

The background of the cover features two traditional wooden houses with steeply pitched, thatched roofs. The houses are built on stilts and have multiple windows. The roofs are decorated with white beads and small lanterns. A decorative horizontal band with geometric patterns runs across the top of the image. The sky is blue with some clouds.

**TIMOR-LESTE**

**ECONOMIC REPORT**

**DECEMBER 2021**

# STEADYING THE SHIP



**WORLD BANK GROUP**



# Timor-Leste Economic Report

## *Steadying the Ship*

December 2021



# Acknowledgment

The Timor-Leste Economic Report (TLER) is a bi-annual World Bank report that assesses recent macroeconomic developments, outlook and risks, as well as specific development challenges for the Timorese economy. In doing so, the TLER aims to inform the public policy debate and is geared towards a wide audience, including the general public, the Government, the private sector, civil society organizations, and other domestic and international stakeholders.

The TLER is a product of the World Bank Jakarta and Timor-Leste office and receives strategic guidance from an editorial board chaired by Satu Kahkonen, Country Director for Indonesia and Timor-Leste. The report is prepared by the Macroeconomics, Trade, and Investment (MTI) Global Practice team, under the guidance of Lars Christian Moller (Practice Manager), Bernard Harborne (Resident Representative) and Habib Rab (Program Leader and Lead Economist). The report production is led by Alief Aulia Rezza (Senior Economist) and prepared by a team composed of Assyifa Szami Ilman (Consultant), Bayu Agnimaruto (Consultant), Elisabeth Vicente (Consultant), Kathleen Victoria Tedi (Consultant), Nizia Lopes Da Cruz (Program Assistant), Yus Medina Pakpahan (Research Analyst). Rideca Duarte provided administrative support and coordinated the organization of the report launch event. Dissemination is organized by Matt Wilkinson under the guidance of Lestari Boediono Qureshi. The report was formatted by Arsianti.

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KEY INDICATORS	
Population (million)	1.3
GDP (USD billion)	1.6
GDP per capita (USD)	1,295
Poverty headcount ratio -national poverty line (% population)	41.8
Poverty headcount ratio-\$1.90 a day (2011 PPP, % population)	22.0
Poverty headcount ratio-\$3.20 a day (2011 PPP, % population)	65.9
GINI index	28.7

Notes: Population and GDP data are for 2019. Poverty and inequality data are for 2014 (with revised PPPs).

# Summary

## Recent Developments

- After dual COVID-19 and natural disaster shocks, available data points to some signs of economic recovery. Receipts from sales and excise taxes rebounded while household credit expanded as government executed a nominally higher budget in Q2 2021.
- The COVID-19 situation has begun to improve. The pace of vaccine rollout continues to accelerate as nearly 71 percent of the eligible population has received one dose and about 46 percent are fully vaccinated. Nevertheless, there is considerable disparity of vaccine coverage.
- The Government collected 11.3 percent less domestic revenue during the first half 2021 compared to 2020. Public spending grew by 20.3 percent, but capital spending remains relatively low.
- Inflation increased to 3.6 percent in the second quarter of 2021, the highest reading in eight years, driven largely by rising food, beverage, alcohol, and tobacco prices. Private sector credit growth doubled to nearly 20 percent, driven by household credit.

## Outlook and Risks

- Non-oil GDP contracted by 8.6 percent in 2020 but is projected to recover by 1.6 percent in 2021 on account of base effects and COVID-19 related fiscal expansion.
- Uncertainty surrounding the growth outlook is high, given that COVID-19 is still evolving locally and globally. Rapidly expanding vaccination coverage is key to containing the pandemic and economic recovery.
- Despite a reduced allocation and more coherent budgeting, allotment for recurrent spending in 2022 budget grows by 24 percent than the 2015-2019 average. In contrast, sustainable sources of revenue are set at nearly 40 percent lower than the recurrent spending. Fiscal deficit is projected to narrow in 2022, but still rather elevated at around 40 percent of GDP.
- The COVID-19 crisis came on top of another period of low growth, suggesting deeper structural problems. Delays in advancing the structural reform agenda could hamper growth, competitiveness, and employment. Raising more fiscal revenues, the special focus of this issue, is part of this agenda.

## Special Focus: Domestic Revenue Mobilization

- Given the finite nature of petroleum resources and associated sovereign wealth fund, it is critical for Timor-Leste to build a strong foundation for sustainable revenue mobilization to finance public spending on development and poverty reduction. Timor-Leste faces the risks of a fiscal cliff as, under the current spending trajectories, the Petroleum Fund may be fully exhausted in about ten years
- In line with the recent Government's efforts, there is an opportunity to collect more revenue using value-added and property taxes. The income tax rate is among the lowest in the world while most excise tax rates are insufficient.
- Estimates on the tax potential suggest that, if existing gaps in tax policy and administration are addressed, tax revenue collection could double from around 8 to 15 percent of GDP.

- The authorities may consider to: (i) introduce a value-added tax (VAT); (ii) raise outdated excise tax rates; (iii) increase income tax rates, with a view to promoting greater alignment with regional peers; (iv) improve revenue administration by modernizing the tax system and investing in capacity; and (v) evaluate the potential of a property tax and reporting on tax expenditures (while planning a gradual phasing out).



# 1. Recent Developments



## 1.1. COVID Cases Abate after two Devastating Waves since March.

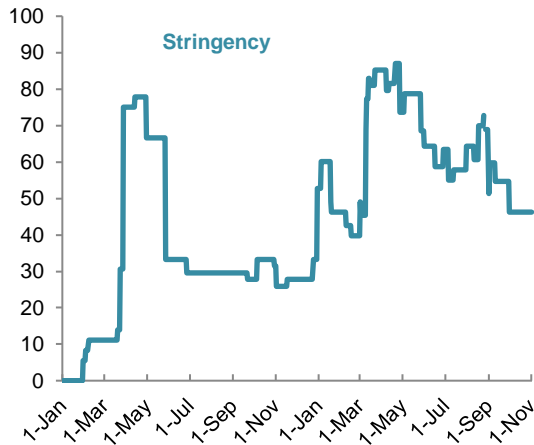
**Until mid-October, the COVID-19 pandemic continued to beleaguer Timor-Leste, with the country facing renewed outbreaks and more infectious variants.** Daily new cases had peaked in May, and then declined in July, before surging again around September. The authorities had attempted various decisive pandemic containment measures. Borders have been closed since March 28, 2020 with few essential and repatriation flights<sup>1</sup> allowed to enter the country each month. Domestically, the Government declared a state of emergency for a period of 30 days in March 2020 that has been largely renewed ever since with various levels of stringency (Figure 1.1). The most stringent measures were put in place on March 9, 2021 to respond to the start of the Delta variant outbreak. Those measures inhibited the movement of the population and the economic activities (Figure 1.2).<sup>2</sup>

**Despite strong measures to contain the spread of COVID-19 in 2020, the emergence of a more contagious and lethal variant of the virus pushed the number of daily infections and fatalities to new highs in 2021.** From a total of 113 cases only by February 28, 2021, the cumulative number of infections rose to 19,613 by October 6, 2021 (Figure 1.3). There were concerns that health facilities would not have the capacity to respond as hospitals were overwhelmed with COVID-19 patients and several health workers were severely infected. The Government responded to the outbreak by reactivating the lockdown (closing schools and churches, prohibiting large gatherings, and closing non-essential businesses) and reinstalling the sanitary fences that prevent people's movement across municipal borders. As of September 30, 2021, the Government had imposed 56 days of lockdown, 204 days of sanitary fences, and 551 days of border closures.

<sup>1</sup> Subject to a mandatory two-week quarantine for non-vaccinated or partly vaccinated travellers and seven days for the fully vaccinated ones.

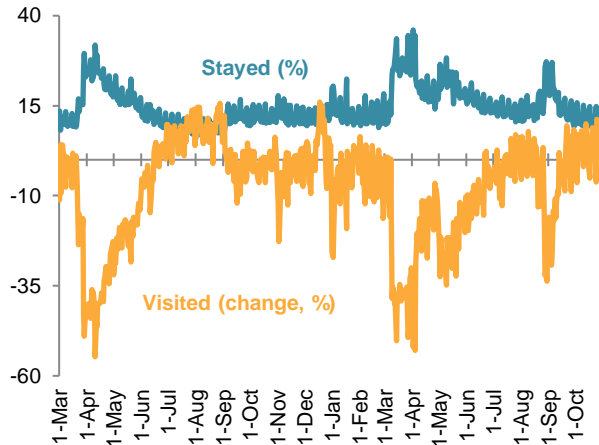
<sup>2</sup> The Government briefly relaxed the stringency of the measures for four weeks following the flash flood in April 2021.

**Figure 1.1: Stringency Index of Pandemic Responses (Index)**



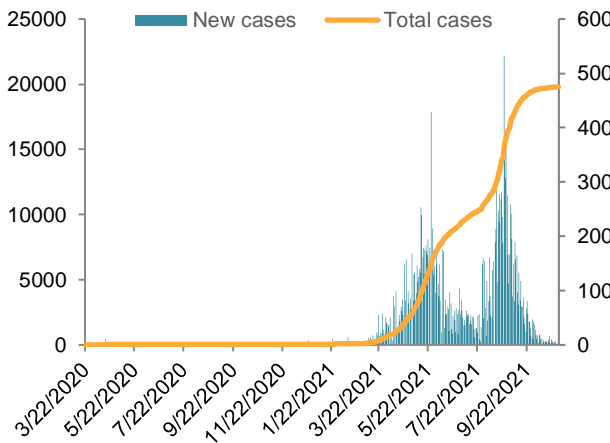
Source: Oxford COVID-19 Government Response Tracker

**Figure 1.2: Mobility in Dili (Change in movement, percent)**



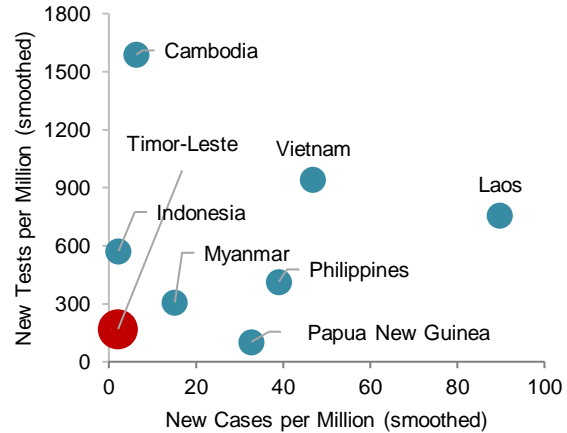
Source: Facebook Population Density Maps  
Note: "Stayed" is a proxy for staying at home, while "visited" measures change in movement

**Figure 1.3: New and Cumulative of COVID-19 by Reporting Date (LHS: cumulative cases; RHS: new cases)**



Source: Our World in Data

**Figure 1.4: COVID-19 Cases and Testing, by October 31, 2021**



Source: Our World in Data

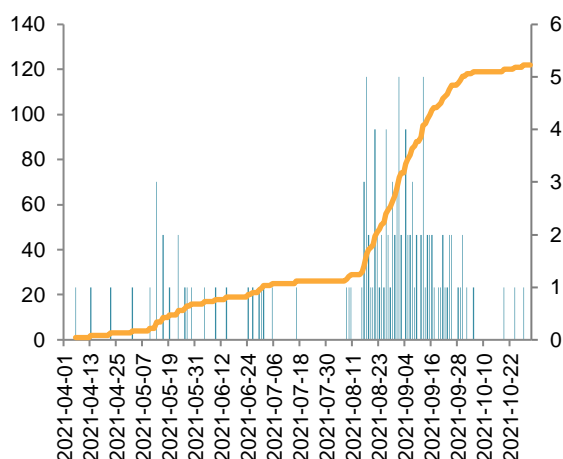
**COVID-19 cases have declined, followed by the test positivity rate, albeit gradually.** According to official statistics, new cases declined to six per day by October 6, 2021, the lowest level since August 2021. Of 43 new cases reported on the day, nine persons (20.9 percent) were fully vaccinated, five partially vaccinated (11.6 percent) and 29 (67.5 percent) were of unknown vaccination status. The test positivity rate was between 15 and 20 percent as of September 14, 2021, well above the recommended WHO target of 5 percent, but drop to reach less than 5 percent at the end of October. In addition, testing rates are 0.9 per 1,000 people which is slightly lower than the WHO standard of 1 per 1,000 and peers<sup>3</sup> (Figure 1.4). Finally, the death rate has

<sup>3</sup> To benchmark Timor-Leste's performance, this report uses three groups of peers: The East Asia Pacific average, structural peers, and aspirational peers.

been slowly decreasing since August (Figure 1.5). Of 118 people who have died with COVID-19 in the country, 93.2 percent were not fully vaccinated.<sup>4</sup>

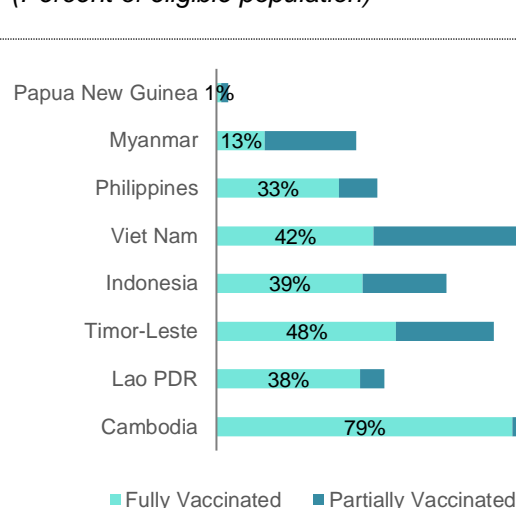
**Figure 1.5: Total and New Deaths in by Reporting Date**

(LHS: total deaths; RHS: New deaths)



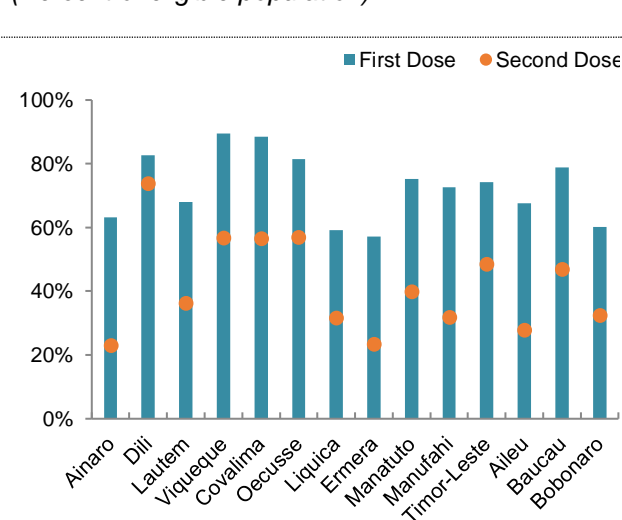
Source: Our World in Data

**Figure 1.6: Vaccination Coverage by Countries (Percent of eligible population)**



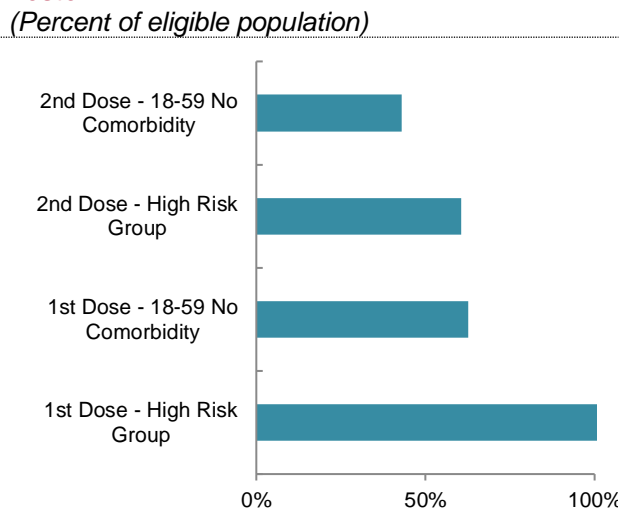
Source: Our World in Data as of October 31, 2021

**Figure 1.7: Vaccination Coverage by Districts (Percent of eligible population)**



Source: Ministry of Health, Timor-Leste

**Figure 1.8: Vaccination Coverage in Timor-Leste (Percent of eligible population)**



Source: Ministry of Health, Timor-Leste

**The pace of vaccine rollout continues to accelerate.** Fully vaccinated coverage reached 20 percent on September 28, 2021 compared to 15 percent on August 31, 2021. As of October 3, there have been 457,060 first doses of COVID-19 vaccine given in Timor-Leste, representing 60.5 percent of the eligible population (i.e., people aged 18 years and above).<sup>5</sup> At the end of October, more than 350,000 people are fully vaccinated, representing nearly 48.0 percent of the eligible population (Figure 1.6). The bulk of those vaccinations, however, happened in the capital city of

<sup>4</sup> Minister of Health and WHO Epidemiological Brief, October 03, 2021.

<sup>5</sup> Over 100,000 doses of Pfizer vaccine arrived in September, allowing for further vaccination programs aimed at citizens 12–18 years of age.

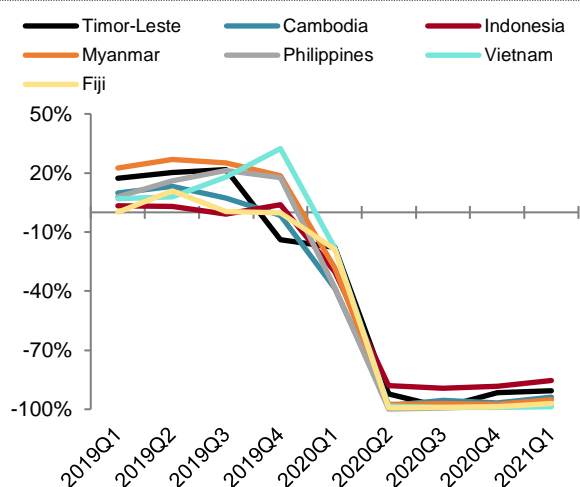
Dili—with fully vaccinated numbers hovering below 30 percent in many municipalities (Figure 1.7). The authorities estimate that nearly 20 percent of the eligible population are within the high-risk group. This includes health care staff and practitioners, other front-line staff, people aged 60 years and above, as well as people aged 18–59 years that have comorbidities. Of this group, 97 percent have received their first vaccination while 55 percent are fully vaccinated (Figure 1.8). The latest joint report by the Ministry of Health and WHO indicate that there are enough COVID-19 vaccines to cover the whole adult population in Timor-Leste.

## 1.2. Economy Hit Hard by Dual Shock.

Despite adopting strong fiscal measures to address the impact of COVID-19, Timor-Leste’s economy had contracted by 8.6 percent in 2020, the largest output contraction since independence in 2002. The contraction was driven through various main channels, including public health measures and consumer choices, political uncertainty, and international travel restrictions. In addition, the country had a challenging year during 2021 as the economy was negatively impacted by a surge of COVID-19 cases since March 2021 and the historic flooding caused by Tropical Cyclone Seroja in April.

**Figure 1.9: Total Foreigner Arrivals at Dili Airport and Select Countries in East Asia Pacific**

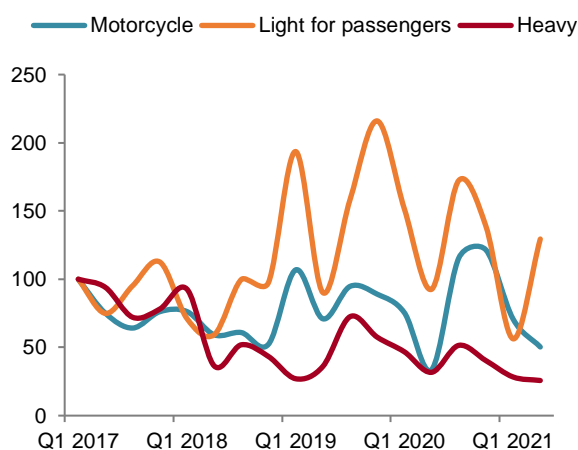
(Year on Year (yoy) growth, percent)



Source: CEIC, Fiji Bureau of Statistics, Statistics Timor-Leste

**Figure 1.10: Registration of Vehicles**

(Index Q1 2017 = 100)



Source: Statistics Timor-Leste

**Available data points to some signs of economic recovery in the face of a dual COVID-19 and natural disaster shock.** The border closures considerably shrank passenger arrivals at the Dili airport (Figure 1.9) and eventually impacted travel service exports and related sectors such as accommodation, food, and transport. The registration of different types of vehicles in Q2 2021 saw a drop for motorcycles, slight growth for light passenger vehicles, and not much change for heavy vehicles (Figure 1.10). Despite the impact of Tropical Cyclone Seroja in April 2021, electricity consumption data show broad-based expansion (Figure 1.11). From the import side, goods associated with investment and those required to fuel economic activities displayed strong growth. Indeed, imports of mineral and petroleum products, machinery and parts, and cement



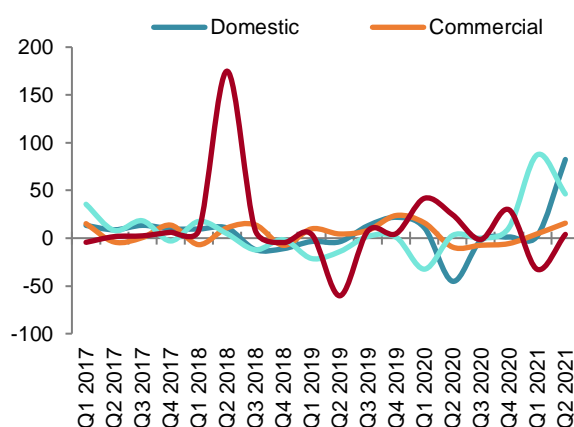
surged (Table 1.1).<sup>6</sup> The unforeseeable development is the halt in the expansion of the telecommunication sector as the total subscribers of mobile services stagnated in 2021 after double-digit growth in every quarter of 2020. (Figure 1.12).

**Table 1.1: Select Good Imports Values**  
(Index Q1 2019 = 100)

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021
Mineral fuels	87.6	28.7	69.5	44.6	46.4	120.4
Machinery and parts	192.2	80.4	113.5	103.2	123.1	295.3
Electrical equipment	100.6	95.6	142.9	116.8	105.9	219.3
Cement	92.1	40.2	110.8	125.6	82.3	157.1
<b>Total</b>	<b>194.1</b>	<b>118.2</b>	<b>177.6</b>	<b>159.7</b>	<b>146.3</b>	<b>358.1</b>

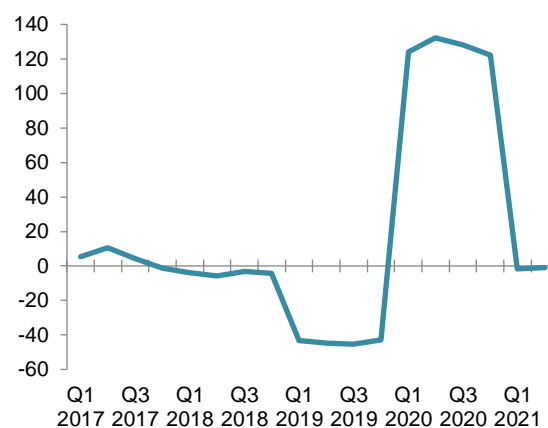
Source: Statistics Timor-Leste

**Figure 1.11: Electricity Consumption in Dili**  
(YOY growth, percent)



Source: Statistics Timor-Leste

**Figure 1.12: Mobile Telephone Subscribers**  
(YOY growth, percent)



Source: Statistics Timor-Leste

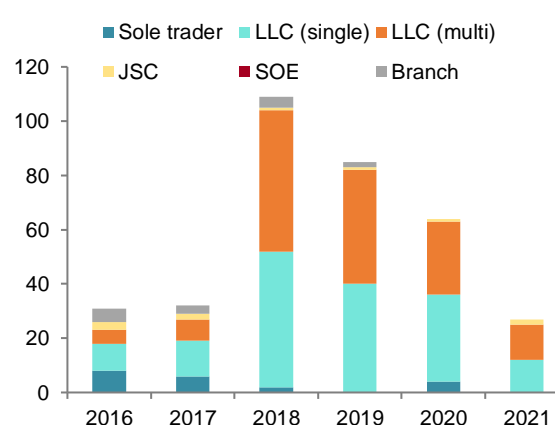
**Figure 1.13: Firm Registrations**  
(Number of firms)



Source: Statistics Timor-Leste

Note: LLC (Limited Liability Company), JSC (Joint Stock Company), SOE (Stated Own Company)

**Figure 1.14: Firm Closures**  
(Number of firms)



<sup>6</sup> It is however impractical to disentangle the growth of the imports' values in volumes and prices due to data limitation. Yet, it is worth pointing that the World Bank monthly energy price index increases during the period, from 73.8 on January 2019 to 93.2 by the end of Q2 2021.

**Both firm entry and exit remain relatively high.** The numbers of new registered firms remain relatively robust, driven by sole trader business and single limited liability company (LLC) (Figure 1.13). The limited economic opportunities due to mobility restrictions and mounting numbers of temporary layoffs may have encouraged people to explore further entrepreneurship prospects. The authorities have made the registration processes easier through the roll-out of its online registry system. In contrast, pending the availability of full-year data, the trend of firm closures seems to persist. Though the number of reported cessations has declined since 2018, it nevertheless remains high—with LLCs, both the single and multi-shareholders, leading the way (Figure 1.14).

**Private consumption in the second quarter of 2021 showed signs of acceleration.**

Receipts from sales and excise taxes rebounded in Q2, reflecting in part a base effect (Figure 1.15). The various supports by the Government through the Economic Recovery Program may explain the relative resilience of the private sector and improved consumption during the most difficult period.

**The economy overall was nevertheless severely hit by Tropical Cyclone Seroja.**

The Government reported that around 30,000 households were impacted by TC Seroja, including nearly 25,000 households in Dili (more than 50 percent of households in Dili). A total of over 4,000 houses were seriously damaged or destroyed, including 3,300 in Dili.<sup>7</sup> In addition to repairing and replacing

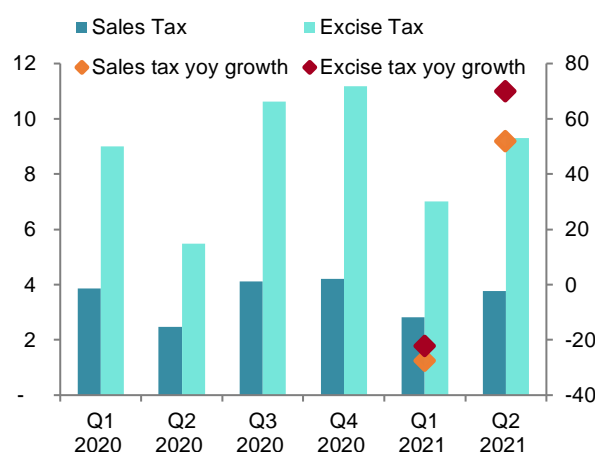
damaged housing assets, it could cost well over USD 150 million to 'build back better' (e.g., restoring basic services and improving settlements to reduce disaster risk) (World Bank, 2021b).

**The passage of TC Seroja resulted in debris flows, flash floods, and landslides that severely damaged the nation's roads.** This includes 420 kilometers along five main corridors and considerable damage along 42 municipal roads. Roads, bridges, embankments, and retaining walls failed due to surface water and debris flow erosion. As the road network deteriorated, travel times and car operating costs increased, further isolating rural communities. The effects of damaged road infrastructure also extended to livelihoods and basic services, including employment, health, and education.

**Agriculture, which engages over half of the population, was very badly affected.** Data suggests that significant hardship will be felt by affected populations as a result of the loss of livestock (used for household consumption) and the destruction of crops.<sup>8</sup> Over 112,000 animals died and over 4,200 hectares of crop land were damaged. Damage to livestock is estimated to be USD 15.7 million and losses to be over USD 13.1 million, with Manatuto, Bobonaro, and Baucau being the most affected municipalities.

**Figure 1.15: Tax Revenue**

(LHS: Revenue Collection, USD Million; RHS: YOY growth)



Source: Statistics Timor-Leste

<sup>7</sup> Government of Timor Leste, *Ciclone Seroja: Levantamento de estragos e necessidades (31 May 2021)*, (Dili: Unidade de Missão de Proteção Civil e Gestão de Desastres Naturais, 2021).

<sup>8</sup> Fordyce, Geoffry, *Enhancing Smallholder Cattle Production in East Timor – Final Report*, Project LPS/2009/036 (Canberra: Australian Centre for International Agricultural Research (ACIAR), 2017).

**Box 1.1: Impacts of Tropical Cyclone Seroja and Recommendations for Resilient Recovery****Timor-Leste's Risk Profile**

Timor-Leste is vulnerable to natural hazards such as floods, landslides, tropical cyclones, droughts, earthquakes, and tsunami, and is ranked 20th among countries with the highest disaster risk.<sup>9</sup> Floods are the most frequent natural hazard, followed by droughts and storms. The country is located south of the equator, in an area known for the occurrence of tropical cyclones with damaging winds, rain, and storm surges. Eight tropical cyclones pass within 400 kilometers of Dili on average every decade, with the majority occurring between November and April. Frances (2017), Marcus (2018), Lili (2019), and Seroja (2021) were the most recent tropical cyclones to hit the country. Climate change impacts as well as the La Niña and El Niño climate patterns further exacerbate floods and storm surges, as well as droughts and cyclones.

**Tropical Cyclone Seroja**

Tropical Cyclone (TC) Seroja impacted Timor-Leste on April 4, 2021 with heavy rains over a 24-hour period, averaging over 14 millimeters per hour with a peak of over 70 millimeters per hour. The country's natural topography coupled with heavy precipitation caused landslides, flash floods, and liquefaction, resulting in severe damage across the country. All 13 municipalities of Timor-Leste were affected, causing at least 44 fatalities and damaging critical infrastructure such as roads, bridges, water supply infrastructure, schools, and hospitals, as well as rural areas and agricultural assets.

While TC Seroja impacted Timor-Leste, the West Pacific Monsoon, Madden Julian Oscillation, and La Nina climate phenomena were also in effect, contributing to the extreme rainfall. In addition, flood risk in Dili was further exacerbated by groundwater extraction, high-density urbanized areas, and urban drainage channels choked with sediment and urban waste.

**Summary of Sectoral Impacts**

TC Seroja impacts will be felt mostly by Timor-Leste's poorest and most vulnerable communities. A remote-based impact assessment carried out by the World Bank, with support from the Global Facility for Disaster Reduction and Recovery (GFDRR), found that the cost of resilient recovery and building back better in three key sectors (agriculture, infrastructure – transport, and housing) could reach approximately USD 422 million – or approximately 32 percent of projected Government expenditure for 2021 (see table below).

**Table 1.2: Impact of TC Seroja to Various Sectors**

Sectors	Damage (USD) <sup>a</sup>	Build back better costs (USD) <sup>b</sup>	Total recovery costs (USD) <sup>c</sup>
Agriculture	15,672,000	–	28,436,000
Infrastructure (Transport)	170,407,000	75,315,000	245,722,000
Housing	59,396,000	42,855,000	147,795,000
<b>Total</b>	<b>245,475,000</b>	<b>118,170,000</b>	<b>421,953,000</b>

Source: World Bank Staff Estimate

**Outlook and Recommendations for improving Resilience**

The Government has an expanding development program that is increasingly threatened by disasters and climate change. The events in early 2021 highlight the need for an approach that integrates preparedness and response for both natural disasters and health emergencies. Such an approach is required as well as clear communication on public health protocols during, and in the aftermath of, disasters.

In the agriculture sector, reconstruction efforts should reduce the sector's vulnerability by improving farmers' access to formal markets; reducing the risk of post-harvest losses; and strengthening climate monitoring and early warning information services to the sector's stakeholders. The housing recovery program will need to not only repair and reconstruct housing but also place a special focus on the risk reduction of housing sites and settlements. These would include enhanced structural engineering practices but also other measures such as establishing guidelines for households doing their own repairs, community preparedness initiatives,

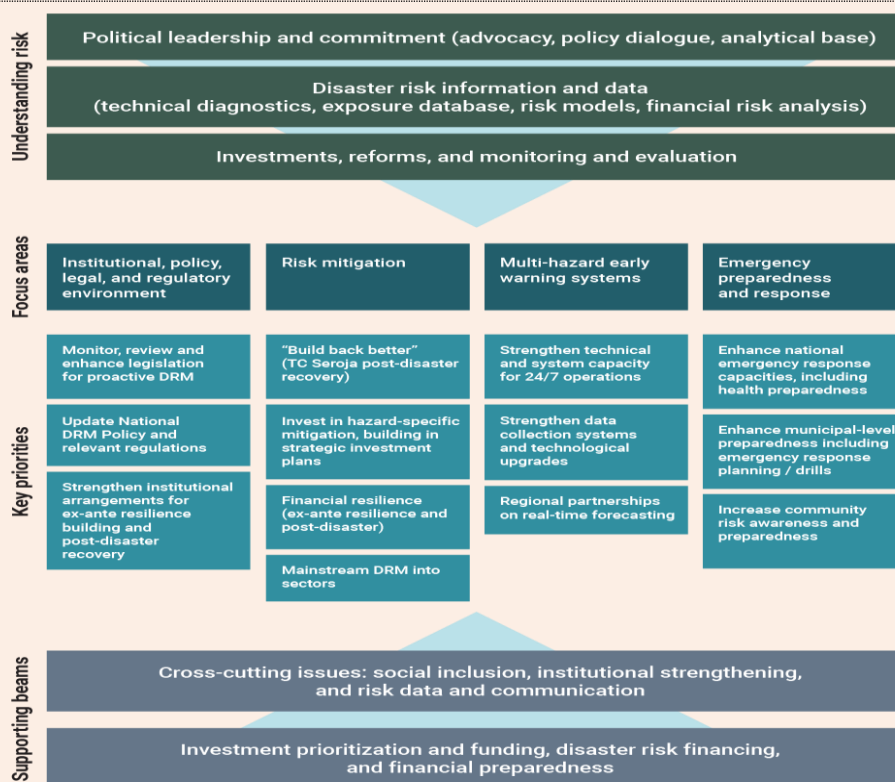
<sup>9</sup> Bündnis Entwicklung Hilft and the Institute for International Law of Peace and Armed Conflict, The World Risk Report 2020 (Berlin: Bündnis Entwicklung Hilft, 2020), <http://weltrisikobericht.de/english/>.

and strengthened capacity for risk-informed site assessments. In the transport sub-sector, new roads and bridge infrastructure should be designed based on comprehensive hydrological analysis and hydraulic calculations; new development should be excluded in unstable and flood-prone areas, wherever possible, while supporting reforestation and planting; and targeted early warning systems should be established along the road network.

Lessons learned from TC Seroja could be prioritized under four key focus areas: (i) the institutional, policy, legal, and regulatory environment; (ii) hazard- and asset-specific risk mitigation; (iii) multi-hazard early warning systems; and emergency preparedness and response. First, increased efforts are needed to understand the country’s risk profile and needs, which requires political leadership and commitment, improvement of disaster risk information and data, and investment prioritization and funding with associated monitoring and evaluation. Key priorities can then be identified in the four focus areas, informed by cross-cutting issues (social inclusion, institutional strengthening, and risk awareness) and supporting instruments (investment financing, contingency financing, resilience funds, and risk transfers).

A proposed framework to strengthen DRM is presented in Figure 1.16. Five immediate priorities might include: (i) updating the National Disaster Risk Management Policy; (ii) developing a baseline analysis to identify high-priority investments for early-warning services and products; (iii) applying risk reduction principles when “building back better” and in key development initiatives; (iv) exploring financial preparedness strategies for ex-ante risk mitigation investments and to respond more effectively to future disasters; and (v) conducting an emergency preparedness and response diagnostic to identify priority investments and capacity needs.

**Figure 1.16: DRM Framework**



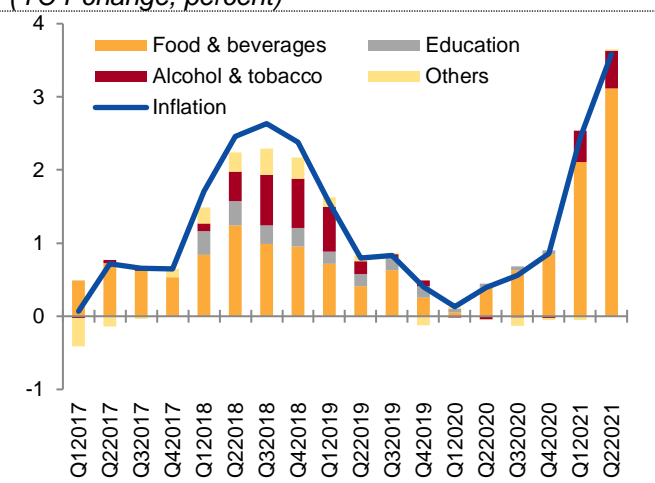
Source: World Bank Staff



### 1.3. Supply pressures fuel price increases whilst household credit expands.

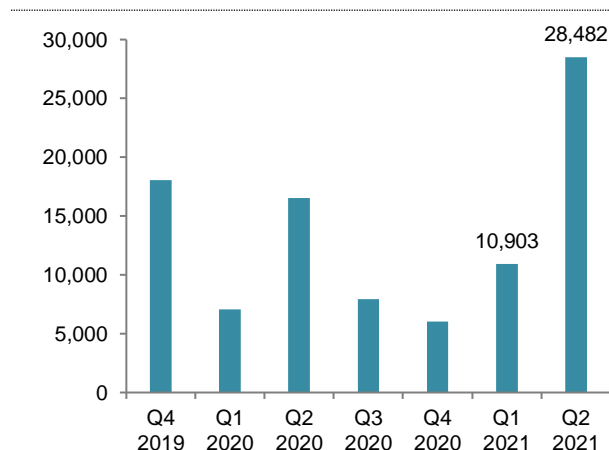
Despite Timor-Leste’s negative output gaps post the pandemic, consumer price inflation grew 3.6 percent year over year (YOY) in Q2 2021. This is a further increase from the previous quarter and the highest reading in eight years, largely driven by rising food and beverage prices as well as those of alcohol and tobacco (Figure 1.17). A steep increase in rice prices (10.4 percent yoy and 11.6 percent in Q1 and Q2 2021, respectively) explained most of the inflationary pressures recorded in 2021. Heavy floods that occurred close to the harvest season in May lowered rice production estimates to below 2019 and 2020 levels.<sup>10</sup> Additionally, the values of cereal imports more than doubled in Q2 2021 compared to Q1 (Figure 1.18).<sup>11</sup> However, agricultural commodity prices, especially rice, stabilized during Q3 2021 (Figure 1.19). Despite tight supply conditions for some food commodities due to unfavorable weather (e.g., maize and soybeans), most food commodity markets remain adequately supplied by historical norms.<sup>12</sup>

**Figure 1.17: Consumer Price Index**  
(YOY change, percent)



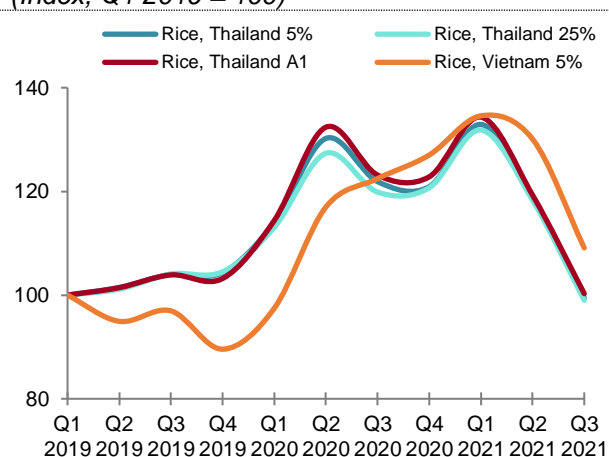
Source: Statistics Timor-Leste.

**Figure 1.18: Values of Cereal Imports**  
(USD million)



Source: Statistics Timor-Leste.

**Figure 1.19: Development of Global Rice Prices**  
(Index, Q1 2019 = 100)



Source: CEIC; World Bank staff calculations.  
Note: Index in January 2019 = 100.

**The banking system is highly liquid and well capitalized.** But a very large portion of the Timor-Leste’s economy is cash-based, making payments inefficient and insecure. Moreover, despite an ample deposit base and a net interest margin of more than 10 percent, banks are reluctant to

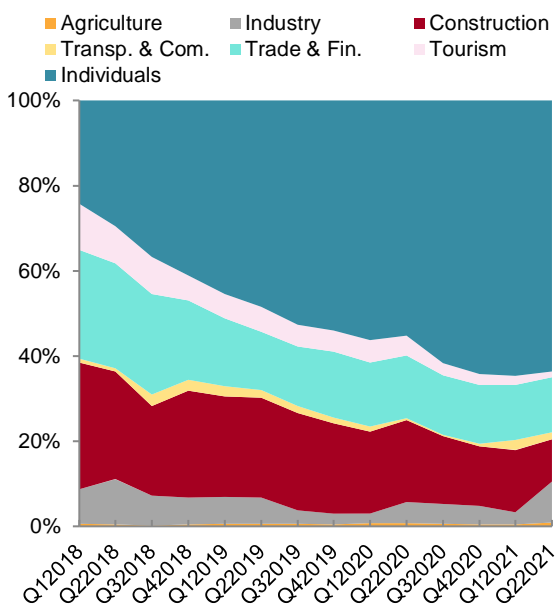
<sup>10</sup> World Food Programme. 2021. *Timor-Leste - Food Security Bulletin Edition no. 21: January - March 2021*.

<sup>11</sup> Admittedly, data on the imported quantity is essential to fully untangle the price impact to the elevated values of cereal imports in Q2.

<sup>12</sup> See World Bank. 2021a. *Commodity Markets Outlook, October 2021*

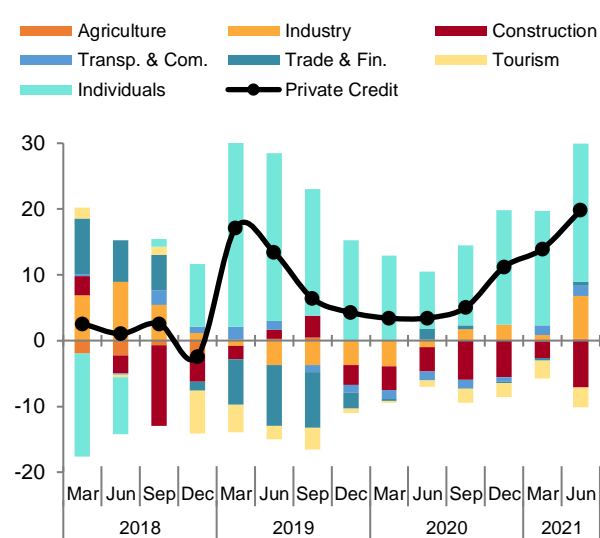
extend credit. The loan-to-deposit ratio remains relatively low with commercial banks primarily lending to Government contractors and individuals with secure wages. Indeed, individuals accounted for more than 60 percent of total loans to the private sector, while trade and finance, construction and industry, as well as manufacturing, followed considerably behind (Figure 1.20). Overall, credit growth to the private sector doubled to nearly 20 percent yoy by mid-2021, as lending to individuals, mainly for consumption purposes, continuously expanded (Figure 1.21). Challenges remain in expanding bank credit to SMEs and rural businesses. Limited access to long-term credit at affordable rates is a longstanding constraint for private sector development.

**Figure 1.20: Credit to Private Sector (Percent)**



Source: Statistics Timor-Leste

**Figure 1.21: Private Credit Growth (YoY, percent)**



Source: Statistics Timor-Leste

### 1.4. Fiscal imbalances grow rapidly in response to twin shocks.

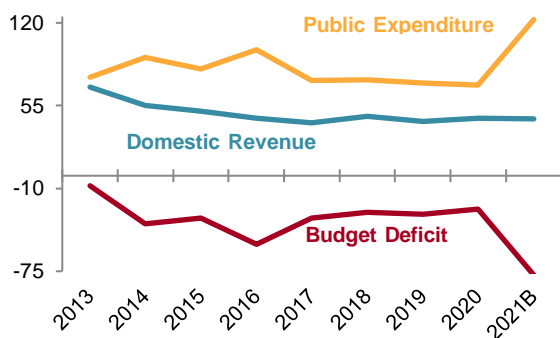
**Timor-Leste’s public expenditure levels have been among the highest in the world over the past 10 years.** Public expenditure grew considerably after 2006, averaging more than 80 percent of GDP since then. The fiscal deficit declined to 26.1 percent of GDP in 2020, from 31 percent in 2019, due to the fall in public spending and investment following long delays in passing the 2020 budget. The 2021 budget was timely approved but later amended in April 2021 in response to the surge of COVID-19 infections and the aftermath of Tropical Cyclone Seroja. The revision increased the budget to USD 2,030 million or 7.1 percent higher than the original consolidated budget. However, the budget revision does not change the projection of revenue and sources of financing. Following the amendment, the Government projects a 79.4 percent of non-oil GDP fiscal deficit for 2021, a record high for the country (Figure 1.22).

**The Government collected lower revenue during the first half of the year, relative to the same period last year (Figure 1.23).** Estimated Sustainable Income (ESI)<sup>13</sup> of the Petroleum

<sup>13</sup> The ESI, a form of fiscal rule, is set at 3 percent of petroleum wealth, which consists of the PF balance and the projected net present value of future petroleum revenues. The ESI is only updated once a year as part of the main

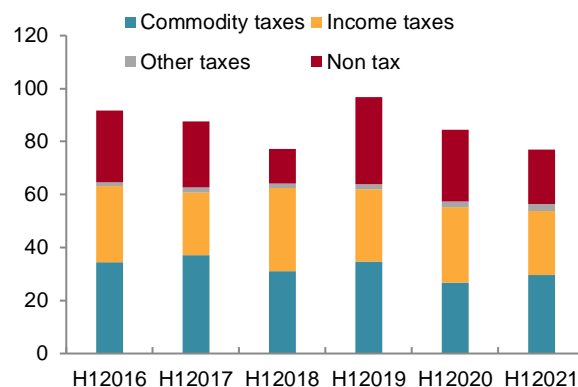
Funds (PF)<sup>14</sup> drove this decline, falling from over 56.4 percent of GDP in 2013 to an estimated 33.5 percent of GDP in 2021. In addition to the adverse impact of various health measures, the weak revenue outturn was in part driven by the transformation of the status of Electricidade de Timor-Leste E.P. (EDTL) and BEE Timor-Leste E.P (BETL) from previously Autonomous Agencies to Public Enterprises since the start of 2021.<sup>15</sup>

**Figure 1.22: Revenue, Expenditure and Budget Deficit**  
(as percent of GDP)



Note: 2021B refers to 2021 revised budget  
Source: Budget Transparency Portal, Ministry of Finance.

**Figure 1.23: Cumulative Realization of Revenues**  
(cumulative realization until end of June, USD million)



Source: Budget Transparency Portal, Ministry of Finance.

**Tax collection, which is the main source of Government revenue beyond withdrawals from the PF, declined in the first half of 2021.** The fall in the outturn was driven mainly by slower collection of Corporate Income Tax (CIT) and withholding tax, which declined 5.4 percent and 32.2 percent respectively. The prolonged mandatory confinement imposed in Dili may have been the explanatory factor for lower CIT collection. Muted Government capital spending during the first half of the year led to a slowing construction sector that dampened the contribution from withholding tax. Income tax from the public and private sector declined marginally by 1.4 percent. On the other hand, collection from indirect taxes rose by 13.0 percent, contributed by strong growth of excise and import taxes. Overall, Timor-Leste’s tax revenues remain below regional and income peers, averaging less than 8 percent of GDP since 2011 (see further discussion in Part 3).

**Non-tax revenues that are mainly dominated by fees and charges have seen a dramatic fall—plummeting by 30 percent during the first half of 2021.** In addition to the exclusion of EDTL and BETL from the revenue-generated Autonomous Agencies, collection from passport, ID, and visa fees saw the largest falls. This is unsurprising given the continuation of the State of Emergency that maintains the validity of all visas for foreign residents, as well as the significant reduction of international travel given the closure of most commercial flights. Revenues from

budget process. The Government can withdraw an amount from the PF in excess of the ESI given an explanation that it is in the long-term interest of Timor-Leste and that it is approved by the national parliament. Parliament has yet to reject a request for excess withdrawals.

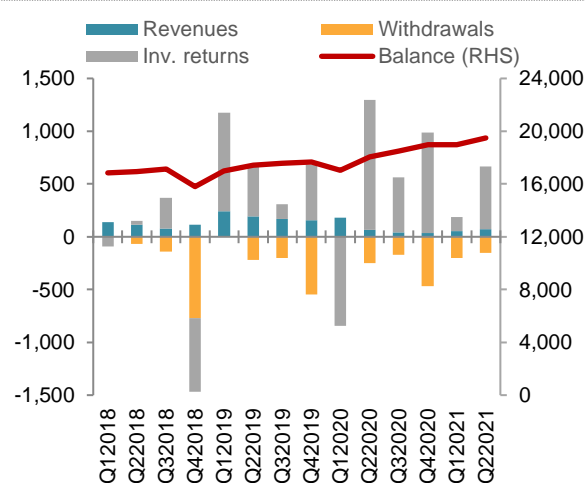
<sup>14</sup> Petroleum Fund was created in 2005. It is a type of sovereign wealth fund that provides budget financing through the ESI rule.

<sup>15</sup> The new status of EDTL and BETL means that the fees and charges collected by the two organization are no longer part of the government revenues. Still, even if revenues from EDTL and BETL are taken into account, domestic revenues collection remains 10.3 percent lower in Q1 2021 relative to Q1 2020. Data to produce year-on-year comparison at the end of Q2 2021 is, unfortunately, not available.

Autonomous Agencies saw a significant increase of 18.2 percent due to a larger number of Autonomous Agencies reporting in 2021.<sup>16</sup> APORTIL, the port authority of Timor-Leste, is the autonomous agency with the highest collections in the first half of 2021—with revenues 26.0 percent higher than for the corresponding period in 2020. UNTL, the National University of Timor-Leste, is the second highest revenue generator, but booked 11.4 percent lower collections than for the same period last year.

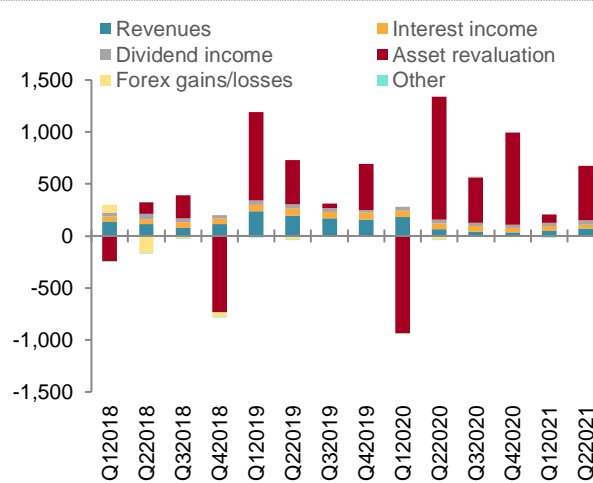
**Despite having a framework to manage its oil revenues that provides a benchmark for sustainable spending, elevated public spending financed by excess withdrawals has been the norm in the country.** The PF balance was recorded at USD 19.5 billion by the end of June 2021, an increase from USD 18.1 billion in Q2 2020. Nevertheless, at USD 74 million, the gross cash inflows to the PF from royalties and taxes during the period were considerably smaller than the total investment return for the period (Figure 1.23).<sup>17</sup> The investment returns in Q2 2021 largely rebounded from a lower level in Q1 2021 when the market was rattled by the new strains of COVID-19 that emerged in January (Figure 1.24). The net gain from financial assets at foreign market was still the highest source of investment income of the PF. On the other hand, the outflow from the PF to the state budget during the period was recorded at USD 350 million.

**Figure 1.24: Petroleum Fund Flows**  
(USD million)



Source: Central Bank of Timor-Leste.

**Figure 1.25: Petroleum Fund Receipts**  
(USD million)



Source: Central Bank of Timor-Leste.

**Given the very large fiscal deficits and the finite nature of petroleum resources, Timor-Leste faces the risks of a fiscal cliff as, under the current spending trajectories, the PF may be fully exhausted in about ten years.** Budget financing from the ESI of the PF for 2021 was set at USD 547.9 million (33.5 percent of GDP) (vs. USD 544.4 million or nearly 35.1 percent of GDP in 2020). However, the total proposed withdrawal for 2021 is set at USD 1.4 billion. This is almost three times the 3 percent benchmark for the ESI. The authorities have indeed been withdrawing more than 3 percent over a sustained period. This means that the asset base of the

<sup>16</sup> There are six Autonomous Agencies reporting their revenues in 2021 while the figure was four in 2020.

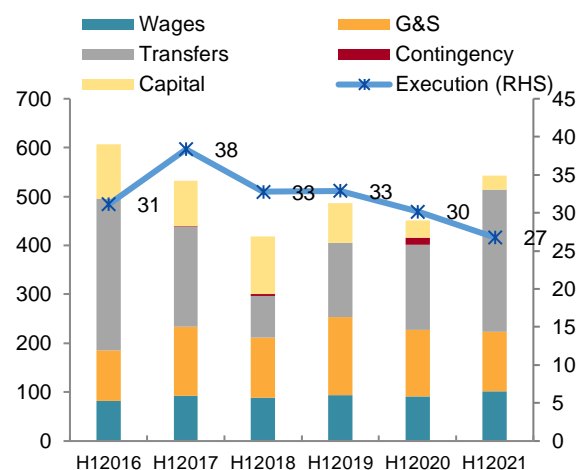
<sup>17</sup> The value of royalties and taxes from the sales of hydrocarbon are determined by the oil price, the volume produced and the costs of production. All petroleum revenues are currently contributed by the Bayu-Undan (BU) field, a mature hydrocarbon complex with a declining production profile. The field is expected to continue to generate revenues for Timor-Leste until at least its current Production Sharing Contracts expire in 2021/2022. The authorities have recently approved the Phase 3C infill drilling program at the BU field in early 2021. The drillings are expected to add over 20 million barrels of oil equivalent gross reserves and to possibly extend the life of the field.



PF is being eroded. Given the annual withdrawals from the fund to the budget, the fund’s targeted asset allocation reflects a preference for a highly liquid portfolio of very low risk assets.

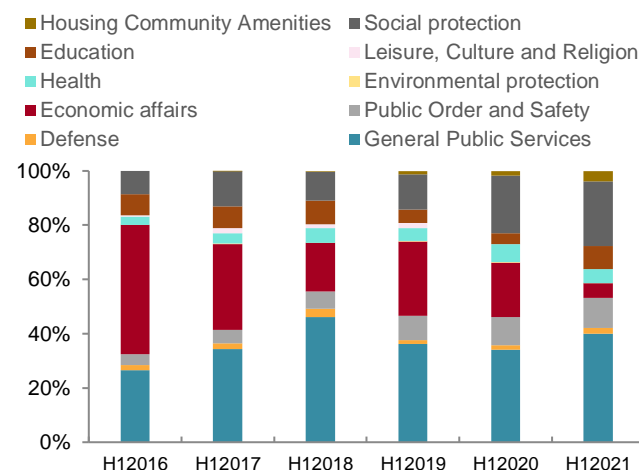
**On the spending side, public expenditure grew by 20.3 percent at the end of the first half of the year, driven largely by appropriation category with high rigidity.**<sup>18</sup> Indeed, transfers in the form of a public grant made to the Ministry of Public Works and increase in salary and wages were behind the surge (Figure 1.26). Given concerns over medium-term fiscal sustainability, a potential fiscal adjustment to bring expenditure levels down to a more moderate share of GDP could be costly if the share of rigid expenditures continues to rise. It is thus important to curb key items of high rigidity before they build a strong momentum that is difficult to halt. On the other hand, capital spending remains relatively low as spending was mostly prioritized for responding to COVID-19.<sup>19</sup> The Government foresees an acceleration of capital spending execution in the coming Q3 and Q4 as this is traditionally the period when infrastructure projects commence. Nevertheless, it is essential to note that capital spending has been declining from the last peak in 2016.

**Figure 1.26: Realization and Execution of Spending (by Economic Classification)**  
(LHS: USD million; RHS: Percent)



Source: Ministry of Finance.

**Figure 1.27: Realization of Spending Year (by Function)**  
(Percent)



Source: Ministry of Finance.

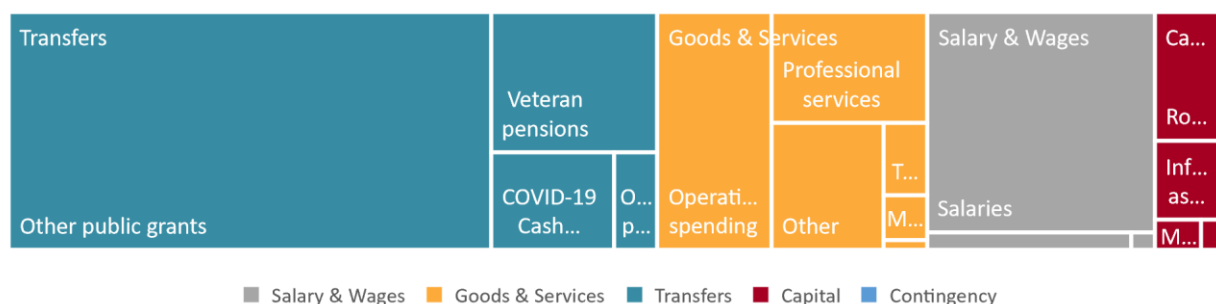
**Despite elevated allocation, budget execution performance has been low, highlighting challenges in planning, budgeting and implementation.** At the end of the first half of 2021, the authorities have only executed less than a third of its budget allocation, which was lower compared to last year at 30 percent. More than 60 percent of the executed budget was under the general public services and social protection (Figure 1.27). On the other hand, one-half of the executed spending was for transfer payments, of which 23 percent was for payment of veterans’ pensions and COVID-19 cash transfers (Figure 1.28). This was followed by salary and wages spending which constituted 19 percent of total expenditure—mostly for the salary payment of

<sup>18</sup> Budget components vary within a spectrum of flexibility, since not all can be easily modified by the authorities in the short term. Having a clear understanding of the budget items driving expenditure growth and how rigid they are can support policymakers in anticipating fiscal pressures. Budget items that cannot be reassigned without entailing a high cost are generally said to be ‘rigid’. Civil servant salaries and public benefit transfers (which includes pensions) fall under the high rigidity category.

<sup>19</sup> Travel restrictions and disruptions to maritime trade may also have affected the availability of foreign workers and construction supplies.

teachers, health workers, police officers, and Government officials. Noticeably, only 5 percent of the total executed spending was for capital.

**Figure 1.28: Realization of Spending at End of June 2021 (by Economic Type)**



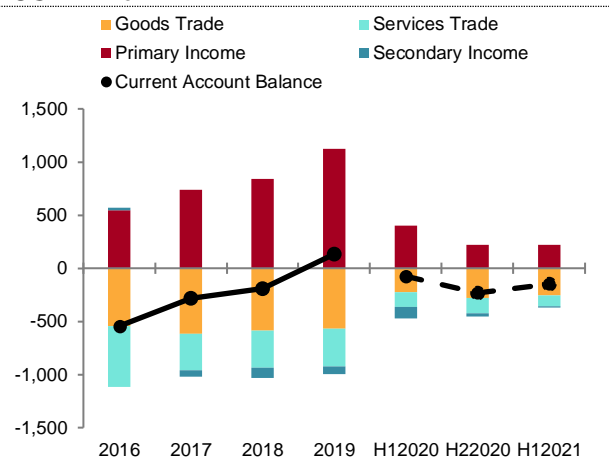
Source: Ministry of Finance.

### 1.5. Reduced import demand contains external imbalances.

**The current account deficit narrowed at the end of Q2 2021 (Figure 1.29).** Nevertheless, constrained exports and domestic production opportunities followed by heavy dependence on imports have developed a structural trade deficit and a persistent current account deficit for Timor-Leste. Indeed, the current account has been in deficit since the last quarter of 2019. As is the case with other import-dependent economies, Timor-Leste is highly vulnerable to global economic shocks and price spikes.

**The trade balance was relatively stable with total imports and exports at levels comparable to 2020.** Nevertheless, it was a tale of two quarters where total imports contracted by 21 percent yoy in Q1 2021 but expanded by 23 percent yoy in Q2 (Figure 1.30). The growth of goods imports was mainly driven by pharmaceutical products, vehicles, mineral fuels, and cement. The import growth of pharmaceutical products is linked to the COVID-19 response. On the other hand, the surge in the import of vehicles may have been driven by the change in preferences, as people avoid using public transportation to curtail the potential transmission of the virus. Overall, at the end of the first half of 2021, total goods imports grew by nearly USD 30 million or 12.7 percent yoy. Conversely, total goods exports escalated nearly 70 percent but from an extremely low base.<sup>20</sup>

**Figure 1.29: Current Account Deficit USD million**

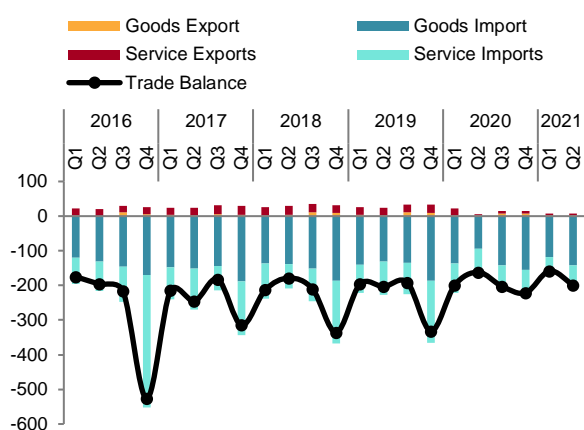


Source: Central Bank of Timor-Leste, World Bank staff calculations

<sup>20</sup> Coffee remains the biggest single export commodity, however, coffee exports consistently register relatively lower value during the first quarter of a year and are highly seasonal.

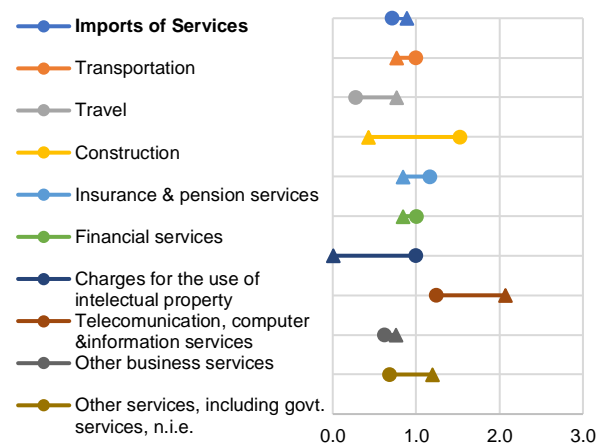
Imports of services contracted considerably, driven chiefly by weaker imports of travel services<sup>21</sup> followed by personal, cultural, and recreational services. The prolonged border closures depressed the number of travelers to and from the country. In contrast, imports of telecommunication services, construction services, and insurance and pension services grew considerably—by 201.0 percent, 94.3 percent, and 56.3 percent respectively (Figure 1.31). On the export side, growth was booked by telecommunication services and travel services that expanded by 184.7 percent and 31.5 percent respectively, albeit from a very low base in each instance. Tourism has been the major contributor to the country’s service exports. The devastating impact of the pandemic has weakened a currently small but impactful sector of the country.

**Figure 1.30: Trade Balance**  
(USD million)



Source: Central Bank of Timor-Leste, World Bank staff calculations.

**Figure 1.31: Ratio of Services Imports**



Source: Central Bank of Timor-Leste, World Bank staff calculations.

Note: (i) (▲) H12020/H12019, (•) H12021/H12020.; (ii) a ratio above 1 indicates sectors that experienced growth, whereas those below 1 experienced a contraction during their respective timeframe.

**Primary income declined by nearly 40 percent yoy, driven almost equally by the drop in investment income<sup>22</sup> and other primary income.<sup>23</sup>** Despite the pick-up in oil and gas prices in 2021, income from the Joint Petroleum Development Area (JPDA), the main driver under other primary income, declined by close to 50 percent. Secondary income, which comprises foreign grants and net workers’ remittances, registered a considerably lower net outflow—mainly because of the larger decline in remittance outflows while the remittance inflows were relatively steady (Figure 1.32).

**The financial account continued to strengthen—benefitting from large portfolio investment inflows during Q1-2021 and positive ‘other investments’ during Q2-2021.** Portfolio investment, which comprises equity and debt securities and largely pertains to PF investments abroad, remains the largest component of the financial account. Other investments, which are typically associated with public external debt disbursements and currency and deposits from the

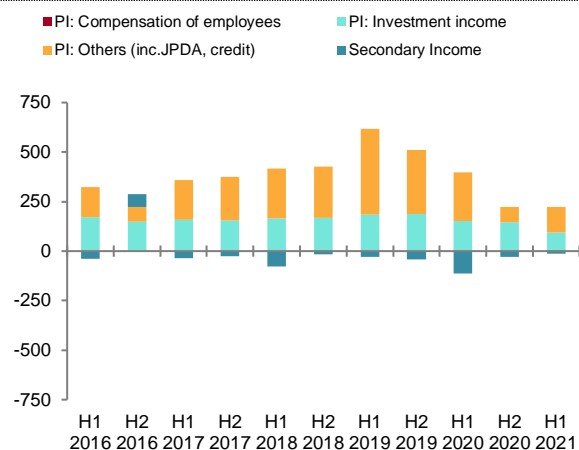
<sup>21</sup> ‘Travel services’ covers goods and services acquired from an economy by non-resident travellers for business and personal purposes during their visits (of less than one year), including local transport but excluding international passenger services (which is included in passenger transport).

<sup>22</sup> Investment income mainly includes interest and dividends accrued from PF assets

<sup>23</sup> Primary income comprises compensation of employees (exceedingly small), investment income, and ‘other primary income’.

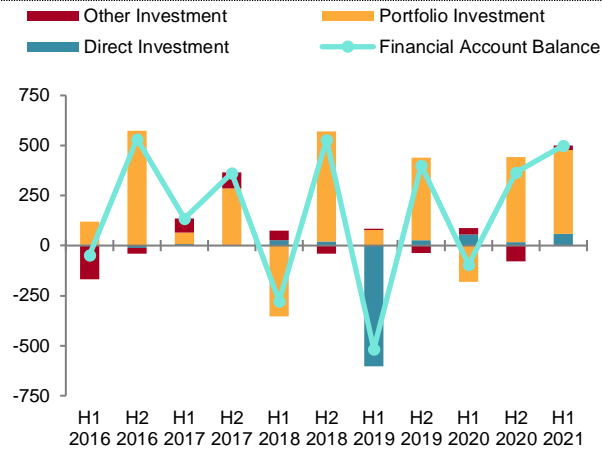
commercial banking sector, increased. Foreign direct investment is relatively small and has declined in recent years. A coherent investment policy, a proactive investment promotion strategy and an enhanced business environment could help attract investors in key economic sectors. The capital account is almost negligible, commonly comprising transfers of asset ownership.

**Figure 1.32: Primary Income Account (USD million)**



Source: Central Bank of Timor-Leste, World Bank staff calculations

**Figure 1.33: Financial Account (USD million)**



Source: Central Bank of Timor-Leste, World Bank staff calculations

**Official reserves stagnated as positive financial and capital accounts were offset by a significant current account deficit.** Positive balances were reported in the financial and capital account, amounted of USD 15 million and USD 498 million, respectively (Figure 1.33). Furthermore, negative balances were also recorded in the current account (USD 150 million) as well as errors and omissions (USD 364 million) (Figure 1.34). This has resulted in a very narrow contraction of USD 474,000 in reserves in the year to June 2021. Overall, reserves stood at USD 656 million at the end of the first half of 2021. This is larger than the USD 520 million recorded in the same period last year but relatively stagnant since the end of 2020. Gross external debt grew to USD 235 million by mid-2018, mainly owing to rising long-term Government liabilities and, to a smaller extent, short-term bank liabilities.

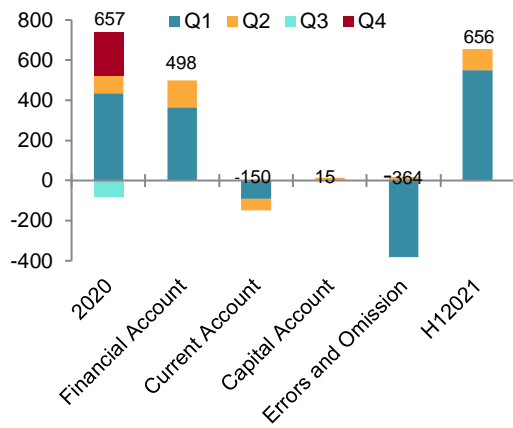
**Despite the increase in domestic prices, the real exchange rate has depreciated slightly.**<sup>24</sup>

The nominal effective exchange rate (NEER), shows that the US dollar has depreciated against the currencies of Timor-Leste’s main trading partners (Figure 1.35). The real effective exchange rate (REER), which provides a more accurate measure of international competitiveness by taking of account price differentials across countries has depreciated slightly. The REER depreciated slightly less than the NEER because the rise of consumer price index in Timor-Leste was comparatively lower than that of its trading partners. In general, a weaker domestic currency stimulates Timor-Leste’s exports and makes the country’s imports more expensive. However, the impact of exchange rates dynamics to the country’s export performance is likely to be negligible as Timor-Leste’s legal tender is the U.S. dollar and its exported goods are dominated by commodities<sup>25</sup>. In addition to keep inflation low and stable, improving business environment is therefore critical to improve Timor-Leste’s competitiveness.

<sup>24</sup> To assess the impact of exchange rate fluctuations on Timor-Leste’s external competitiveness, a trade-weighted average of bilateral exchange rates is calculated.

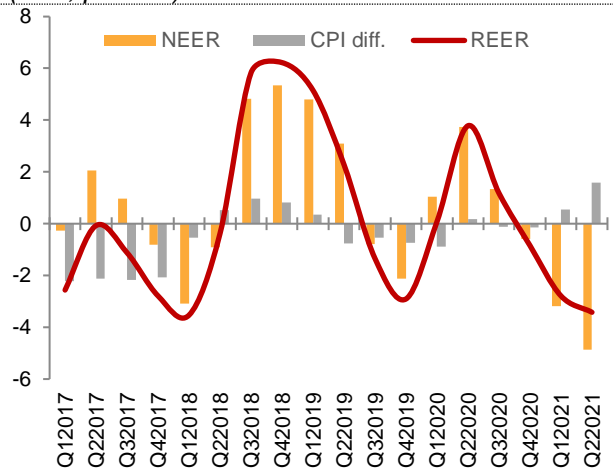
<sup>25</sup> In particular, hydrocarbons and coffee accounted for slightly more than 80 percent of exported goods in recent years.

**Figure 1.34: Reserves**  
(USD million)



Source: Central Bank of Timor-Leste, World Bank staff calculations

**Figure 1.35: Contribution to REER changes**  
(YoY, percent)



Source: Statistics Timor-Leste.



## 2. Outlook and Risks



**With the onslaught of both domestic and external shocks, Timor-Leste’s economic outlook has turned significantly weaker.** The non-oil GDP contracted in 2020 but is projected to recover over 2021-2022 (Table 2.1). Real GDP growth is forecast to improve to 1.6 percent in 2021 on account of low base effect, COVID-19 related fiscal expansion and cyclone-related reconstruction. The economy is project to expand further in 2022, driven by more manageable COVID-19 infections, an intensive vaccination campaign to interrupt virus transmission, and, accordingly, less restrictive public health measures<sup>26</sup>. On the demand side, a gradual rebound in private consumption (2.9 percent), supported by public sector wages and personal benefit transfer, and higher execution of Government expenditure will drive economic growth in 2022 (Table 2.1). Private investment is likely to remain low.<sup>27</sup> Global trade is expected to pick up further, positively affecting both exports and imports. Nevertheless, net exports will continue to be a drag on growth due to structural external sector imbalances (i.e., lack of diversified exports and high import demand).

**External pressures will persist in the short term, owing to higher imports driven by domestic demand and import-intensive infrastructure projects.** Although it is coming from a low base, exports of goods will expand, driven by better production and prices of coffee. Border openings, if carefully managed, will enhance export services from the tourism sector. Moreover, elevated prices of hydrocarbons<sup>28</sup> and slightly higher oil and gas production from the Banyu-Undan field<sup>29</sup> will narrow the deficit in the current account. The financial account surplus will

<sup>26</sup> High frequency indicators of economic activity and econometric analysis reveals that recent economic activity has been relatively resilient to infections, even in countries with low vaccination rates. In most countries, the public health measures provoked by the outbreak restrict overall mobility less, and economic agents have learned to function in the face of infections and diminished mobility. (see World Bank 2021c)

<sup>27</sup> The average of private sector’s contribution to Timor-Leste’s growth through gross fixed capital investment during the last 10 years is -0.2 percentage point.

<sup>28</sup> Average crude oil prices are expected to rise yoy by 69.5 percent in 2021, and 5.7 percent in 2022 (See World Bank 2021b).

<sup>29</sup> If the endeavours to extend the life of the Banyu-Undan field are fruitful.

expand, although mainly due to divestments of the PF used to cover both the fiscal and current account deficits.

**Table 2.1: Economic Forecast**  
(Percent)

	2018	2019	2020	2021f	2022f	2023f
Real GDP growth, at constant market prices	-1.1	1.8	-8.5	1.6	2.4	4.3
Private Consumption	1.7	3.6	-2.3	1.6	2.9	3.7
Government Consumption	-0.3	3.2	1.0	3.1	0.8	1.8
Gross Fixed Capital Investment	-1.5	-17.2	-48.1	19.5	25.4	16.8
Export, Goods and Services	16.6	-17.2	-41.4	13.1	11.8	13.8
Import, Goods and Services	2.8	-6.5	-17.1	5.6	9.8	6.4
Inflation (Consumer Price Index)	2.2	0.9	0.5	1.6	2.1	2.5
Fiscal Balance (Percent of GDP)	-29.1	-30.5	-26.2	-33.2	-54.5	-41.2

Source: World Bank Staff Calculations

**Despite Timor-Leste's negative output gaps post the pandemic, consumer price inflation is projected to gradually pick up, reflecting the increase in higher Government spending and the global energy prices<sup>30</sup>.** Despite lower agricultural commodity prices in Q3 2021, the rally in energy prices, especially coal and natural gas, have sharply increased agricultural input costs. This includes fertilizers, which, by October, have risen more than 55 percent since January. As an import-dependent economy, the evolution of international prices is a critical risk to the inflation outlook for Timor-Leste.

**The fiscal deficit is projected to reach more than 50 percent of non-oil GDP in 2021 as authorities aimed to respond to rising COVID-19 infections and the adverse impact of Tropical Cyclone Seroja.** The fiscal deficit is projected to narrow gradually to slightly above 40 percent<sup>31</sup> in 2022 (see Box 2.1) and about 30 percent on average in the medium term.

#### **Box 2.1: Lower allocated budget being proposed in 2022**

The Government has recently presented the proposed 2022 budget for Parliament's approval. Depending on the budget execution, the overall fiscal deficit may still be at an elevated level of around 40 percent of GDP, lower than the Government's estimated 2021 revised budget of 79.0 percent. The proposed budget was set at nearly USD 1.7 billion, prominently lower than USD 2.0 billion in 2021, but slightly higher than the 2020 budget of nearly USD1.2 billion. Overall, the reduced budget allocation for 2022 reflects the increasing awareness that the state lacks the institutional capacity to follow through on big spending plans. The authorities also acknowledge that the reduced budget allocation is consciously done to put public finances on a more sustainable footing to preserve the country's PF. Finally, the lower budget may indicate the authorities' assertion that the COVID-19 malaise may somewhat be more manageable in 2022.

The 2022 budget for recurrent spending is set at nearly USD 1.2 billion, which is nearly 24 percent higher than the average of actual recurrent spending between 2015 and 2019. On the other hand, sustainable sources of revenue for the proposed 2022 budget are set at USD 705 million, considerably insufficient to the proposed recurrent spending. Revenue collection, beyond the ESI and excess withdrawal from the PF, is expected to grow by 8.4 percent compared to the projected 2021<sup>32</sup> realization to reach USD 151.1

<sup>30</sup> The current global inflation trend mainly comes from supply shortage and boosted demand, driven by exceptional monetary and fiscal expansion.

<sup>31</sup> Under the assumption that the execution rates will be 95 percent and 70 percent for recurrent and capital spending, respectively.

<sup>32</sup> Government revenue realization in the 2021 is projected at USD 139.2 million, 27.0 percent lower than what was estimated in the 2021 budget.

million<sup>33</sup> (Table 2.2)). Collection from direct taxes is projected to improve by 8 percent while that from indirect taxes is estimated to expand by 11.6 percent compared to projected 2021.

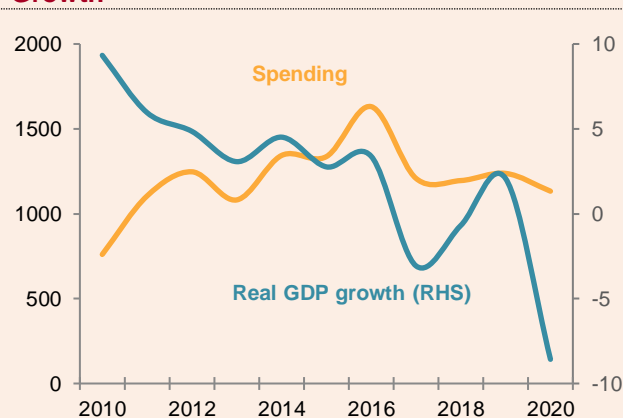
**Table 2.2: Proposed Budget for 2022 (Millions of USD)**

	2019 actual	2020 actual	2021 rectified budget	2022 Proposed budget
Revenue	727.6	726.7	738.5	705
Of which				
Taxes	126.2	118.6	112.5	121.7
Non-taxes revenues	65.4	63.5	62.2	29.4
ESI	529.0	544.4	547.9	554.1
Expenditure	1,243.8	1,156.0	2,030.3	1,675.0
Financing	516.2	429.2	1,291.8	970.0
Excess Withdrawal	440.0	342.0	829.7	488.4
Budget Support	6.7	10.1	9.1	15.6

Source: Ministry of Finance.

Despite reduced budget allocation, the authorities consider that the economy could still expand at 2.1 percent in 2022, predicated on the stronger budget execution and the implementation of several Public-Private Partnership (PPP) projects. Historical data from the last few years indeed suggests that there has been no obvious positive link between spending and economic growth in Timor-Leste (Figure 2.1). Devising a sustainable growth-oriented fiscal strategy, linked with pragmatic public financial management reforms, will be essential to enhance the country's public spending efficiency and effectiveness (Figure 2.2).<sup>34</sup> The strategy to help accelerate and sustain economic growth necessitates improvements in the quality of capital spending and streamlining of undue recurrent expenditures.

**Figure 2.1: Relationship Between Spending and Growth**



Source: Ministry of Finance.  
Note: LHS USD; RHS: Percent.

The year 2022 will be the first year of the implementation of Program Budgeting in Timor-Leste,<sup>35</sup> a type of budget classification that groups expenditures with related policy objectives. Overall, the 2022 General State Budget highlights six national priorities for 2022: (i) human capital development;<sup>36</sup> (ii) housing and social inclusion; (iii) productive sectors;<sup>37</sup> environment and connectivity; (iv) private sector development; (v) rural development; and (vi) good governance. The authorities have identified 45 programs for next year

<sup>33</sup> The budget document discusses various measures to enhance revenue collections, including the introduction of VAT Law and various Fiscal and Public Financial Management reforms. Nonetheless, they are still being discussed and are yet to receive approval from parliament.

<sup>34</sup> Through benefits provisions or tax reductions, effective fiscal policies can also be employed to absorb the adverse impacts of economic shocks on aggregate demand.

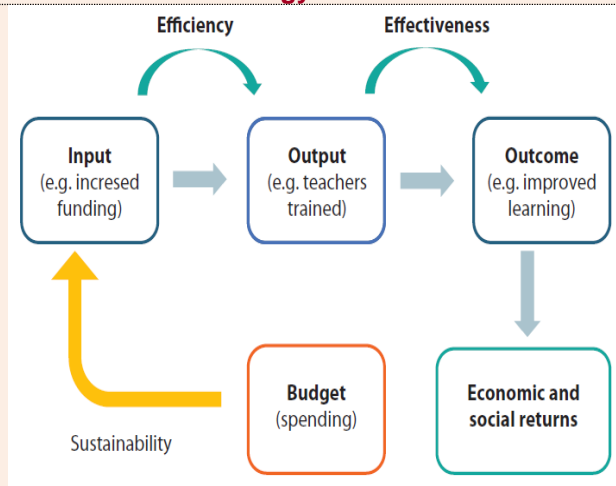
<sup>35</sup> A program budget shows exactly what the Government does and how much it costs. Rather than just departments, objects of expenditure, and line items, a program budget is organized into service areas. This setup is, arguably, believed to be more meaningful to the public because programs are directly relevant to how the public experience public services. For the Government, a program budget may promote budgetary decisions that more closely align with Government priorities.

<sup>36</sup> Specifically, education, vocational training, and health.

<sup>37</sup> Particularly agriculture and tourism.

with a program on Good Governance and Institutional Management receiving the largest share of the budget followed by Gender Equality and Social Inclusion (Figure 2.3). On the other hand, if comparison is made according to the four pillars of the country's Strategic Development Program (SDP), the Institutional Framework receives the largest allocation. The allocation for infrastructure pillar saw considerable expansion, potentially to offset the muted infrastructure spending and largely sluggish execution in 2020 and 2021. Conversely, the social capital pillar saw a sizable decline, possibly reflecting a drop in the fiscal support to people and firms as the pandemic is gradually brought under control (Table 2.3).

**Figure 2.2: Components of Sustainable Growth-oriented Fiscal Strategy With PFM Reform**



Source: World Bank Staff

**Figure 2.3: Ten Biggest Programs of General State Budget 2022**



Source: Ministry of Finance.

**Table 2.3: Budget Allocation by Development Pillar (% of Total Spending)**

SDP Pillars	2020 (Actual)	2021 (Budget Rectified)	2022 (Proposed Budget)
Institutional Framework	23.2	32.5	40.6
Economic Development	16.9	21.7	6.0
Infrastructure Development	14.5	12.8	30.9
Social Capital	45.4	33.0	22.5

Source: State Budget 2022

**Uncertainty surrounding the growth outlook is high due to COVID-19.** The sanitary fence, which restricted movement in and out of Dili, was lifted in early October. Increased movement and interaction between people will increase the risk of COVID-19 transmission. Rapidly expanding the vaccination coverage is, therefore, the key to containing the pandemic and returning to a normal socioeconomic life. Other countries are more likely to re-open travel to Timor-Leste and re-engage in trade, commerce, and tourism once Timor-Leste has controlled transmission and can report high vaccination coverage across the country. This will hopefully boost economic activity in the country.

**There are gaps in vaccination coverage, particularly in some municipalities.** Resources should consequently be allocated to increase access to vaccines, particularly in areas with low coverage. Innovative methods to increase motivation to receive vaccination or to reach out to the population residing in remote areas should be investigated. This should include community-based

or social incentives to receive vaccines, particularly in areas with low vaccine uptake. The authorities should encourage community leaders to urge their followers to become vaccinated.

**The COVID-19 crisis came on top of another “lost decade” of low growth, suggesting deeper structural problems.** From 2011 to the outbreak of the pandemic, Timor-Leste grew at 2.5 percent, in average, per year while the East Asia Pacific as a region grew at 6.3 percent. The forecasts for 2022 and 2023 are similarly lackluster at 2.4 and 2.5 percent, respectively. The sluggish recovery, together with the low growth rates of the previous decade suggest structural problems internal to the country and point to the urgency of addressing the list of long-recognized growth-impeding internal shortfalls in the quality of public spending, development of the private sector and trade diversification while confronting some new climate change challenges. Delays in advancing the structural reform agenda could hamper GDP growth, competitiveness, and employment.

**Political stability is a fundamental precondition to ensure a sustained economic recovery.** Timor-Leste has had eight different governments since independence. Political instability has been responsible for large falls in investment and fiscal revenue. The decline in public investment was particularly sharp in the 2019 and 2020 as the budgets were not approved in time. In addition, private investment has been low and stagnant for decades, reflecting the endemic uncertainty that entrepreneurs face. A political consensus around key policy and regulatory reforms to support the economic recovery and overcome socio-economic challenges is urgently needed.



### 3. Domestic Revenue Mobilization



*Enhancing domestic revenue collection is indispensable to help secure fiscal sustainability. Given the finite nature of petroleum resources, it is critical for Timor-Leste to build a strong foundation for sustainable revenue mobilization that bridges the very large fiscal financing gap. Despite increasing over time, tax revenue collection remains considerably below peers – averaging 8 percent of GDP since 2011. The tax framework comprises several types of taxes, but value-added and property taxes are notably absent while income tax rate is among the lowest in the world. Average effective tax rates are low, owing to a narrow tax base as well as low compliance and enforcement. Estimates on the tax potential suggest that, if existing gaps in tax policy and administration are addressed, tax revenue collection could double in the medium term. Policy recommendations include: (i) introducing a value-added tax (VAT) while adopting complementary social transfers to protect the poor; (ii) raising excise tax rates (e.g. on alcohol and tobacco) and introducing a sugar tax to increase revenues and improve health outcomes; (iii) raising income tax rates, with a view to promoting greater alignment with regional peers; (iv) improving revenue administration by modernizing the tax system and investing in capacity; and (v) evaluating the potential of a property tax (vi) start reporting on tax expenditures with a view of gradually reducing ineffective ones.*

#### **3.1. Enhancing Domestic Revenue Mobilization is Critical for Development.**

Despite notable socio-economic achievements after gaining independence in 2002 and ending the civil unrest in 2006, there remain considerable development challenges. Large investments in the energy sector have contributed to enhance access to electricity, while spending on road rehabilitation has led to improvements in transport connectivity. Moreover, child and maternal mortality rates have declined significantly, while youth literacy has increased. However, Timor-Leste remains a fragile post-conflict nation with weak human and institutional capacity, large infrastructure gaps, and high dependence on petroleum revenues. Child stunting levels and learning outcomes are unacceptably poor. The private sector is incipient, characterized by small firm size, informality, and low productivity, and mostly reliant on public sector contracts. There is

limited (formal) employment creation, with most of the population still engaged in subsistence agriculture. Its population is young – about 60 percent are under the age of 25 – while poverty levels are among the highest in the region.

**It is pertinent and opportune to revisit the current domestic revenue mobilization strategy, especially tax policy, to create fiscal space for financing large development needs.**<sup>38</sup> While public expenditure has grown considerably in the past decade, domestic revenues have failed to bridge the financing gap – thus contributing to a very large fiscal deficit. Meanwhile, the Petroleum Fund (PF) is being pressured by declining petroleum revenues and large withdrawals exceeding the Estimated Sustainable Income (ESI).<sup>39</sup> Hence, medium-term fiscal sustainability is partly contingent on the Government’s ability to increase domestic revenues. Strengthening domestic revenue collection would ease these pressures, which would in turn avert a fast decline of the ESI. Reducing the dependence on the PF to finance the public spending is key to protect its assets for future generations. Encouragingly, achieving sizable gains in tax collection in a fragile environment is not impossible (Box 3.1).

### **Box 3.1: Building tax capacity in Fragile and Conflict-Affected States (FCS)**

Building tax capacity and increasing tax collection are essential for FCS to improve state building and development. The ability to mobilize revenue is also a crucial factor for a country to exit from fragility. Indeed, around 90 percent of countries that escaped from fragility had substantially improved their Country Policy Institutional Assessment (CPIA) sub-score for “efficiency of revenue mobilization.”<sup>40</sup>

Enhancing tax collection is also critical for facilitating the post-COVID-19 recovery. Many countries are allocating more fiscal resources to the health sector by increasing spending on monitoring, containment, and mitigation. Countries are also experiencing a fall in fiscal revenues as economic activity and trade decline. After the pandemic recedes, temporary tax measures implemented to mitigate the economic fallout should be lifted and compliance should be strengthened to help rebuild tax bases.

The experiences from several countries indicate that a series of tax reforms can strengthen the country’s capacity to generate higher revenue collection (Table 3.1).<sup>41</sup> Several key lessons that can be drawn include the following: (i) the political commitment and buy-in from key stakeholders are essential to ensure the continuity of the tax reforms; (ii) simultaneous reforms in both revenue administration and tax policies tend to yield larger and sustainable gains; and (iii) countries are advised to start with fiscal reform measures with immediate effect to build reform momentum.

**Table 3.1: Tax Revenue Increased in Select Countries that Pursued Tax Reforms**

	Reform Period	Tax collection (% of GDP)	
		Before Reform	After Reform
Burkina Faso	2009-2013	11.9	16.8
The Gambia	2011-2015	13.2	17.6
Maldives	2011-2017	8.8	20.9
Mauritania	2010-2014	11.1	17.2
Rwanda	2010-2015	11.9	15.6

Source: Country authorities and IMF staff estimates

<sup>38</sup> Fiscal reforms that are underway include the preparation of VAT Law and a new General Tax Law (that include income tax, service tax, sales tax, corporation tax and import duties) as well as various efforts to strengthen tax administration and customs. The latter part of the efforts involves, among others, the introduction of SITGAS Version 3, automation of clearance certificate, creation of e-Services Portal and the utilization of ASYCUDA World System at the port, airport, and order pots.

<sup>39</sup> Petroleum production has been gradually declining since its peak in 2012 and the last petroleum field in operation (Bayu-Undan) is scheduled to cease operations by 2022-2023.

<sup>40</sup> See IMF (2017)

<sup>41</sup> Further discussion can be found in IMF (2019)

Seeking growth-neutral revenue mobilization can be another option in post-Covid-19 environment. Recent work on the value-added tax (VAT) for a large set of industrial and developing countries shows that tax hikes are not always contractionary (Gunter et al. 2021). When the initial tax rates are low or moderate, the impact of tax changes on long-run economic activity is very small (or virtually zero), becoming negative only as the initial level of the tax rate rises. As such, tax changes may have merely modest effect on GDP in countries with low tax rates. The initial level of taxes is thus a critical consideration when contemplating tax hikes.

**Tax reforms are needed to ensure that revenue levels are adequate to sustainably finance public expenditures.** Some of the desired features of a tax system include efficiency (in revenue collection), equity (through income redistribution), simplicity (of the tax system), revenue adequacy (to fund basic public services), and stability (to avoid economic instability). A prioritized and sequenced set of tax reforms (relating to both policy and administration) should be pursued in the coming years with a careful attention on certain policy trade-offs. Measures to diversify revenue sources, expand the tax base, and improve compliance are key to generate sufficient domestic resources to bridge the large budget financing gap – especially by enabling the funding of key public services without threatening fiscal sustainability. In addition, taxation is known to promote transparency and accountability – between citizens and the state. However, strong political commitment and ownership is required, especially bearing in mind the presence of a large sovereign wealth fund that may reduce the incentive for reforms.

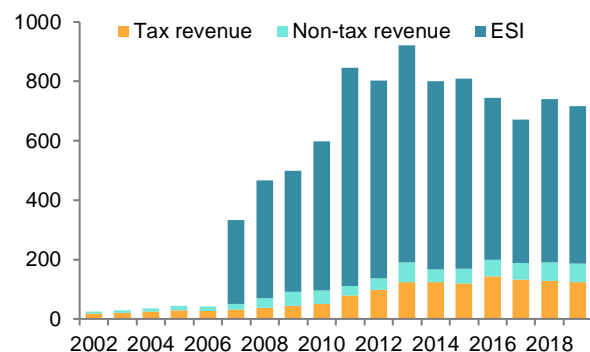
### **3.2. Timor-Leste is Heavily Dependent on ESI.**

**Government revenue comprises tax revenue, non-tax revenue, and the Estimated Sustainable Income (ESI).**<sup>42</sup> The ESI accounts for most Government revenue and exhibits significant volatility – more so than other sources of revenue (Figure 3.1). The ESI reached a peak value of USD 734 million in 2011 and has been declining gradually since, partly due to large of total withdrawals which outpacing petroleum revenues. In recent years, however, the ESI has been largely driven by strong asset revaluations that have affected the balance of the PF. The strong performance of international equity markets in 2017 and 2019 have led to a higher ESI for 2018 and 2020, respectively. In 2018, asset revaluation was negative as global stock markets recorded considerable falls towards the end of the year. In terms of domestic revenue, Timor-Leste tends to rely more heavily on non-tax revenue than its peers – 32 percent of total domestic revenue in 2019 (Figure 3.2).

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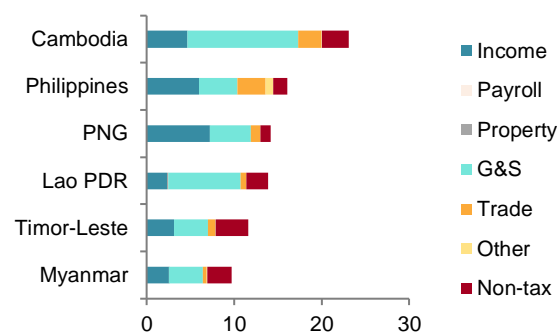
<sup>42</sup> The ESI is computed every year based on existing data and a few assumptions. The key assumptions include the discount rate for future petroleum revenue, as well as forecasts for production level, prices, and production costs. Since the ESI is calculated during the budget preparation process, some additional assumptions (for the final months of the year) are required to estimate the final Petroleum Fund balance.

**Figure 3.1: ESI has dominated Government revenue (USD million)**



Source: Ministry of Finance.

**Figure 3.2: Contribution of non-tax revenue was high compared to peer countries (2019, % GDP)**



Note: Excludes ESI, grants, and social contributions.  
Source: IMF (GFS).

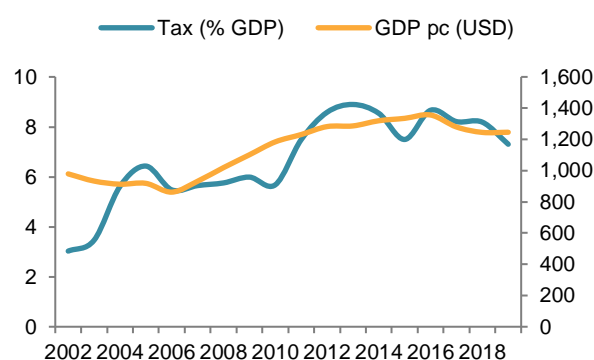
**Tax revenues are low at 8 percent of GDP, but have increased in recent years, partly supported by growing public spending.** Tax revenues averaged about 6 percent of GDP between 2004-2010, after which a notable step change occurred (Figure 3.3). Since 2011, tax collections have averaged 8 percent of GDP. This increase could be partly explained by increased public spending (e.g., through revenues from public construction projects subject to withholding tax) and higher disposable incomes (e.g., rising excise tax collections), as well as improvements in tax administration. The tax cuts introduced in 2008 do not appear to have had an immediate impact on revenue collection – especially in 2009 and 2010. Strong GDP growth in 2007-2010 – averaging 10 percent and a clear sign of expanding economic activities – may have partly compensated the impact of the tax cuts on revenue collection. The relationship between GDP and tax collection was relatively weak until 2008, but it has strengthened since then – illustrating its strong pro-cyclicality.

**The composition of tax revenues has changed somewhat since 2002, with income and excise taxes growing in importance.** Income and excise taxes have increased considerably through time, increasing their weight in total tax collection (Figure 3.4). Excise taxes have experienced considerable growth, rising from 1.1 percent of GDP in 2008 to a peak of 2.9 percent of GDP in 2013 – although they have declined somewhat in recent years. The withholding tax increased from 0.9 percent of GDP in 2010 to a peak of 2 percent in 2012 and has averaged about 1.7 percent since then. The withholding and excise taxes account for about half of total tax revenue collections. Individual and corporate income taxes have remained broadly stable in recent years, accounting for about 20 percent of total tax receipts. Import duties and the sales tax are also a vital source of revenue, jointly comprising about one quarter of the total. However, the services tax provides very little revenue compared to other taxes. Overall, the step change increase in tax collection can be largely accounted by excise taxes and the withholding tax.<sup>43</sup> Tax collection has become less volatile in recent years – as measured by the coefficient of variation. Withholding taxes appear to be more volatile than other types of tax, which can be explained by its strong reliance on public investment – which is quite volatile itself.

<sup>43</sup> The increase in consumption tax revenues (e.g., excise) may have been supported by public spending (in the form of a growing wage bill and social protection payments), while the increase in income (withholding) taxes has been influenced by public infrastructure investments.

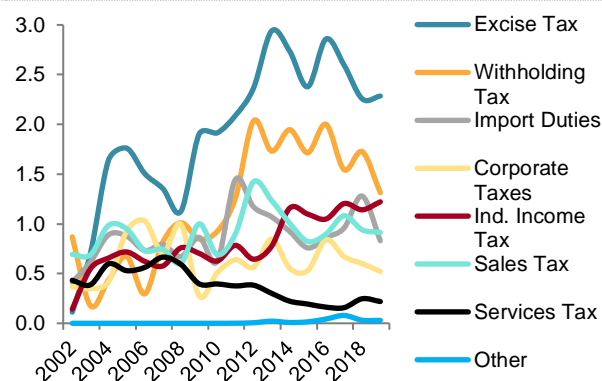


**Figure 3.3: After 2011, tax revenue collection has increased and has strengthened link with GDP**  
(Percent of GDP (left), USD (right), 2012-2019)



Source: Ministry of Finance

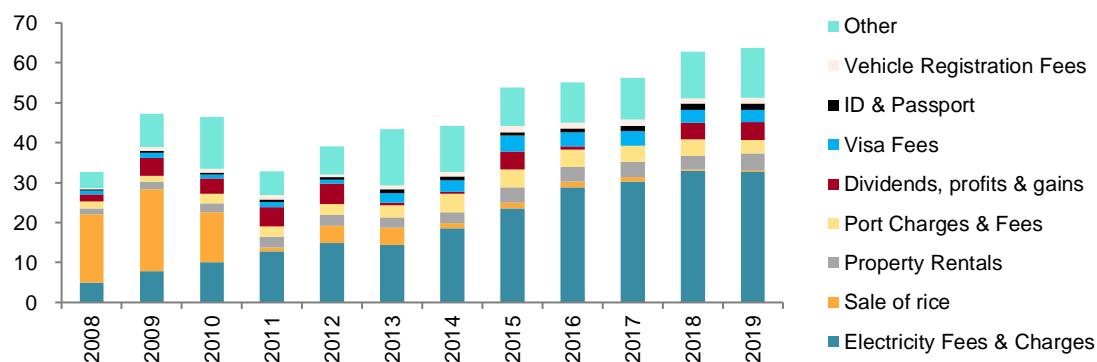
**Figure 3.4: Income and excise taxes have grown considerably through time**  
(Percent of GDP, 2012-2019)



Source: Ministry of Finance

**While non-tax revenues have also grown as a source of revenue, this has been mainly due to electricity fees & charges.** In 2019, over half of non-tax revenues was accounted by electricity fees & charges (Figure 3.5). Revenues retained by autonomous public agencies (APAs) were also significant, mainly owing to the Port Authority of Timor-Leste (APORTIL) – which collects port fees & charges. Other relevant autonomous agencies include the National University of Timor-Leste (UNTL) and the National Communications Authority. In fact, there are 23 revenue-collecting APAs – although none of them is wholly self-funded and thus still rely on Government funding. Property rentals and visa fees are also relatively important sources of revenue.

**Figure 3.5: Revenue collection from electricity fees increased in level and importance**  
(USD million)



Source: Ministry of Finance

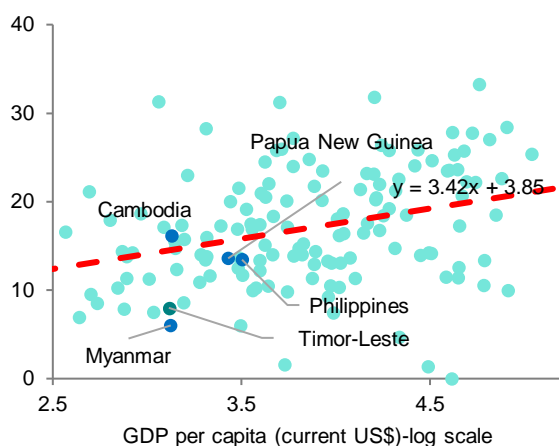
### 3.3. Timor-Leste collects too little, often ineffectively, from its various taxes.

**Despite improvements, tax revenue collection remains considerably below regional and income benchmarks.** The tax-to-GDP ratio increased from about 3 percent in 2002 to a peak of 9 percent in 2013. However, tax collection stagnated since then and still lags significantly by international standards (Figure 3.6). It is also considerably lower than averages for the East Asia & Pacific region and lower-middle-income countries. The tax base remains small, partly because the expansion of economic activity has been driven by the public sector, with limited lasting effects on the private sector. Additionally, low tax rates contribute to sub-optimal revenue collection,



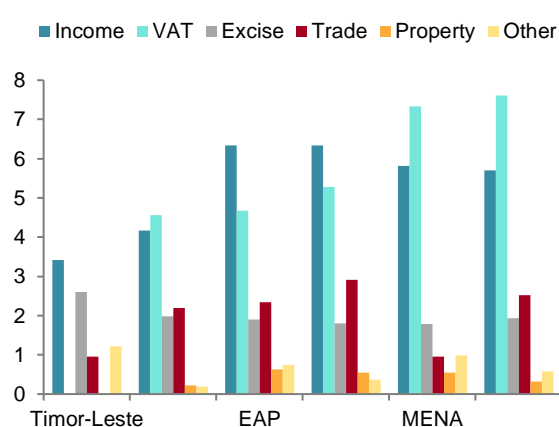
which limits the Government's capacity to mobilize adequate resources to sustainably finance growth-enhancing public spending. In fact, the recent stagnation in tax revenue collection may suggest that the 2008 tax framework has become outdated and unable to raise adequate resources.<sup>44</sup>

**Figure 3.6: Tax revenue was considerably low**  
(Percent of GDP)



Notes: Averages for 2015-2019.  
Source: Ministry of Finance and IMF.

**Figure 3.7: VAT and property tax are absent**  
(Percent of GDP)



Notes: 2017 data  
Source: World Bank.

**Timor-Leste has not yet adopted a value-added tax, which accounts for much of the gap to its peers.** Benchmarking against regional peers suggests that income tax collection is significantly below potential (Figure 3.7). Income taxes, comprising the withholding, individual, and corporate taxes – represented 3.4 percent of GDP in 2017, which was considerably below the regional average of 6.3 percent. Revenues from trade taxes are also comparatively low. In contrast to most country peers, Timor-Leste does not have a value-added tax (VAT). The VAT is a key instrument for tax collection in most countries, suggesting that its introduction in Timor-Leste could significantly enhance tax collection<sup>45</sup>. Many countries also have a property tax, which complements other revenue sources. Looking beyond the EAP region also suggest that the tax revenue shortfall is mainly due to the absence of a VAT and low-income taxes.

**Revenue collection has broadly kept pace with economic activity, but it needs to go well beyond that benchmark.** The estimated buoyancy coefficients<sup>46</sup> were highly uncertain for different types of taxes, which precludes a clear conclusion.<sup>47</sup> Nonetheless, the relatively stable GDP ratios seem to suggest that revenue collection has kept pace with economic activity. However, raising the tax-to-GDP ratio to desired levels will require much stronger domestic revenue mobilization efforts.

<sup>44</sup> This trend precedes that 2017-2018 economic recession.

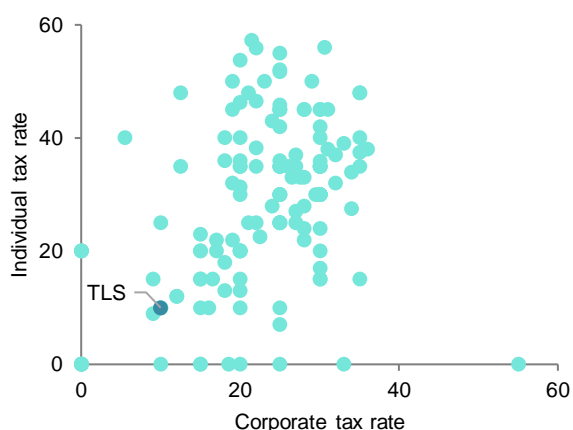
<sup>45</sup> A value-added tax (VAT) is a tax on consumption, collected on a product at every stage of its production during which value is added to. As lower-income households spend a larger share of their income on consumption than higher-income households do, the burden of a VAT is regressive: the tax burden as a share of income is highest for low-income households and falls sharply as household income rises. Countries may take measures to remove the regressivity of VAT. These include (i) exempting social necessities from VAT or (ii) taxing luxuries at high rates and necessities at low rates.

<sup>46</sup> Tax buoyancy, or tax elasticity, assesses whether growth in tax collection has been keeping pace with economic growth over time.

<sup>47</sup> Annual elasticities were characterised by significant variation (with many large negative and positive values), while the results from regression analysis (to estimate a single coefficient for the period) had very large standard errors.

**Tax productivity is relatively low and has stagnated in recent years.** Tax productivity (or tax collection efficiency), which is calculated as the ratio of actual tax revenues (as a share of GDP) and the tax rate, measures efficiency in both tax policy and administration. The results suggest that efficiency for both corporate and individual income taxes has increased somewhat since 2008, but it has been relatively stagnant since about 2014. This highlights the need to undertake reforms to improve the efficiency and effectiveness of the tax system.

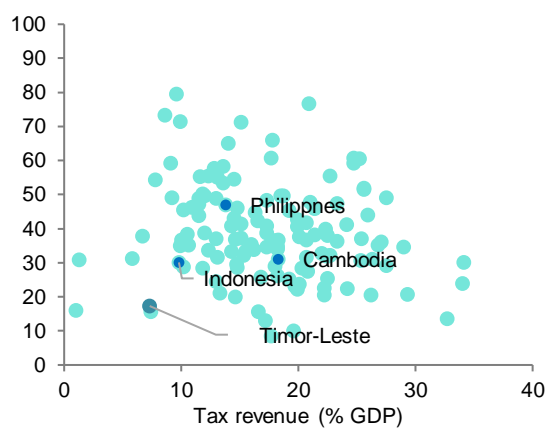
**Figure 3.8: Current rates is among the lowest**  
(Percent)



Source: KPMG.

Note: Sample is restricted to countries with values for both rates.

**Figure 3.9: Tax rates (% commercial profits)**  
(% commercial profits)



Source: Ministry of Finance and World Bank.

Note: The total tax rate includes profit tax, labor tax and contributions, and other taxes.

**The current income tax rate is among the lowest statutory tax rates in the world.** Between 2002 and 2008, natural persons paid a progressive tax according to three income brackets: 10 percent (up to USD 3,368), 15 percent (between USD 3,369 and USD 6,737), and 30 percent (above USD 6,737). Legal persons paid a flat rate of 30 percent. With the Taxes and Duties Act of 2008, the maximum tax rate was lowered to 10 percent.<sup>48</sup> This rate, which is levied on both private and corporate incomes, is among the lowest in the world (Figure 3.8). In the Asia region, the average corporate tax rate is 21 percent, while the average individual tax rate is 28 percent. The statutory corporate and individual tax rates are, respectively, 30 and 42 percent in Papua New Guinea, 30 and 35 percent in the Philippines, 20 and 35 percent in both Thailand and Vietnam, and 25 and 30 percent in Indonesia. In Cambodia, both are 20 percent, while in Myanmar both are 25 percent. In fact, the corporate tax burden in Timor-Leste is one of the lowest in the world – as measured by the total tax rate as a share of commercial profits (Figure 3.9).

**Average effective tax rates are low, owing to a narrow tax base as well as low compliance and enforcement.** Taxes can be grouped by the source of revenue: consumption, labor, capital, and imports. Consumption is subject to a statutory sales tax rate of 2.5 percent and a range of excise taxes on designated goods. Capital income is subject to a tax rate of 10 percent, except for incomes that are already subject to a withholding tax. Labor income is also taxed at 10 percent.

<sup>48</sup> The minimum income tax was removed in 2008, while interest expense is no longer an allowable deduction – except for financial institutions.

Imports of goods are levied an import duty of 2.5 percent. However, effective tax rates<sup>49</sup> can provide a better measure of the tax burden than statutory tax rates.<sup>50</sup> It also enhances comparability across countries. The calculations suggest that average effective rates for 2012-2019 have been around 3 percent for consumption and capital income, and slightly under 2.5 percent for imports of goods.<sup>51</sup> This suggests that the tax burden is even lower than what the statutory tax rates suggest – especially for capital – due to narrow tax bases as well as low compliance and enforcement.

**Table 3.2: Gap in current tax revenue collection and potential**  
(percent of GDP)

	Domestic Revenue	Tax revenue	Income taxes	Taxes on Goods and Services	Trade taxes
Tax potential	20.7	15.0	3.8	7.4	2.0
Tax (policy and administration) gap	8.9	7.9	1.0	4.1	1.1
Actual revenue (average since 2006)	11.3*	7.3	2.9	3.1	0.9

Note: Results are for 2006-2019. \*Including non-tax revenue  
Source: World Bank staff calculations.

**Tax collection is currently significantly below its full potential, suggesting that there is ample scope for tax policy and administrative reforms.** There is considerable potential to mobilize additional domestic revenues. Estimates suggest that tax revenue could more than double when considering the structural factors that account for its underperformance (Table 3.2).<sup>52</sup> The structural gap analysis confirms the skewedness of the current tax composition, particularly the underutilization of consumption taxes. When compared to the level of taxation and a series of structural and institutional determinants in peer countries, Timor-Leste has an average tax potential of 15 percent of GDP, with the corresponding tax policy and administration gap at 7.9 percent of GDP. While the gap is measured structurally, the underutilization is partly explained by the fact that consumption taxes are significantly underused when compared to peer countries. Indeed, the average tax policy and administration gap regarding goods & services is estimated at 4.1 percent, which can be further corroborated by the absence of a VAT and an insufficiently diversified tax base.<sup>53</sup> The tax gap for both income taxes and trade taxes is estimated at around 1 percent. The gap is estimated at 8.9 percent of GDP, considering all revenues sources, including non-tax revenues. Another method to estimate the tax potential such as a proxy on tax bases

<sup>49</sup> The average effective tax rate on consumption can be calculated as the ratio between consumption-related tax collection (namely, from excise and sales taxes) and final consumption expenditure (net of tax). Final consumption expenditure – from both the private and public sectors – is taken from the national accounts and is discounted by the value of related taxes. It is not possible to estimate an effective tax rate on labour since there is no data on payroll tax collection. The effective tax on capital can be computed as the sum of individual and corporate income tax collection (excluding wages) as a share of total gross operating surplus. Finally, the measure for imports is reported as the value of import duties as a share of imports of goods.

<sup>50</sup> The tax base refers to taxable income or consumption. Narrow tax bases can result from exempted income (either a type of income, such as dividends, or incomes below a threshold) and exempted goods and services. Moreover, allowable deductions and other provisions (such as loss carry forward) also reduce taxable income.

<sup>51</sup> Although the AETR for consumption is above the sales tax rate, the excise tax rates are usually above 10 percent (including those set at a value per unit) and relate to a non-trivial proportion of consumption. If only computed for the sales tax, the AETR for consumption is less than 1 percent.

<sup>52</sup> The structural domestic revenue potential, tax revenue potential by instrument type, and related tax gaps were estimated in the context of a large group of peers using panel data. The predicted tax-to-GDP ratio is calculated using the estimated coefficients of the regression specification and Timor-Leste's specific characteristics. Consistent with other studies, greater trade openness, lesser reliance on agriculture, and lower corruption levels are associated with higher tax-to-GDP ratios. However, the results should be interpreted cautiously, as they can be sensitive to modelling assumptions and estimation techniques.

<sup>53</sup> These include excise taxes, for which collection in Timor-Leste is relatively high.

from the National Accounts also confirms that the compliance gap is quite high for corporate taxation, while for individual taxes it has declined.

### **3.4. Despite endeavors to improve tax collections, the need and scope for additional reforms remain large.**

**The stated policy objective is to achieve a domestic revenue level of 18 percent of GDP by 2023.**<sup>54</sup> The program of the VIII Constitutional Government asserts that revenue diversification is critical to reduce the reliance on the PF. For that purpose, the Government aims to improve institutional capacities (especially human resources and systems) and approve new legislation (including a review of the current tax law and the introduction of a value-added tax). It also aims to promote efficiency and effectiveness in tax collection, while maintaining a neutral and competitive tax burden. Domestic revenues (which include non-tax revenues) have been consistently around 11-12 percent of GDP since 2014. Hence, there remains a significant gap between the Government targets (e.g., 15 percent of GDP by 2020 and 18 percent by 2023) and the actual amounts collected. Renewed efforts will be required to approach those targets. Recent research suggests that a minimum tax-to-GDP ratio of 15 percent is associated with significant accelerations in economic growth.<sup>55</sup> Below that threshold, economic growth is likely impacted by poor financing of basic public services that are crucial for growth – such as education and health. Tax collection averaged 8 percent of GDP since 2011. Greater diversification of revenue sources and efficiency in revenue collection will be key to enhance domestic revenue mobilization – and thus support medium-term fiscal sustainability.

**The legislation governing Timor-Leste’s revenue framework was approved more than 10 years ago and needs to be updated.** The tax regime is based on the provisional legislation passed by the United Nations Transitional Administration in East Timor (UNTAET) – Regulation 2000/18 on a Taxation System for East Timor and related amendments.<sup>56</sup> Most of the current tax instruments were developed by then. The latest changes were in 2008 where the Parliament passed the Taxes and Duties Act (Law 8/2008) – an overarching law governing direct and indirect taxes – to “relieve the fiscal burden that has been considered to be disproportionate and excessive in view of the reality of the country.” Most of the modifications reduced the statutory tax rates applied, which was enabled by growing (offshore) petroleum revenues and a view to attracting foreign investment. The Taxes and Duties Act also introduced special provisions for the petroleum sector. This remains the main legislation governing the tax framework.<sup>57</sup>

**The Taxes and Duties Act has some shortcomings, which undermine the efficiency and effectiveness of the tax system.** There is often a trade-off between the complexity of a tax regime and its administrative costs. The more tax thresholds, exemptions and rules are created, the more challenging (and costly) it is to comply with and enforce the tax code. It may also encourage informality. The current legislation is arguably complex and thus difficult to be

<sup>54</sup> This is significantly above the 11-12 percent revenue, comprising tax revenue, non-tax revenue, and ESI, collected since 2014

<sup>55</sup> IMF (2016), ‘Tax Capacity and Growth: Is there a Tipping Point?’ The authors suggest that countries with low tax-to-GDP ratios should aim for 15 percent. It is also mentioned that other sources of revenue (e.g., natural resource rents) have not been found to be closely related to economic development.

<sup>56</sup> For instance, regulations 2000/32, 2000/35, 2001/16, 2001/17, 2001/20.

<sup>57</sup> Others include the Private Investment Law (Law 15/2017), which provides significant tax benefits for eligible investors. The benefits include income tax, sales tax, and service tax exemptions, as well as customs duty exemptions – from 5 to 10 years, depending on the location of the investment. These benefits apply to investment projects in certain economic sectors (ISIC Rev. 4 classification in brackets): agriculture, forestry and fishing [A]; manufacturing [C]; accommodation [I.55]; and tour operator activities [N.7912].

adequately implemented by an incipient tax administration system. Tax rates vary by sector and residency status and include several exemptions. Rules and regulations are enforced by institutions that lack sufficient technical and operational capacity, which leads to inefficiencies and low revenue collection. Complexity makes it difficult to distinguish between (legitimate) tax avoidance and (illegal) tax evasion thus increases the potential for misinterpretation. Hence, streamlining and simplifying the tax framework could yield considerable benefits.

### **Recent fiscal reform efforts have not led to new legislation or a tangible impact on systems.**

The Fiscal Reform Commission (FRC) was formed in 2015 to lead a comprehensive fiscal reform aimed at increasing revenue, securing fiscal sustainability, and creating conditions for economic growth. The FRC drafted a General Tax law (revising the Taxes and Duties Act), a new VAT law, a new Customs Procedures Code decree law, and a decree to transform the Tax and Customs General Directorates in the Ministry of Finance into semi-autonomous authorities. In 2018, the Tax and Customs Authorities were established as semi-autonomous agencies. However, many of the other reforms have not been approved and/or fully implemented, partly owing to the political uncertainty observed since 2017. Meanwhile, the FRC was dissolved in 2019. However, there is a renewed momentum to revise outdated legislation, modernize the revenue system, and introduce new legislation with the creation of a unit within the Ministry of Finance to advance comprehensive Public Financial Management and fiscal reform.

## **3.5. How can Timor-Leste Collect More Revenues?**

**There has been some progress in improving tax administration and simplifying the tax structure, but further reforms are needed.** It is important to recognize key achievements since independence, when institutional and human capacities were extremely low. Since 2002, there has been an effort to strengthen institutions and build capacity in the civil service. In 2008, key legislation was enacted reducing the number of wage income tax thresholds and the number of excisable goods – thus somewhat simplifying the tax system. More recently, IT systems have been (or are in the process of being) upgraded, and the Tax and Customs Authorities were created. Tax collection as a share of GDP increased, albeit partly driven (at least indirectly) by public spending. Nonetheless, the analysis suggests that domestic revenue performance has been lagging, and even stagnated in recent years. Hence, there is considerable scope to improve the level and efficiency of revenue collection (Table 3.3).

**Table 3.3: Policy recommendations to improve revenue collection.**

Recommended Action	Timeline	Impact
Introduce a <b>value-added tax (VAT)</b> to enhance domestic resource mobilization, while adopting complementary measures to ensure equity	1-2 years	Very high
Raise outdated <b>excise tax</b> rates (e.g., on alcohol and tobacco) and Introduce a <b>sugar tax</b> to increase revenues and improve health outcomes	1-2 years	Very high
Produce an assessment evaluating the potential of a <b>property tax</b> , and regularly report on <b>tax expenditures</b> (while planning a gradual phasing out).	1-2 years	High
Streamline and raise <b>income tax</b> rates, with a view to promoting greater alignment with regional peers.	1-2 years	High
Improve <b>revenue administration</b> by modernizing the tax system and investing in capacity.	2-5 years	High

### **Improving tax policy by increasing tax rates and identifying new tax potential**

**Introducing a value-added tax (VAT) would generate considerable revenue in an efficient manner.** It is crucial to revise and approve the draft VAT law with a view to introducing the tax within 2-3 years. The VAT is a domestic (final) consumption tax that helps broaden the tax base



and improve revenue diversification. A single rate could be levied at 10 percent – which is close to the ASEAN average – while eliminating the sales tax to simplify the tax system and avoid duplication. The VAT indirectly taxes individuals that would otherwise not comply with other taxes (such as income), thus increasing the efficiency of the tax system. Introducing a VAT could promote greater Government accountability to citizens. Concerns over its regressive nature can be addressed through pro-poor public spending or through targeted exemptions (e.g., food predominately consumed by poor households). However, it is important to restrict exemptions, as some could disproportionately benefit wealthier households and erode the tax base. The introduction of a VAT could improve record keeping (by businesses), with potential spillover effects on bank credit. It could also encourage formalization (i.e., tax registration) and generate information to identify income tax avoidance. The VAT could zero-rate exports with a view to support value addition, although there is currently limited transformation due to low productive capabilities.<sup>58</sup>

**Raising income tax rates could boost revenues without deterring business activity or undermining the purchasing power of individuals.** There is significant scope to increase tax rates. At 15 percent, the corporate tax rate would remain low by international standards<sup>59</sup>, and thus unlikely to affect (foreign) investment. In fact, evidence suggests that firms are more responsive to other factors (beyond tax) when deciding where to locate their operations.<sup>60</sup> Regarding individual incomes, the current differentiated treatment may create uneven tax burdens across types of income. The separate wage income tax – which is independent from the (broader) income tax applied to individuals – may lead to a higher burden on wages, thus promoting inequity. Merging the wage income tax and the (general) personal income tax could address this issue – thus creating a unified tax on all income. The application of extensive withholding (mostly as a final tax) would have the benefit of avoiding the need for filing annual returns. Introducing multiple (individual) income brackets could support tax progressivity, although that could come at the cost of complexity and create incentives for tax avoidance and evasion.<sup>61</sup> Moreover, a unified (corporate and individual) income tax rate would reduce the incentives and scope for tax avoidance schemes – by disguising personal income as corporate income. Finally, income coverage could be expanded since dividends are not currently taxed – although they were up until 2008.

**Raising (outdated) excise tax rates and introducing a sugar tax would increase revenues while tackling emerging health and environmental concerns.** Taxing goods that present a threat to public health and safety could deter their consumption while supporting revenue mobilization efforts. The introduction of a sugar tax could raise significant revenue while discouraging the consumption of sugary drinks. This could help tackle obesity and diabetes, which entail significant costs to society and the healthcare system.<sup>62</sup> The initial tax rate could be set at

<sup>58</sup> This could include merchandise exports and well as travel and transport services. However, zero-rating can increase the burden on the refund system, when compared to an exemption. Refunds and reverse charges should be considered when implementing a VAT.

<sup>59</sup> The G20 leaders have recently endorsed a global corporate minimum tax of 15 percent during the Rome G20 summit on October 30-31, 2021.

<sup>60</sup> These include market size, income levels, the availability of affordable and quality inputs (e.g., skilled workers and land tenure), adequate infrastructure, legal systems (e.g., contract enforcement), as well as macroeconomic and political stability. Hence, tax policy is a poor instrument to attract foreign companies.

<sup>61</sup> Progressive tax rates increase administrative costs for both taxpayers and tax administrators, while a flat rate is generally regressive from an equity perspective. Hence, the benefits of introducing tax thresholds need to be weighed against these costs – especially when capacities are limited.

<sup>62</sup> Diabetes prevalence in adults is estimated to be 7 percent in 2019 (nearly double from that estimated in 2010), while overweight prevalence was estimated at 19 percent for adult males (WDI).

around 10 percent, which would be broadly in line with regional rates.<sup>63</sup> Moreover, existing excise tax rates were set in 2008 and have been gradually eroded by inflation – for those set on a per unit basis. It is therefore pertinent to reassess these rates in view of the twin objectives of raising adequate revenues and tackle public health and environmental concerns. For example, higher excise tax rates on tobacco products and alcoholic beverages could help address emerging health concerns (such as lung cancer and alcoholism) while raising revenue. Higher excises on gasoline and diesel, as well as on small passenger vehicles, could help promote alternative sources of energy (e.g., renewables and LNG) and modes of transport.<sup>64</sup> Only small passenger vehicles with a value above USD 70,000 currently pay excise tax – which means very few vehicles are taxable. The current threshold could be lowered, or even eliminated – although vehicles for public transportation could be tax exempted. In fact, thresholds could be introduced based on engine size (introducing progressivity), but this could raise administration costs. The collection of excise taxes requires physical control (e.g., at importation), therefore it is important to keep the number of excisable goods at manageable levels.

**A property tax could support the diversification of tax sources and raise further revenue in the medium term.** Efforts to diversify revenue sources and increase tax collection would benefit from an assessment exploring the potential and viability of new taxes. A property tax (or municipal tax) could provide an additional source of finance and even support the ongoing decentralization process. While it is vital not to overburden taxpayers and tax administrators, a focus on compliance and enforcement would ensure the economy ‘grows into’ the tax system. Developing a good cadastre, using mass-valuation techniques (instead of market-based valuations), and adopting a uniform rate would help tackle some of the challenges typically associated with the adoption and implementation of a property tax. Satellite imagery could support the development of a comprehensive cadastre, as well as enable a regular and inexpensive monitoring of the tax base. Moreover, real-time satellite data can be cross-checked with administrative data to identify tax evasion. Developing (local) capacities for tax administration and enforcement would also be crucial.

**Minimizing discretionary tax exemptions could yield significant benefits, while reporting tax expenditures would enhance transparency.** Fiscal incentives include tax exemptions (or holidays), reduced/preferential rates, tax credits, investment allowances, among others. Eligibility may vary according to sector, location, investment volume, and firm characteristics such as size, ownership, and export-orientation. However, fiscal incentives can generate considerable revenue losses (especially if investment would have taken place without them), distortions (different treatment), administrative costs, leakages, and even corruption.<sup>65</sup> To date, there is no measure of tax expenditures, but these are thought to be high. For example, the national accounts estimated import subsidies at \$100 million in 2018, which is not far from total tax revenue collection in the same year – \$128 million. The empirical evidence suggests that tax incentives are more effective in developed countries and that investments are not strongly influenced by low(er) tax rates in countries with a weak investment climate.<sup>66</sup> Hence, removing ineffective tax incentives would promote transparency and fairness, as well as minimize tax expenditures (i.e.

<sup>63</sup> Since the per unit tax is easier to apply (upon physical inspection), an ad valorem rate could be calculated on sample market values and then transformed to a per unit rate. However, values should be periodically adjusted for inflation.

<sup>64</sup> Taxing luxury goods would also improve the income distribution, since these are predominately purchased by wealthier households (e.g., passenger vehicles).

<sup>65</sup> Tax incentives can be abused by existing enterprises disguised as new ones through nominal reorganization. Additionally, for foreign investors, tax incentives are frequently far from being the most important determinant to invest in a new country. Tax incentives could also be of questionable value to a foreign investor because the true beneficiary of the incentives may not be the investor, but rather the treasury of his home country.

<sup>66</sup> See “Foreign Direct Investment Determinants in OECD and Developing Countries”.

foregone revenues) – without undermining investment.<sup>67</sup> Reporting on tax expenditures would help identify ineffective exemptions and provide a guide for their gradual phasing out.

### **Strengthening taxation legal framework**

**Revising the Taxes and Duties Act of 2008 would help improve the legal framework.** It is pertinent to revisit the current revenue framework to lay the foundation for a modern tax system. This will require addressing policy design shortcomings (e.g., unclear or omitted provisions), revising existing instruments, and adjusting tax rates. A new (general) tax law should comprise all tax measures, including new instruments, and incentives. Developing and approving a Tax Code that lays out clear operational procedures, rules and regulations would improve tax administration and complement the recent Customs Code (Decree-Law 14/2017) that codified the customs legal framework. Simplifying and streamlining existing tax laws and processes/procedures would support (voluntary) compliance and enforcement. An adequate national tax regime could comprise an (integrated) income tax, a broad-based consumption tax (VAT), an excise tax regime, an import duty compliant with international standards (including ASEAN), and could be supplemented by a property tax.

### **Enhancing tax administration capacity**

**A focus on modernizing systems, updating legislation, and building human capacity is crucial.** An efficient tax system can enhance revenue performance without deterring private investment and household consumption. The adoption and full implementation of appropriate IT systems will reduce collection costs, enhance information sharing across relevant agencies, integrate and mainstream tax procedures, and minimize errors and arrears. In addition, efficient revenue generation would require a revision of existing legislation, as well as building institutional and human capacities within the Tax and Customs Administrations – including enhancing and clearly defining their powers.

**Improving revenue administration is vital to increase (voluntary) compliance and enhance tax collection.** The implementation of revenue policies depends critically on the quality of revenue administration. Key areas of improvement include taxpayer registration, access to information, risk management, and auditing. Some measures could include improvements to the taxpayer database – by addressing inconsistencies, errors and information gaps – and greater integration between the business registration process (in SERVE) and tax registration. Information sharing could help classify taxpayers as active and inactive, and thus improve non-compliance statistics. Tax identification number (TIN) assignment should be in accordance with international best practices and should be consolidated – as some taxpayers have multiple TINs, which complicates assessment of tax liabilities and audits. The penalties and fines imposed are also thought to be insufficient to significantly deter non-compliance. There is also a need to improve tax auditing by enhancing human resources and adopting a risk-based model.<sup>68</sup> Improved monitoring of revenue arrears and stronger debt recovery measures are needed to avoid long backlogs that become irrecoverable. The dissemination of complete, accurate and

<sup>67</sup> Under the Private Investment Law, investors may be eligible to apply for a private investor certificate and have (generous) tax exemptions granted for a certain period. It is not clear if these are subject to a policy review to assess the impact of these exemptions on investment and employment levels.

<sup>68</sup> The model should combine data sources (e.g., customs data and procurement contracts) to identify discrepancies and irregularities. Risk management can be significantly improved through data integration – since information sharing is currently undermined by the use of different systems (that are not interfaced) across agencies.

clear tax information would help clarify tax obligations and steps to comply.<sup>69</sup> This could be complemented by tax education, public awareness programmes, and enhanced taxpayer services – such as call centers to provide advice and tax centers to support electronic filing.<sup>70</sup> The development of compliance improvement plans – by the Tax and Customs Authorities – could help address the most pressing constraints.

**Modernizing tax administration would improve efficiency by reducing non-compliance and collection costs.** A modern revenue administration should comprise clear and simple regulations (to facilitate their application and compliance), efficient collection systems and procedures, risk-based analysis, service orientation, function-based organizational structures, and high level of automation. Some of these can be supported by information technology (IT) solutions. It is therefore important to fully implement the rollout of ASYCUDA World and SIGTAS v.3 and ensure greater interoperability with other relevant IT systems. Online systems for lodging tax statements save time, minimize errors, and facilitate the reconciliation of accounts. Affordable, fast, and reliable internet is key for taxpayer accessibility, but bandwidth and server capacity are also important to deal with an expanded electronic filing system (paperless tax administration with returns, payments, invoices and other services done online). Therefore, it is crucial to improve service access and quality.

**Investing in capacity building, training, and recruitment is of vital importance.** Human resource is a cross-cutting theme, since the effectiveness of policy, legislation, procedures, IT systems, customer service, and audit hinge on the availability of a sufficient number of qualified staff. Institutional capacity is limited, with the Tax and Customs Authorities being understaffed and lacking skills and required equipment (for inspection). Providing tailored training and capacity building can support the operational capabilities of the tax system. It will be important to work closely with educational institutions – such as the National University of Timor-Leste – to ensure that there is a stream of qualified resources that can be recruited into the civil service. Meanwhile, because it may not be possible to rapidly increase the number of skilled personnel, it is critical to find a balance between policy objectives and the administrative burden – through the simplification of tax instruments in line with existing capacities. Moreover, improving tax analysis would facilitate and improve decision-making. For instance, several countries have conducted tax-related assessments, such as the Tax Expenditure Assessment (TEA), Tax Policy Assessment Framework (TPAF), Tax Administration Diagnostic Assessment Tool (TADAT), and Revenue Administration Gap Analysis (RA-GAP). Accurate revenue forecasting, a more granular assessment of tax gaps (using administrative data), and a cost-benefit analysis on tax expenditures (using tax exemption data) would be useful to inform policy making.

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<sup>69</sup> Laws and procedures are available in the MoF website and relevant offices but are not always up to date and sometime are only in Portuguese – undermining access to information.

<sup>70</sup> These measures would increase voluntary compliance by supporting self-assessment.

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## Annex 1: Key Indicators

**Annex Table 1: Economic Indicators**

	2016	2017	2018	2019	2020
<b>Real sector</b>	<i>(annual percentage change, constant)</i>				
Gross domestic product (non-oil)	3.4	-4.1	-1.1	1.8	-7.3
Final consumption expenditure	1.7	-1.2	0.8	3.4	-2.8
Gross fixed capital formation	15.3	-16.7	-1.5	-17.2	-46.5
Consumer price index, period average	-1.5	0.5	2.3	0.9	0.5
<b>Fiscal sector</b>	<i>(percentage of non-oil GDP)</i>				
Total Revenue	45	42	48	43	46
Domestic revenue	12	12	12	11	12
Estimated Sustainable Income	33	30	35	32	35
Total expenditure	99	76	77	74	72
Recurrent expenditure	62	59	52	55	62
Capital expenditure	36	16	25	19	10
Fiscal balance	-54	-34	-29	-31	-26
<b>Monetary and Financial sector</b>	<i>(as stated)</i>				
Credit to the private sector (% growth)	-5.3	24.5	-2.4	4.3	11.2
Lending interest rate (%)	14.5	12.1	11.9	12.0	11.3
Nominal effective exchange rate (index)	94.4	94.8	96.3	97.4	98.7
Real effective exchange rate (index)	110.9	109.0	111.2	112.0	113.2
<b>External sector</b>	<i>(percentage of non-oil GDP)</i>				
Current account	-33	-18	-12	8	-19
Goods and services	-68	-60	-60	-55	-50
Primary income	33	46	54	67	39
Secondary income	2	-4	-6	-4	-9
Capital account	3	2	3	2	1
Financial account	29	31	16	-1	17
Direct investment	0	0	3	4	-40
Portfolio investment	42	21	13	-16	58
Other investment	-12	9	0	10	-2
Net errors and omissions	-9	1	1	-9	2
Change in reserves	9	-16	-8	1	0
<b>Memorandum items</b>	<i>(as stated)</i>				
Oil production (million BOE)	47	42	39	38	36
Petroleum Fund, closing balance (USD million)	15,844	16,799	15,804	17,692	18,991

Source: Ministry of Finance

