

## FISCAL RULES FOR TIMOR-LESTE

*Ministry of Finance, Timor-Leste*

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### ABSTRACT

*Petroleum Fund accounted for more than 85 percent annual budget, domestic revenue was less than 12.1 percent to GDP in 2018, and public debt to GDP in 2020 is 16%. This contributed to \$437 million of average fiscal deficit during the period of 2009-2019. The need for fiscal rules as corrective instruments for political and economic biases that aim for ensuring fiscal responsibility and macroeconomic stability are emerging. The Government of Timor-Leste therefore may consider to design, introduce and enforce country specific fiscal rules that include limiting growth of overall or categorical budget to GDP, commit to the Fiscal Reform target as a revenue flooring rule, enforcing Estimated Sustainable Income (ESI) as a revenue windfall rule, limiting excess withdrawal of Petroleum Fund with ESI, balancing budget through limiting fiscal deficit and recurrent expenditure to GDP, limiting debt stock to GDP and continue benchmarking cost of borrowing with Petroleum Fund Investment Return.*

This paper provides guidance on how to select fiscal rules for Timor-Leste as a commodity based developing economy to ensure fiscal sustainability and macroeconomic stability. The paper is structured as follows: general information on Timor-Leste's fiscal situation, most common type of rules and their pros and cons, a description on the rationale of rules setting, the principles of rules selection, and fiscal rules for Timor-Leste.

### INTRODUCTION

Timor-Leste is the second most oil dependent country in the world and the revenue from off-shore oil and gas reserves has dominated the economy. The absorption of oil rents into the economy has occurred mainly through

transfers from the Petroleum Fund (PF)<sup>1</sup> to public spending, with the historical financing of over 85 percent to the annual state budget.

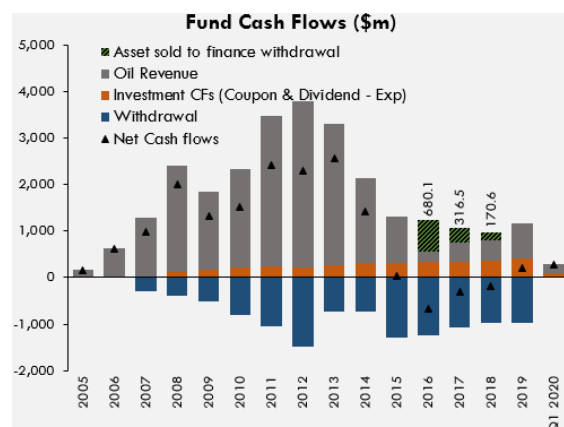
The revenue from off-shore oil and gas as the main source of income for the Government reached the annual peak of \$3.5 billion in 2012, but has declined since then. The revenue has decreased to the level of \$756 million in 2019.

Oil and gas revenue and the investment return<sup>2</sup> that are accumulated in the PF has cushioned a macroeconomic impact of the volatility in oil and gas prices. An evidence is that the Government was able to create a fiscal stimulus package in response to covid-19 impacts to people, business and workers

<sup>1</sup> Petroleum Fund (PF) was established in 2005 with the initial balance \$204.6 million, since then it has grown to around \$17.9 by the end of May 2020. All off-shore oil and gas revenues transfer directly to PF and the withdrawal is only for the state budget with approval of the National Parliament. PF is currently the only financial asset of the Government.

<sup>2</sup> PF is invested in international financial markets with the portfolio of 60 percent in fix income (bond), 35 percent in shares and 5 percent in alternative assets. Since investment inception in 2005, the average rate and accumulated return are 3.8 percent and \$6.7 billion, respectively.

despite the fact that oil & gas prices declined due to the price war and stock markets crash.



Source: PFAU, MoF-TL, June 2020

Domestic resource mobilization as the function of consumption (Government and private) and production (corporate and individual) is still weak. It represent about 12.1 percent of 2018 GDP and accounted only 13.6 percent to the 2019 State Budget. Tax revenues typically (average) accounted for about 72 percent to the total domestic revenue.

Low private sector investments, which accounted for less than 3 percent GDP in 2018 and a growing but less diversified economy contributes to the weak domestic resource mobilization. Despite domestic revenue mobilization increased in 2019 after experiencing declines in two previous consecutive years, the revenue is projected to decline again in 2020 as the result of the economic contraction due to limitation in public spending (*duo-decimal regime*) and Covid-19 impacts.

Constraints in revenue mobilization, the needs to finance development to be an upper-middle income country with educated and healthy population by 2030, and the strategy to ensure fiscal responsibilities and macroeconomic stabilities over medium to long-term require Government of Timor-Leste to design and use consolidated fiscal rules. Some rules are exist, but need to be

revised and strongly enforced, and some need to be designed and implemented.

## TYPE OF FISCAL RULES

*Definition* - fiscal rule(s) or fiscal target(s) imposes long-lasting constraint on fiscal policy through numerical limits on budgetary aggregate which aims at correcting distorted incentives and containing pressures to overspend, particularly in good times.

While fiscal rules can help governments to achieve fiscal objectives and macroeconomic stability, there is no one-size-fits-all rule for every country. Fiscal rules (individual or combined) may focus on different elements of Government fiscal performance. Table below summarizes typical fiscal rules and their advantages and disadvantages.

Expenditure Rules (ERs)
Set limit the growth of total/investment/recurrent expenditures and/or limit expenditure to GDP. + easy to communicate/monitor; + allow macroeconomic stabilization; + clear operational guidance; + can ensure debt sustainability, if well designed; - could lead to change in budget composition; - may reduce incentive to mobilize revenues.
Revenue Rules (RRs)
Set floors or impose ceilings on Government's income proceeds or use of windfall revenues. + raise revenue; + limit tax burden; - can lead to procyclicality - no direct link to debt sustainability
Budget Balance Rules (BBRs)
Constraint the size of the deficit and thereby control the evolution of the debt to GDP ratio + easy to communicate/monitor + clear operational guidance; + contribute to macroeconomic stabilization; - can lead to procyclicality ; - could lead to changes in budget composition.
Debt Rules (DRs)
Set an explicit limit on the stock of public debt. + easy to communicate/monitor; + allow debt sustainability; + intergenerational equity; - could lead to changes in budget composition; - could lead to procyclicality.

*Expenditure rules (ERs)* typically sets expenditure limits in absolute term or growth rates and occasionally in percent of GDP. The upsides of ERs are, generally easier to understand, monitor and enforce because they target a part of budget that the Government controls directly, and ERs can also contribute to macroeconomic stabilization provided that the limits are define in level or growth rate of the economy. This contribution could be accomplished by constraining spending growth at the same rate as outputs. For example: allowing a fast increase of expenditures in good times and force spending to decline in bad times.

On the other hand, downsides of ERs are they do not take revenue as part of the design features, thereby only partially impact on debt dynamics. For example, simple ERs design for countries with low revenue to GDP ratio can weaken their efforts to increase fiscal sustainability by creating disincentives to enhance revenue mobilizations and could induce lower level of public investment (politically less difficult to introduce) in budget composition, as the rules do not specify kinds of spending that need to be contained to ensure compliance. This effect is most striking in countries with developing economies, where weak public financial management systems can be ineffective to prevent policymakers from deferring high capital investments to formally comply with the rule.

The design of expenditure rules should consider the following features:

- a) Growth targets/projections that are derived from economic modeling and fiscal sustainability objective should drive the decision on what level of expenditure to GDP ratio to be used;
- b) The choice between real and nominal spending targets over the time horizon. The nominal is suggested for short-term

(annual) and the real is appropriate for the medium-term.

- c) Expenditure rules should adopt a multi-annual perspective to align with macroeconomic and tax revenue prospect, fiscal stabilization objectives and Medium-Term Expenditure Framework (MTEF);
- d) Exclusion of some cyclically sensitive spending items, such as payment for social security/retirement benefits, as expenditure rules has counter-cyclical spending norms;
- e) The coverage should apply for all Government institutional layers (Central Government and municipalities) and an appropriate coordination mechanism should be established to ensure the compliance and the effectiveness of the rules;
- f) Since expenditure rules only focuses on the spending side of the budget, the rules need to be complemented with other rules. The combination is highly subject to the appropriateness, responsiveness and sustainability principles.

*Revenue Rules (RRs)* that target Government's income to balance fiscal both at national or sub-national levels can be done through limiting revenue floors or ceilings. Revenue floors aim to boost revenue collection and revenue ceilings seek to prevent an excessive tax burden. These two revenue rules can complicate macroeconomic stabilization efforts as revenue floors might require tax hikes in bad times, exacerbating fiscal procyclicality (typically when is expressed in level instead of percent to GDP) and revenue ceilings can limit revenue mobilization and government savings in good times.

Neither revenue floors nor ceilings constraint spending, therefore do not ensure fiscal sustainability. In addition, windfall revenue

rules mandates are to reduce debt and to mitigate deficit and procyclical biases.

*Budget Balance Rules (BBRs)* have nominal and cyclically adjusted balance rules, but the focus of this note is on nominal BBRs as they are easy to understand<sup>3</sup>. The nominal balance rules impose limit on the deficit headline, with the possibility of excluding some expenditure or revenue items. These balance rules are effective in supporting debt sustainability and simple to communicate as the aggregate deficit easy to understand.

On the other hand, the rules do not contain good economic stabilization features<sup>4</sup> and can reduce the quality of budget composition<sup>5</sup>. The nominal or unadjusted balance rules could exclude loan repayment from the balance<sup>6</sup> or net the balance from capital expenditure (also known as current *balance*). The latter is call golden rule which typically design to permit borrowing for investment only and to promote and protect capital expenditure that are more pro-growth and politically easier to cut rather than other spending.

*Debt Rules (DRs)* that set an explicit limit on the stock of public debt and are typically restricted to finance public investment only contribute to debt sustainability, fiscal responsibility and intergenerational equity, as the rules will limit loan mobilization for financing fiscal deficit, and public investments will benefit current and future generations. In addition, DRs are easy to understand and monitor provided that the rules simply limit debt stock with GDP. The link between debts with the economy is

important to ensure that debt services are sustainable.

DRs that focus on limiting debt stock could lead to adjustments and changes in budget compositions if Government does not have sufficient revenue to finance expenditure. Moreover, the absolute number of debt stock may increase if the economy is doing well, which could lead the Government to adopt procyclicality policies.

## RATIONALE OF FISCAL RULES

Characteristics of fiscal rules are presenting a constraint that binds political decisions (by executive and legislative) and serves as a concrete indicator of executive fiscal management.

**Rationale** – the choice of fiscal rules is generally based on ad hoc rationale, and are used as fiscal disciplinary measures and corrective actions for:

- (i) Determining optimal level of fiscal aggregates/stabilization policies that improve welfare by reducing macroeconomic volatility;
- (ii) Defining the approach and economic model that budgets are prepared based on welfare maximizing objectives, not a political process of budgeting;
- (iii) Time inconsistency issue – incentives to deviate from previous promises when people and markets have already adjusted their expectations and behaviors;
- (iv) Preventing a persistent high level public debt that can adversely affect economic welfare through adverse self-fulfilling

<sup>3</sup> Provided that this is the first paper on “fiscal rules” for Timor-Leste.

<sup>4</sup> Which can lead to a procyclical fiscal stance: in bad times, the rule might force a country to consolidate to offset the cyclical decline in revenues; in good times, the rule cannot prevent a country from spending windfall revenues (Blanchard and Giavazzi 2004).

<sup>5</sup> Because they are silent on the composition of the fiscal adjustment needed to comply with the rule. (Guerguil, Mandon, and Tapsoba 2017).

<sup>6</sup> Allowing policy makers to have direct control over the balance, but it weakens the link of the balance to debt.

- expectations regarding Government (in)ability to service debt;
- (v) Electoral motivation to increase spending and reduce taxes in an election year;
  - (vi) Common pool problem – coordination issue among public institutions government/coalition partners;
  - (vii) Fiscal illusion – population’s imperfect understanding of tax and debt finance, combined with a misperception of the government’s inter-temporal budget constraint;
  - (viii) Bureaucratic behavior – which tends to focus on budget maximization rather than welfare maximization;
  - (ix) Free rider problem – conflict of interest over who should pay for reducing the deficit, making deficit reduction a long delayed process;
  - (x) Countercyclical fiscal policy – expenditures are raised in a recession but not sufficient lowered in an expansion to balance the budget over the cycle;
  - (xi) Intergenerational concerns - each generation is selfish and does not care about the situation for future generation.

### PRINCIPLES OF RULES SELECTION

Fiscal rules are selected on the basis of desired features and criteria that allow rules to ensure fiscal sustainability and economic stabilization, and to be implemented in efficient manners (simplicity, operational guidance, resilience, and ease of monitoring and enforcement).

**Criteria** – fiscal rules must meet the following criteria:

- a) *Sustainability* - compliance with the rule will ensure long-term debt sustainability;
- b) *Stabilization* - the rule should ensure economic stability by allowing discretionary countercyclical changes in taxes or expenditures;

- c) *Simplicity* - the rule should be simple for policy makers and public to understand easily;
- d) *Operational guidance* – the rule should be integrated in the budgeting process and the policy makers to control the aggregate targets;
- e) *Resilience* - a rule should be implemented in a period of time and it should be maintained even after the shock to build credibility;
- f) *Ease of monitoring and enforcement* – monitoring of the compliance should be easy and simple, and there should be costs associated with deviations from targets.

**Rules selection process** sometime involves combined criteria and is possibly conflicting. The Government is therefore advised to consider the following steps in the rules selection process: (i) *minimize trade-offs* - some rules are better than others at fulfilling all criteria, but the selection exercise should ensure minimization of trade-offs between potential rules; (ii) *country preferences* – even with the best-designed rule, trade-off are unlikely to disappear entirely, therefore the choice of rule depends on which criteria are most important and which rule is most needed and preferred; and (iii) *consider multiple rules* – to achieve fiscal sustainability and macroeconomic stabilization objective, a country can adopt multiple rules. But it should be aware that too many rules can complicate fiscal policy making process and result in overlap and inconsistency of targets.

**Guiding principles of rules combination** – traditionally, criteria have been used to analyze, compare and assess the merit of various rules, but often less analyses are done for interaction of rules. The following are some guiding principles for the design of a fiscal framework that combine several fiscal rules:

- *Fiscal rules do not substitute for good fiscal policies* – because they are meant to mitigate policy biases (in particular, the deficit bias) and prevent misusing of fiscal discretion. Therefore, multiple rules should lead to the optimum efficiency of fiscal policies. Introduction of new fiscal rules for Timor-Leste should aim for complementing the existing *frontloading fiscal policy* and the guiding principles (*fiscal sustainability, programs and priority, institutional capacity, quality of budget, and economic absorptive capacity*) that are used by the Ministry of Finance to define budget ceiling in budget preparation process.
- *Minimizing the overlap of fiscal targets* – overlap typically occurs when more than one rules apply to the same fiscal aggregate but constraint it to different degrees. For example, the Government may introduce a rule that limit budget deficit to GDP as well as a rule that require budget balance.
- *The rules system should not be over-determined* – too many constraints can impair the ability of the Government to achieve its fiscal objectives and create inconsistencies between the requirements of different rules. Fiscal framework that constrain revenue, expenditure, budget balance and debt stock are common, but will be undesirable if the framework presents some form of over-determination of discretionary items of the rules that cannot be easily modified.

**Legal foundation** - fiscal rules can have different national legal foundations, and may be enshrined in constitutions, primary or secondary legislation, or may stipulate in public political commitments or in internal rules set out by the Ministry of Finance.

One of the most important lessons from empirical experiences is that unduly rigid rules tend to be unworkable and could be insensitive to economic or political

circumstances. In turn, strong fiscal rules regimes may rely rather on the strength of political commitment, monitoring by independent fiscal institutions and other actors, as well as clear and effective enforcement procedures for non-compliance. Concerning the latter, different kinds of measures can be implemented, from the need to present a corrective proposal to the legislature to automatic correction mechanisms and sanctions.

### FISCAL RULES FOR TIMOR-LESTE

Timor-Leste is a commodity based developing economy that exposes to commodity price volatility and depletion of natural resources risks, and unstable macroeconomic environment which could lead to high volatility of government revenues and deeper recessions.

Fiscal rules for commodity based economy are primarily designed to cope with the price volatility, achieve macroeconomic stability, fiscal sustainability and ensure an equitable intergenerational allocation of resources. Establishment of PF with ESI and EW attributes are meant for these objectives.

Government of Timor-Leste currently has two legally binding rules: (i) Estimated Sustainable Income (ESI), which is an element of Revenue Rules (ERs); and (ii) loan-cheap money. In addition, Ministry of Finance applies growth limit to budget categories in the fiscal sustainability model, but it has no legal compliance requirement.

Under the existing Fiscal and Public Financial Management (PFM) reform, which aims for increasing domestic revenue collection to reduce fiscal deficit, improve efficiency, accountability, transparency and sustainability of PFM, the government should consider to design and use fiscal rules that have best practice and country context features.

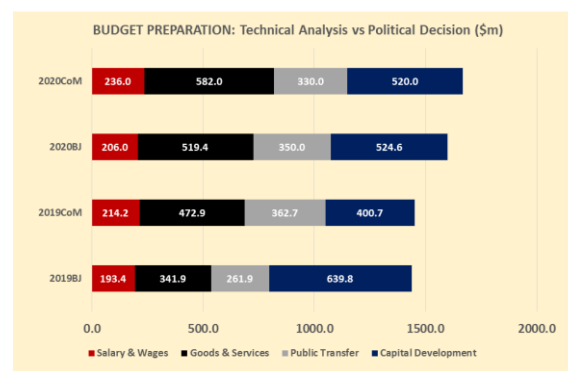
Table below outlines the summary of the proposed fiscal rules with implementation timeframe and legal foundations for each rule that could be considered by the Government.

PROPOSED FISCAL RULES FOR TIMOR-LESTE			
<b>Expenditure Rules (ERs)</b>			
80% Expenditure to GDP	◇	○	●
10% Recurrent Growth	◇	○	●
30% Capital to GDP	◇	○	●
<b>Revenue Rules (RRs)</b>			
3% ESI	●	○	●
60% Excess Withdrawal to ESI	◇	○	●
15% of Domestic Revenue to GDP	◇	○	◇
<b>Budget Balance Rules (BBRs)</b>			
30% Budget Deficit to GDP	◇	○	●
50% Recurrent to GDP	◇	○	●
<b>Debt Rules (DRs)</b>			
60% Debt to GDP	◇	○	●
3% Borrowing Cost	●	○	●

<sup>7</sup>Note: ● Law and decree law; ○ Government decree; ◇ political commitment; ■ Short-term; ■ Medium-term; ■ Long-term

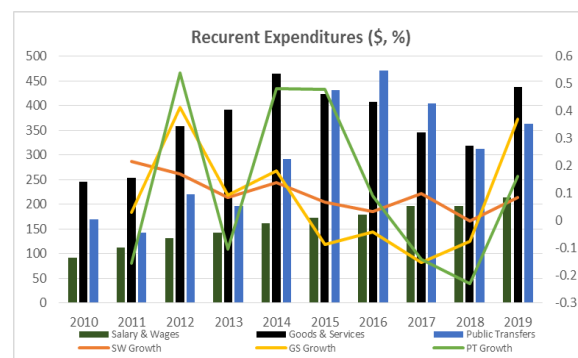
## EXPENDITURE RULES

The Ministry of Finance applies the rule of growth limitation up to 4 percent to budget categories in its fiscal sustainability model. It is a model that aims for adjusting budget allocation with public institutional capacity and for a healthy and sustainable fiscal policy. However, this rule is not legally binding and historically the political process of budgeting<sup>8</sup> prevailed the rule, as it shows in the below graph that there were consistent difference of budget figures derived from fiscal modeling presented in Budget Journey (BJ) sessions with decision of Council of Ministers (CoM).



Source: MOFTL, June 2020

This historical evidence suggests that the rule has to be enforced beyond modeling. The Government may consider to gradually enforce the rule from political commitments in short-term to a legally binding rules over medium to long-term time horizon. Political commitments can be started in the 2021 budget preparation process by complying to the defined budget categories growths limits and describe these rules in the budget circular, the pre-budget statement and the budget book.



Source: MoFTL, June 2020

With the average growth 10.2 percent of recurrent expenditures (10% of salary and wages, 8.2% of goods and services, and 12.5% of public transfers) during the period of 2010-2019, and the headline inflation that has been below 4 percent target since 2012, the government should consider to limit annual growth for recurrent expenditures to a

<sup>7</sup> Short-term is a year, medium-term is 2-3 years, and long term is over 3 years

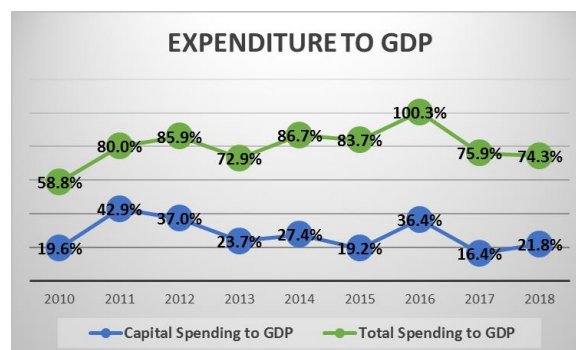
<sup>8</sup> The process include “Political Budget Committee Review” and “Council of Ministers”

maximum of 10 percent. Ministry of Finance will have to allocate this growth limit to each recurrent category in its fiscal sustainability model.

For the capital expenditure, as the growth pattern are very volatile from 137 percent in 2011 down to a negative 57 percent in 2017, the average growth 19.8 percent in the last 10 years, infrastructures are needed for sustaining the economy, and considering institutional capacity constraint that limits absorptive capacity of capital budgets, the Government could consider to benchmark it to GDP for a maximum of 30% percent, and then imposing a growth limit for the medium to long-term (after the frontloading fiscal policy schedule – up to 2024).

These fiscal rules that limit budget categories growth should be combined with budget balance rules given that they impose limits on budget which most likely will affect budget composition.

In addition to the abovementioned expenditure growth limit rules, the Government could also introduce expenditure to GDP ratio rule. However, the design and implementation will face challenges as the publication of Timor-Leste's economic data is typically one year lag. This is a short-term challenge and unlikely to continue prevail in the long-term. Graph below presents historical patterns of spending ceiling limit to GDP that indicate consistent variations.



Source: MoFTL, June 2020

The design of expenditure ceiling to GDP ratio rule for Timor-Leste should consider features such as use total expenditure which include loan disbursement, link to existing fiscal framework and the MTEF once it is established, and strong commitment to implement by putting this rule in budget circular, pre-budget statement, and budget book. In the future, compliance commitment could be upgraded to a legally binding level once the issue of the delay in publication of National Account data has been addressed. Based on the historical trend and considering the alignment of the rule to multi-annual perspective of Timor-Leste's macroeconomic and fiscal objectives, the Government may consider to introduce the fiscal rule of a maximum 80% percent of total ceiling expenditure to GDP.

## REVENUE RULES

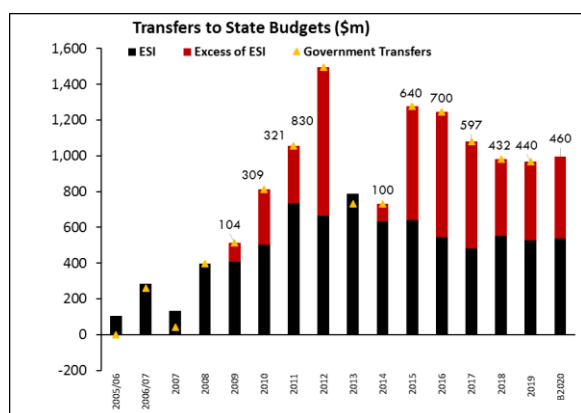
Government needs to introduce revenue rules provided that the current Government's revenue is mainly from oil and gas with domestic revenues (tax and fees) that accounted only 12.1 percent to GDP in 2018.<sup>9</sup> Through the Fiscal Reform (improve soft and hard infrastructure for enforcing compliance and ensuring efficient collection), the Government is aiming to

<sup>9</sup> Stipulates in the 8<sup>th</sup> Constitutional Government's five years program



increase domestic revenue ceiling to 17 percent of GDP by 2023.

The Government has introduced a windfall country specific rule since establishment of the Petroleum Fund in 2005. The rule is the “Estimated Sustainable Income (ESI), which is the estimated average rate of return of PF in the long-run. ESI is a rule that limits withdrawal of PF<sup>10</sup> up to 3 percent only. This rule is enshrined in the PF law, but it has a drawback, that is, an” Excess Withdrawal (EW)”<sup>11</sup> could be made if the Government justifies to the National Parliament that the EW is to finance development with long-term interest. As a result, a total of \$4.5 billion has been excessively withdrawn since 2009. Noncompliance to the ESI rule is likely to continue till the end of the front-loading<sup>12</sup> fiscal policy in 2024.<sup>13</sup>



Source: PFAU-MoFTL, June 2020

For the objective of PF sustainability over the long-run, the Government may consider to revisit the ESI and Excess Withdrawal (EW) rules. The ESI definition of 3 percent maybe limited to PF balance instead of petroleum wealth. The EW that currently serves as the main source of financing for fiscal deficit and for capital development should have a limit.

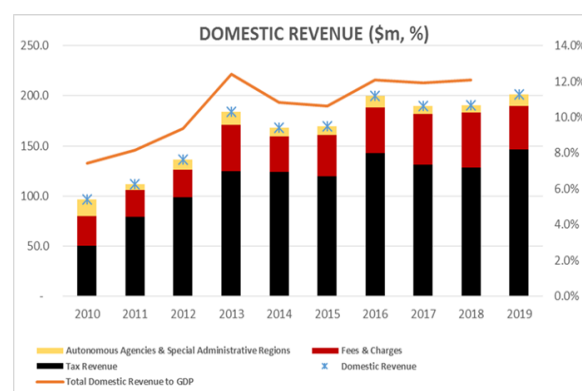
<sup>10</sup> The only financial asset and the main financial source for the annual budget.

<sup>11</sup> Article 9 of Petroleum Fund Law.

<sup>12</sup> *Frontloading* fiscal policy is a policy to withdraw more than 3 percent of ESI for financing basic

The withdrawal limit should have strong alignment to the frontloading fiscal policy and the 30 percent of capital development to GDP rule. The average EW over the period of 2009-2019 is \$405 million, which represents 64 percent of ESI. The Government may set an EW limit to 60 percent of ESI. Both ESI revision and the imposition of EW limit should be in PF Law.

Establishment of floors or ceilings rules for tax revenues are needed, but the Government is yet to introduce them given that PF currently provides fiscal buffer and tax incentives are required for attracting private investments. The growth patterns of domestic revenue<sup>14</sup> over the period of 2010-2019 suggest that future design of revenue rules should balance revenue targets with macroeconomic stability as they are strongly linked.



Source: PFAU-MoFTL, June 2020

The Government may consider to introduce 15 percent of domestic revenue to GDP ratio by 2023 as a revenue floor rule instead of revenue target only, with caution that a regular annual review is required for necessary adjustment. The Government can gradually enforce this rule. In the short-term,

infrastructure and human resource development. The policy is scheduled to resume in 2024.

<sup>13</sup> Derived from MoF’s fiscal sustainability model.

<sup>14</sup> Revenues from taxes, and fees and charges.

introducing and integrating this rule into budget circular, pre-budget statement and budget book, and establish a legal foundation for this rule in the medium to long-term.

The Government may consider to design as well specific revenue ceiling rules. Some options to be considered for the short to medium-term time horizon are, increasing and introducing progressivity to the Personal Income Tax (PIT) to the level that does not compromise the income distribution objective, and increasing and introducing Corporate Income Tax (CIT), Sales and Service, and Value Added Tax (VAT) that support economic efficiency and promote private investment and jobs creation. These revenue rules will have a strong legal foundation as they are principal revenue components in the Tax and Duty Act and the VAT Act. For the long-term, the Government can consider to revenue ceiling to GDP.



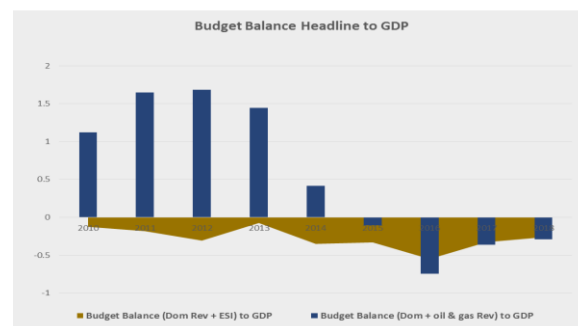
Source: ASEAN Secretariat & MoFTL, 2020

### BUDGET BALANCE RULES (BBRs)

The headline budget balance of Timor-Leste is observed from two different perspectives. First, the budget balance is the difference between Domestic Revenue and RSE with the total expenditure. With this definition, the Government has budget deficit since 2007 and budget balance deficit to GDP has reached 27% in 2018.

Second, budget balance is the difference of domestic and oil & gas revenues with the total expenditure. As an oil & gas producing

economy, the country was in budget surplus until 2014, but since then the budget balances have been deficits as the oil and gas revenues declined and the expenditures increased. With this definition, budget deficit to GDP headline has reached 30 percent in 2018.



Source: MOFTL, June 2020

There are still delinks between budget balance with GDP. The Government may consider to design and introduce country specific BBRs to address fiscal deficit. Two proposals to be considered:

- i) Budget deficit headline to GDP – The starting point of designing this rule is to determine which definition of budget balance to be used. For the short to medium-term horizon, it will be appropriate to use the budget balance headline from the difference between domestic revenue and ESI with expenditures, as it delinks from commodity price volatility risks, and therefore lead to counter cyclicity. With the historical data from the last 9 years, of which the average budget deficit to GDP was 28 percent, imposing a maximum of 30 percent of budget deficit headline to GDP could be considered;
- ii) Recurrent Balance Rule – To complement the 10 percent recurrent expenditure growth rule, the Government may consider to benchmarking composition of recurrent budget with GDP. Payment for veterans could be excluded and the loan repayment is

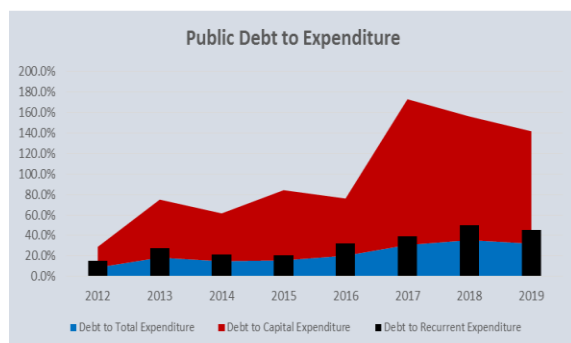
suggested to be included, provided that the burden to the budget is still relatively low (at least for the short to medium-term). With the average 53 percent of recurrent expenditure to GDP over the period of 2010-2018, the Government may consider to impose a maximum of 50 percent recurrent expenditure to GDP rule.

### DEBT RULES (DRs)

The Government needs to introduce country's specific DRs to address the current low debt distress but growing, and the emerging need to protect PF sustainability from mobilization of cheap loan to finance development.

The overall DRs that set an explicit limit of the debt stock to GDP is yet to be introduced. However, the existing policies on “costs of borrowing should be lower than the PF investment return (political commitment and economic principle)” and “loans should only finance infrastructure investment (legally binding)”<sup>15</sup> provide implicit links to the economy.

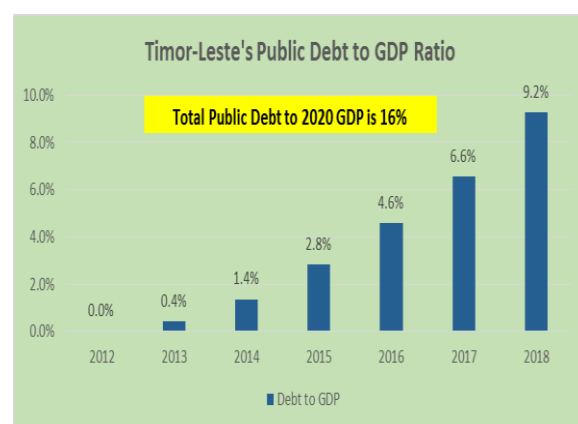
The design of DRs is for all public debts (external debts and treasury instruments) and to balance fiscal deficit, ensure debt sustainability, and protect PF, the only Timor-Leste's financial asset, from its depletion.



Source: MoFTL, June 2020.

Current rule of benchmarking costs of borrowing (external debt) with the average rate of PF investment return should be maintained (subject to regular review – adjusting to PF investment strategies) as it provides economic incentives, fiscal responsibility and safeguard PF.

Debt to GDP ratio of Timor-Leste in 2020 is 16 percent, which is considered low, and debt services of the current stock will conclude in 2059. Despite the fact that there is no rule of thumb on the level of the ratio to sustain debt services and in fact the Government uses PF withdrawal to repay loans, there is a need to impose limit on total debt service to the economy, which will help the Government to have fiscal responsibility to finance fiscal deficit and in the meantime ensure debt sustainability. In addition, mobilization of loans under this rule should be limited to finance investment expenditures in infrastructure and human capital development only. Government can gradually enforce the 60 percent to debt to GDP ratio rule as a political commitment by including in budget documents (budget circular, pre-budget statement and the budget book) and establish its legal based (preferably in public debt law) after the time lag issue of National Account publication has been addressed.



Source: MoFTL, June 2020

<sup>15</sup> Defines in Timor-Leste's public debt decree law

## IMPLEMENTATION STRATEGY

Implementing all 10 proposed fiscal rules in the same time horizon and with strong legal foundation are unrealistic, although 2 of them (ESI and a Maximum of 3% of Cost of Borrowing rules) are currently enforced.

The combined deployment of fiscal rules for Timor-Leste are inevitable, therefore the Government should select and use rules that are contextual and preferable, and can ensure PF sustainability, fiscal responsibility and macroeconomic stability.

The combined fiscal rules that will be used should complement the existing *frontloading* fiscal policy, ESI, 3 percent cost of borrowing, and budget preparation guiding principles (*fiscal sustainability, programs and priority, institutional capacity, quality of budget, and economic absorptive capacity*), and also should minimize overlapping of fiscal targets and implementable. The later refers to the rules should not be legally over-determined because they can impair the ability of the Government to achieve its fiscal objectives. The government is advised to enforce the combined fiscal rules with political commitment first and then gradually establish their legal foundations when appropriate.

With the current economy structure where public expenditure drives the economy and PF provides a buffer for fiscal policy, the Government may primarily focus on fiscal rules that contribute directly to macroeconomic stability, and then subsequently deploy rules that can ensure fiscal sustainability.

The existing fiscal rules on “*ESI and 3 percent of costs of borrowing*” should continue be enforced. But for the ESI, the Government is advised to narrow its definition to 3 percent of financial asset (PF) instead of petroleum wealth, provided that revenue from oil and gas has been on

downward trend and to protect sustainability of PF.

To ensure macroeconomic stability, the Government may primarily focus on ERs and BBRs. Given that these rules focus on budget as the target, Government needs to ensure that implementation of the combined fiscal rules on “*80% of total expenditure to GDP, 10% recurrent growth, 30 capital expenditure to GDP, 30% fiscal deficit and 50% recurrent to GDP*” should have very minimum overlapping issues.

On the other hand, Fiscal rules on “*15% of domestic revenue to GDP, 60% of debt to GDP and EW must be limited to 60% of ESI*” are for fiscal and debt sustainability, and therefore they could be enforced to complement ERs and BBRs, but with caution all deployed rules should be in harmony, no overlapping, serving macroeconomic stability and fiscal sustainability objectives, and with different political commitments and legal compliance over different time horizon.

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