Timor-Leste: The Political Economy of a Rentier State

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Introduction

Since 2005, Timor-Leste's state receives multi-billion dollars from Petroleum Revenues. These revenues, on one side, enable the state to expand its programs by financing million-dollar infrastructure projects, social services, subsidizing veterans and elderly, and expand the state's bureaucracy during the last five years. On the other side, it turns Timor-Leste into a Rentier State, confirmed by various quantitative data and qualitative analyses. The argument that Timor-Leste is a Rentier State based on various characteristics, namely independence of the state *vis-a-vis* domestic economy, composition of GDP, proportion of public expenditure as domestic economy, employment structure, and Dutch Disease. Due to this, it shapes the economic structure in its own unique way, and the characteristics in which the state and society interacts. This paper discusses some of the current economic policies and some of its impacts. Furthermore, this paper intends to provide some theoretical as well as conceptual framework to help understand the current political economy of Timor-Leste, and the challenges that it faces as a petro-dependent country.

Conceptual Framework

The concept of a Rentier State is frequently used to explain various issues in countries where rent plays dominant roles in their domestic economy. Hossein Mahdavy (1970, 428) is considered the pioneer of this theory when he used it to explain the socio-political and socio-economic development in many Middle Eastern countries that received a high amount of money from exploring oil and gas (Mahdavy 1970, 428). He defined a Rentier State as a country that receives a substantial amount of external rents from foreign individuals or foreign government to a given country. Some scholars measure a Rentier State based the proportion of natural resources rents against the total government revenues (Karl 2004, 661). This term primarily applies to oil. However later on, it also applies to externally generated revenues such as remittance, or renting assets to foreign entities. For the last thirty years, many academics have used the Rentier State concept to explain the socio-political and socio-economic dynamic in many developing countries; in Iran (Mahdavy 1970) in Arab Saudi (Hertog 2012), in Gulf States (Gray 2011), in Central Asia (Gawrich, et all 2010), and in Africa (Gray 2010).

As a political and economic concept, the most important feature of Rentier State is that it explicates the relationship between state and the society. Hazem Beblawi and Giacomo Luciani, wrote that:

> "A rentier or exoteric state will inevitably end up performing the role of allocating the income that it recieves from the rest of the world. It is free to do so in variety of ways.... As long as the domestic economy is not tapped to raise further income through domestic taxation, strengthening of the domestic economy is not reflected in

> the income of the state, and is therefore not a precondition for the existence and expansion of the state..."

Historically, looking at the economy of Middle Eastern countries, the period of 1951-1956 is seen as the landmark since a massive amount of foreign currency and credit generated from petroleum revenues came into the state's coffers, thus, turning some oil-producing countries into Rentier States (Yates 1996, 12). This revenue then enabled the Middle Eastern states to expand state services rapidly (Mahdavy, 432). As it expands, it turned states into 'estatism.' By this, the state assumes power to direct the economy and to manage the overall economy, and control means of production. Politically, and historically, 'Estatism' facilitates newly independent states at that time to foster their legitimacy, and state's presence in the society through various means (Kemrava 2005, 258).

Although manifestation of Rentier States different from one country to another, there are some common phenomena, which are important in the context of Timor-Leste. Economically, the revenue that the state receives from the oil sector is independent from the domestic economy (Mahdavy, 429). Based on the data that Mahdavy derived on the economy of the Middle Eastern countries during the 1950s, he noted that the inputs from the local economy to the oil industry was very small, therefore oil revenues is the same as free gift (Mahdavy, 429). Nathan Jensen and Leonard Wantchekon from the University of Washington put it nicely: 'Rents are typically generated from the exploitation of natural resources, not from production (labor), investment (interest), or management of risk (profit).' In this context, the relationship between local economy and state is rather than interdependent, it is the domestic economy that depends on the public expenditure.

Second impact is the Dutch Disease. The Dutch Disease originates from a booming resource sector, which leads to a contraction of the manufacturing sector via loss of competitiveness, due to currency appreciation (Butler, et all 1980). The way that Dutch Disease manifests in developing countries is different. The revenues from oil push inflation, therefore making it harder for the country to develop a non-oil economy. As such, Import-Substitution Industry is difficult and imported goods and services becomes more attractive. Despite manufacturing losing its competitiveness, the agriculture sector is also underfinanced; this drives people to move to urban areas. Nigeria is one of many examples. The massive revenues from exporting oil drove country's currency to appreciate. Such appreciation caused imports to become cheaper. Later on, it disincentives investment in productive sectors, such as agriculture and non-oil industries (Lewis, 98).

Third is the characteristic of the state. According to many researchers, the government in the Rentier State tends to spend only, since they generate their revenues from external sources (Bosch 2012, 4). Mathew Gray (2011, 8) observed that the government in a Rentier State has limited interest to support, to sustain, and to diversify the non-rent domestic economy when the rents grew. Hence, Beblawi and Luciani noted that, the state becomes the main intermediary between the oil sector and the rest of economy, by channelling it through public expenditure (Bosch 2012, 5). In a way, the state's role is to allocate the rents to the domestic economy (Brocard & Vallet; Basedau ad Lay, 5,).

Fourthly, since state's revenue is high, it enables the government to embark on large public expenditure, without any balance of payment deficit or the government has to tax its citizens. This is done through expanding state bureaucracy, state-run social services, expansion of public sector employment, and state-funded infrastructure programs. As the public sector expands rapidly, the public sector becomes very dominant, and other sectors are dependent on the expenditure from the public sector. In addition to that, in term of public employment structure, the public sector tends to employ more people, and becomes more attractive. In Arab Saudi, when the second oil peaked arrived by late 1970s, the oil and the public sector accounted for 65% of Saudi's economic activity and the government drove 63% of total investment in physical assets (Hertog 2012). At the same time, the state expenditure increased consistently and public services, such as electricity, generation, water and sanitation, and roads, expanded rapidly (Hertog 2012). This strategy also has some political motivation, which is to buy off opposition groups, to keep everyone happy with the regimes, and finally, to stay in the power.

Finally, it is argued that in a state where the government generates most of its revenues from external sources, it disincentives the state to extract tax from the domestic economy. However, from political, sociology, and economic point of view, taxes have an important role to play in nation-state building, state-capacity, society-state relations, and the quality of the institutions. One clear argument is that ability to tax citizens indicates the state capacity. This argument is suggested by Christopher Hood (2003, 213), "ability to tax is central to state capacity as ordinarily conceived, since state that cannot levy effective taxes will have only limited capacity to do anything else." The Danish Institute for International Studies (DIIS), in its Policy Brief (2008) underlines correlation between tax, state building, and the capacity of the government. In its Policy Brief, it argued that taxation helps the state building; since state building involves: government's capacity to interact with the society, obtain support and resources from those interests, and pursuing public goals. It identified three ways in which taxation promotes state-building: providing revenues which key state functions cannot be carried out; encouraging constructive state-society relations around taxes; creating more effective tax administration.

Timor's Context of Rentier State

Various statistics prove that Timor-Leste is a "Rentier State." In term of total GDP, according to National Account (2000-2011), since 2005, the Petroleum Sector has taken over non-oil in term of proportion to Timor's GDP. In 2011 alone, 76.9% of the GDP came from the Petroleum Sector. In term of the state's revenues, in 2012, 96% of state's revenues was from Petroleum, and in 2013, 94% of the state's revenues was from Petroleum (MoF; 2013). In term of Public expenditure, in 2010, 2011, and 2013, domestic revenues contributed 12.7%, 10.18% and 11.5% respectively, which means that the rest was from the Petroleum Fund Account (MoF; 2013). While more than 95% of state's revenues are from oil, the oil industry is independent from the domestic economy. Another way of looking Timor as a Rentier State is to compare the percentage of the state's annual expenditure as the non-oil GDP. In 2011, 2012, and 2013, public expenditure was 97.2%, 88.72 and 107.3% respectively of non-oil GDP in every given year.

As far as linkage between oil industry with the rest of economy, oil industry is independent from the rest of the economy. Oil processing takes place in the Northern Territory of Darwin, and Timor-Leste's government only receives profit and tax revenues, which is transferred to the Petroleum Fund Account. The proportion of public expenditure compared to the domestic economy provides a strong foundation for this. In this circumstance, it is valid to argue that, looking from a fiscal point of view, the state in Timor-Leste is independent from the domestic economy. Although every year, the state suffers non-oil fiscal deficit more than one billion dollars during the last three years, the state still functions due to rents from petroleum revenues. During the last three years, Timor-Leste experienced more than one billion dollars in non-oil fiscal deficit. However, this has been closed by the transfers from Petroleum Fund. For the next five years, based on the current projection, there will not be any structural changes.

This situation shapes the roles of the state in a society in a certain ways, by which it plays roles to allocate the rent resources from petroleum to the rest of the economy. This is reflected in the government's economy policy to inject capital into the market. While the economic rationale behind this policy is to create demand, on the other hand, the state becomes allocative. There are many measures in which the state allocates its resources. One important measure is the establishment of several autonomous agencies and public-owned enterprises, such as EDTL, SAMES, IGE, Centru Bamboo, RTTL, and Timor Gap.[1] Although in theory these institutions are autonomous, and Public Enterprises, they are heavily subsidized by the state. In this context, these institutions serve to allocate resources to the domestic economy.

Another measure is through public transfers expenditure. This item consists of various subsidies, such as elderly subsidy, veterans' subsidy, subsidy to civil society, subsidy to the village, subsidy to local business, etc. This item increases every year, and is projected to continue increase in the future. In 2011, 2012, and 2013, the Government's spent \$142.6 million, \$233.7 million, and \$239 million respectively. In term of proportionality, it accounts for 12.6%, 17.3% and 15.5% respectively. Compare to the other countries, this considerably high, compare to other countries in the region, or other fragile states (World Bank; 2013; 41).

Another characteristic of the Rentier State in Timor-Leste is inflation, which is a manifestation of Dutch Disease. Since Timor-Leste does not have an independent monetary policy, the manifestation of Dutch Disease in evident in the fiscal policy. Since 2008, the government embarked a large public expenditure to finance an infrastructure program's recurrent expenditure. Expansionary fiscal policy contributes to inflation in Timor-Leste that has been higher than 10% on an annual basis for the last three four years (IMF; 2012). The Ministry of Finance also acknowledges the impact of the government's policy as well, in its analysis on inflation in Timor. This inflation, in turn, hinders incentives for the domestic market to produce. Subsidy in itself is a form of social welfare, which is important in a country like Timor-Leste. However, if it is not strategically designed, it will stimulate consumption, and disincentive people to produce.

[1] EDTL stands for Eletrisidade de Timor-Leste; SAMES stands for Serviço Autónomo de Medicamentos e Equipamentos de Saúde, IGE stands for Institutu Gestão Ekipamentu, RTTL stands for Radio Televizaun Timor-Leste, and Timor Gap is a Public Enterprises.

Rentierism and the State's Expansion

Timor-Leste's government's macroeconomic policy has been to inject capital into the domestic market. The main assumption is that by injecting capital into the domestic economy, it will stimulate the demand for goods and services, and the supply side will respond to domestic market's demand (Book 1 of State Budget 2012, 23). Capital is injected into the market through wage and salary, personal benefit to the elders and veterans, small-scale projects such as PDD and PDL, as well as certain amount of goods and services. This has contributed to the current GDP growth rate. In doing so, the government increased its annual budget significantly from 2008 to 2012. By 2013, the state proposed budget has already reached $1.8 billion, compared to $200 million in 2007. Such an increase makes Timor-Leste one of world leaders in term of budget increase.

One area of the state's expansion is the bureaucracy. Beside various ministries and secretary of state, various commissions including the Anti Corruption Commission, the Public Service Commission, the National Election Commission, the National Development Agency, the National Ombudsman, and others were also established. Some of these institutions were created as part of "Administrative Reform" that fell under the Gusmao-led government. There are also various autonomous agencies, and public enterprises namely: EDTL, Portu, Sames, and Aviasaun. State owned enterprises or Emprezariu Públiku include Timor Gap, and Radio Televizaun Timor-Leste, SAMES, and Centru Bamboo. Theoretically these institutions are self-funded and enjoy autonomy from the Government; however, in reality, they are still heavily subsidized by the state.

Another sector is the infrastructure sector. This is one of key issues in Timor-Leste because poor quality of infrastructure is seen as the main constraint for the private investment and overall economic development in Timor-Leste (IMF 2012, 4). During the last five years, under the leadership of Xanana Gusmao, physical infrastructure, including roads, public buildings, and electricity became the core program for the government. In 2008, the government's direct spending on infrastructure, as indicated by the Capital Development items, was still $86.5 million or 17% of the total annual budget at that year (RDTL State Budget; 2012; 17). By 2012, it reached $915.3 million, or without inflation, it increased 775% (RDTL State Budget 2012, 17). The government is more likely to maintain this level of expenditure on infrastructure, as it is one of the government's top priorities as lay down by the Strategic Development Plan.

Social Services are another critical sector for Timor-Leste, mainly education and health. The expansion of these sectors is critical, given that in the rural areas, these sectors make state's presence visible to the people. Between 2009 and 2013, the government's recurrent expenditure on education increased from 53% from 2009 level (RDTL; State Budget 2013). The government's expenditure on health during the same period increased 115% from the 2009 level (RDTL; State Budget 2013). In addition to health and education, the government has various forms of subsidy: the elders' subsidy and the veterans' subsidy are the most famous ones. In 2009, the annual budget allocation to this sector was $31 million. However by 2012, the government's allocation to the personal benefit payment reached $109 million, or increased more than 240% in four years. In term of its contribution to the GDP, according to National Account report, in 2011, government expenditure on public administration, which covers education, health, and defence, increased by 25% compared to the previous year. Outside of Dili, these services are critical to make the state's presence visible to the population.

The increase of public expenditure and the expansion of the public bureaucracy also have implications for the employment structure in Timor-Leste. The current employment structure bears similarities with other Rentier States, where the formal employment structure directly or indirectly relates to the oil sector. In term of its growth, according to data derived from National Statistics, between 2004 to 2010, people who are engaged in the Public Administration, Administrative Support, Professional and Scientific, Education, Health and Social work increased by 155%. According to the data from the government, by the end of 2012, public sector employed around 39,226 people, including PNTL, F-FDTL, Teachers and Nurses and not included advisors and consultants employed in every public institution. As the public servants increase, the government's allocation for wage and salary also increases. By 2008, the government's allocation on wage and salary was $50.3 million and it reached $140 million or increased by 270% by 2012 (RDTL 2012, 17). In 2013, Government expenditure on salary and wages is more than 10% of projected non-oil GDP. According to the World Bank Report (2011, ii), as the percentage of GDP, Timor-Leste's wage and salary is about 25% to 50% higher than countries such as Fiji, Tonga, and Vanuatu. The expansion of the bureaucracy also has implications for Household Income in Timor-Leste. According to the recent Survey on Household Income, at the national level, 54.4% of household wage income per month comes from the government, or public sector, compared to the private sector, which is 45.6%. Employment in the private sector also directly relates to the public expenditure. According to the Survey on Business Activities, in 2011, 30% out of 58,200 employments in the private sector were under construction, and 80% of them were centralized in Dili. This directly relates to public sector spending as most of the petro dollars are recycled in Dili, and infrastructure has been one of the governments' priorities during the last five years.

The Impact of Political Economy of Rentier State

It is common in the history of the developing world, especially after colonization, that although the state as an institution is new, it is very powerful, and determinant in the transformation of society. In such a situation, the state expands rapidly through various sectors, in which the state intends to make itself visible to the society. In Timor-Leste's case, it is to a certain degree unavoidable because the capacity of the private sector was very weak. What is unique for Timor-Leste, as a petroleum-dependent country, is that only petroleum revenues enabled this expansion. Therefore, the central argument of this paper is that the state's expansion takes place independent from the domestic economy. Therefore, relations between the state and the domestic economy are not mutually dependent, but it is the domestic economy that depends on the recycle of petro dollars.

It is widely agreed that economic development in Timor-Leste takes place because of public expenditure, which is the recycle of petro dollars. It is arguable to state that the public sector in Timor-Leste functions as the intermediary between petroleum revenues with the domestic economy. It facilitates the distribution of the petro dollars through public expenditure. This shapes the politicians and bureaucrats in the public sector to neglect developing the domestic economy and other productive sectors, as it does not take part in the state's revenues. It shapes the way that policymakers think, which is how to spend money easily, without thinking creatively. In the end, public investment is mainly to spend petro dollars and less investment is given to generate income domestically, and less investment is directed toward long-term return.

The public sector, which is the main driver of economic growth, employs around 3.5% of the population. The agriculture sector, which is still considered to be the main source of livelihood for the people in the rural areas, declined in terms of its contribution to the GDP. Heavy emphasized by the infrastructure, aside from the quality of the spending, it also means that the current political economy only satisfies small groups of people in Dili, especially the contractors, whereas the population outside of Dili are not equally benefited. This is confirmed by various reports from the Department of Statistics, where infrastructure grew by 19%. At the same time, in term of employment distribution, 80% of employment in the private sectors is in Dili, whereas twelve districts only share 20%. In this context, it is simple to think that only a small proportion of the population contributed to this growth; therefore, the growth is also not equally distributed.

This economic structure leads to a third implication, which is the relationship between the state and society. A modern state, as defined by Western philosophers like Thomas Hobbes, John Lock, Jean Jacqueas Rosseau, is a result of the social contract. In a modern world, this contract also implies that the mutual dependence between the state and the domestic economy, and fiscal dependence from the state toward the citizens should exist. In other words, people need to contribute to the state's operations. This mutual dependence does not exist in Timor. The fact is that tax is merely seen as the source of income, tax is the state's instrument to intervene in the market, to distribute resources, to shape the society character's are not reflected in the political economy. Finally as tax is played down, it also implies that the fiscal contract between the state and its citizens are not strong, which later on undermines state-society relations.

The fourth implication of the state's expenditure is inflation in Timor-Leste. Many observers have pointed out that while external factors contribute, current inflation to greater extent is due to massive public expenditure. During the last three years, the increase of the price of basic needs has become one of the main concerns in Timor-Leste. In the last two years, 2011 and 2012, while Timor-Leste experienced "double-digit" economic growth, the inflation rate was even higher. For example, based on the report from the National Directorate of Statistics (2012), in 2012, the rolling year rate of CPI range from 11% up to 17% during the whole year. According to a study conducted by the Asian Development Bank, a 10% rise in food price in Timor-Leste could increase poverty incidence by 2.25% points (cited by the IMF 2012, 9). As such, the IMF (2012; 7) has warned, "high inflation could push back progress on poverty reduction and lead to real currency appreciation that would hurt private-sector-led growth". For the long run, if the inflation rate continues, it makes it hard for domestically produced goods and services to grow, import substitution will continue to be hard, and there will be an increase in dependency on imported goods and services.

Finally, the question of sustainability of Timor-Leste is an important one. The concept of Rentier State is used to explain the situation in Middle Eastern countries, where oil dominates the national economy. In the context of Timor-Leste, statistics speak for themselves. However, Middle Eastern countries are rich in natural resources, such as oil and gas. On the other hand Timor-Leste, by any account, does not resemble Middle Eastern countries. Therefore, the question is for how long will petroleum revenues sustain Timor-Leste's economy? A recent article by Charlie Scheiner (2013) gives us some alarming commentary about the risk of Timor's political economy of a Rentier State. Recent revision of the

Petroleum Wealth by the Ministry of Finance also confirms what many already stated, where the current oil field that is in production is expected to be depleted four years faster than last year projection.

Conclusion

This article intends to provoke critical and deeper analysis into the impact of the petroleum revenues toward the state-society relations. This article argues that offshore petroleum revenues enable the state to expand through public administration, infrastructure, and social services. This expansion takes place independently from the domestic economy, as the domestic economy contributes less than 10% to the total state's revenues. As such, it shapes the economic structure, and the way in which interactions between society and the state takes place.

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