

Can Timor-Leste's Next Government Pursue Much-Needed Budget Cuts?

It's politically risky, but budget cuts are needed to tackle low productivity, inefficient public spending, and the trade deficit.

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April 26, 2018



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For the third time in less than a year, Timorese are going to cast their votes. The early election, scheduled for May 12 is the direct consequence of failed political negotiations among the parties. They failed to form a coalition government with majority support in Parliament and the minority government formed by FRETILIN and the Democratic Party was unable to pass a budget — prompting Parliament's dissolution and the early election.

Tension is high among political elites, reflected in campaign rhetoric. At the same time, nearly all the political parties are concerned with Timor-Leste's current development challenges and future trajectory. These challenges are related to limited employment opportunity for the youth and demographic pressure, low agriculture productivity leading to the import dependency, allegations of corruption and mismanagement of public resources, and more importantly, the state's dependence on the Petroleum Fund account to finance the budget. Moreover, despite big spending on infrastructure, complaints over poor infrastructure, and the poor service delivery are facets of daily conversations.

There are even deeper problems. Timor-Leste's political and economic institutions — a legacy of history and circumstance — hinder efforts to address the country's economic ills.

In the last decade, Timor-Leste has followed in the steps of oil-dependent countries, perceiving money as the solution to every problem. Public spending is the easiest policy instrument. Between 2008 and 2015, on average, government expenditure was 77 percent of non-oil GDP. Between 2009 until 2017, on average, the government's budget grew by 14 percent annually, whereas non-oil GDP grew at 5.7 percent annually.

This imbalance between spending and growth contributes to a variety of economic problems. When the government has money, its tendency is to spend it as quickly as possible. In this way, budget execution becomes a key performance indicator for ministries. Import dependency is the direct consequences of such government spending incentivizing household consumption. Demand for goods and services, from both the public administration and private sector, turns to imports when domestic supply is unavailable.

The injection of petroleum money into the domestic market also drives the domestic prices up, making inputs for domestic production more expensive and less competitive. This then undermines the government's efforts to diversify the economy, particularly in the agriculture, tourism, and manufacturing sectors. Facing this structural problem, instead of looking for a long-term solution, some politicians turn to subsidies to prop up domestic producers.

More importantly, while all the parties are critical of each other for these challenges and the failure of previous governments, none of them are proposing new approaches, let alone radical new ideas. Close observation of ongoing public debates reveals that nearly all political parties fall into the same trap: seeing money as the solution to every problem. Consequently they tend to opt for the same policy prescription: public spending. Where they differ however is the “micro-management” in which some promise to do better by improving the “quality of spending” or reorganization of budget allocation across sectors.

The Challenges Ahead

Cutting public spending is the most important policy position that the next government needs to commit to. This is not only a way to prolong the life of the Petroleum Fund, but more importantly, to change the incentives that have contributed to Timor-Leste’s economic dysfunction. This may slow economic growth. Nevertheless, it is a strategic option if the government aims to increase domestic productivity, reduce demand for imported goods and services, and improve the efficiency of public spending.

However, the real challenge for decision-makers will come from the political side. As the politicians are used to big spending, it becomes challenging for them to cut the budget, even when revenues are already falling. This requires efforts to adjust ambitious plans already underway, and cut unnecessary spending to sustain the already costly public administration. Further, unnecessary subsidies need to be cut. At this point, the budget already stands at \$1.5 billion annually. The recurrent expenditure already exceeds \$1 billion.

Meanwhile, although the government’s spending is already disproportionate, people in rural areas, particularly outside of Dili, are demanding better quality service delivery and better infrastructure. To make things worse, party leaders campaign with a lot of promises, including increasing subsidies. People who are used to various kinds of government subsidies will continue to demand them. It is difficult for any politician to campaign based on budget cuts and subsidy slashes.

More importantly, government spending has given rise to a small “rentier class,” primarily in Dili. These are people who have relied on the informal connections with Dili’s elites to make disproportionate profit from government contracts. Although street discussions admit that the rentier class exist in every major political party, the issue is not touched. Given that the rentier class is influential in term of financing political campaigns, it makes sense to speculate that any efforts to cut the budget will always pose threats to the interests of the rentier class which politicians need to get elected.

The challenge for the upcoming government is how to navigate through this complex reality. On the one hand, if it is serious about increasing domestic productivity, it has to change the economic incentives. Based on the existing context, the best way to do so is through budget cuts. On the other hand, the new government will have to manage divergent interests, particularly powerful groups who have been benefited disproportionately from the existing economic structure and have influence over political decisions.

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