

This private memo from the World Bank and IMF to the Government of Timor-Leste was inadvertently made public in July 2008.

Timor-Leste Petroleum Fund: A Case for Caution

Note Prepared by the World Bank and IMF, May 2008

Some people are arguing that the Petroleum Law should be amended, to allow more money to be transferred to the Budget. This is motivated by a strong commitment to tackling the country's poverty and suffering as quickly and comprehensively as possible, and by frustration at the disappointing impact of development efforts so far. Some economists have sympathized with this impulse, arguing that the returns to investments made today will outweigh the benefits of spending the funds at some future date.

The World Bank and IMF advise against amending the Petroleum Fund Law at this time---for three reasons:

(1) **The Government is unable to spend the revenue currently available under the Petroleum Fund Law's sustainable income formula.** Government spending has increased sharply in recent years, but remains well below what has been planned. In 2006/7, only 49% (US\$181 million) of the Budget was spent (and only 16% of the capital portion). The expenditure rate increased slightly under the recent 2007 six-month Transition Budget, to 55%. The 2008 Budget is 6% larger than in 2006/7 (US\$348 million), and the Government plans to add as much as US\$190 million at the Mid-Year Review. Budget execution to date suggests that expenditures on a commitment basis are increasing, but cash outlays are once again likely to fall far short of appropriations and to remain well below the sustainable spending level (US\$434 million for 2008).

The reasons for these chronic expenditure shortfalls are well-known: they stem principally from the country's inadequate budget planning/execution systems and poor implementation capacity (both in Government and the private sector). Since independence, Timor-Leste has enjoyed abundant international aid and rapidly-growing budgets. Successive governments have promised to deliver services to the population, but have been frustrated by weak capacity. In turn, these contributed to civil unrest (which has further compromised Budget execution). Per capita income in the non-oil economy is about 4 percent lower in real terms than it was in 2002, which suggests that poverty is increasing. Until planning and implementation capacity is strengthened it will be difficult to spend current sustainable income---let alone any additional appropriations.

(2) **The Petroleum Fund Law already allows for transfers from the Fund to the Budget in excess of the estimated sustainable income (see attached Box for an explanation of the sustainable income concept).** Transfers in excess of sustainable income are permitted as long as the Government provides Parliament with "a detailed explanation of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the Estimated Sustainable Income."¹ Submitting the issue to public debate ensures transparency and adequate consideration, and is an important aspect of the good governance practices for which the Petroleum Fund is renowned.²

¹ Article 9, Petroleum Fund Law.

² In a survey by the Peterson Institute that evaluated the structure and operation of 32 sovereign wealth funds. Timor-Leste's Petroleum Fund was ranked third best in terms of its governance arrangements and management performance.

A change to the Petroleum Fund Law would present Timor-Leste with reputational and governance risks. The Petroleum Fund is a credit to Timor-Leste, creating confidence at home and abroad that the Government is serious about good governance. The Fund's procedures-- publication of quarterly and annual reports, mandatory external audits, a Consultative Council, an Investment Advisory Board--have been designed to ensure honesty, transparency, and due diligence in the use of the revenues. The design is based on lessons learned from other countries, where petroleum revenues have amounted to a distortionary curse rather than a blessing. It is tempting to accelerate spending on transfers like pensions or social supplements, which are potentially quick-disbursing, visible, and can be targeted to the poor. These instruments are no panacea, however. If expenditure outruns the capacity of the country's systems and skills, waste and misappropriation are an inevitable consequence.

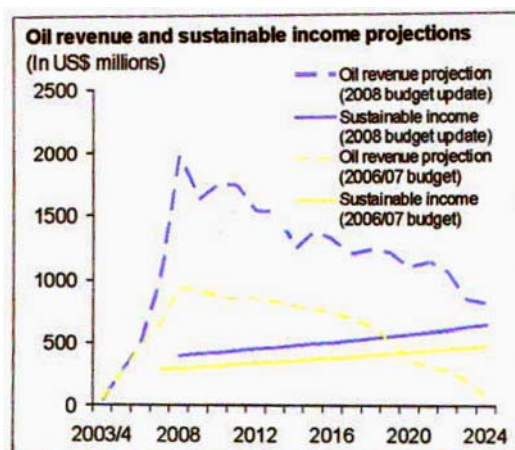
(3) Too rapid an expansion in oil-derived expenditure could have perverse and damaging macroeconomic effects. The sustainable income formula (and the investment of revenues overseas) helps mute the emergence of severe supply bottlenecks (in Timor-Leste's case, a tiny private sector, limited port facilities and a lack of skilled labor). Increased spending is likely to exacerbate these constraints, increasing the rate of inflation and raising the real exchange rate. This could well create a cost structure that would destroy the competitiveness of Timor-Leste's non-oil economy (the phenomenon known as "Dutch disease"). The cost of goods and services is already considerably higher than in next-door Indonesia.

In conclusion, caution is advised before making changes to the Petroleum Fund Law. The availability of funds is not a major constraint for Government today--current spending remains far below budgeted amounts (about 55-60% of total funds), and well below sustainable income levels. Expenditure should and will increase as planning and implementation capacity increases. Once absorptive capacity has increased, raising the sustainable income limit may be justified. Rather than focus on this issue now, the Government and its development partners need to concentrate on enhancing capacity (including by contracting-out), and on ensuring that available revenues are well spent. This, not promises of additional spending, is what will improve Timorese livelihoods.

The Petroleum Fund and Timor-Leste's Revenue Outlook

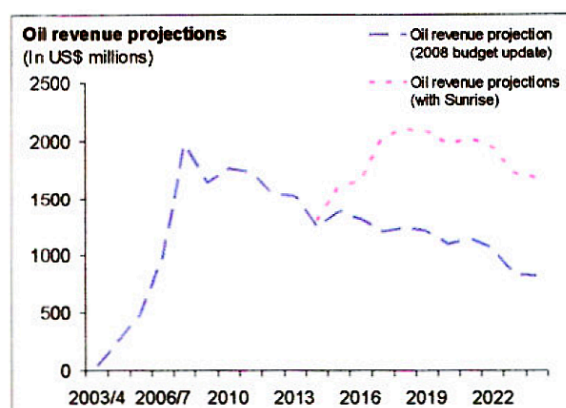
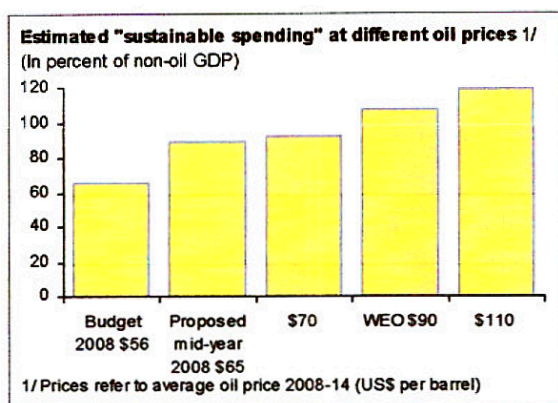
Policy Features of the Petroleum Fund

- Funding the Budget.** Timor-Leste's Petroleum Fund was established in 2005 to receive all revenue generated by Timor-Leste's petroleum resources.¹ Money from the Petroleum Fund is used to finance the Government's budget-money from the Fund can only be used in this way to ensure that it funds only official Government programs. In addition, money from the Petroleum Fund can only be transferred after approval of the budget by Parliament.
- Sustainable Income** Petroleum resources will not last forever. To preserve money generated by petroleum for use by the country over the long-term, the Petroleum Fund is managed on the concept of "sustainable income." Sustainable income is the amount of money that can be transferred from the Petroleum Fund each year to finance the budget without reducing the country's overall "petroleum wealth" (petroleum wealth is defined as financial assets from petroleum already produced and estimated revenues from petroleum still in the ground). The Petroleum Fund Law defines sustainable income as 3 percent of the total estimated petroleum wealth. Given current high international oil prices, the annual amount available to the budget from the Petroleum Fund under the sustainability criterion has increased from US\$103 million (30 percent of non-oil GDP) in FY2005/06 to US\$396 million (about 85 percent of non-oil GDP) in FY2008. Combined with domestic revenue, currently projected at some \$38 million in 2008 (8 percent of non-oil GDP), this sets the total estimated "sustainable spending" limit.
- Fund Management/Investment.** The Banking and Payments Authority manages the Petroleum Fund on behalf of the Ministry of Finance, investing the proceeds abroad to minimize real exchange rate appreciation. To date, in accordance with the Petroleum Fund Law assets have been invested safely in U.S. Government securities, obtaining an average annual return of 4.4 percent. Plans are underway to outsource management of part of the Fund's portfolio to try to increase the return. In addition, the Law allows for a review of the current conservative investment strategy after five years of the Fund's operation; the Government is already beginning this review. An Investment Advisory Board advises the Minister of Finance on the investment strategy.
- Transparency.** In accordance with the Petroleum Fund Law, the Government publishes information on the amount of money in the Petroleum Fund on a quarterly basis. The Government also publishes an Annual Report on the Petroleum Fund, including (as required by law) an independent, external audit of money received by the Fund (the auditor also reviews the sustainable income estimates used by the Government). An independent Consultative Council advises Parliament on issues related to the Petroleum Fund, including whether appropriations from the Petroleum Fund are being used effectively to benefit current and future generations of Timorese people.



Petroleum Revenue Outlook

- High global oil/gas prices have boosted current and potential revenues, raising estimated sustainable spending limits. In addition, Bayu-Undan LNG prices are likely to rise next year (under scheduled contract negotiations), while the Greater Sunrise oil/gas field may come on-stream by 2015 (with revenues estimated at about US\$10 billion, or 10-15 times 2007 non-oil GDP). These developments will further raise sustainable Budget allocations over the medium term.



¹ Petroleum resources are the oil and gas extracted from under the ground or under the seabed. Revenue from petroleum resources is generated largely through taxes and royalties on the exploration, development, exploitation, transportation, and sale of petroleum.