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Comparing Experiences with State Building in Asia and Europe: The Cases of East Timor, Bosnia and Kosovo

BUILDING EAST TIMOR'S ECONOMY

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Introduction

Peace and reconstruction on the eve of the new millennium are dramatically altering the physical and economic landscape of East Timor and have the potential to bring many tangible benefits to its people. Building a viable economy is an essential part of peace and state building in independent East Timor.

Like other nations emerging from a trauma, such as Bosnia and Herzegovina (World Bank, 1996), East Timor has experienced its first stage of peace and the beginnings of political, economic, and social recovery. However, the reconstruction program needs to be accelerated and extended throughout the country if it is to meet the aspiration of its citizens. Institutional and policy foundations must be firmly and swiftly laid to prepare East Timor for sustainable recovery and growth, so as to enable the country to rely increasingly on its own to design and implement the policies required, and institutions for long-term development. An essential ingredient to provide that firm foundation is effective macroeconomic management to encourage trade and investment and foster the private sector.

As East Timor begins to move towards a self-functioning economy, attention has been focused on the issue of how to properly manage the flow of aid, encourage growth in production, promoting exports, and ultimately boost consumption and social welfare. The new country's development efforts will have to start from scratch with scant domestic resources (Da Costa, 1999). It provides the potential for the future government to commit to market-based economic growth, that is to a development strategy that allows full exploitation of the country's comparative advantage in agriculture, fishing, oil and natural gas, and tourism activities (Saldanha and da Costa, 1999).

Recognizing the daunting task of rebuilding the East Timor economy in the post conflict era, due to the decline in economic activities in recent times, reliance on foreign aid, aid management, appropriate trade and investment policies pose formidable challenge for East Timor's policy makers in the future. One of the most important tasks is to transform

appropriate institutional arrangements and bureaucratic structures. The core strategies proposed by Larcombe (1999) include developing an overall economic program for government, establishing a new currency and capital works, redirecting resources to give greater emphasis to meeting basic social needs. To that end, it is imperative to establish an integrated institutional and policy framework for managing monetary policy, collecting taxes and controlling expenditures, regulating trade and investment, and coordinating aid.

Economic Development in the Past

The civil war in the 1970s had severely damaged East Timor's already fragile economy. Agricultural output fell sharply in the mid-1970s. East Timor's incorporation into Indonesia following the civil war was followed by large transfers of resources, but these transfers did not bring about greater economic viability to that new province. East Timor became highly dependent on Jakarta. There were questions whether this was Jakarta's strategy to keep the province under its fold. However, this was not only East Timor's fate. Under the highly centralized structure, other provinces in Indonesia were equally made increasingly dependent on the center.

Following a period of rehabilitation, consolidation and stabilization under Jakarta's rule, the economy of East Timor began to grow at respectable rates since the early 1980s. From 1983 to 1990, real GDP grew by an average of 7.8 percent per annum (Saldanha, 1994). In the 1990s, up to 1996, East Timor's economy experienced growth of about 10 percent per annum. East Timor was not spared from the effects of the Asian crisis. Real GDP slowed down to 4 percent in 1997 and experienced negative growth of minus 2 percent in 1998.

Under Indonesian rule, the economy underwent a major structural change. The contribution of agriculture to regional GDP steadily declining from about 60 percent in 1981 to 42 percent in 1986, 37 percent in 1990, and 25.5 percent in 1998. However, about 75 percent of the population continued to live in the rural sector and drew their livelihood from agricultural activities. In fact, a similar trend could be observed in the rest of Indonesia.

Economic activity rapidly increased in three sectors: (a) construction; (b) trade, hotel and restaurants; and (c) transportation and communication. The construction sector reached a peak in 1984 with a contribution of about 22 to regional GDP. Manufacturing and mining activities remained small. The government was very important for the economy, accounting for more than 20 percent of regional GDP throughout the period under Indonesian rule for more than two decades. However, the growth of the economy that was driven by the above economic activities did not benefit the local, "indigenous" population as they did benefit the non-Timorese, the migrants (*pendatang*) that dominated trade and other services, the civil servants from outside the region that occupied the higher echelons in government, and building contractors from outside the province.

For security reasons, that province was officially declared close until about the late

1980s. However, this did not prevent the inflows of migrants and other workers that were either related to or were paying bribes to local civilian and military officials. When the province was declared open, the influx of migrants, mostly from the eastern parts of Indonesia, increased rapidly. Unemployment among East Timorese increased, especially among the educated youth (Soesastro, 1994). Unemployment statistics in East Timor and the rest of Indonesia are suspect, but estimates suggest that in 1998, open unemployment was about 6 percent and underemployment about 11 percent.

The need to develop East Timor's economic viability was recognized in the late 1980s. The transfer of resources from Jakarta of about \$100 million annually was found to be unsustainable. Through these large transfers Jakarta also failed to win the hearts of the people. They desire a just treatment and participation in the affairs of the region, including in the development of the economy. Economic viability was to be achieved through economic integration of the province into the national economy (of Indonesia), and the promulgation of strategic development plans to overcome major bottlenecks and enhance the region's comparative advantage (Soesastro, 1991). Such a focus could be built on the development of potential areas such as cash crops, livestock, and tourism. This would have to be complemented by improving inter-island shipping networks, by extending the physical infrastructure, and by continuing large investments in carefully devised programs of education and health.

As the security situation remained dangerous there was no way that the province could develop its tourism. Private investors were also discouraged. The opening up of the economy in the late 1980s was argued on the basis of making the region attractive to private investment, including foreign direct investments (Soesastro, 1988). No foreign investors ever entered the province, and until mid-1999 only 10 domestic investment projects were registered with the Board of Investment (BKPM). The 1991 Santa Cruz massacre was a turning point in the province's development. Indonesia's incorporation of East Timor rapidly lost supports from within the region itself. The security situation became more unbearable. There were increasing calls for granting autonomy status (Saldanha, 1994) or for providing some "special treatment" (Soesastro, 1995) to East Timor. While these issues were being debated upon, East Timor's economy became even more dependent on transfers from Jakarta and on the public sector, led by the local government that by the late 1990s had become very corrupt.

By 1996, per capita GDP in East Timor was \$ 431, less than half of Indonesia's average (\$1,153). An estimated 30 percent of households, about twice that in Indonesia as a whole, were living below the poverty line. Life expectancy averaged 52 years, compared with the Indonesian national average of 61.5 years. Infant mortality was as high as 149 per 1,000, a rate that was amongst the worst in the world. However, the socio-economic conditions of East Timor were not significantly worse than those in the province of East Nusa Tenggara, which includes West Timor. East Timor may turn out to be luckier than East Nusa Tenggara because of its off-shore resources (Timor Gap). However, building a viable economy cannot rest simply on the exploitation of those resources.

The Destruction of September 1999

The outbreak of violence led by the militia began on the night of 30 August 1999 after the closing of polling stations. The destruction that followed the announcement of the results of the ballot was almost total. It cut across all sectors of the economy and throughout the territory, and it affected both physical infrastructure and “soft infrastructure”. About 75 percent of administrative buildings and 80 percent of social infrastructure (schools and clinics) were completely or partially destroyed. Perhaps more than half of the population were relocated, in large part by force. Some 300,000 persons were estimated to be internally displaced and more than 200,000 went to West Timor.

The markets collapsed, and shortage of transportation aggravated the situation. Agricultural production was disrupted and a large proportion of livestock was lost. Only the coffee sector remained intact. All power generators, except in Dili and Bacau, were damaged or destroyed. Before the disturbance total generating capacity was about 40 megawatts. Most of the 12,000 telephone lines were damaged. The modern sector of the economy, almost exclusively run by non-Timorese, also collapsed. Real GDP was estimated to have declined in 1999 by 38 percent (IMF, 2000) or even by as much as 40 to 45 percent (Joint Assessment Mission, 1999). Prices of goods increased by 200 percent and those of manufactures increased by more than 500 percent from August to October 1999.

Most critical, however, was the disappearance of the administrative structures of the government, as most high echelon officials have fled the territory. Government archives were lost, and the institutional memory was gone. Budgetary transfers from Jakarta ceased in early September 1999. No new structure can be created without the ability to make payments, including wages and salaries. Nothing was left of the central bank regional office, and banks have been looted and destroyed. All transactions shifted to a cash basis of payments. The total size of the civil service in East Timor as a province of Indonesia was around 28,000. Of this, about 10,000 were accountable to the central government, and about 25 percent of the total were non-Timorese, that filled top echelons in both vertical and provincial administration. The departure of judges, prosecutors, and court clerks created a serious void in the legal system. Likewise, the departure of police personnel left behind only one senior police officer.

The health system completely broke down due to the departure of all senior health staff, including 130 of the 160 doctors, and the complete loss of all equipment and drugs. During the Indonesian administration the total health sector work force was about 5,000, distributed among 67 sub-district centers and 309 fixed satellite sub-centers. The situation in the education sector was equally distressed. Approximately 95 percent of schools and other educational institutions were destroyed. The provincial administration lost 70 to 80 percent of senior administrative staff and secondary teachers. About 90 percent of teachers at the secondary level were non-Timorese, whereas 75 percent of teachers at the primary level were Timorese.

On 20 September 1999 the first multinational force (INTERFET) arrived in East Timor to restore peace and security. On 29 September donors, UN agencies and representatives from East Timor met in Washington, DC to support World Bank’s role in donor coordination and endorsed a proposed Joint Assessment Mission (JAM) to East Timor. JAM, accompanied by an IMF mission, visited East Timor in October/November 1999. It identified priority reconstruction objectives and provided estimates of external financing

needs. It also adopted a comprehensive development framework approach, covering 8 sectors. The donors meeting in Washington agreed about the need for an early deployment of the mission based on lessons drawn from other post-conflict countries, where lack of coordination between relief and development planning had delayed the transition from emergency relief to more sustainable support.

East Timorese organizations and communities also did mobilize quickly to reconstruct their territory. CNRT, the Catholic Church and local NGOs were active in distributing humanitarian aid and were organizing local reconstruction committees.

On 9 December of that year, the World Bank Board of Executive Directors established a Trust Fund for East Timor (TFET) to assist East Timor during the transition to independence. On 17 December an International Donors' Conference was held in Tokyo. They pledged a total of about \$523 million for 3 years to rebuild East Timor, in addition to \$700 million a year reserved for UNTAET to be provided from the UN assessed contribution budget. The donors supported the coordinated approach to the rebuilding of East Timor, and endorsed the establishment of TFET under the trusteeship of the World Bank, to complement the UNTAET trust fund, the Consolidated Fund for East Timor (CFET) for recurrent expenditure, equipping the civil service and capacity building. It was also agreed that TFET priorities will be determined every six months by key East Timor counterparts. This was initially undertaken by CNRT technical groups and the National Consultative Council (NCC). Later, this function was taken over by ETTA, the East Timor Transitional Administration, established by UNTAET and CNRT in June 2000.

In a Memorandum to the Executive Directors of 3 November 2000, World Bank's President, James Wolfensohn, made the following assessment: "The state of affairs in East Timor is similar to that in some other post-conflict situations in which the World Bank has conducted rapid assistance programs, such as West Bank/Gaza, Bosnia/Herzegovina, Kosovo and Rwanda. Some lessons learnt from these operations are applicable to East Timor, but there are also substantive differences. In a positive sense, East Timor does not face internal conflict and the political leadership is relatively unified on crucial economic and reconstruction issues. The degree of destruction of basic infrastructure was however much greater, the institutions of the state suffered total collapse, and a strong cadre of East Timorese public sector managers are not yet in place. Security remains a long-term concern. UNTAET has a key role to play in building East Timorese institutions and effecting a transition of authority to the East Timorese." (World Bank, 2000).

THE 20-POINT ACHIVEMENTS OF UNTAET :

A Critical Assessment

East Timor's endeavor to rehabilitate and reconstruct the economy has been supported by generous external financial assistance from the broad international community. This assistance has taken the form of grants and donations to avoid the creation of external liabilities for the future independent country. The country is experiencing an on-going revival of economic activity, led by growth in construction, commerce and trade, and

basic services. This observed recovery is led by agriculture, commerce, basic services and reconstruction of public and residential buildings.

Following the announcement of the World Bank's \$US523 million aid package, UNTAET began its mission in January 2000 with considerable optimism. INTERFET had restored security to virtually all parts of the territory and had facilitated humanitarian relief operations. Most Timorese were persuaded to return from their mountain havens to what was left of their towns and villages. UNTAET's task, as set out in the UN Security Council Resolution 1272, went well beyond the restoration of security. Getting this complex operation under way has not been easy and allegations of a sluggish performance have frequently been made by Timorese and foreign observers alike, a performance, compared unfavourably to the achievements of INTERFET, an inappropriate comparison.

UNTAET is entrusted with the task of rebuilding the structure of governance including a public administration capable of providing basic services. Despite immense difficulties in the first half of 2000, much has been accomplished through UNTAET's emerging governance and administration structures from the start up phase. With the stabilization of the humanitarian and security situation in East Timor, a more urgent task in this newly emerging country is to establish a small, competent and transparent government from the beginning. UNTAET is slowly establishing the foundations for the major reconstruction and development program.

As stated earlier, in the first donors' coordinating meeting in Tokyo, the donor countries pledged around US\$ 523 million in grant funding for a three-year reconstruction effort (2000-02). The fund comprises US\$ 157 million in support of humanitarian programs, and US\$ 366 million in support of governance and administration, capacity building and reconstruction in East Timor to ensure its smooth transition to future independence (World Bank, 1999a). This is by far the largest contribution of aid inflows to East Timor. Despite numerous obstacles, donors have managed to achieve modest disbursement levels and have successfully established aid institutions for channeling assistance to enhance the speed and responsiveness of operations. To date, the largest pledges have mainly come from five countries: Japan (US\$129 million), the US (\$98 million), Portugal (\$91 million), European Union (\$68 million), and Australia (\$44 million). A list of donors assistance by pledges is presented in Table 2. The summary of budget allocation by sector over the last two years is presented in Table 3. Not surprisingly, the greatest lag between commitments and disbursements was in the infrastructure category, while disbursements for capacity building and technical assistance have been more in line with commitments. A set of targets for the delivery of donor assistance was presented in the Canberra donor conference in June 2001. The CFET projected at US\$65 million has since been approved by the donors. A modest, fiscally responsible and sustainable medium term consolidated budget is expected to cover the needs for the recurrent and capital costs in East Timor.

The more recent Donors' Conference on East Timor in Oslo, focused on a number of issues namely East Timor's independence on May 20; the recently launched national

development planning process; and the medium term fiscal strategy. East Timor's Minister of Finance outlined the future government's broad macroeconomic policy objectives of achieving fiscal self-sufficiency by 2006, increasing savings and developing non-oil and gas sectors, and investing oil and gas revenues for the benefit of future generations. Poverty alleviation and the diversification of the economy were also mentioned as key elements of the fledgling nation's development plan.

The East Timor Public Administration (ETPA) presented a three-year budget with a cumulative external financing need of \$154 million to \$184 million. The future oil revenue stream is likely to begin in 2005/2006. Based on the latest oil revenue projections, which are significantly higher than those available at the last donors' meeting in Canberra, the three-year budget framework reflects a sustainable fiscal path over a longer time horizon. The ETPA, supported by the IMF, defines the fiscal strategy as sustainable in the sense that expenditures would be fully covered by domestic revenues, interest earnings on oil savings, and a manageable level of concessional borrowing. This assessment depends on the implementation of sound policies needed to generate a stable macroeconomic environment and a high rate of growth of the non-oil economy.

Although the guiding principles structuring the medium term fiscal framework were generally supported, donors and representatives of the ETPA agreed on the need to keep under review the assumptions underpinning revenue and expenditure projections. Prospects for a rapid recovery are hampered by impediments to private investment, including the lack of skilled labor, infrastructure, legislation for property rights and secure land tenure, and a legal and regulatory framework for business.

It was just over 24 months ago that the UN arrived to Timor to set up what is regarded as the UN's most ambitious operation of its kind, a mix of peacekeeping, national rehabilitation and nation-building. In the minds of the Timorese leaders, at least, the lead-up time to independence has been reduced, so that this century's newest independent state could well be proclaimed on 20 May 2002.

Has UNTAET passed the test in meeting these challenges? Despite some worrying shortcomings, which are largely to do with the limitations placed on the UN by its member states, it is acknowledged that the UN has demonstrated a dedication to East Timor's rehabilitation, and great skills in dealing with the impatient Timorese leaders, with numerous NGO complaints.

Many of these criticisms have been justified, especially in relation to district administration, unemployment and the setting up of Timor's justice system. But they do need to be considered against the realities of the UN's role in such situations. Missions are hastily put together and the selection process is faulty. Given that such operations are short term, developing a unified approach among a disparate group of officials is very difficult. The role of this unique UN mission has understandably developed slowly. As Vieira de Mello, the UN Secretary General Special Representative pointed out, its magnitude was not fully appreciated at first. Not only were East Timor's towns and villages in ruins: the hasty departure of thousands of Indonesians, who virtually ran the

local government, the education system, the justice system and the provinces commercial life, left the country devoid of an infrastructure. A hasty assemblage of officials and experts from more than fifty countries had to start at ground zero. Other setbacks were encountered, such as congestion in the port of Dili, which has a limited capacity, especially when INTERFET was moving out its considerable quantity of heavy equipment.

The massive task of material reconstruction is at last under way, and an ambitious program of political and administrative reform, which means giving the Timorese their plates, has been implemented. This latter program should set the scene for the rapid development of East Timor's political system. The 20-point of UNTAET key achievements is outlined in Table 1. Despite sluggish beginnings, it can be said that the new nation of East Timor is slowly beginning to take shape.

Table 1. The 20-point Key Achievements of UNTAET

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1. The establishment of peace and security in East Timor.
 2. The addressing of humanitarian needs by UNHCR, IOM, WFP and UNICEF, which were all instrumental, together with UNTAET, in ensuring that humanitarian needs were met quickly after the violence of 1999. Over 190,000 refugees, one-quarter of the population, have since returned to East Timor.
 3. The holding of free, fair and completely peaceful elections on 30 August 2001 that resulted in an 88-member Constituent Assembly now in the process of writing East Timor's first Constitution .
 4. The creation of the Second Transitional Government and appointment of the fully Timorese Council of Ministers now running much of the day-to-day activities of the Government. The Council, appointed on 20 September 2001, replaced the Transitional Cabinet created in July 2000 (which consisted of four East Timorese members and four UNTAET representatives).
 5. The establishment of a Timorese-led national programme of civic education which by the end of July 2001 had trained over 5,500 community leaders and directly involved over 100,000 East Timorese.
 6. The holding of 200 Constitutional Public Hearings in June and July at which 38,000 East Timorese turned out to air their views on what should be considered by the Constituent Assembly when drafting the first Constitution.
 7. The registration of 737,811 people, virtually the entire population currently living in East Timor (excluding the refugees in West Timor), over a three-month period. This data formed the basis for the electoral rolls for the Constituent Assembly elections.
 8. The creation of the East Timor Defence Force, with 600 soldiers having undergone basic training; and the establishment of the East Timor Police Service, with more than 1,300 East Timorese Police Officers deployed in all 13 district.
 9. The establishment of a Civil Service. To date, 9,633 East Timorese civil servants have been recruited.
 10. The establishment of a functioning judicial and legal system, including an East Timorese Prosecutor General's Office and a Defender Service; 3 District Courts; a Court of Appeals, and prisons in Dili, Baucau and Ermera.
 11. The basic rehabilitation of schools throughout the country. More than 700 primary schools,

- 100 junior secondary schools, 40 pre-schools and 10 technical colleges are now teaching approximately 240,000 children and older students.
12. The reconstruction of 32 major public buildings by the East Timor Transitional Administration. Seven major buildings are currently under reconstruction, two in the capital Dili and five in Baucau, Ermera, Liquiça and Oecussi districts.
 13. The initialization of an agreement with Australia on oil and gas reserves, the Timor Sea Arrangement; commencing in 2004, this has the potential to provide East Timor with billions in revenue over the following 20 years.
 14. The creation of Radio UNTAET, whose coverage extends to all of East Timor and some refugee camps in West Timor; TVTL, whose broadcasts are seen in Dili and Baucau with highlights shown at public gatherings in other districts, and Tais Timor, the only national news bulletin, with a monthly circulation of 50,000.
 15. Basic public services have been put in place in a wide range of areas including health, education and infrastructure. Electricity has been re-established and clear water is being provided in urban areas following the widespread destruction in 1999.
 16. The initiation of a major road rehabilitation programme, focusing on the repair and maintenance of a 1,000-kilometer core road network neglected for more than two decades. The Dili Port is busy with shipping. The Dili international airport was reopened for commercial flights in early 2000. Now under civilian administration, it handles international flights by five carriers.
 17. The early formation of a Central Fiscal Authority, the precursor to the current Ministry of Finance, to ensure that East Timor's limited resources are used effectively, and that the country has a stable fiscal framework for a sustainable economy.
 18. The collection of more than US\$38 million in taxes and other revenues. The establishment of a Central Payments Office that functions as the proto-Central Bank. This institution has developed and manages correspondent banking facilities with foreign and central commercial banks, and manages the government payroll.
 19. The establishment of a Small Enterprises Project to help restart viable economic activities in the private sector. This has helped create an entrepreneurial class while generating employment in urban areas.
 20. The rehabilitation of two thirds of the arable land; the restoration of livestock by importing and vaccinating cattle and buffalo; and the provision of nets and boats to small fishing enterprises to tap the rich potential of East Timor's waters. The above developments were achieved with the active assistance of donor countries, World Bank, UN Agencies, NGO's and other partners.

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Sources : Compilation from various sources, UNTAET (2001), World Bank (2001), East Timor Update (August 2001)

The reconstruction process, however, has a long way to go. Dili's central business area is still in ruins, its redevelopment being hampered by, among other things, ownership disputes often involving property acquired illegally by Indonesian military commanders. While major reconstruction projects are still few the general housing situation has greatly improved, especially in Dili where most dwellings have at least been temporarily repaired. Most power stations and other utilities are again in operation. The position of the Timorese has also substantially improved, particularly from the point of view of security, food supply and health. If anything the medical situation is now being monitored more comprehensively than ever before, thanks to the work of the numerous

NGO humanitarian missions and specialized UN agencies.

Private reconstruction activity and hence investment is expected to be more intense in the first year due to housing reconstruction. This high transitional level of investment is expected to be supported by grant assistance from abroad. East Timorese domestic savings will be negative for the next years before gradually recovering to their traditional level of about 20 percent of GDP that prevailed in 1995-1997. Given the severe domestic supply constraints many goods and materials used in the reconstruction process must be sourced abroad. The external accounts are therefore likely to register large deficits in fiscal year 2000-1 and fiscal year 2001-2 as imports are projected to rise sharply, reflecting the high import content of capital projects (UNTAET and World Bank, 2000a). Once again, this deficit would be financed by capital grants from abroad and foreign investment. A summary of estimates by sector (eight sectors) is presented in Table 4. A key feature of the development of the budget is the establishment of a framework in which resource allocation decisions are made against clear outputs targets and policy objectives.

Despite substantial pledges, low disbursement to the UNTAET Trust Fund has caused serious problems that are constraining expenditure. Key among these has been the government procurement capacity as well as regulations, as distinct from classic UN peacekeeping operations. Furthermore, with no substantive national development planning apparatus, or indeed no agreed consolidated budget in these early stages of reconstruction and development, it would have been unwise to forge ahead with rapid disbursement while clear priorities for Trust Fund expenditure were not in place. The slow disbursement is largely explained by two main factors. The first is the “pipeline effect” of the phase-in of programs. This reflects the planning phase of agencies, with recent intensive program implementation. The second factor is that while urgent expenses were being met from other international agencies, additional delays were due to unforeseen difficulties in the first half of 2000 in the procurement of certain goods and services. Nevertheless, problems of funds flow mechanisms are being overcome.

Indeed, East Timor is receiving generous support from donor countries to finance its reconstruction program and a large part of recurrent expenditure during the transition. This support will not continue indefinitely, and future government services will need to be financed from domestic resources. It is therefore imperative for UNTAET that investment funds are used wisely during the transitional period, and do not create burdensome recurrent obligations for the future independent state. However, it is unlikely that the donor community will show the same willingness to provide long-term financial support. Aid fatigue (Raffer and Singer, 1996) may eventually come into play. It is likely that the need for such support will also be lower as East Timor further consolidates its revenue collection effort. It is clear that to generate sustained future increases in income, the tax base must be strengthened and broadened, and investment must rise.

As East Timor is moving fast along the path towards full independence in May 2002, major efforts should be aimed at integrating political, administrative and socio-economic plans so as to achieve a smooth transition to independence. These efforts should have a maturing impact on the Timorese political leaders, who will become directly engage in

the responsibilities of government. It will also remind UN officials of the transitory nature of their presence in East Timor. However, it may also further increase pressures on UNTAET and the international presence generally, in relation to development strategies and priorities.

Critical Economic and Social Issues

a. Economic Outlook

The state of East Timor's economy is now characterized by an artificial economy that is not sustainable. The capital, Dili, appears to be bustling, but most restaurants, hotels, vehicles and apartment rentals are part of a bubble economy fed by the huge foreign presence. The official currency, the US dollar, has displaced its major rivals, the Indonesian rupiah and Australian dollar, but not without controversy and no small profiteering at the changeover, when many traders simply rewrote prices from \$A to \$US, effectively doubling them at a stroke. However, the real problem is outside the capital, where most people are living on less than \$US1 a day. Unemployment is rampant, about 80 percent, hospitals and clinics nearly non-existent and illiteracy common.

The reconstruction period needs to maintain priority activities in order to meet basic needs (food, shelter, water, health, education) as well as in order to maintain the conditions of political stability, personal security, reconciliation and economic recovery. The problem is one of fostering economic development with underdeveloped essential ingredients: capital, skilled labor, technical know-how, institutional infrastructure and policy direction. The limited size of the domestic market precludes economies of scale. Crucial choices have, therefore, to be made on the scale, timing and phasing of investments in support of economic development. Enhancing the country's capacity to absorb investment and aid flows for efficient use in promising ventures would be a crucial issue.

Economic growth is forecast to stall in 2002 and 2003 after two years of rapid growth in the wake of the devastation of 1999. While some parts of the economy will continue to grow, other parts will contract with the winding down of the international presence. The nett-effect is likely to be little change in the overall level of economic activity in the next two years relative to 2001. Following this pause, a resumption of economic growth is forecast for subsequent years, though at more moderate and sustainable levels than those of 2000 and 2001. It is expected that the single most important influence on the East Timorese economy in the next year will be the planned reduction in expenditure from the assessed contributions budget as the UNTAET mandate ends. Most of the assessed contribution budget is spent outside East Timor and does not affect the level of economic activity here. However, about \$100 million will be spent in East Timor during 2001-2002. This includes the direct expenditure of UNTAET on goods and services, and the personal expenditure of international staff.

Of that \$100 million, about half is spent on items that are supplied locally and contributes to economic activity and incomes in East Timor, while the rest is spent

on imported items. This puts the direct effect of the assessed contribution budget at about 10 to 15 per cent of East Timor's non-petroleum GDP of about \$400 million. There is also an indirect effect of this expenditure. Most of the income earned locally is subsequently spent by the recipients. This, in turn, boosts the incomes of other East Timorese.

Spending from the assessed contribution budget has made a significant contribution to the rise in incomes in East Timor since late 1999. Correspondingly, the projected fall in this spending will inevitably reduce incomes in East Timor during the next year. Spending through the assessed contributions budget in East Timor could fall to around \$60 million during 2002-03. That would lead to a direct reduction in incomes of about \$20 million (and a similar reduction in imports). This represents about 5 per cent of non-oil GDP. Once again, the direct reduction in spending would have an additional indirect effect.

The reduction in spending through the assessed contributions budget, while significant, will not be the only factor affecting economic activity in 2002. Expenditure from the CFET budget is projected to rise from about \$65 million in 2001-02 to about \$80 million in 2002-2003, subject to any changes by the Council of Ministers. This will help offset the reduction in spending from the assessed contributions budget.

The World Bank (2001) reports that TFET expenditure is expected to be broadly unchanged in 2002-03, thus neither adding nor detracting from economic growth in that year. However the completion of almost all TFET activities by the end of FY2003-04 will adversely affect economic growth in 2005. Expenditure by bilateral and multilateral donors is difficult to forecast because it depends upon future decisions by donors. Nevertheless, some fall from relatively high levels of expenditure is expected after independence. This would also lead to a modest detraction from economic activity.

The impact of these changes will be uneven, with parts of the East Timor economy likely to be relatively unaffected. For example, almost all agricultural production is determined by factors unrelated to the international presence. Coffee production has considerable potential for growth, though the industry is currently suffering from low world prices. Animal husbandry and non-cereal production also have potential for further growth. Other rural industries will be buoyed by the projected increases in agricultural incomes. Employment generated by TFET projects will expand further, with labour demand totaling close to 2.8 million person days, equivalent to keeping well over 10,000 people fully employed for a year. The rural hinterland will be the major beneficiary of increased activity.

While the aggregate level of economic activity might be broadly unchanged, different parts of the economy will experience very different conditions. The pattern of economic activity in East Timor may change considerably. In particular, some industries will continue to experience growth while there will be contractions in

other industries that have grown to unsustainable levels on the basis of international expenditure.

Broadly, those East Timorese people and industries that have benefited most from the large international presence will also suffer most of the effects of its downsizing. The hospitality industry has been the obvious beneficiary: the restaurants, cafes, bars and hotels in Dili. Cottage industries such as carpentry and *tais* weaving have also evolved in response to international demand. Industries such as rice, maize and coffee production that have been least affected by the international presence will also be least affected by the downsizing.

A range of other industries depend upon the level of activity in other sectors. For example, the transport industry largely depends upon the level of economic activity in and between population centres. Industries such as these will probably change their pattern of activity, but their overall level of activity may change little.

There is likely to be a change in the geographical distribution of growth. Economic activity in Dili will be most affected, regional centers less so, and rural areas least of all. At the same time, rural areas will benefit from expanded employment under reconstruction and development programs. This shift in the locus of economic activity may help to reverse urban drift.

The high visibility of the industries in Dili that will be most affected could lead to a marked reduction in confidence among business and the wider community. Some of the international businesses that have come to East Timor in the last two years will leave. Local businesses and workers that have lost their livelihood would likely pressure the government for assistance.

Economic activity during the course of 2002 will be affected by a mix of factors. The celebration of independence in 2002 will lead to higher expenditures, incomes and confidence. The capital expenditure programs of TFET will boost East Timorese employment and incomes during the dry season in the middle of 2002. There may be some bunching of public expenditures towards the end of the financial year, followed by a slow start to the next financial year. The major part of the withdrawal of United Nations personnel should be completed in the first half of 2002, with further progressive reductions over a two year period until the UN presence is withdrawn altogether.

b. The Impact of downsizing

Although the wind-back in the UN presence will take place within several months, departures are likely to accelerate closer to the date of independence, leaving the new government to manage the economic and social pressures at the same time as the festive mood of the independence celebrations gives way to the hard slog of everyday life.

Over the last two years, the restriction of opportunities has regularly prompted public protest of some sort, and the loss of employment on any scale is generally the trigger for

demonstrations and organised action, sometimes lasting for days or weeks. The examples are legion. In the last few weeks there have been demonstrations and disturbances in various parts of the country over the shortage of high school places (Dili), over the restriction of university entrance numbers (Dili), over high levels of youth unemployment (Baucau) and over job losses with the closure of an NGO program (Manufahi).

The Office of National Security of UNTAET has identified several potential threats associated with the international wind-down and a flat economy. Although there are no crime statistics as such for East Timor, reports of general crime have been on the increase, particularly property crime and domestic violence. High levels of unemployment, urban drift and increased and visible social inequity are contributory factors. Organised crime - including smuggling, money laundering and protection rackets - is also in evidence, buoyed by an inefficient market, an underdeveloped regulatory system and weak enforcement of regulatory powers. A weaker economy and perceptions of weaker social controls in the immediate aftermath of the administrative transition could trigger a rise in crime. It has been reported that the East Timorese, who have until now been governed by others, are apprehensive about the authority of their own officials to ensure internal security. This perception could encourage criminal elements.

Government's capacity to deliver services may also be affected by the downsizing, both by the reduction in international personnel and resources supporting public administration, and by a redirection in government priorities if unemployment, crime and social unrest become more prominent. This would be an uncomfortable legacy for a new government.

The end of strong economic growth could impact disproportionately on women, not only because of their concentration in the hospitality and domestic sectors, but also because women typically are the reserve labour force. Typically in post-conflict situations, women are pushed back into the domestic sphere as the labour market contracts.

c. Will East Timor be based on its natural wealth?

One big issue facing the new government will be over how much agreement there is about "quarantining" the gas revenue rather than spending it all on current expenditure. East Timor's real economic future lies in the wealth of gas in the Timor Sea, which under the 90-10 per cent split wrestled out of Australia will provide \$7billion over 20 years. However, this has hit a hitch with the decision by US-owned Phillips Petroleum and its partners to defer exploitation of the biggest field because of Timor's decision to raise an extra \$1billion in royalties. There is a common view that the country should save at least 50 per cent of the money in a trust fund. It is expected that East Timor's economic growth will be incremental rather than rapid. This means the oil money, and the question of how to spend it, will be central to the country's future for years.

An endowment fund could act as a stabilizing force, safeguarding income from resource sales that rightly belong not only to East Timorese citizens of today but to those of the generation to come. Saving too much would mean wasting development opportunities and increase the risk of corruption, while saving too little would be risky given the

uncertain nature of oil and gas revenues (Francino, 2001). A strong growth of the non-oil sectors of the economy will provide a tax-base for revenues to cover an increasing proportion of total spending.

The objective is to depend increasingly less on oil revenues and more on the private sector as the engine of growth of the economy. In the long-term, non-oil revenues are expected to increase to some 13-15% of non-oil GDP. Recurrent expenditures could increase at 3% annually in real terms over the 20-year period of oil flows (slightly higher in the early years, so as to accommodate the current impact of continued capital and development spending permit the extension of services in response to population growth).

In the lead up to the 2002/03 Budget, East Timor will undertake a comprehensive review of the revenue system in East Timor with the objective of increasing revenue over the medium term. This will include exploring new revenue sources, such as: broad sales tax; a tax on the users of land; taxes on gambling or national lotteries; additional user charges; and local fees and charges. However, compliance efforts will also be increased. Particular attention will be paid to reducing smuggling, including at the land border with Indonesia; increasing the administrative capacity for East Timor staff; and promoting administrative systems to collect user charges.

It is estimated that about the middle of this decade the ongoing costs both recurrent and capital of the government in East Timor will be between \$120-170 million. According to Francino (2001) this level of spending can be financed from three sources:

- Domestic revenues excluding Timor Sea
- Donor grant funding and, for a while at least, concessional financing from the multilateral institutions like the World Bank and the Asian Development Bank
- Timor Sea revenues.

It is suggested that East Timor should have a four part fiscal strategy:

- To hold government spending down wherever possible while giving a priority to spending in essential areas like health and education that improve the long term economic prospects for the country.
- To maximise domestic non-oil and gas revenues. In particular, East Timor should avoid subsidising services that go to the more prosperous sectors of urban society. For example, user fees should be favoured for all services provided on a discretionary basis.
- To retain donor confidence in order to continue to attract grant-financed donor investment in sustainable infrastructure.
- To make careful choices about the use of oil and gas revenues which can be spent on supporting government programs, on stimulating economic activity or invested for future income.

The challenge facing East Timor is to hold the promotion of government spending by Timor Gap revenues to the low of the range given above. If the proportion of Timor Gap revenue pre-empted by government spending grows it will squeeze out the possibility of using those same revenues both to stimulate economic development and to provide a cushion of investment income that East Timor will need when oil and gas revenues are no

longer available.

d. The way forward

The daunting task of rebuilding East Timor places many formidable challenges for the people of East Timor. Looking beyond donor assistance, the real issue perhaps is how to support investment projects to ensure sustained growth and poverty alleviation without relying solely on public finance beyond UN transitional administration. The challenge will be to assist and encourage the private sector to undertake projects, with donors offering complementary finance by offering political risks guarantees or insurance. Likewise, more efforts should be given to capacity building within East Timor, thus ensuring a capable system of governance that fosters and complements private sector-driven growth.

Ultimately, the degree of success of this effort will be determined by activities in the private sector, which generate output, savings, investment and trade. Hence the role of public policy is to create a policy environment within which the private sector can expand and flourish.

Given that three-quarters of the population is engaged in agriculture, a future independent East Timor will strengthen traditional agriculture by increasing crop yields and providing access to rural banking and micro-credit facilities, which will increase output and improve the ability to market surpluses. Appropriate policies will provide a sound basis for sustained economic growth and poverty alleviation via export-oriented primary activities.

East Timor should actively engage in trade with its neighboring countries if it wishes to develop its economy rapidly. A future independent East Timor will welcome sound investment by firms that wish to operate in an environment free of artificial barriers to trade. But a secure investment climate will need appropriate laws protecting property rights and contracts, establishing a fair commercial code, codifying labor relations, and minimizing the cost of doing business.

The challenge is to ensure that a viable and vibrant nation can rely on its resources and that short and medium term initiatives are compatible with sustainable development in the longer term.

Concluding Note

Despite the slow and difficult beginning, the UN operations in East Timor has performed reasonably well in laying down the groundwork for a functioning economy. When East Timor gained its independence on 20 May 2002, preparations by UNTAET have been less than 3 years. Within this period it has not fully overcome the main challenges faced by this new nation caused by a total collapse of the institutions of state and the serious lack of cadres to manage the public sector and the economy. Yet, extending the UN

mandate will not necessary solve the problem. It is a longer term proposition. What has been the main achievement of UNTAET has been the maintenance of security and a smooth transition to political self-rule. In a sense, UNTAET has been successful in its economic and reconstruction efforts because there were no internal conflicts and the political leadership has been relatively unified on crucial economic and reconstruction issues.

The role of the World Bank has been critical. It has swiftly organized its participation in the reconstruction of that war-torn economy to provide the coordination function in the wake of the involvement of a number of donor governments. World Bank's continued involvement in East Timor's development beyond independence will be important. It can help the East Timor government organize its development administration and provide technical assistance as well as mobilize continued donor countries' support. The World Bank can also help lessen the impact of the downsizing of the international presence, a problem that is always present in UN operations. The UN itself can reduce this effect by a more gradual process of winding down its operations but given its mandate it cannot do more than that. Thus, a continued support by the international community should be channels through and be mobilized by such multilateral institutions as the World Bank and the Asian Development Bank.

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Table 2. Summary of donor pledges to East Timor, 1999 to 2002								
Country	Total	UN-CAP ^a	UNTAET Trust Fund	World Bank Multidonor Trust Fund	UNTAET & WB Trust Fund	Bilateral	Specific Agency Funding	Miscellaneous Unallocated
Australia ¹	44.52	23.87			16.13	4.52		
Austria								
Belgium	0.76							0.76
Brazil								
Canada ²								
Finland	7.50							7.5
Grace								
Germany	7.00		2.00			3.30		1.23
Ireland	2.43	1.70						
Italy		1.23						
Japan	129.00	30.00	9.00	28.00				62.00
Korea								
Netherlands	9.34		2.22				7.13	
New Zealand	2.08			0.10		1.98		
Norway ³	12.50	6.50						6.00
Philippines	0.20	0.20						
Portugal	91.60	10.60	7.50	50.00		23.50		
Singapore								
Spain	0.65	0.65						
Sweden	4.00	1.00	1.00					2.00
Thailand								
UK	29.84	8.87			20.97			
USA	98.00	65.00						30.00
ADB	5.00							
EU	68.63		9.80	58.82				5.00
WB	10.00			10				
Total ⁴	523.09	149.62	31.52	146.93	37.10	33.30	7.13	117.49

Source: UNTAET (2000d)

Notes : ^a UN-CAP : United Nations Consolidate Appeal Process, launched by Office of Coordinating Humanitarian Affairs (OHCA) for humanitarian and Emergency

¹ Australia indicated funding commitments only for the period to 30 June 1999, prior to further Parliamentary budget considerations in early 2000.

² Canada was unable to indicate specific commitment levels prior to Parliamentary considerations

³ Norway indicated that similar levels would anticipate in future years.

⁴ All figures are subject to verification with the respective donor countries/agencies

Note : The UNTAET Trust Fund carryover needs to remain positive to ensure that cash flow problems are not encountered

Table 3 Summary of East Timor's consolidated budget, 2000-1 to 2002-3

	2000-1	2001-2	2002-3
	(in US \$ million)		
Expenditure	59.23	55.32	56.82
Recurrent	23.63	45.57	47.57
Capital	15.60	9.75	9.25
Revenue	17.00	30.00	40.00
Deficit=Financing requirement	42.23	25.32	16.82
UNTAET Trust Fund carryover	29.75	3.52	3.20
Additional donor contributions	16.00	25.00	15.00
Source : UNTAET (2000e)			

Table 4. Summary of budget allocation by sector, East Timor, 2000-01 to 2002-03

Sector Agency	2000-01			2001-02			2002-03		
	Current \$'000	Capital \$'000	Total \$'000	Current \$'000	Capital \$'000	Total \$'000	Current \$'000	Capital \$'000	Total \$'000
1. Education,Health,Social Affairs									
1.1.Education	10950	2700	13650	12125	1000	13125	12125	1000	13595
1.2.Health	7000	500	7500	7410	1000	8410	7520	1000	8520
1.3.Office of Social & Labour Affairs	310	200	510	310		310	320		320
Subtotal	18260	3400	21660	19845	2000	21845	20435	2000	22435
2. Political Affairs	150		150	150		150	150		150
3. Defence &Security, Law & Order									
3.1. Police	2300	2000	4300	3485	2000	5485	4685	1500	6185
3.2. Guarding Services	360		360	380		380	400		400
3.3. Fire and Ambulanew e Services	100	250	350	100	250	350	110	250	360
Subtotal	2760	2250	5010	3965	2250	6215	5195	1750	6945
4. Justice	900	2000	2900	920	1000	1920	930	1000	1930
5. Internal Administration	1800	700	2500	1820	500	2320	1850	500	2350
6. Finance									
6.1. Monetary Authority	360	950	1310	360		360	370		370
6.2. Central Fiscal Authority	800	700	1500	810	500	1310	820	500	1320
6.3. Customs	800	700	1500	810	500	1310	820	500	1320
Subtotal	2060	2750	4810	2100	1500	3600	2150	1500	3650
7. Economic Development									
7.1. Agriculture	700		700	710	500	1210	720	500	370
7.2. Trade, Tourism & Industry	350	300	650	350		350	360		1320
7.3. Invesment Promotion	250	100	350	250		250	250		1320
Subtotal	1300	400	1700	1310	500	1810	1330	500	3650
8. Infrastructure									
8.1. Transport and Communications	3500	1500	5000	3550	1000	4550	3610	1000	4610
8.2. Pow er	6800	1000	7800	6800	1000	7800	6800	1000	7800
8.3. Water and Sanitation	2600		2600	2600		2600	2600		2600
8.4. Land and Property	500	1600	2100	510		510	520		520
Subtotal	13400	4100	17500	13460	2000	15460	13530	2000	15530
Contingency	3000		3000	2000		2000	2000		2000
Total	43630	15600	59230	45570	9750	55320	47570	9250	56820
Source : UNTAET (2000c)									