



Briefing Note To Respond to “The Resource Curse in Timor-Leste” Article Authored by Charles Scheiner (La’o Hamutuk)

Introduction

An article was recently published on the resource curse in Timor-Leste¹. The first part of this briefing note considers whether Timor-Leste is suffering from the resource curse. The second part critiques some of the specific arguments used in the resource curse article.

Part 1: Is Timor-Leste Suffering from the Resource Curse?

Defining the Resource Curse

The resource curse occurs when natural resource wealth causes conflict, macroeconomic instability and poor quality public spending. These in turn lead to stagnant or falling economic growth and living standards and result in countries that are wealthy in natural resources developing more slowly than other countries.

Conflict

Resource wealth in countries like Nigeria and South Sudan has contributed to political instability and conflict. It is, however, clearly not the case that resource wealth has contributed to political instability in Timor-Leste. Political instability in Timor-Leste from 2006 to 2008 was not over access to natural resource wealth. In addition, since 2008 Timor-Leste has enjoyed political stability and increased security even as oil production and oil revenues have increased. Indeed resource wealth has directly contributed to political stability in Timor-Leste, as the Government has used this oil revenue to finance war veterans’ pensions, old age pensions and the PDID program which provide a peace dividend to the population and reduce the chances of conflict.

Macroeconomic Instability

Many countries have spent natural resource revenues soon after they have been collected. This has meant that volatility in commodity prices has fed through to government revenues and expenditures. Volatile government expenditures have in turn led to macroeconomic economic instability as demand, exchange rates and inflation have fluctuated.

Timor-Leste has completely avoided this type of macroeconomic instability. Oil revenues are saved in the petroleum fund and do not flow directly into the state budget. Withdrawals from the petroleum fund are based on what is considered sustainable in the long term and not short term changes to oil revenues (see graph 1).

¹ School of International, Political & Strategic Studies, The ‘Resource Curse’ in Timor-Leste, <http://ips.cap.anu.edu.au/sites/default/files/IB-2014-29-Scheiner-ONLINE.pdf>



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Dutch disease is another kind of macroeconomic instability. This occurs when the expenditure from natural resources increases demand in the economy and causes inflation. Higher inflation increases costs and reduces the competitiveness of businesses that export goods or compete with imports (e.g. manufactured goods). Higher prices raise profits and wages in the non-traded sector that does not have to compete with imports (e.g. construction, restaurants). Domestic labor and capital, therefore, move away from the traded sector to the non-traded sector. The end result is that the domestic economy is dominated by the non-traded sector (e.g. construction, restaurants) and most traded goods are imported. This can reduce long term economic growth if labor productivity growth and technological innovation occur more quickly in the traded sector (e.g. manufacturing) than the non-traded sector (e.g. construction).

There is limited evidence that Dutch Disease is currently occurring in Timor-Leste. Inflation in Timor-Leste is currently lower than most other countries (see graph 2). So there is no reason to think the traded sector is currently losing competitiveness due to money from natural resources flowing into the economy. Inflation has been high in the past, but this was partly driven by increases in international food prices and depreciation of the USD and not just increased expenditure from natural resource wealth. Domestic production in the traded sector in Timor-Leste is small and there are significant imports. But there is little evidence that this has occurred due to capital and labor moving from the traded to the non-traded sectors. Most businesses argue that a lack of skilled labor, poor access to finance and the investment climate are the main factors constraining growth in the traded sector and not scarce labor and capital being concentrated in the non-traded sector.

Poor Quality Public Spending

In resource curse countries governments waste money on ambitious white elephant projects that do not benefit the people.

From 2008 to 2013 the largest amount of infrastructure spending was on electricity (\$896.2 million). This project sharply increased electricity generation, distribution and transmission. A reliable electricity supply is essential for economic growth and industrial development. Better access to electricity has benefited many people. This project cannot be regarded as a white elephant project that hasn't benefited the population.

Roads and bridges and transport are the two largest sectors for infrastructure spending going forward (\$516.3 and \$537.5 million for 2014 to 2018 in the 2014 state budget). Roads are in a poor condition in Timor-Leste and need to be improved. Better roads are essential for bringing agricultural produce to market and economic growth. This spending is clearly not on unnecessary white elephant projects.

Government spending on education and health is also high and has been increasing since 2008 (see graph 3). Together these two sectors accounted for almost 18% of total Government spending in 2013. As discussed in the next section, health and education outcomes have significantly improved since oil production started in Timor-Leste. So overall Government spending has been in important areas and has had an impact.



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Living Standards and Economic Growth

Resource curse countries suffer slower economic development and stagnant or falling living standards. This has not been the case in Timor-Leste. Indeed Timor-Leste has seen very substantial increases in economic growth and living standards. More specifically:

- **Timor-Leste's non-oil economy grew at an average rate of 11.8% per annum from 2008 to 2012. (see graph 4).** This rate of growth is much faster than that of most other countries.
- **Household consumption (which is more strongly related to living standards than non-oil GDP) sharply increased by 6.7% on average per annum from 2008 to 2012.** This rate of growth is much higher than that of most other countries (see graph 5).
- **Infant mortality declined by 50% in Timor-Leste from 2001 to 2009.** This is one of the sharpest declines in infant mortality in the world.
- **The primary school net enrollment rate significantly increased from 65.6% in 2007 to 91.9% in 2013 in Timor-Leste.**
- **The prevalence of underweight children under 5 years of age decreased from 48.6% to 37.7% from 2007 to 2013.**

In short, since oil was discovered in Timor-Leste households have consumed more, there is less chance of their children dying and more chance they will attend school. It is hard to regard this as a curse.

Conclusion

The resource curse occurs when natural resource wealth leads to conflict, macroeconomic instability, poor quality public spending and stagnant living standards. Resource wealth in Timor-Leste has helped cement peace and has not caused political instability. The petroleum fund means the most severe forms of macroeconomic instability have been avoided. And most public spending has been in important areas like electricity, roads, education, health and social assistance and not on white elephant projects. Economic growth has been strong and living standards have increased. Thus there is little evidence Timor-Leste is suffering from the resource curse.



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Part 2: Specific Comments on the Resource Curse Article

This part of the briefing note directly comments on the resource curse article. The relevant sentence from the article is quoted and then comments are made.

Non-Oil GDP Growth

“non-oil GDP’ has grown at ‘double-digit rates’, this obscures the fact that productive sectors agriculture and manufacturing comprise only 4% of GDP and have not increased significantly since 2002.”

Although agriculture and manufacturing together do only account for a small part of GDP, this is because of large oil GDP. Whenever a poor country exploits natural resources then this will add to total GDP in the short term and any particular sector of the non-oil economy will therefore be a small part of total GDP. The only way to avoid this would be to deliberately not exploit oil resources, which would be a very unusual policy and few economists would recommend it.

It is true that agriculture and manufacturing have grown slowly. However, agriculture and manufacturing are not the only sectors that improve living standards or household consumption. Many households would rather have a new house or access to healthcare than they would a new manufactured good. So growth in other sectors and not just agriculture and manufacturing also matters.

“All the growth in ‘non-oil GDP’ comes from the state spending oil money: public administration, infrastructure construction, and supplying goods and services to the government.”

This is incorrect. Government administration does not account for all the growth in non-oil GDP. It is obvious to anyone living in Timor-Leste that the retail (e.g. Timor-Plaza) and private sector construction (e.g. people’s houses) sectors have also grown.

In addition, when oil production is offshore Government spending is the only mechanism for this wealth to flow into the domestic economy and benefit the Timorese people. Therefore, it will always be the case that in the initial years of natural resource wealth extraction a significant amount of demand and non-oil GDP growth will be due to Government spending. The only way to avoid this would be to deliberately not use oil wealth to benefit the Timorese people.

Timor-Leste’s oil wealth is leaking out rapidly. In 2013, Timor-Leste spent US\$535 million on imported goods, while non-oil exports totaled only US\$16 million, nearly all coffee.

This point is based on the simplistic argument that imports are bad and exports are good. In economic terms this is incorrect as imports increase consumption and welfare.

Timor-Leste is a small country and it is very unlikely that it will be able to manufacture its own motorbikes or anti-malaria drugs. So reducing imports would clearly reduce living standards. Even large rich countries import significant amounts of goods for consumption (e.g. Australia imports cars, the UK imports wine).



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In addition, imports are needed to produce exports. Increased agriculture production in Timor-Leste will require fertilizer to be imported. Brewing beer would require importing bottling machinery. So increasing exports in the future will require imports.

There are few countries that make all the components of a manufactured good themselves. Rather in the modern world countries specialize in a particular part of production. Rolls Royce may export cars from the UK, but it imports motors from Germany to make those cars.

The key question is can Timor-Leste afford the current level of imports in the long term? With total exports (including oil) current exceeding imports and even the current yield on petroleum fund assets exceeding imports the evidence is that it can (see graph 6).

State Spending

During 2014, the Ministry of Finance projects that 61% of state revenues will come from oil and gas exports. Another 32% will be from investing past petroleum income, with only 7% from non-oil sources.

In any poor country that starts exploiting significant natural resources it is obviously the case that oil revenues will initially be large compared to domestic revenues. There is nothing wrong with this and the only way to avoid this would be to not tax the international oil companies extracting Timor-Leste's oil.

The important point is whether domestic revenue is increasing and whether overall fiscal policy is sustainable. Domestic revenue has grown strongly in Timor-Leste and detailed fiscal modeling shows that a budget of \$1.3 billion or less would be sustainable for 2015 and the Government is committed to not exceeding this amount.

Although health and education are gradually getting more, Timor-Leste still invests 40% less on them than well-managed developing countries.

This point is impossible to verify as there is no broadly accepted definition of what constitutes “a well managed developing country”. The author of the article probably only regards developing countries that spend a lot on education and health as being well managed. So most likely the sample Timor-Leste is being compared to is biased.

Timor-Leste's post-1999 'baby boom' are not getting adequate nutrition or education, which will have long-lasting consequences.

Access to education has sharply increased since oil production started and child mortality and malnutrition have sharply declined. This isn't evidence of the resource curse.

“Despite this, inflation continues because there are more dollars than goods”

The rate of inflation for December 2013 to December 2014 was 4%. This is a low rate of inflation and is lower than many other countries (see graph 2).



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The Resource Curse Has Many Faces

In addition, special interest groups veterans, contractors, people displaced by the 2006 unrest, former office holders, soldiers who deserted, political party leaders claim privileged entitlement to public funds.

It is not clear what the phrase “entitlement to public funds” means. There are certainly programs to assist veterans and the displaced. Contractors are certainly paid if they have fulfilled a contract with the Government and undertaken the specified construction. But these are all entirely legitimate (even desirable) areas of Government spending.

“Oil attracts the most persuasive, creative and ambitious people, leading to a brain drain from more productive or service-oriented professions”

The oil industry employs relatively few people. There has not been a significant movement of professionals (doctors, nurses etc) to the oil industry.

“The Future is Predictable Development of Greater Sunrise oil and gas is stalled due to disputes with Australia over maritime boundaries and with the oil companies, who want to liquefy the natural gas at sea, rather than pipe it to Timor-Leste. Even if this project proceeds with an LNG plant in Timor-Leste, total oil and gas revenues will average US\$1 per person per day for four decades, about one-third of the 2014 budget”

The article was originally arguing that oil has cursed Timor-Leste and made it worse off. Now the article is arguing that running out of money from natural resources will also make Timor-Leste worse off and that it is a problem that Timor-Leste’s oil resources are limited. These two arguments are inconsistent.

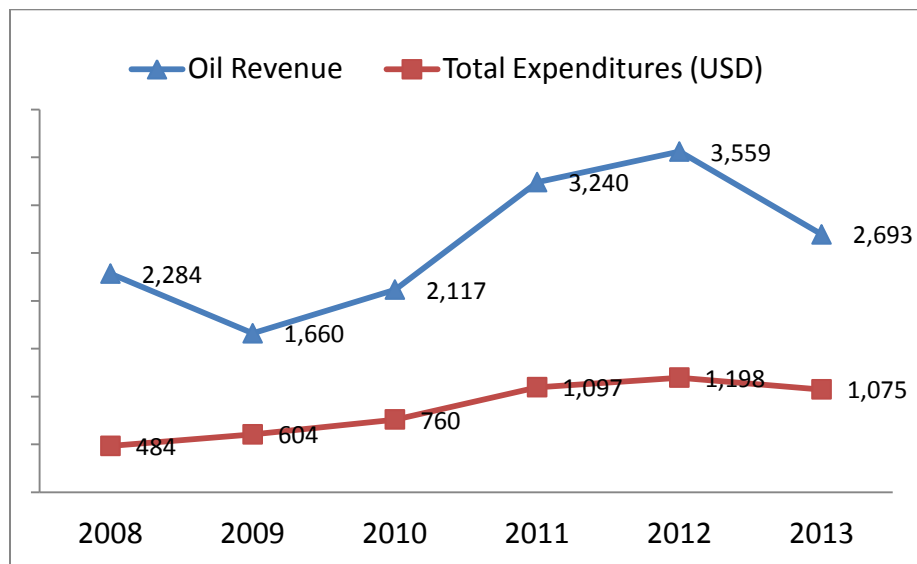
“Timor-Leste must fortify its strongest resource its people by investing in education, nutrition and health care”

There has been huge investment in these areas (see graph 3). Education, nutrition and health outcomes have all sharply increased since oil production started.

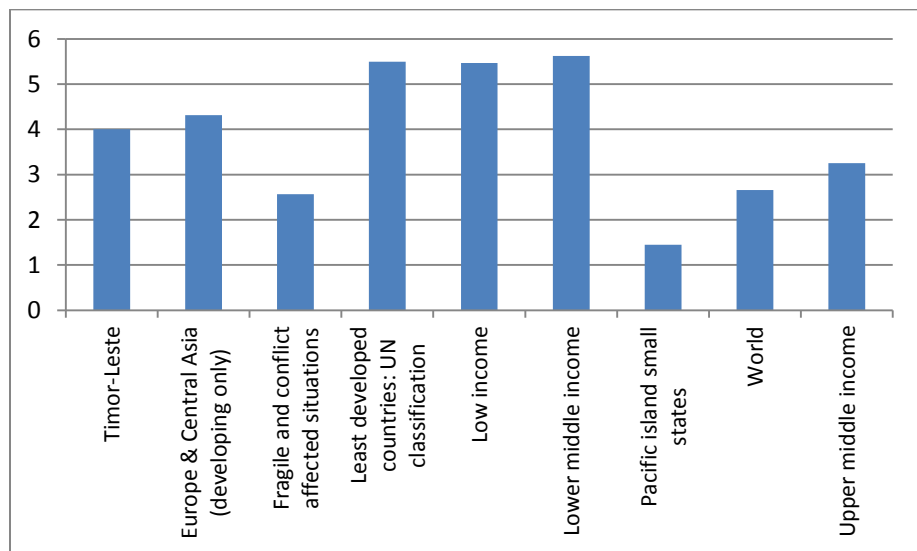
Conclusion

The article is a long list of criticisms. Some of which are valid but many of which are based on a simplistic understanding of economics. The article doesn’t show that Timor-Leste is suffering from the resource curse. There is very strong evidence that living standards have increased since oil production started.

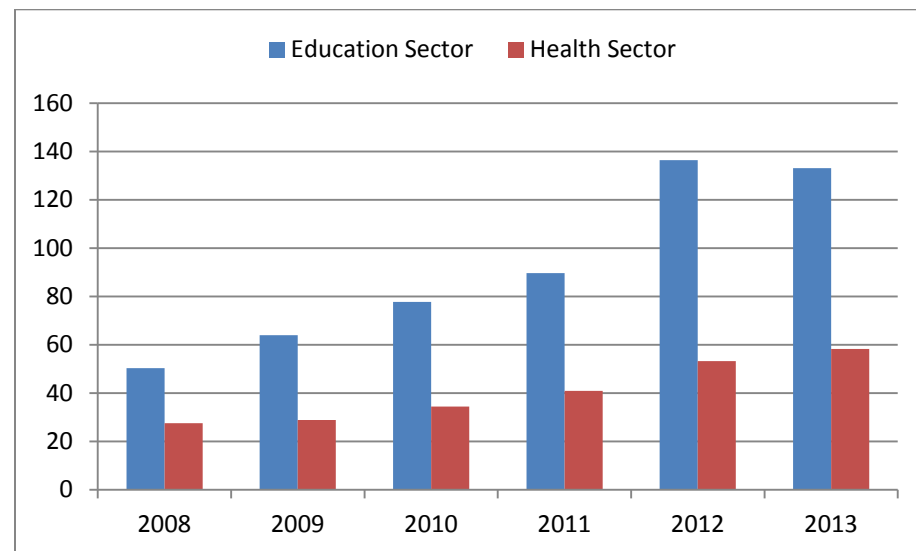
Graph 1: Oil Prices, Oil Revenue and Expenditure in \$ million



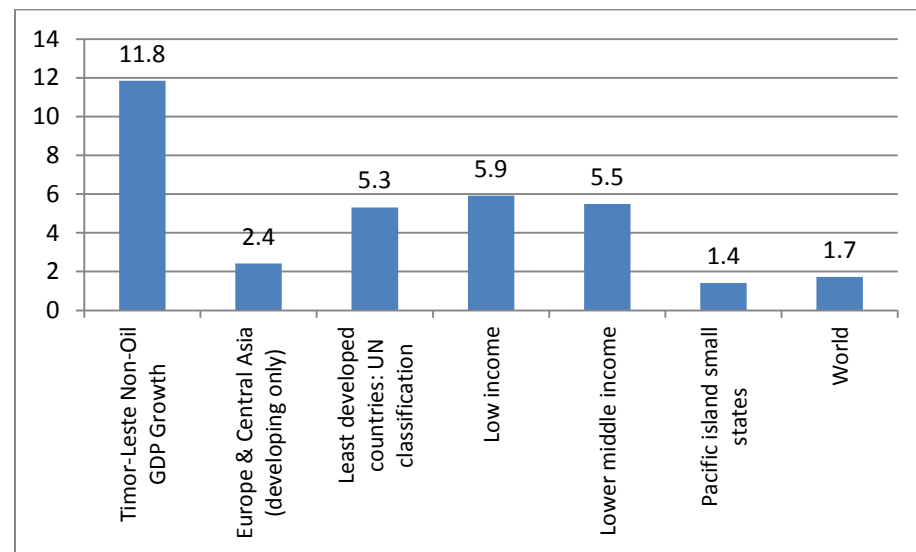
Graph 2: Inflation in 2013 in Timor-Leste and other regions and country groupingsⁱ in percent



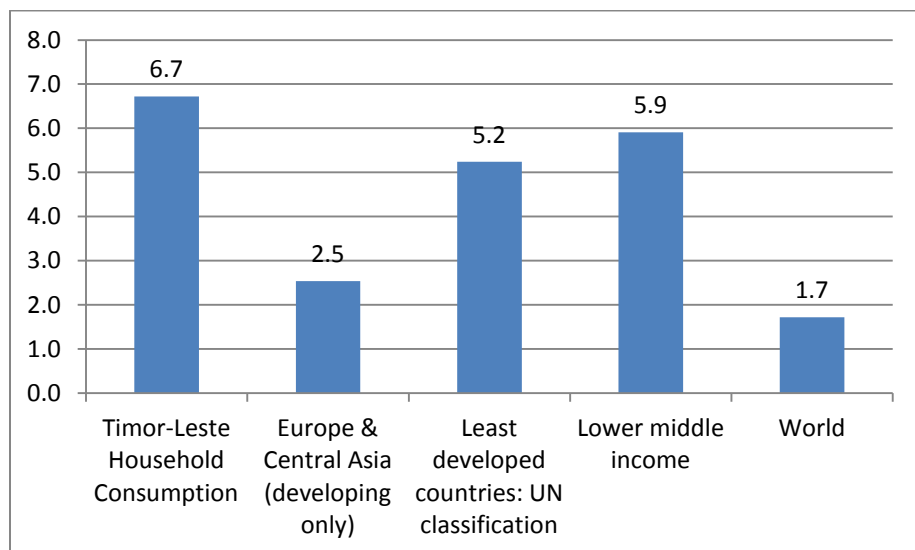
Graph 3: Spending on Education and Health in \$ millionⁱⁱ



Graph 4: Average Economic Growth for 2008 to 2012 in Timor-Leste and other region and country groups in percent



Graph 5: Household Consumption Growth (2008 to 2012) in Timor-Leste compared to regions and country groups in percent



ⁱ Inflation in Timor-Leste is year on year inflation from December 2012 to December 2013

ⁱⁱ The education sector is defined as the Ministry of Education, National University, Secretary of State for Professional Training and Employment Policy, Human Capital Development Fund and school and university sub-programs in the Infrastructure Fund. The health sector is defined as the Ministry of Health and the hospital/clinic program in the Infrastructure Fund.

Graph 6: Imports and the Yield from Petroleum Fund Investments in \$ million

