, to ensure national treatment of foreign investors. Timor-Leste will also have to develop a WTO-compliant legal regime for the management and recognition of intellectual property rights. While WTO accession may allow special and differential treatment for developing economies with respect to market access commitments, little leeway is given with respect to implementing some of the more institutionally demanding agreements.

Meeting the obligations of membership can be very costly to low income countries. A study which examined how developing countries have addressed the challenge of implementing certain obligations of membership of WTO (namely the GATT customs valuation agreement, the Agreement on Sanitary and Phytosanitary Matters (SPS) and the Agreement on Trade Related aspects of Intellectual Property (TRIPS) made the following observations:

- Implementation of these agreements involves considerable investments in human and physical capital: these could cost more than the annual development budget in some low-income countries.

- The content of the obligations imposed by the WTO take very little cognisance of the circumstances and reform needs of developing countries.
- In many developing countries, there can be little domestic ownership of the reforms, reflecting in part the limited capacity many low-income countries have for full participation in WTO negotiations (Finger and Schuler 1999).

Support for accession

Recognising the daunting task that accession poses for developing economies, the WTO and multilateral development partners have put in place mechanisms to provide technical assistance, through the Enhanced Integrated Framework for Trade Related Assistance for the Least Developed Countries (EIF). Timor-Leste has already benefitted from assistance from the EIF, with the conduct of the Diagnostic Trade Integration Study of 2010. Some bilateral partners are already providing support with policy and institutional reforms which will assist implementation of WTO agreements (for example, USAID has recently announced a programme of support for the Customs Authority (IBI, 2017). In addition, support that agencies such as the Asian Development Bank are giving to assist with accession to ASEAN will have important spill-over benefits for Timor-Leste's efforts to join the WTO.

ASEAN Accession

Joining ASEAN should be a less complex process for Timor-Leste: but there is less clarity about what accession - and the process of acceding - actually entails. ASEAN has changed significantly since the last time a new member joined the organisation (Cambodia in 1999). In particular, with the commitment to create the ASEAN Community, and in particular the ASEAN Economic Community (AEC)[20]. ASEAN moved to a significant deepening of economic integration, and to expect stronger commitments from members.

The ASEAN Charter adopted in 2007 specifies four conditions for membership:

- location in Southeast Asia;
- recognition by all ASEAN Member States;
- agreement to be bound by and to abide by the ASEAN Charter; and
- ability to carry out the obligations of membership.

There is an understanding that at this point in time, the fourth condition means that new members will have to accede to 64 substantive legal agreements, and make necessary changes to domestic legislation to ensure consistency (ADB 2016). But, in contrast with the WTO, there is no specified process through which compliance is agreed or assessed, and it is not clear what pre-conditions will be placed on accession once a leader-level agreement to accept Timor-Leste's application has been reached.

The most important agreements, in terms of implications for policy and potential economic impact, are the:

- ASEAN Trade in Goods Agreement (ATIGA);
- ASEAN Framework Agreement on Services (AFAS);
- ASEAN Comprehensive Investment Agreement (ACIA); and

The AEC also has members working to develop a common approach on some other areas of policy, such as competition and consumer protection policy and, but as yet this has not led to binding

[20] The ASEAN Community comprises three distinct elements: The ASEAN Security Community, the ASEAN Economic Community and the ASEAN Socio-Cultural Community.

agreements. Similarly, while the ASEAN Blueprint indicated that there would also be a binding agreement on intellectual property rights (the ASEAN Framework for Intellectual Property Rights Cooperation AFAIPRC), this agreement has no mechanism for enforcement, so will have few immediate implications for a new member.

In addition to these 'within-ASEAN' agreements, new members will also have to address the trade agreements that ASEAN has signed with major trading partners – namely China, Japan, Australia, New Zealand, the Republic of Korea and India. At the moment, the 10 current members of ASEAN and the parties to these separate agreements are negotiating a Regional Comprehensive Economic Partnership to standardise commitments under a single framework. Timor-Leste may conceivably move directly to joining these negotiations rather than negotiating accession to the existing agreements – but this is currently not clear.

Trade in Goods

Because Timor-Leste already has very low tariffs on imports (and may be in a position to eliminate them altogether if it proceeds with introduction of a VAT), the requirement in ATIGA to remove tariffs on imports from ASEAN will have very little economic impact on import-competing activities in the country (of which there are very few). The agreement would, of course, mean that Timor-Leste would not be able to increase duties on ASEAN imports in the future. Accession to ATIGA may have implications for customs procedures, and Timor-Leste would be expected to move towards adopting the ASEAN Single Window and GATT Customs Valuation Code. (In the 2017 Budget, the Government of Timor-Leste signalled its commitment to amend the Custom's Procedures Code and link to the ASEAN Single Window (Ministry of Finance, 2016c).) ATIGA also has elements that are very close to the WTO SPS and Technical Barriers to Trade Agreements – implementation will require legal and institutional development to ensure that ASEAN members accept Timor-Leste's processes.

Services and investment

The AEC envisages that ASEAN will become a single market and production base, which would imply removing barriers to trade in services as well as goods. Under the ASEAN Framework Agreement on Services, members have been negotiating successive rounds of liberalisation of services trade (primarily to grant MFN and national treatment to service suppliers from other members), usually on a sectoral basis. The progress under the approach embedded in AFAS has been criticised as too slow (World Bank, 2015). (Members have committed to signing a more dynamic agreement - the ASEAN Trade in Services Agreement - but have not yet completed the necessary negotiations.) Because of Timor-Leste's current policy stance, accession to AFAS or ATISA may not involve significant changes, other than, as with goods, committing not to introduce barriers.

ASEAN's agreement on investment calls for national treatment of ASEAN investors, and will require some changes in Timor-Leste's discriminatory investment incentives. These may have already been made in a revision to the Private Investment Law that is foreshadowed in the 2017 Budget papers (Ministry of Finance, 2016c).

Support for accession

The Asian Development Bank has committed to supporting ASEAN accession in its Country Programme Strategy, and support that may be given with respect to WTO accession will have spill-over benefits for the preparation to join the Association. It is very likely that the ASEAN Secretariat will be able to provide support, drawing in resources provided by some dialogue partners. Presumably, if and when Timor-Leste accedes to AANZFTA, it will be eligible for assistance under the development cooperation programme attached to the agreement. Partners such as New Zealand may also be prepared to offer support – English language training is one obvious area for consideration, given that English is the official language of ASEAN, and that New Zealand is already working in this area. But care will have to be taken not to 'get ahead' of ASEAN in the accession process.

Conclusion

Joining the WTO and becoming a member of ASEAN are now firm objective of the Government of Timor-Leste. In the short run, accession to these organisations is likely to have limited economic impact: Timor-Leste is already an open economy, so increased completion from foreign suppliers is unlikely to require significant adjustment, and the nascent state of the country's private sector suggests that it will be some time before firms can take advantage of any increased market access for exports.

The bigger impacts of accession will come from the legislative and institutional reform and development that compliance with each organisation's agreements will require. In many ways, these requirements are consistent with each other and mutually supportive. But preparing to implement agreements will require an extensive process of legislative review and development, a process which is more complicated because of Timor-Leste's adoption of a civil code, rather than a common law, legal system.

Implications for New Zealand

The economic implications of Timor-Leste's accession to the WTO and ASEAN will probably be very small. But New Zealand may have important strategic interests in Timor-Leste's membership of these organisations. This is because of New Zealand's strong interest in supporting the expansion of multilateral and regional trade architectures. But it also stems from the implications of having a 'friendly' country in a political and economic community that is central to New Zealand's strategic interests.

New Zealand may well wish to provide assistance to Timor-Leste in the process of accession to both organisations. Assistance could be in the form of mentoring and facilitation (New Zealand may well wish to be a member of the Working Party for Timor-Leste's WTO accession, for example), or in the form of technical assistance with policy reform and institutional development associated with acceding to the various agreements of both organisations.

Timor-Leste is in many ways an 'infant economy', with a limited history of private entrepreneurial initiative, poorly functioning and poorly coordinated market systems and a lack of instruments for managing risk. Most of its people still operate in a quasi-subsistence low technology system, with little specialisation and limited access to markets that might provide a stimulus to increase productivity and experiment with innovation. And education levels are low. Adopting the approaches inherent in WTO and ASEAN agreements may create a more favourable legal and regulatory environment for foreign investors. Given Timor-Leste's inherent lack of competitiveness, this may not generate much of an immediate response. More importantly, it may not do much to stimulate local private activity either. New Zealand should be conscious of the need to help the Government and the people create the conditions in which local private initiative can develop, and to approach WTO and ASEAN accession with a realistic appreciation that it will need to be complemented, and perhaps preceded, by work on other issues.

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