



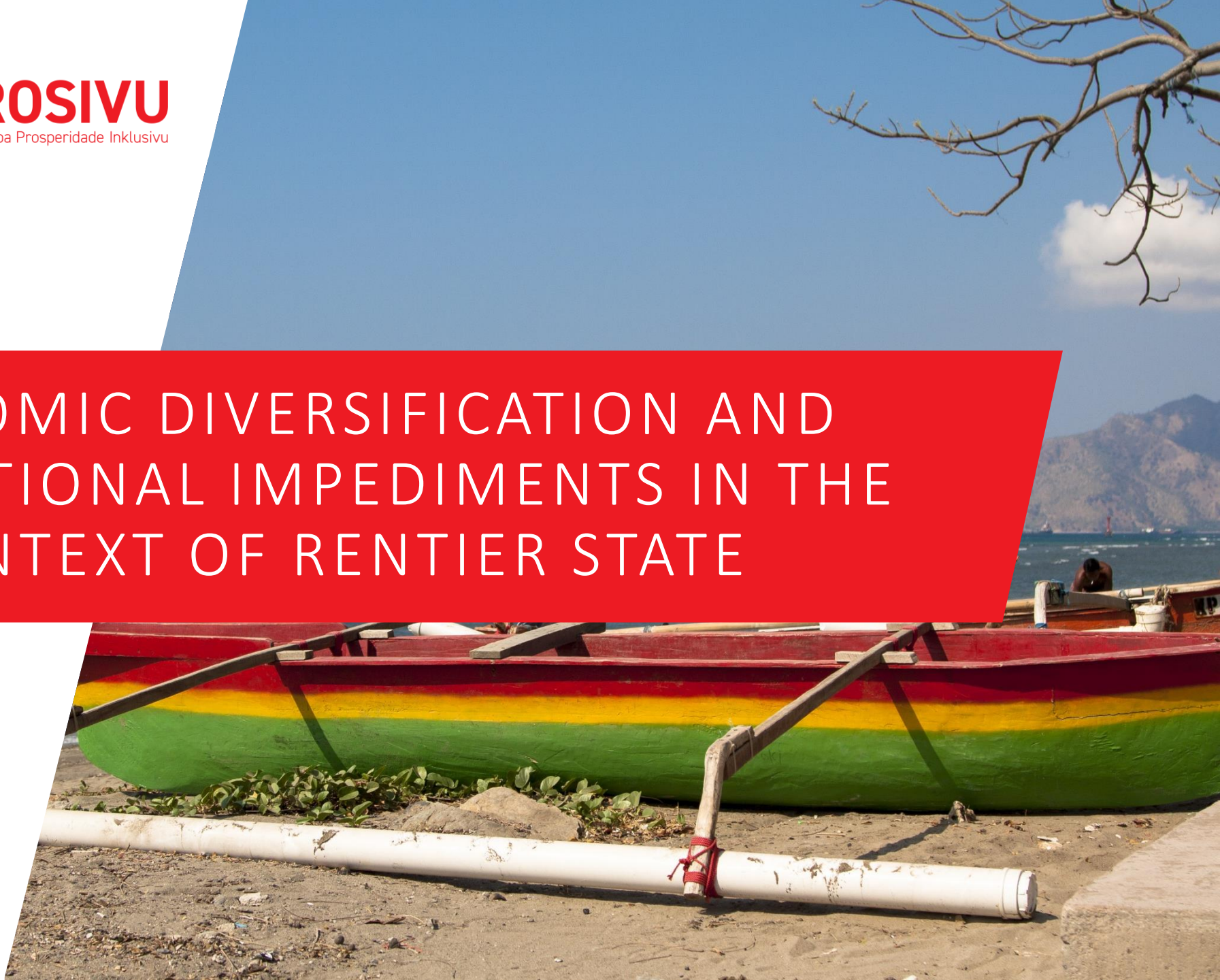
ECONOMIC DIVERSIFICATION AND INSTITUTIONAL IMPEDIMENTS IN THE CONTEXT OF RENTIER STATE

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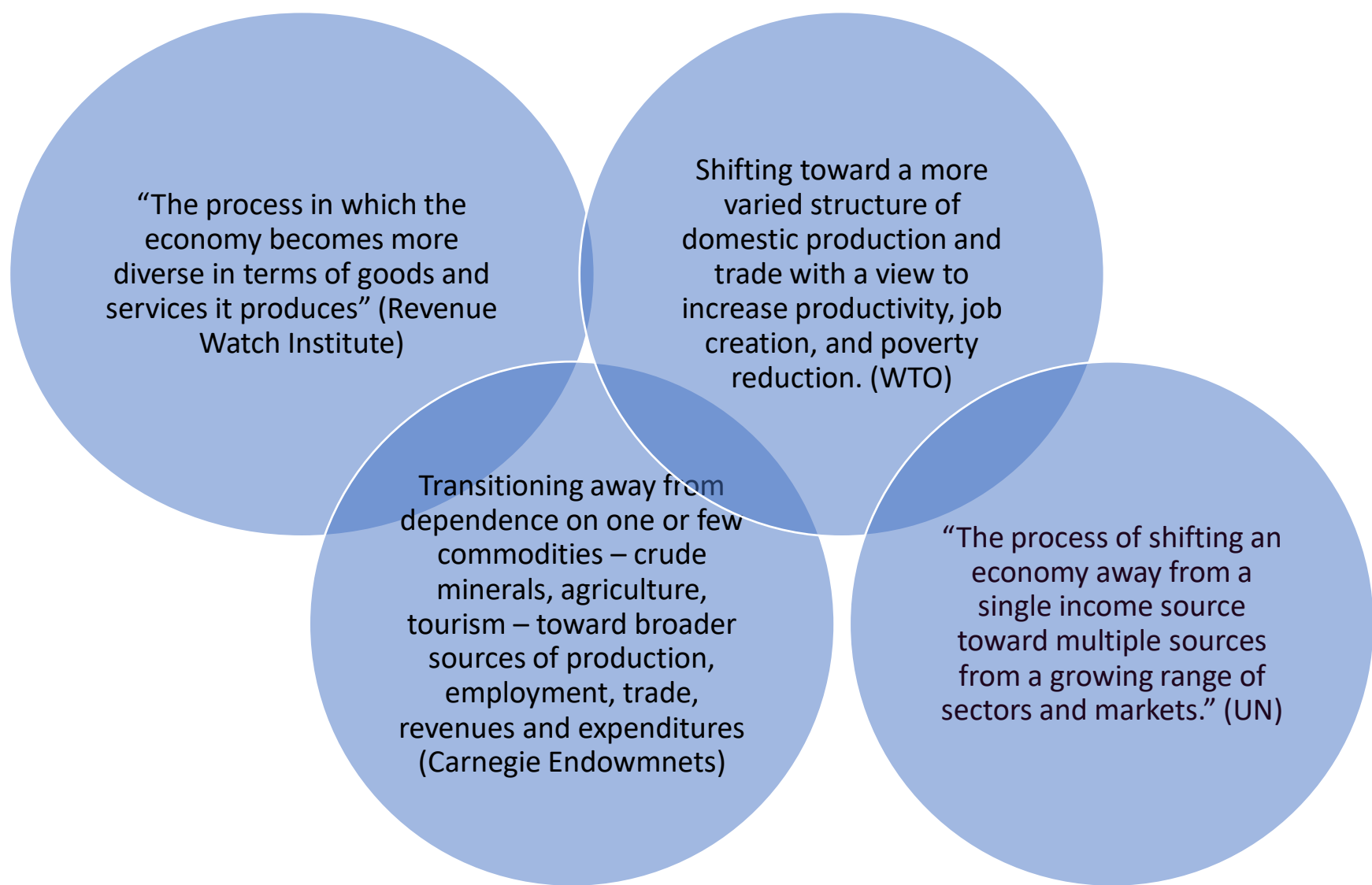
PROSIVU

December 2023

PROSIVU is supported by the Australian
Government and implemented by DT Global



Different Definition of Economic Diversification



“The process in which the economy becomes more diverse in terms of goods and services it produces” (Revenue Watch Institute)

Shifting toward a more varied structure of domestic production and trade with a view to increase productivity, job creation, and poverty reduction. (WTO)

Transitioning away from dependence on one or few commodities – crude minerals, agriculture, tourism – toward broader sources of production, employment, trade, revenues and expenditures (Carnegie Endowmnets)

“The process of shifting an economy away from a single income source toward multiple sources from a growing range of sectors and markets.” (UN)

ED in Broader Context

It is not an end/final goal;
but a mean to achieve
broader development goals

Resilient and Sustainable Economic Growth
Rate

Sustainable and Inclusive development

Risk Management.

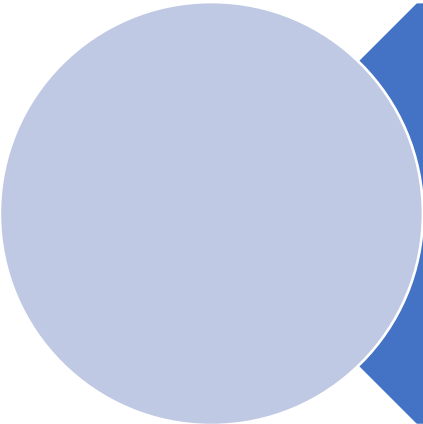
Poverty Reduction

To my mind, promoting economic diversification is akin to weaving a beautiful traditional fabric. What do I mean by that? I mean weaving an *economic* fabric that is more complex, more resilient, and more beneficial to *all* families and communities. We know that economic diversification is good for growth.” Christine Lagarde, 2019.

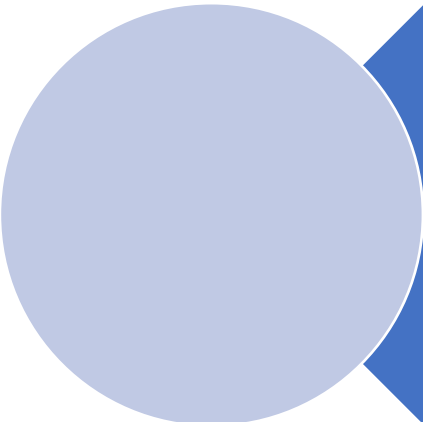


“A lack of economic diversification is often associated with increased vulnerability to external shocks that can undermine prospects for longer-term economic growth.”
(WTO)

ED and economic Structural Transformation



Movement of a country's
productive resources
from low productivity sector
(agriculture) to higher productivity
sectors (manufacturing and
services)



It facilitates the diversification
sources of production and
employment, international trade,
revenues and expenditures through
various dimensions

Three Inter-related Concepts

GDP diversification

- Sectoral contributions to employment and production
- It involves Structural change – transition from low value-added activities toward high value-added industries and services
- Characterized by Industrial Transformation, Rising Per Capita Income, and Poverty Reduction

Exports diversification:

- Diversification of a country's majority trade exports and partners
- Increase and diversify range of goods and services that are exported and its destinations

Fiscal Diversification.

- Fiscal Diversification.
 - Expanding the sources of government revenues and the targets of public expenditures.
 - Increase the numbers of economic sectors that contribute to government revenues
 - Indicated by sources of Government's Revenues

Economic Diversification in Oil Dependent Countries

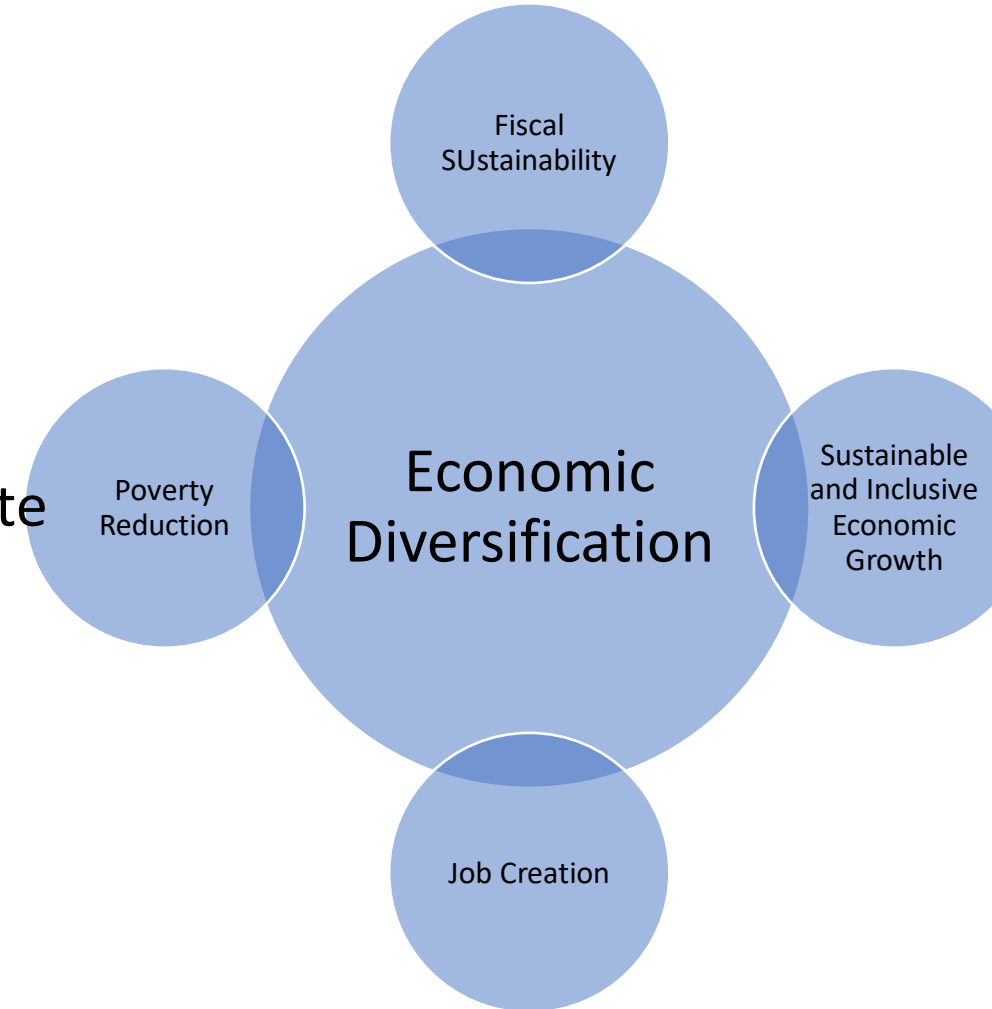
- Major policy issue in the oil dependent countries in the last two decades (Mahroum, 2017)
- Developing non-Petroleum Economic Sectors to reduce Dependency on natural resources, diversifying exports and source of fiscal revenues.
- ED is the key to long-term economic development in the Natural Resource Dependent Countries



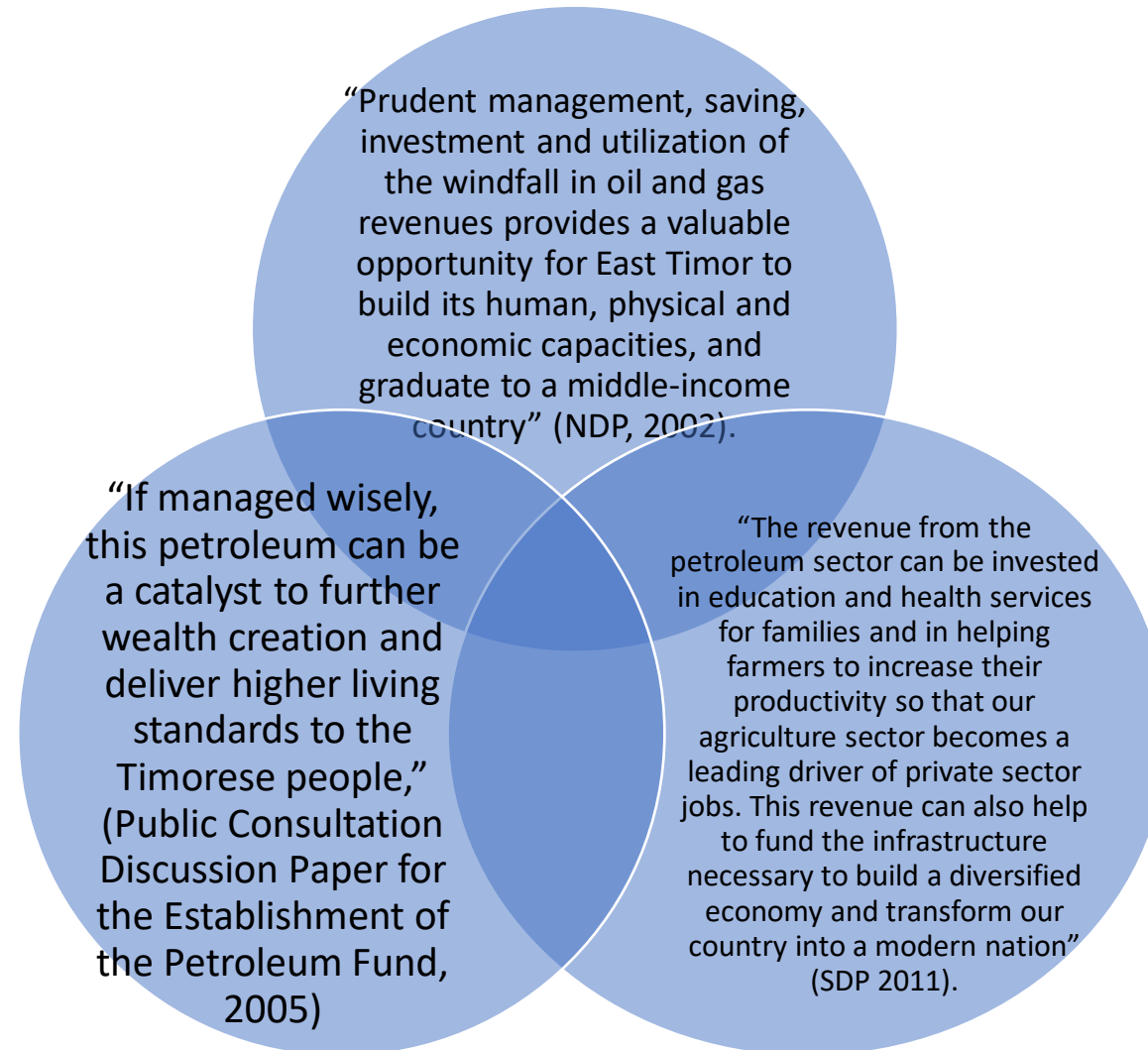
ECONOMIC DIVERSIFICATION: TL CONTEXT

Economic Diversification in TL: Stated Policy

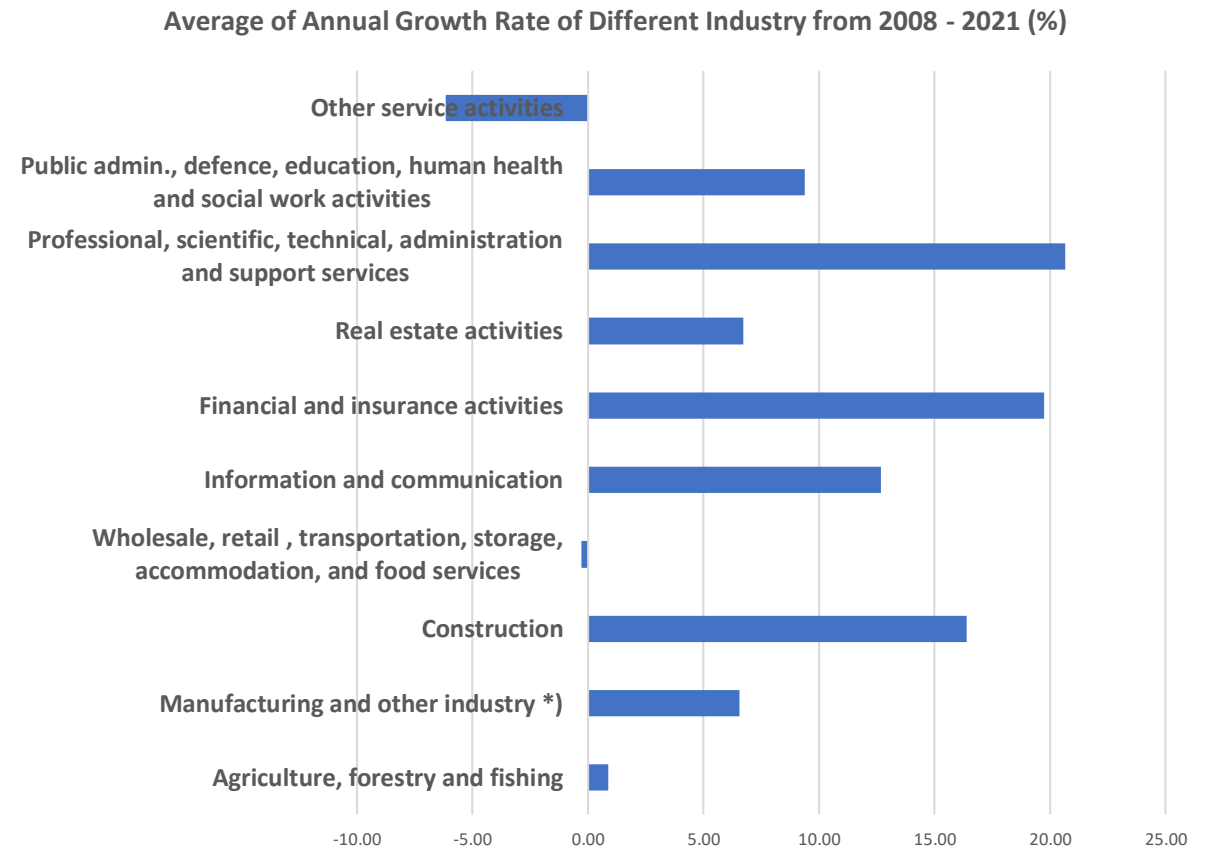
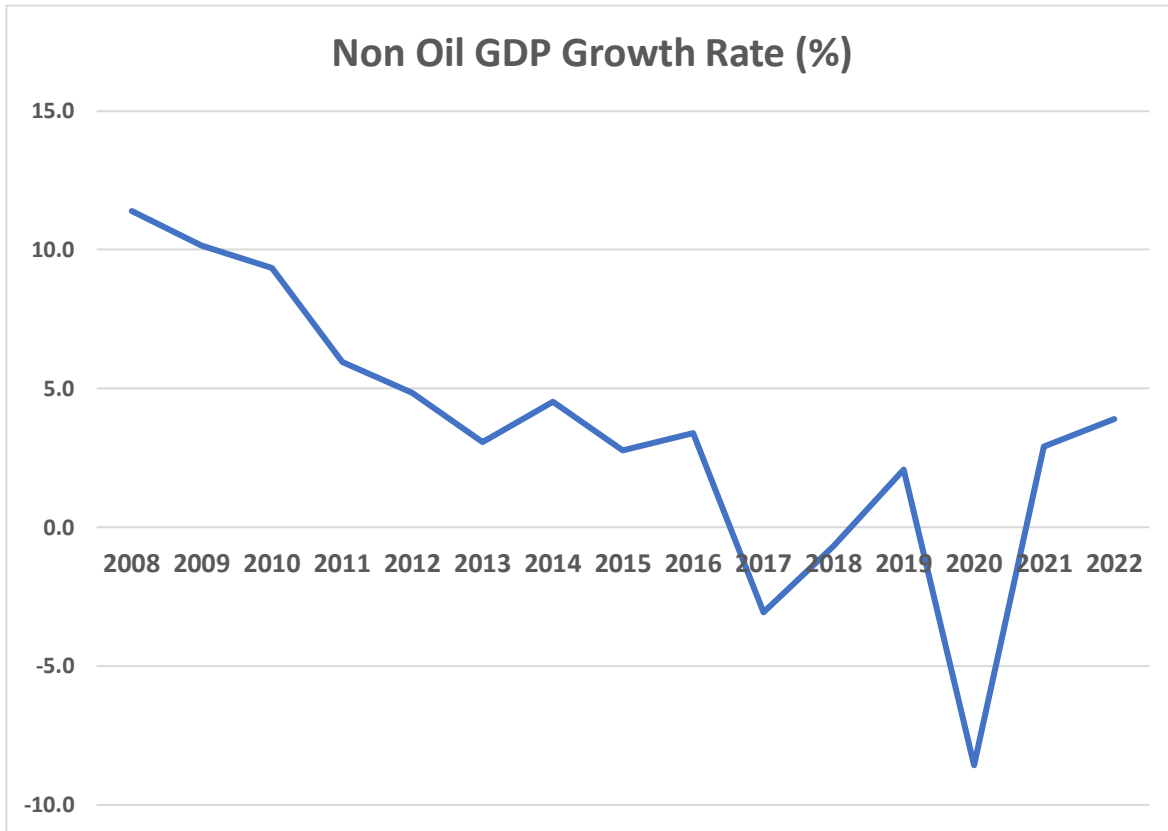
- It is the major policy issue over the last ten years
- Immediate Goals are to reduce
 - State's dependence on the Petroleum Revenues
 - Economic Dependence on the Public Spending
- Four Key Sectors:
 - Agriculture
 - Tourism
 - Manufacturing
 - Petroleum
- Complementary Roles of State (Public Sector and Private Sectors)
- Policy Intervention focusing on Enabling Environment through
 - Physical Infrastructure
 - Human Capital
 - Institutions and Governance



The Basic Idea has been there for a while



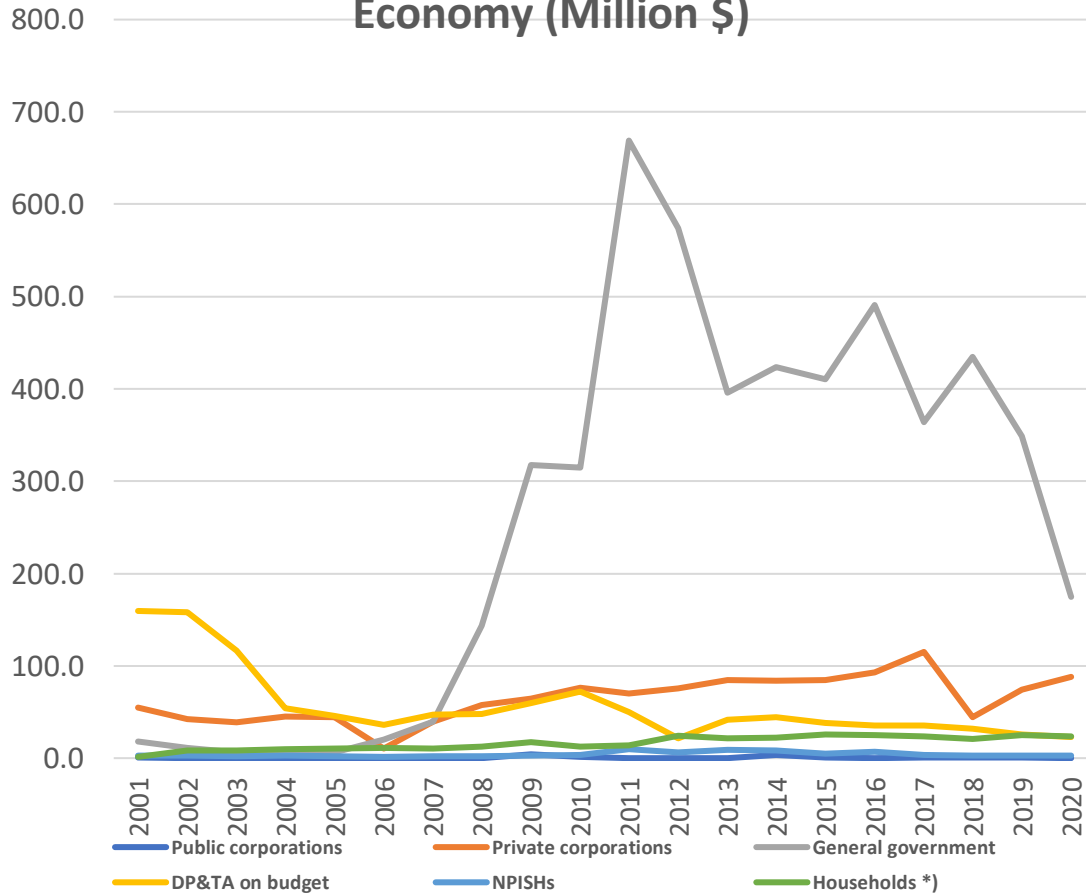
Assessing the Result: Economic Growth



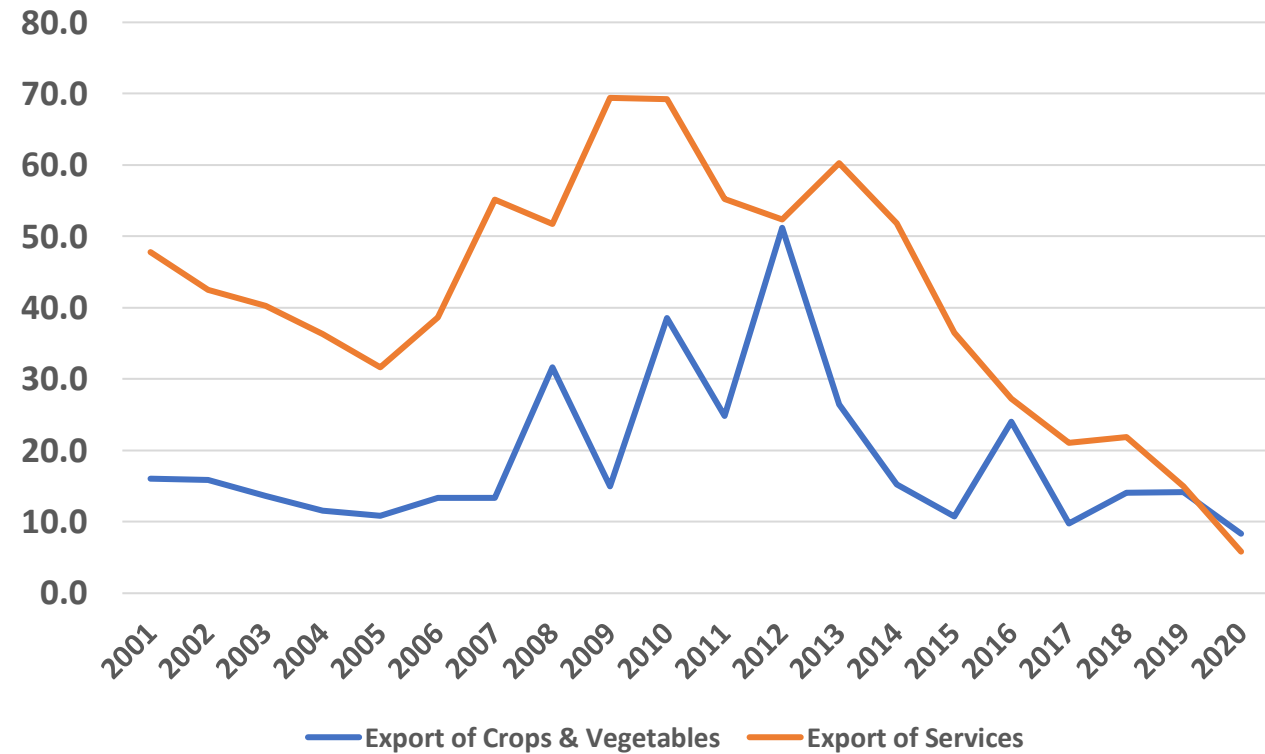
This Data is Derived from National Directorate of Statistics, Timor-Leste National Account Report 2001-2020,

Capital investment in the economy

Stagnancy of Private Investment in the Economy (Million \$)



Non Oil Export is in Declining trend (G&S) (Million \$)

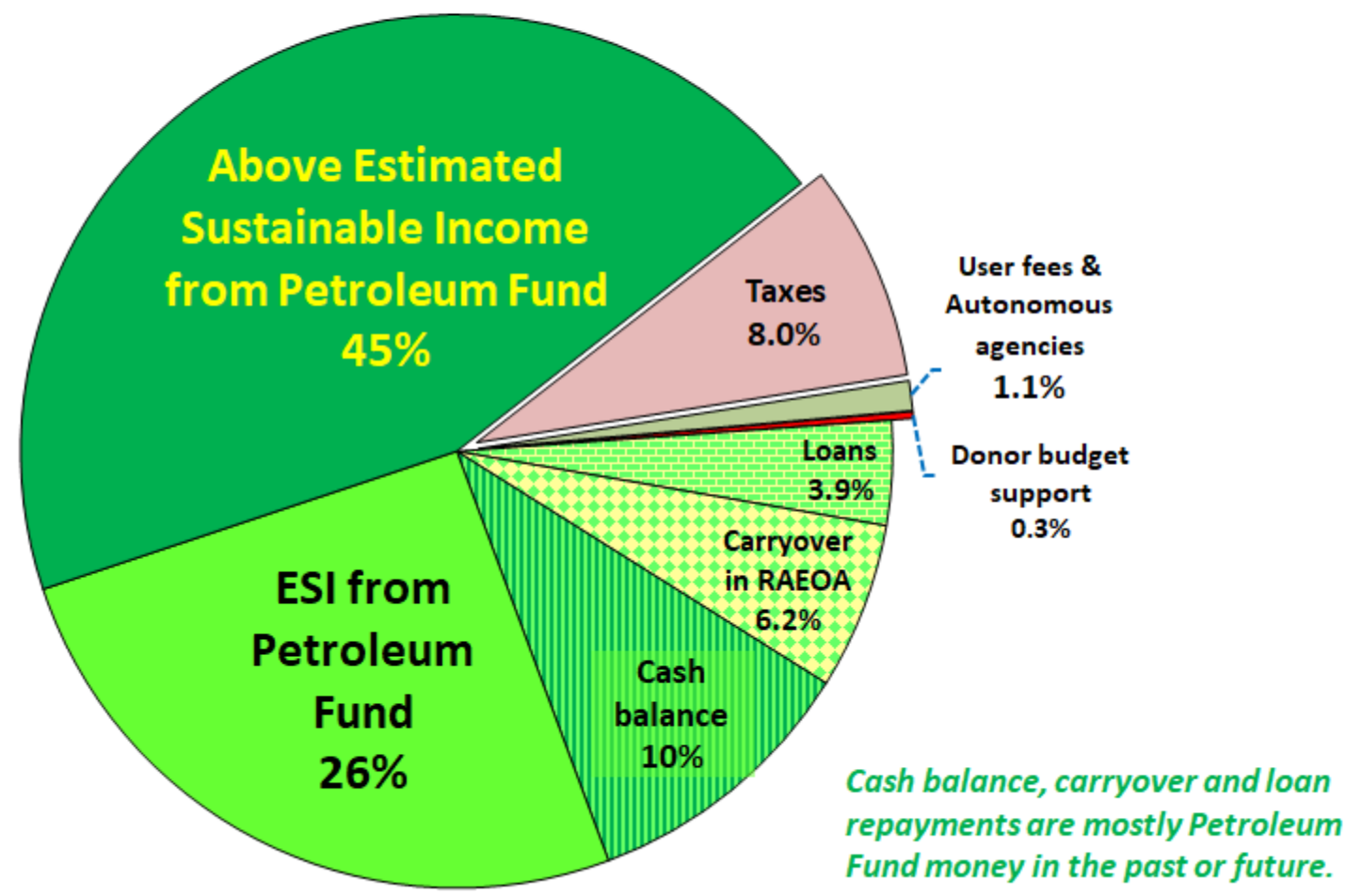


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Revenues in approved 2023 State Budget

\$1,920 million total (excluding Vet's Fund & Soc.Sec. internal transfers)

86% is from the Petroleum Fund in the past, present or future.



Graph by La'o Hamutuk based on the approved State Budget for 2023. December 2022

What do the Data Reveal

1. Deepening State's Dependence on the Petroleum Fund
2. Domestic Revenues is Stagnant
3. Non-oil GDP Growth Rate is lower than Other Countries in the Region and it is stagnant
4. Stagnant of the Agriculture Sector
5. Non-Oil Export is declining and does not show any indications of significant growth

NO CLEAR EVIDENCE OF ECONOMIC DIVERSIFICATION

IMPEDIMENTS TOWARD ECONOMIC DIVERSIFICATION

Distinctive Characters of Private Sector in Oil-Dependent Country

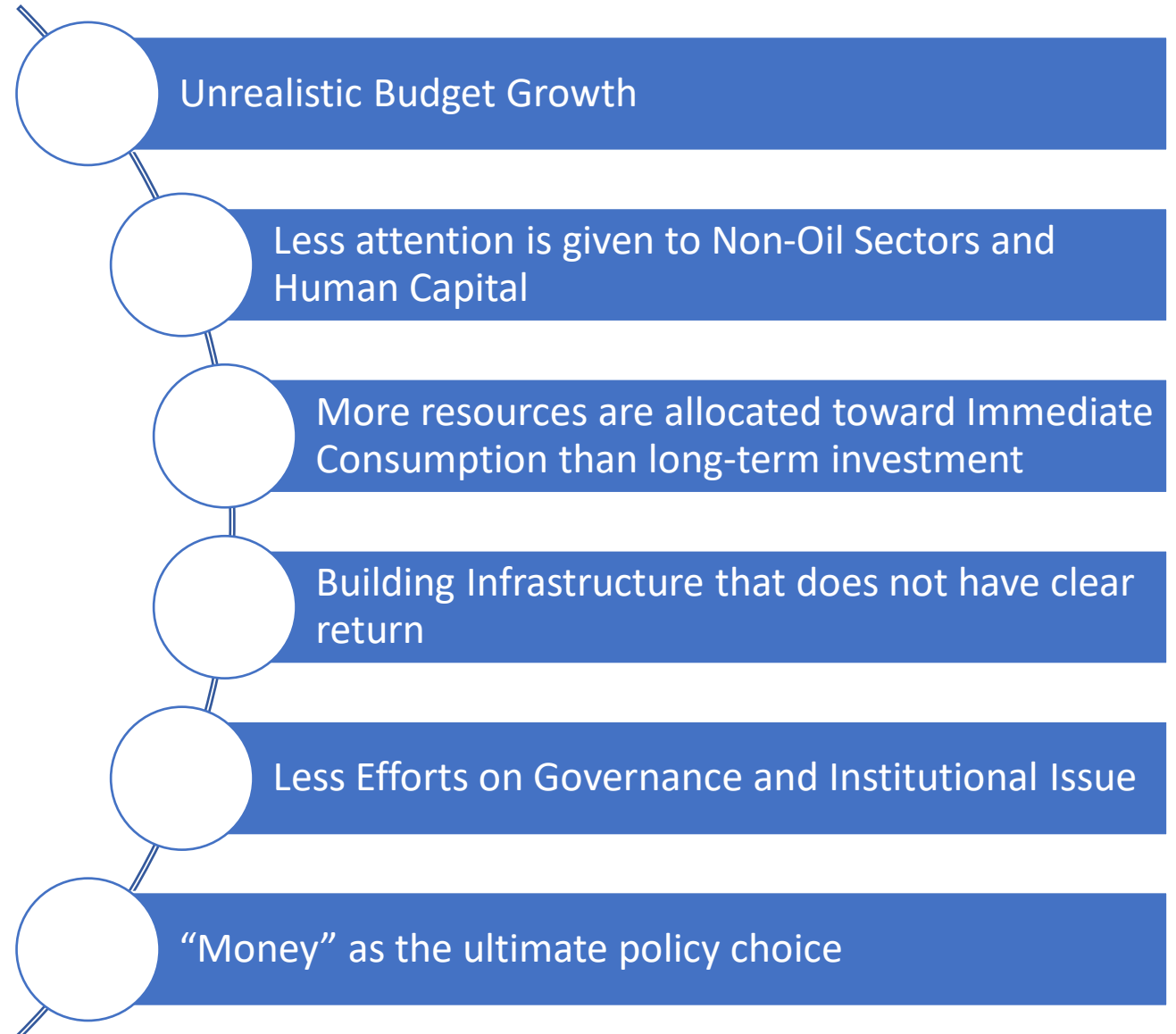
- Oil Industry is an Enclave Industry
 - It does not facilitate other sectors to grow due to limited Backward Linkage
- Oil Revenues relatively higher than the domestic economy
- It enables Government to increase its spending
- High Public Spending Drives Public Sector to Grow
- Public Spending creates Distinctive Characteristics of Private Sector
 - Private Sector is benefitted through Public Sector Spending
 - Public Spending Crowds out Private Sector
 - Public Spending leads to Dutch Disease

Dutch Disease

1. It is the Result of Government's Spending – Spending Effect
2. It creates short-term and even artificial demand, particularly in urban sector
3. High Demands Leads to:
 1. High Inflation Rate – This can be observed between 2008 - 2012
 2. Deepening Import Dependency – The domestic industry cannot satisfy growing demand
 3. Making it hard for the Domestic Products to be competitive
 4. Hard for the Manufacturing Sector to Emerge

Policy failure/misguided policy

1. The outcome of the Policy Choice
2. Natural Resource Dependent Countries are more Prone to Policy Failure
3. In Timor-Leste's Context, it is about Government's decision on:
 - How much to spend, spending on what, and the outcome of that.
 - Sectoral prioritization and Opportunity Cost Involved
 - Political Cost Involved
4. It follows the same trend of other Countries
 - Increase Government's Spending
 - Government's priority on the short-term consumption over long-term one
 - Disproportionate growth of public spending
 - Less attention and resources are allocated to productive sectors



The Importance of Institutions

• Oil affects the Quality of Institutions

- “The Fate of oil-exporting countries must be understood in a context of which economies shape institutions, and, in turn, institutions shape the economies” (Karl, 1997).
- Oil damages Institutions (Michael Ross, 2012), by making governments weaker, more corrupt, less competent, and less able to maintain wise fiscal policies and unable to develop sound economic policies.
- Rent Discourages politicians from investing in the state’s bureaucratic capacity, leaving it weak and unable to foster private-sector growth (Karl, 1997; Besley and Persson)

A. Oil turns countries into a Rentier State

- External Rent accounts for Around 90% of the State’s Revenues
- The Size of Public Expenditure Relative to Domestic Economy – 80 – 100 %
- Social Contract is based on Rent Distribution and Not the Taxation – Fiscal Contract

B. Oil makes certain policy choices becomes easier and cheaper over the others.

- Easier to Spend than to Generate Revenues
- Taxing Citizens incurs high political cost than distributing the money
- Easier to distribute the money than to develop domestic economy

C. Society’s Views on the Development and Prosperity

- Money can buy peace, development and prosperity
- Cash Distribution as the Primary means of governing society

- **Institutional Setting in the Rentier State does not Support Economic Diversification**

- Presence of easy money displaces Incentive and Urgency to move away from Petroleum
- The state is resourced through rents rather than taxes
 - little organization all effort from the state apparatus to develop non-oil sector.
- State becomes autonomous from the society
 - It displaces the necessity and Urgency to develop domestic economy since it is NOT pre-condition for the state to expand
- Petroleum Development capture nation's attention
 - Example is Public or Nations Attention on Greater Sunrise and the way u Sunrise and Tasi Mane is being Presented to the Public
 - Little attention or less incentives for the development of non-oil or Diversify Economy
- Political Setting encourages rent distribution through Clientelist Network than through broader development
 - Recruitment in the Public Offices
 - Awards of Public Contracts to the Political Clientilists
- Easy Money Enables state to “live beyond its means” or spending higher than what it earns

ED and Institutional Change/Reform

- A. Economic Diversification requires changing in the Economic Structure and the Structure of Economic Growth
- B. Economic Diversification Requires Institutional Changes, such as:
 - A. Framework of Policy Formulation in the Economic Development area
 - B. Impose Certain Fiscal Discipline through Fiscal Rules
 - C. Improving the efficiency and the effectiveness of the Bureaucracy
 - D. Harmonizing Rules and Regulations that shape economic incentives in the society
- C. Institutional Change Requires Changes in Political Context
 - A. The Political Party's (Leadership, Recruitment, Financing)
 - B. Political Accountability Mechanism
 - C. Political Clientelism
 - D. Long-Term Political Stability and Certainty
 - E. Addressing Political Clientelism
 - F. Mutual Understanding among major political forces and society in general on major policy issues

Implication for the Development Partnership

- ED and Inclusive Economic Growth is a complex and long-term undertaking
- Long-term view
- Supporting TL to Institutional and Governance
- Public Engagement through local Civil Society
- Working together with Youth and Emerging Leaders
- Flexibility to adjust in a rapidly changing context



THANK YOU

This publication has been funded by the Australian Government through the Australian Embassy. The views expressed in this publication are the author's alone and are not necessarily the views of the Australian Government.