

2019 State Budget Book 1

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Part 1 Speech of the Prime Minister

Part 2 Description and Analysis of the 2019 State Budget

2.1: Executive Summary

2.1.1: Government Policy

The Government of Timor-Leste's policies as guided by Strategic Development Plan are laid out in the Annual State Budget, with the long-term objective to become an upper middle income country by 2030. Achieving this goal, the Government is investing in infrastructure and key economic sectors including tourism, health, education and agriculture. Budget Book 1 for 2019 summarizes the plans on pursuing these policies for the current fiscal year.

Table 2.1.1.1: Combined Sources Budget 2017-2023, \$ million

| | 2017 Actual | 2018 Budget | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Combined Sources Budget | 1,371.4 | 1,459.1 | 1,989.6 | 2,280.4 | 1,941.9 | 1,918.4 | 1,798.5 |
| Government Expenditures by Fund | 1,194.7 | 1,277.4 | 1,827.0 | 2,160.0 | 1,876.6 | 1,902.9 | 1,798.5 |
| CFTL (excl. loans) | 1,140.7 | 1,200.0 | 1,720.0 | 2,099.2 | 1,841.5 | 1,870.7 | 1,775.1 |
| HCDF | 23.9 | 15.8 | 20.0 | 20.8 | 21.6 | 22.5 | 23.4 |
| Borrowing/Loans (disbursements) | 30.1 | 61.6 | 87.0 | 40.0 | 13.5 | 9.7 | - |
| Development Partner Commitments | 176.7 | 181.7 | 162.6 | 120.4 | 65.3 | 15.5 | - |

Sources: National Directorate of Budget and Development Partnership Management Unit, Ministry of Finance, 2018

2.1.2: Economic Growth

Becoming an upper middle income country by 2030 requires strong, high-quality non-oil economic growth. Public investment seen from 2007 to 2016 through the frontloading fiscal policy has driven growth in the non-oil economy, averaging at 6.9% per year. This was aimed at providing necessary foundations for long-term sustainable private sector led development. The real non-oil GDP growth was strong in 2016 at 5.3%, up from 4.0% in 2015. In particular, household consumption increased by 6.0% suggesting that living standards are continuing to increase in Timor-Leste. There were challenges during 2017 that have continued into 2018, and these have affected the growth forecasts. However, the 2019 Budget will deliver strong growth of 5.9% as the country returns to a normal budget for the whole year.

2.1.3: Expenditure

Total expenditure in the 2019 budget is \$1,827.0 million (excluding donor funded activities of \$162.6 million). The total 2019 State Budget is higher than that allocated for 2018. This is because the 2018 State Budget was affected by the duodecimal system for most of the year.

The Government is focussed on continuing to develop key infrastructure throughout Timor-Leste, in order to stimulate growth and reduce poverty. As with the 2018 budget, electricity, roads and bridges, ports, airports and water & sanitation still remain a priority. A strategic increase in public transfers has been made to finance the 30% share from Conoco Philips of the Greater Sunrise project, expected to spur Timor-Leste's growth in the future. At the same time, there is a decrease in capital development allocation as the government expects to ensure that key infrastructure projects are able to develop at a good rate while monitoring costs.

Line ministries and autonomous agencies have been allocated a 35.5% overall increase in Goods and Services allocations from 2018. While they were encumbered by the duo-decimal system in 2018, this increase will give them more room to execute their priorities in 2019. Government is still oriented towards addressing the needs of vulnerable and deserving groups focussing on social protection channels like pensions and other social programmes.

Table 2.1.3.1: Fiscal Table, \$ million

| | 2015 Actual | 2016 Actual | 2017 Actual | 2018 Budget | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|--|----------------|----------------|----------------|----------------|----------------|---------|---------|---------|---------|
| Total Expenditure by Appropriation Category (incl. loans) | 1,336.7 | 1,629.9 | 1,194.7 | 1,277.4 | 1,827.0 | 2,160.0 | 1,876.6 | 1,902.9 | 1,798.5 |
| Total Expenditure by Appropriation Category (excl. loans) | 1,312.5 | 1,599.3 | 1,164.6 | 1,215.8 | 1,740.0 | 2,120.0 | 1,863.1 | 1,893.2 | 1,798.5 |
| <i>Recurrent</i> | 1,029.6 | 1,027.7 | 931.3 | 878.5 | 1,397.4 | 1,453.3 | 1,511.5 | 1,571.9 | 1,634.8 |
| Salary and Wages | 173.4 | 178.6 | 197.2 | 200.3 | 214.0 | 222.6 | 231.5 | 240.8 | 250.4 |
| Goods and Services (inc. HCDF) | 423.8 | 378.1 | 328.4 | 354.0 | 478.3 | 497.4 | 517.3 | 538.0 | 559.5 |
| Public Transfers | 432.5 | 471.1 | 405.8 | 324.2 | 705.1 | 733.3 | 762.7 | 793.2 | 824.9 |
| <i>Capital</i> | 307.1 | 602.2 | 263.3 | 398.9 | 429.6 | 706.6 | 365.2 | 330.9 | 163.7 |
| Minor Capital | 33.9 | 20.8 | 13.1 | 5.1 | 29.4 | 30.6 | 31.8 | 33.1 | 34.4 |
| Capital and Development (including loans) | 273.1 | 581.4 | 250.2 | 393.7 | 400.2 | 676.1 | 333.4 | 297.9 | 129.3 |
| Revenue*** | 808.5 | 744.2 | 671.2 | 739.2 | 727.6 | 708.9 | 680.9 | 659.5 | 637.7 |
| Domestic Revenue | 170.0 | 199.4 | 189.6 | 188.825 | 198.6 | 206.4 | 217.3 | 228.2 | 240.4 |

| | | | | | | | | | |
|------------------------------------|---------|---------|---------|---------|------------------|-----------|-----------|-----------|-----------|
| Estimated Sustainable Income (ESI) | 638.5 | 544.8 | 481.6 | 550.4 | 529.0 | 502.5 | 463.6 | 431.3 | 397.2 |
| Fiscal Balance | (528.2) | (885.8) | (523.5) | (538.1) | (1,099.4) | (1,451.0) | (1,195.8) | (1,243.3) | (1,160.9) |
| Financing | 528.2 | 885.8 | 523.5 | 538.1 | 1,099.4 | 1,451.0 | 1,195.8 | 1,243.3 | 1,160.9 |
| Excess Withdrawals from the PF | 640.0 | 700.0 | 597.1 | 432.1 | 1,012.4 | 1,411.0 | 1,182.3 | 1,233.6 | 1,160.9 |
| Use of Cash Balance | (136.0) | 155.1 | (103.7) | 44.4 | - | - | - | - | - |
| Borrowing/Loans (disbursements) | 24.2 | 30.6 | 30.1 | 61.6 | 87.0 | 40.0 | 13.5 | 9.7 | - |

Sources: National Directorate of Budget, National Directorate of Economic Policy, Petroleum Fund Administration Unit, Development Partnership Management Unit, PPP&Loans Unit, Ministry of Finance, 2018.

2.1.4: Domestic Revenue

In 2019, domestic revenue growth regains strength, following the stagnation that occurred in 2017 and 2018. This positive trend is driven by the stronger macro-economic performance of the country, as private sector conditions improve and public expenditure returns to normality. Non-oil revenue is expected to keep growing in the medium term thanks to a combination of improvements in administration, fiscal reform and the introduction of new fiscal instruments, at current economic growth expectations.

The Estimated Sustainable Income (ESI) is the sustainable amount of petroleum revenue which can be withdrawn from the Petroleum Fund each year. Since spending only up to non-oil revenue and the ESI allows the maintenance of fiscal sustainability, ESI is considered a component of total revenue. The ESI for 2019 is calculated at \$529.0 million.

2.1.5: Financing

The fiscal deficit is equal to revenue minus expenditure. The Government uses excess withdrawals from the Petroleum Fund (PF), loans and the cash balance to finance the deficit in 2019.

The total amount budgeted to be withdrawn from the PF in 2019 is \$1,541.4 million, with excess withdrawals of \$1,012.4 million. The Government considers that excess withdrawals are necessary in the medium term to finance priority capital expenditures.

Loans are becoming an increasingly important tool for financing in the Government of Timor-Leste. The current loans contracted by the Government of Timor-Leste are used to finance key infrastructure projects and have relatively low rates of interest and significant grace periods. Total loan financing for 2019 is \$87.0 million.

2.2: Economic Overview

2.2.1: Summary

Table 2.2.1.1 Economic Indicators, 2019-2021 (%)

| Summary | Forecast | | |
|----------------------|----------|------|------|
| | 2019 | 2020 | 2021 |
| % change | | | |
| Real GDP (non-oil) * | 5.9 | 7.0 | 7.0 |
| Inflation CPI | 2.7 | 3.2 | 3.7 |

Growth 2019 source: DNPE, Ministry of Finance. CPI source: IMF. *Target growth for 2020 and 2021.

- Real non-oil GDP growth is expected to accelerate, with growth of 5.9% in 2019. This return to growth is driven by an end to political uncertainty and return to normal government expenditure following the end of the duodecimal system.
- Inflation is expected to remain low and stable at 2.7%. This will positive contribute to increasing Timor-Leste competitiveness, with inflation expected to be lower than the regional average.
- The exchange rate forecast suggests there will some small depreciation in the near future, providing an overall stable foundation for traders, alongside improved competitiveness.

2.2.2: Macroeconomic Trends

2.2.2.1: Growth

Table 2.2.2.1 Real Economic Growth 2017-2019 (%)

| Country | Actual | Forecast | |
|-----------------------------------|--------|----------|------|
| | 2017 | 2018 | 2019 |
| World | 3.7% | 3.7% | 3.7% |
| Advanced Economies | 2.3% | 2.4% | 2.1% |
| Emerging and Developing Economies | 4.7% | 4.7% | 4.7% |
| Emerging and Developing Asia | 6.5% | 6.5% | 6.3% |
| China | 6.9% | 6.6% | 6.2% |
| Euro area | 2.4% | 2.0% | 1.9% |

Sources: IMF World Economic Outlook October 2018.

| Timor-Leste | Forecast | | | Target | |
|-------------|----------|------|------|--------|------|
| | 2017 | 2018 | 2019 | 2020 | 2021 |
| Non-oil | -5.3% | 0.6% | 5.9% | 7% | 7% |

Source: Ministry of Finance, 2018.

Timor-Leste

Since the 2018 Budget, there have not been many new developments in economic data, and so the forecasts for 2017 and 2018 remain as in the 2018 Budget Overview. There is expected

to have been negative growth in 2017 and stagnation in 2018. The latest National Accounts GDP data remains for 2016, when there was 5.3% growth. The private sector developments and employment data are the same as presented in the 2018 budget.

The passing of the 2018 budget provides confidence that growth will return as the state budget returns to normal for the last part of 2018. This positive news provides hope for 2018 GDP and sets good momentum for 2019.

International

Globally, growth is remaining steady, projected by the IMF to be 3.7 percent in both 2018 and 2019. This is a reduction over previous forecasts, driven by the negative effects of trade measures as well as a weaker outlook for some key emerging market and developing economies. Nevertheless global growth remains well above its level during 2012-2016, and high levels of growth, especially in Asia, still provides a solid foundation for Timorese exporters and economic development.

Growth in advanced economies is projected at 2.4 percent in 2018, higher than in 2017 at 2.3 percent. The growth is above trend and driven by fiscal stimulus in the USA. It is expected to soften in the following years. For the emerging and developing economies, growth is forecast to remain steady at 4.7 percent in 2018 and in 2019 as a result of a strong emerging Asia, led by a projected increase in India's growth alongside China's gradual moderation. Higher oil prices lifted growth among fuel-exporting economies.

China's economic growth is strengthening in 2017 at 6.9 percent and is projected to decrease to 6.6 percent in 2018 and 6.2 percent in 2019. The decline in growth seen in 2018 and 2019 is due regulatory tightening of the property sector and non-bank financial intermediation, and the fiscal adjustment towards a lower growth path.

Overall, the international environment provides favourable conditions for Timor-Leste to take advantage of in 2019 and beyond.

2.2.2.2: Prices and Inflation

Table 2.2.2.2.1: Global and Regional Inflation Rates (%)

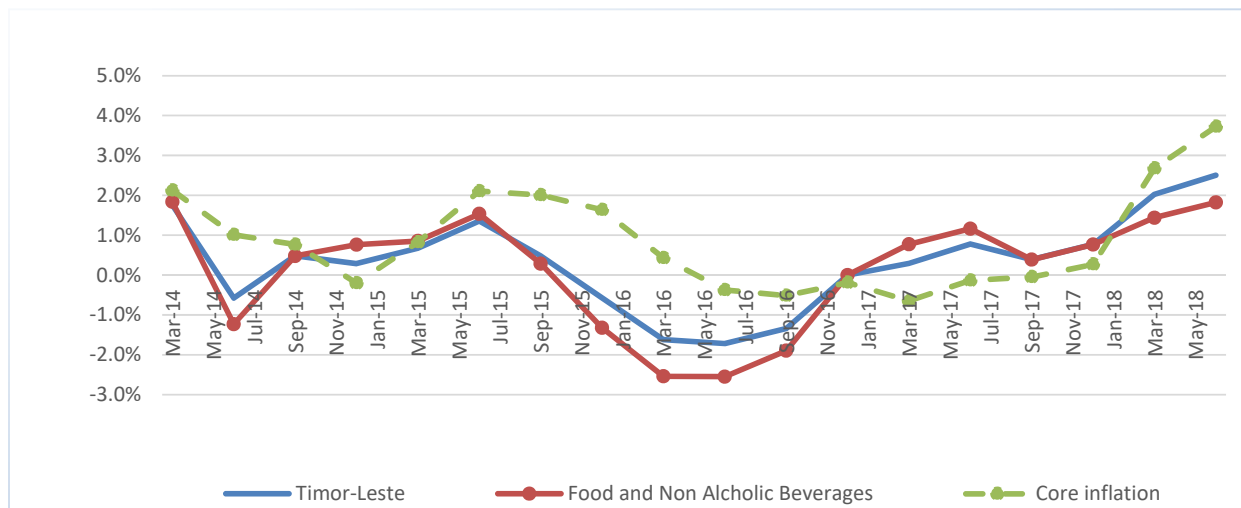
| Country | Actual | | Forecast | |
|-----------------------------------|--------|------|----------|------|
| | 2016 | 2017 | 2018 | 2019 |
| World | 2.8% | 3.2% | 3.8% | 3.8% |
| Advanced Economies | 0.8% | 1.7% | 2.0% | 1.9% |
| Emerging and Developing Economies | 4.2% | 4.3% | 5.0% | 5.2% |
| Emerging and Developing Asia | 2.8% | 2.4% | 3.0% | 3.2% |
| Timor-Leste | -1.3% | 0.6% | 2.4%* | 2.7% |

Sources: IMF World Economic Outlook October 2018. *Ministry of Finance-adjusted forecast.

Timor-Leste

With year on year inflation in June of 2.5%, Timor-Leste still enjoys a low level of inflation. Due to the significant weight of food and non-alcoholic beverages in the CPI basket and the high proportion of food imported into Timor-Leste every year, international food prices remain one of the key drivers of the overall CPI rate, and the MoF continues to monitor price levels. The Food and Agricultural Organization's (FAO) food price index was flat at 0% year on year change in June, following a period of decline in early 2018. This moderates earlier upward swings in food prices. Domestic food prices rose in June, though these remained muted at +1.8%. It is expected that the current world food markets will provide a moderating impact on prices in the near future. A one-off 16.6% increase in education costs will affect annual inflation in Timor-Leste throughout 2018.

Figure 2.2.2.2.1: Change in Consumer Price Index Timor-Leste 2014-2018 (%)



Sources: National Directorate of Economic Policy and Statistics Directorate, Ministry of Finance 2018.

International

According to the IMF, global inflation is projected to rise to 3.8 percent in 2018. Inflation in advanced economies is projected at 2.0 percent in 2018 and decline to 1.9 percent in 2019.

For the advanced economies inflation is below central bank targets. For the emerging and developing economies the inflation is projected to increase to 5.0% in 2018 from 4.3% in 2017. Low inflation in Timor-Leste in this context will tend to help improve competitiveness.

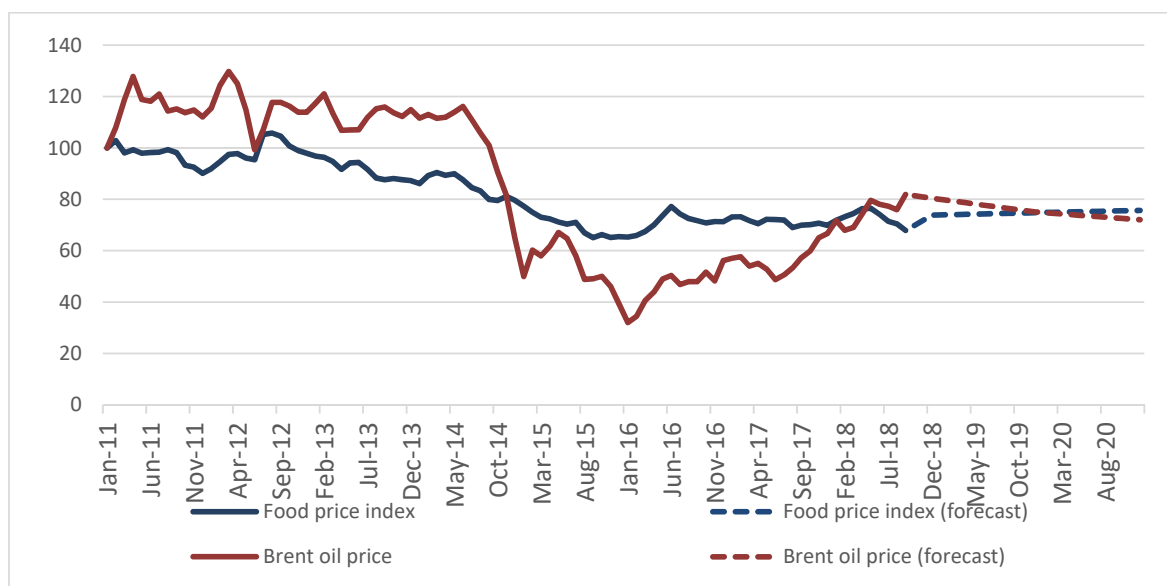
Oil prices

Oil prices are important to Timor-Leste both for consumers, through consumer prices, and as an oil exporting country. The international price of Brent oil has witnessed dramatic declines since June 2014 from highs of \$111.9 per barrel to lows of \$32.2 per barrel in January 2016. The decline in oil prices was driven by the increased global supply during a period of low global demand. However, for the period following this, the oil market began to recover reaching an average of \$78.9 per barrel in September 2018. This strengthening recovery has been driven by collapsing Venezuelan production, rising geopolitical tensions and both agreed and unplanned restrictions on oil supply in Canada, Libya, and Iran (see figure 2.2.2.2.2).

Agricultural Commodity Prices

A significant portion of the food consumed in Timor-Leste is imported and thus changes in international food prices can have a significant impact on both the rate of inflation and standard of living. According to the World Bank Commodities Prices Forecast the international food prices have continued to decline from 2011. Food prices will rise marginally throughout the rest of 2018 and 2019, however the increase is small, and overall food prices are expected to remain relatively low. This will benefit poorer households in Timor-Leste.

Figure 2.2.2.2: Commodity Price Indices



Source: National Directorate of Economic Policy and Statistics Directorate, Ministry of Finance, 2018

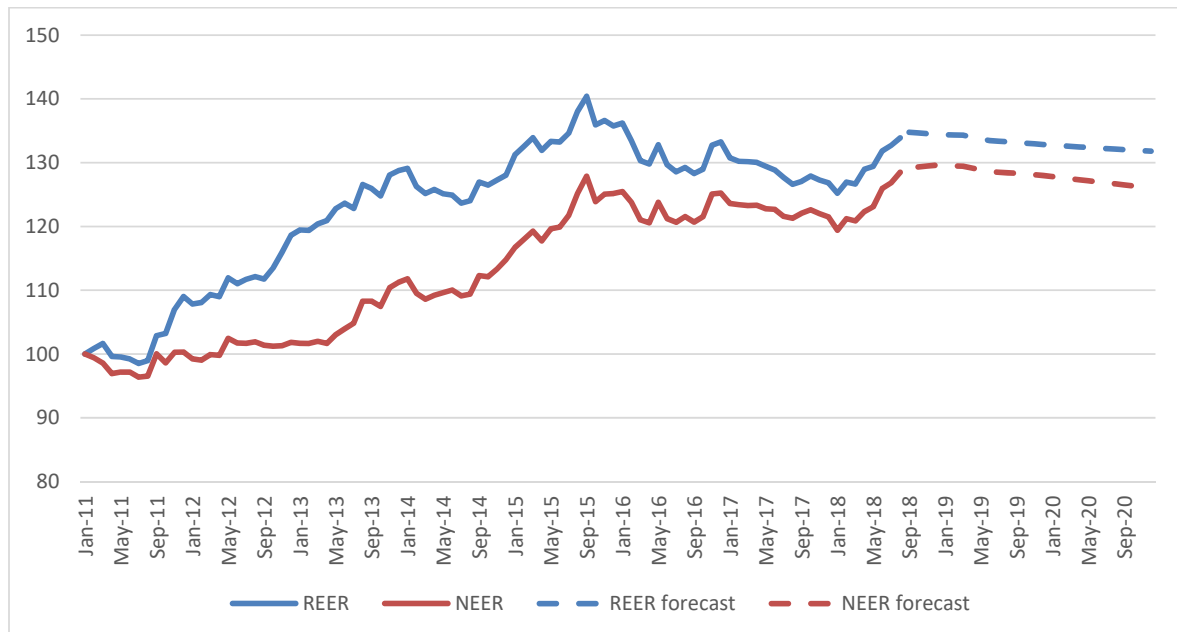
2.2.2.3: Exchange Rates and Competitiveness

Between August 2017 and August 2018 the US dollar appreciated by 4.9% against a weighted basket of currencies of Timor-Leste’s trading partners (the nominal effective exchange rate, NEER). There has been a small overall appreciation in the last few years which has reduced the price of imports, placing downward pressure on domestic inflation, benefiting Timorese consumers. However, this appreciation makes Timorese non-oil exports more expensive in international markets constraining the development of the country’s exports sector.

An inflation-adjusted measure of the exchange rate, the real effective exchange rate (REER), is a better measure of competitiveness. If inflation in Timor-Leste is lower than in other countries, this can help mitigate exchange rate appreciation. The REER has appreciated by 5.6% between August 2017 and August 2018, which indicated that Timor-Leste has had higher inflation than its neighbours over the last year.

The low expected inflation rates outlined above indicate that Timor-Leste can expect an improvement in competitiveness in the future. This will help the Timorese export market be well-placed in the international market. While this is to be welcomed, the government is not complacent about the issue of competitiveness. A key priority is improving the business environment to encourage improved competitiveness. The Inflation target policy is a part of the “improving business environment package”.

Figure 2.2.2.3: Exchange Rate Indices



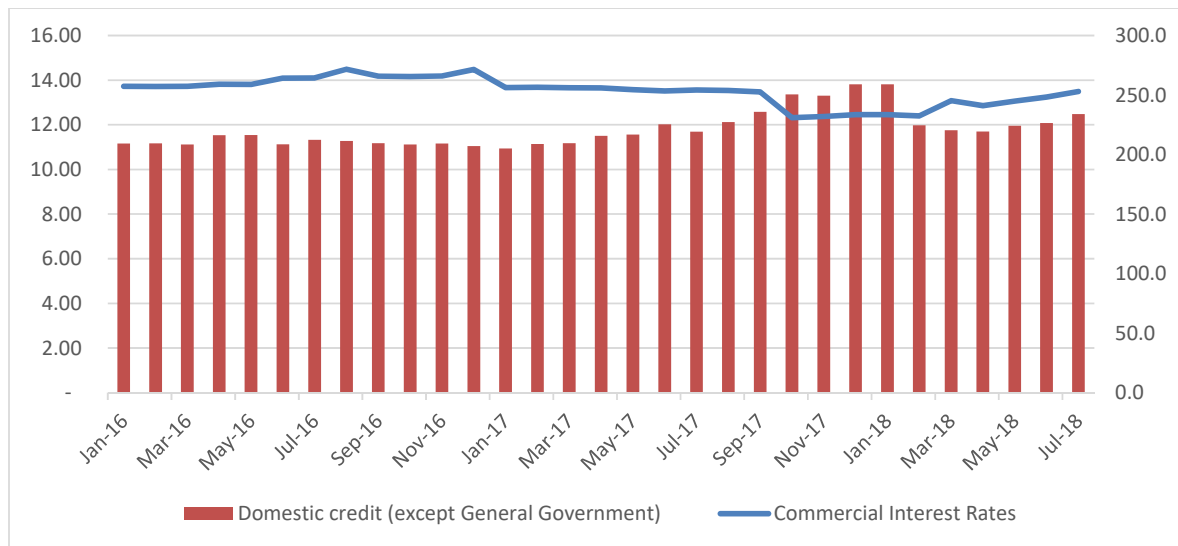
Source: National Directorate of Economic Policy and Statistics Directorate, Ministry of Finance, 2018.

2.2.3: Financial Sector Trends

2.2.3.1: Commercial Interest Rates and Credit

The amount and cost of credit to the private sector is an important indicator for private sector development. Loans to the private sector were at an average interest rate of 13.5% in July 2018. Total domestic credit, excluding general government, was \$234m in July 2018, a reduction from the peak at the end of 2017.

Figure 2.2.3.1.1: Commercial Interest Rates and Credit

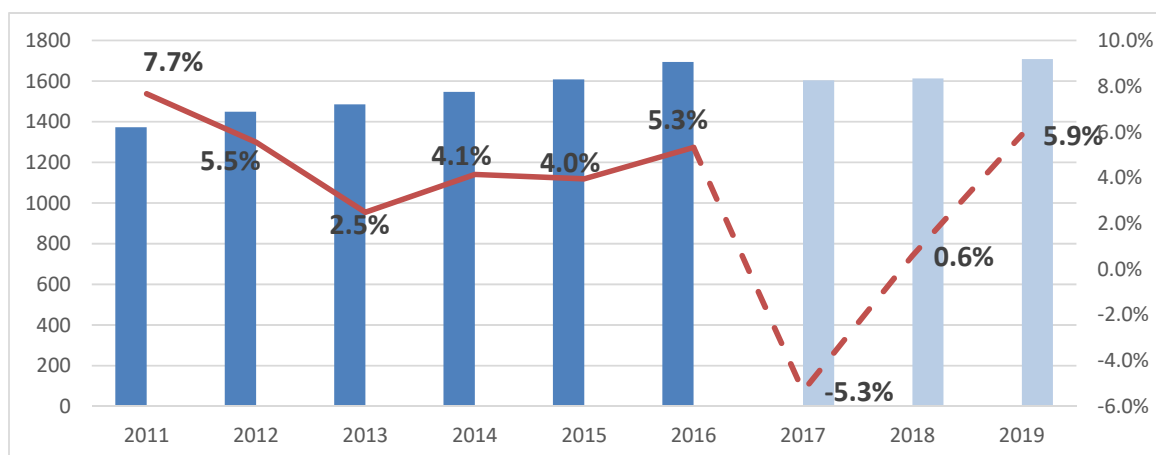


Source: Banco Central Timor-Leste, 2018. Interest Rate (LHS, %), Credit (RHS, \$m).

2.2.4: Economic Outlook

The Ministry of Finance is forecasting non-oil GDP growth to be +5.9% for 2019. With the uncertain economic environment finally ending in 2018, growth is expected to pick up in 2019. Factors contributing to high 2019 growth include an end to political uncertainty, a return to normal budgetting procedures, and a resurgence in private sector investment. Over the medium term, the government is targeting a growth rate of 7% driven by private sector-led, sustainable development.

Figure 2.2.4.1 Real non-oil GDP growth (RHS, %) and levels (LHS, \$m)



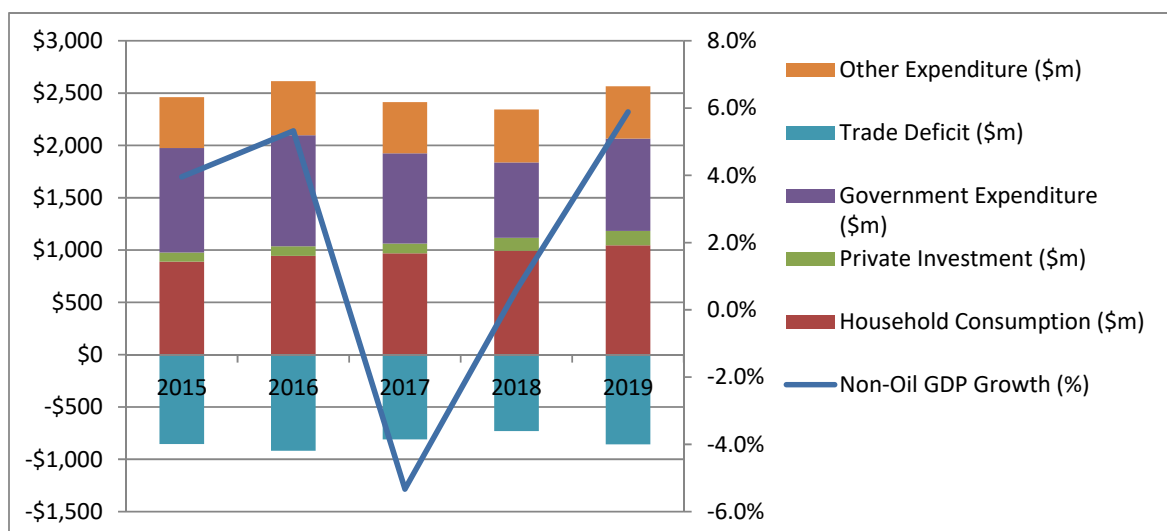
Source: Timor-Leste National Accounts 2000-2016, General Directorate of Statistics, Ministry of Finance, 2018, and Economic Forecasts, National Directorate of Economic Policy, Ministry of Finance, 2018.

Living standards are expected to improve with household consumption growing as it returns to the trends seen in previous years. Steadily growing consumption is boosted by a low inflationary environment. Looking forward across the medium-term, this environment is likely to continue given regional growth rates, the world commodity price outlook and exchange rate projections (see Figure 2.2.2.2.3).

Public sector investment is expected to provide a strong contribution to growth. Infrastructure projects, especially in education, health, and water & sanitation are expected to commence. These will improve social capital as well as providing jobs and economic activity during construction. Road and bridge projects continue to be built or improved and with greater momentum in 2019, providing better and lower cost transportation within the country. The infrastructure assets resulting from this public investment as well as legal reform will create an environment conducive to strong growth in the private sector, boosting growth after 2019.

Large-scale private sector investments will result in a significant increase in private sector investment. 2019 will see construction on the Tibar Bay Port, and the expansion of existing commercial and retail properties throughout the country. Such investments are consistent with the Government's economic strategy, alongside continued investments in human capital and education, to attract investors and consequently creating jobs domestically.

Figure 2.2.4.2: Components of non-oil GDP, 2015-2019



Sources: Source: Timor-Leste National Accounts 2000-2016, General Directorate of Statistics, Ministry of Finance, 2018, and Economic Forecasts, National Directorate of Economic Policy, Ministry of Finance, 2018

2.3: Revenue

2.3.1: Overview of Revenue Projections

Non-oil domestic revenues are expected to regain strength in 2019, reaching \$198.6m (see table 2.3.1.1) – 5% higher than the previous year. This follows after the stagnation in domestic revenue growth of 2017 and 2018, which was largely caused by the protracted political impasse and weak macroeconomic performance. The positive macroeconomic environment will drive this growth. This is as the country regains political stability, stronger private sector activity, and government bodies return to standard annual budgetary and planning processes, which were constrained by the duo-decimal budget regime until late 2018. The positive trend is expected to continue until 2023, at the macro-economic growth expectations.

Despite the expected positive growth in domestic revenue, Timor-Leste is highly dependent on oil revenue which represents over 90% of total revenue. However, petroleum revenues are expected to decline as production from existing fields draws to a close (see table 2.3.1.1). This makes fiscal reform a crucial priority for the country going forward. Overcoming the tax base issue, improving revenue collection capacity, and revisiting tax policies and legislation that promotes investments and increase revenue collection could considerably improve the fiscal and non-fiscal revenues.

Table 2.3.1.1 Total Revenue, 2017 – 2023, (\$m)

| | 2017 Projection | 2017 Actual | 2018 Projection | 2019 Projection | 2020 | 2021 | 2022 | 2023 |
|-----------------------|--------------------|----------------|--------------------|--------------------|----------------|----------------|--------------|--------------|
| Total Revenues | 1,312.6 | 2,223.1 | 861.7 | 1,162.0 | 1,239.8 | 1,059.0 | 809.3 | 240.4 |
| Domestic Revenues | 206.2 | 189.6 | 188.8 | 198.6 | 206.4 | 217.3 | 228.2 | 240.4 |

| | | | | | | | | |
|--------------------|---------|---------|-------|-------|---------|-------|-------|---|
| Petroleum Revenues | 1,106.3 | 2,033.5 | 672.8 | 963.4 | 1,033.4 | 841.8 | 581.1 | - |
|--------------------|---------|---------|-------|-------|---------|-------|-------|---|

Source: National Directorate of Economic Policy and Petroleum Fund Administration Unit, Ministry of Finance, 2018.

2.3.2: Domestic Revenues

Domestic revenues in Timor-Leste are composed of tax revenues, fees and charges, interest, revenues from autonomous agencies and ZEESM Taxes. Table 2.3.2.1 breaks down domestic revenues into these categories showing actual and forecasted amounts between 2017 and 2023.

Table 2.3.2.1: Domestic Revenue 2017 – 2023, (\$m)

| | 2017 Projection | 2017 Actual | 2018 Projection | 2019 Projection | 2020 | 2021 | 2022 | 2023 |
|-------------------------------|--------------------|----------------|--------------------|--------------------|--------------|--------------|--------------|--------------|
| Total Domestic Revenue | 206.2 | 189.6 | 188.8 | 198.6 | 206.4 | 217.3 | 228.2 | 240.4 |
| Taxes | 149.3 | 132.6 | 130.1 | 136.3 | 143.1 | 150.3 | 157.8 | 165.7 |
| <i>of which ZEESM Taxes</i> | 3.6 | 4.7 | 5.3 | 5.2 | 5.4 | 5.7 | 6.0 | 6.3 |
| Fees and Charges | 50.0 | 49.0 | 50.3 | 52.5 | 53.1 | 56.4 | 59.4 | 63.3 |
| Interest | - | - | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| Autonomous Agencies | 6.9 | 7.9 | 8.0 | 9.3 | 9.7 | 10.1 | 10.5 | 10.9 |

Source: National Directorate of Economic Policy, Ministry of Finance, 2018

2.3.2.1: Tax Revenues

Tax revenues comprise the largest source of domestic revenues in Timor-Leste, totalling 68.6% of total domestic revenues in 2019. Tax projections are summarized in Table 2.3.2.1.1 and are divided into Direct taxes, Indirect taxes and Other tax revenues.

Tax collection in 2018 has broadly underperformed compared to 2017 numbers. This trend has been the likely consequence of negligible GDP growth, interruptions of several government projects (especially in the area of construction), private companies either benefitting from tax exemptions or closing down and weak private sector activity.

In 2019, the tax collection trend is expected to be reversed. This largely results from an improvement in the private sector conditions and the macro-economic outlook, with total tax revenue reaching \$136.3m. Additionally, higher revenue from custom activities is also expected as fiscal reform in this area continues. Finally, the re-start of interrupted publicly funded infrastructure projects should significantly contribute to fiscal receipts over the course of the year. The trend is expected to continue until 2023, at the current growth expectations.

Table 2.3.2.1.1: Total Tax Revenue 2017 – 2023, (\$m)

| | 2017 Projection | 2017 Actual | 2018 Projection | 2019 Projection | 2020 | 2021 | 2022 | 2023 |
|---------------------|--------------------|----------------|--------------------|--------------------|--------------|--------------|--------------|--------------|
| Total Tax | 119.8 | 132.6 | 130.1 | 136.3 | 143.1 | 150.3 | 157.8 | 165.7 |
| Direct Taxes | 53.3 | 54.7 | 58.9 | 61.6 | 64.6 | 67.9 | 71.3 | 74.8 |
| Income Tax | 17.5 | 19.3 | 21.3 | 22.4 | 23.5 | 24.7 | 25.9 | 27.2 |

| | | | | | | | | |
|----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Individual Income | 5.4 | 7.3 | 8.7 | 9.1 | 9.6 | 10.0 | 10.5 | 11.1 |
| Individual Income Other | 12.1 | 11.9 | 12.6 | 13.3 | 13.9 | 14.6 | 15.4 | 16.1 |
| Corporate Tax | 8.5 | 10.7 | 9.5 | 10.0 | 10.5 | 11.0 | 11.5 | 12.1 |
| Withholding Tax | 27.3 | 24.7 | 28.1 | 29.2 | 30.7 | 32.2 | 33.8 | 35.5 |
| Indirect Taxes | 66.2 | 76.7 | 70.7 | 74.2 | 77.9 | 81.8 | 85.9 | 90.2 |
| Service Tax | 3.1 | 2.5 | 4.1 | 4.3 | 4.5 | 4.7 | 5.0 | 5.2 |
| Sales Tax | 13.1 | 17.3 | 15.2 | 16.0 | 16.8 | 17.6 | 18.5 | 19.4 |
| Excise Tax | 37.9 | 41.5 | 37.7 | 39.6 | 41.6 | 43.7 | 45.9 | 48.2 |
| Import Duties | 12.1 | 15.3 | 13.6 | 14.3 | 15.0 | 15.8 | 16.6 | 17.4 |
| Other Tax Revenue | 0.2 | 1.3 | 0.5 | 0.6 | 0.6 | 0.6 | 0.7 | 0.7 |

Source: National Directorate of Economic Policy, Ministry of Finance, 2018

2.3.2.2: Fees and Charges

Fees and charges include a wide selection of categories from non-tax sources that contribute to domestic revenue. These comprise administrative fees, utility payments and royalty payments to the Government from natural resources other than petroleum.

In 2019 and onwards, the principal component of fees and charges will continue to be from electricity payments. Additionally, mining and quarrying revenues are expected to become more sizeable, following infrastructural developments in south coast and activities from the TL Cement investment. Social games' receipts are also expected to grow, with the expansion of activities in the area of slot machines. Auctions, which had fallen in 2018 due to bureaucratic reasons linked to the political impasse, will grow back to historical levels in 2019. Growing deconcentration of collection activity sees the growing introduction of non-fiscal instruments in the municipalities, as in the case of Dili and Covalima. Fees and charges from transport activities are expected to be stable.

Projections for outer years are expected to continue on a positive trend, following the improvement and reinforcement of collection mechanisms in line ministries, further decentralized collection and introduction new non-fiscal instruments.

Table 2.3.2.2.1: Fees and Charges Projections 2017 – 2023, (\$000's)

| | 2017 Projectio n | 2017 Actual | 2018 Projectio n | 2019 Projectio n | 2020 | 2021 | 2022 | 2023 |
|--------------------------------------|------------------------|-----------------|------------------------|------------------------|-----------------|-----------------|-----------------|-----------------|
| Total Fees and Charges | 49,950.4 | 49,016.8 | 50,267.2 | 52,468.4 | 53,137.0 | 56,413.0 | 59,400.2 | 63,312.8 |
| Commercial License Fees | - | 663.5 | 113.0 | 117.5 | 122.2 | 127.1 | 132.2 | 137.5 |
| Postage Fees | 44.4 | 55.6 | 47.9 | 49.8 | 51.8 | 53.9 | 56.1 | 58.3 |
| Property Rentals | 3,632.4 | 3,878.8 | 3,330.5 | 3,463.8 | 3,602.3 | 3,746.4 | 3,896.3 | 4,052.1 |
| Water Fees | 177.7 | 333.3 | 162.3 | 333.3 | 346.7 | 360.5 | 375.0 | 39- |
| Vehicle Registration Fees | 1,629.1 | 1,614.3 | 1,383.3 | 1,452.5 | 1,525.1 | 1,601.4 | 1,681.5 | 1,765.5 |
| Vehicle Inspection Fees | 689.7 | 756.4 | 924.5 | 970.7 | 1,019.3 | 1,070.2 | 1,123.7 | 1,179.9 |
| Vehicle Inspection Imported | 11.3 | - | 231.9 | 243.5 | 255.7 | 268.5 | 281.9 | 296.0 |
| Driver Licence Fees | 371.2 | 397.1 | 270.9 | 284.5 | 298.7 | 313.6 | 329.3 | 345.8 |
| Franchising Public Transport Fees | 319.0 | 358.9 | 236.8 | 248.6 | 261.0 | 274.1 | 287.8 | 302.2 |
| Transport Penalties | 136.2 | 153.0 | 336.0 | 352.8 | 370.4 | 389.0 | 408.4 | 428.8 |

| | | | | | | | | |
|---|----------|----------|----------|----------|----------|----------|----------|----------|
| Other Transport Fees | 39.7 | 48.4 | 62.6 | 65.7 | 69.0 | 72.5 | 76.1 | 79.9 |
| ID and Passport | 961.9 | 1,211.6 | 1,715.8 | 1,784.4 | 1,855.8 | 1,930.0 | 2,007.2 | 2,087.5 |
| Visa Fees | 3,782.6 | 3,748.2 | 3,222.8 | 3,061.7 | 2,908.6 | 2,763.2 | 2,625.0 | 2,493.7 |
| Court Fees | 186.5 | 247.5 | 52.0 | 54.1 | 56.2 | 58.5 | 60.8 | 63.2 |
| Fines-Health professionals | - | 5.6 | 17.3 | 18.0 | 18.7 | 19.5 | 20.3 | 21.1 |
| Dividends, Profits, and Gains | 759.1 | - | 3,450.8 | 2,997.3 | 2,997.3 | 2,997.3 | 2,997.3 | 2,997.3 |
| Fines and Forfeits | 135.4 | 252.3 | 543.8 | 150.2 | 169.4 | 206.8 | 201.7 | 199.0 |
| Mining and Quarrying | 364.0 | 1,026.0 | 1,101.4 | 1,500.0 | 1,500.0 | 1,500.0 | 1,500.0 | 1,500.0 |
| Bid Document Receipts | 162.8 | 56.4 | 18.7 | 19.5 | 20.3 | 21.1 | 21.9 | 22.8 |
| Auctions | 886.2 | 1,000.2 | 37.0 | 1,200.0 | 600.0 | 750.0 | 400.0 | 700.0 |
| Forestry Products | 83.3 | 95.1 | 75.7 | 78.8 | 81.9 | 85.2 | 88.6 | 92.1 |
| Rent of Government Property | 231.6 | 116.5 | 41.6 | 43.3 | 45.0 | 46.8 | 48.7 | 50.7 |
| Sanitation Service Fee | 17.8 | 8.2 | 17.7 | 18.1 | 18.9 | 19.6 | 20.4 | 21.2 |
| Pharmaceutical Fee | 0.0 | - | 17.4 | 18.1 | 18.9 | 19.6 | 20.4 | 21.2 |
| Other Non-Tax Revenue | 1,518.5 | 1,173.9 | 85.2 | - | - | - | - | - |
| Other fees | - | - | - | - | - | - | - | - |
| Social Games Receipts | 1,544.1 | 1,428.4 | 1,526.6 | 1,984.6 | 2,183.1 | 2,401.4 | 2,641.5 | 2,905.7 |
| Parking Fee Dili | - | 13.2 | 26.3 | 27.3 | 28.4 | 29.5 | 30.7 | 31.9 |
| Registration of Health Professionals | - | 10.6 | 28.8 | 30.0 | 31.2 | 32.4 | 33.7 | 35.1 |
| Polytechnic Institute of Betano | - | 48.2 | 37.5 | 39.0 | 40.5 | 42.2 | 43.8 | 45.6 |
| Administrative Sanctions and Fines | - | 5.5 | 1.3 | 1.4 | 1.4 | 1.5 | 1.6 | 1.6 |
| Printing Fee - PCM | - | - | 390.6 | 234.4 | 239.1 | 243.8 | 248.7 | 253.7 |
| Electricity Fees and Charges | 30,635.4 | 30,285.2 | 30,471.0 | 31,471.0 | 32,239.3 | 34,800.2 | 37,565.8 | 40,552.5 |
| AM de Dili - Advertising Revenue | - | 24.9 | 148.0 | 153.9 | 160.1 | 166.5 | 173.1 | 180.1 |
| AM de Covalima - Advertising Revenue | - | - | 0.7 | 0.7 | 0.7 | 0.8 | 0.8 | 0.8 |
| Returned TPOs from Prior Years | - | - | 106.8 | - | - | - | - | - |
| Bank Credits with insufficient details | - | - | 32.6 | - | - | - | - | - |
| Revenues from institutions that are now autonomous agencies | 2,529.4 | - | - | - | - | - | - | - |

Source: National Directorate of Economic Policy, Ministry of Finance, 2018.

2.3.2.3: Interest

Interest reflects interest payments received from cash held in Government funds. The increase of overnight repo rates in the Federal Reserve System (FED) of New York recently improved Timor-Leste's interest revenue, which is expected to reach \$0.48m in 2019.

2.3.2.4: Autonomous Agencies

The number of autonomous agencies has been increasing steadily in recent years, reflecting government's desire to grant greater financial independence to institutions so to improve their efficiency. From a revenue perspective the port in Dili generates the majority of

revenues for this group, as detailed in Table 2.3.2.4.1. Other significant contributions are expected to derive from the National Communication Authority (ANC), whose receipts will grow thanks to a larger base for collection and new revenue following the activation of the spectrum fee; the National University, which expects an increase in the volume of students; ZEESM fees and charges and the National Logistic Center.

Table 2.3.2.4.1: Autonomous Agencies 2017 – 2023, (\$000's)

| | 2017 Projection | 2017 Actual | 2018 Projection | 2019 Projection | 2020 | 2021 | 2022 | 2023 |
|--|--------------------|----------------|--------------------|--------------------|----------------|-----------------|-----------------|-----------------|
| Total Autonomous Agencies | 6,924.5 | 7,923.2 | 7,984.5 | 9,306.6 | 9,683.3 | 10,075.8 | 10,484.7 | 10,910.6 |
| Archive and Museum Resistência Timorese | - | 4.3 | 4.3 | 4.5 | 4.7 | 4.8 | 5.0 | 5.2 |
| Press Council | - | - | - | - | - | - | - | - |
| Institute of Support for Enterprise Development | - | - | - | - | - | - | - | - |
| Service for Registration and Verification of Entrepreneurs | 250.6 | - | - | - | - | - | - | - |
| Bamboo Centre | 48.0 | 74.9 | 164.2 | 180.0 | 189.0 | 198.5 | 208.4 | 218.8 |
| Training Centre (SENAI) | - | - | - | - | - | - | - | - |
| Forensic Police | - | - | - | - | - | - | - | - |
| National Hospital Guido Valadares | 175.2 | 249.5 | 230.0 | 239.2 | 248.8 | 258.7 | 269.1 | 279.8 |
| SAMES | 3.7 | 213.8 | 300.0 | 312.0 | 324.5 | 337.5 | 351.0 | 365.0 |
| National Laboratory | - | - | - | - | - | - | - | - |
| Institute of Health Sciences | - | - | - | - | - | - | - | - |
| Specialized Agency for Investment | 4.4 | 19.8 | 23.0 | 23.9 | 24.9 | 25.9 | 26.9 | 28.0 |
| National Center for Rehabilitation | - | - | - | - | - | - | - | - |
| Institute for Equipment Management | 57.5 | 483.5 | 450.0 | 213.3 | 213.3 | 213.3 | 213.3 | 213.3 |
| Administração de Aeroportos e Navegação Aérea de Timor-Leste* | - | - | - | - | - | - | - | - |
| Administration of Ports of Timor-Leste | 4,959.8 | 3,993.8 | 3,287.9 | 3,419.4 | 3,556.2 | 3,698.4 | 3,846.4 | 4,000.2 |
| National Authority of Communication - License Fee | - | - | 1,077.5 | 1,120.6 | 1,165.5 | 1,212.1 | 1,260.6 | 1,311.0 |
| National Authority of Communication - TL Internet Domain Revenue | - | 133.4 | 70.6 | 73.4 | 76.3 | 79.4 | 82.6 | 85.9 |
| National Defense Institute | - | - | - | - | - | - | - | - |
| National University Timor Lorosa'e | 656.6 | - | 881.6 | 916.9 | 953.6 | 991.7 | 1,031.4 | 1,072.6 |
| Infrastructure Fund | - | - | - | - | - | - | - | - |
| Authority for Food Inspection and Economic Activity | - | - | 145.3 | 152.6 | 160.2 | 168.2 | 176.7 | 185.5 |

| | | | | | | | | |
|--|-------|---------|-------|---------|---------|---------|---------|---------|
| National Agency for Evaluation and Academic Accreditation | - | - | - | - | - | - | - | - |
| National Logistic Centre - Sale of Local Product | - | 107.2 | 50.5 | 360.0 | 374.4 | 389.4 | 405.0 | 421.1 |
| National Logistic Centre - Sale of Rice | - | 1,050.4 | 375.1 | 1,320.0 | 1,372.8 | 1,427.7 | 1,484.8 | 1,544.2 |
| National Centre for Employment and Professional Training – Tibar | - | - | - | - | - | - | - | - |
| ZEESM* | 768.5 | 794.2 | 924.5 | 970.7 | 1,019.2 | 1,070.2 | 1,123.7 | 1,179.9 |

Source: National Directorate of Economic Policy, Ministry of Finance *ZEESM revenue includes fees and charges only, tax revenue is presented separately in table 2.3.2.1.

2.3.3: Petroleum Revenues and the Petroleum Fund

The Petroleum Fund is the main source of funding for the state budget each year. Withdrawals from the Fund are guided by the ESI. The ESI represents the maximum amount that can be appropriated from the Petroleum Fund in a fiscal year so as to leave a sufficient Fund balance for an amount of the equal real value to be appropriated in all later years. The ESI is set to be 3 percent of the Petroleum Wealth, which comprises the balance of the Fund and the Net Present Value of future petroleum revenue.

The Government can withdraw an amount from the Petroleum Fund in excess of the ESI where it provides to Parliament justification why that is in the long-term interests of Timor-Leste. Government withdrawals in excess of the ESI have been justified on the grounds of economic development. Withdrawing more than the ESI, by definition, depletes the purchasing power of the Fund.

2.3.3.1: Calculating Petroleum Wealth and the ESI for 2019

Table 2.3.3.1.1 shows the estimated Petroleum Wealth and the ESI from 2017 and onwards, assuming that withdrawals from the Fund are equal to the projected withdrawals in this budget book.

Table 2.3.3.1.1: Petroleum Wealth and the Estimated Sustainable Income (ESI)

| | 2017* | 2018* | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|---|----------|----------|-------------|----------|----------|----------|----------|
| Estimated Sustainable Income (PWx3%) | 481.6 | 550.4 | 529.0 | 502.5 | 463.6 | 431.3 | 397.2 |
| Total Petroleum Wealth (PW) | 16,054.6 | 18,345.8 | 17,633.6 | 16,749.9 | 15,452.4 | 14,377.2 | 13,240.5 |
| Opening PF Balance | | | 16,489.6 | 15,911.6 | 15,031.5 | 14,227.4 | 13,143.6 |
| Net Present Value of Future Revenues | | | 1,144.0 | 838.3 | 420.9 | 149.8 | 96.9 |

*ESI for 2017 & 2018 figures as estimated for in Budget 2017 and Budget 2018. Sources: Petroleum Fund Administration Unit, Ministry of Finance, 2018.

Petroleum Wealth for the 2019 Budget Book calculations is estimated to be \$17,633.6 million. Accordingly, the 3% ESI is estimated at \$529.0 million for 2019. This is about \$12.8 million

lower than the estimate for the 2019 ESI in Budget 2018. The key assumptions behind the calculations and the differences with Budget 2018's estimate are discussed below.

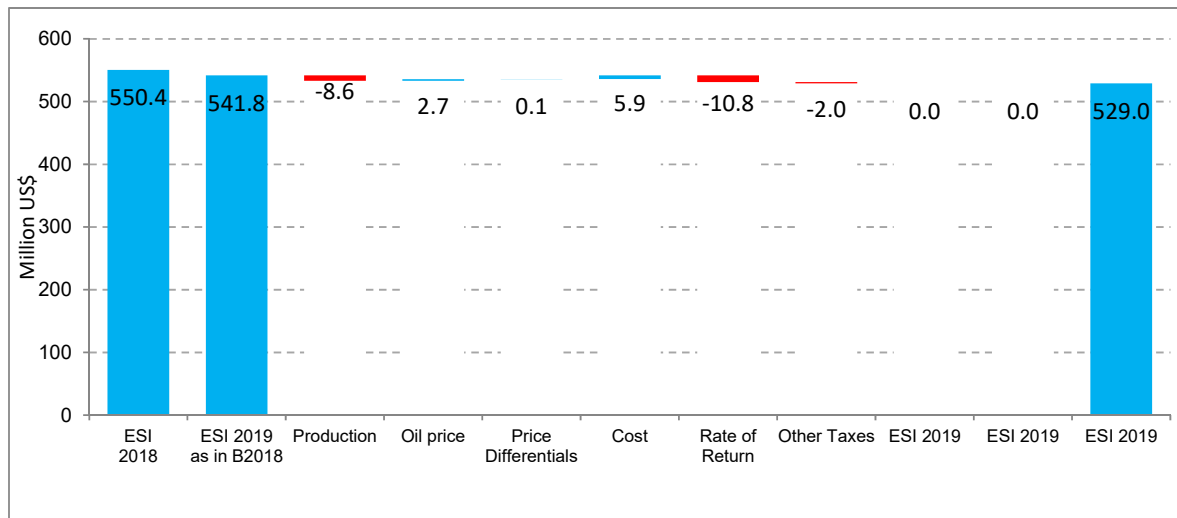
Table 2.3.3.1.2: Key assumptions behind the ESI

| | |
|--|--|
| Asset recognition | Forecast petroleum revenues are included only for projects with approved development plans. Bayu-Undan (BU) is the only operating field since Kitan was closed in 2015. |
| Petroleum Reserves and Production Forecasts | Project operators provide production estimates. The Operator provided 3 forecasts scenarios; low, base, and high. Average Low-Base case production is used for ESI 2019. |
| Oil price forecast | Brent crude oil has been shown to be the best indicator of the price of BU liquid products (condensate and LPG). ESI for Budget 2019 is prepared using the average of Energy Information Agency (EIA) low case and reference case for Brent in its Annual Energy Outlook (AEO) for 2018, released in February 2018. |
| Prices for specific petroleum products | BU produces condensate, Liquefied Petroleum Gas (LPG) and Liquefied Natural Gas (LNG). Forecast assumptions for each product are derived from historical differentials observed with Brent. Liquefied Natural Gas (LNG) prices are forecast using the provisional price formula negotiated between the Darwin LNG (DLNG) facility and Japanese LNG buyers. The price formula is renegotiated every three years. |
| Production costs | Central estimate of future capital and operating costs as provided by project operators. |
| Discount rate | Under Schedule 1 of the Petroleum Fund Law, the interest rate used to discount future petroleum revenue is the expected rate of return on the portfolio of financial assets held in the Fund. The Fund's investment strategy is for 60 percent bonds and 40 percent equities. |

Changes in the ESI from 2018 to 2019

Figure 2.3.3.1.1 shows the key incremental changes in the current estimate of the 2019 ESI relative to the estimate in Budget 2018. A lower expected investment return in 2018 is the main driver of the decrease in the 2019 ESI, along with changes to the production forecast and other taxes.

Figure 2.3.3.1.1: Changes in the 2018 ESI (from Budget 2018 to Budget 2019)



Source: Petroleum Fund Administration Unit, Ministry of Finance, 2018.

Production

The production forecast for Bayu-Undan are lower than Budget 2018 because the estimates of the ESI is using the average low-base production forecasts. In Budget 2018, the Base case production forecast was used as it was the only projection provided by the Operator. In previous years, the low case production forecast for petroleum production was used for ESI. This year the average of the low and the base forecasts was adopted for petroleum production so as to be consistent with the change in methodology for petroleum prices from low to the average in 2011.

Figure A and B show the latest available Operator’s revised petroleum production forecasts in three scenarios; low, base and high. **Figure C and D** compare the liquid (condensate and LPG) and gas (LNG) production forecast used in the current Budget 2019 estimate with the forecast used for the Budget 2017 and Budget 2018. For period 2017-2022, the liquids (condensate and LPG) production forecasts are around 7% lower and the LNG is approximately 8 percent lower compared to forecast used in Budget 2018. This results in a US\$8.6 million decrease in ESI for 2019.

Figure A. Liquids Forecasts for Budget 2019

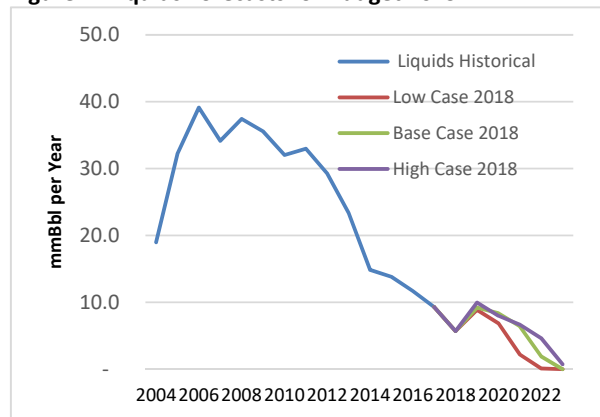


Figure B. Gas Forecasts for Budget 2019

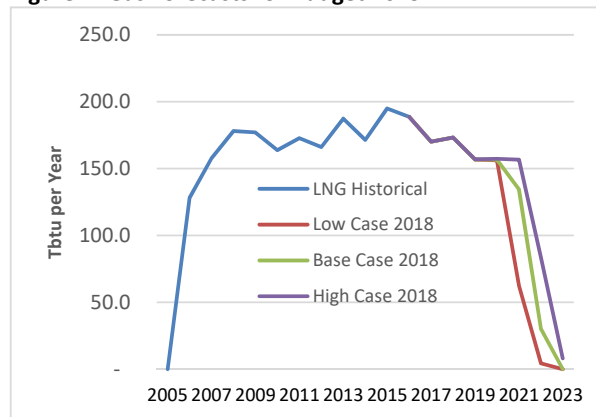


Figure C. Liquids, Budget 2017/18 vs Budget 2019

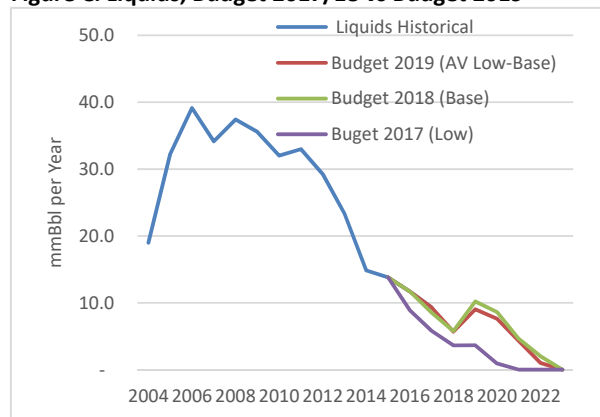
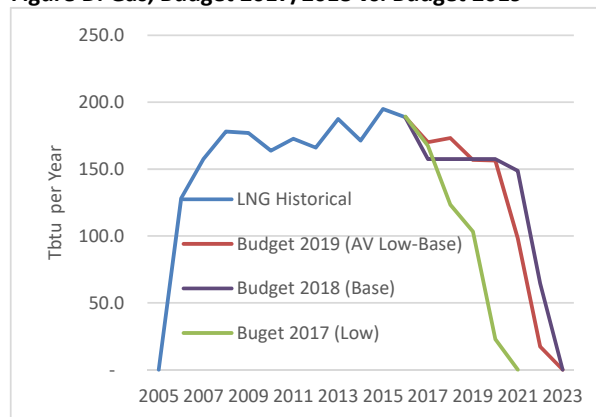


Figure D. Gas, Budget 2017/18 vs. Budget 2019



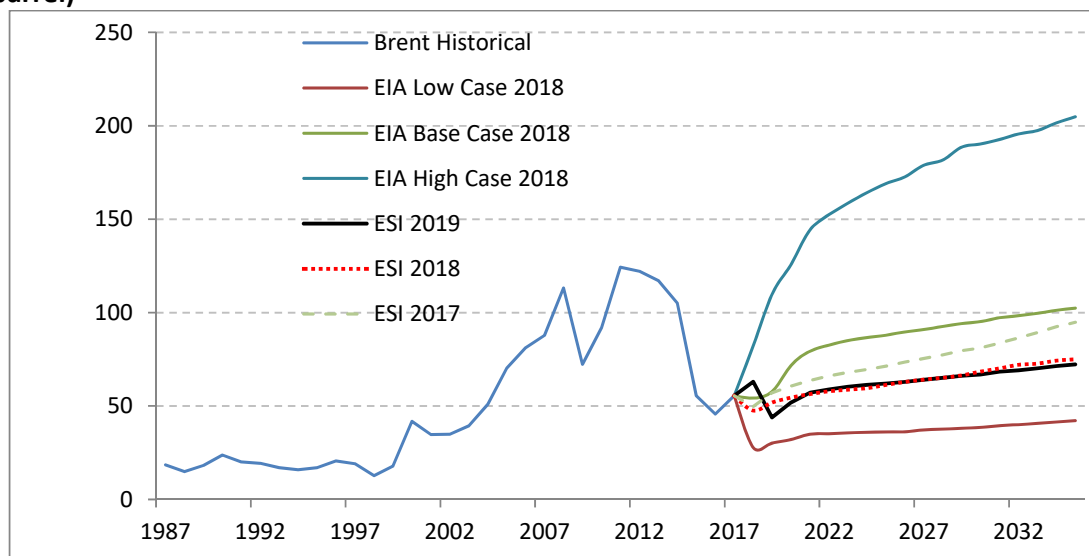
Source: Petroleum Fund Administration Unit, Ministry of Finance, 2018

Oil prices

The methodology for projecting future oil prices has been based on the average low –base price case of the Brent oil prices forecast by the US Government’s Energy Information Administration (EIA). Figure 2.3.3.1.2 shows that the oil benchmark forecast used for ESI 2019 which is similar to the forecast used for ESI 2018, with the exception of 2018 where new information was incorporated. The actual average Brent benchmark price from January to August 2018 was \$71.3 per barrel. Applying the weighted average of actual prices and the average EIA low-base prices for the remainder of the year, the 2018 price is estimated at \$63.0/barrel. This compares to \$47.4/barrel used in Budget 2018.¹ The new average EIA low-base price for 2019 is revised down from \$52.7 to \$44.8 per barrel. The change in Brent benchmark forecast results in a US\$2.7 million increase in the ESI 2019.

¹ The EIA’s Short-term Energy Outlook released in August, shows its reference scenario of the expected average Brent price for 2018 as \$74/b and \$75/b in 2019. Futures for Brent for delivery in December 2018 is between \$74 to 76/b. Therefore, the assumed price of \$63/b is prudent and reasonable.

Figure 2.3.3.1.2: Historical Changes and Future Projections in the Brent Oil Price (\$ per barrel)



Source: Petroleum Fund Administration Unit, Ministry of Finance, 2018

Production price differentials (liquids and LNG)

There are several petroleum products (condensate, Liquefied Petroleum Gas (LPG) and Liquefied Natural Gas (LNG)) which come from the Bayu-Undan project. As in previous years, the prices for liquids products (condensate and LPG) are forecast by applying a differential to the forecasted Brent benchmark price based on the historical relationship between the benchmark and the Bayu Undan products price. The relationship between liquids product prices and the Brent benchmark price has been relatively stable, with condensate averaging about 95 percent and the LPG averaging about 71 percent of the benchmark between 2008 and 2017.

LNG prices are forecast using the provisional price formula negotiated between the Darwin LNG (DLNG) facility and Japanese LNG buyers. The price formula is renegotiated every three years. The current formula went into effect in 2018.

The result of these new price differentials is an increase in ESI of US\$0.1 million.

Production costs

Forecasts of production costs from the operator (COP) for period 2018-2022 are around 7% lower than last year forecasts. The result of these new costs projection is an increase in ESI of US\$5.9 million.

Rates of return and discount rate

Under Annex 1 of the Petroleum Law Fund, the discount rate used in the NPV calculation of future petroleum revenues must be the expected rate of return of the Petroleum Fund portfolio. The expected nominal return on the portfolio is 3.9 percent for 2019 onwards. This

is similar to the previous year’s ESI assumption of expected return. The expected return for 2018 incorporates realized returns until September 2018. The resulting 1.7% nominal return results in a lower estimate of the opening balance in January 2019, causing the ESI 2019 to decrease by US\$10.8 million.

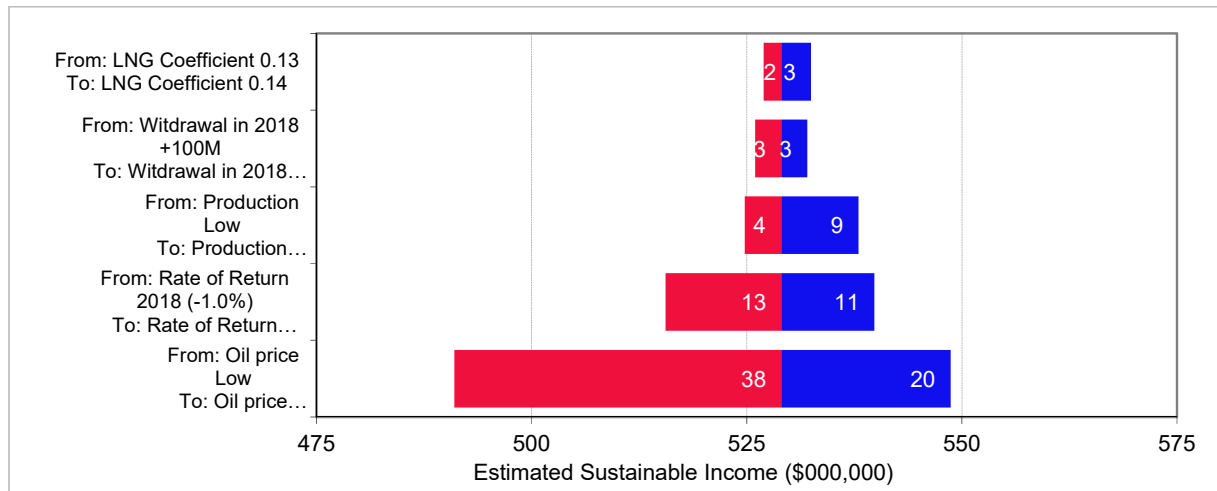
Other Taxes

Other taxes include wage taxes and tax collections from subcontractors and exploration drilling. These taxes are forecast for Budget 2019 based on an analysis of recent collections and taking into account exploration work commitments. The analysis takes into account the Government’s approval to refund from the Petroleum Fund claims by Operators of the Kitan fields for \$64 million overpayment of taxes for period 2011-2013. This has decreased ESI 2019 by \$2 million.

Sensitivity Analysis

The Government’s objective is to prepare an ESI that is prudent overall, as required by the Petroleum Fund Law. While the calculations are based on the best information available, each input is inherently subject to significant uncertainty. Figure 2.3.3.1.3 shows how 2019 ESI would change if some key assumptions were changed individually. Increases in ESI are shown in blue, and decreases are shown in red. The sensitivity analysis starts with the 2019 ESI of US\$529.0 million and shows by how much ESI would change if a different assumption for each key variable was used. Each sensitivity calculation is briefly described below.

Figure 2.3.3.1.3: Sensitivity Analysis – Estimated Sustainable Income (\$m)



Source: Petroleum Fund Administration Unit, Ministry of Finance, 2018.

1. *The calculated ESI 2019 is sensitive to the Rate of Return used in 2018 to estimate the Fund's starting balance.* If the ROI used in 2018 is the long-run estimate of 3.9% the ESI would increase by \$11 million; if the return is -1.0%,² the ESI is \$13 million lower.
2. *The calculated ESI 2019 is somewhat sensitive to the forecast production.* As noted above, the ESI now uses the average Low-Base production forecast. If the Low case forecast or Base case is used instead, the ESI would decrease by \$4 million or increase by \$9 million, respectively.
3. *The calculated ESI 2019 is sensitive to the forecast of oil prices.* Compared to the ESI, which is using the average of the Low and Reference Cases, the ESI would fall by approximately US\$38 million by adopting the Low case or increase by \$20 million by adopting the Reference case.
4. *The calculated ESI 2019 is sensitive to the forecast withdrawals from the Petroleum Fund.* If the amount of withdrawals from the Petroleum Fund in 2018 is changed by \$100 million up or down from the \$982.5 million approved for Budget 2018, the ESI changes by \$3 million up or down. This follows because the ESI is 3% of Petroleum Wealth.
5. *The calculated ESI 2019 is not overly sensitive to changes in the forecast of other key components of ESI.* For example changing the LNG slope coefficient (used in pricing LNG contract sales) between 0.13 and 0.14 has a modest impact, between US\$ 2 and US\$ 3 million respectively.

2.3.3.2: Petroleum Fund Management and Projections

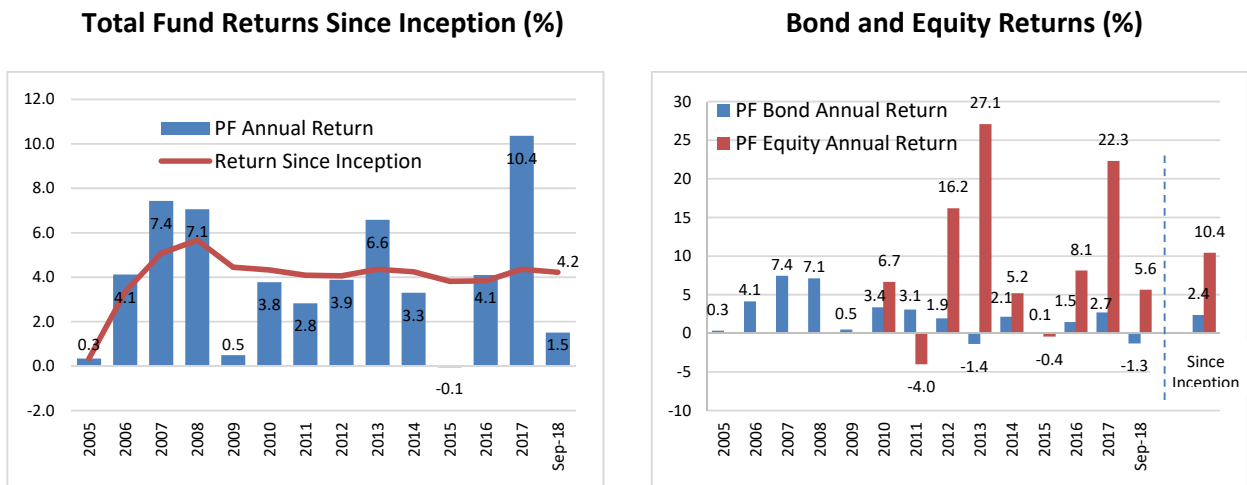
The Petroleum Fund is currently invested 40% in equities and 60% in Government bonds. The investment strategy was designed to target a real return of 3%, which would offset withdrawals equal to the ESI and preserve the Fund's purchasing power.

The investment in equities was progressively implemented and completed in June 2014. The Fund's return since inception to September 2018 is 4.2 per cent per annum, which is 2.2 per cent in real terms after accounting for US inflation. Equities have fulfilled their growth role. Figure 2.3.3.2.1 shows the equity portfolio has boosted the Fund's performance by returning 10.4 per cent per annum since the first investment in stocks in 2010. This compares to the bond portfolio's average annual return of 1.3 per cent over the corresponding period.³

² The total Fund's benchmark performance on 19 October, the time of writing, was -1.3%.

³ Please see the Petroleum Fund Annual Report for 2017 for more detailed discussion on the performance of the Fund.

Figure 2.3.3.2.1: Petroleum Fund Investment Returns



Source: Petroleum Fund Administration Unit, Ministry of Finance, 2018.

The ESI framework is designed to preserve real wealth but is challenged when withdrawals are persistently in excess of the ESI. In addition, investment returns over the next decade are likely to be lower than previously projected. That expectation is primarily driven by lower bond yields, which act as a drag on the return forecasts for bonds. This is captured in our central estimate of a real return of 1.9 per cent over the next 10 years. It is unlikely that the Fund’s current asset allocation will provide a real return of 3 per cent.

The Investment Advisory Board (IAB) advised the Minister of Finance in May 2018 to continue with the Fund’s existing asset allocation. The expected return from bonds is very low by historical standards and equities are required for the Fund to earn a suitable return over the long-term. However, targeting a 3 per cent real return would require a significantly higher equity allocation and the additional risk does not appear suitable for Timor-Leste, at least for the time being. The Board reviews the Fund’s asset allocation each year to account for any new information, including expectations about withdrawals and future oil revenues.

Updated projections for the Petroleum Fund

Table 2.3.3.2.2 shows an update of petroleum revenues. The revenues in 2017 amounted to \$421.7 million. As of September 2018, petroleum revenue is \$331.3 million, which already exceeds the projection of \$317.1 million in the Budget 2018. Oil prices were higher than estimated, averaging about \$71.1 per barrel from January to August. Accounting for this and actual revenues received, the expected total revenue for 2018 is revised up to \$389.4 million, after deducting the tax refund to Kitan’s Operators.

Under the current assumptions, the revenue is projected to pick up slightly in 2020 before it declines to \$98.7 million in 2023.

Table 2.3.3.2: Petroleum Revenues 2017-2022 (\$m)

| | 2017 Actual | 2018 Provisional | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|-------------------------------------|----------------|---------------------|----------------|----------------|--------------|--------------|--------------|
| Total Petroleum Fund Revenue | 2,033.5 | 672.8 | 963.4 | 1,033.4 | 841.8 | 581.1 | 582.9 |
| Petroleum Fund Investment Return | 1,612.1 | 283.4 | 619.7 | 591.8 | 559.6 | 523.5 | 484.1 |
| Total Petroleum Revenue | 421.4 | 389.4 | 343.7 | 441.5 | 282.1 | 57.6 | 98.7 |
| FTP/Royalties | 177.3 | 176.5 | 33.0 | 38.1 | 26.6 | 4.3 | 0.2 |
| Profit oil | 56.7 | 68.2 | 161.1 | 210.8 | 143.7 | 28.9 | 0.0 |
| Income Tax | 65.7 | 83.0 | 45.5 | 62.1 | 20.7 | 0.0 | 0.0 |
| Additional Profit Tax | 91.6 | 92.8 | 76.2 | 102.3 | 64.6 | 0.0 | 0.0 |
| Value Added Tax | 4.5 | 6.4 | 9.3 | 9.6 | 8.9 | 7.6 | 98.5 |
| Other Tax Payments | 25.7 | -37.6 | 18.6 | 18.7 | 17.6 | 16.7 | 0.0 |

Source: Petroleum Fund Administration Unit, Ministry of Finance, 2018.

The Fund's balance is \$17,155.6 million as of September 2018. This is an increase of \$356.3 million from the start of the year. Investment income after expenses for the year to date is \$234.9m. Equities have posted gains of 5.6% as at September, while bonds recorded losses of -1.3%. Taking into account the realized returns, the expected investment income for 2018 is revised down from the central return expectation of 3.9% used in the ESI calculation to 1.7%. This translates to an expected income of \$283.4 million.

There has only been \$210 million of withdrawals for the year until September. The Fund balance is expected to be \$16,489.6 million by the end of 2018 after deducting the estimated withdrawal of \$982.5 million in 2018 adopted by Parliament.

The Fund is forecast to decline each year, falling to \$12,168.4 million by the end of 2023. Petroleum revenues and investment income are not expected to offset withdrawals. These are central forecasts and considerable variation must be expected. Investment income is by its nature volatile. In some years, like 2017, the Fund will outperform expectations; in other years, the Fund will incur losses. The Fund is expected to continue to decline in value beyond the projection period, unless there is a significant change in fiscal policy or until significant new petroleum revenues come online.

Table 2.3.3.3: Estimated Petroleum Fund Savings (\$m)

| | 2017 Actual | 2018 Prov. | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Opening PF Balance | 15,844.3 | 16,799.3 | 16,489.6 | 15,911.6 | 15,031.5 | 14,227.4 | 13,143.6 |
| Petroleum Revenue (excluding PF Interest) | 421.4 | 389.4 | 343.7 | 441.5 | 282.1 | 57.6 | 98.7 |
| Petroleum Fund Interest, Net | 1,612.1 | 283.4 | 619.7 | 591.8 | 559.6 | 523.5 | 484.1 |
| Total Withdrawals | 1,078.8 | 982.5 | 1,541.4 | 1,913.5 | 1,645.8 | 1,665.0 | 1,558.1 |
| Closing PF Balance | 16,799.3 | 16,489.6 | 15,911.6 | 15,031.5 | 14,227.4 | 13,143.6 | 12,168.4 |

Sources: Petroleum Fund Administration Unit, Ministry of Finance, 2018.

2.4: Expenditure and Development Partners' Commitments

The 2019 combined sources of the State Budget totals \$1,989.6 million. This is composed of \$1,827.0 million in Government expenditures (including \$87.0 million in loan-financed projects) and \$162.6 million from development partners.

The total 2019 State Budget is higher than that allocated for 2018. This is predominantly due to an increase in Public Transfers driven by the budgeted amount for buying the 30% share from Conoco Philips of the Greater Sunrise project, and the extraordinary nature of the 2018 State Budget, which was affected by the duodecimal system for most of the year.

2.4.1: Expenditure by Fund

Public expenditures are spread across the Consolidated Fund of Timor-Leste (CFTL), the Human Capital Development Fund (HCDF) and loans. Since 2016, the Infrastructure Fund is an autonomous agency under the CFTL. Compared to the allocations for the 2018 State Budget, all allocations for 2019 have increased: HCDF by 26.6%, loan disbursements by 41.2%, and the CFTL by 43.3%.

Table 2.4.1.1: Expenditure by Fund, (\$m)

| | 2017 Actual | 2018 Budget | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Combined Sources Budget | 1,371.4 | 1,459.1 | 1,989.6 | 2,280.4 | 1,941.9 | 1,918.4 | 1,798.5 |
| Government Expenditures by Fund | 1,194.7 | 1,277.4 | 1,827.0 | 2,160.0 | 1,876.6 | 1,902.9 | 1,798.5 |
| CFTL (excl. loans) | 1,140.7 | 1,200.0 | 1,720.0 | 2,099.2 | 1,841.5 | 1,870.7 | 1,775.1 |
| HCDF | 23.9 | 15.8 | 20.0 | 20.8 | 21.6 | 22.5 | 23.4 |
| Borrowing/Loans (disbursements) | 30.1 | 61.6 | 87.0 | 40.0 | 13.5 | 9.7 | - |
| Development Partner Commitments | 176.7 | 181.7 | 162.6 | 120.4 | 65.3 | 15.5 | - |

Sources: National Directorate of Budget and Development Partners Management Unit, Ministry of Finance, 2018

2.4.2: Consolidated Fund Timor-Leste (CFTL)

The CFTL is the Government's central account and includes all expenditures for line ministries and autonomous agencies with the exception of the HCDF. Within it, recurrent and capital expenditures are spread across five appropriation categories as laid out in table 2.4.2.1.

Total allocations in the CFTL will increase by 43.3% in 2019 compared to the 2018 State Budget. This is driven by a significant increase in the allocation for Public Transfers, which has risen by

117% compared to the allocation for 2018. This budgets for buying the 30% share of the Greater Sunrise project from Conoco Philips.

The Goods and Services allocations for many ministries and agencies have also increased, with the allocation for the category as a whole 35.5% higher than in the 2018 State Budget.

The allocation for Capital and Development has decreased by 5.7% in 2019 compared to the 2018 State Budget. The Government will ensure that key infrastructure projects are able to develop at a good rate, in line with its program and priorities, while monitoring and revising costs.

Table 2.4.2.1: Breakdown of CFTL expenditure, (\$m)

| | 2017 Actual | 2018 Budget | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Total CFTL Expenditure | 1,140.7 | 1,200.0 | 1,720.0 | 2,099.2 | 1,841.5 | 1,870.7 | 1,775.1 |
| Recurrent | 907.5 | 862.7 | 1,377.4 | 1,432.5 | 1,489.8 | 1,549.4 | 1,611.4 |
| Salary and Wages | 197.2 | 200.3 | 214.0 | 222.6 | 231.5 | 240.8 | 250.4 |
| Goods and Services | 304.5 | 338.2 | 458.3 | 476.6 | 495.7 | 515.5 | 536.1 |
| Public Transfers | 405.8 | 324.2 | 705.1 | 733.3 | 762.7 | 793.2 | 824.9 |
| Capital | 233.2 | 337.3 | 342.6 | 666.6 | 351.7 | 321.2 | 163.7 |
| Minor Capital | 13.1 | 5.1 | 29.4 | 30.6 | 31.8 | 33.1 | 34.4 |
| Capital and Development | 220.1 | 332.1 | 313.2 | 636.1 | 319.9 | 288.2 | 129.3 |
| <i>Infrastructure Fund (Autonomous, excl. loans)</i> | 201.6 | 323.6 | 279.4 | 600.9 | 283.3 | 250.2 | 89.8 |

Source: National Directorate of Budget, Ministry of Finance, 2018

2.4.2.1: Salaries and Wages

The allocation for Salaries and Wages has increased by 6.9% in the 2019 State Budget compared to the allocation for 2018. This is due to resulting cost increases from changes to the structure of government and pay structures.

2.4.2.2: Goods and Services

The CFTL Goods and Services budget for 2019 is set to increase by 35.5% compared to the allocation in the 2018 State Budget. Most ministries and agencies experienced reductions in their 2018 Goods and Services budgets due the extraordinary nature of that budget. The budgets presented here for a full year better reflect the requirements of line ministries and autonomous agencies, and are therefore higher compared to the low amounts in 2018.

Key Measures

The main measures for Goods and Services are:

- \$88.7 million to the Ministry of Public Works towards fuel and maintenance of electricity generators in Hera and Betano. Providing electricity throughout the whole country is key to generating growth and development across the country.

- \$33.2 million is allocated to the Whole of Government for the contingency fund. This fund is available in case any ministry falls into financial difficulties because of unexpected circumstances that require an urgent resolution.
- \$18.1 million is allocated to the Municipalities for the School Feeding program, subsidies for schools, and operational costs and services for administrative authorities.
- \$12.2 million to the Ministry of Public Works for the maintenance of roads and bridges, both urban and rural. Maintaining existing infrastructure is vital to ensure the continued development of the country.
- \$12.0 million to the Whole of Government for legal services. These are funds that enable the state to defend itself in various legal cases.
- \$11.7 million to the Ministry of Public Works for a clean water and sanitation programme in rural and urban areas. Infrastructure development for water and sanitation is a key priority for the government for 2019 and over the course of five years.
- \$10.0 million to the Ministry of Public Works for designing a master plan for clean water and roads infrastructure.
- \$9.5 million to the Whole of Government for recapitalising BCTL and payments to TT.
- \$7.8 million to the Ministry of Justice for the cadastral survey. This is a key program for improving land rights in Timor-Leste, which are a key factor for personal security as well as for promoting economic growth.
- \$5.0 million to the Whole of Government for the Counterpart Fund. This will contribute to the continued implementation of key counterpart funding projects.
- \$5.0 million to the Whole of Government for the Agricultural Census. This will greatly increase knowledge of the agricultural sector and improve policy effectiveness aimed at rural households.
- \$4.3 million to SAMES for medication to help improve the quality of health services provided throughout the country.
- \$4.0 million to the Ministry of Finance to support the Public Financial Management (PFM) Reform. PFM reform includes the fiscal reform, program budgeting, expenditure reform (transformation of accounting and improvement of public procurement systems) and performance management reform. These reforms are crucial for strengthening Public Financial Management across government.

- \$2.5 million to the Whole of Government for the payment of quotas to international institutions. This will ensure the continued participation of Timor-Leste in regional and international activities.
- \$1.9 million to APORTIL for fuel for the Berlin Nakroma to ensure the operation of the ferry and continued access to Oecusse and Atauro for the population of Timor-Leste
- \$1.4 million to the National Logistics Centre towards rice imports and the support of local products. This will normalise the price of rice in the local market and ensure basic access to food for the population.

2.4.2.3: Public Transfers

Public Transfers comprise all of the money the Government spends on public grants and consigned payments. The allocation for this category will increase significantly in 2019 to \$705.1 million, an increase of 117.5% compared to the 2018 State Budget. This increase is explained by Timor-Leste becoming a party to the Greater Sunrise joint venture.

Measures

The main measures for Public Transfers include:

- \$350 million to the Ministry of Petroleum and Mineral Resources for Timor-Leste shares in the Greater Sunrise project.
- \$95.5 million to Ministry for National Liberation Combatants Affairs for veteran pensions.
- \$ 76.0 million to the Special Administrative Region of Oecusse Ambeno (RAEOA) and the Oecusse Ambeno and Atauro Special Zones for Social Market Economy (ZEESM).
- \$48.9 million to the Ministry of Social Solidarity and Inclusion towards social programs, including the old age and disability pension schemes, Bolsa de Mãe, and support to victims of natural disasters. These programs look after vulnerable and deserving groups and contribute to reducing poverty.
- \$28.7 million given to the Ministry of Petroleum and Mineral Resources to support the National Petroleum Authority and Minerals (ANPM), TIMOR GAP and the Institute of Petroleum and Geology (IPG). This money is required to ensure Timor-Leste maximizes the benefits from its natural resources.
- \$17.2 million to the Whole of Government for the provision of pensions for permanent civil servants under the contributory regime.

- \$10.3 million to the Ministry of Health for treatments abroad, primary healthcare and the subsidy for Cuban Doctors in Timor-Leste. These investments are important to further improving the quality of health services for the population.
- \$10.0 million to the Whole of Government to support the activities of the Church in Timor-Leste, in line with the plans and policies of the Government.
- \$9.6 million to the Ministry of State Administration to support the urban solid waste management program and the operational costs of the National program for Village Development (PNDS), helping aid rural development.
- \$7.1 million to the Whole of Government to cover loan repayments.
- \$6.0 million National Commission for Elections this expenditure provides subsidy to political parties to continue the follow-up and strengthen the democratic process in Timor-Leste.
- \$5.0 million to former leaders and former members of sovereign bodies for a lifetime pension due to the dedication and service provided to the country.
- \$4.9 million to the Whole of Government for preparatory work for Timor-Leste Cement.
- \$4.5 million to the Office of the Prime Minister to provide support for NGOs and various activities of the Church.
- \$3.9 million to the Ministry of Education, Youth and Sport, to provide support for various sporting events and youth activities throughout the year. Promoting sports and culture is important for the morale as well as to promote Timorese traditions.
- \$2 million to the Whole of Government as contributions for international financial support. This will support the international community and allow Timor-Leste to further influence the global community.
- \$1.6 million to the Secretary of State for Social Communication to provide subsidy for Radio Television Timor-Leste (RTTL, E.P).
- \$1.6 million to the Secretariat of State for Vocational Training Policy and Employment (SEPFOPE) for the rural employment programme. This will contribute towards promoting job creation and economic growth, particularly in rural areas.
- \$1.5 million to the Whole of Government for the g7+ secretariat. The work of this secretariat ensures that the voice of fragile states is heard and acted upon by the international community.
- \$1.3 million to Secretary State for Cooperatives for subsidy to cooperative groups.

- \$1.0 million to Ministry of Public Work for purchase of solar panels to ensure access to electricity in rural areas.
- \$1.0 million to Ministry of Transport and Communication for subsidy for Aviation Authority of Timor-Leste.

2.4.2.4: Minor Capital

Minor Capital includes expenditures on vehicles, furniture and other movable assets. The 2019 budget (\$29.4 million) for this category reflects a 474.6 % increase as compared to the 2018 State Budget (\$5.1 million).

Expenditure under the Minor Capital category is used for the purchase of capital equipment such as furniture and electrical equipment, as well as machines that last for several years and do not need to be repurchased in the near future.

Measures

The main measures for Minor Capital include:

- \$3.4 million to the Ministry of Public Works to buy vehicles, multi-functional four and two wheelers, laboratory equipment, transformers and water sanitation materials.
- \$2.3 million to Ministry of Defence for purchase vehicles for special vehicles, electronic equipment and furnitures..
- \$2.2 million to Ministry of State Administration to purchase vehicles for municipalities and local leaders.
- \$1.8 million to the National University of Timor-Leste to purchase vehicles, electronic equipment and furnitures.
- \$1.5 million to National Parliament to purchase cars for the members of Parliament.
- \$1.3 million to Ministry of Health to buy six ambulances, ten multifunctional vehicles, operational vehicles for monitoring and evaluation, and dialysis machines for six hospitals
- \$1.2 million to Ministry for National Liberation Combatants Affairs purchase funeral vehicles associated to the activities of the jardins Herois Metinaro.
- \$1.1 million to the Electronic Government-ITC to purchase IT equipment.
- \$1.0 million to the Ministry of Justice for purchase of vehicles and electronic equipment.

- \$1.0 million to FALINTIL-Forças de Defesa de Timor-Leste to buy vehicles for the newly appointed general, operational vehicle's and electronic equipments.
- \$0.5 million to SAMES for medical equipment.

2.4.2.5: Capital and Development

The 2019 allocation for Capital and Development has decreased by 5.7% compared to the allocation for 2018. This is driven by a decrease of 39.7% in the allocation for the Tasi Mane project. There is more than a 60% decrease in Urban and Rural Development, Public buildings and Informatics, however the absolute allocation to them is also low. As shown in Table 2.4.2.5.1, Capital and Development allocations under the CFTL are broken down into \$279.4 million for the Infrastructure Fund, \$7.8 million for the District Development Programs, and \$25.9 million for other Capital and Development projects across line ministries.

Table 2.4.2.5.1: Capital and Development Expenditures, (\$m)

| | 2017 Actual | 2018 Budget | 2019 Budget | 2020 | 2021 | 2022 |
|---|----------------|----------------|----------------|--------------|--------------|--------------|
| Total Capital and Development | 220.1 | 332.1 | 313.2 | 636.1 | 319.9 | 288.2 |
| Infrastructure Fund (Autonomous, excl. loans) | 201.6 | 323.6 | 279.4 | 600.9 | 283.3 | 250.2 |
| District Development Programs | 12.6 | 4.1 | 7.8 | 8.1 | 8.5 | 8.8 |
| Ministries / Agencies | 5.9 | 4.4 | 25.9 | 27.0 | 28.1 | 29.2 |

Sources: National Directorate of Budget, Ministry of Finance; National Development Agency and Major Projects Secretariat, Ministry of Planning and Strategic Investment, 2018. For 2016-2017, PDIM figures include MPIE's ministerial capital spend.

2.4.3: Infrastructure Fund

According to the Strategic Development Plan, a central pillar for the long-term development of Timor-Leste is the building and maintenance of core, productive infrastructure in order to create employment and promote sustainable economic growth. The Infrastructure Fund was established in 2011, with the role of financing and overseeing key infrastructure projects (over \$1 million) in accordance with the Government's priorities and vision. Since 2011, a total of \$3.87 billion has been approved and allocated to the IF to finance 22 programs, and includes Public Private Partnerships (PPPs) and external loans. Since 2016, the Infrastructure Fund has operated as an autonomous agency.

The VIII Constitutional Government has set the infrastructure development priorities in the area of basic physical infrastructure on both social and economic grounds. This includes programs such as roads, bridges, water and sanitation, and the provision of a sustainable energy supply. Many projects relating to these areas have already been started in previous years. As well as further progress in these areas, other important infrastructure that will be required to support the modernization and growth of the Timor-Leste economy includes digital infrastructure, transport and logistics infrastructure for trade, as well as the creation of a broader framework for supporting industrial development.

The total budget for the Infrastructure Fund (excluding loans) in 2019 is \$279.4 million across 21 programs. This is a 13% decrease compared to the 2018 budget. This is because the projects in the 2019 State Budget are not new, but instead reflect the ongoing financial demands for programs that have already been planned and approved in previous years.

In line with the 2018 needs of programs and the Government's priorities, the largest portions of the 2019 Infrastructure Fund budget are still allocated to the roads program (46%) the Tasi Mane Development Program (22%), and the electricity program (5%).

Table 2.4.3.1: Infrastructure Fund Projections, (\$m)

| Infrastructure Data, \$ millions | 2017 Provisional | 2018 Budget | 2019 | 2020 | 2021 | 2022 | 2023 |
|--|---------------------|----------------|--------------|--------------|--------------|--------------|-------------|
| Total Infrastructure | 230.9 | 385.2 | 366.4 | 640.9 | 296.8 | 259.8 | 89.8 |
| Total Infrastructure (excluding loans) | 200.8 | 323.6 | 279.4 | 600.9 | 283.3 | 250.2 | 89.8 |
| Agriculture | 2.8 | 3.8 | 2.5 | 3.1 | 6.6 | 3.9 | 1.1 |
| Water and Sanitation | 0.2 | 0.6 | 3.7 | 0.3 | 0.0 | 0.0 | 0.0 |
| Urban and Rural Development | 5.0 | 5.4 | 9.5 | 3.3 | 1.0 | 1.0 | 0.8 |
| Public Buildings | 1.1 | 10.2 | 2.9 | 9.0 | 5.6 | 6.0 | 3.7 |
| Education | 0.2 | 1.7 | 0.4 | 25.0 | 17.1 | 9.1 | 6.5 |
| Electricity | 12.2 | 16.1 | 15.3 | 0.6 | 0.0 | 0.0 | 0.0 |
| Informatics | 1.6 | 8.0 | 2.9 | 0.0 | 0.0 | 0.0 | 0.0 |
| Millennium Development Goals | 0.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Health | 0.0 | 1.9 | 1.1 | 5.0 | 2.5 | 2.5 | 2.5 |
| Security and Defence | 0.4 | 4.4 | 3.3 | 3.9 | 0.7 | 0.5 | 0.0 |
| Social Solidarity | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Tasi Mane | 67.8 | 100.5 | 60.6 | 196.2 | 185.3 | 221.2 | 73.3 |
| Airports | 17.1 | 10.3 | 11.6 | 1.7 | 0.6 | 0.4 | 0.0 |
| Preparation of Designs and Supervision | 0.7 | 0.8 | 3.9 | 0.0 | 0.0 | 0.0 | 0.0 |
| Roads | 69.3 | 128.8 | 129.5 | 341.6 | 57.9 | 5.5 | 1.8 |
| Bridges | 7.8 | 10.6 | 10.0 | 10.1 | 5.8 | 0.0 | 0.0 |
| Ports | 0.5 | 0.8 | 2.2 | 0.2 | 0.0 | 0.0 | 0.0 |
| Tourism | 0.3 | 0.2 | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| Financial System and Supporting Infrastructure | 6.8 | 4.9 | 3.9 | 0.0 | 0.0 | 0.0 | 0.0 |
| Youth and Sport | 1.9 | 1.9 | 2.8 | 0.5 | 0.0 | 0.0 | 0.0 |
| Maintenance and Rehabilitation | 4.6 | 12.5 | 13.0 | 0.6 | 0.0 | 0.0 | 0.0 |
| Loans Program | 30.1 | 61.6 | 87.0 | 39.9 | 13.4 | 9.7 | 0.0 |

Source: Major Projects Secretariat, Ministry of Planning and Strategic Investment, 2018

2.4.4: Expenditure by Loan Financed Projects

Expenditure on loan-financed projects in 2019 is expected to reach \$87.0 million, as presented in Table 2.4.4.1. This a 41.1% increase compared to the allocation in the 2018 State Budget. A detailed description of these projects is presented in Section 2.5.3.

Table 2.4.4.1: Expenditure on Loan Financed Projects, (\$m)

| | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|-------------------------|----------------|------|------|------|------|
| Loan Expenditure | 87.0 | 40.0 | 13.5 | 9.7 | 0.0 |

Source: PPPLU Ministry of Finance and Ministry of Planning and Strategic Investment, 2018.

2.4.5: Human Capital Development Fund

The purpose of the HCDF is to finance expenditures on scholarships and capacity development in line with the Strategic Development Plan of Timor-Leste. For the 2019 budget, the HCDF is broken down into four major programs: Vocational Training, Technical Trainings, Scholarships and Other Types of Training.

Table 2.4.5.1 summarizes the budget appropriations for HCDF by program. The total 2019 budget is \$20.0 million, 26.6% higher than the allocation for the 2018 State Budget.

Table 2.4.5.1: Human Capital Development Fund by Program, (\$m)

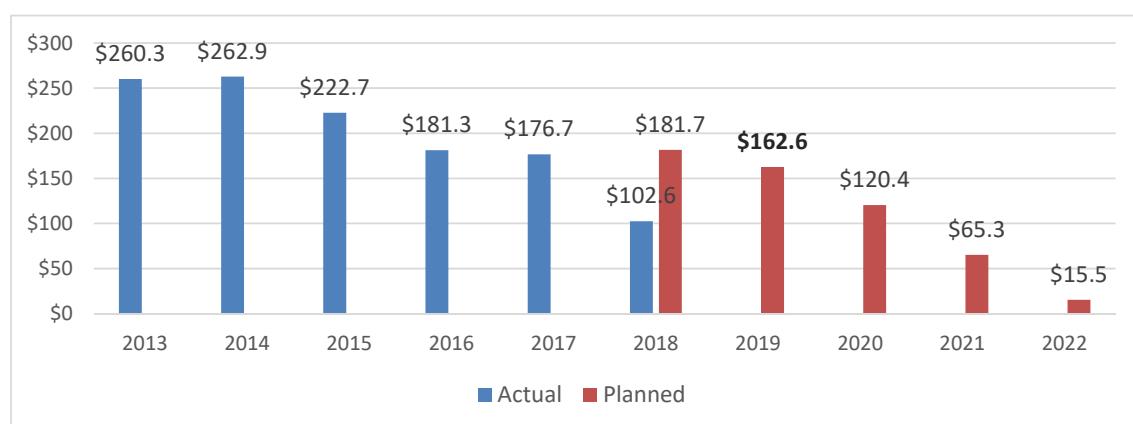
| | 2017 | 2018 | 2019 Budget | 2020 | 2021 | 2022 | 2023 |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Total HCDF (by Program) | 23.9 | 15.8 | 20.0 | 20.8 | 21.6 | 22.5 | 23.4 |
| Vocational Training | 6.3 | 1.5 | 2.7 | 2.8 | 3.0 | 3.1 | 3.2 |
| Technical Training | 1.8 | 0.4 | 6.4 | 6.6 | 6.9 | 7.2 | 7.5 |
| Scholarships | 13.0 | 12.5 | 8.7 | 9.1 | 9.4 | 9.8 | 10.2 |
| Other Training | 2.8 | 1.3 | 2.2 | 2.3 | 2.3 | 2.4 | 2.5 |

Source: Secretariat for Human Capital Development Fund, 2018.

2.4.6: Development Partners' Commitments

The amount of Overseas Development Assistance (ODA) to Timor-Leste exceeded US\$200 million from 2011 to 2015, but has experienced a significant downward trend in non-lending beginning in 2015 that has led to the lowest levels of non-lending assistance in Timor-Leste, totalling US\$176.6 million in 2017. ODA as a percentage of the Combined Source Budget has become smaller, decreasing from 23.5% in 2010 to 10% in 2019 on a planned basis. In 2019, a planned total of US\$162.6 million will be provided to Timor-Leste. Figure 2.4.6.1. highlights trends in non-lending support from development partners.

Figure 2.4.6.1 Development Partner Non-lending Disbursements 2013-2022, (\$m)



Source: 2013-2017 and 2018 planned disbursement data was collected from previous budget books; 2018 actual and 2019-2022 was drawn from the Aid Transparency Portal as of 21 September, 2018.

Forecasted funding more than one year in advance is typically unreliable for several reasons, most notably due to the fact that many donors operate on single year budgets. The dramatic decline in funding shown in the future years above is based on data collected at the project level, thus it does not include donor’s funding that has been secured yet not committed towards specific projects. For example, the Millennium Challenge Corporation’s future contributions are not included in these figures even though they are likely to contribute significantly towards the donor funding landscape.

2.5: Financing

2.5.1: Definition of Financing

The total budgeted expenditure for 2019 is higher than the domestic revenue that will be collected over the same period. This results in a non-oil deficit (domestic revenue minus expenditure) which is financed by withdrawals from the Petroleum Fund (PF), loans and use of the cash balance. Withdrawals from the PF can be either within a sustainable amount, using the revenue of the fund, or excess withdrawals above this sustainable level (see next section). Table 2.5.1.1 below shows the amount drawn from each of the financing items.

Table 2.5.1.1: Financing 2019 to 2023, (\$m)

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|----------------------------------|----------------|----------------|----------------|----------------|----------------|
| Total Financing | 1,099.4 | 1,451.0 | 1,195.8 | 1,243.3 | 1,160.9 |
| Excess Withdrawals from PF | 1,012.4 | 1,411.0 | 1,182.3 | 1,233.6 | 1,160.9 |
| Use of Cash Balance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Borrowing /Loans (disbursements) | 87.0 | 40.0 | 13.5 | 9.7 | 0.0 |

Sources: National Directorate of Budget, General Directorate of Treasury, Petroleum Fund Administration Unit, 2018.

2.5.2: ESI and Excess Withdrawals

There are important economic reasons for distinguishing between revenue and financing items. Domestic revenue results from taxes borne by companies and individuals in Timor-Leste from production and income made. The ESI is the sustainable level of use of petroleum revenue, to ensure the continued use of the petroleum fund for ever. Spending only up to total revenue (domestics and ESI) is a position that maintains fiscal sustainability, and is a benchmark level of spending for understanding the long run trend of government finances. The ESI can therefore be considered revenue, whereas excess withdrawals reduce the wealth of the fund and can therefore be considered like borrowing. In line with IMF advice, the government has changed the definition of revenue to include the ESI as it makes clearer what is fiscally sustainable.

The ESI is equal to 3% of the net petroleum wealth and is \$529.0 million in 2019. Further details on the ESI and petroleum wealth can be found in Section 2.3.3 of the Budget Book.

The Government plans to withdraw \$1,012.4 million in excess of the ESI. Excess withdrawals are in line with the Government's frontloading policy. These excess withdrawals are being used to finance core infrastructure and human capital, which is necessary for long-term growth.

2.5.3: Loans

Existing External Loans

Infrastructure development plays a key role at contributing to turning Timor-Leste into an upper middle-income country by 2030 in accordance with the Strategic Development Plan 2011-2030. While it is essential, the costs of addressing it are often large and ongoing; therefore, relying solely on the state financing may not be enough when at the same time facing multiple development challenges. One way of making infrastructure financing possible without compromising other development needs is by exploring other favorable public financing options including foreign loans, grants and public-private partnership arrangements.

The policy of using foreign loans for infrastructure development began in 2011 following the approval of Public Debt Act No. 13/2011 by the National Parliament and is expected to continue over a medium term to long term. At present, loans are mainly taken from development partners who lend to the Government on concessional terms and with a number of advantages. Those advantages include enhanced access to technical assistance and know-how as part of the loan packages; greater budgetary flexibility, in particular reduced pressure upon any one year's budget envelope; and a reduction in the total cost of the projects, whenever the financial cost of the loans is lower than the opportunity cost of withdrawing resources from the Petroleum Fund. Concessional loans, as opposed to commercial loans, carry a lower interest rate, a longer maturity (interval to repayment) and a grace period (interval to the first repayment of capital). As it allows loan costs to be spread over a period of many years, this arrangement effectively puts less pressure on the state budget than immediately withdrawing the money from the petroleum fund, contributing to fiscal sustainability.

Currently, the financing terms of concessional loans offered by development partners have on average maturity period of 25-32 years with interest rate in the range of 0.7%-3% and grace period 5-10 years.

In light of the above, a policy note has been established to provide a well-structured approach to the mobilization of external lending by introducing a set of guidelines, criteria and procedures. The specific aims of this set of guidelines are to establish a more formal and explicit process for when and how the recourse to external lending is to be pursued including

to provide for a more structured and formal dialogue between the GoTL and potential lenders. The following are some important qualities of the general guidelines:

- i) Only project-based loans shall be pursued;
- ii) Loans should be exclusively used to fund capital expenditures in the context of physical infrastructure projects with a high rate of return (which shall have been explicitly estimated by means of cost-benefit analysis prior to the mobilization of loans being considered);
- iii) US dollar-denominated loans shall generally be preferred; non-US dollar loans with favourable terms should be considered a second best;
- iv) For analogous reasons, fixed-interest loans should also generally be preferred;
- v) For efficiency reasons, the total loan-funded component of any project to be funded by loans should not be lower than US\$ 40m and for a specific project;
- vi) Loans requiring collateral or guarantees beyond the gotl's sovereign commitment to repay shall not be accepted;
- vii) The maximum annual ceiling on new loans shall be prudently established by the ministry of finance in light of the existing liabilities and macroeconomic perspectives;
- viii) Decisions regarding loan maturities and repayment profiles shall take into account the impact of future debt servicing on the State Budget's sustainability and liquidity;
- ix) All loan contracts shall be the object of detailed legal analysis prior to execution.

Complying with these rules, to date, the government has signed eight loan packages with lenders such as the World Bank, Asian Development Bank, and JICA worth approximately \$355m of which 36% has already been spent on road infrastructure projects. This figure is accounting for only about 7-8% of the Country's nominal non-oil GDP which is still well-below 30% an international standard for low income countries⁴.

Table 2.5.3.1: Loan Portfolio

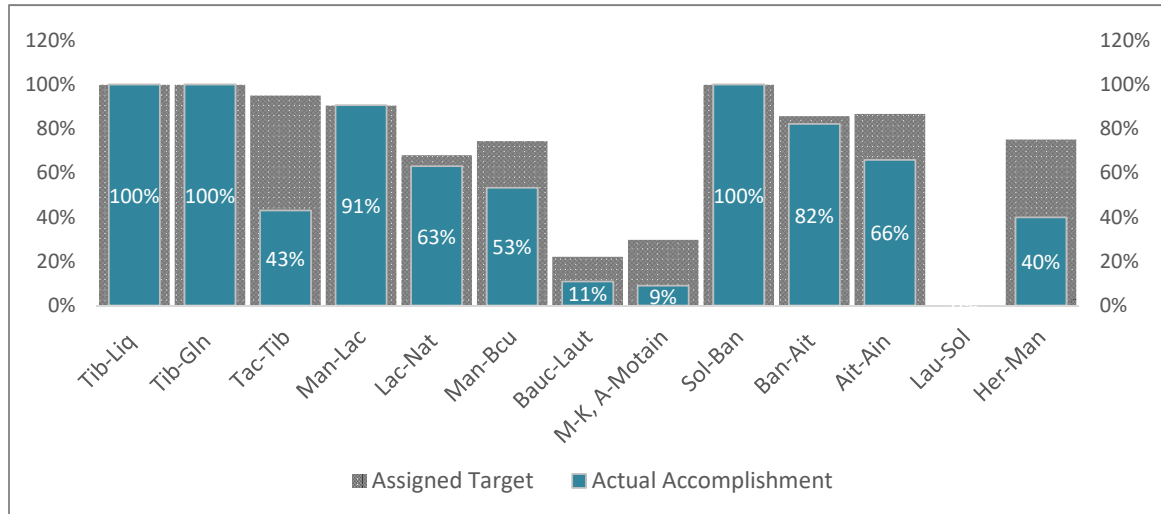
| Lending Institution | Loan Amount (\$m) | Government Contribution (\$m) | Total Financing | Disbursement as of 25 August 2018 (\$m) | | Total Disbursement |
|------------------------|-------------------|-------------------------------|-----------------|---|---------------------|--------------------|
| | | | | Loan | Infrastructure Fund | |
| Asian Development Bank | 226.80 | 57.90 | 284.70 | 87.52 | 29.48 | 117.00 |
| World Bank | 75.20 | 53.90 | 129.10 | 29.2 | 42.15 | 71.35 |
| JICA | 52.80 | 9.80 | 62.60 | 11.92 | 3.01 | 14.93 |
| Total | 354.80 | 121.60 | 476.40 | 128.64 | 74.64 | 203.28 |

Source: Ministry of Finance & MPW, 2018.

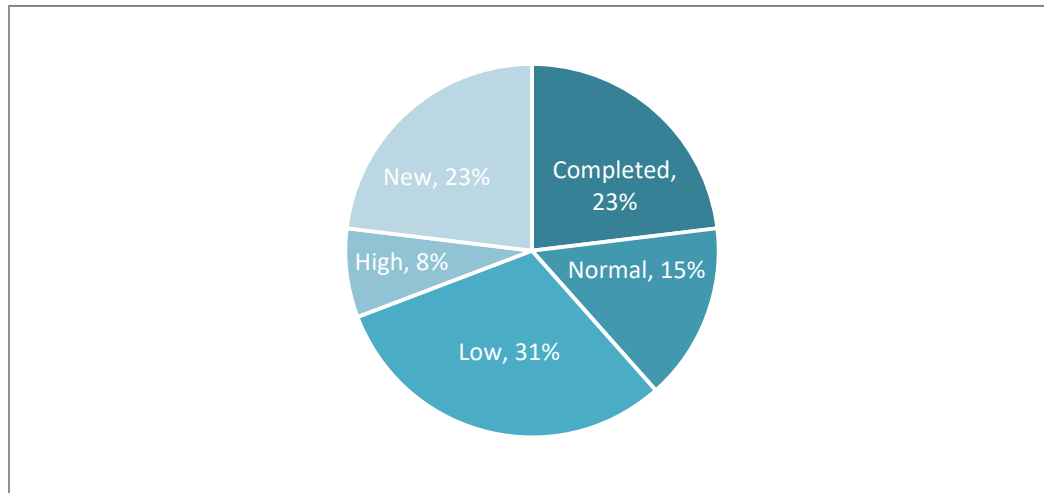
⁴ TL was classified as a low income country by IMF based on the List of LIC DSAs for PRGT-Eligible Countries As of August 01, 2018. The debt to GDP ratio is likely to be lower by using nominal GDP oil sector.

Furthermore, loan funds are disbursed as a function of project progress. Regular monitoring, discussions and meetings were held with project implementation agencies for assessing and confirming project progress and performance. Regular visits were also conducted to the project sites. Below is a summary update on these activities:

Figure 2.5.3.1: Individual Project Progress



Source: MPW, as of 25 August 2018.



Source: MPW, 2018.

Three road projects have been completed representing approximately 23% of the thirteen projects currently being funded by concessional loans. These include roads connecting Tibar to Gleno, Tibar to Liquica, and Solerema to Bandudatu along Dili-Ainaro corridor.

This completion rate is likely to increase by next year taken into consideration for those projects which are currently grouped under “normal” and “high” execution categories. While normal category refers to projects with minor delays, high is progressing ahead of schedule. Continuous improvements are necessary for projects which are suffering significant delays due to various issues (e.g. environment license, resettlement and payment delays), to catch-

up and finish the construction on time as originally scheduled, such as the dual carriageway from Tacitolu to Tibar and the highway from Hera to Manatuto. Other projects which are at relatively early phases of implementation include the road from Baucau to Lautem, and the missing links between Maubara-Karimbala , Atabae-Motain and Laulara -Solerema.

Debt servicing costs change as project progresses through its life cycle particularly due to the level of disbursements. These include principal repayment, interest and other administrative charges. The following table shows historical and projected debt service for the next five years 2019-2023.

Table 2.5.3.2: Debt Service, \$m

| Annum | 2012 (Hist.) | 2013 (Hist.) | 2014 (Hist.) | 2015 (Hist.) | 2016 (Hist.) | 2017 (Hist.) | 2018 (Hist.) | 2019 (Proj.) | 2020 (Proj.) | 2021 (Proj.) | 2022 (Proj.) | 2023 (Proj.) |
|--------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Debt Service (\$m) | 0.02 | 0.10 | 0.32 | 0.34 | 0.86 | 1.76 | 2.22 | 7.17 | 8.27 | 10.31 | 17.03 | 22.39 |

Source: MPW, 2018

Table 2.5.3.2: Outstanding Principal, \$m

| Loan Amount (\$m) | 2019 | 2020 | 2021 | 2022 | 2023 |
|-------------------|------|------|------|------|------|
| 355 | 213 | 285 | 334 | 325 | 309 |

Source: MPW, 2018

Loan Ceiling 2019

Concessional borrowing is projected to increase in the medium term driven by the need for infrastructural development. In this respect, every year the Government is required to submit for Parliamentary approval, in the context of the State Budget Law, a proposed maximum ceiling for new concessional loans. The amount is set according to project cost estimates and debt sustainably analysis. On DSA, the process is assessed both internally by the Ministry of Finance and externally by the International Monetary Fund. While the two assessments may have been prepared separately the conceptual framework underlines the analysis are similar by referring to DSA framework for low income countries. The IMF Debt Sustainability Analysis in 2017 indicates that Timor-Leste’s external debt remained at moderate risk with a low level of debt stock at approximately 2.8% of the country’s GDP. IMF has consistently supported greater use of concessional loan for large infrastructure projects and in support of more fiscal space.

Considering the above, it is proposed a \$60m as a borrowing ceiling for 2019 to implement Aituto-Letefoho-Gleno road project. The development of the Aituto-Hatubuiliko-Letefoho-Gleno road will boost tourism and agricultural potentials as it links to areas with popular site for religious, cultural events, trekking, coffee plants and other agricultural commodities. A feasibility study has been completed. It is expected that this loan could be negotiated and signed in 2019.

2.5.4: Use of the Cash Balance

The use of the cash balance for the Consolidated Fund of Timor-Leste (CFTL) at the end of 2018 is forecast to be insignificantly small, and hence no cash balance will be included to finance expenditures in the 2019 State Budget. Similarly, there is also no forecasted rollover of cash balances for the IF and HCDF from 2018.

Table 2.5.4.1 Use of Cash Balance in 2019

| | |
|---|------------|
| Total | 0.0 |
| HCDF Rollover | 0.0 |
| Drawdown of Cash Balances from the Treasury Account | 0.0 |

Source: General Directorate of Treasury, Secretariat for the Human Capital Development Fund, 2018.

2.5.5: Public Private Partnerships

Public-Private Partnerships (PPP) are long-term relationships between the government and a private sector company whereby the private sector company provides a public interest good or services and share the respective financial, technical and operational risks.

The underlying rationale for PPPs in Timor-Leste stems from the fact that this arrangement may potentially allow the Government to benefit from the private sector expertise and financing, which then results in higher quality and efficiency, as well as lower risk borne by the Government. The government will also benefited from shifting the risks onto the private partner – for example, the risk of delays or cost run-ups in construction. Another advantage is the fact that the bundling together of the various stages of providing an infrastructure service creates the right incentives for the contractor to perform to a high standard. Should the same contractor is responsible for building, operating and maintaining a piece of infrastructure for a number of years, it will have an inherent incentive to build it in a way that optimises the operation. Another advantage of proceeding with PPP arrangement is the fact that PPP contracts are typically output-based and extracting value-for-money through risk transfer to the private sector over the life of the project, rather than input-based as is generally the case with traditional procurement. This means that the Government is certain of paying for actually-functioning services that meet actual social needs.

Timor-Leste began exploring PPPs as a modality for project implementation over the last 7 years and started out by establishing a PPP Policy, PPP legislation and a dedicated PPP and Loans Unit under the Ministry of Finance. The PPP policy establishes key principles of PPP, while the legislations (Decree-Laws no. 42/2012 as amended by Decree-Law no. 02/2014 and Decree-Law no. 08/2014) confirms the policy as formal process, sets a framework for enabling the public and private sectors to be parties in a PPP arrangement; define the powers of relevant agencies and regulates the procedures associated with the PPP projects cycle. All of

these seek to ensure that only high-quality projects, which have high social and economic returns and which are aligned with the government's strategic priorities, are considered for implementation through a PPP modality. For instance, the legislations on PPPs includes a requirement that all PPP projects undergo both a pre-feasibility study and a full-fledged feasibility and environmental study prior to proceeding to the procurement phase.

The Government is aware that PPPs can involve a number of risks, and indeed have been associated with technical and fiscal risks. In order to mitigate against these risks, the Government has taken a cautious approach in this domain, which among other things are establishment of the PPP Policy and PPP legal frameworks and procedures before initiating any PPP project. As such, all PPP projects goes through five key stages from identification, selection of the projects, feasibility and environmental as well as risks assessment and mitigations, procurement and negotiation, contract award, implementation and transfer the assets back to relevant and ready-capable public agency. The stages allow for each PPP project to be individually tailored to its particular characteristics and environment, essential for successful implementation. For instance, the PPP projects initiated over the last 7 years were enlisted several projects as potential for implementation through PPP modality. Further to formal and systematic assessment, including risks assessment and contingent liabilities, only 5 out of 20 projects were declared as fulfilling the criteria to be implemented through PPP modality.

Currently there are three projects in the PPP scheme – in the transport and healthcare sectors. Tibar Bay Port, the country's future main international container and cargo hub to be built about 12 km to the West of the capital, has entered the implementation stage following the signing of the concession agreement between the government as Grantor and the Timor Port SA as Concessionaire in June 2016. Over a period of 30 years, the Concessionaire will design, co-finance, build, operate and transfer back a world-class greenfield port subject to technical specifications and performance standards set by the Government. The new port will overcome the limitations of the existing Dili Port, which has very limited expansion possibilities, and give back the waterfront to the city and its inhabitants. It is expected to bring very high economic returns to the country, in addition to a positive financial return to the government by way of the royalties, navigation and dockage fees, and tax returns that the government will receive during the duration of the concession.

Currently, the project reached Financial Closing period where preliminary design has been completed and approved by the Government. A direct agreement between the Grantor, Concessionaire and Key Subcontractor for the construction has also been signed. Environmental license has also been secured for the development. The project is now under mobilisation phase and construction of the port begins on the fourth quarter of 2018 with completion scheduled within three years.

The government was contractually required to deposit the full amount of its Viability Gap Funding (VGF) which is the government’s financial participation in the amount of \$129.45m in an Escrow Account. An Escrow Agreement was reached between GoTL, Timor Port SA and United Overseas Bank (UoB) of Singapore in November 2016 with the full amount deposited at the end of 2016. The Escrow Agreement sets out terms and conditions for the management of the VGF for the benefit of the Concessionaire and Grantor. The VGF will be disbursed based on achievement of construction milestones certified by the independent engineer as shown in Table 1 below.

| Milestone Numbers | Detail of Milestones Completed | Percentage of VGF | VGF Disbursement Amount (USD) | Expected Date based on Project Schedule |
|--------------------------|---|--------------------------|--------------------------------------|--|
| 1 | Engineering design and mobilisation | 5% | 64,725.00 | Oct-18 |
| 2 | 25% completion of dredging and reclamation | 10% | 129,450.00 | Jun-19 |
| 3 | 25% completion of quay wall | 5% | 64,725.00 | Sep-19 |
| 4 | 50% completion of dredging and reclamation | 10% | 129,450.00 | Nov-19 |
| 5 | 50% completion of quay wall | 10% | 129,450.00 | Jan-20 |
| 6 | 75% completion of dredging and reclamation | 10% | 129,450.00 | May-20 |
| 8 | 75% completion of quay wall | 5% | 64,725.00 | Aug-20 |
| 11 | 50% completion of equipment in place | 5% | 64,725.00 | Aug-20 |
| 9 | 50% completion of paving and utilities | 5% | 64,725.00 | Sep-20 |
| 7 | 100% completion of dredging and reclamation | 10% | 129,450.00 | Oct-20 |
| 10 | 100% completion of quay wall | 10% | 129,450.00 | Nov-20 |
| 12 | 50% completion of building and facilities | 5% | 64,725.00 | Nov-20 |
| 13 | Service Commencement | 10% | 129,450.00 | Oct-21 |

Note: Estimated as of September 2018, PPPLU.

The first disbursement of the VGF from Escrow Account is expected to occur upon mobilisation is completed. Therefore, there is no disbursement incurred yet to the Escrow Account. Meanwhile, the total interest earned, as of end September 2018, from Escrow Interest Account amounts US\$ 2.4 million. As per the agreement, the interest amount earned can be transferred to Government only after closing of the account(s) and/or termination of the Escrow Agreement. There is another project in the PPP project cycle is Dili Water Supply. This project is currently in the feasibility stage, after a pre-feasibility study was conducted and approved by the Council of Ministers. The purpose of the ongoing study is to provide information and analysis that will enable the government to decide whether and how to involve the private sector in the water supply services in the capital city of Dili. This feasibility study is currently entering its second phase, in which a small number of PPP modalities selected in the first phase (lease, reduced-risk lease and management contract) will be examined in detail from the technical, financial, economic and legal perspective. Further to this and if a PPP modality is selected for the reform, the government will launch an

international tender to select the private partner. Due to technical and social constraints, this project may be difficult to turn it into a PPP project.

Finally, the government is also looking for possible partnerships with the private sector in the health sector, specifically for the provision of medical diagnostic services. Timor-Leste's Constitution establishes that medical care is a fundamental right for all citizens and imposes a duty on the government to promote and establish a national health system that is universal, general, free of charge and, as far as possible, decentralized and participatory. Diagnostic service provision was identified as a domain with the potential to attract high-quality international private partners, to allow for considerable savings in terms of the government's health expenditure, and to make it possible, through more timely and accurate diagnosis, to significantly foster public health. The pre-feasibility study of a possible PPP in this domain was undertaken with the support of the International Finance Corporation (IFC) and approved by the government in 2015, and the full feasibility study is on-going and expected to be finalized at the end of 2018.

The Government is also developing new initiatives looking for possible partnerships with the private sector through PPP in the potential areas of public and community housing, Tibar Bay Industrial Park PPP at Tibar area to take advantage of synergies with the future port of Tibar, a Vocational Education PPP project, Tourism and related infrastructures. Preliminary assessment and investigation of these potential projects have been initiated with some projects have entered into conceptual stage that precedes the formal PPP cycle.

2.6: Priorities and Results

This section outlines the priorities of the government, detailing what the government wants to achieve through the 2019 Budget and a brief summary of key indicators for development results.

2.6.1: Government Policies and Their Targets

The government is guided by a few key documents in its approach to the 2019 budget. These shape the priorities of the government that underpin the budget. On the biggest scale, the government remains committed to the 2011-2013 Strategic Development Plan (SDP), as the main guiding document leading national policy. The international Sustainable Development Goals agenda has been adopted. These documents are cornerstones of government planning, and are then implemented by the VIIIth Constitutional Government through the 5 Year Program 2019-2023, which was summarised and presented in the 2018 Budget Book 1.

The main themes of the government program are on:

- **Strengthening Social Capital**, especially in health and education.

- **Strengthening Infrastructure** to lay the foundations for growth.
- **Continue Economic Development**, bringing prosperity through more jobs and sectoral diversification.
- **Strengthening Institutions** for good governance and better service delivery.

For 2019, the government has adopted a limited number of priorities to concentrate on. This consolidates a comprehensive government programme into specific areas of focus.

- 1) Raise the quality of basic infrastructure in clean water & sanitation, rural and urban roads, electricity, ports and airports.
- 2) Increase agricultural production to provide food security and reduce malnutrition.
- 3) Promote education and training that is of high quality, inclusive, and market oriented
- 4) Strengthen access to health services, and continue the family health visits program.
- 5) Strengthen the tourism sector, concentrating on community tourism sites.
- 6) Continue the implementation of the decentralisation of administration program.

These priority sectors are reflected in the sectoral allocations of the 2019 General State Budget, following international standards.

Government's Priorities 1, 2, and 5 fall within the recurrent budget allocated to **Economic Affairs**. The related activities target these priorities through programs aimed at ensuring access to electricity across the country, development of tourism, and financing to public agencies involved in economic affairs such as the Ministry of Tourism, Commerce and Industry and the Ministry of Agriculture and Fisheries. Additionally, in line with the wider goal of **economic diversification**, the government will invest a significant portion of its recurrent spending in transfers to the petroleum and manufacturing sectors. Finally, investments will be made to ZEESM and RAEOA to continue to develop basic infrastructure and create a favourable environment for private sector investments. With regards to the Capital and Development Budget, which is composed by the Infrastructure Fund for over 90%, capital projects will be mainly aimed at roads and bridges, airports, and ports for their maintenance, (**priority 1**), and the oil sector, though investments in the South Coast.

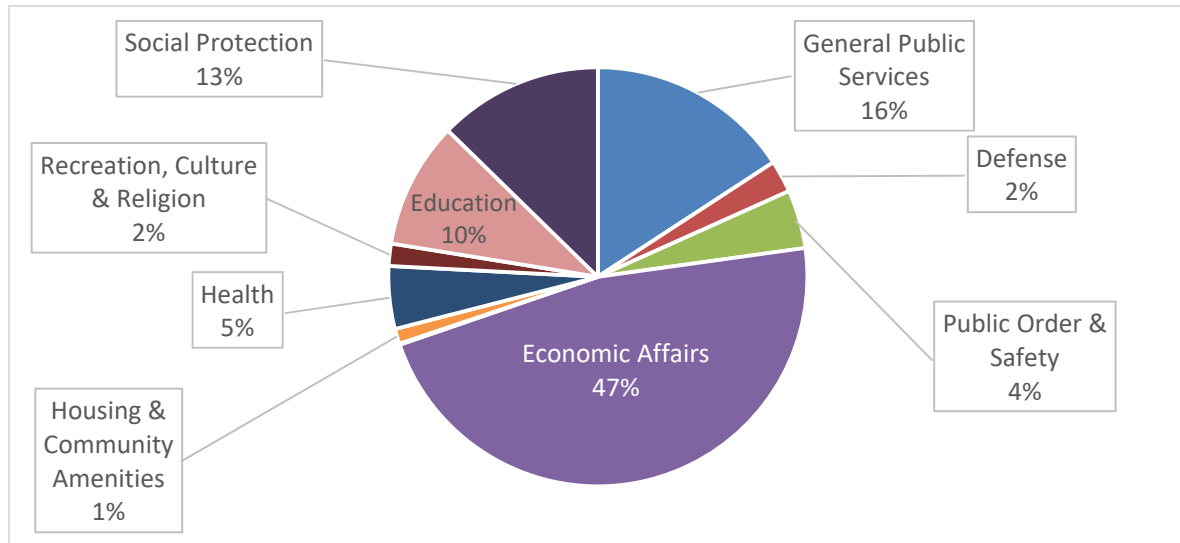
For Priority 3, 10% of the recurrent Budget will target the **Education Sector**. This includes budgetary increases to the Human Capital Development Fund, the Ministry of Education, Youth and Sport and the State Secretary for Vocational Training and Employment.

Priority 4, will aim at strengthening the **Health Sector**, with investments in local and national hospital facilities and in basic sanitation across the country. 5% of the proposed budget will be allocated to this area.

For Priority 6, municipal bodies, including special administrative regions, will receive 8% the recurrent budget across all of the sectors, in order to ensure decentralized public sector delivery.

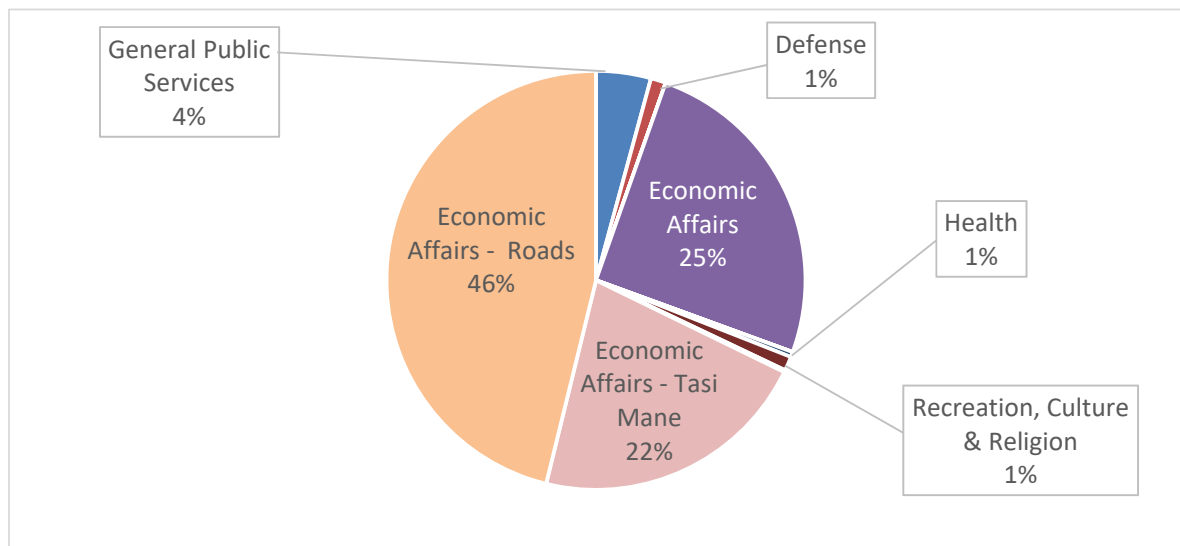
Above all, the Government is committed to reduce poverty and ensure prosperity to the Timorese People. For this reason, **Social Protection** represents the third largest sector of the 2019 recurrent budget. Allocations in this sector will aim at financing social welfare programs such as *Bolsa da Mae*, Veterans' and old people's payments and other pensions, and the school feeding program.

Figure 2.6.1.1: Recurrent Expenditure by Sector for 2019



Source: Estimate based on proposed ministerial allocations, Ministry of Finance, 2018.

Figure 2.6.1.2: Infrastructure Fund by Sector for 2019



Source: Estimate based on proposed IF allocations, Ministry of Planning and Strategic Investment, 2018.

2.6.2: Poverty and Inequality Reduction

There has been a resounding reduction in poverty from government spending on education, health, and transfer payments.⁵ This section the results from a recent analysis of the impact that government fiscal policy has on Timorese households. It looks in particular at transfers, health and education expenditure, together with the impact of taxes and subsidies. It summarizes the results of the analysis on three issues: poverty, inequality, and the distribution of the net benefits of state expenditure and taxation.

Poverty

Overall, the combined impact of taxes and expenditures in Timor-Leste have a very large effect on poverty. The headcount – the percentage of households below the poverty line – is reduced by 21.8 percentage points. The headcount poverty rate in Timor-Leste is 42%, which means without government expenditure, poverty would be around 64%. This is based on detailed analysis of the living standards survey of Timor-Leste, and reflects the actual impact of government policy.

However, the government recognizes that more needs to be done to further reduce poverty and improve public service delivery. That is why this government aims to reduce poverty by 10% by 2023.

The reduction in poverty is driven by two types of spending: transfers and public services. Transfers reduce the poverty headcount **by 10.4 percentage points**. Public service spending on health and education lower poverty **by 11 percentage points**.

This is much larger than in other countries where this analysis has been done. Based on international experience, we would expect no improvement in poverty for a country with Timor-Leste's GDP per capita.

Taxes increase poverty in Timor-Leste by only a small amount. This is unusual compared to other countries, especially for indirect taxes which tend to increase poverty by much more than in Timor-Leste. This is partly due to low rates applied which leads to the low amount of taxes collected and the off-setting effect of the indirect subsidy on electricity.

⁵ This section outlined recent research on the impact on poverty of government taxation and expenditure, using data from the 2014 Timor-Leste Survey of Living Standards (TLSLS 2014). The analysis uses incidence analysis, a description of who benefits when the government spends money and who loses when the government taxes, following the methods developed by the Commitment to Equity (CEQ) Institute. The analysis was carried out jointly by CEQ, the Asian Development Bank, and the Ministry of Finance.

Inequality

The reduction in inequality was 5 percentage points.⁶ The reduction in inequality is driven by two types of spending: transfers and public services. Transfers reduce inequality by **3.1 percentage points**. Public services spending on health and education reduce inequality by **1.6 percentage points**.

Timor-Leste already has a low level of inequality, which is partly why the decrease is lower than for poverty. In addition, the existence of the Petroleum Fund allows taxation to be relatively low, and it is taxation that often reduces inequality. With efforts ongoing to raise the amount of domestic revenue, inequality may reduce as the level of taxation increases in the future. The government will ensure a balance between the objectives of increasing domestic revenue and equality.

Based on international experience, we would expect a reduction in inequality of around 3 percentage points in Timor-Leste. This means Timor-Leste is doing better at reducing inequality than the average for its level of development.

Distribution of benefits

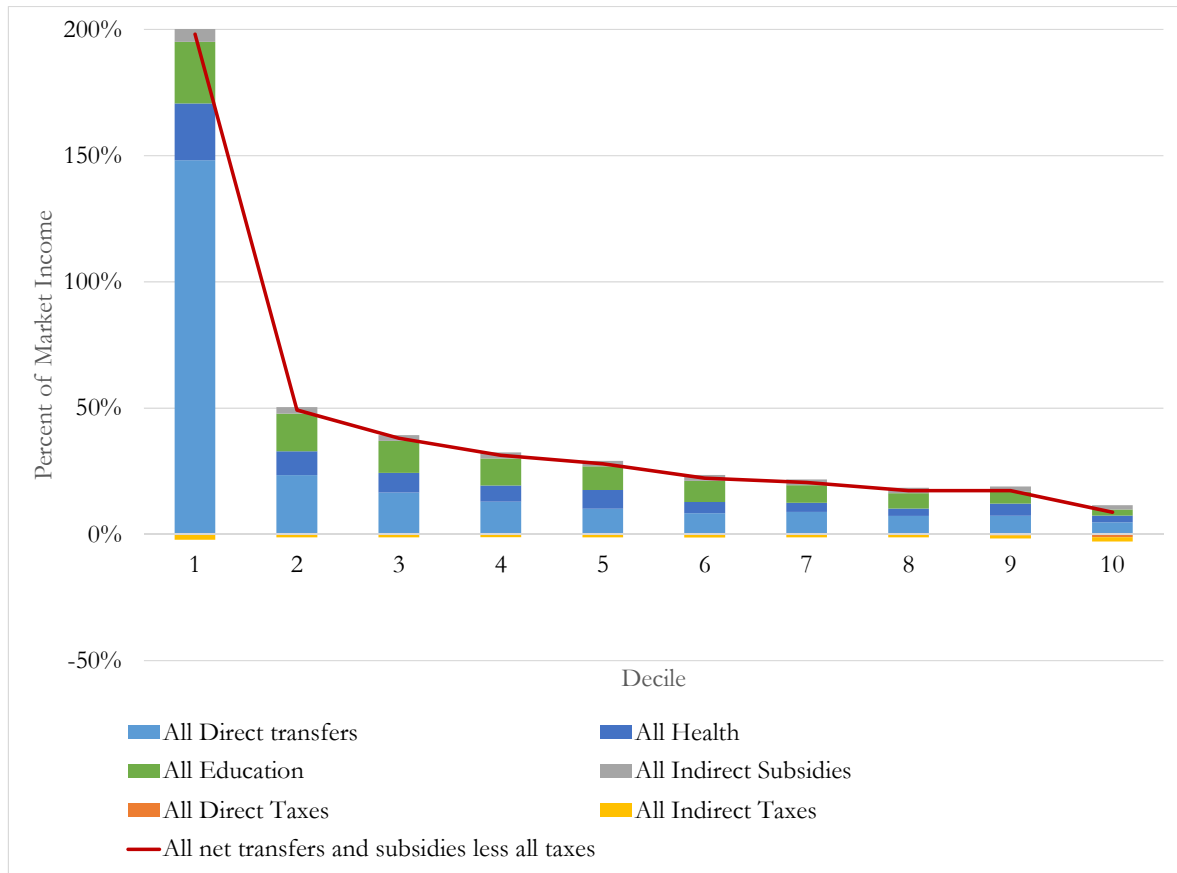
Government spending is progressive: the poorest get relatively larger net benefits from government expenditure than the richest. The households with the lowest 10% of income get an additional amount of worth almost 200% of their pre-tax income through government expenditure.

The lower income the household, the higher proportion benefit the household receives from the government. Figure X shows the impact of government expenditure as a percentage of income for 10 deciles. The total population is cut into 10 groups, with 'decile' 1 having the smallest income and 'decile' 10 having the largest.

Every group is a net beneficiary – even the richest. This means most households, in every decile, receive more in benefits from government spending than they pay through taxation. This results from the use of Petroleum Fund withdrawals to finance the budget and the low level of taxation. This is unusual. In most countries, households from as low as the 2nd or 3rd decile and above are net payers.

⁶ As measured by the percent reduction in the Gini coefficient, a common measure of inequality.

Figure 2.6.2.1 – Net Payers/Beneficiaries Of Taxes And Social Expenditures, By Decile



Source: TLSLS 2014 and CEQ report

Part 3 2018 General State Budget Law

Part 4 Supporting Documents

4.1: Petroleum Fund Law Articles 8 and 9

4.1.1: Requirement for Transfers from the Petroleum Fund

4.1.2: Independent Reassurance Report to the Ministry of Finance