Timor-Leste

Growth accelerated in 2016 as the government implemented a large fiscal stimulus ahead of elections in July 2017. Growth is expected to moderate in 2017 before reaccelerating in 2018 as large public and private investments move forward. Decentralization provides an opportunity to improve public service delivery. Well-designed rules for allocating funding to municipalities will help to ensure that decentralization also promotes equity.

Economic performance

Growth picked up in 2016 as GDP excluding the large offshore petroleum sector (hereafter GDP) expanded by an estimated 5.4% (Figure 3.35.1). Public spending was the main driver of growth, rising by an estimated 17.7%. Grants from Timor-Leste's development partners fell by an estimated 3.4% and accounted for 11.7% of public spending in 2016, while government expenditures excluding grants rose by 21.2%.

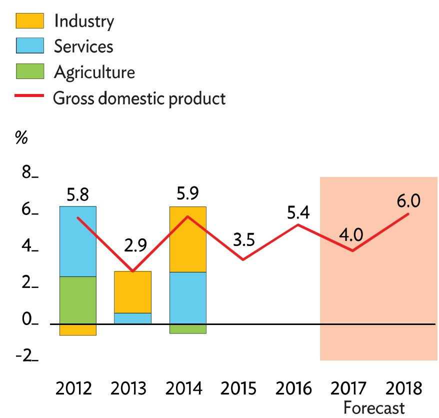
The surge in public spending followed the approval of a supplementary budget in June that doubled planned capital investment and raised the 2016 budget by 25.0% to $1.95 billion, equal to 129% of GDP. Actual capital expenditure rose by 82.2% to $590 million with increased investment in transport infrastructure (Figure 3.35.2). Transfer payments, which increased by 6.3%, also contributed to the growth of public spending. Transfers to the Special Administrative Region of Oe-Cusse Ambeno rose by 57.6% to $217 million. Other components of public spending showed a modest decline, with salaries and wages down by 2.7% and payments for goods and services 3.7% lower.

The surge in public investment improved business prospects and strengthened private sector growth, as indicated by business electricity consumption rising by 17.5% year on year in the first half. Manufacturing received a boost in 2016 as Heineken completed Timor-Leste's first major brewery, but commissioning of a new private port and a cement bagging plant was delayed. In the petroleum sector, state-owned Timor Gap initiated a multiyear program to find more oil and gas in an area of Timor-Leste's exclusive economic zone for which it has been granted an exclusive license.

Coffee production rose in 2016, but quality was harmed by rain during the harvest. In coastal areas, El Niño continued to affect agricultural production. Maize harvests fell by 8% to 21% below the average for 2011–2015, and rice production fell by 6% to 30% below the average for the period.

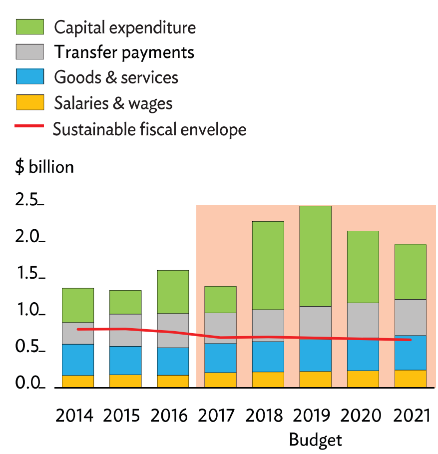
Increased food imports helped to offset the inflationary impact of reduced local production. Thanks to the continued pass-through of previous falls in international food prices, improved logistics, and

3.35.1 Supply-side contributions to growth



Sources: Statistics Timor-Leste; ADB estimates.

3.35.2 Fiscal outlook



Sources: Timor-Leste 2017 State Budget; Timor-Leste Budget Transparency Portal.

This chapter was written by David Freedman, Timor-Leste Resident Mission, ADB, Dili.

increased retail competition, consumer prices fell by an average of 1.3% in 2016 (Figure 3.35.3). Deflation was more pronounced in the capital, Dili, where prices fell by 1.6%, compared with 0.5% deflation in the rest of the country.

Domestic revenue collection strengthened in 2016 by 28.6% with invigorated private business and intensified collection effort. Customs was a notable area of improvement, with revenues up by 20.9% despite a 14.4% decline in merchandise imports. Planning for fiscal reform continued in 2016 with the finalization of draft legislation for a value-added tax and the approval of legislation to restructure customs and tax administration under two new independent authorities.

Income from offshore petroleum production continued its sharp decline in 2016, when Timor-Leste received $223.9 million in taxes and royalties, down from $978.9 million in 2015 and an average of $2.5 billion per annum during 2008–2014. The fall in revenue came from both falling production, down by 6.8% in 2016, and lower oil prices, down by an average of 15.9%. Another factor was the settlement in the first quarter of 2016 of four tax disputes between the Government of Timor-Leste and ConocoPhillips, the lead operator of the Bayu-Undan oil field. The settlement terms have not been disclosed, but analysis of tax and royalty payments to Australia and Timor-Leste suggests that Timor-Leste had to forego $152.4 million in tax revenue in 2016 (Figure 3.35.4).

Lower petroleum tax income was partly balanced on paper by investments of Timor-Leste's Petroleum Fund that earned $647.7 million in 2016. The fund's equity and bond holdings both outperformed their benchmarks for an overall return on assets of 4.7%, compared with a benchmark yield of 4.0%. The fund maintained its investment strategy in 2016, but new procedures for cash management were introduced in June to reduce its exposure to losses from short-term volatility.

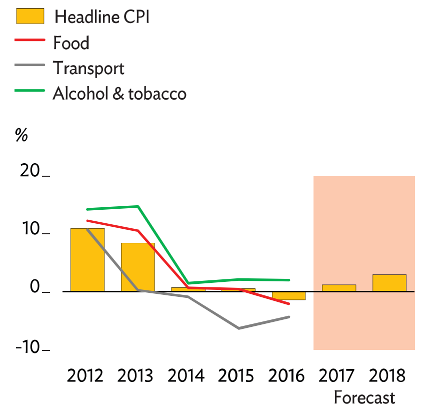
As in previous years, withdrawals from the Petroleum Fund financed most public spending. Withdrawals reached $1.24 billion in 2016, more than double the estimated sustainable income of $544.8 million. As a result, the fund balance declined by 2.3% in 2016, ending the year with $15.8 billion of assets, or 10.5 times GDP. The sharp decline in income from oil production and elevated spending on imported goods and services was reflected in the current account, which went from a surplus equal to 16.4% of GDP in 2015 to a deficit estimated at 49.9%.

Economic prospects

Growth is forecast to slow to 4.0% in 2017 before recovering to 6.0% in 2018 as major public and private investments move ahead. The implementation of public investments is likely to falter in 2017 as attention shifts to national elections in July and the formation of a new government. A supplementary budget may be passed immediately after the elections to reflect changes in government structure and priorities.

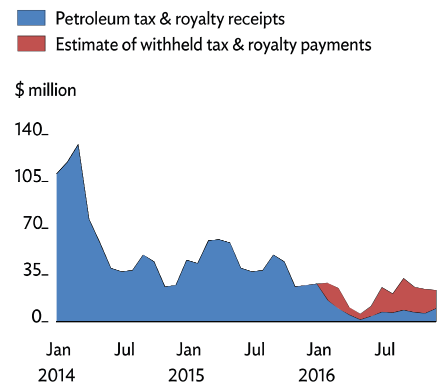
The 2017 budget includes new appropriations for almost $1.39 billion in expenditure this year excluding grants from development partners. This is down from an average of $1.63 billion during 2011–2016. Of the total, $361 million is for capital investment and $1.03 billion for recurrent expenditures. Recurrent expenditure includes a $172 million

3.35.3 Inflation



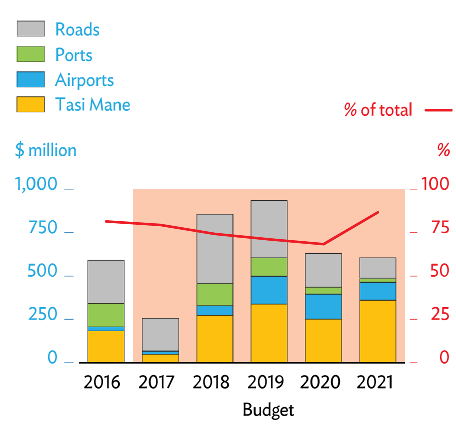
Sources: Statistics Timor-Leste; ADB estimates..

3.35.4 Actual and foregone taxes and royalties from petroleum production



Sources: Timor-Leste National Petroleum Authority; ADB estimates.

3.35.5 Planned infrastructure fund investments



Sources: Timor-Leste Budget Transparency Portal; Timor-Leste 2017 State Budget.

transfer to Oe-Cusse Ambeno, of which 72.8% is allocated to capital works. Allocations for salaries and wages are 14.8% higher in 2017 because of increases across many ministries. However, setting aside transfers to Oe-Cusse Ambeno, the allocation for recurrent items is 3.9% lower than in 2016. Most of the savings have been achieved by allocating less for transfers and for goods and services.

The 2017 budget maintains the growth strategy in force since 2011, led by public investment. The budget for the autonomously managed Infrastructure Fund during 2017–2021 is $4.5 billion, or 3 times the GDP in 2016. Of this, 80% is allocated to roads and bridges, airports, seaports, public buildings, and the Tasi Mane project to develop a petrochemical industry on the south coast (Figure 3.35.5). An operations and maintenance program has been included in the Infrastructure Fund plan for 2017–2021 with an initial allocation of $9.6 million in 2017 and an average of $9.1 million per annum in 2018–2021. Despite the large capital budget, planned investments in water and sanitation, education, and health care may not be sufficient to achieve national targets for service delivery.

The discounted forecast for petroleum revenues during 2017–2022 is 44% less than in the 2016 budget, reflecting updated oil price forecasts (Figure 3.35.6). As a result, the estimated sustainable income from the Petroleum Fund has been reduced to $481.6 million, well below the $787.0 million peak in 2013. Projections for domestic revenue growth have been lifted, reflecting strong collections in 2016 and the expected impact of fiscal reforms. Non-oil revenues are now projected to rise to $247.9 million by 2020, compared with a forecast of $210.3 million in the 2016 budget (Figure 3.35.7).

With revenues from oil and gas production in steep decline, the current account position is increasingly determined by income from Petroleum Fund investments and the magnitude of deficits in merchandise and services trade. The current account deficit is projected to narrow to 12.2% of GDP in 2017 as the trade deficit shrinks with lower government spending.

A current account deficit equal to 40.2% of GDP is forecast for 2018 as the trade deficit widens and income from petroleum production declines further. In the absence of new oil and gas developments or substantial fiscal consolidation, Timor-Leste is likely to see widening fiscal and current account deficits and a steady drawdown of Petroleum Fund assets in the years after 2018.

In January 2017, Timor-Leste and Australia announced their shared intention to negotiate a permanent maritime boundary between the two countries by September 2017. The termination of their revenue-sharing agreement and demarcation of a permanent border in the Timor Sea could clarify ownership of the Greater Sunrise oil field and pave the way for its development. This would not affect government revenues during the forecast period but could make fiscal consolidation less urgent.

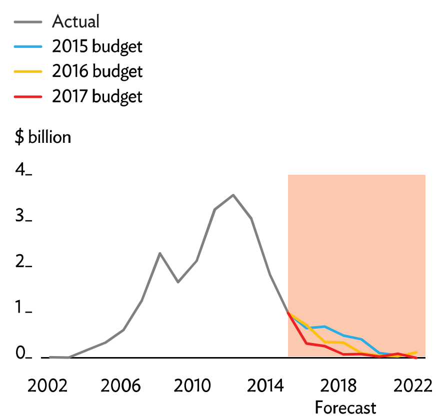
Consumer prices are expected to increase in 2017 and 2018 with private business picking up and higher international food and fuel prices. Consumer price inflation is forecast at 1.2% in 2017, rising to 3.0% in 2018 as international food prices continue to rise and increased investment stimulates demand.

3.35.1 Selected economic indicators (%)

	2017	2018
GDP growth	4.0	6.0
Inflation	1.2	3.0
Current account balance (share of GDP)	–12.2	–40.2

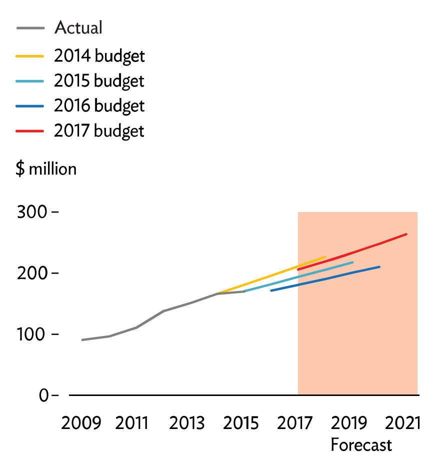
Source: ADB estimates.

3.35.6 Petroleum revenues



Sources: Timor-Leste national budget documents (various years).

3.35.7 Domestic revenues

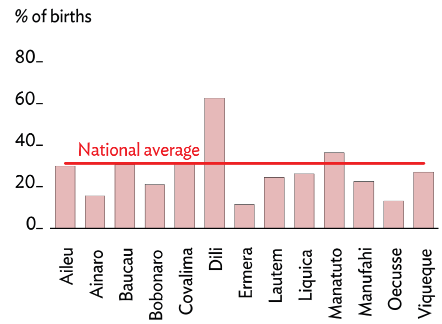


Source: Timor-Leste national budget documents (various years).

The outlook for private investment is positive during 2017 and 2018 with the Heineken brewery set to expand its operations in 2017 and the Tibar Bay port likely to garner the approvals necessary to commence construction in the second half of the year. Elections are a wild card in 2017, and final decisions could slip to 2018 regarding the development of the cement factory in Baucau and two large tourism investments near Dili.

The finalization of a range of legislative reforms could stimulate private investment and business activity. In February 2017, the national parliament approved a package of land laws that provides the first clear framework for regulating landownership and resolving competing historical claims since Timor-Leste achieved independence in 2002. Other notable reforms targeted for completion before the 2017 elections are a new mining code, investment law, and framework for secured lending.

3.35.8 Births attended by health professional



Source: Timor-Leste Population and Housing Census 2015.

Policy challenge—managing the decentralization of service delivery

The decentralization program that began with establishment of the Special Administrative Region of Oe-Cusse Ambeno in 2014 is set to expand in 2017. The government approved in 2016 a new law defining the structures, roles, and responsibilities of new municipal authorities in the four largest municipalities—Baucau, Bobonaro, Dili, and Ermera—and new municipal administrations in the remaining eight municipalities.

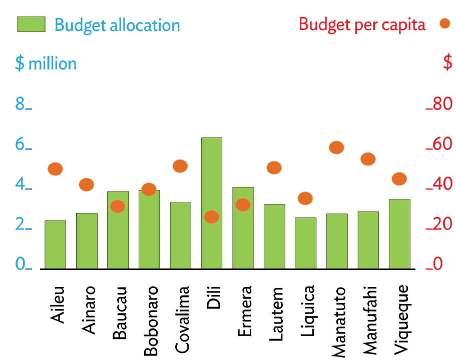
The new law provides a framework for administrative decentralization and assigns significant responsibilities for health, education, public works, and other public services to the new municipal bodies. The law empowers central government agencies to delegate additional functions to subnational administrations and authorities.

Timor-Leste can benefit from the lessons learned in other countries as it moves forward with its own decentralization. While the legal framework has now been established, many details still need to be worked out. It will be important to ensure that the transfer of functions to subnational governments aligns with capacity in the new municipal bodies, which is currently limited, and that funding allocations from the central government are consistent with their service delivery mandates.

Fiscal policy is one area where further analysis is needed. Analysis of data from the 2014 Survey of National Living Standards and the 2015 census highlight significant regional variation in poverty rates and other human development indicators (Figure 3.35.8). While a number of government programs target poverty, current patterns of subnational spending do not reflect regional differences in poverty rates (Figure 3.35.9 and Figure 3.35.10).

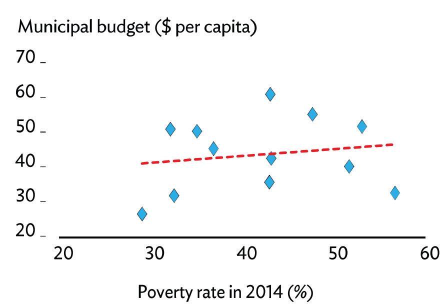
Decentralization will better promote equity if fiscal rules provide a clear and objective framework for aligning funding allocations to regional variations in poverty, human development, and the cost of service delivery. It may also provide scope to incentivize service delivery by delegating selected revenue collection functions to subnational governments and establishing revenue-sharing arrangements.

3.35.9 Municipal budget allocations



Sources: Timor-Leste State Budget, 2017; Timor-Leste Population and Housing Census 2015

3.35.10 Municipal budget allocations and poverty rates



Sources: Timor-Leste State Budget 2017; Poverty in Timor-Leste, 2014.