FISCAL RULES FOR TIMOR-LESTE

HELDER LOPES

MINISTRY OF FINANCE OF TIMOR-LESTE

DILI, JUNE 2020

Outline

- Timor-Leste's fiscal headlines
- Why Government needs fiscal rules?
  - Definition;
  - Objectives;
  - Type of fiscal rules with their pros. & cons;
  - Rational;
  - Principles;
  - Legal Foundation
- Proposed fiscal rules for Timor-Leste;
- Implementation Strategy.

Timor-Leste's Fiscal Headlines

I. PUBLIC SPENDING TO THE ECONOMY

- Public sector driven economy/oil economy – the economy depends on public expenditure;
- During the period of 2010-2018, public expenditures accounted for average of:
  - ✓ 80% of total spending to GDP;
  - ✓ 27% of public investment and 53% of public consumption to GDP, respectively

II. EXPENDITURES

- During the period of 2010-2019, the Government has spent
  - ✓ $12.38 billion, with average annual spending and growth of $1.23 billion and 9.9%, respectively;
  - ✓ $8.2 billion for recurrent spending, with average annual spending and growth $828 million and 11.6%, respectively;
  - ✓ $$4.3 billion for capital development, and average annual spending and growth are $393 million and 20%, respectively.

III. PETROLEUM FUND (PF)

- Petroleum Fund (PF) balance was $17.02 billion (May 2020);
- Oil & Gas revenue peaked $3.6 billion in 2012 and downed to $756 million in 2019;
- Average rate and cumulative income of PF investment return are 3.8% and $5.6 billion, respectively;
- PF financed more than 85% of the annual state budget;
- PF is the only financial assets, which delinks budget with commodity price volatility risks and countercyclical by nature.
- Total PF withdrawal since 2007 is $11.58 billions, of which excess withdrawal accounted for $4.7 billion to finance fiscal deficits.

Timor-Leste's Fiscal Headlines

IV. DOMESTIC REVENUE

- In 2019, domestic revenue collection was $201.2 millions, which accounted for only 13.6% of the state budget;
- Domestic revenue growth has been very volatile, ranging from 31.1% in 2012 downed to negative 5.1% in 2017;
- During the period of 2010-2019:
  - ✓ Domestic revenue grew at an average of 8.8%;
  - ✓ Tax revenue accounted for an average of 72% to domestic revenue;
- Average tax revenue to GDP was 10.3% during the period of 2010-2018;
- The Government wants to increase domestic revenue to GDP ratio from 12.1% in 2018 to 17% in 2023.

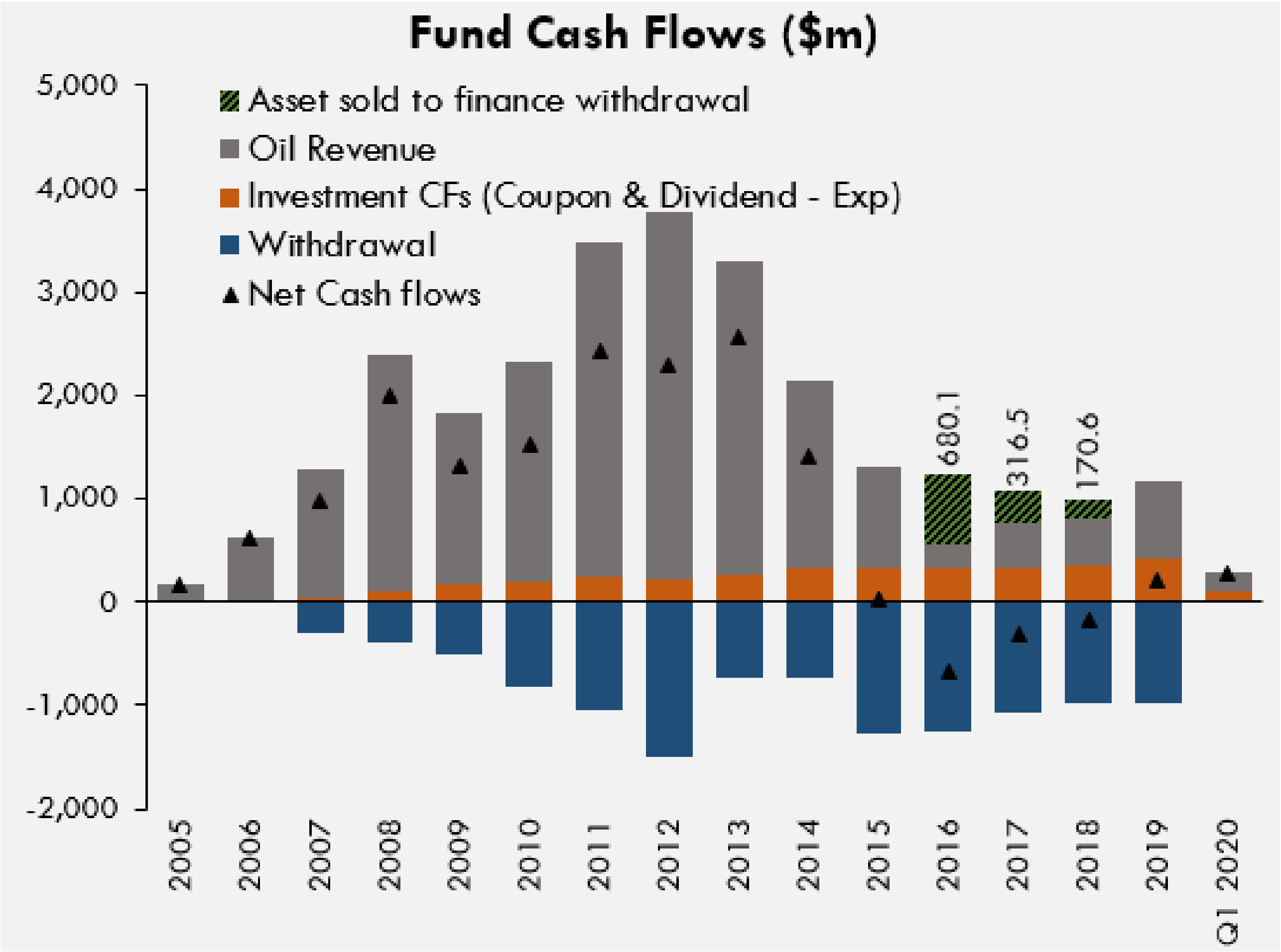
V. FISCAL BALANCE

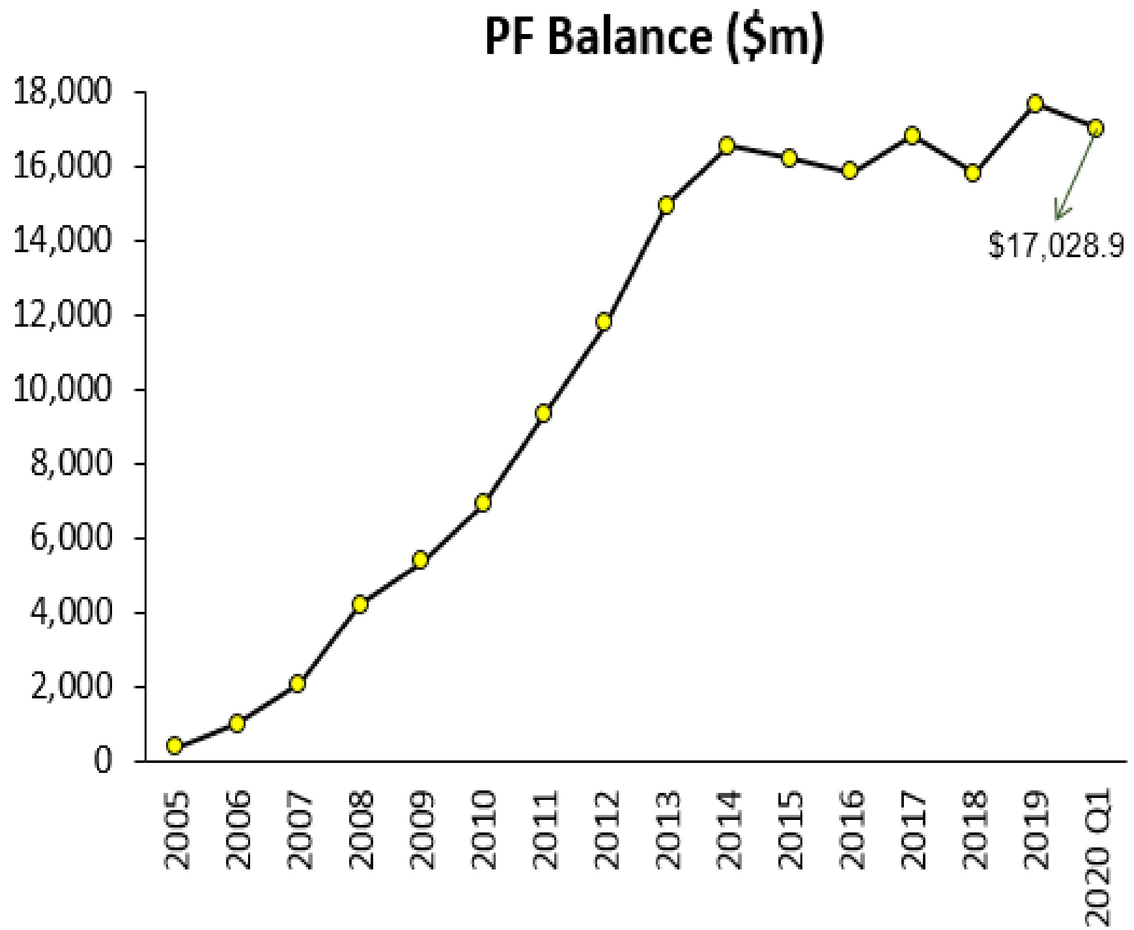
- Two fiscal balance headline:
  - ✓ The difference between domestic revenue and ESI with total expenditure – currently used;
  - ✓ The difference between domestic and oil & gas revenues with total expenditure;
- Government has run fiscal deficit since established, with an average $464 million in the last 10 years;
- Fiscal deficit in 2018 was 27% and the average fiscal deficit to GDP during 2010-2018 was 28%.

VI. PUBLIC DEBT

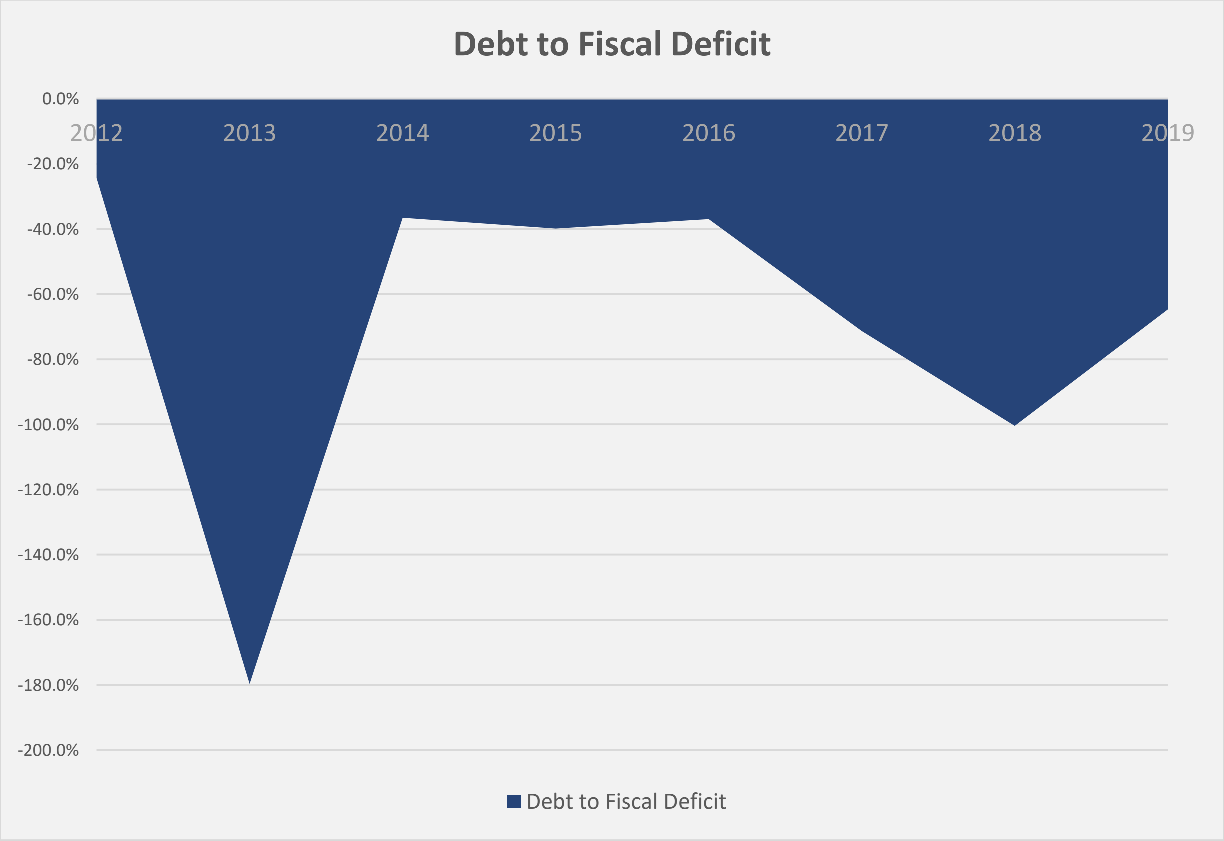
- No public debt from treasury instruments (T-bill, T-note, etc) yet;
- Current public debt is external projects based financing with total commitment (signed) $474.6 millions;
- TL debt distress is low, thereby sustainable, with 30% debt to GDP in 2018.

Timor-Leste's Fiscal Headlines

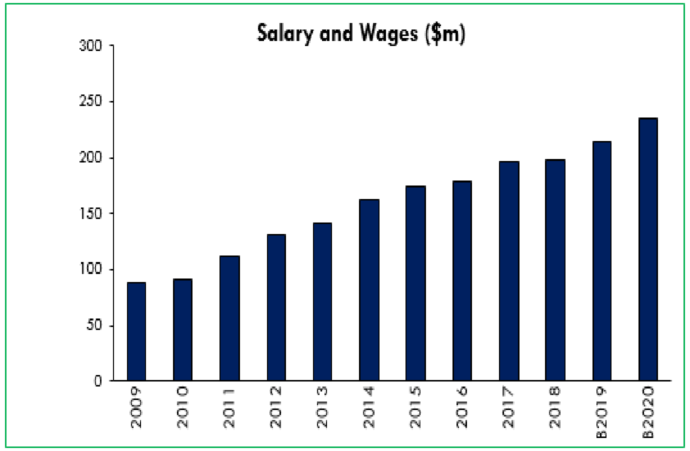


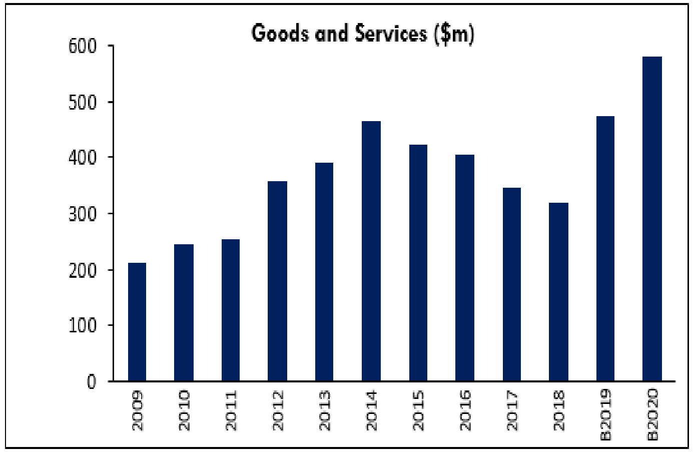


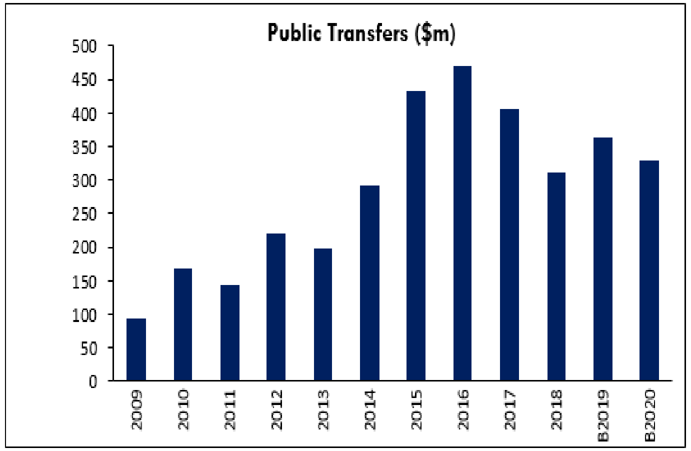
Timor-Leste's Fiscal Headlines

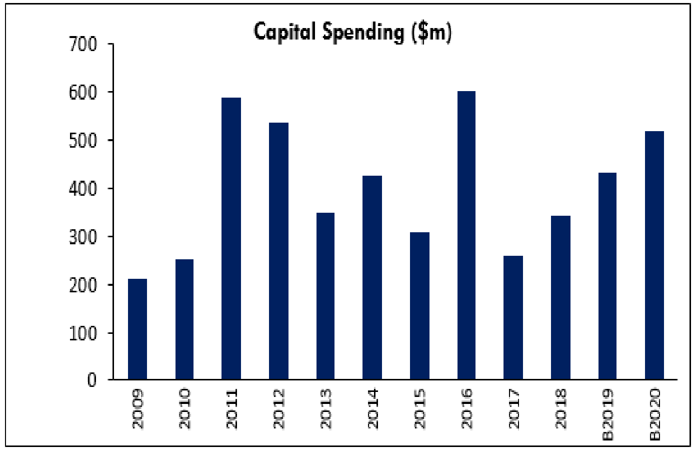


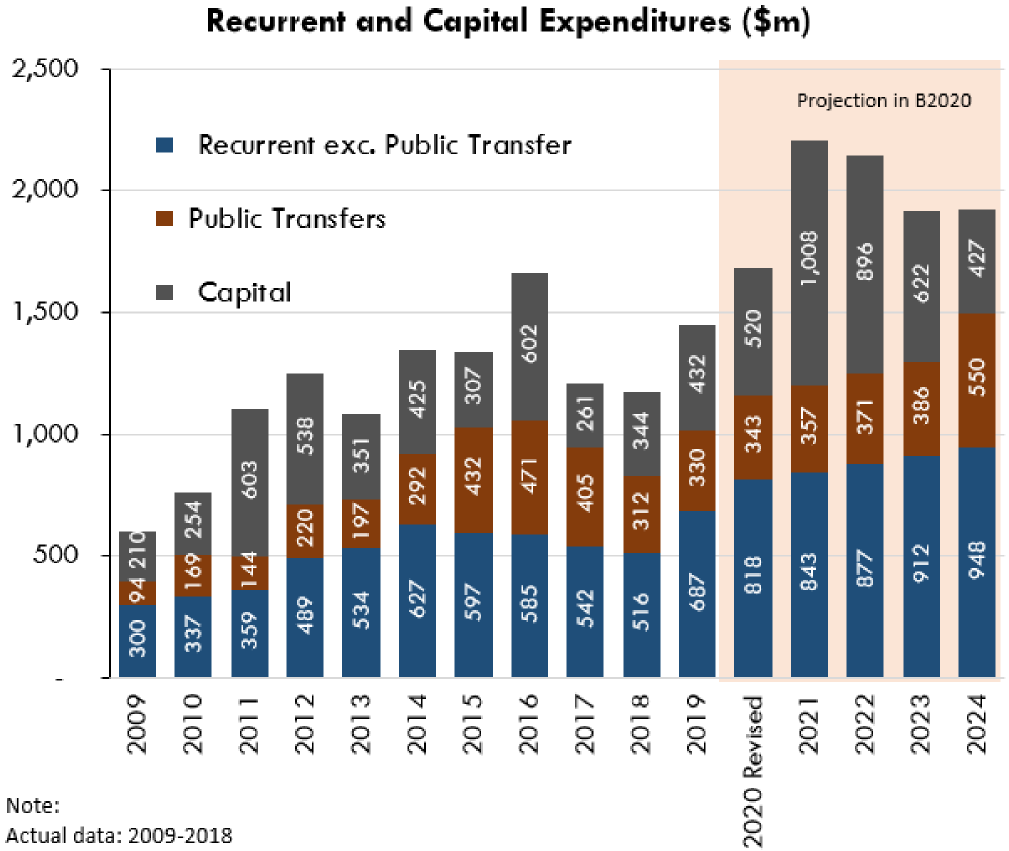
Timor-Leste's Fiscal Headlines











Note:
Actual data: 2009-2018
Budgeted data: 2019-2020
Projection: 2021-2024

Why Government Needs Fiscal Rules?

I. DEFINITION

*F*iscal 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.

II. OBJETIVE

Ensure fiscal sustainability/responsibility and macroeconomic stability

III. TYPE OF FISCAL RULES

1. EXPENDITURE RULES (ERs)

Set limit the growth of total/investment/recurrent expenditures and/or limit expenditure to GDP.

2. REVENUE RULES (RRs)

Set floors or impose ceilings on Government's income proceeds or use of windfall revenues.

3. BUDGET BALANCE RULES (BBRs)

Constraint the size of the deficit and thereby control the evolution of the debt to GDP ratio

4. DEBT RULES (DRs)

Set an explicit limit on the stock of public debt.

Why Government Needs Fiscal Rules?

FISCAL RULES: Pros. & Cons.

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 procyclicaclity
- 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 procyclicaclity;
- 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.

Why Government Needs Fiscal Rules?

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

- *Determining optimal level of fiscal aggregates/stabilization policies* that improve welfare by reducing macroeconomic volatility;
- *Defining the approach and economic model* that budgets are prepared based on welfare maximizing objectives, not a political process of budgeting;
- *Time inconsistency issue* – incentives to deviate from previous promises when people and markets have already adjusted their expectations and behaviors;
- *Preventing a persistent high level public debt* that can adversely affect economic welfare through adverse self-fulfilling expectations regarding Government (in)ability to service debt;
- *Electoral motivation* to increase spending and reduce taxes in an election year;
- *Common pool problem* – coordination issue among public institutions government/coalition partners;

Why Government Needs Fiscal Rules?

- **Rationale –**
  - *Fiscal illusion* – population's imperfect understanding of tax and debt finance, combined with a misperception of the government's inter-temporal budget constraint;
  - *Bureaucratic behavior* – which tends to focus on budget maximization rather than welfare maximization;
  - *Free rider problem* – conflict of interest over who should pay for reducing the deficit, making deficit reduction a long delayed process;
  - *Countercyclical fiscal policy* – expenditures are raised in a recession but not sufficient lowered in an expansion to balance the budget over the cycle;
  - *Intergenerational concerns* - each generation is selfish and does not care about the situation for future generation.

Why Government Needs Fiscal Rules?

V. Criteria

- ✓ *Sustainability* - compliance with the rule(s) will ensure long-term fiscal sustainability;
- ✓ *Stabilization* - the rule(s) should ensure economic stability by allowing discretionary countercyclical changes in taxes or expenditures;
- ✓ *Simplicity* - the rule(s) should be simple for policy makers and public to understand easily;
- ✓ *Operational guidance* – the rule(s) should be integrated in the budgeting process and the policy makers to control the aggregate targets;
- ✓ *Resilience* - a rule should be implemented in a period of time and it should be maintained even after the shock to build credibility;
- ✓ *Ease of monitoring and enforcement* – monitoring of the compliance should be easy and simple, and there should be costs associated with deviations from targets.

Why Government Needs Fiscal Rules?

VI. Rules selection process

- *Minimize trade-offs*;
- *Country preferences;*
- *Consider multiple rules* – to achieve fiscal sustainability and macroeconomic stabilization objectives.

VII. Guiding principles of rules combination

- *Fiscal rules do not substitute for good fiscal policies;*
- *Minimizing the overlap of fiscal targets*;
- *The rules system should not be over-determined.*

Why Government Needs Fiscal Rules?

VIII. Legal Requirements

- Fiscal rules can have different national legal foundations, and may be enshrined in:
  - Internal rules of MoF;
  - Political Commitment;
  - Primary or secondary legislation;
  - Constitutions.

- Excessively rigid rules tend to be unworkable and could be insensitive to economic or political circumstances;

- Strong fiscal rules regimes may rely rather on:
  - the strength of political commitment;
  - monitoring by independent fiscal institutions and other actors;
  - effective enforcement procedures for non-compliance.

Proposed Fiscal Rules for Timor-Leste

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

[7]Note: ● Law and decree law; ○ Government decree; ◊ political commitment; Short-term; Medium-term; Long-term

Short-term: 1 year; Medium-term: 2-3 years; and Long-term: over 3 years

Proposed Fiscal Rules for Timor-Leste – EXPENDITURE RULES

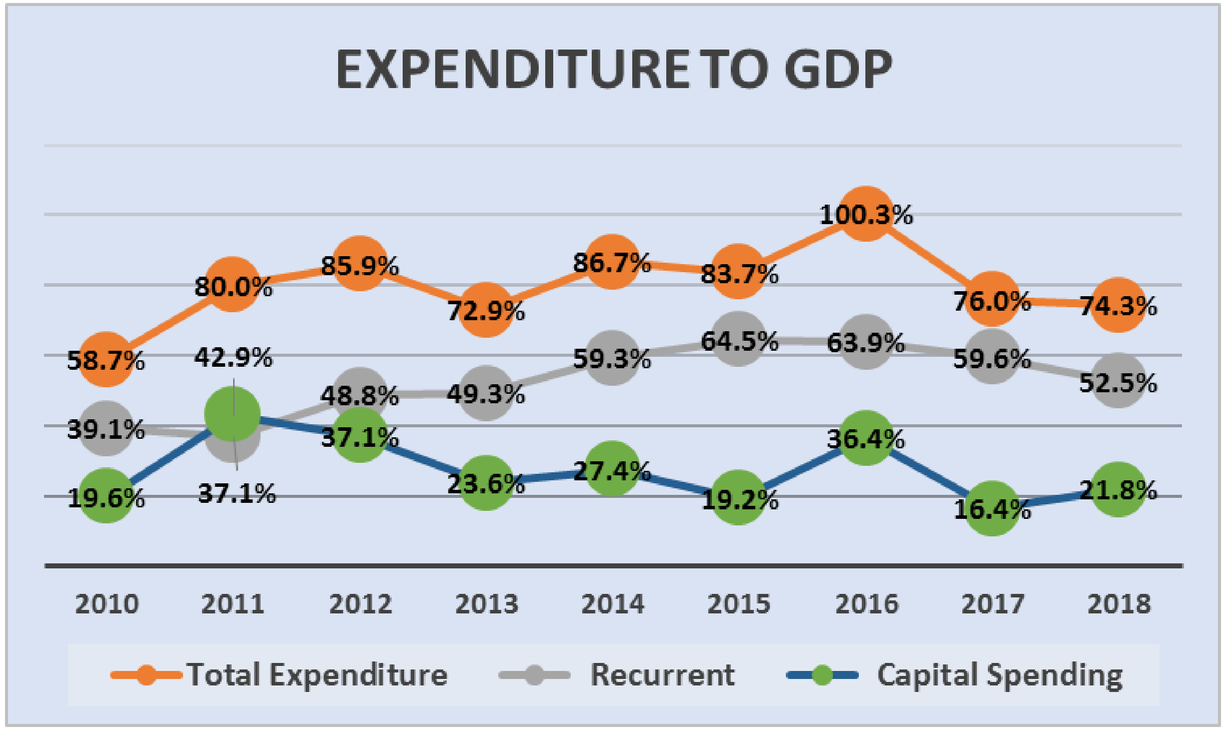
EXPENDITURE RULES (ERs): set growth limit of total/investment/recurrent expenditures and/or limit expenditures to GDP

Expenditure Rules (ERs)			
80% Expenditure to GDP	◊	○	●
10% Recurrent Growth	◊	○	●
30% Capital to GDP	◊	○	●

- There is still a missing rule that link expenditure to GDP;
- Despite growth limits to recurrent expenditures are in place, but they are for technical analysis only - no political commitments nor legally binding;
- Growth patterns of expenditure to GDP and capital and/or recurrent expenditures are very volatile;
- Target to fiscal sustainability and macroeconomic stability;
- Combined with “Budget Balance Rules.”

Proposed Fiscal Rules for Timor-Leste – EXPENDITURE RULES

80% Expenditure to GDP

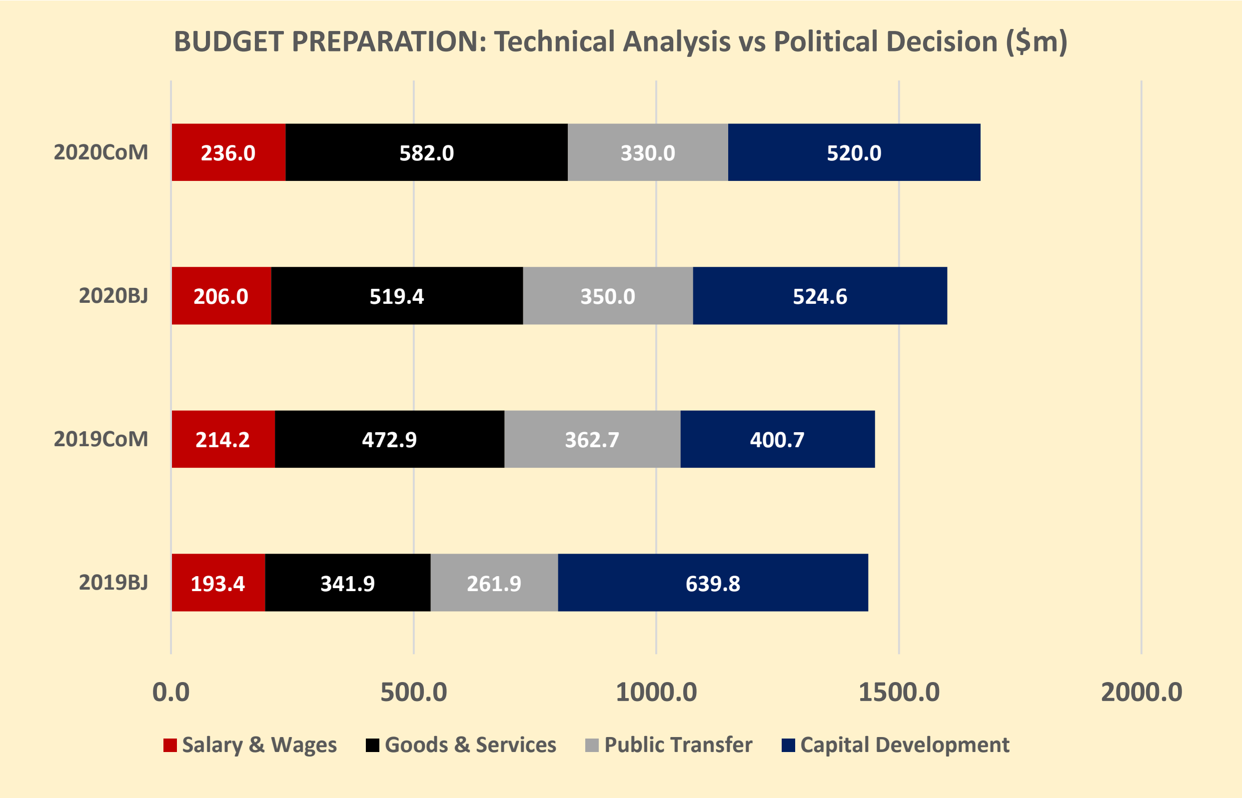


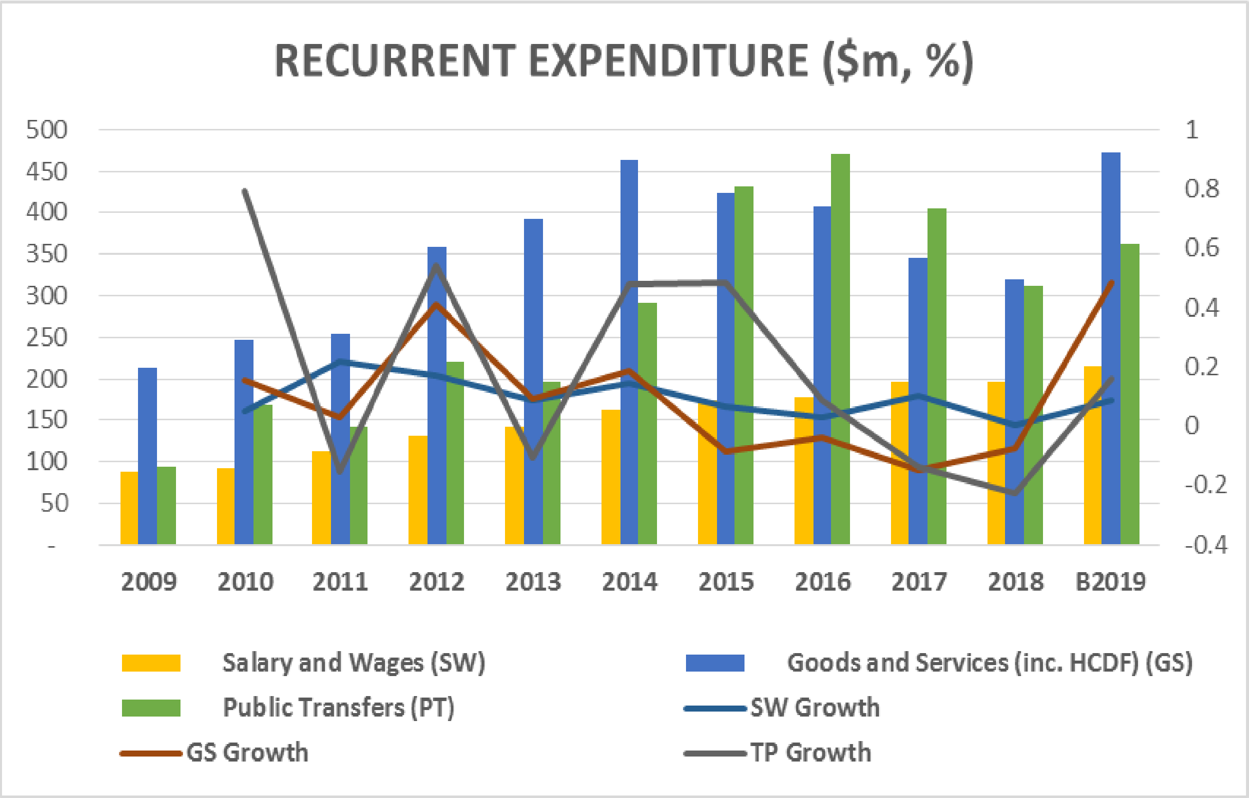
- **Evidences suggest that:**
  - There is still a missing rule to address the delink between expenditure to GDP;
  - Expenditure to GDP in the last 10 years ranging from 58.8% to 100.3%;
  - Average expenditure to GDP during the period of 2010-2018 is 80%;
  - Expenditure to GDP in 2018 was 74.3%.
- Fiscal rule on **"80% Expenditure to GDP"** will:
  - link expenditure with the economy;
  - Typically, public expenditures and the economy are two sides of a coin, of which need each other;
  - Set to 80% because it is the average of expenditure to GDP during the period of 2010-2018, as well as considering institutional capacity constraints and fiscal sustainability;
  - Gradually enforced: started with political commitments and then establish its legal foundation in the future when appropriate.

Proposed Fiscal Rules for Timor-Leste – EXPENDITURE RULES

10% Recurrent Growth

30% Capital Expenditure to GDP





Proposed Fiscal Rules for Timor-Leste – EXPENDITURE RULES

10% Recurrent Growth	30% Capital Expenditure to GDP

- **Evidences suggest that:**
  - ✓ political process (BRC & CoM) prevailed growth limits applied in fiscal sustainability model;
  - ✓ Growth patterns for recurrent and capital expenditures were very volatile;
  - ✓ In the last 10 years, average growth for recurrent and capital are 11.6% and 20%, respectively;
  - ✓ Capital development expenditure very volatile, ranging from 159.4% in 2011 to negative 57.2% in 2017.

FISCAL RULES

- **10% recurrent growth**
  - ✓ To control recurrent (SW, GS & PT) growth;
  - ✓ 10% limit will be distributed to all recurrent budget categories;
  - ✓ 10% because average recurrent growth for the last 10 years was 11.6%.
- **30% Capital Growth**
  - ✓ The needs to capital development is huge;
  - ✓ Capital stocks are intergenerational equity and can sustain the economy;
  - ✓ 30% is above the average growth in the last 10 years, but consistent with *"frontloading";*
- Enforcement started with strong political commitments

Proposed Fiscal Rules for Timor-Leste – REVENUE RULES

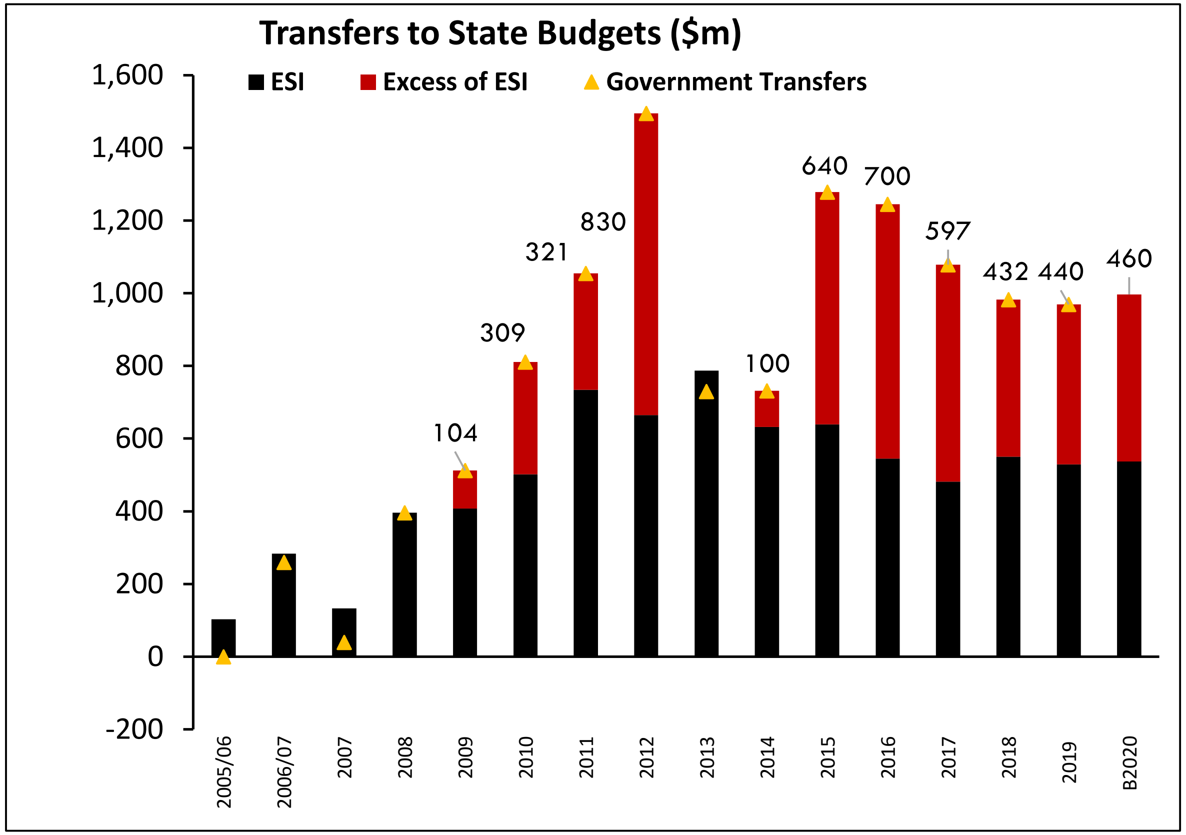
REVENUE RULES (RRs): impose floor or ceiling limit on Government's revenue or use of windfall revenue

Revenue Rules (RRs)			
3% ESI	●	●	●
60% Excess Withdrawal to ESI	◊	●	●
15% of Domestic Revenue to GDP	◊	◊	◊

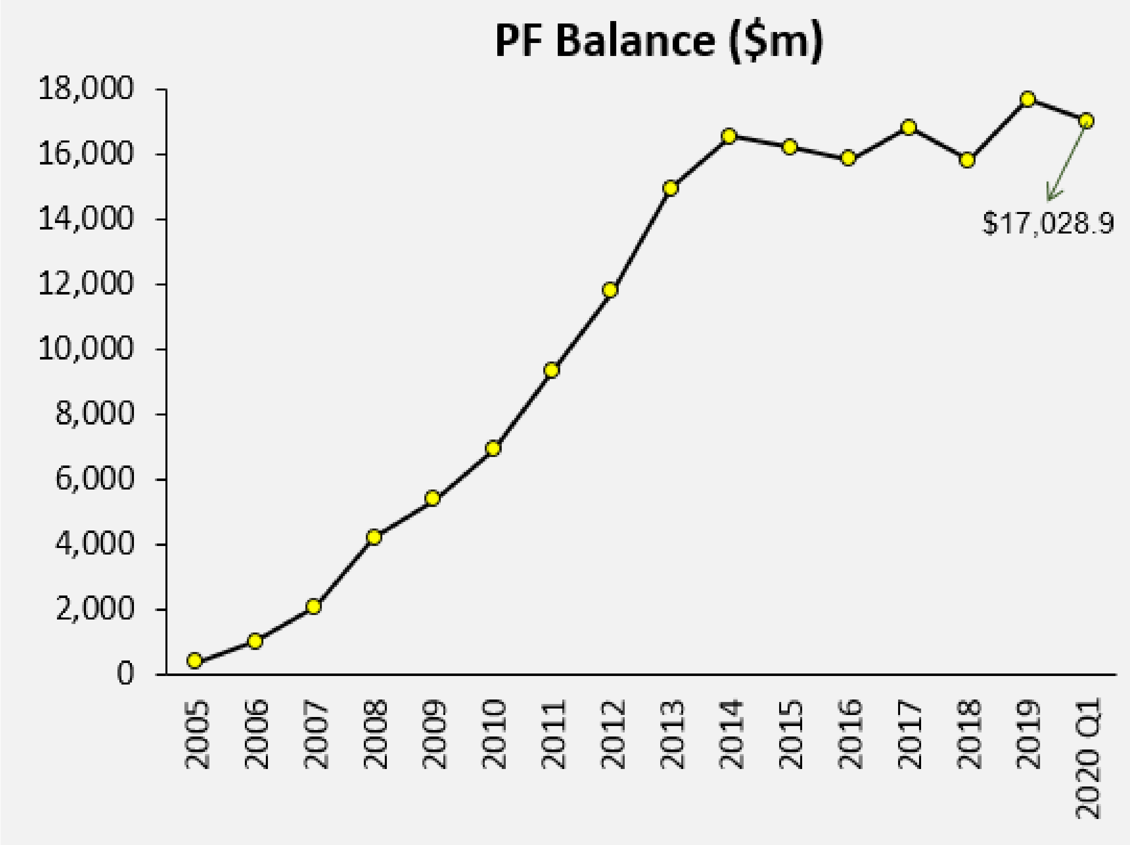
- Fiscal rules that primarily target to fiscal sustainability;
- Petroleum Fund (PF) is to delink budget from commodity price volatility risks;
- PF is a fiscal buffer and counter-cicyclicality by nature;
- 3% ESI is a windfall rule to ensure PF sustainability;
- Excess Withdrawal is to finance fiscal deficit, but no limit;
- Domestic revenue is growing but with a very low pace;
- Domestic revenue contributed less than 15 to state budget and on average accounted around 12% only to GDP in the last 10 years.

Proposed Fiscal Rules for Timor-Leste – REVENUE RULES

3% Estimated Sustainable Income (ESI)



60% of Excess Withdrawal to ESI



Proposed Fiscal Rules for Timor-Leste – REVENUE RULES

3% Estimated Sustainable Income (ESI)	60% of Excess Withdrawal to ESI

- **Evidences suggest that:**
  - PF accounted for more than 85% of financing source for public expenditures;
  - ESI definition is to Petroleum wealth instead of PF balance;
  - PF balance as of May was $17 billion;
  - Average ESI and Excess Withdrawal (EW) in the last 10 years are $601m and $460m, respectively;
  - Oil revenue has declined since 2013 and reached $224m (the lowest level) in 2016;
  - Average PF Investment return is 3.8%.

FISCAL RULES

- **3% ESI**
  - Maintain 3% ESI rules as it ensures inter-generational financial stocks;
  - Narrow definition of ESI to PF balance instead of PF wealth;
  - The revision is due to oil revenue has declined, PF balance contribute the most, and 3% reflects to the investment return.

- **60% of EW to ESI**
  - EW is to finance fiscal deficit, but no limit;
  - No limit for EW poses risk for PF sustainability;
  - 60% limit will mitigate the risk;
  - EW should finance hard and soft investment only and must be inline with *"frontloading schedule";*

- Gradually enforced: political commitments (short-term) to a legally biding rule (medium to long-term).

Proposed Fiscal Rules for Timor-Leste – REVENUE RULES

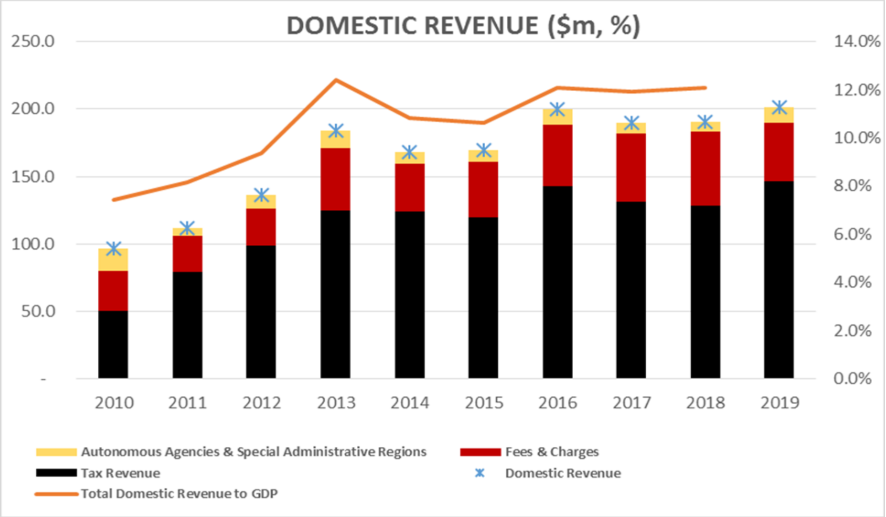
15% of Domestic Revenue to GDP

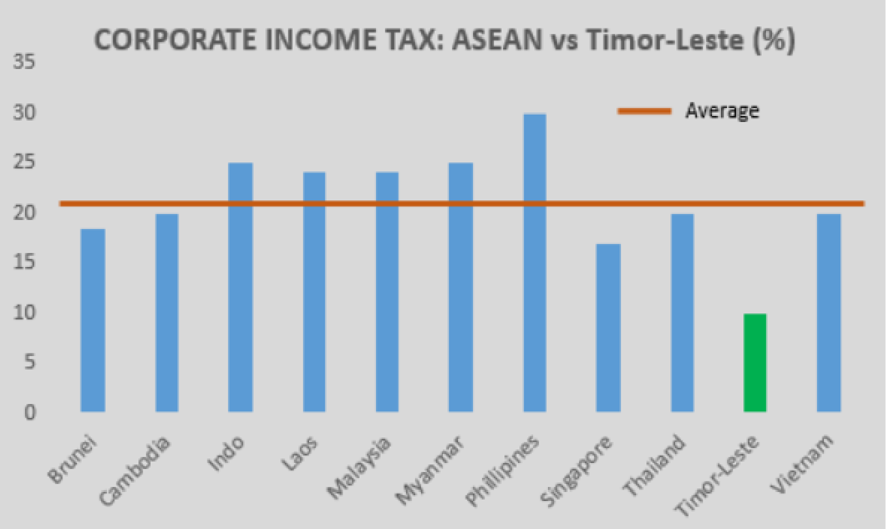
- **Evidences suggest that:**
  - ➢ Government's target is 17% domestic revenue to GDP by 2023;
  - ➢ There is no rule on domestic revenue floor or ceilings;
  - ➢ Domestic revenue growth pattern is slightly volatile but upward trend;
  - ➢ Tax revenue accounted for an average of 70% to domestic revenue;
  - ➢ Tax rates are lowest in the region – tax incentives for investment;
  - ➢ Less economic and revenue source diversifications.
  - ➢ Fiscal and PFM reform to increase domestic revenue collection;

FISCAL RULES

- **15% Domestic Revenue to GDP**
  - ➢ Set as the domestic revenue floor;
  - ➢ 15% is the median line between 12% of average revenue and Government's target of 17% domestic revenue to GDP;

- Strong political commitment is required to enforce this rule and the 15% target is to achieve before 2023.





Proposed Fiscal Rules for Timor-Leste – BUDGET BALANCE RULES

BUDGET BALANCE RULES (BBRs): constraint the size of deficit and thereby control debt to GDP

Budget Balance Rules (BBRs)			
30% Budget Deficit to GDP	◊	○	●
50% Recurrent to GDP	◊	○	●

- Two definitions on budget balance:

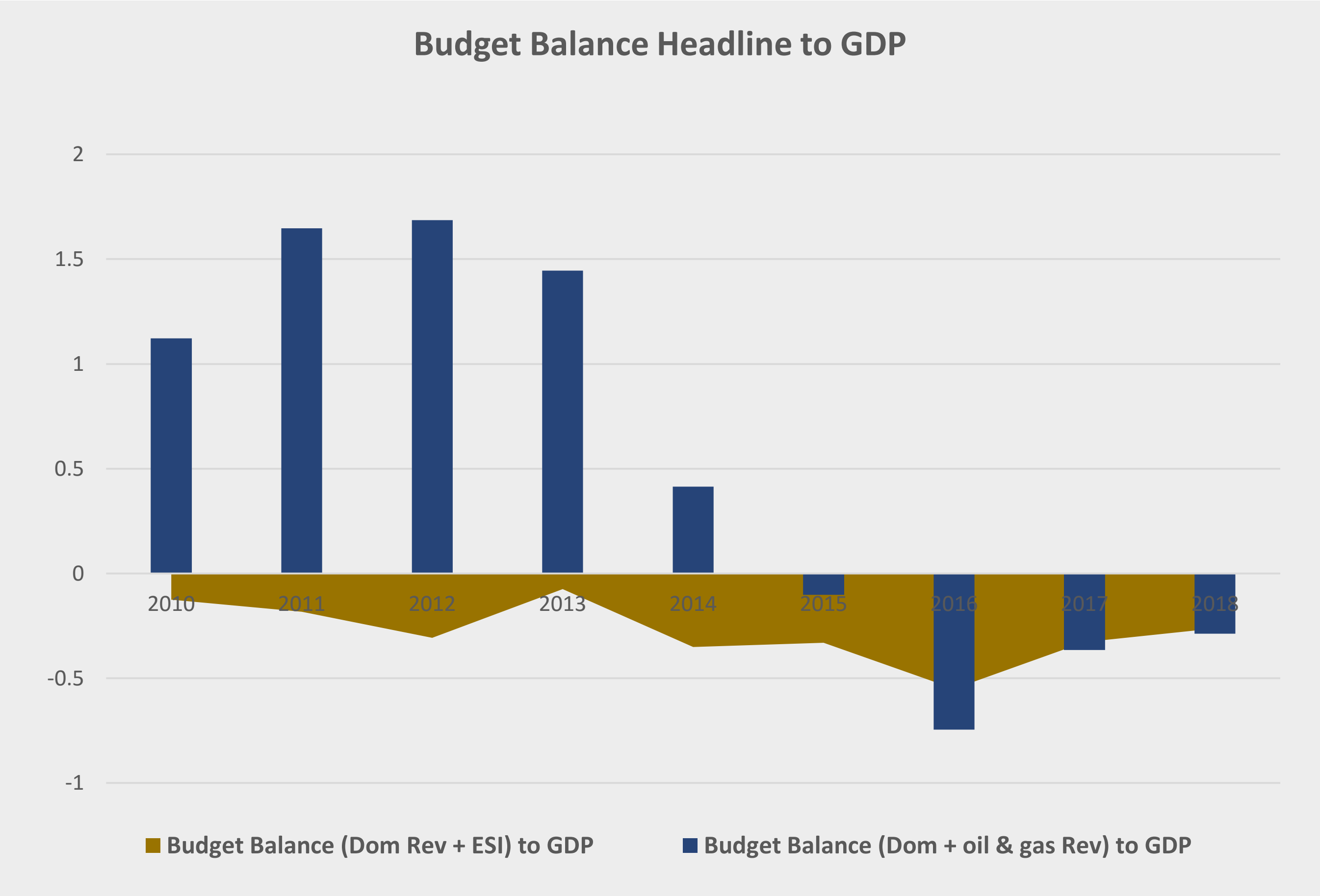
  ✓First, the difference between domestic revenue and ESI with total expenditure – Government is in budget deficit since 2007, and 27% budget deficit to GDP in 2018;

  ✓Second, the difference between domestic revenue and oil & gas revenue with total expenditure – Government was in budget surplus until 2014, but in budget deficit since then;

- PF is a financial asset, not a revenue;
- During the period of 2010-2018, recurrent expenditure represented an average of 53% to GDP;
- When appropriate, combine with expenditure rules.

Proposed Fiscal Rules for Timor-Leste – BUDGET BALANCE RULES

30% of Budget Deficit to GDP



50% Recurrent o GDP

- **Evidences suggest that:**
  - ✓Average budget balance deficit during the period of 2010-2018 was 28%, with 55% highest deficit experienced in 2016;
  - ✓Fiscal deficit varied overtime, implies that there is no fiscal rule targeting fiscal deficit.
  - ✓Recurrent to GDP has been over 50% since 2014

Proposed Fiscal Rules for Timor-Leste – BUDGET BALANACE RULES

30% of Budget Deficit to GDP

50% Recurrent o GDP

FISCAL RULES

- **30% budget deficit to GDP**
  - ✓ No rule for limiting fiscal deficit – EW and loan have been used to finance fiscal deficits;
  - ✓ PF as fiscal buffer is an incentive for prociclycality;
  - ✓ Budget balance deficit to GDP has been very volatile and consistently above 25% since 2013 – no fiscal discipline;
  - ✓ Expansion of fiscal deficit pose risks on PF and debt sustainability;
  - ✓ 30% limit is based on consideration to the 28% average during 2010-2018, PF and debt sustainability;
  - ✓ Compliance to the rule will ensure fiscal responsibility and sustainability.

- **50% recurrent to GDP**
  - ✓ Recurrent expenditures have to control within the space of domestic revenue and ESI – so far budget balance is positive;
  - ✓ Recurrent growth limit must be linked to GDP as domestic revenues are from the economy;
  - ✓ Recurrent expenditures contribute to demand aggregate, but typically do not create intergenerational stocks;
  - ✓ 50% limit is based on consideration to the average 53% during the period of 2010-2018, fiscal sustainability and responsibility.

- Gradually enforced these fiscal rules, started with strong political commitments.

Proposed Fiscal Rules for Timor-Leste – DEBT RULES

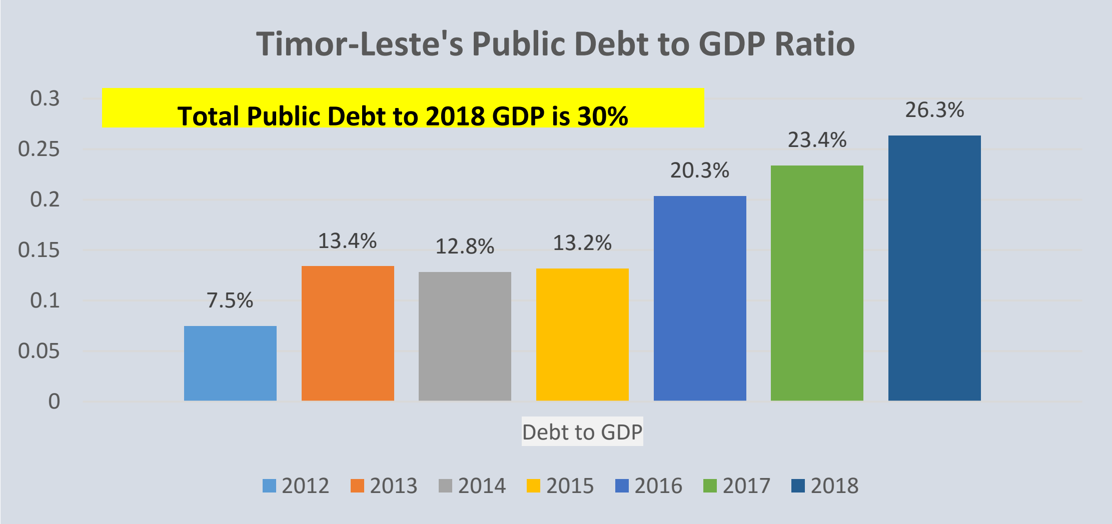
DEBT RULES (DRs): impose an explicit limit on the stock of public debt thereby control debt to GDP

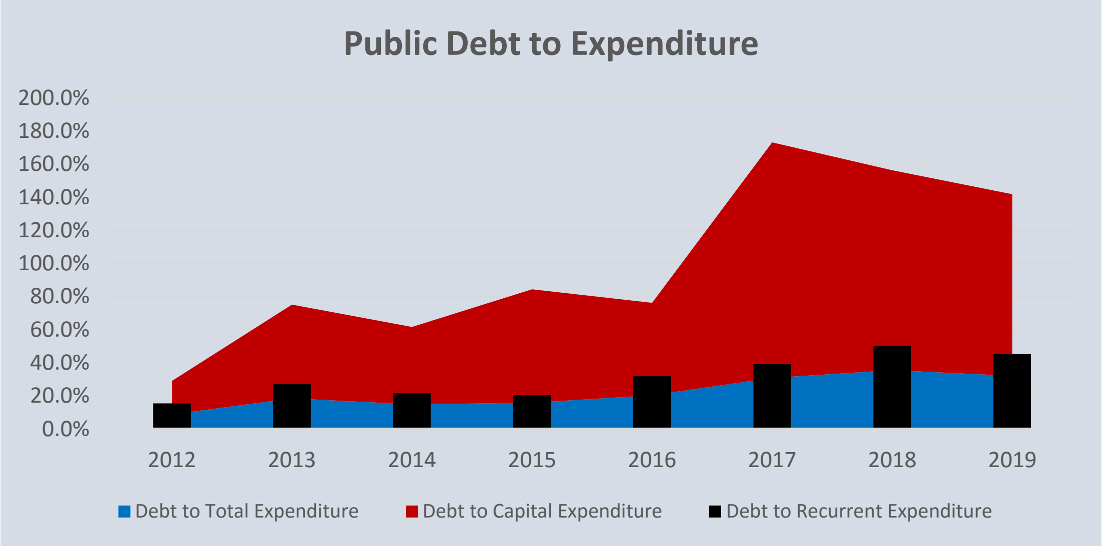
Debt Rules (DRs)			
60% Debt to GDP	◊	●	●
3% Borrowing Cost	●	●	●

- Sovereign loans is currently limited to external project based loan – all concessional;
- All existing loan are for infrastructure development – mainly land transportation;
- No public debts from Treasury Instruments (T-bill, T-Note, etc);
- “3% cost of borrowing” rule exist – the notion is to benchmarking cost of borrowing with the opportunity cost of PF investment;
- Current debt distress is relatively low thereby debt service is sustainable;
- Government yet to establish Debt to GDP rule;
- Debt should link to GDP to control debt mobilization and service.

Proposed Fiscal Rules for Timor-Leste – DEBT RULES

60% Debt to GDP





3% of Borrowing Cost

FISCAL RULES

- **60% debt to GDP**
  - Current debt stock is $474.6 million;
  - Current debt stock to 2018 GDP (the latest) is 30%;
  - Debt stock has been increasing since first debt signed in 2012;
  - Institutional capacity constraints to mobilize loan financing are still limited;
  - 60% limit is set as the maximum number to control loan mobilization and ensure a sustainable debt service.

- **3% of borrowing cost**
  - This fiscal rule should maintain as it provide economic and financial incentives and safeguard PF;
  - The rule is currently conservative given that PF average investment return is around 4%;

- The first rule could gradually enforce with political commitment and then include in the public debt when the revision is made.

Implementation Strategy of the Proposed Fiscal Rules for Timor-Leste

- Combined fiscal rules are inevitable, thereby:

  1. They should complement the existing policies: "frontloading, ESI, 3% costs of borrowing" and 5 guiding principles of budget preparation (*fiscal sustainability, programs and priority, institutional capacity, quality of budget, and economic absorptive capacity);*

  2. Minimize overlapping of fiscal targets;

  3. They should be implementable and not over-determined:

     - Commitments (political and/or legal compliance).

- Implementation timeframe should be realistic and adjustable:

  - Follow the proposed implementation timeframe;
  - Consider to enforce new fiscal rules with political commitments.

- Consider to enforce rules that contribute directly to macroeconomic stability, and then follow with the rules that target fiscal sustainability.