

TIMOR-LESTE

ECONOMIC REPORT

DECEMBER 2022

Honoring the Past, Securing the Future

Timor-Leste Economic Report

Honoring the Past, Securing the Future

December 2022



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.

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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

1. Recent Developments

The global economy continues to face steep challenges, but Timor-Leste's economy is slowly recovering. The war in Ukraine continues to disrupt the global economy. Inflation in many countries has risen sharply as a result. Against this backdrop, Timor-Leste is recovering from its recent economic slump caused by COVID-19 and devastating impacts of Cyclone Seroja. After a rebound of 2.9 percent in 2021, the economy is on track to further grow by 3.0 percent in 2022.

Nevertheless, GDP per capita has not returned to pre-pandemic levels. The economy has experienced three years of negative growth in non-oil real GDP in the last five years. GDP per capita has declined since population growth has averaged 1.9 percent annually. Political uncertainty, a global health emergency and a natural disaster have taken a toll on an economy that is largely reliant on the public sector.

Consumer price inflation reached 7.9 percent yoy in August 2022, one of the highest in the East Asia Pacific region. Food inflation rose by 8.3 percent, partly due to higher global food prices driven by higher costs of transport and fertilizer, and concerns about the impacts of the floods in Pakistan. Relatively elevated food prices place the heaviest burden on vulnerable populations in Timor-Leste.

The real effective exchange rate (REER) has appreciated by about 10 percent since the first quarter of 2021. A stronger US dollar, the legal tender of Timor-Leste, makes the country's exports more expensive but imports cheaper. The stronger US dollar may have also helped moderate price pressures. The current account that includes receipts of hydrocarbon sales maintained a surplus of nearly 5 percent of GDP. Nevertheless, despite a strong expansion of tourism receipts from a very low base, the growth of total imports considerably outpaced that of total exports.

The Petroleum Fund balance was at USD 16.9 billion (nearly 10 times 2022 GDP) by the end of September 2022, a decline of nearly USD 1 billion from USD 17.8 billion in Q2 2022. The Fund recorded more than USD 2.5 billion losses during the first three quarters of 2022 due to weak investment returns and asset revaluations. Until there are inflows from a new hydrocarbon production field or a considerable change in the government's fiscal policy, the Petroleum Fund balance is expected to be fully depleted by 2034.

Revenue collection and capital budget execution are yet to return to pre-pandemic levels. Excluding withdrawals from the Petroleum Fund, the authorities collected slightly higher revenues of 2 percent yoy during the first three quarters of the year compared to the same period last year. On the other hand, public expenditure execution grew by 15 percent. Capital spending surged from a very low base. At 16.7 percent by the end of September 2022, though relatively improved, the execution rate for capital spending is still very low.

2. Outlook and Recommendations

The economy is expected to continue its recovery, supported mainly by government spending, with non-oil GDP forecast to grow by 3.0 percent in 2023-24, in line with the average expansion of countries in the Pacific. Consumer price inflation is projected to decline to around 2.5 percent in 2023. The Bayu-Undan offshore field will be decommissioned by end-2022. In turn, the current account and Petroleum Fund balance will be adversely affected. The balance of the Petroleum Fund will deteriorate further while the current account balance will shift back to a large deficit in 2023 when oil exports will cease. Timor-Leste remains at moderate risk of overall and external debt distress beyond the medium term.

Downside risks include an abrupt global slowdown, COVID-19 outbreaks, and natural disasters. These are exacerbated by higher commodity prices, a stronger US dollar, and worsening global financial conditions. High international commodity prices – especially food – have a considerable impact on the purchasing power of (poorer) households. The exchange rate dynamics may either compound or offset the impact of commodity prices on purchasing power. Depressed international stock markets would affect the Petroleum Fund’s investment returns through negative revaluations.

Enhancing productive capabilities through structural reforms and improving quality of public spending hold the key for accelerating and sustaining economic development. To achieve the 7 percent growth target envisaged in the government program, it is crucial to support private sector development. To capitalize on its youth bulge, Timor-Leste needs to improve the efficiency, equity and sustainability of its human capital investments, including that of social protection (see Chapter 3). Continuously improving public financial management (PFM) and procurement systems are also fundamental for improving the quality of fiscal policies.

Extending the life of Petroleum Fund through fiscal consolidation is essential to delay the fiscal cliff and ensure the perpetuation of government spending to support economic growth Despite receding impact of the pandemic, the level of government spending has not returned to the pre-COVID 19 levels. Combined with the low level of domestic revenue, fiscal sustainability continues to be a major concern, as the current flow of petroleum revenue is projected to cease in 2022. Fiscal sustainability should be secured through fiscal consolidation and the commitment to stop relying on excess withdrawals from the Petroleum Fund.

3. Special Focus: Improving Performance of Timor-Leste’s Social Protection System

Timor-Leste has one of the highest rates of social protection spending in the developing world, but with limited impact on poverty and vulnerability. In 2019, its total social protection expenditure was 7 percent of non-oil GDP. However, the better part of spending is allocated for the Veterans’ Pension program. Over USD 1 billion has been spent on the Veterans Pension over the last ten years for a small cohort of the population; there are currently about 28,000 beneficiaries. Excluding the veterans’ pension, social protection spending corresponds to the ASEAN regional average of approximately 3 percent GDP.

Given there is such a high level of spending on social protection, it is important to first spend better before considering spending more. Much more can also be done in terms of using social protection as a tool to reduce poverty and at the same time help build, protect, and employ human capital. Despite the wide range of services and the high level of social protection spending, improvements in welfare remain limited. In light of the depleting oil revenue, now is a crucial moment for Timor-Leste to start reforming its social protection system to ensure it secures for future generations. Specific reform areas to consider include:

- **A reform agenda should cover both aspects of veteran’s benefits: veteran pensions and the Veterans Fund.** Veteran pensions cannot be easily adjusted. However, there are reform options worth discussing such as reducing or ultimately terminating the inter-generational benefits which is roughly estimated to cost around 4.8 per cent of non-oil GDP per year for a generation to come¹; making the pension more means-tested to focus on poorer beneficiaries; changing pension from annuities to lump sum payments; and customizing payments according to age.

¹ The estimated cost of fulfilling obligation to one subsequent generation will be around USD 2.5 billion (total - for the next 33 years, as per Timor-Leste’s life expectancy at 40) or equivalent to 4.8 percent of Timor-Leste non-oil GDP in 2021 per year. This calculation assumes that the benefit will be passed on when the survivor turns 40, survivors receive the minimum level of survival pension benefit (USD 230), and that there is no change in the amount of benefit in the future. The actual costs will likely be higher as the amount of pension varies based on the type of survivorship and can go as high as USD 750 per month. More detailed estimates can be produced subject to availability of administrative data.

- **Options for the design of the Veterans Fund could encompass:** (i) including Victims/ Survivors in the eligibility criteria; (ii) focusing on productive activities or (iii) basing transfers more on needs rather than on years served. What will be important is that all these options and others are considered and discussed with a wide community of stakeholders.
- **A more efficient and equitable allocation of fiscal resources can also be pursued by expanding coverage of social protection programs more effectively.** While most of the programs have gradually expanded the number of direct beneficiaries over the past decade, there are considerable gaps in reaching the poorest households. With a basic welfare assessment system in place, a larger proportion of spending could be devoted toward the poorest households, with ideally a stronger focus on children and mothers. Given the mere 34 percent coverage of the labor force in the social security program, it would also be sensible to extend the contributory scheme to cover more informal workers. However, given the existing challenges with the social security programs' parameters including the relatively high target replacement ratio for old-age benefits, the coverage expansion has to be approached carefully. The contributory old-age and disability pension parameters would also benefit from recalibration to ensure an actuarially-fair contribution rate and appropriate benefit level.

Reducing the fragmentation of social protection implementation and delivery mechanisms can further improve the overall effectiveness of Timor-Leste's social protection system. Fragmentation is not only burdensome for the beneficiaries, but fragmentation also deprives key stakeholders and decision-makers of an opportunity to conduct monitoring and impact analysis more systematically. The planned implementation of Unique Identification presents key opportunities to reduce fragmentation foster integration and interoperability across social protection delivery systems.

The recently launched National Social Protection Strategy can serve as a policy and priority compass for all social protection stakeholders. The strategy stipulates clear visions and targets that aim to improve the effectiveness and efficiency of the various social protection programs in reducing poverty and in providing protection throughout the life cycle. It can be further strengthened with a robust monitoring and evaluation framework to allow rapid adjustment of government interventions when needed and to maintain the relevance of the various goals and policy actions.

1. Recent Developments



1.1. Timor-Leste's economy is recovering despite global economic turmoil.

The global economy continues to face steep challenges only two years after the COVID-19 pandemic caused the deepest global recession since World War II. The war in Ukraine continues to disrupt the global economy. Inflation in many countries has risen sharply as a result, fueled by a combination of surging energy, food, and commodity prices and supply disruptions. High prices are imposing serious hardship for low-income households, who have only partially recovered from the COVID shock. The frequent lockdowns under its zero COVID policy in China have taken a toll on the economy. The property sector that represents nearly one-fifth of economic activity in the country is also weakening. Given the size of its economy and its importance for global supply chains, developments in China are weighing heavily on global trade and activity.

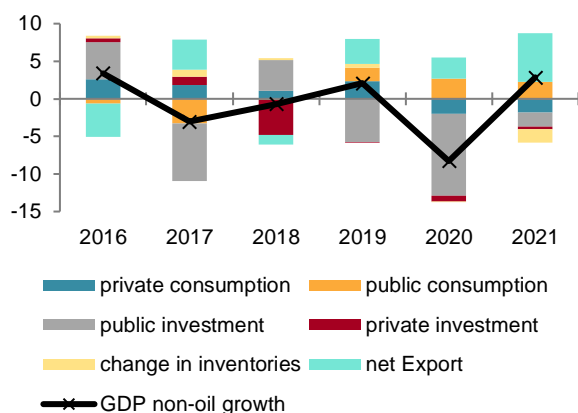
Against this backdrop, Timor-Leste is recovering from its recent economic slump caused by COVID-19 and severe floods from Cyclone Seroja. Following a sharp contraction of 8.3 percent in 2020, the non-oil economy rebounded by 2.9 percent in 2021, helped by record-high government spending (Figure 1.1). With close to 80 percent of the eligible population fully vaccinated, the cessation of travel restrictions and strict health measures, economic activity, as measured by the national accounts, is getting closer to its pre-pandemic level.² Various economic indicators corroborate this. Electricity consumption in the commercial sector has surpassed the pre-pandemic level, growing by 28.9 percent year-on-year (yoy) by the third quarter of 2022. A similar pattern is also evident in the residential sector, which grew at 38.7 percent, while electricity consumption by the government declined by 27.1 percent (Figure 1.2).³

² The first booster dose coverage was recorded at 27.5 percent by September 27, 2022.

³ Higher electricity consumption has partly driven by increased efforts on billing by *Electricidade de Timor-Leste* (EDTL), including the installation of electricity meters.

Figure 1.1: The economy rebounded in 2021 on the back of strong fiscal support.

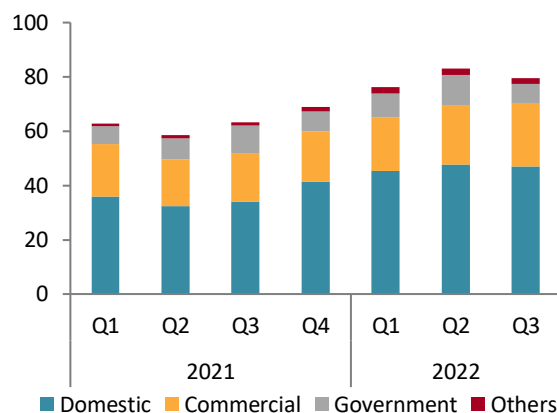
(Percentage point and percent growth)



Source: World Bank calculations using data from DG Statistics of Timor-Leste.

Figure 1.2: Domestic and Commercial electricity consumption increased.

(millions KW/h)



Source: World Bank calculations using data from EDTL.

As the economic activity picked up and cross-border travel intensified, the firms’ registration rates bounced. The number of new registered firms accelerated in 2022, particularly for sole trader businesses and single limited liability companies (LLC) (Figure 1.3). This is linked to a reopening of the economy, including removal of mobility restrictions, pick-up in demand, and resumption of employment growth. The authorities have also made the business registration processes easier through the roll-out of its online registry system. In contrast, pending the availability of full-year data, the firm closures rate seems to experience a considerable decline (Figure 1.4).

Figure 1.3: The number of registered firms remain strong

(Number of registered firms)



Source: World Bank calculations using data from SERVE. Note: Full year data except for 2022 (year-to-September).

Figure 1.4: Number of firms closure declines

(Number of firms closure)

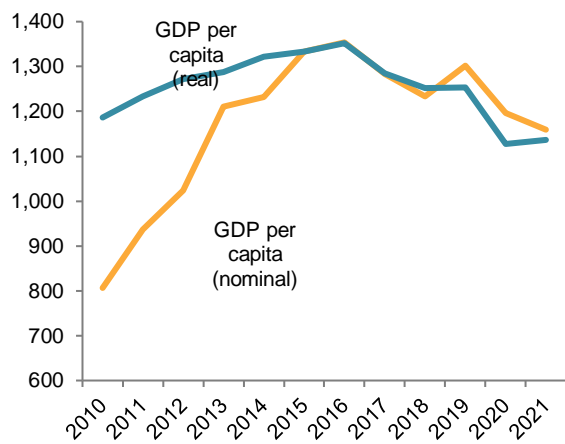


Nevertheless, non-oil real GDP and, therefore, GDP per capita has not returned to pre-pandemic levels. The economy has experienced three years of negative growth in non-oil real GDP in the last five years, 2017, 2018, and 2020. Even with the modest expansion of the GDP in 2021, GDP per capita declined since population growth averaged 1.9 percent annually since 2011. This implies that GDP per capita fell for three consecutive years (Figure 1.5). Political uncertainty (2017-2018 and 2020), a global health emergency and a natural disaster (2021) have taken a heavy toll on a fragile economy that is largely reliant on the public sector.

The extent of the recovery going forward will depend on the persistence of the “scarring”, the economic damage caused by the three years of negative growth.

Figure 1.5: Non-oil GDP per capita has been declining from the last peak in 2016

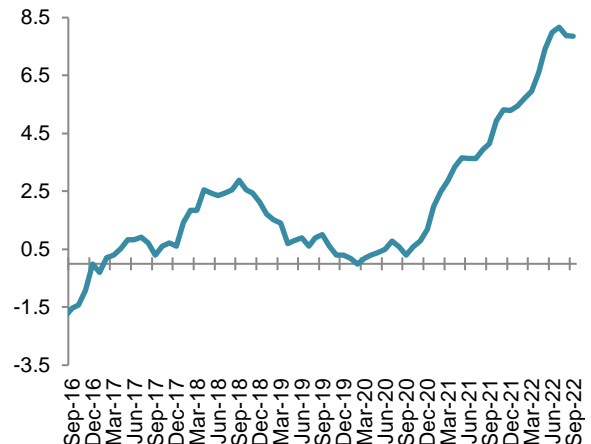
(USD per capita)



Source: World Bank calculations using data from DG Statistics of Timor-Leste

Figure 1.6: Inflation started to decline in August 2022

(Percent, Monthly YoY, 2018=100)



Source: World Bank calculations using data from DG Statistics of Timor-Leste

1.2. Price pressures remains high.

Consumer price inflation (CPI) reached 7.9 percent yoy in August 2022 (Figure 1.6). Stubbornly high global hydrocarbon prices have translated into higher fuel and logistic costs as well as increased prices of other petrochemical products. Additionally, the Food Price Monitoring Analysis report indicates a further increase in the international rice prices that was partly driven by the change in the India’s export policy and the impacts of heavy floods in Pakistan.⁴ The Government allowed the global fuel and food prices to pass through to the domestic fuel process to some extent, impacting prices in Dili and in the rest of the country (Figure 1.7). Increased excises on alcohol and tobacco also had a one-off impact on prices. Price increases, however, were broad-based: all product categories in the CPI basket saw higher yoy inflation during 2022 except for clothing and footwear categories. The August 2022 reading of the headline inflation in Timor-Leste was one of the highest in East Asia Pacific region after Lao PDR, Myanmar, Mongolia, Samoa, and Tuvalu (World Bank, 2022).

Food inflation in Timor-Leste rose by 8.2 percent in September 2022. These figures were slightly lower in Dili at 7.0 percent (September 2022) but considerably higher at 10.0 percent (September 2022) in the districts outside Dili and Baucau. Higher food inflation was partly due to higher agricultural input costs, including for transport, fertilizer, and animal feed. Most commodity prices have, however, retreated from their peaks in the aftermath of the post-pandemic demand surge and the initiation of the war in Ukraine (Figure 1.8). A sharp global slowdown in growth and concerns about an impending global recession have driven the decline, although price developments across commodities have diverged amid differences in supply conditions and their response to softening demand.⁵ Despite the trend, relatively elevated food prices place the heaviest burden on vulnerable communities in Timor-Leste (see Box 1.1).

⁴ <https://www.fao.org/3/cc2461en/cc2461en.pdf>

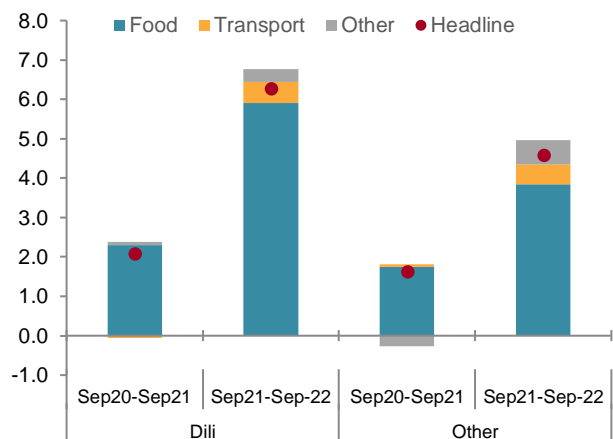
⁵ However, outside Timor-Leste, commodity prices remain high in many countries in domestic currency terms because currencies have depreciated. From February 2022 to September 2022, for instance, the price of Brent crude oil in U.S. dollars fell nearly 6 percent, yet because of currency depreciations, almost 60 percent of oil-importing emerging market faced an increase in domestic-currency oil prices during this period.

The Government amended the annual budget in May, inserting measures to temper the impact of price pressures. In line with sharp increases in global commodity prices, transportation prices rose sharply. Transportation prices rose 17.3 percent yoy in the districts outside Dili and Baucau and 13.0 percent in Dili by September 2022. This compares to 6.1 percent and 3.6 percent, respectively, in September last year. The housing sub-index of CPI, which includes electricity, remains relatively muted over the year as the rising cost of fuel for power generation has not been fully passed on to consumers. The Government has allocated close to USD 60 million (23.5 percent of the additional 2022 budget agreed in May this year, close to 3.5 percent of GDP) for *Electricidade de Timor-Leste* (EDTL) to contain electricity price pressures, amidst rising prices of diesel, the main source of electricity generation in Timor-Leste.⁶ From late April until the end of July 2022, the Government allocated temporary fuel subsidies for national public, air, and maritime transport operators working in agricultural and fishing activities.

Nevertheless, the Government in-kind transfers and subsidies may add further inflationary pressures. The USD 80 million for *Cesta-Basica* (the Food Basket Program) in the 2022 budget is a continuation of similar program, initiated in October 2020, to address the impact of the pandemic. The *Cesta Basica* offers essential food items worth up to USD 50 for key family needs. To stimulate agricultural output, the program requires that a minimum of 75 percent of the products included in the basket are locally produced.⁷ Government also earmarks close to USD 70 million (nearly 4 percent of GDP) in 2022 budget for USD 200 “Christmas bonus” for households with income less than USD 500 a month. If not carefully designed, however, the *Cesta Basica* and the Christmas bonus programs may add inflationary pressures to the economy, particularly if the domestic production capacity is not able to meet the additional demand.

Figure 1.7: Price pressures are experienced throughout the country, driven mainly by prices of food and transportation prices

(Percent, average Monthly YoY, 2018=100)

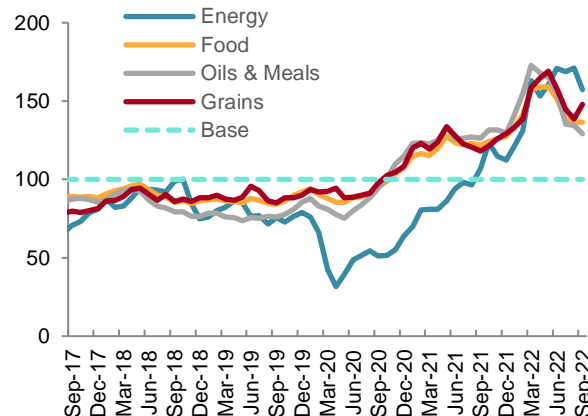


Source: World Bank calculations using data from DG Statistics of Timor-Leste

Note: (i) Food inflation comprises of all commodities included in broader categories of food and non-alcoholic beverages and alcohol and tobacco. (ii) Other areas include Baucau and other areas.

Figure 1.8: Global energy prices remain elevated

(Monthly indices based on nominal US dollars, 2010=100)



Source: World Bank calculations using data from World Bank Commodity Price data (The Pink Sheet)

Box 1.1: Food Inflation and Poverty in Timor-Leste

Lack of more recent data poses a challenge to fully understand the current poverty situation and impacts of inflation on households. The poverty rate at the national poverty line fell from 50.4 percent in 2007 to 41.8 percent in 2014. The latest poverty measurement was produced using the 2014 Timor-Leste Survey of Living Standards (TL-

⁶ Timor-Leste Energy Profile (IRENA, 2022).

⁷ The Decree-Law no 36/2022.

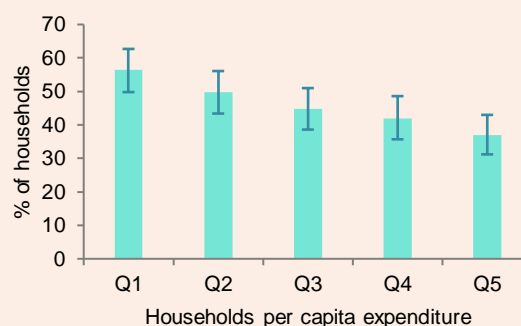
SLS) and the next one is planned in 2023. A 2019 joint report by The National Council on Food Security, Sovereignty and Nutrition in Timor-Leste (KONSSANTIL), WFP, and FAO found that the majority of Timorese cannot afford a nutritious diet. On average, households in the bottom 40 percent of the distribution allocated about 60 percent of their consumption of food.⁸ Thus, inflation induced by increasing global food price may set back any progress in poverty reduction.

Around two out of ten households in Timor-Leste suffer from moderate or severe food insecurity⁹. Using the Food Insecurity Experience Scale (FIES), households that experience moderate food insecurity typically eat low quality diets and might have been forced to reduce the quantity of food they would normally eat. Whereas households that experience severe food insecurity typically have run out of food and at worst gone a day or more without eating, putting

their health at risk¹⁰. According to the June 2022 round of Timor-Leste High Frequency Household Phone Survey, conducted by the General Directorate of Statistics (GDS) Ministry of Finance (MoF), UNDP and the World Bank, the prevalence of moderate or severe food insecurity is estimated at 44.5 percent¹¹.

Poorer households are more likely to experience moderate or severe food insecurity. Figure 1.9 shows the proportion of households that reported moderate or severe food insecurity in the bottom 20 is significantly higher compared to the top 40 percent. This suggests that affordability is a critical issue and that the poorest are highly vulnerable to upward pressure on food prices. Moreover, the survey also indicates that households that live in rural areas and outside Dili are more likely to experience moderate or severe food insecurity. In turn, this inevitably will have a deleterious impact upon children, 47 percent of whom are stunted.

Figure 1.9: Poorer households are more likely to experience moderate or severe food insecurity
(Percent of households, Proportion households with moderate or severe food insecurity)



Source: WB staff calculation using May-June 2022 round of Timor-Leste High Frequency Household Phone Survey. FIES calculation was done by FAO using the same data. Households per capita expenditure was imputed using SWIFT methodology based on Timor-Leste High Frequency Household Phone Survey.

1.3 Real Effective Exchange Rates appreciated while private credit growth decelerated.

Following global inflation and currency developments, Timor-Leste's real effective exchange rate (REER) have appreciated by about 10 percent since the first quarter of 2021.¹² Further, the US dollar appreciated sharply in Q3 2022 relative to the Indonesia rupiah and the Australian dollar (Figure 1.10); Indonesia and Australia are Timor-Leste's main trading partners. The REER provides a more accurate measure of international competitiveness by taking of account price differentials across countries. In general, a stronger dollar makes Timor-Leste's exports more expensive but imports cheaper. The stronger US dollar may have helped moderate price pressures somewhat. The impact of exchange rate dynamics on the country's export performance is likely to be negligible as Timor-Leste's exports are dominated by commodities such as coffee and hydrocarbons. The appreciation of the US dollar, however, adds to the challenge of establishing new

⁸ TL-SLS 2014

⁹ This measure captures the broad concept of food insecurity used as SDG indicator 2.1.2.

¹⁰ www.fao.org/in-action/voices-of-the-hungry/fies/en

¹¹ The result is not significantly different statistically relative to the comparable results from SEIA 2.0 (June 2021).

¹² The NEER is a weighted average of at which one country's currency exchanges for a basket of foreign currencies. The weights are assigned based on the relative importance, computed through the trade share, of each currency in the basket trade shares. The REER simply is the adjusted NEER for the inflation differentials with the countries whose currencies are in the basket. The REER is expected to reflect foreign competitiveness of domestic products. As such, a trend appreciation of REER is considered unfavorable for the growth of exports.

exports or developing local production. It is accordingly important to ponder measures to improve competitiveness of domestic production and mitigate the impacts of a stronger US dollar.

The current account posted a surplus at the end of the first half of 2022, sustaining a trend since the first quarter of 2021 (Figure 1.11).¹³ Growing hydrocarbon exports driven by higher-than-anticipated prices have driven Timorese goods exports during the quarter. Hydrocarbon exports, comprised of Liquefied Natural Gas, Condensate Oil and Liquefied Petroleum Gas, represent close to 99 percent of merchandise exports. Coffee exports have also accelerated rapidly. On the other hand, import of goods increased by close to 50 percent. Imports of fuel and food account for more than half of merchandise imports. A larger services trade deficit was contributed by nearly all categories under import services, but there was a noticeable growth under export of travel services. The current account is projected to shift back to a deficit post the cessation of hydrocarbon production in the Bayu-Undan field.¹⁴ As FDI inflows have been relatively small, withdrawals from the Petroleum Fund, recorded under portfolio inflows, will still be the main source of external financing in the medium term.

Figure 1.10: US dollar appreciates against the currency of Timor-Leste’s major trading partners
(Index, 2016=100)

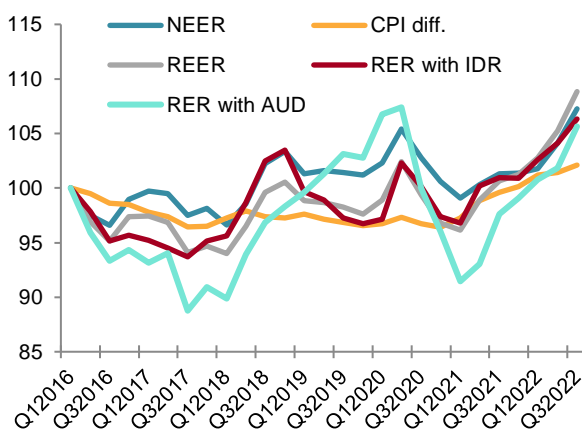
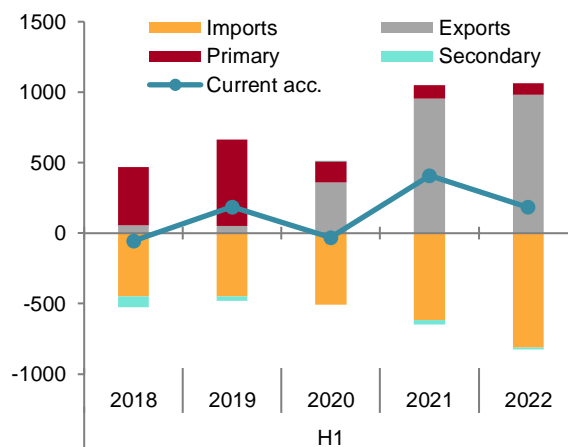


Figure 1.11: The current account maintained a surplus for the first half of 2022.
(USD million)



Source: World Bank calculations using data from Central Bank of Timor-Leste (BCTL)

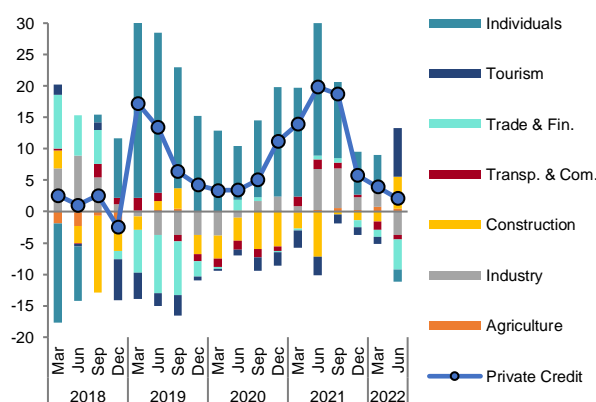
At 2.1 percent yoy, the growth of credit to the private sector by the end of Q2 2022 continued to slow. Credit to individuals, that have historically had low credit risk, continue to dominate with 60 percent of outstanding loans. This is followed by construction, tourism and trade and financial sectors (Figure 1.12). After the cessation of the state of emergency and the continuous increase in the number of inbound passenger arrivals at the Dili International Airport, a considerable rise was observed in the loans to the tourism sector (550.1 percent). On the other hand, the average bank lending rate has remained stable at 11.0 percent in Q2 2022 (compared to 11.1 percent in the same quarter a year before). Deposit rates have also remained stable during the same period (Figure 1.13). The Central Bank survey in 2021 appraises that credit risks, operational costs and collateral law are the main factors determining commercial banks’ lending policies.

¹³ With the ratification of the Maritime Boundary Treaty in August 2019, oil and gas fields previously shared between Australia and Timor-Leste in the Joint Petroleum Development Area (JPDA) transitioned to Timor-Leste’s exclusive jurisdiction. Offshore petroleum production has since been considered as part of Timor-Leste’s Gross Domestic Product (GDP) and trade statistics. As such, time series analysis comparing pre- and post-2019 is challenging.

¹⁴ The flow of remittances to the country has emerged as the largest source of non-oil income since 2018. Publicly available information on remittances from Timorese working abroad, however, is limited.

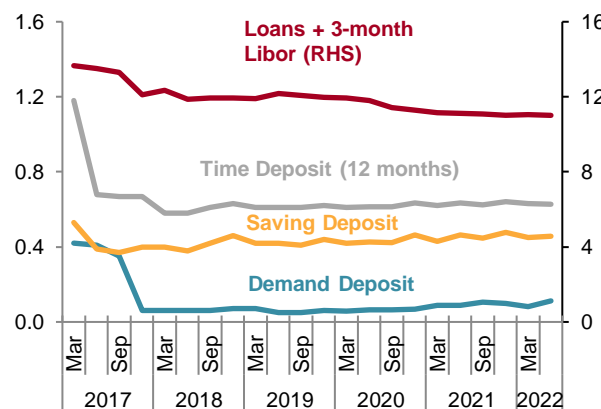
A recent World Bank Enterprise Survey in Timor-Leste reveals that access to finance remains a constraint to firms. The transition towards a more-diversified economy will depend on the ability of existing firms to grow and become more competitive. Unfortunately, firms still have issues in accessing finance, limiting their potential growth. While three out of four firms in the country have a checking or savings account, 8 percent have a loan or a line of credit. Most firms rely on internal funds to finance their investment and working capital. Most firms finance their needs internally (91 percent) and a small percentage of firms use banks to finance working capital (5 percent). This limited access to finance and usage of formal financial services negatively affected firms’ performance. Expanding access to finance to a broader base will entail addressing institutional constraints around land titling and contract enforcement and should be accompanied by the efforts to strengthen regulatory and supervisory framework.

Figure 1.12: The growth of private credit decelerated
(Percentage points and percent)



Source: World Bank calculations using data from DG Statistics (Quarterly Statistical Indicators)

Figure 1.13: Lending spread for commercial banks increased marginally
(percent)



Source: Central Bank of Timor-Leste (BCTL)

1.4 Petroleum Fund balance shrank as Bayu-Undan production is diminishing.

The Petroleum Fund balance was at USD 16.9 billion (about 10 times of 2022 GDP) by the end of September 2022, a decline of nearly USD 1 billion from USD 17.8 billion in Q2 2022 (Figure 1.14). The gross cash inflows to the Fund from royalties and taxes during the period were USD 93.9 million, significantly lower than the peak inflows from the same sources of close to USD 950 million in Q1 2013.¹⁰ The lower figure is driven by the natural decline of the Bayu-Undan field that is set to fully cease operations in a few months. The Fund recorded more than USD 2.5 billion losses during the first three quarters of 2022 due to weak investment returns and asset revaluations (Figure 1.15). The sticky inflation, expectations of future Fed rate hikes and geopolitical tensions weighed heavily on stocks and bond markets. On the other hand, the outflow for the third quarter includes USD 404 million for state budget financing and close to USD 4 million for management fees. The Government has withdrawn a total of USD 854 million by September 2022 against the total estimated sustainable income (ESI) of nearly USD 550 million.¹¹ Until there are inflows from a new hydrocarbon production field (See Box 2.1) or a considerable change in the Government’s fiscal policy, the Petroleum Fund balance is expected to keep declining. Transfer to the state budget in the future will likely have to be financed by selling the Petroleum Fund’s capital assets as investment returns are likely to be lower than historical averages.

Figure 1.14: The Petroleum Fund balance has been declining for three consecutive quarters...

(USD million)

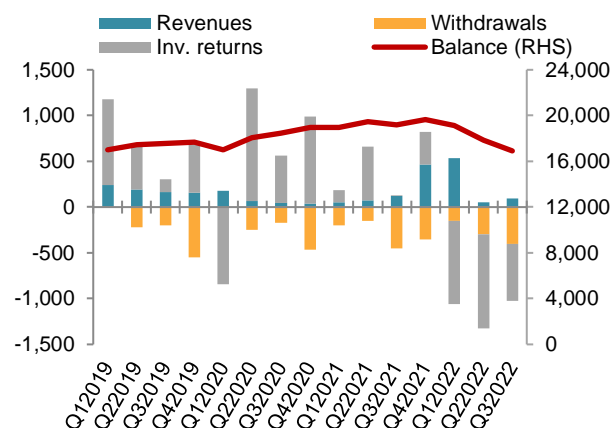
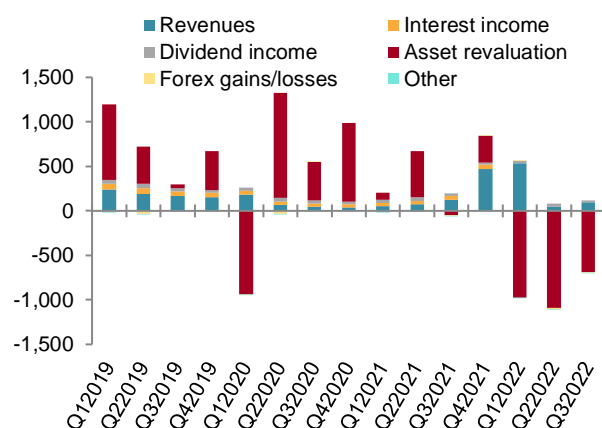


Figure 1.15: ... as bearish financial market eroded its valuation.

(USD million)



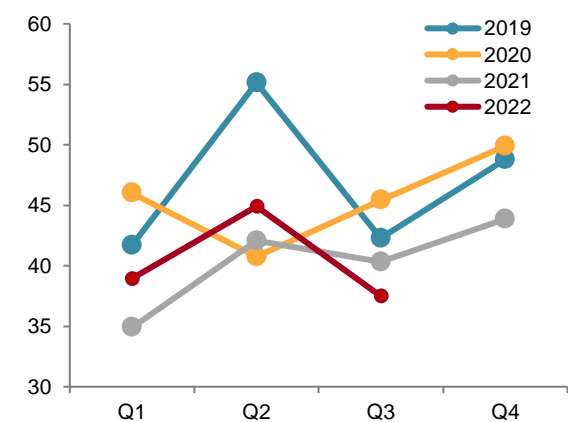
Source: Central Bank of Timor-Leste (BCTL)

1.5 Revenue collection and budget execution yet to return to pre-pandemic levels.

Excluding withdrawals from the Petroleum Fund, the authorities collected slightly higher revenue during the first three quarters of the year compared to the same period last year. The total revenue collected was nearly 2.3 percent higher yoy, (Figure 1.16). The collection from non-tax revenue, which is a volatile source, was considerably lower, notwithstanding better performance on tax collections (Figure 1.17). Improved collection of individual income tax for private sector workers, corporate tax, and sales tax is reflective of economic activity recovering from the impact of the pandemic and natural disaster. Nevertheless, there is still a gap to bridge before revenue collection returns to pre-pandemic levels.¹⁵

Figure 1.16: Domestic revenue declined in Q3 2022...

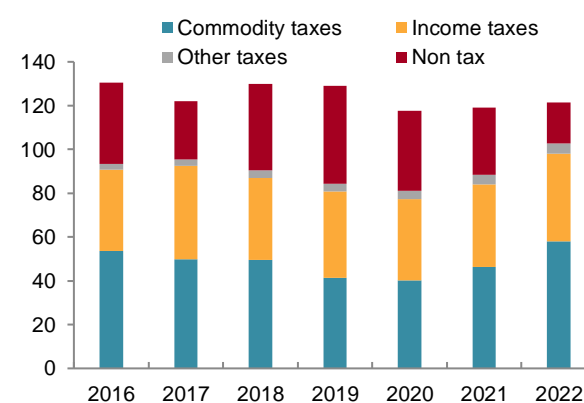
(USD million)



Source: Ministry of Finance

Figure 1.17: ... but year-to-date total revenue collection is still marginally higher.

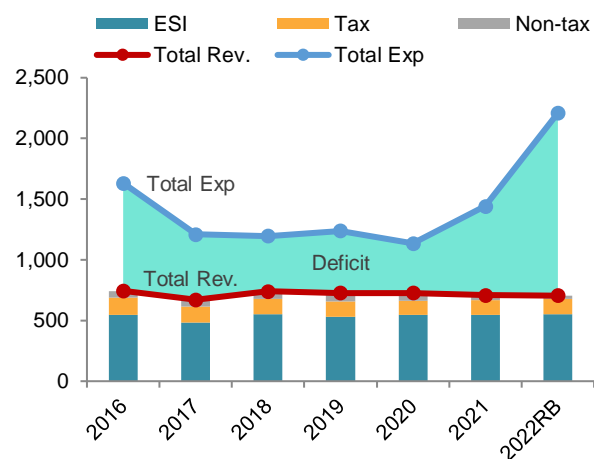
(Domestic revenue collection from Jan-Sep, USD million)



¹⁵ This is partly because of the decision to exclude the revenue collected by Bee-TL and EDTL, after the two became public entities, from the state revenues.

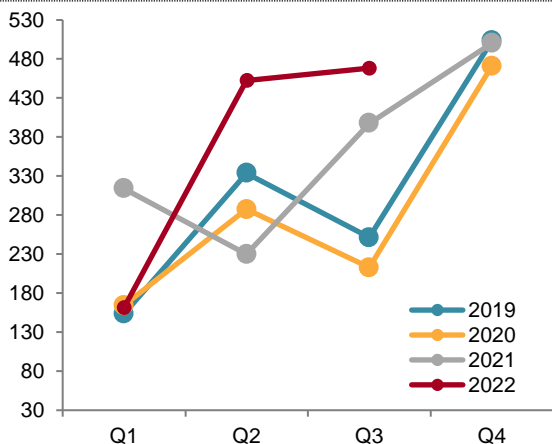
The level of government spending has been persistently high despite the receding impact of the pandemic (Figure 1.18). The disbursement level grew by 15 percent by the end of the third quarter of 2022, higher than the disbursement rates during the last three years (Figure 1.19) but is also considerably distant to meet the full disbursement by the end of the fourth quarter.^{16 17} Nearly half of the rectified budget has been disbursed, driven mainly by relatively higher disbursement of transfers and wages. For the last four years, however, spending on public transfers, including personal benefit transfers and public grants, has been growing significantly at 31 percent on average. Spending on social protection may not necessarily target the poorest or the most vulnerable. There are also concerns over the sustainability of social security spending in general. Public grants include support to state-owned enterprises and payments to private institutions. Improving the targeting and transparency of public grants and reforming the social protection system would significantly improve the impact of public spending while promoting fiscal sustainability.

Figure 1.18: Fiscal deficit expanded despite the receding impact of the pandemic



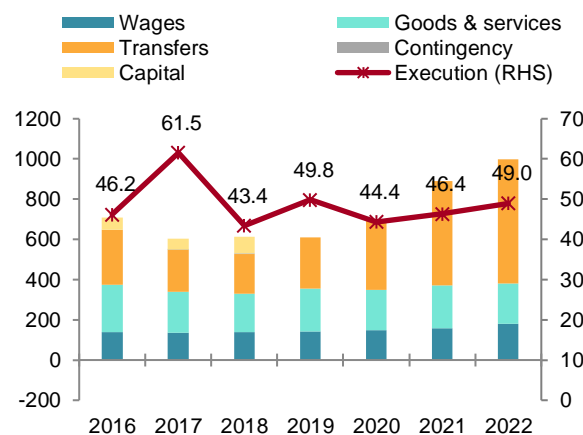
Source: Ministry of Finance

Figure 1.19: Almost half of the 2022 budget has been disbursed...
(USD million)



Source: Ministry of Finance

Figure 1.20: ... driven by the spending on transfers, goods and services and wages
(Budget disbursement from Jan-Sept, USD million)



The execution of capital spending surged by 58 percent yoy by September 2022 from a very low base. Disbursing capital spending was challenging in the second half of 2021 due the state of emergency imposed by the Government in response to the Omicron wave. Though relatively improved, at 16.7 percent for the first 9 months, the execution rate for capital spending is still very low. It is crucial to prioritize capital spending projects and make improvements along the entire project cycle to enhance its impact on economic growth. On the other hand, the realization of wages and salary spending by September 2022 is at 67.2 percent, higher than the five-

¹⁶ Total expenditure of rectified 2022 budget is USD 2.2 million (excluding USD 1 million for National Liberation Combatants' Fund (NLCF)).

¹⁷ The materiality directive of Timor-Leste states that the government must spend 100% of the budget by the fourth quarter

year average of 65.3 percent. Although spending on salary & wages does not account for a large share of total spending, it averaged 12 percent of GDP in recent years. This is quite high when compared to regional and income peers, as well as other small (island) states (see Box 1.2).

Box 1.2: Government spending on Wages and Salaries

Spending on salaries and wages warrants close scrutiny. Between 2015 and 2021, expenditure on salaries and wages increased from 10.9 to 14.5 of non-oil GDP. The salary per employee, however, only increased by 7 percent over the same period as the additional expenditure was largely driven by a 16 percent increase in the number of government employees.¹⁸ In 2019, three ministries accounted for over half of the total expenditure on salary and wages: Ministry of Education (30 percent), Ministry of Health (11 percent) and Ministry of Interior (11 percent). In fact, the education and health sectors account for over half of the total wage bill when including autonomous public agencies – such as the National Hospital Guido Valadares (HNGV) and the National University of Timor-Leste (UNTL) – and other related institutions. On top of this, there is expenditure on national and international advisors with fixed term contracts, which until the 2023 budget, was classified under goods and services (professional services category).¹⁹

At 12.6 percent of GDP in 2020, the budget for wages and salaries in Timor-Leste is higher than countries such as Fiji, Solomon Islands, and Laos (Figure 1.21Error! Reference source not found.). However, at 18 percent of total spending in 2020, the budget for wages and salaries in Timor-Leste was lower than in Fiji, Solomon Islands, Vanuatu and Laos (Figure 1.22).

Figure 1.21: Wages and salaries spending were relatively high compared to other peer countries...
(percent)

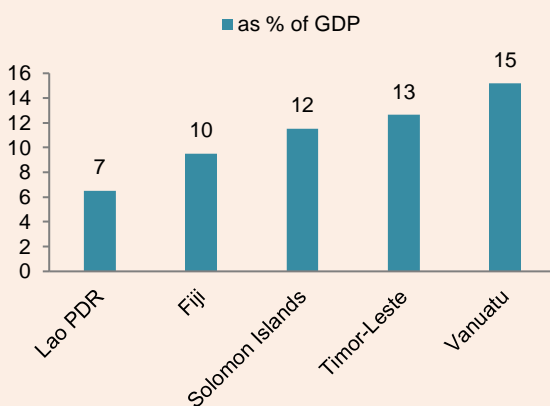
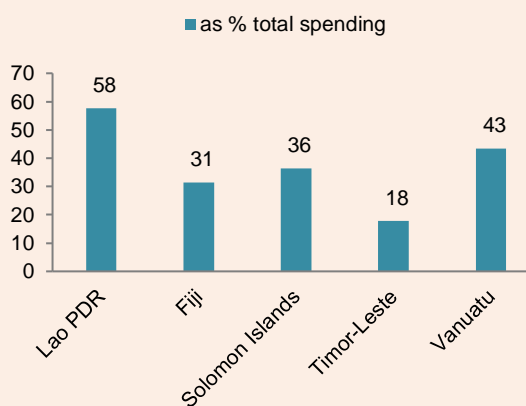


Figure 1.22: ...yet low in terms of proportion of spending
(Percent of total spending)



Source: IMF Government Financial Statistics

There are about 16,000 civil servants under the general regime, 10,000 under the teachers’ regime, 3,600 health professionals, and 1,900 in management positions.²⁰ Additional regimes include: anti-corruption specialists, scientific police and criminal investigation, labor inspection, auditors, UNTL teachers, justice officers, and parliament. The proliferation regimes within the civil service makes compliance checks by relevant entities and payroll review more complex. As such, information on the composition of the civil service needs to be better consolidated among relevant institutions. An independent Civil Service Commission (CSC) was established in 2009 to strengthen the efficiency and effectiveness of the civil service. To better track employee’s history, the CSC manages individual records through a personnel information management system called SIGAP. However, there are discrepancies between SIGAP and both the Ministry of Finance’s record and human resource departments within line ministries and agencies. Information on the public sector workforce – such as headcount and the average pay – needs to be reconciled to provide an accurate representation of the civil service.

¹⁸ The inflation during the similar period (June 2015 – June 2021) was recorded at 6 percent.

¹⁹ It has not been possible to break down the expenditure on professional services which accordingly limits the scope of the analysis.

2. Outlook and Risks



The economy is expected to continue its recovery amid a decline of COVID-19 infections and strong fiscal support. GDP is forecast to grow by 3.0 percent in 2023 and 3.0 percent in 2024, assuming political and economic stability post the parliamentary election (Table 2.1). Setting aside the Veteran Fund – see Section 3, the 2023 state budget provides a resource envelope of USD 2.2 billion (nearly 113 percent of GDP), slightly lower than the rectified 2022 budget, but is nearly 1.8 times higher than the actual spending in 2017-2019. If adequately executed, public consumption and investment are expected to stimulate the economy.

Table 2.1: Economic Forecast

(Percent)

	2018	2019	2020	2021	2022f	2023f	2024f
Real non-oil GDP growth	-0.8	2.1	-8.6	2.9	3.0	3.0	3.0
Private Consumption	2.6	3.7	-2.5	-2.7	3.1	3.7	3.8
Government Consumption	-1.0	3.2	4.9	3.5	5.7	2.3	1.9
Gross Fixed Capital Investment	-1.8	-17.4	-42.5	-13.0	28.0	11.8	14.0
Export, Goods and Services	8.4	-17.2	-51.1	151.9	12.2	13.8	14.0
Import, Goods and Services	2.3	-6.5	-8.5	-9.1	10.3	6.4	7.0
Inflation (Consumer Price Index)	2.2	0.9	0.5	3.8	7.5	3.5	2.5
Fiscal Balance (Percent of non-oil GDP)	-28.7	-29.9	-25.6	-47.0	-54.0	-53.8	-53.7
Current Account Balance (Percent of non-oil GDP)	-12.1	7.8	-19.1	2.8	-13.5	-35.7	-39.3

Consumer price inflation is forecast to surge to 7.5 percent this year before receding to around 2.5 percent in 2023, largely caused by the high base effect. The increase in excise tax earlier this year has led to a one-off increase in the level of tobacco and alcoholic beverage prices in 2022. Strong fiscal stimulus combined with higher demand due to “local content requirement” of the food basket program (*Cesta Básica*) may have exacerbated the upward pressures on consumer prices.²¹

The 2023 state budget allocates slightly lower spending than in 2022 even if it is larger than the average of the pre-COVID-19 budget. Following the recently approved Major Planning Options Law, the authorities envision the 2024 and 2025 budget to escalate by 5.3 percent and 3.9 percent respectively. Without major revenue reforms, the fiscal deficit is projected to hover at around 50 percent of GDP in the medium term. Curbing expenditures – especially from those that are not pro-poor – and prioritizing capital investments would help promote fiscal sustainability.

The country’s current account and its Petroleum Fund balance will be adversely affected by the cessation of hydrocarbon production in the Timor Sea. The Bayu-Undan offshore field will be decommissioned by year-end, with the production of gas liquids from the field to finish over the same timeframe. The operator of the field proposed to redevelop the field for carbon capture and storage. The project is however likely to be less lucrative for the Government in terms of tax revenue than hydrocarbon extraction. In turn, the balance of the Petroleum Fund would deteriorate faster while the current account balance will shift back to a large deficit as early as 2023 when oil exports will cease.

Downside risks include an abrupt global slowdown, COVID-19 outbreaks, and natural disasters. These risks are exacerbated by higher international prices of commodities, a stronger US dollar, and worsening global financial conditions. High international commodity prices, especially food, have a considerable impact on the purchasing power of (poorer) households as much of the food must still be imported. Unless the Greater Sunrise or other new producing fields are online, trends in petroleum prices will have no impact on petroleum revenues (See Box 2.1). The performance of the US dollar against the currencies of Timor-Leste’s main trading partners has an important effect on the country’s international competitiveness. Depressed international stock markets would affect the Petroleum Fund’s investment returns through negative revaluations.

Box 2.1: The Conundrum of Greater Sunrise

As the world begins a substantive shift to renewables, Timor-Leste remains overly reliant on hydrocarbon production for sustaining its economy. More than 90 percent of total exports and over 80 percent of the Government’s revenues are from hydrocarbon-related activities. Nonetheless, the country faces a perilous future as oil producing activities in the Bayu-Undan fields are to be concluded this year. Without the oil revenues, the undiversified economy of the country will solely rely on the rapidly depleting Petroleum Fund to bridge the considerable fiscal gap in its annual budget. Yet, according to the Government’s own projections, the Petroleum Fund is likely to be fully depleted in 2034 or even sooner depending on the spending trajectories. In this context, the Government is looking to the exploitation of the Greater Sunrise fields as a solution to the challenge of poor economic performance and low non-oil domestic revenues.

The Greater Sunrise is an important source of untapped revenue in the form of deep-water hydrocarbon fields. The fields are in the Timor Sea, south of Timor-Leste and north of Australia and hold a total contingent resource of 5 trillion cubic feet of dry gas and over 230 million barrels of condensate.²² In comparison, Bayu-Undan was estimated to have produced around 3 trillion cubic feet of gas and 400 million barrels of oil.²³ Despite close estimates of the resources stored in their reserves, the oil and gas prices have changed dramatically from around USD 37.3 a barrel in

²¹ The *Cesta Básica* was an initiative under the Economic Recovery Plan as the basket included locally produced commodities-with the aim to stimulating local production.

²² 2010 Annual Report of Woodside Petroleum Ltd. See:

<https://www.laohamutuk.org/Oil/Sunrise/2011/SunriseWoodside2010AnnualReport.pdf>

²³ See <https://www.offshore-technology.com/projects/bayu-undand/>

2004 (the year Bayu-Undan fields started its production) to USD 69.1 a barrel in average in 2021²⁴. If successfully developed, the Greater Sunrise fields offer a significant upside risk for Timor-Leste.

Discovered in 1974, the field has, however remained undeveloped for nearly three decades. The development of Greater Sunrise has been hindered in part because of the maritime boundary dispute between Timor-Leste and Australia and the decision as to whether to process the extracted petroleum in Timor-Leste or Australia. Yet, on March 6, 2018, a maritime boundary treaty was signed and ratified by both governments in August 2019. The agreement essentially removed a significant impediment for the development of the fields while setting a stable legal framework for both countries to jointly develop the fields and share the associated revenue.

Nevertheless, the ownership structure over Greater Sunrise is dynamic, with state and private entities having their say on how the field should be further developed. Timor Gap, a state-owned company, owns approximately 56.6 percent, while Woodside and Osaka Gas retain close to 33.4 percent and 10 percent of the operations, respectively. Accordingly, the development of the Greater Sunrise fields is highly uncertain, driven by the difficulties in finding a commercially viable option that is acceptable to all parties. The two options being considered include:

- (i) Processing the hydrocarbons along the Southern Timorese coastline, which is geographically closer to the Greater Sunrise fields. The transformation of the south coast of Timor-Leste as a regional petroleum center is a key part of the Government's development strategy. When the upstream and downstream industry is developed, the Government expects it to contribute more broadly to the development of the economy and the south coast, generating over 10,000 direct jobs and more than 50,000 indirect jobs.²⁵ Nevertheless, considerable investment spending is necessary to build suitable infrastructure to allow this proposal to be successful.
- (ii) Processing the hydrocarbons in Darwin, Australia, which has an existing liquified natural gas infrastructure, including a port, processing plants, highways and a skilled workforce that have served well the Banyu-Undan field in the past. As such, this option offers a relatively quicker timeline for the development of the field.

Even if arduous, it may be in the best interest of Timor-Leste's authorities to find a viable solution through a thorough cost and benefit analysis for the Greater Sunrise to start producing within the near future. Irrespective of the option chosen, the development of the field is further confronted by the declining Petroleum Fund and the dwindling appetite of investors to finance fossil-fuel related projects. Accordingly, raising the funds to meet the development of the required infrastructure is yet another conundrum to resolve. On the one hand, if the Greater Sunrise does not come to fruition, Timor-Leste will miss out on its future revenue potential. On the other hand, even if it does generate revenue, an oil-based economy can struggle to create jobs, which is a priority for Timor's young and growing population. As such, it is imperative for the authorities to intensify the efforts to grow other sectors and to diversify the economy away from the oil sector.

Although the acute impact of the COVID-19 pandemic is fading, there is still an opportunity to minimize the cost of living with the virus. Universal vaccination remains the best source of protection and should be backed by broad public health campaigns to encourage vaccine uptake. Public support for better systematic responses to future epidemics remains essential.

Extending the life of Petroleum Fund through fiscal consolidation is essential to delay the fiscal cliff and ensure the perpetuation of government spending to support economic growth. Despite receding impact of the pandemic, the level of government spending has not returned to the pre-COVID 19 levels. The issue of fiscal sustainability continues to be a major concern as the current flow of petroleum revenue is projected to cease in 2022. Fiscal sustainability should be secured through fiscal consolidation and the commitment to stop relying on excess withdrawals from the Petroleum Fund. Fiscal consolidation, in turn, should be supported by revenue mobilization and expenditure rationalization.

²⁴ World Bank Commodity Market Outlook (2022)

²⁵ The Oil and Mineral Resources program of the Eight Constitutional Government of Timor-Leste. See <http://timor-leste.gov.tl/?p=19915&lang=en>

Enhancing productive capabilities through structural reforms holds the key for accelerating and sustaining economic development.²⁶ To achieve the 7 percent growth target envisaged in the Government program, it is crucial to support private sector development. This would not only contribute to boost economic growth, but it would also increase economic resilience, support economic diversification and help ease trade imbalances. Strengthening domestic linkages and promoting competitiveness will also be key to creating a large number of employment opportunities for a growing young population. To capitalize on its youth bulge and translate it into a demographic dividend, on the other hand, Timor-Leste will need to improve the efficiency, equity and sustainability of its human capital investments.

Enhancing the effectiveness and the efficiency of public spending is essential to improve the impact of fiscal policy on economic activity. The 2021 World Bank Public Expenditure Review (PER) suggests that large increases in public spending have had a limited impact on medium-term economic growth. Continuously improving public financial management (PFM) is fundamental to improving the quality of fiscal policies (see Box 2.2). Additionally, despite the wide range of services and the high level of social protection spending, improvements in welfare remain limited. Chapter 3 discusses various reform options to improve the social protections system in the country.

Box 2.2: The Importance of Public Financial Management Reforms in Timor-Leste

Public Financial Management (PFM) is important to ensure fiscal discipline that is essential for macroeconomic stability, strategic resource allocation, and efficient service delivery. The Ministry of Finance has produced its first PFM Strategy for 2022-2027, which is at an advanced stage of being approved by the Council of Ministers. The strategic vision is to have efficient, effective, transparent and sustainable PFM that will deliver services to enable socio-economic transformation. There are five strategic goals, which are to: (i) strengthen fiscal policy to improve fiscal discipline and macroeconomic stability; (ii) enhance resource mobilization to create fiscal space; (iii) allocate resources consistent with the priorities in the Strategic Development Plan 2011-2030; (iv) promote the efficient use of public resources and delivery of services through better budget execution; (v) promote accountability through external scrutiny and transparency of the budget.

Given the limited available resources, priorities of the implementation of the PFM strategy will be essential and should include efforts to strengthen fiscal policy. In the medium term, the economy of Timor-Leste will still considerably rely on government spending. However, the projected depletion of the Petroleum Fund in 2034 implies that “change government spending and revenue behavior” to “improve fiscal sustainability and macroeconomic stability”, as illustrated in the draft of the PFM Strategy, is urgent. Accordingly, a two-pronged approach, aimed at mobilizing more domestic revenue and rationalizing expenditure, is of extreme priority.

Timor-Leste has started creating a good foundation for these reforms with the passage of key legislation. These include the Framework Law on the General State Budget (GSB) and Public Finance Management (PFM) approved in 2022; and the Legal Regime for Procurement, Public Contracts, and Respective Infractions approved in May 2022 but expected to enter into force on January 1, 2023. A new tax law is being drafted along with tax procedure code to replace the Tax and Duties Act. The introduction of a Value Added Tax (VAT) is also planned.

Key challenges facing the implementation of the strategy include the political will to carry out the reforms, especially after the elections in 2023, which is essential for sustainability. Another key issue is the capacity constraints to implement the reforms, although the PFM strategy has a plan to develop the skills of government staff within the country by having a PFM Training Centre. Despite these challenges, the country is moving in the right direction to benefit from the important aspects of a good PFM system, which is essential in enhancing development.

²⁶ The forthcoming Timor-Leste Country Economic Memorandum: Pathways to Economic Diversification discusses Timor-Leste’s economic performance in recent decades and proposes policies to enhance growth. It highlights two key inter-related constraints to sustained and inclusive growth: the ‘missing’ private sector and the need to tap into the growth-enhancing benefits of international trade.

3. Improving the Performance of Timor-Leste’s Social Protection System



3.1. Introduction

Social protection plays an important role in reducing poverty while at the same time it helps build, protect, and employ human capital. The social protection systems in many countries comprises tax-financed social assistance programs, activation and labor market interventions, and a social insurance system which consists of both contributory and non-contributory schemes.

Timor-Leste’s unwavering commitment to social protection is reflected in a national system that provides a wide range of benefits and services. Following a 2006 internal political crisis, Timor-Leste has embarked on an ambitious expansion of social assistance through a series of cash transfers programs launched in early 2008. These programs included pensions for veterans, elderly and disabled as well as Bolsa da Mae, a conditional cash transfer program targeting vulnerable households with children. Other benefits and services were introduced in due course including the disaster recovery program, child protection services, emergency support to individuals and vulnerable families, support services to victims of gender-based violence and domestic violence as well as support to prisoners. In 2012, a non-contributory social protection scheme was developed for public civil servants aiming to replace lost income in the event of old-age, disability and death. This scheme was kept in force until its convergence with a national contributory social security general scheme launched in 2016. The new contributory general scheme provides protection in case of old-age, disability, death, maternity, paternity and adoption. The scheme is mandatory for employed workers and voluntary for self-employed and other independent workers.

In November 2021, the Government launched the National Social Protection Strategy that sets out clearer visions and objectives of the country's social protection system. The strategy builds on the targets set out in Timor-Leste's Strategic Development Plan 2011 – 2030 and the SDGs and is also part of the Strategic Plan of the Ministry of Social Solidarity and Inclusion. The strategy stipulates three main objectives namely: 1) reducing poverty, 2) improving and expanding social security for workers, and 3) promoting institutional development. Each of these objectives contains priority interventions and foresees the establishment of a National Council for Social Protection and Executive Secretariat for Social Protection to promote stronger coordination and monitoring.

Despite the wide range of services and the high level of social protection spending, improvements in welfare remain limited. Over the past decade, Timor-Leste's social protection expenditure has both expanded in nominal terms and contracted in terms of non-oil Gross Domestic Product (GDP) share. Social protection expenditure has decreased sharply from 15 percent to 7 percent of non-oil GDP.²⁷ The high allocation a decade ago reflects the social stabilizing function of social protection following the violent 2006 conflict. An impact analysis shows that Timor-Leste's core social protection spending had prevented poverty from increasing by 9.3 percentage points, a relatively unsatisfactory outcome considering the large costs. While the country accelerates its economic diversification efforts to overcome the depleting oil revenue, large portion of the population will continue to rely on government transfers. It is therefore timely to look into existing programs' performance to identify rooms to increase spending efficiency.

The fragmented implementation and delivery mechanisms also jeopardize the overall effectiveness of the country's social protection system. Each program has its own delivery chain and information system which require beneficiaries to interact with different entities in accessing different types of benefit. Interoperability between systems does not exist mainly due to the absence of a unique identification number. This lack of interconnectedness also deprives key stakeholders and decision makers of an opportunity to conduct systematic monitoring and impact analysis. The COVID-19 pandemic has further highlighted the urgency to revamp the existing social protection delivery and to develop an adaptive social protection system to better protect the Timorese during future socio-economic and environmental downturns.

To improve the performance of the social protection system, a combination of reforms on financing and delivery mechanism can be pursued. When it comes to spending efficiency, the Government could consider reviewing the existing programs performance and prioritize allocation for those yielding higher poverty reduction and human capital accumulation impact. Efficient allocation of fiscal resources can also be pursued by expanding coverage of social assistance programs more effectively to ensure supports are received by the most in need. For contributory social insurance programs, coverage increase should be approached carefully. At the same time, reforms that mitigate the unfunded pension liability emanating from the low contribution and a high replacement rate should also be considered. Improvements along the delivery chain, from outreach to grievance redress, would also improve the overall performance of the country's social protection system in reducing poverty and in building, protecting, and deploying its human capital.

3.2. Timor-Leste's Social Protection Financing

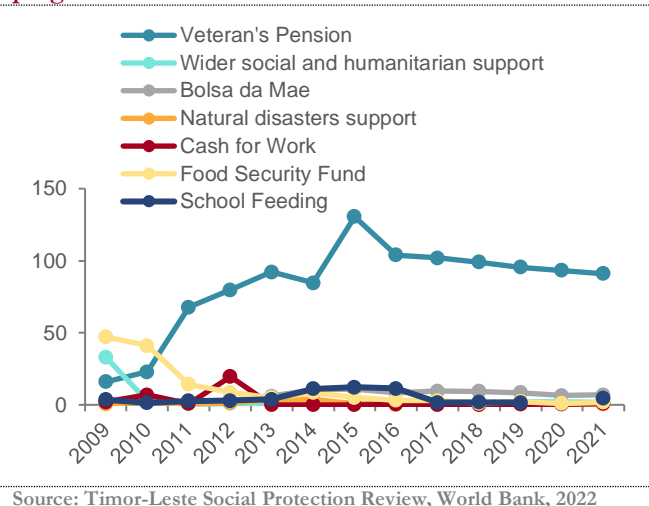
Timor-Leste has one of the highest rates of social protection spending in the developing world, but most is allocated for the Veterans' Pension program. In 2019, its total social protection expenditure is 7 percent of non-oil GDP. Excluding the veterans' pension, social protection spending corresponds to the ASEAN regional average of approximately 3 percent GDP. Up to 64 percent of the 2019 social protection budget was allocated to the Veteran's Pension program and very little had been effectively channeled to children and youth, particularly the poor and most vulnerable. This proportion is excessively generous considering its

²⁷ It is assumed that the non-oil GDP is a better proxy for income of the average Timorese than total GDP, which includes the oil sector. A portion of the Timor-Leste Petroleum Fund is taken out to support the government budget, benefiting the non-oil sector.

coverage of a very restricted group of people, estimated to comprise just 3.7 percent of the poorest 40 percent in 2019.

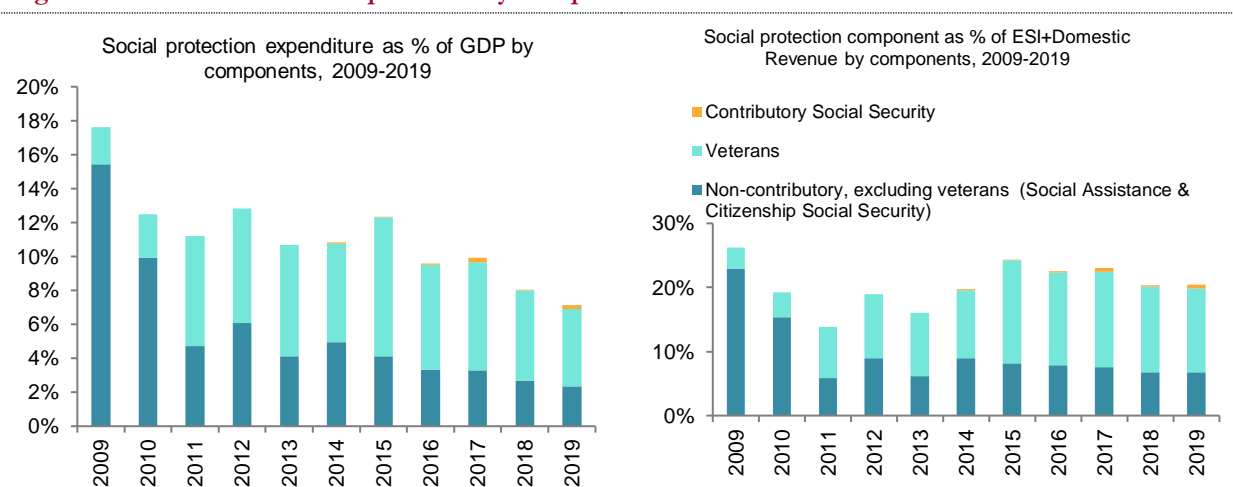
The social protection budget comprises mainly non-contributory programs, with the Veterans’ Pension accounting for the largest portion. While the budget for the Veterans’ Pension has expanded since 2009, the remaining expenditure on social assistance programs was decreased from 15 percent to 2 percent of non-oil GDP in 2019. After 2010, budgets for programs such as food assistance and support to internally displaced persons was also significantly reduced. Concurrently, other programs targeting specific groups and vulnerable people started attracting larger budget shares. The budget for the *Bolsa da Mãe* program had steadily increased from USD 3 million to USD 11 between 2009 and 2015, before it progressively lessened to USD 8.5 million in 2019. Remarkably the cash-for-work programs experienced variations in budget allocation. It increased from USD 2 million in 2009 to almost USD 21 million in 2012 and eventually contracted to USD 0.4 million in 2019. Similarly, the school feeding program budget also varied over time. Meanwhile, the contributory pension system, designed as a Pay As You Go scheme, is bound to incur some fiscal burden once the scheme matures. As the scheme is still in its early stage of implementation, the share of budget allocated for the contributory pensions and other social security benefits is still low.

Figure 3.1: Absolute trends in largest social assistance programs 2009-2021



Source: Timor-Leste Social Protection Review, World Bank, 2022

Figure 3.2: Social Protection Expenditure by Components 2009 - 2019



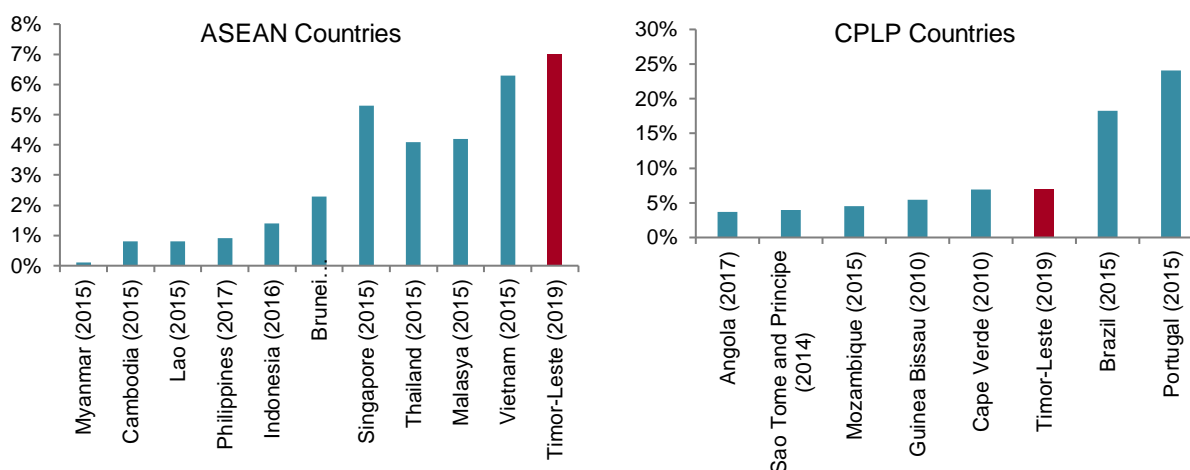
Source: Timor-Leste Social Protection Review, World Bank, 2022

Note: The Estimated Sustainable Income (ESI) corresponds to the amount that Timor-Leste can spend from the Petroleum Fund without depleting its long-term balance and is calculated on an annual basis. The ESI is set at 3 percent of the Petroleum Wealth that includes the Petroleum Fund balance and the forecasted net value of the future petroleum revenues.

Excluding veterans, the island nation’s social protection spending corresponds to ASEAN regional average of approximately 3 percent GDP. In the Community of Portuguese Speaking Countries (CPLP), social protection’s spending is more varied, ranging from 4 percent of GDP in Sao Tome and Principe and Angola to about 24 percent of GDP in Portugal.

The anticipated fiscal crisis due to the declining oil revenue provides very little room to increase social protection spending but there is ample opportunity to improve its overall efficiency. The social protection spending has been financed mostly by the General State Budget and increases in the social protection budget have relied on spending in excess of the Estimated Sustainable Income (ESI) of the Petroleum Fund. Very little comes from social security contributions or from the Social Security Fund interest as also shown in Figure 3.2 above. With the expected decline in petroleum production, the Government needs to explore options to generate sufficient fiscal space to extend social protection and bridge existing gaps in human capital. This also includes exploring the opportunity to reallocate across programs based on each program’s efficiency in reducing poverty as well as in promoting and protecting human capital. This exercise also entails a thorough analysis of the adequacy of benefit, the coverage, and the poverty reduction impact of the social protection programs as discussed below.

Figure 3.3: Total Social Protection Expenditure as % of (non-oil) GDP in ASEAN and CPLP Countries



Source: SP Country Reviews and Assessments for Angola, Philippines, Indonesia; ILO Report for Brunei and CPLP countries except Angola; ADB Report 2019 on SP for Asia for remaining countries

3.3. Performance of Social Protection

This section will discuss the performance of the Protection System by looking at the extent to which the programs cover the poor and vulnerable and their fiscal implication.

a. Coverage and Adequacy of Social Assistance Programs

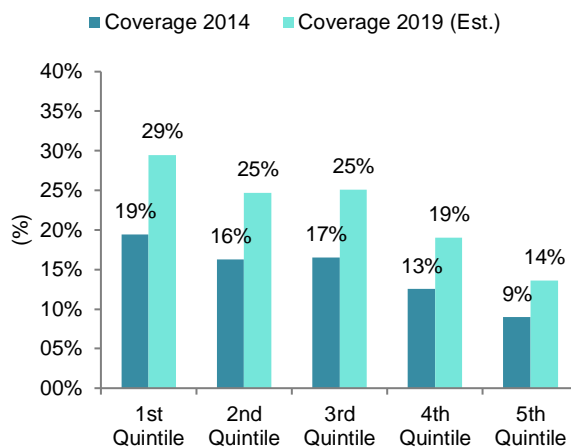
The Social Assistance programs consist of two main cash transfer and a number of other smaller interventions that provide in-kind and cash benefits.²⁸ The main social assistance cash transfer programs include the Conditional Cash Transfer (CCT) *Bolsa da Mãe* program implemented by the MSSI, and a Veterans’ Programs implemented by the MACLN (Ministry of National Liberation and Combatant Affairs). In 2022, the Government launched *Bolsa da Mae Jerasaun Foun* to provide non-conditional cash transfer to expecting mothers, children, and children with disability up to the age of six. Other smaller cash and in-kind benefits implemented by the MSSI include a wide range of on-demand social support programs, namely: Natural Disaster and Social Conflict Recovery Program; Funeral Services; Emergency Support to Individuals and Families in Vulnerability; Emergency Support to Victims of Gender-based Violence and Domestic Violence; Support to Prisoners and

²⁷ In the Social Protection Review conducted by the World Bank in 2013, main social assistance cash transfers included the *Bolsa da Mãe* program, Veterans’ Pension and the Allowance for the Support of the Elderly and Invalid (SAII - or social pensions for the elderly and disabled) all of which were non-contributory programs providing social assistance benefits. Following the implementation of the social security system in 2016, SAII was categorized as a social insurance component dubbed ‘Citizenship Social Security’, which is non-contributory. Section V on social security will elaborate with further information.

their Social Reintegration; and Support to Children in Conflict with the Law. In addition to programs implemented by the MSSSI, the Government also implemented other social assistance through other ministries. This includes Cash for Work program and Roads for Development Program which provides short-term employment opportunities for citizens living in rural area.²⁹

The *Bolsa da Mãe* (BdM) is the only program targeting poor and vulnerable households with children, with the explicit goals to reduce poverty, promote attendance of nine years basic education and increase use of primary health care services. The program benefits are contingent upon meeting specified conditions in education and health. It offers USD 5 cash transfers per child per month for up to three children such that USD 15 is the maximum amount a household may receive per month. *Bolsa da Mãe* beneficiaries have increased significantly over the past years. In 2019, there were 60,525 vulnerable households with children eligible for the *Bolsa da Mãe* program, which corresponds with 37 percent of Timorese households, compared to the initial 7,051 households in 2008. Figure 3.4 presents the 2014 and 2019 coverage for the *Bolsa da Mãe* program which clearly demonstrates that program coverage rate has improved significantly, particularly among the poorest 20 percent, from 19 to 29 percent. However, a substantial gap remained with an estimated 71 percent and 75 percent uncovered by the program in the poorest two quintiles in 2019.

Figure 3.4: 2014 and 2019 estimated share of household covered by *Bolsa da Mãe* program by expenditure quintiles (Direct and Indirect beneficiaries)



Source: Timor-Leste Social Protection Review, 2022

The *Bolsa da Mãe* 's benefit adequacy relative to the average total household expenditure is irrefutably low. In 2019, it is estimated that *Bolsa da Mãe* benefits amount to about 6 percent of the average household budget of the poorest quintile. This amount corresponds to 2.7 percent of the total consumption among all beneficiaries which is low compared to other CCT programs that vary from 6 to 29 percent (Figure 3.5). The amount of transfer can also be compared to other indicators to contrast the benefit adequacy against the context of Timor-Leste. Figure 3.6 below shows the relative size of the *Bolsa da Mãe* cash transfer program estimated at merely 4 percent of national minimum wage and 5 percent of per capita non-oil GDP. The benefit accounts for 11 percent and 12 percent of the national and international poverty lines, respectively.

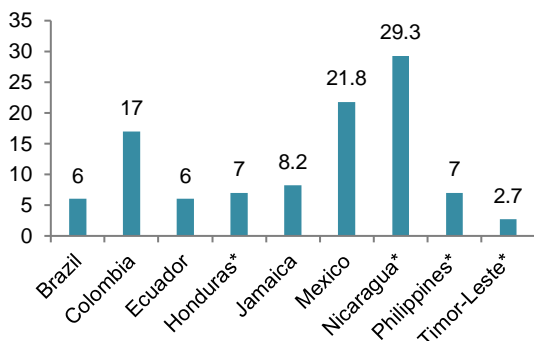
In 2021, the Government approved the launch of *Bolsa da Mae Jersaun Foun* with initial piloting in three districts with the highest rates of poverty and malnutrition: Ainaro, Bobonaro and Oecussi. The “new generation” of BdM will introduce universal cash transfer to children and pregnant mothers with additional disability allowance for children with certified disabilities and chronic illnesses. Expecting mothers will receive USD 15/month while children under 17 will receive USD 20/month.³⁰ This initiative is expected to universally address the adequacy and coverage issue previously discussed. However, it is important to note that the costs for non-conditional and universal cash transfer tend to fall on the higher end. The estimated costs of covering all children up to six years old for the next eight years is around USD 359 million or equivalent to

²⁹ Cash for Work program to provide short-term employment opportunities for rural communities. The program targets 17-59 years old and offers USD3 per day in exchange of short-term labour-intensive work. ILO and EU supported segment of the initiative provides USD5 per day. Meanwhile the MTPIC (Ministry of Public Works, Transport, and Communication) is in charge of implementing Roads for Development (R4D). The program creates short-term employment opportunities for women and men and is affirmatively designed to promote gender equality and employment access to person with disability. R4D offers USD5 per day for unskilled workers and USD10 for skilled workers.

³⁰ Information Brief: *Bolsa da Mae – Jersaun Foun*, Partnership for Human Development (draft), September 2021.

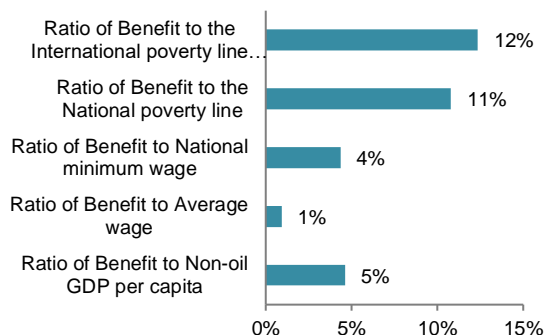
2.9 percent of 2021 non-oil GDP per year.³¹ Before long the Government will need to explore sustainable sources of funding and regularly revisit the program design to identify opportunities to further enhance the human capital impact of the transfers.

Figure 3.5: Adequacy of CCT Programs’ Benefit (as percentage of total consumption among all beneficiaries)



Source: Assessing the Bolsa da Mae Benefit Structure: A Preliminary Analysis, World Bank, 2015

Figure 3.6: Relative size of Bolsa da Mãe cash transfer program



Source: Timor-Leste Social Protection Review, World Bank, 2022

In July 2022, the Government also increased the benefit level of the school feeding program from 25 cents to 42 cents per pupil per day which makes the program at par with the international standards. The program was designed to combat hunger and promote school attendance by providing one hot meal per day at school. The initiative targets students between 3 and 15 years old and in 2018 there were 329,403 pupils benefiting from the program. The program covers universally the 6-15 years old children but fell short in covering pre-school age children at only 11 percent which reflects the low pre-school enrolment mainly due to the lack of infrastructure in the country.

Over the past ten years, Veterans’ Pension beneficiaries had substantially increased but coverage is skewed towards those who are better off. In 2019, some 28,123 veterans received payments compared to only 4,093 recipients in 2009. Figure 3.7 shows that in the early days, the Veterans’ Pension had benefited around 8 percent of the richest quintile compared to only 3 percent of the poorest quintile (based on 2014 data). The same figure also presents an estimate for the share of people covered in 2019, showing a similar pattern but with a coverage increase across all consumption groups most pronounced in the higher consumption groups. It is estimated that in 2019 the Veteran’s Pension had reached 21 percent of the richest 20 percent and about a third of that coverage for the poorest 20 percent. Meanwhile, households that fell in the poorest group (bottom 20 percent) accounted for merely 13 percent of all beneficiaries.

The Veterans’ Pension offers a very generous benefit. Using 2014 TLSLS data, it is estimated that the Veterans’ Pension may have financed up to 47 percent of average Timor-Leste’s household expenditures and 60 percent of the average household expenditures of the bottom 20 percent. Compared to other specific indicators, the Veterans’ Pension is consistently a very large source of household income. As shown in Figure 3.8 it is estimated that the Veterans’ Pension amounts to approximately 32 percent of average wage, 145 percent of minimum wage, 361 percent of national poverty line and 414 percent of international poverty line. The transfer amount could go as high as 155 percent of the non-oil GDP per capita.

³¹ Costing Timor-Leste’s Consolidated National Action Plan for Nutrition and Food Security 2023-2030, World Bank, 2022. This amount makes up 85% of the estimated total cost of CNAP NFS implementation.

Figure 3.7: Share of people covered by Veterans' Pension by consumption group (Direct and Indirect beneficiaries)

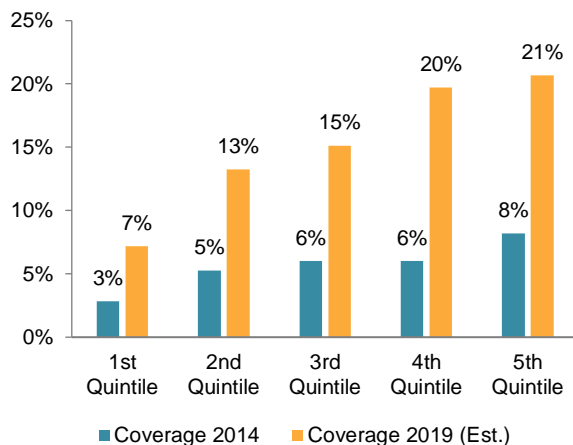
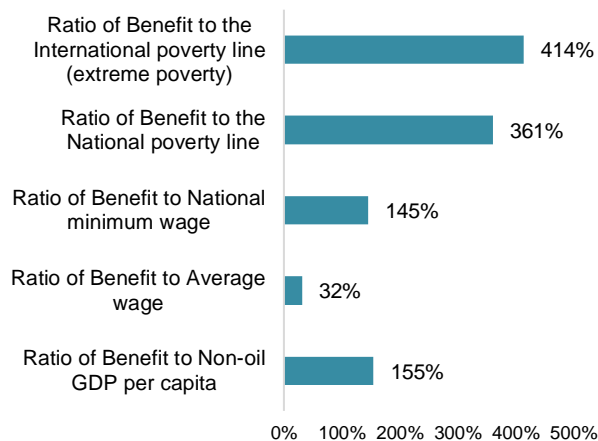


Figure 3.8: Relative Amount of Veterans' Pension



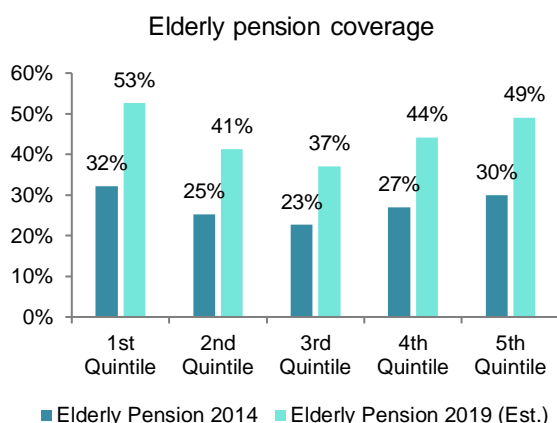
Source: Timor-Leste Social Protection Review, World Bank: 2022

Source: Timor-Leste Social Protection Review, World Bank: 2022

b. Coverage and Adequacy of Social Insurance Program

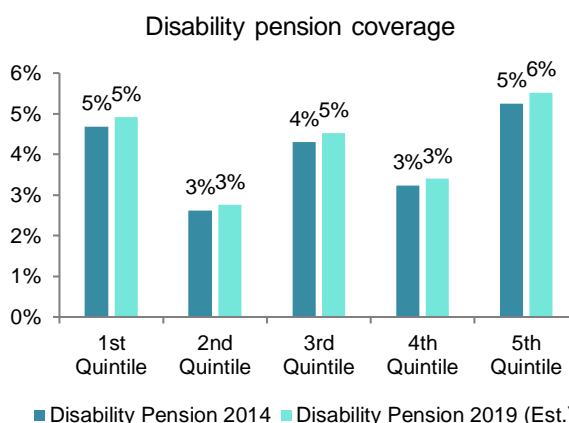
Timor-Leste's new social insurance system was established in 2016 and is organized into three systems: (i) Non-Contributory Citizenship Social Insurance System, (ii) Contributory Social Insurance System and (iii) Complementary Social Insurance System. The Citizenship Social Insurance programs are universal in nature and its coverage has been steadily increasing over the years. Its flagship includes the Allowance for the Support of the Elderly and Invalid (SAII) program -an elderly social pension that aims to guarantee a minimum income for citizens over 60 years who are neither receiving veterans' benefits nor covered by other compulsory social insurance scheme. Meanwhile, the Allowance for the Support of the Invalid is a disability social pension that aims to protect people who are above 18 years old with severe disabilities and are unable to work.

Figure 3.9: Elderly Pension Coverage by Consumption Group



Source: Timor-Leste Social Protection Review, 2022.

Figure 3.10: Disability Pension Coverage by Consumption Group



Source: Timor-Leste Social Protection Review, 2022.

The coverage of the elderly social pension has gradually increased and continued to reach the intended eligible groups since it was established in 2008 (Figure 3.9). The elderly pension benefit has reached 45 percent of eligible beneficiaries across income quintiles in 2019, compared to only 27 percent in 2014. Although

the number of disability social pension beneficiaries has more than doubled since the program’s inception³², it is difficult to ascertain that the benefit is indeed reaching the eligible population. The disability benefit only covers those with permanent inability to work and in 2019 this corresponds with 8,727 individuals. This number is much lower when compared with Timor-Leste’s disability prevalence of 3.2 per cent or equivalent to more than 37,800 individuals. This implies that, as of 2019, only around 21 percent of potentially eligible Timorese are covered.

The benefit level during inception, USD 30 per person per month, was considered inadequate. In 2022, the Government increased the allowance for the elderly and disabled to USD 50 per month, a reform that significantly increase the adequacy of the benefit. Similarly, the adequacy of the current benefit can be assessed by comparing it with Timor-Leste’s economic indicators including average wage, national minimum wage, per capita non-oil GDP and poverty lines as shown in Figure 3.11 below.

The Contributory Social Insurance System provides cash benefits that aim to replace reduced or lost income in case of old age, disability, death, maternity, paternity and adoption. Established through Law No.12 of November 14, 2016, the Contributory Social Insurance System comprises a *General Scheme* and a *Voluntary Scheme*, which offers a Pay-As-You-Go (PAYG) defined-benefit pensions and other allowances. The General Scheme is contributory and mandatory for all formal employed workers (employees and employers) from private and public sector. The Voluntary Scheme is a voluntary contribution for all other workers who are not covered by the mandatory scheme, namely entrepreneurs, self-employees, and domestic workers.

Figure 3.11: Relative size of annual benefits of the elderly and disability social pensions

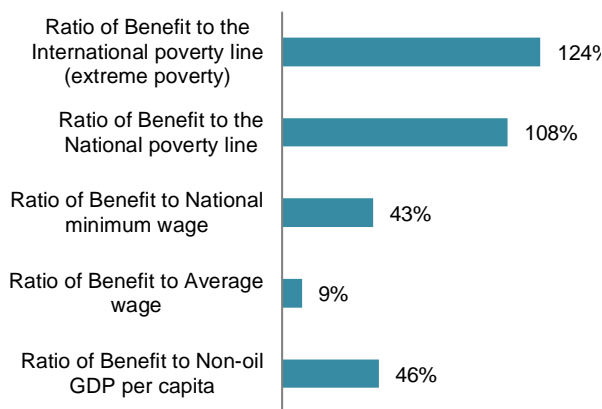
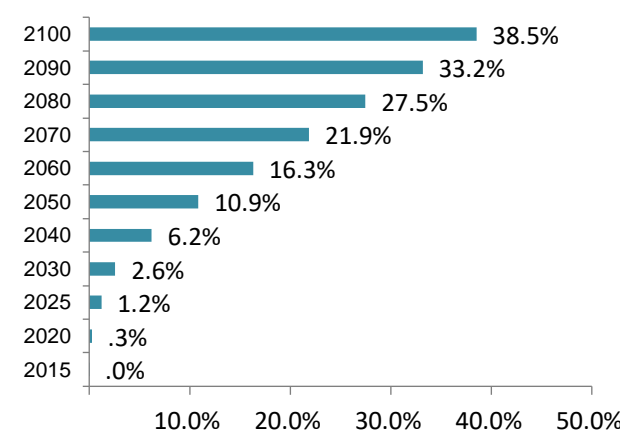


Figure 3.12: Required Pension Contribution as % of Payroll



Source: Authors' calculations based on LFS 2013, TL-SLS2014, IMF Country Report No. 19/124 May 2019 for Non-oil GDP estimates and, NSD-MOF Population projections 2004-2050. Source: World Bank (2014)

The current set up of the contributory pension scheme is facing a risk of an unfunded liability primarily due to low contribution rate that is actuarly insufficient to generate a high replacement rate. The existing general scheme allows a 100 percent replacement rate for old age, disability, and survivor pension for those fulfilling 30 years of contribution.³³ The replacement rate³⁴ is, therefore, much higher when compared to other countries. Most OECD countries average gross replacement rate at 1.5 times average earnings (called “high earnings”) is 45 percent³⁵. Meanwhile in ASEAN member countries replacement rates vary between 45

³² Timor-Leste Social Protection Review, World Bank, 2022

³³ The pension amount is calculated based on the average earnings of the best-paid ten years.

³⁴ Replacement rate corresponds with the level of pension benefits in retirement from mandatory pension schemes relative to earnings when working (OECD, 2019). It measures how effectively a pension system provides a retirement income to replace earnings. Replacement rate is also expressed as the ratio of the pension to final earnings (just before retirement).

³⁵ OECD (2019), Pensions at a Glance 2019: OECD and G20 Indicators, Paris: OECD.

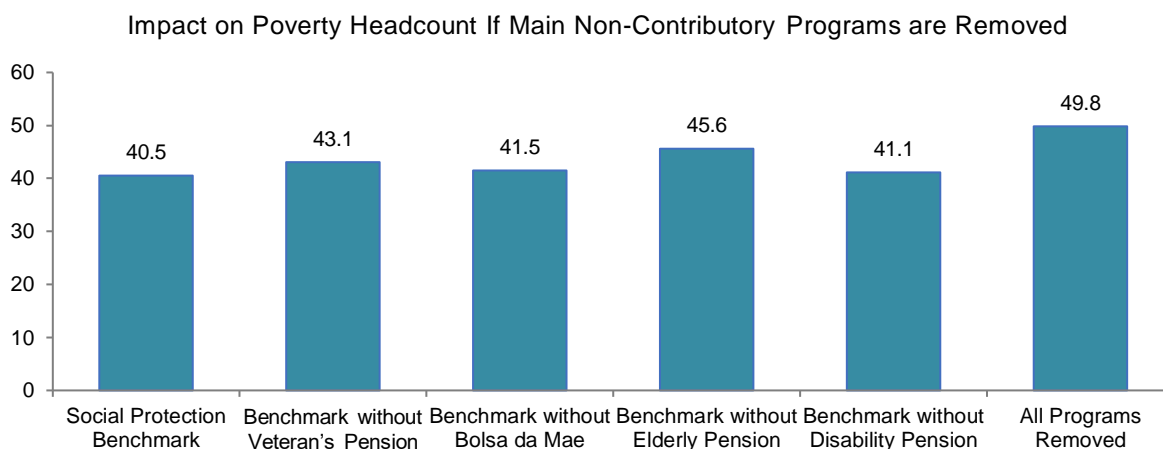
percent and 75 percent of insurable earnings.³⁶ The World Bank’s 2014 study estimated that a contribution rate of 6.2 percent is required to fund the plan over the period of 2015-2040 followed by an increase to 27.5 percent for the next 40 years. Ultimately, to finance the promised benefit, and taking into account the increasing dependency ratio,³⁷ the contribution rate must be increased to 38.5 percent by 2100 (Figure 3.12).

c. Poverty Impact of Social Protection Programs

The continually high level of public spending on social protection inevitably poses a confounding contrast to the high poverty rates and low human development outcomes. Timor-Leste’s human capital index stands at 0.45, which signifies that a child born today will only be 45 percent productive compared to when they are born in better health and education context. Overall, it is important to first spend better before spending more. With the impending exhaustion of the main source of social protection financing (and most public spending) by the end of the decade, adjustments towards pro-poor spending allocations while solidifying programs implementation and delivery systems is pressing.

The analysis shows that the main social assistance programs’ impact varies from negligible to small impact on national welfare. Figure 3.13 indicates the impact of the main set social assistance programs on poverty reduction. The *Bolsa da Mãe* program has gradually prevented people from falling below the poverty line by 0.9 percentage points from 40.5 percent to 41.4 percent. Meanwhile, the Veterans’ program has prevented poverty from increasing by 2.5 percentage points from 40.5 percent to 43 percent. Although the Veterans’ Pension program appears to be quite effective, this comes at a great opportunity cost. The simulation also shows that the elderly pension is the single non-contributory social security benefit that has the largest impact in reducing poverty by about 5.1 percent which is primarily driven by the program’s universality.

Figure 3.13: Impact on Poverty Headcount if Main Social Assistance Programs are Removed



Source: World Bank Staff Calculation based on Timor-Leste’s Social Protection Review, 2022

Meanwhile, despite its significant impact on beneficiaries’ income and livelihood, the disability social pension does not appear to bear noticeable impact on poverty reduction. This is because it only affects a very limited group of people, mainly those permanently unable to work. Proportion of the disability pension

³⁶ UN/ILO/MSS (2018), Challenges and ways forward to extend social protection to all in Timor-Leste: Assessment-Based National Dialogue report, UN/ILO/MSS: Dili.

³⁷ Beneficiaries of the contributory social insurance will start to grow faster after 2025 as the number of old-age pensioners accumulates. In the early stages, beneficiaries will most likely include those with disability, and survivors as very few would be eligible for old-age pension. After 2025, however, the number of beneficiaries will grow exponentially due to the accumulation of old-age pensioners. This will occur only 9 years ahead of the Petroleum Fund expected exhaustion. Predictably, the dependency ratio will continue to surge beyond 2100.

recipients within consumption groups indicates that the program is not pro-poor as exhibited with only less than half of beneficiaries are in the two poorest quintiles (See Figure 3.130).

As the only program targeting poor households with children, *Bolsa da Mãe* remains a far cry from achieving relevant poverty impacts at national level. With an allocation of 15 percent of the MSSSI total budget in 2019 (or 0.4 percent of non-oil GDP), the program has achieved an almost negligible reduction in the national poverty rate. This is due to the very small benefit level and low coverage of the poor population. The proportion of the program benefit—estimated at an average 6 percent of total household budget for the lowest quintile households (10 times less than the veterans’ benefit level)—is indeed too low to affect household welfare status. Not to mention that due to the lack of an effective targeting system, about 47 percent of the beneficiaries were estimated to be non-poor.

Despite the commendable tenacity to reward service during the struggle for Timor-Leste’s independence, the Veterans’ Pension allowance is very generous for a program that reaches very few. With such large transfer values, at triple the poverty line or about 50 percent of consumption, there is a large chance that the Veteran’s Pension inadvertently disincentivizes work although more analysis would be required to establish the significance and causality.³⁸ Further, although the Veterans’ Pension is estimated to have some impact on poverty reduction it comes at a great cost of 4.5 percent of non-oil GDP in 2019 and the poverty reduction impact is driven largely by the size of the transfer.

d. Delivery Systems and Covid-19 Challenges

Timor-Leste’s Social Protection programs do not share administrative tools. Each program uses its own methods for identification of beneficiaries, targeting, and payment delivery. As no strong, objectively developed targeting system exists, there is little convergence of programs. The MSSSI, for instance, has developed SIGAS as a Management and Information System for core social assistance programs, but it has only been limitedly used. Other cash transfer programs, including the veterans’ transfers, also maintain their own Management and Information System. Accordingly, the social protection identification and enrollment system remains disconnected, hindering policymakers’ capacity to discern whether programs converge or overlap, reducing the overall system’s efficiency and effectiveness. Lastly, the lack of strong monitoring and evaluation of programs ensures that Timor-Leste continues facing a challenge when preparing and executing a shock response for the poor. The latter was further confirmed during the implementation of the Covid-19 pandemic emergency response.

The implementation of the COVID-19 response inevitably faced implementation delays that are attributable to inefficient and fragmented delivery system. As one of the earliest responses, The Parliament had established a COVID-19 Fund with a budget of USD 219,5 million to finance both health and economic measures. In April 2020, the Government approved an economic response package which included a one-time USD 200 COVID-19 grants to households with a monthly income below USD 500, a food basket program targeting the entire Timor-Leste’s population by providing food, a personal care product up to USD 25 per-month during November- December 2020. To deliver the COVID-19 grants, MSSSI needed to establish a new national taskforce and coordination teams at municipal and local levels to support planning and the disbursement of the cash. MSSSI also needed to quickly put together a standard operating procedure and organized trainings on the procedure at different levels of government.

The pandemic highlights the importance of a robust delivery system and mechanism. This includes the importance of an integrated social protection information system that comprises social registry and beneficiary registries that can be deployed to generate list of eligible beneficiaries and execute payments in a speedy manner.

³⁸ A cross tabulation of TL-SLS 2014 data shows that 38 percent of the program recipients of working age had worked in the last week prior to being surveyed, compared to 60 percent of non-recipients. Controls included not suffering from a disability and work included work conducted at home.

The system should also employ a case management and grievance redress mechanism that is shock-resilient (could respond to sudden influx of cases), as well as protocols for data interoperability across government agencies. Had the Government invested in an integrated information system and unique identifier for every citizen, verification across multiple sources and complementary systems could have prevented multiple errors and progressed with a timely response to the COVID-19 emergency context.

3.4. Priorities for Reform

To improve the overall performance of the social protection system, the Government could consider several measures aimed at improving social protection spending efficiency, expanding the effective coverage both for social assistance and social insurance program, and improving the adequacy of the benefit. Equally important is investing in an integrated and interoperable social protection information and administrative systems that hinges on a unique identification number and robust population database.

a. Improving social protection spending efficiency.

The continually high level of public spending on social protection inevitably poses a confounding contrast to the high poverty rates and the persistently large exclusion among the poorest population. To improve current social protection budget's efficiency, the government could consider reviewing the existing programs performance and prioritize allocation for those yielding higher poverty reduction impact. With the impending depletion of the main source of social protection financing (and most public spending) by the end of the decade, adjustments towards pro-poor spending allocations while solidifying programs implementation and delivery systems is pressing.

Overall, it is important to first spend better before considering spending more. Instead of looking to spend more, Timor-Leste could first consider reallocating from within the social protection expenditures as well as from sectors with very low returns in poverty reduction. More specifically, based on a political consensus, the Veterans' Pension could be gradually reformed to i) limit future increases in coverage by redefining eligibility criteria, ii) adjust benefit amount to more appropriate level to promote equality and reduce disincentive to work, and iii) to limit the inter-generational transfers. Fiscal savings emanating from this exercise could be reallocated to, for example, increase the effective coverage and adequacy of *Bolsa da Mae* or to enhance the health and nutrition promotional activities under *Bolsa da Mae Jerasaun Foun*. More can also be allocated to help finance important delivery systems' improvements.

Box 3.1: Reforming the Veterans Pension

The Veterans' Pension was designed to recognize and compensate national former combatants for their past service during the liberation struggle. The Government created a pensions scheme by way of two decree laws in 2006 and 2008 with a number of amendments and revisions since. There are various types of pension with eligibility defined by participation in the independence struggle as part of the 'structures or organizations of the Resistance'.

Since 2002, there have been various registration processes to identify veteran combatants (World Bank 2008). Over that time over 250,000 individuals have self-identified as former resistance participants, approximately 60 per cent of the population over the age of 30. This number far outstrips historical estimates of participation (CAVR 2005). In a 2002 interview, the current Prime Minister, Taur Matan Ruak, summed up how difficult it was to identify those to be identified as veterans: *If we were to recognize all those who supported our struggle, we would have to extend this recognition to most of the population, as all have, at some point in time and in their own way, participated in the liberation of our nation* (Meden, 2002).

Over the past ten years, veteran pension beneficiaries and amounts have substantially increased. In 2022, some 27,981 veterans received payments compared to only 4,093 recipients in 2009. In 2012, the Government introduced the one-off payments (for 4-7-year participation) that contributed to a large increase in spending. These one-off payments accounted for 37 percent of the total veterans' pension, but this number sharply decreased to 3 percent the next year.

In 2018 the Council of National Liberation Combatants was created to represent ex-combatants and veterans at the national level as well as contend with the challenges related to eligibility. Under the pension legal framework there are seven pensions as follows: (i) special retirement pension (20-24 years participation) – 198 beneficiaries; (ii) special retirement (15-19 year participation) – 479; (iii) special retirement with high distinction – 3; (iv) Subsistence pension (8-14 year participation) – 13,267; (v) subsistence pension due to incapacity – 317; (vi) survivor pension – 12,872; (vii) survivor pension with higher distinction – 9. Of the 27,981 beneficiaries (2022) 19,515 are men and 8,466 are women.

As described above, about 65 percent of the total social protection budget is devoted to the Veterans: being USD 87 million in 2020, USD 88 million in 2021, USD 80 million in 2022 (as of November 2022) and USD 95 million projected for 2023. Although the pension benefits vary by beneficiary according to length of service, disability etc – this represents on average USD 3,395 per veteran for 2023. Over USD 1 billion has been spent on the Veterans Pension scheme since inception. Meanwhile, the ballpark estimate of the cost of fulfilling obligation to one subsequent generation will be around USD 2.5 billion (total - for the next 33 years, as per Timor-Leste’s life expectancy at 40) or equivalent to 4.8 percent of Timor-Leste non-oil GDP in 2021 per year.⁹⁾

In May 2022, through the Budget Rectification Law, the Government created a USD 1 billion Veterans Fund. This is to be administered as part of, but set aside from, the Petroleum Fund. The management board of the Veterans Fund comprises of representatives from the Prime Minister’s office, the Ministry of Veteran Affairs and the Ministry of Finance. The management board is supported by a technical committee that formulates the investment strategy of the Fund while BCTL is assigned to oversee the operational management. While there are no official documents relating to the Fund available for review, the reported intentions are for it to cover 160,000 of the self-identified former combatants and those involved in support functions (the *clandestinos*), who are currently registered and who are not under the Veterans Pension scheme. The reported scope to be financed includes: i) social transfers including health and education support and ii) loans for productive business activities. The stated intention is to draw only upon the investment return of the Fund to finance these activities.

In this context, the National Council and the Government face a number of very tough challenges. In the short term they relate to eligibility for the Veterans Fund, how to avoid ‘double-dipping’, and above all to avoid perceptions of exclusion by those who are not entitled. Further, under the Veterans Pension scheme, beneficiaries now pay a contribution of USD 30/ month which has created a growing fund (currently USD 25 million) but with little concrete planning of how to use this fund towards sustaining pension benefits. But above all, given the pending fiscal crisis, the question is how reforms can be put in place that render the veterans schemes more sustainable, poverty focused and inclusive.

Options to Transform Veterans Benefits

There are several options that the Government may consider to transform social protection for the veterans. These include reducing the inter-generational benefits, subjecting benefits to higher taxes or contributions, or making the veterans pension more means tested and based upon need. What appears important is for government and veteran leaders to discuss reform options going forward that honors the ‘liberation generation’ but allows the Government greater fiscal room to secure the future of the next generation.

One option to address the high fiscal implication of veterans’ pensions payout is customizing payments over a pre-defined period. Recognizing the wide age ranges of the ex-fighters – from as old as age 80 to as young as age 17 – the predefined period would need to accommodate both the short remaining life expectancy of older ex-fighters, and the longer ranging needs of younger ex-fighters – while maintaining some fiscal discipline on how long the Government can stretch out the payment. One potential approach would be to pay out the promise over a period that is the shorter of (i) the remaining life expectancy based on the ex-fighter’s current age and (ii) 20 years. Thus, with the same number of years of participation in the conflict, the older ex-fighters will receive larger annual payments for a shorter period, while the younger ones will receive smaller annual payments for a longer period.

Table 3.1: Illustration of payment schedules and annual compensation payments

Current age	40	60
Number of payments (in years, calculated using life expectancy at current age)	20	17.5
Annual compensation payment (in Dollars)		
With 8 years of participation	1,670	2,213
With 15 years of participation	2,264	3,000

Source: World Bank Staff Calculation

Table 3.1 illustrates the payment schedules and annual compensation payments using current average benefit level and hypothetical profiles of ex-fighters – ages 40 and 60, who participated in different years of conflict. Veteran pension payments could potentially also be executed as a lump sum instead of annual payments, taking into account many people’s presumably high discounting rate. There is also scope for reform in the benefit level and policies for survival pensions. Means testing can also be pursued, that is, limiting benefit payment to recipients meeting certain welfare criteria. Any changes to these parameters will have to be based on consensus among relevant stakeholders.

On the Veterans Fund there is more opportunity to consider options in the design phase. These could include making the Fund more inclusive, for example by including Victims/ Survivors as defined by the Commission for Reception, Truth and Reconciliation (CAVR) in the criteria for eligibility. Other options would include (i) to focus on productive activities and (ii) to link transfers at least partly on a needs-basis rather than entirely on years served. What will be important is that all these options and others are considered and discussed with a wide community of stakeholders.

*) This calculation assumes that benefit will be passed on when the survivor turns 40, survivors receive the minimum level of survival pension benefit (USD 230), and that there is no change in the amount of benefit in the future. The actual costs will likely be higher as the amount of pension varies based on the type of survivorship and can go as high as USD 750 per month. More detailed estimates can be produced subject to availability of administrative data.

A ‘bigger bang for the buck’ can also be pursued by ensuring that social protection programs directly contribute to human capital accumulation, focusing first on the poor and vulnerable. For example, the human capital impact of the *Bolsa da Mãe Jersaun Foun* could be further enhanced by introducing additional nutrition-focused design features and campaigns to promote behavioral changes among beneficiaries. See Box C for an illustration of how social protection programs could boost nutrition outcomes. Through its universality and higher benefit level, *Bolsa da Mãe Jersaun Foun* is expected to yield significant poverty reduction impact but is also important to note that the sustainability of a universal program once scaled nationally is a key concern given the lack of sustainable domestic revenue generating mechanisms and the impending depletion of the oil fund. An alternative option to consider would be to focus on the bottom quintiles by developing an affluence testing or welfare assessment system that would allow allocation of benefits to the poor and vulnerable, followed by progressive universalism at the later stage.

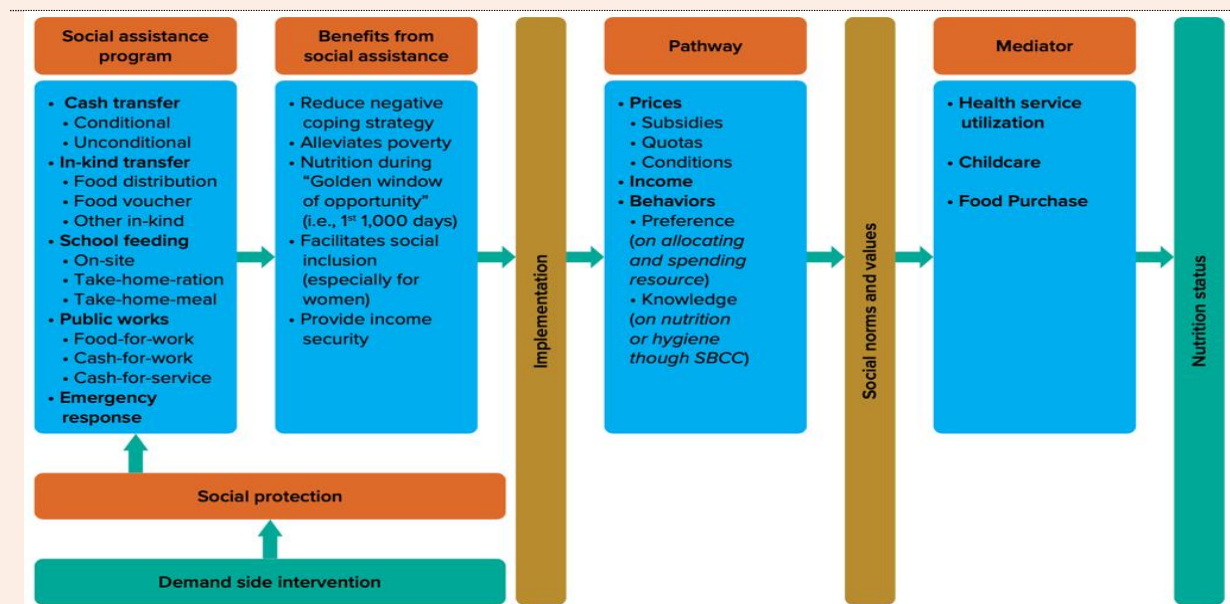
Box 3.2: Improving Nutrition Outcome through Social Protection

The role of nutrition in children’s development, especially during their first 1000 days from birth, has known to be crucial in determining their health and productivity in the future. Proper nutrition in utero and in early childhood improves children’s physical and mental well-being, enabling them to attend and perform well in school. More specifically, global evidence has shown that children with healthier diets perform better in the English language and the sciences, while malnourished children have lower scores on IQ tests. Additionally, children who are stunted in early life (first 1,000 days from pregnancy to 24 months) have lower incomes in adult life compared to their peers who were well-nourished, perpetuating the poverty–stunting vicious cycle. Social protection programs that include design features that are nutrition-sensitive, therefore could improve the overall nutrition status of children and help accumulate human capital from the early stage of life.

To some extent, all social protection programs contribute to the effort in reducing undernutrition problem. Social assistance program, such as cash transfer, increases the income of vulnerable households, which enable them to have more resources to spend on food and to access health care services (Alderman, 2022). A meta-analysis of 57 studies of 38 cash transfer program by Manley et al. (2022) shows that the amount of transfer as a percentage of income has shown to significantly increase household dietary diversity.

Furthermore, social assistance program can also improve nutritional outcomes by promoting behavioral change. Providing knowledge to caregivers and reorienting their preferences in allocating and spending resources allow household to improve their health more effectively (Alderman, 2022). As the meta-analysis shows, complementing cash transfer program with BCC shows significant impact in improving anthropometric markers of nutrition status, in this

case height-for-age z-score (HAZ), and the underlying determinants of malnutrition, such as consumption of animal-source food and prevalence of diarrhea (Manley et al., 2022).



Source: Alderman, 2022

Behavioral Change Communication (BCC) provides knowledge on specific child-care issues, hygiene, as well as nutrition. It is often provided as a conditionality in a cash transfer program. Different combinations of transfer programs have been studied in Myanmar and Bangladesh to find that complementing cash transfer with BCC positively improved nutrition outcomes when cash transfer alone did not (Alderman, 2022).

Reference:

"Gentilini, Ugo (editor). 2022. *Social Protection, Food Security and Nutrition: An Update of Concepts, Evidence and Select Practices in South Asia and Beyond*. Washington, DC. © World Bank.

b. Expanding coverage and improving adequacy

An efficient allocation of fiscal resources can also be pursued by expanding coverage of social protection programs more effectively. While most of the programs have gradually expanded the number of direct beneficiaries over the past decade, there are considerable gaps in reaching the poorest households. Among the poorest 20 percent of the population, coverage rates are highest for elderly social pension, which is a universal program, followed by the *Bolsa da Mãe* program, estimated at just 29 percent of poor households in 2019. Coverage rates among the poor for all other programs are even lower. This discrepancy highlights some of the main social protection programs' less than satisfactory performance, particularly for *Bolsa da Mãe*, not only in terms of its poor allocative efficiency but also in terms of overall coverage and benefit adequacy. With a basic welfare assessment system in place, a larger proportion of spending could be devoted toward the poorest households, with ideally a stronger focus on children and mothers, while at the same time reducing coverage of the better off households. As reference points, similar cash transfer such as the Philippines' *Pantawid Pamilya* (2015) and Sri Lanka's *Samurdhi* (2013) had allocated 18 and 3 percentage points more of the program benefits to the poorest 20 percent of the population than *Bolsa da Mãe* is estimated to have done in 2019.³⁹

³⁹ World Bank staff's calculations based on regional survey data.

Given the mere 34 percent coverage of the labor force in the social security program, it would be sensible to extend the contributory scheme to cover more informal workers. Based on the 2013 LFS data, informal employment represents roughly 70 percent of employed population. As informal workers often face challenges in paying regular contributions due to unstable work arrangements and lack of regular earnings, proactive approaches, compelling behavioral change campaigns and other innovative ways to increase voluntary uptake could be considered. Cape Verde, for instance, succeeded in increasing social security coverage among independent workers from 0 to 9 percent in one year, which included agricultural workers, street vendors, traders, and professionals.⁴⁰ This success was mainly achieved through proactively approaching target groups, incorporating communication campaigns with education and awareness-raising activities conducted at the local level.

However, given the existing challenges with the social security programs' parameters, the coverage expansion has to be approached carefully. A particular challenge to overcome is the relatively high target replacement ratio for old-age benefits of the contributory social security benefits. International standards do not recommend a 100 percent of average earnings as target replacement ratio. Only countries with a high standard of living might be in a position to offer such high retirement benefits and it is usually done to protect low-income workers⁴¹ from old-age poverty, most often through subsidized contribution. Examples include Denmark, which sets out a future gross replacement rate of 114 percent following a full career for low-income workers, meaning that their retirement benefits will be higher than their earnings while they were working.⁴²

The original version of *Bolsa da Mãe* program should continue but with a higher benefit level, to maintain support to school-age children. Bolsa da Mãe program's potential for poverty reduction and improved human capital will be higher if the benefit level and program coverage amongst the poor is significantly raised. As a comparison, the coverage of Indonesia's Family Hope Program among the poor is around 21.5 percent. Enhancing the monitoring of conditionalities fulfillment, preferably through an integrated data exchange, would further enhance the health and education outcomes of the program. It is estimated that poverty could be reduced by about 7.2 percentage points at a cost of 4.4 percent GDP if *Bolsa da Mãe* benefit levels were raised fivefold and the elderly and disability benefit level at inception (USD 30) were doubled. The estimated improvement could be higher when the program implements more robust monitoring on eligibility and fulfillment of conditionalities.

The contributory old-age and disability pension parameters have to be recalibrated to ensure actuarially-fair contribution rate and appropriate benefit level. Review of contribution rate and benefit level of the old age pension is needed, to ensure financial and fiscal sustainability of the scheme. Meanwhile, current design of the disability pension calculates accrued benefit at the time of disability, which may provide an inadequate benefit for a worker who becomes disabled at a young age. An alternative would be to define the benefit level as a flat proportion of salary regardless of age and years of contribution. Most common design feature is to have a replacement ratio for disability that is lower than the one for old-age benefits to prevent earlier retirements and continue to provide incentives for work.

c. Strengthening the delivery systems

As in most countries, Timor-Leste's social protection benefits and service delivery is implemented through more than a few steps made possible by various key actors/institutions and sustained by a handful of enabling factors including but not limited to coordination, communication and management information systems. Given that many programs by and large go through these comparable steps, there remains considerable scope for potential integration or interoperability which would significantly

⁴⁰ Durán Valverde, F.; Flores Aguiar, J.; et Al (2013), Innovations in extending social insurance coverage to independent workers: Experiences from Brazil, Cape Verde, Colombia, Costa Rica, Ecuador, Philippines, France and Uruguay, ESS Document 42, Geneva: ILO.

⁴¹ Low-income workers are defined as workers earning half of average worker earnings (0.5 times) (OECD, 2019).

⁴² OECD (2019), Pensions at a Glance 2019: OECD and G20 Indicators, Paris: OECD.

raise social protection program's efficiency, effectiveness and accountability while promoting citizen's ease of access to benefits they are entitled to.

It is timely for the Government to start investing in a social registry and a common administrative system in light of the planned roll out of the National Unique Identification number. A social registry typically contains a wealth of demographic, dwelling, and socioeconomic information relevant for addressing vulnerability and disaster risks and comprise of a large number of individuals and households. Such information hinges on a unique identification number that allows for rapid assessment of welfare condition and needs. The linkage with unique identification number could systematically disentangle a number of problems, such as the use of several identity systems and numbers that are prone to errors, duplications of registries and fragmented information on individuals. Moreover, a unique identifier allows for faster integration of different programs and sectorial databases with greater potential to improve benefits and service delivery.

Enhancement along the social protection delivery chain could also improve the overall effectiveness of the system in reaching out to the poor and vulnerable. Beneficiary *intake and registration* should be preceded by an *efficient outreach* effort to ensure those wishing to avail of the benefit knows what to do and where to go. Their *eligibility criteria* have to be established clearly and the enrolment process should be supported by a robust and interoperable information management system that allow for easy tracking when certain conditionality (death, age limits, etc) have changed. A social registry which pool information on people's welfare status could also serve as an administrative backbone from which the list of beneficiaries can be generated in a speedy manner with high accuracy to ensure benefits are provided for those who are truly eligible. When it comes to the *payments* of the benefits, more payment channels should be explored to improve the efficiency of the program delivery and to promote greater financial inclusion. Options could include non-cash payments and mobile money. An ideal payment system should also anticipate instances where connectivity is an issue which is commonly found in remote areas or in post-disaster context. Last but not least, social protection should have a *robust grievance redress system* (GRS). A good GRS system should allow beneficiaries and general public to file a complaint or request information regarding the social protection programs and for such requests to be properly recorded and followed up.

Box 3.3: Revamping Social Protection Delivery System: Lessons from Jamaica

Jamaica's population reach 2.8 million people in 2020, with 20.8 percent young population between the ages of 0-14, 72.1 percent productive population between the age of 15-64, and finally 7.2 percent are elderly population 65+ (UNDESA, 2022). Poverty in Jamaica is high among young and elderly population, people living in rural areas, female-headed households, and large families (Levy and Ohls, 2010). The country has managed to significantly reduced poverty between 1989 and 2006, in which poverty rate decreased from 30.4 to 14.3 percent (World Bank, 2018).

In 2002 the Government of Jamaica (GoJ) launched a social assistance program called the Programme of Advancement through Health and Education (PATH). PATH is a conditional cash transfer program administered by the Ministry of Labor and Social Security (MLSS) targeting vulnerable households with children (up to secondary education), pregnant and lactating women, persons with disability, and elderly. To receive the benefit, school-age children are required to maintain 85 percent attendance rate at school while children under 6 are required to maintain preventive health visits established by the Ministry of Health. Currently there are 350,000 recipients of the program.

The introduction of PATH and its associated delivery system aimed to rationalize the implementation of social assistance programs and to increase the effectiveness of program delivery. Prior to PATH, 54 social assistance programs were administered by 12 ministries. Many of these programs were poorly targeted while others were not designed to target of vulnerable population. PATH was introduced to replace three assistance programs namely the Food Stamps, the Poor Relief, and the Public Assistance Program.

PATH utilizes Beneficiary Management Information System (BMIS) as the main delivery system. The system functioned efficiently and flexibly, allowing successful on-time payment to intended beneficiary, data entry on compliance, and changes to the Proxy Means Testing (PMT) when required. More specifically, the program has managed to improve the following key processes:

- **Program registration and targeting.** Applicants' demographic and socio-economic data are collected and the information is entered into the system. The system would then apply PMT to determine eligibility. The program has conducted multiple reviews of targeting mechanism and methodology and adjusted this instrument in BMIS to identify potential beneficiaries. Between 2006 and 2016, program beneficiary at the bottom quintile increased from 59 percent to 64 percent.
- **Beneficiary registry.** The program was considered effective and flexible. PATH managed to deliver uninterrupted benefit to the registered beneficiaries and expanded the coverage when necessary, such as during the 2008-2009 Food, Fuel, and Financial crises.
- **Benefit amount adjustment.** A mechanism to periodically review benefit structure allows the Government to adjust benefit amount based on the need of poor households, inflation and other market factors. Program benefit represents 41 percent of poor household's income in 2016 while only about 20 percent in 2008.
- **Benefit delivery.** The program currently offers benefit payment through checks that can be collected at the post offices, Keycard Cash which beneficiary can use to withdraw cash from ATM and point of sale transactions, as well as electronic transfers. Other payment options such as mobile money and direct fund transfer is currently being explored.
- **Monitoring and evaluation.** The program conducted program audit, spot checks, as well as systems for process evaluation, internal audit, and quality control were established for the program. MLSS utilizes administrative data to show program coverage, track compliance rate, and enrolment in associated programs. Furthermore, creation of service standards reduced varying quality in program delivery across regions. BMIS produces periodic report that serves as accountability mechanism.
- **Improved appeal mechanism.** The Government also improved the mechanism for appeal process to be more responsive to applicant when they are not deemed eligible for benefit.

In addition to the improvement of key processes, the program later introduced case management model to complement the existing cash transfer and activation programs. Case management model was introduced as additional service to help household address non-financial poverty-related issues. Activation program, such as Steps-to-Work (StW), promotes economic independence through skills and competencies building, job matching and business development for working age PATH beneficiaries.

3.5. Moving Forward: Governing the Reform

The recently launched National Social Protection Strategy can serve as policy and priority compass for all social protection stakeholders but needs to be complemented with a robust monitoring and evaluation framework. The strategy stipulates clear visions and targets that aim to improve the effectiveness and efficiency of the various social protection programs in reducing poverty and in providing protection throughout the life cycle. The strategy can be used to initiate a government-wide discussion and galvanize efforts to establish a coherent forward-looking social protection system. The strategy also provides guidance to further disentangle overlapping mandates and coordination issues. Importantly, the mandate to create a coherent legal basis for social protection is also timely given the current regulatory framework of social protection system which comprises piecemeal legislations with overlapping roles and responsibilities across ministries. Ultimately, an effective implementation of the national strategy also necessitates a robust monitoring and evaluation (M&E) framework and tools to assess the implementation of each action plans. A robust monitoring of the strategy's implementation will not only help ensure all efforts are geared towards achieving the same objectives but will also allow rapid adjustment of government interventions when needed, to maintain the relevance of the various goals and policy actions.

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Annex 1: Key Indicators

Annex Table 1: Economic Indicators

	2016	2017	2018	2019	2020	2021	2022f
Real sector	<i>(annual percentage change, constant)</i>						
Gross domestic product (non-oil)	3.4	-3.1	-0.7	2.1	-8.3	2.9	3.0
Final consumption expenditure	1.7	-1.2	0.8	3.5	0.6	0.3	3.1
Gross fixed capital formation	15.3	-16.7	-1.5	-17.4	-42.5	-13.0	28.0
Consumer price index, period average	-1.5	0.5	2.3	0.9	0.5	3.8	7.5
Fiscal sector	<i>(percentage of non-oil GDP)</i>						
Total Revenue	45	42	47	43	46	45	41
Domestic revenue	12	12	12	12	11	10	8
Estimated Sustainable Income	33	30	35	31	34	35	33
Total expenditure	99	75	75	73	71	92	95
Recurrent expenditure	62	59	51	54	61	84	84
Capital expenditure	36	16	24	18	10	9	11
Fiscal balance	-54	-33	-29	-30	-26	-47	-54
Monetary and Financial sector	<i>(as stated)</i>						
Credit to the private sector (% growth)	-5.3	24.5	-2.4	4.3	11.2	5.8	NA
Lending interest rate (%)	14.5	12.1	11.9	12.0	11.3	11.0	NA
Nominal effective exchange rate (index)	94.4	94.8	96.3	97.4	98.7	97.9	NA
Real effective exchange rate (index)	110.9	109.0	111.2	112.0	113.2	112.4	NA
External sector	<i>(percentage of non-oil GDP)</i>						
Current account	-33	-18	-12	5	-5	64	-6
Goods and services	-68	-59	-59	-38	-20	50	47
Primary income	33	46	53	47	19	14	NA
Secondary income	2	-4	-6	-4	-4	0	NA
Capital account	3	2	3	2	1	1	1
Financial account	29	31	16	-7	17	13	12
Direct investment	0	0	3	-34	5	4	1
Portfolio investment	42	21	12	29	15	10	9
Other investment	-12	9	0	-2	-3	-1	3
Net errors and omissions	-9	1	1	0	-13	-60	8
Change in reserves	9	-16	-8	1	0	-18	-9
Memorandum items	<i>(as stated)</i>						
Oil production (million BOE)	47	42	39	38	36	37	11.7
Petroleum Fund, closing balance (USD million)	15,844	16,799	15,804	17,692	18,991	19,651	16,259

Source: Ministry of Finance, BCTL

