

INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT

1. Timor-Leste has made progress in state building since its independence in 2002. Access to essential services has improved, but key human development indicators remain low. The country remains in a fragile and conflict-affected situation, and is a small island developing state with a narrow economic structure, increasing inflation, volatile food prices, a weak private sector, a high cost of service delivery, and a large reliance on government spending.¹ Environmental degradation and climate change risks pose challenges to agriculture and food security, social well-being, and sustainable development. The government's vision of achieving a vibrant economy hinges on prudent and effective use of revenues from petroleum production to finance investments in physical infrastructure, human capital, and institutions to support economic diversification and growth. This inclusive and sustainable growth assessment lays out the rationale for the Asian Development Bank (ADB) country partnership strategy (CPS) for Timor-Leste, 2023–2027.

A. Growth, Poverty, Inequality, and Other Development Dynamics

1. Economic Growth Trends and Drivers

2. **Economic growth.** Rising government expenditure, funded from offshore petroleum income, has underpinned gross domestic product (GDP) growth.² Real GDP grew at an average of 7.9% per annum during 2007–2013 before slowing to 1.5% during 2014–2019 as the government's large capital investments slowed (Figure 1). In 2017–2018, political uncertainty constrained public spending because of delays in budget approvals, resulting in a contraction of GDP of –3.1% in 2017 and –0.7% in 2018. The 2018 elections ended the political impasse, and real GDP growth recovered to 2.1% in 2019. However, in 2019, the failure to approve the 2020 state budget triggered another bout of political uncertainty. The new coalition, formed in May 2020, reestablished stability but the decline in public spending from the delayed budget approval, combined with lockdown measures and global economic slowdown caused by the coronavirus disease (COVID-19) pandemic, led real GDP to contract by –8.6% in 2020. Exports of coffee, the main non-oil export, fell to zero. Economic recovery in 2021 was hindered by a second COVID-19 wave and the most severe floods since 1973.³ Growth is estimated at 1.5% for 2021 and forecast at 2.5% for 2022 and 3.1% for 2023. The adverse socioeconomic impacts of the COVID-19 pandemic are likely to be long lasting and intensified by the Russian invasion of Ukraine, which has already increased inflation. The lack of economic diversification and heavy reliance on imports of food and fuel make Timor-Leste vulnerable to global economy shocks.

3. **Sector share, employment, and productivity.** The production base and competitiveness in Timor-Leste is limited partly because of a weak private sector, poor internal and external connectivity, and the relatively small size of the domestic market. The major

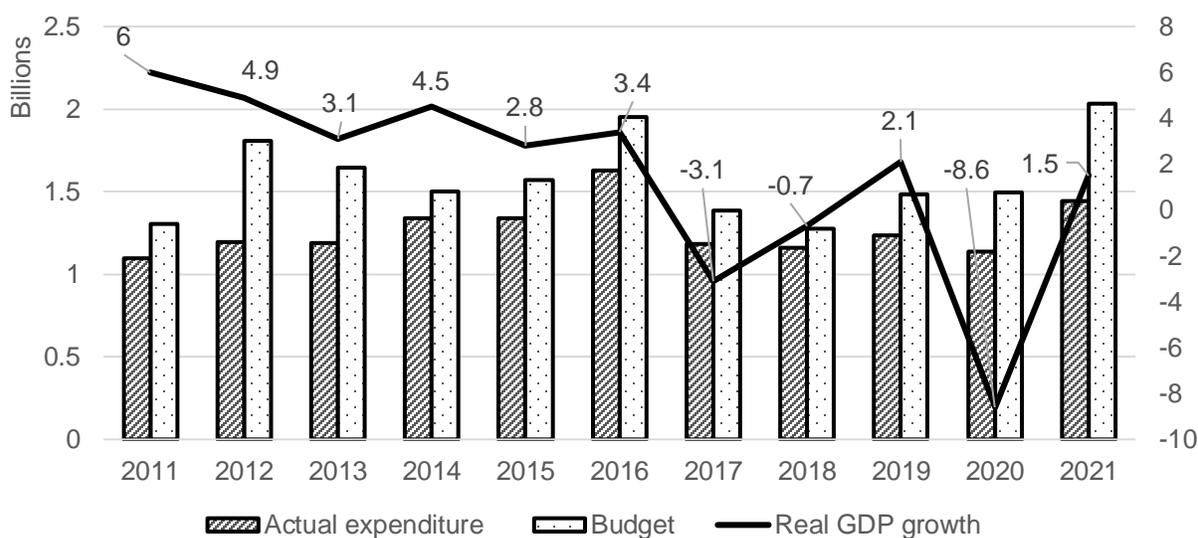
¹ A country is considered in a fragile and conflict-affected situation if the average rating is 3.2 or less in the country performance assessment of the Asian Development Bank (ADB) and the country policy and institutional assessment of the World Bank. The score for Timor-Leste is 3.1.

² GDP is used to refer to the domestic economy, excluding production activity, in areas of joint sovereignty, such as the Joint Petroleum Development Area. The contribution of the oil and gas sector to GDP was 16% in 2020, but will decline as current reserves come to an end. However, the Timor-Leste Petroleum Fund continued to fund a large share of public spending, averaging 88% per year during 2015–2020.

³ Neves, Guteriano. 2021. [Timor-Leste: Natural Disasters and COVID-19 Take Their Toll](#). *The Diplomat*. Stringent lockdown measures included a “sanitary fence” around Dili. Congested housing and limited sanitation increased the risk of community transmission. The national vaccination program, launched in April 2021.

contributors to GDP in 2020 are the public sector at 30%, agriculture at 19%, small-scale wholesale and retail activities at 16%, real estate activities at 12%, and construction at 11%.. The share of manufacturing has remained negligible, accounting for only 2% of GDP in 2020.⁴ About 70% of Timor-Leste's population is rural, and 66% of households are involved in some form of agricultural activity.⁵ The share of agriculture in GDP decreased from 30% in 2008.⁶ Agricultural productivity is very low, and the sector has untapped potential. The country has underdeveloped productive capacity, with a Productive Capacities Index score of 29.28 that is below the average of small island developing states.⁷ Formal employment opportunities are mostly in the public sector.⁸

Figure 1: Gross Domestic Product Growth (%)



Sources: Government of Timor-Leste, Ministry of Finance. [Budget Transparency Portal](#). (accessed 4 Mar 2022), Government of Timor-Leste.2020. [National Accounts 2001-2020](#). Dili. and Government of Timor-Leste. 2021. [Timor-Leste Preliminary Non-Oil GDPe 2020 Growth Rate](#). (accessed 9 Jun 2022)

4. **Petroleum wealth.** Petroleum revenues represented 88% of total government revenues during 2015–2020, making Timor-Leste one of the world's most natural resource-dependent countries.⁹ Petroleum wealth provides a unique opportunity for development, although the production from current oil field has shown a declining trend since 2007.¹⁰ The Timor-Leste

⁴ Government of Timor-Leste. 2020. [National Accounts 2001-2020](#). Dili

⁵ Government of Timor-Leste. 2015. [2015 Timor-Leste Population and Housing Census](#). Dili.

⁶ Government of Timor-Leste. 2020. [Timor-Leste Agriculture Census 2019: National Report on Final Census Results](#). Dili.

⁷ United Nations Conference on Trade and Development. [Productive Capacities Index](#).

⁸ The public sector includes public administration, defense, education, human health, and social work activities.

⁹ All petroleum revenues and investment returns are paid into the Petroleum Fund, managed by the Central Bank, which is mostly invested in high quality international bonds and equities.

¹⁰ Government of Timor-Leste. 2022.. [State Budget 2022: Book 1](#). Dili. As the Bayu-Undan field is expected to become depleted in 2023, decisions on future developments also impact the long-term prospects of the Petroleum Fund. Timor-Leste became a major shareholder of the Greater Sunrise project in 2019, acquiring 56.6% of the equity from two multinational oil companies in the Greater Sunrise Joint Venture through an investment of \$650 million. The government plans to develop a liquefied natural gas plant, oil refinery, logistics base, new townships, and transport infrastructure, but the commencement of the project is uncertain.

Petroleum Fund's net assets peaked at an all-time high of almost \$19.6 billion in 2021.¹¹ This provides a cushion to support medium-term public investments and to finance imports. The government has expressed a commitment to long-term sustainability of the Petroleum Fund through increased revenue mobilization and enhanced public financial management (PFM).¹²

2. Macroeconomic Balances and Inflation

5. **Fiscal policy and balance.** Petroleum Fund withdrawals financed 68% of public spending during 2016–2020 to pay for increases in the public sector payroll, expansion in pensions and other social assistance programs, and large capital investments in new infrastructure.¹³ Excluding petroleum revenues, the fiscal balance has been in deficit over the same period. With the slowdown in public investment in 2017–2019, the deficit narrowed from 53% of GDP in 2016 to 25% in 2020. It rose to 62% in the 2022 budget because of the large jump in government spending and decline in domestic revenues. Current tax rates are low and tax bases narrow because of the limited size and scope of the formal private sector. Domestic revenues averaged only 13% of GDP during 2015–2020. The Fiscal Reform Commission, created in 2016 to design and implement comprehensive reforms, was decommissioned in 2019, and little of the planned legislation was enacted. Political instability also slowed the implementation of reforms to increase tax revenues. However, the government recognizes the need to increase domestic revenue collection, and a new umbrella law on PFM was approved by Parliament in 2021 and accompanying legislations are being drafted.¹⁴

6. **COVID-19 response.** In 2020, the government transferred \$333.2 million from the Petroleum Fund toward a COVID-19 emergency fund to finance a range of policy responses.¹⁵ Medium-term strategies to limit the socioeconomic consequences of the slowdown are included the government's 2020 Economic Recovery Plan.¹⁶ The 2021 budget in the amount of \$2.0 billion, the largest at the time, aimed to provide fiscal stimulus and finance economic recovery.

7. **Trade and current account.** Timor-Leste has a structural trade deficit, averaging 61% of GDP in 2015–2020. Merchandise imports are mostly sourced from member states of the Association of Southeast Asian Nations (ASEAN), in particular Indonesia. The country exports a narrow range of products. Agricultural products, mainly coffee, make up the bulk of non-oil exports. Coffee provides cash income to about 20% of households. Exports of coffee fell by 84% in 2020 because of the COVID-19 pandemic. There is potential to increase coffee production and develop other high-value agricultural exports, such as fresh produce, spices, marine products, and timber products. Travel-related service exports, mostly related to business travel, are the second biggest source of non-oil foreign exchange, which fell from 77% of service exports in 2019 to 57% in 2020 but is gradually recovering (footnote 4). Remittances increased from 2.4% of GDP in 2013 to 8.2% of GDP in 2020.¹⁷ Income from oil production resulted in large current account surpluses during 2005–2015, but the current account went into a deficit of

¹¹ Central Bank Timor-Leste. 2021. [Petroleum Fund of Timor-Leste, Quarterly Report, vol 17 no. XIV](#). Dili.

¹² The estimated sustainable income measures the level of resources that can be sustainably withdrawn from the Petroleum Fund annually, calculated as 3% of the net present value of petroleum wealth.

¹³ Excluding capital spending in the Oecusse Special Administrative Region and Atauro special economic zones.

¹⁴ Government of Timor-Leste. [National Parliament overall approves the Law Proposal on the General State Budget Framework and Public Financial Management](#). (accessed 10 Jun 2022)

¹⁵ Such as subsidies for wages and salaries, partial or total waivers on utility bills and rent on state properties, credit guarantees for microenterprises, and cash transfer programs.

¹⁶ Government of Timor-Leste. 2020. [Economic Recovery Plan](#). Dili.

¹⁷ World Bank. [Personal remittances received \(% of GDP\) – Timor-Leste](#). (accessed 9 Jun 2022).

34.7% of GDP in 2016, returning to a surplus of 7.8% in 2019. In 2021, the current account is estimated to be in a deficit of –39.1% of GDP because of high imports and diminishing production from the current oil fields.

8. **External debt and international reserves.** The government began sovereign borrowing to finance infrastructure investments in 2012 and signed loan agreements with ADB, the Japan International Cooperation Agency, and the World Bank to upgrade national roads; these total \$514.6 million, of which \$271.7 million is from ADB.¹⁸ In 2019, the government announced plans to increase and diversify the loan portfolio beyond road transport to other strategic sectors, including water and sanitation, education, and housing. In 2020, it signed loans in the water and education sectors with the World Bank.¹⁹ ADB’s portfolio diversified to include its first-ever loans for the airport, water, and energy sectors to Timor-Leste in 2021. The share of expenditure funded by loans was 3% of the budget in 2018, 7% in 2019, and 3% in 2021 and 2022. Timor-Leste is rated as being at moderate risk of debt distress.²⁰ The debt–GDP ratio is small, estimated at 17% at the end of 2021.²¹ The large reserves of the Petroleum Fund provide a significant buffer, which helps ensure the adequacy of international reserves.

9. **Dollarization and inflation.** The United States dollar is the official currency of Timor-Leste, and though dollarization limits the scope for independent monetary policy, its use has contributed to price stability.²² The real effective exchange rate appreciated moderately by 1.0% in 2020 and by 6.5% in 2021, reflecting increasing domestic inflation and the appreciation of the United States dollar as compared with trading partners. In 2021, inflation increased to 3.8% from 0.5% in 2020, and is forecast at 2.6% in 2022 with the increase in public and private consumption. The Russian invasion of Ukraine has put further pressure on international food and fuel prices. An upward trend in prices of edible oil, rice, wheat, and eggs has been recorded. It is likely that a prolonged elevation of fuel prices could raise transport and production costs, further aggravating food insecurity and malnutrition in the country. The invasion has also affected the supply and price of construction materials.

10. **Banking sector.** Monetization has improved, with the broad money–GDP ratio rising from 30% in 2011 to 53% in 2020, while total assets of the banking system registered growth, but with limited changes to the deposit structure. The banking system is stable and profitable but underdeveloped, as seen in the limited domestic credit base and low credit ratios. Banco

¹⁸ Figures from the 2022 budget book, as of June 2021. ADB signed 3 additional loans in 2021 for a \$47 million urban water project, a \$135 million air transport project, and a \$35 million energy project.

¹⁹ Government of Timor-Leste. 2020. [State Budget Book 2020: Book 1](#). Dili.

²⁰ IMF. 2021. [Democratic Republic of Timor-Leste: Staff Report for the 2021 Article IV Consultation—Debt Sustainability Analysis](#). *IMF Staff Country Report*. No. 21/152. Washington, DC. The analysis rates Timor-Leste’s debt distress risk *moderate* from the previous *low* rating, as the values of debt-to-exports and debt-service-to-exports breach the benchmark in the baseline scenario. The large, liquid, and accessible net foreign assets in the form of the Petroleum Fund serve as a strong mitigating factor in Timor-Leste’s ability to carry and service debt in the medium term. Under the revised guidelines for the debt sustainability analysis in low-income economies, Timor-Leste is rated as having weak debt carrying capacity, with an ability to borrow up to 35% of non-oil GDP without undue risk of debt distress.

²¹ Gross international reserves amounted to \$656.5 million as of the end of 2020, amounting to an import coverage of 9.4 months, which is slightly below the IMF’s estimated “adequate” level of cover for Timor-Leste of 9.5 months of imports (compared with the traditional metric of 3 months).

²² IMF. 2021. *Democratic Republic of Timor-Leste: Staff Report for the 2021 Article IV Consultation*. *IMF Staff Country Report*. No. 21/152. Washington, DC; and Banco Central de Timor-Leste. 2022. [Annual Report 2021: Revitalizing the National Economy through Innovations and Synergies](#). Dili. Given limited financial sector development and institutional capacity, the IMF concludes that dollarization is an appropriate policy choice that has worked well for Timor-Leste.

Central de Timor-Leste, the country's central bank, has limited scope to influence private lending. Commercial banks continue to prefer investing their excess liquidity in bank deposits abroad. Client deposits are the main source of funds for banking institutions, accounting for 74% of banks' liabilities in 2020. The domestic credit–GDP ratio was about 13% in 2018, far lower than 75%, the average across all countries in Southeast Asia. Overall credit growth was moderate, at 11% in 2020, but credit to individuals expanded by 32% and represents 64% of all credit to the private sector, signaling a larger share of consumer credit.

3. Poverty, Inequality, Human Development, and Gender

11. **Poverty, inequality, and the rural–urban gap.** Timor-Leste's population is estimated at 1.3 million (footnote 5). Despite oil and gas revenues since 2005, it remains one of the world's poorest countries, ranking 155th out of 192 on GDP per capita in 2021, reflecting a wide gap with the ASEAN average.²³ During 2007–2014, the share of the population below the national poverty line fell from 50% to 42% and the poverty gap index also declined from 13.8 to 10.4.^{24, 25} Although the absolute number of poor is higher in Dili than in other municipalities, poverty remains higher in rural areas, with 47% of rural residents living in poverty compared to 28% of urban residents.²⁶ A village-level analysis showed that there is greater variation in poverty rates within municipalities than between municipalities, suggesting that local factors are more important than regional variations. Access to basic services also shows significant disparities between urban and rural areas, e.g., 73% of urban dwellers have access to at least basic sanitation compared with only 30% of rural inhabitants, and 98% of urban dwellers have access to electricity compared with 68% of rural inhabitants.²⁷ The decline in poverty has also been greater in urban areas. The lack of a comprehensive household survey since 2015 complicates the assessment of poverty levels. The pandemic further impacted vulnerable households, with reports of the poorest households resorting to coping strategies by reducing health and education spending because of their income loss, which was aggravated by the 2021 floods.²⁸ Movement restrictions worsened systemic food insecurity.²⁹ It is estimated that the poverty rate increased by 3 percentage points in 2019–2020.³⁰

²³ IMF. [World Economic Outlook Database](#) April 2022 (accessed 9 Jun 2022).

²⁴ The national poverty line is calculated as the average cost of basic needs in relation to food, shelter, and nonfood items, set at \$46.37 per person per month in 2014, above the international poverty line of \$40.45. Poverty also declined from 47.2% to 30.3% 2007–2014 relative to the international poverty line of \$1.90 per day.

²⁵ The poverty gap index (i) estimates the depth of poverty by measuring the average shortfall in income or consumption from the poverty line and (ii) is expressed as a percentage of the poverty line. The Gini coefficient for per capita consumption estimated from the 2014 living standards survey data is 0.29, reflecting a relatively low level of inequality by international standards and only slightly higher than the level of 0.28 estimated for 2007. Timor-Leste's score on the United Nations Human Development Index (HDI) increased from 0.496 in 2005 to 0.628 in 2015. In 2019 the country's HDI value fell to 0.606, putting the country in the medium human development category at 141st out of 189 economies.

²⁶ World Bank. 2020. [Timor-Leste Poverty Monitoring and Analysis: Estimating Small Area Poverty and Welfare Indicators in Timor-Leste using Satellite Imagery Data](#). Washington, DC.

²⁷ World Health Organization and United Nations Children's Fund (UNICEF). 2017. [Progress on Drinking Water, Sanitation and Hygiene: 2017 Update and SDG Baselines](#). Geneva and Government of Timor-Leste, Ministry of Finance, GDS and the Demographic and Health Surveys Program. 2018. [Timor-Leste Demographic and Health Survey 2016](#). Dili and Rockville, Maryland.

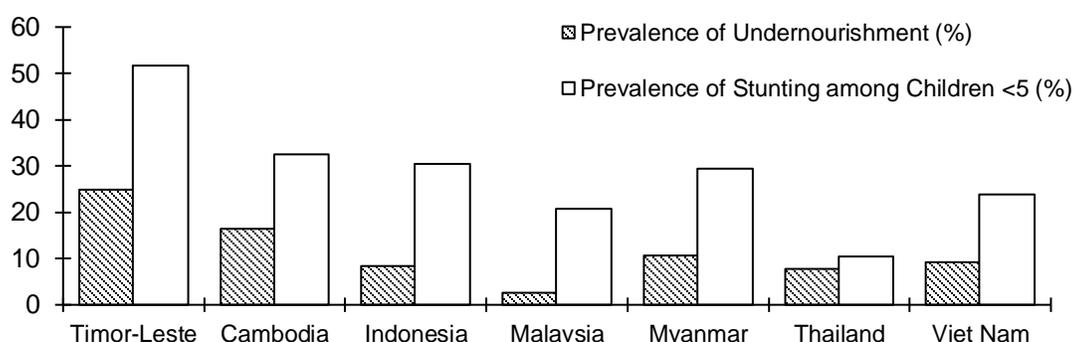
²⁸ United Nations Development Programme (UNDP). 2021. [Socio-Economic Impact Assessment of COVID-19 in Timor-Leste, Round 2, 2021](#). Dili.

²⁹ Food and Agriculture Organization of the United Nations. 2020. [National Agrifood Systems and COVID-19 in Timor-Leste: Effects, Policy Responses, and Long-term Implications](#). Rome.

³⁰ World Bank. 2021. [Macro Poverty Outlook: Country-by-country Analysis and Projections for the Developing World](#). Washington, DC. pp. 36–37.

12. **Food security and malnutrition.** Cross-country comparisons of the United Nations multidimensional poverty index, which uses a range of health, education, and standard of living indicators to assess poverty, show a rate of 46%, far above the rates of other ASEAN members with lower Human Development Index (HDI) scores.³¹ Only 25% of the population is food secure and 36% suffers from chronic food insecurity. Timor-Leste was ranked 108th out of 116 economies in the 2021 Global Hunger Index, which describes “serious” levels of hunger, highlighting the huge challenge the country faces regarding food security and the nutrition of women and young children.³² It has one of the highest rates of child malnutrition in the world, with more than half of children under 5 being stunted (Figure 2).³³ The underlying factors are low agricultural productivity, poor quality of food consumed and poor nutritional practices, limited access to safe drinking water and sanitation systems, and limited income options. A key concern is the impact of elevated fuel prices and rising inflation, which could further undermine food insecurity and nutrition.

Figure 2: Prevalence of Malnutrition, 2016–2018 (%)



Source: Asian Development Bank. 2020. *Basic Statistics 2020*. Manila

13. **Education.** Timor-Leste has moved closer to achieving 100% primary school enrollment, but there are significant issues with the quality of education. Learning levels remain low, with 30% of pupils unable to read by the end of second grade.³⁴ The expected years of schooling are 10.3 years for boys and 10.9 years for girls, but this falls to 6.0 and 6.3 years when adjusted for expected learning.³⁵ Technical and vocational education and training, which has been largely underfunded, accounted for only 14% of the total number of students in secondary education in 2016. The skills gap of the employed population is widening: the share of persons employed in occupations with skill requirements below their educational attainment rose from 5% in 2010 to 12% in 2016. This reflects a mismatch between courses offered and labor market needs, which makes employers favor foreign workers for management positions. A healthier, adequately educated, more skilled population is needed to meet future workforce needs.

³¹ UNDP. 2020. *Human Development Report 2020*. Geneva.

³² K. von Grebmer et al. 2021. *Global Hunger Index: Hunger and Food Systems in Conflict Settings*. Dublin: Concern Worldwide and Bonn: Welthungerhilfe.

³³ Development Initiatives. 2018. *2018 Global Nutrition Report: Shining a light to spur action on nutrition*. Bristol.

³⁴ World Bank. 2019. *Timor-Leste Basic Education Quality Improvement (P166744): Project Information Document/Integrated Safeguards Data Sheet (PID/ISDS)*. Washington, DC.

³⁵ World Bank. 2020. *Timor-Leste Human Capital Index 2020*. Washington, DC.

14. **Health services.** Timor-Leste imposed strict entry measures to control the spread of COVID-19, and under the national vaccine program, 71% of the population aged 12 and over has received two doses.³⁶ However, the fragility of the health system was highlighted by the limited facilities, supplies, and disruptions to normal services, particularly immunization, maternal and child health services and treatment for other health needs. Since 2012, community-based health services have been expanded, and there has been a large reduction in infant and maternal mortality, a reduction in the fertility rate, improved birth spacing, large increases in vaccinations, and fewer cases of malaria. However, the under-5 mortality rate was still high at 41 per 1,000, as was the maternal mortality ratio at 56.7 maternal deaths per 100,000 live births. There are only 7 physicians and 17 midwives and nurses per 10,000 inhabitants. Health services are provided free, but limited connectivity hinders remote rural households from accessing these services. Low access to health care services stems from physical and financial difficulties (footnote 28). Although the government health budget increased in absolute terms from \$67.2 million in 2014 to \$114 million in 2022, with a historic high of \$372.2 million in 2021, the health expenditure per capita is \$51.8.³⁷

15. **Employment and job creation.** Timor-Leste has one of the youngest populations in the world, with about 60% below the age of 25 (footnote 5). The youth unemployment rate is about 12%, much higher than the national average of 5%. The proportion of youth not in education, employment, or training is 21%, highlighting the lack of opportunities for young people entering the labor market. Only 30% of the working age population is engaged in formal work. Most of the households involved in agriculture are in subsistence farming and two-thirds of farmers work on land averaging only 1 hectare (footnote 6). There is some transition toward more market-based agriculture and nonagricultural economic activities.³⁸ The high rate of informality leaves many people out of reach of the social security system, especially women, who are less likely to enter the labor market. It is estimated that during the COVID-19 pandemic, 59% of household members lost their income, and among those who retained incomes, 55% reported a reduction.³⁹ With the large Timorese diaspora, there has been a rapid increase in remittances since 2013.⁴⁰

16. **Gender inequality.** Timor-Leste has the highest rate of political participation of women in the Asia Pacific region, with 40% female members of Parliament, because of the quota system for party lists.⁴¹ Progress is seen both in equal levels of primary education enrollment across the genders. However, when disaggregating by gender, the female HDI value falls to 0.589 in contrast with 0.655 for males, confirming strong gender bias in key dimensions of health, education, and income.⁴² The female labor force participation rate increased steadily

³⁶ State-of-Emergency was imposed in March 2020 and repeatedly extended till November 2021. There were no cases of community transmission in 2020 and the total number of recorded cases, as of May 2022, was 22,912 with 131 deaths. Of the population, 13% of the total population has also received a booster shot.

³⁷ World Bank [Domestic General Government Health Expenditure per capita \(current US\\$\)](#). (accessed 23 Jun 2022). This is far below the average of \$228.9 for East Asia and the Pacific, excluding high-income economies (World Bank categorization).

³⁸ Government of Timor-Leste. 2019. [Timor-Leste Labour Force Surveys 2010–2013–2016: Main trends based on harmonized data](#). Dili.

³⁹ UNDP. 2020. [Socio-Economic Impact Assessment of COVID-19 in Timor-Leste](#). Dili.

⁴⁰ World Bank. [Personal remittances paid](#) (current \$) (accessed 31 Jan 2022); and World Bank. [Personal remittances received](#) (current \$) (accessed 31 Jan 2022).

⁴¹ Inter-Parliamentary Union. [Global Data on National Parliaments](#). (accessed 9 Jun 2022).

⁴² UNDP. 2019. [Human Development Report 2019—Beyond income, beyond averages, beyond today: Inequalities in Human Development in the 21st Century](#). New York.

from 15% in 2010 to 41% in 2016, although this was still considerably below the male labor force participation rate, which increased from 33% to 53% in the same period.⁴³ The Land Law, 2017 specifies equality between women and men, but customary norms are deeply entrenched and women tend not to ask for their rights.⁴⁴ Domestic violence is a serious concern, with an estimated 60% of women having experienced physical or sexual violence by their male partners at least once. There are reports of failures in the judiciary system in enforcing the law against domestic violence.⁴⁵

17. **Sustainable Development Goals.** Timor-Leste published its Sustainable Development Goal (SDG) road map in 2017 and conducted a voluntary national review on the progress against select SDGs in 2019. The review reported progress on several SDGs, including SDG 4 (quality education) and SDG 3 (good health and well-being), and success was noted for SDG 16 (peace and quality institutions). Despite being the youngest country in Asia and having seen civil unrest in 2006, Timor-Leste democracy indicators are satisfactory, with strong post-conflict institutions.⁴⁶ However, overall progress across the SDGs has been uneven. The review highlighted high levels of chronic food insecurity (SDG2, zero hunger); and lack of access to safe water for a large proportion of the population (SDG 6, clean water and sanitation), especially in rural areas.

4. Environment and Climate Change

18. **Natural hazards.** Timor-Leste is vulnerable to a range of both geophysical and climate-related hazards. The heavy seasonal rainfall on steep slopes causes flash floods, landslides, and erosion. Disasters lead to high economic costs and food insecurity issues with damage to homes, crops, and infrastructure. Although largely localized, the impact has far-reaching effects on the poor because of existing vulnerabilities and limited state capacity. In 2021, Timor-Leste was ranked 16th out of 181 economies in the highest disaster risk category.⁴⁷ The country is also significantly impacted by the El Niño and La Niña phenomena, which can result in severe drought conditions and increased flooding and landslides.

19. **Environmental degradation.** Land degradation has been amplified by deforestation with illegal logging and firewood collection and unsustainable agricultural practices. Indirect factors driving environmental degradation include an insecure land tenure system and ineffective law enforcement. Curtailing overfishing in certain areas is a challenge because of weak enforcement capacity and lack of appropriate regulations. Many marine species are endangered, and harvest and trade of threatened species is rampant. Collection of environmental data is limited and relies on periodic compilation during projects implemented by development partners.

⁴³ United Nations; International Labour Organization; and Government of Timor-Leste, Ministry of Social Solidarity. 2018. *Challenges and Ways Forward to Extend Social Protection to All in Timor-Leste: Assessment-Based National Dialogue Report*. Dili and Geneva.

⁴⁴ United Nations Entity for Gender Equality and the Empowerment of Women. 2018. [Women's Multiple Pathways to Justice: Alternative Dispute Resolution and the Impact on Women in Timor-Leste](#). New York.

⁴⁵ The Asia Foundation. 2016. *Understanding Violence against Women and Children in Timor-Leste: Findings from the Nabilan Baseline Study—Main Report*. Dili.

⁴⁶ Government of Timor-Leste. 2019. [Report on the Implementation of the Sustainable Development Goals: From Ashes to Reconciliation, Reconstruction and Sustainable Development—Voluntary National Review of Timor-Leste 2019](#). Dili.

⁴⁷ Bündnis Entwicklung Hilft. 2021. [WorldRiskReport 2021](#). Berlin.

20. **Climate change and increasing environmental and disaster risks.** Climate change is one of the key drivers of fragility in Timor-Leste. Under all emissions pathways, Timor-Leste is projected to experience increased frequency of high temperatures and increased but erratic rainfall, with impacts on human health and productivity. This underscores the importance of steering long-term infrastructure development in a climate- and disaster-resilient direction. Staple crops are sensitive to rising temperatures, changes in the seasonality of rainfall, seawater inundation, and salinization of coastal aquifers. The majority of agriculture is rain-fed, increasing the vulnerability of livelihoods and food security. Timor-Leste ratified the Paris Agreement on Climate Change and submitted its Nationally Determined Contribution to the United Nations Framework Convention on Climate Change, identifying measures to mitigate climate change and priority adaptation areas.⁴⁸ It also submitted its National Adaptation Plan, 2020–2022 in 2021.⁴⁹ Some mitigation measures have been implemented, such as the protection of mangroves and the integration of customary practices in the legal system for natural resource management. However, most policies related to waste management, efficient and renewable energy, land rehabilitation, and sustainable agriculture have yet to be initiated and will require the establishment of legal and regulatory mechanisms and national and subnational environmental systems.

5. Regional Cooperation and Integration

21. **Inclusion into the international community.** The Council of Ministers adopted the Foreign Aid Policy, 2019, which reaffirms principles of aid practices based on the Paris and Busan declarations. The country has strong links to the Community of Portuguese Language Countries. Indonesia, Timor-Leste's nearest neighbor and largest trading partner, accounted for 34% of merchandise imports as of 2019 and 62% of international arrivals as of 2016.⁵⁰ More than 50 memoranda of understanding have been signed with Indonesia to establish cooperation on matters including transport, goods and services trade, and cross-border movement. Strengthening cooperation and trade integration with Nusa Tenggara Timur (on the western part of Timor island) is an important political priority. Timor-Leste has important ties with Australia, its largest donor (footnote 10). Emigration is a growing trend, and it is estimated that many Timorese travel to the United Kingdom for work using Portuguese passports.⁵¹

22. **Association of Southeast Asian Nations and World Trade Organization accession.** ASEAN and World Trade Organization (WTO) accession is a national and strategic priority. Timor-Leste became a member of the ASEAN Regional Forum in 2005 and officially applied for membership to ASEAN in 2011. ASEAN has indicated full consideration will be made upon completion of the fact-finding missions for all three pillars, i.e., political security, sociocultural, and economic. The fact-finding mission for political security took place in 2019 and the remaining are to be convened in July 2022. Since becoming an observer at the WTO in 2016,

⁴⁸ Government of Timor-Leste. 2016. [Intended Nationally Determined Contributions Timor-Leste](#). Dili.

⁴⁹ Government of Timor-Leste. 2021. [Timor-Leste's National Adaptation Plan: Addressing Climate Risks and Building Climate Resilience](#). Dili.

⁵⁰ Government of Timor-Leste. 2020. [Timor-Leste in Figures 2019](#). Dili; and The Asia Foundation. 2019. [Timor-Leste Tourism Barometer 2018](#). Dili.

⁵¹ A. McWilliam. 2020. *Post-Conflict Social and Economic Recovery in Timor-Leste: Redemptive Legacies*. London: Routledge. There could be as many as 16,000 Timorese in the United Kingdom. Pre-pandemic, 2,500 were doing 3-year stints as guest workers (through the Employment Permit System) in the Republic of Korea. M. Rose. 2020. [How the PLS can build a stronger Timor-Leste](#). *Devpolicy Blog*. 3 November. The maximum number of Timorese working in Australia has never been more than 1,250.

Timor-Leste has initiated procedures for accession to full membership.⁵² WTO accession is targeted by March 2023. The Fourth Working Party meeting is scheduled in October 2022. Timor-Leste's integration in global value chains remains limited, but the government is keen to improve sea and air transport connectivity to foster greater regional cooperation and integration. Membership in both organizations will provide direct benefits through closer trade, investment, and labor market linkages.

B. Key Impediments to More Inclusive and Sustainable Growth

23. The extent of Timor-Leste's fragility is manifested through its undiversified economy, with limited private sector participation, vulnerability to environmental hazards, and weak capacity in public administration (including for service delivery). The critical constraints include inadequate and poor-quality infrastructure and services, food insecurity, poor quality and insufficient access to health, low education quality and human capital, a fragmented and inequitable social protection system, a financial market limited to the banking sector, a weak business environment, high risk of environmental degradation and vulnerability to climate change, and weak public sector management.

1. Infrastructure and Basic Services

24. **Transport infrastructure.** The government has made substantial investments in road and energy infrastructure development, but increased efforts are needed to develop capacity and improve quality and maintenance. Trade is constrained by the limited capacity and location of the current cargo port and the only international airport. Electricity grid coverage has progressed, but persistent service outages and full electrification need to be addressed. Despite overcapacity in electricity production, about 24% of the population, mostly in remote rural areas, does not have access to electricity. Renewable energy tends to account for a small part of the energy mix. The digital divide continues to be a challenge. Regulatory issues need to be addressed for broadband development, digital identification, cybersecurity, and e-governance. ICT capacity in the workforce and ICT literacy in the country needs strengthening.

25. **Access to water and sanitation.** Timor-Leste has adequate water resources, with heavy rainfall in several months in the year, but poor infrastructure and lack of proper water management cause severe shortages and inefficiencies. In 2015, only 34% of urban residents had direct access to piped water, with 30% relying on public taps, 16% on tube wells or bore holes, and 5% on protected springs. Only 14% of rural residents had access to piped water.⁵³ Potable water is practically nonexistent and there is widespread contamination of water sources, leading to high prevalence of waterborne diseases. The efficiency of water supply systems in Dili is far below standard, and 98% of the water is nonrevenue.⁵⁴ In 2020, 26% of urban households and 62% of schools had no or poor access to sanitation services.⁵⁵ The allocation for water supply and sanitation infrastructure for domestic and industrial needs has been underbudgeted at just 1.4% of the allocation of the Infrastructure Fund during 2012–2022.⁵⁶ The ongoing corporatization of Bee Timor-Leste Empresa Publica (BTL), the water utility created in

⁵² Including submission of a memorandum on its foreign trade regime to the WTO working party.

⁵³ World Bank. 2018. [Timor-Leste Water Sector Assessment and Roadmap](#). Washington, DC.

⁵⁴ Estimates by Bee Timor-Leste Empresa Publica, 2021.

⁵⁵ World Health Organization/UNICEF Joint Monitoring Programme for Water Supply, Sanitation and Hygiene. [Data](#) (accessed 10 Jun 2022).

⁵⁶ Government of Timor-Leste. 2022. [State Budget 2022: Book 3A](#). Dili. Including loans; the Infrastructure Fund finances key infrastructure projects valued at more than \$1 million. ADB estimates.

2021 presents an opportunity for transitioning toward a performance-based model, but further progress is contingent on good corporate governance frameworks.⁵⁷

26. **Power.** In 2016, 76% of households had access to electricity, compared to only 38% in 2010 (footnote 28). However, persistent service outages brought by unmet maintenance needs need to be addressed. Despite overcapacity, about 20% of the population across 95 villages in remote areas do not have access to grid-connected electricity. Extending the grid to achieve a 100% electrification rate is economically unviable, and alternate power solutions are required, such as solar, solar-diesel, or a solar-wind hybrid mini-grid. The high cost of supply can be attributed to the sector's dependence on expensive imported fuel, high system losses, lack of metering infrastructure, and a low collection rate for delivered electricity. Despite high potential, investment in renewable energy has been very low.

27. **Climate change and disaster risks.** Heavy seasonal rainfall causes frequent flash flooding, landslides, and erosion. Timor-Leste is also exposed to tropical cyclones and storms and coastal flooding because of rising sea levels. Natural hazards threaten lives and livelihoods and the sustainability of infrastructure. Climate change further results in changes to physical, hydrological, and ecological processes that control floods, drought, soil erosion, and landslides, which impacts the frequency, intensity, and spatial distribution of natural hazards.⁵⁸ Damage to agriculture, roads, bridges, and housing during 2021 was estimated at \$245 million. The cost of resilient recovery was estimated at more than \$420 million, about 33% of government expenditure in 2021.⁵⁹ The national health laboratory, medical warehouse, and other critical health facilities were damaged. Displaced people congregated in evacuation centers with limited infection control measures, leading to a surge in COVID-19 cases in April-June 2021. The impacts of the dual shocks of this COVID-19 surge combined with devastating floods highlight how health-related emergencies can multiply risks and draw attention to the need for a multi-hazard approach to disaster and crisis management.

28. **Information and communication technology development.** Information and communication technology (ICT) infrastructure and connectivity access is limited and the digital divide is wide. Almost half the population was recorded as internet users in January 2021, an increase of 16% over 2020, but internet penetration remains low.⁶⁰ In addition, the country has the slowest speeds and most expensive internet connections in Southeast Asia.⁶¹ Constraints include lack of policies and plans for broadband development, cybersecurity, e-government, digital economy infrastructure, and gaps in ICT capacity in the workforce and literacy in the general population.

29. **Infrastructure governance.** Infrastructure development is one of the core pillars of the Strategic Development Plan 2011-2030.⁶² During 2011–2019, capital spending represented almost 40% of the state budget.⁶³ This put pressure on the different infrastructure agencies and

⁵⁷ ADB. 2016. [Finding Balance 2016: Benchmarking the Performance of State-Owned Enterprises in Island Countries](#). Manila.

⁵⁸ Climate change also potentially exacerbates conflicts, displaces people, and destroys lives and livelihoods, especially for vulnerable populations.

⁵⁹ Government of Timor-Leste and United Nations. 2021. *Timor-Leste Post Disaster Needs Assessment*. Dili.

⁶⁰ DataReportal. [Digital 2021: Timor-Leste](#) (accessed 31 Jan 2022).

⁶¹ B. Inder. 2018. *Speed Matters: The Case for an International Cable Internet Connection for Timor-Leste*. Melbourne: Monash University.

⁶² Government of Timor-Leste. 2011. [Timor-Leste Strategic Development Plan 2011-2030](#). Dili.

⁶³ This spending was in large part channeled through the Infrastructure Fund established in 2011 (averaging 59% of the state budget per year for 2016–2020) and reflecting the government's front-loading policy during that period.

their staff, and there were systemic weaknesses in project management.⁶⁴ There was also a lack of costing and monitoring or institutional capacity development for investment projects, and an absence of published economic analyses.⁶⁵ There are overlapping and fragmented mandates between institutions, lack of transparency, limited capacity for asset monitoring, and a lack of comprehensive and integrated information systems. Institutional capacity to manage infrastructure services, procurement, and contract management systems needs strengthening.

2. The Environment for Economic Diversification

30. **Human capital development.** The assessment of progress on the SDGs highlights the need for sustained and additional investments in human capital (footnote 46). The quality of education is impacted by the lack of adequate and good quality physical infrastructure. Some schools resort to two to three shifts, burdening teachers.⁶⁶ Weak planning and budgeting result in inequities.⁶⁷ Students in remote areas must travel long distances, especially for higher education. Secondary education and tertiary education also suffer from inadequate ICT infrastructure. Technical and vocational education and training (TVET) instruction needs strengthening, and there are few training programs or centers. Studies show a lack of alignment between the existing curriculum and labor market needs.⁶⁸ TVET also suffers from a high level of fragmentation and lack of coordination between different government agencies. Health is an important aspect of human capital development. The population faces low access to health care services, which stems from physical and financial difficulties. A multisector response is needed to address malnutrition and food security, including education, access to safe water and sanitation, and health care. Initiatives like the school feeding program and quality social protection programs have potential but lack funding and coordination.

31. **Access to credit and financial inclusion.** The financial sector is limited in size and is comprised mostly of the banking sector and microfinance institutions. There is no capital market and few nonfinancial institutions. Private sector credit is limited and expensive. Commercial banks require high collateral, which makes it difficult for many businesses. Microfinance institutions play a key role in access to loan and deposit services, especially for women. In 2020, only 61% of the population owned a bank account and 16% were excluded from any financial services.⁶⁹ Constraints to deeper financial inclusion include access points limited to urban areas; inconvenient, expensive, and non-user-friendly financial products and services; poor financial literacy; and lack of consumer protection.

32. **Regulatory framework for trade, investment, and private sector development.** Legal and governance weaknesses relating to contract enforcement, commercial dispute resolution, land rights, and the lack of capacity in the judiciary to deal with commercial-related legal cases impede private sector development. The “time tax” imposed by regulations

The Infrastructure Fund is part of the state budget but follows different budget and/or procurement procedures and is used exclusively for capital development.

⁶⁴ World Bank. 2015. *Democratic Republic of Timor-Leste Public Expenditure Review: Infrastructure*. Washington, DC.

⁶⁵ World Bank. 2020. *Timor-Leste Public Expenditure and Financial Accountability Assessment 2018: Public Financial Management Performance Report*. Washington, DC.

⁶⁶ Government of Timor-Leste. 2015. *National Policy for Inclusive Education in Timor-Leste*. Dili.

⁶⁷ World Bank. 2019. [Basic Education Strengthening and Transformation Project \(Timor-Leste\)](#). Washington, DC.

⁶⁸ ADB. 2019. [Policy and Planning for Skills Development in Secondary Education](#). Consultant’s report. Manila (TA 9006-TIM).

⁶⁹ Banco Central de Timor-Leste. 2021. [Financial Inclusion Report 2021](#). Dili.

(percentage of time spent by senior management dealing with regulatory compliance) is high.⁷⁰ The frameworks for bankruptcy and to promote and regulate market competition are outdated. The Council of Ministers approved an insolvency law in March 2017 but it has not been enacted by Parliament. The land law framework suffers weakness.⁷¹ Business regulations need to be better coordinated and harmonized across responsible line ministries to facilitate market entry. Strengthening ASEAN, WTO, and trade policies will open opportunities (i) for the domestic private sector to integrate into regional and global value chains, and (ii) for competitive niche sectors to be established. Despite a liberal trade policy, preferential market access to many economies, an open foreign investment regime, and a low corporate tax rate and generous tax incentives, foreign investment has been minimal. Private investment has remained low, averaging about 3% of GDP in 2010–2016. The relatively small domestic market and constraints in the enabling environment have contributed to low levels of foreign investment. The government is also institutionally constrained to implement public–private partnerships.

3. Crosscutting Challenges

33. **Gender and social protection.** Ensuring equitable access to resources, assets, services, and labor is a key development challenge. Despite approval of the second National Action Plan on Gender-based Violence, 2017-2021 and enactment of a law prohibiting domestic violence, greater effort is needed to increase prevention, raise awareness for both men and women, and improve access to justice. Supporting female access to employment, including female participation in higher education and nontraditional trades, is also important to foster private sector growth. Improving the targeting of social expenditure could also improve poverty and inequality. Social protection is fragmented across programs, which include a universal social pension for older persons, conditional cash transfers for vulnerable families with children, a school feeding program, a rural public works program, a disaster relief program, and free universal public health care. In 2022, social protection accounted for 6.4% of the budget (footnote 10). The veteran program absorbs more than 50% of total allocations due to which there is a significant gender gap in the spending per capita, at 4% of GDP for women against 8% of GDP for men, despite programs targeted at women.⁷² Old age social protection is the most comprehensive program, but most of the working age population is without support in a precarious labor situation. Existing programs for children and women have huge potential to tackle food security and malnutrition but are undermined by poor targeting and lack of efficient delivery systems.

34. **Governance.** Despite progress toward peace and the establishment of democratic institutions, political conflicts beginning in 2017 led to an unanticipated election and delayed parliamentary approval of the state budgets in 2018 and 2020, which exerted a negative impact on economic growth. Post-pandemic recovery will largely rely on political forces to maintain a consensus on the need for and the implementation of necessary socioeconomic development reforms envisaged by the Strategic Development Plan 2011-2030 and the Economic Recovery Plan. Timor-Leste rates relatively poorly on the government effectiveness dimension of the Worldwide Governance Indicators, scoring –0.80 on a scale of –2.5 to 2.5 in 2020, placing it in the 19th percentile of economies assessed.⁷³ The country ranks 82th out of 180 in

⁷⁰ World Bank. 2022. [Enterprise Surveys: Timor-Leste 2021 Country Profile](#). Washington D.C. It is more than double than the average of economies in East Asia and Pacific (World Bank categorization).

⁷¹ Rede ba Rai. 2019. [Land Registration in Timor-Leste: Impact Analysis of the National Cadastral System \(SNC\)](#). Dili. For instance, joint spousal claims constituted less than 2% of registered claims.

⁷² ADB. 2019. [The Social Protection Indicator for the Pacific: Assessing Progress](#). Manila.

⁷³ World Bank. [Worldwide Governance Indicators](#). (Accessed 9 Jun 2022).

Transparency International's 2021 Corruption Perceptions Index.⁷⁴ The Open Budget Survey puts Timor-Leste in the category of "limited information available," noting that the country registered progress in terms of transparency, public participation, and oversight since 2019.⁷⁵ Shortcomings in operational efficiency reflect constraints on technical skills and the challenge of creating a more performance-oriented culture in the civil service, where close networks of familial ties exist. Core administration capacity in policy and regulatory management needs strengthening.

35. **Public financial management.** The country's PFM system has basic functionalities in place, including transparency of public finances, predictability and control in budget execution, and accounting and reporting. However, the PFM system is relatively weak in management of assets, external scrutiny and audit, and policy-based fiscal strategy and budgeting. The institutional framework is relatively clear, and a process of updating older laws and regulations is ongoing. Reforms to the PFM system have been stepped up since 2019, including the development of a new monitoring and evaluation system and the rollout of program budgeting, but fiduciary risks need to be addressed.

36. **Procurement regulatory framework.** Timor-Leste scored a "D" in the 2020 Public Expenditure and Financial Accountability assessment on all four indicators related to procurement: monitoring, methods, public access to procurement information, and complaints management.⁷⁶ Legislation is unclear, with many overlapping and contradictory decree-laws. The online public procurement portal on the Ministry of Finance's website is not regularly updated with new tenders, and the use of less competitive procurement instruments (such as single sourcing) is prevalent, although there is a procurement module in the Government Resource Planning System. There is no independent body for appeal.

C. Implications for ADB Country Engagement

37. The CPS for Timor-Leste, 2023–2027 needs to focus selectively on a few areas to unlock Timor-Leste's growth potential in the new global context. In line with government priorities, the CPS should broaden the investment portfolio and strengthen institutional capacity for economic diversification and private sector development to help build strong fundamentals and reduce dependency on the Petroleum Fund. Climate change is a key concern for Timor-Leste, given its vulnerabilities, and this highlights the importance of integrating climate-resilience into all projects. Operational priorities of Strategy 2030 and the government's call for ADB to continue financing, policy advice, technical assistance, capacity building, and knowledge support in its areas of expertise should also guide the CPS. Based on the analysis of key impediments and considering the country's priorities, this assessment identifies two strategic objectives and critical crosscutting priorities on which to anchor the CPS.

38. **Climate-resilient infrastructure and basic services.** ADB needs to help improve infrastructure to promote food security and improve reliable connectivity with markets within and outside the country, while supporting environmental sustainability with climate adaptation and mitigation measures. Water and other urban infrastructure services, including sanitation, are also essential to protect health and hygiene. The CPS should support the progress in the power

⁷⁴ Transparency International. 2022. [Corruption Perceptions Index 2021](#). Berlin.

⁷⁵ International Budget Partnership. 2022. [Open Budget Survey 2021](#). Washington D.C.

⁷⁶ World Bank. 2020. [Timor-Leste Public Expenditure and Financial Accountability Assessment 2018](#). Washington, DC.

sector to strengthen reliability and quality, and the sector's shift to renewable energy sources. Building ADB's comparative advantage in building climate-resilient infrastructure and services would also support Timor-Leste achieve its SDGs.

39. **Enabling environment for economic diversification.** Human capital development and improved productivity are essential for economic diversification. The CPS should target education, complementing efforts of development partners who are active in the sector. Support for agriculture will contribute to improving agricultural productivity and the development of value chains. To diversify the economic base and accelerate job creation, it is essential to strengthen the business environment for private sector participation, support regional cooperation and integration, and boost trade.

40. **Crosscutting priorities.** ADB's non-lending program needs to continue support for the preparation of high-quality investment projects and the country's efforts to improve governance and capacity through support for public institutions in project implementation, staff training, knowledge products, and development of regulations and procedures.. In complementarity with other development partners, policy reforms and PFM systems for planning, budgeting, procurement, and controls should be supported., including capacity building for national accounting systems, fiscal policy, domestic resource mobilization, and financial sector development. The CPS should include an enhanced focus on gender mainstreaming across operations, and enforcement of legal and policy frameworks on gender equality. It also needs to promote the adoption of advanced technologies by supporting digital solutions, which will promote public service delivery. Access to electricity is essential for broader ICT development and dissemination.

41. Timor-Leste can achieve inclusive and sustainable growth with targeted investments and institution building for climate-resilient infrastructure and basic services; and by promoting economic diversification, including the strengthening of policy frameworks.