

Section on Sustainable Development and Countries in Special Situations

TIMOR-LESTE: structural transformation and economic diversification towards a sustainable graduation from LDC category

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1. Abstract

Although Timor-Leste met the least LDC graduation criteria of GNI per-capita and the human assets index during the 2018 and 2021 triennial reviews and was found eligible for graduation, it was recommended that graduation be deferred to 2024, owing to continued concerns about the sustainability of the country's development progress.

Pathways towards LDC graduation and achieving the Sustainable Development Goals are broadly defined in the country's strategic development plan and the sustainable development framework, which are being implemented through the SDG road map and the Government's short- and medium-term plan.

Timor-Leste has made substantial economic progress over the past 20 years but graduating from LDC remains challenging and fully achieving any of the SDGs by 2030 is unlikely under the current development pace. Noted progress in development gains has been in the benchmarks related to school attendance, child and maternal health, and electricity access. Timor-Leste, however, is lagging with regard to poverty reduction and equality of access to quality services and opportunities. Prospects for the country's sustainable development is uncertain in view of a significant decline of oil revenue, limited economic diversification and a recent slowdown in economic development.

Tangible and more practical actions are needed to prepare for LDC graduation and progress towards achieving the Sustainable Development Goals. Timor-Leste needs to

enhance the implementation of the development framework by integrating strategies for graduation into the planning framework, building institutional capacities, including the establishment of a national committee for LDC graduation, and promoting good cooperation and partnerships with development partners to efficiently deliver services at all levels of governance.

A conducive macroeconomic and business environment and prudent fiscal policy must underpin the economic diversification process and private sector development in order to attain vibrant and inclusive growth, which are paramount for the country's preparation to graduate from LDC status as well as for it to build a resilient economy. The Government needs to immediately restore macroeconomic stability and quickly recover from recent economic recessions. Prudent fiscal policy grounded in fiscal sustainability and rationalization of expenditure are necessary to build sustainable infrastructure, as well as for human capital development, facilitation and promotion of private sector investment, and economic diversification based on the development the following there sectors: agriculture; tourism; and manufacturing. Creating more market opportunities for investment and trade through economic integration are important – mobilizing resources under the Belt and Road Initiative for infrastructure development and accelerating the country's accessions to WTO and ASEAN needs to be promoted.

It is also critical for Timor-Leste to ensure the sustainability of the Petroleum Fund, mobilize more tax and domestic resources through efficient tax administration and policy, enhance implementation of the “Foreign Aid Policy” for efficient

management of ODA, mobilize more external concessional borrowings, and encourage mobilization of private sector resources through PPP, equity participation, and the development of institutions and legislation for the creation of a bond market.

Key words: least developed country, economic development, and mobilization of resources

2. Acronyms

ADB	Asian Development Bank
ADF	Asian Development Fund
AEC	ASEAN Economic Community
AIIB	Asian Infrastructure Investment Bank
ASEAN	Association of Southeast Asian Nations
ESCAP	Economic and Social Commission for Asia and the Pacific
FDI	foreign direct investment
GDP	gross domestic product
GNI	gross national income
HAI	human asset index
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Financial Cooperation
IDMs	international support measures
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
KPIs	Key Performance Indicators
LDC	least developed country
ODA	official development assistance
OECD	Organization for Economic Cooperation and Development
SDGs	Sustainable Development Goals
SERVE	Service of Registration and Verification of Enterprises
UNTACD	United Nations Conference on Trade and Development
WHO	World Health Organization
WTO	World Trade Organization

3. Introduction

Since attaining independence nearly two decades, Timor-Leste has made substantial progress in nation-building. The country has emerged from massive destruction and conflict to become one of the most peaceful and democratic countries in Asia and the Pacific (Economist Intelligence Unit, 2020).

Despite milestone achievements, progress towards graduation from least developed country (LDC) status and achieving sustainable development aspirations remains challenging, as the country is highly vulnerable to barriers and external shocks, faces infrastructure gaps and is still structurally underdeveloped.

Pathways towards LDC graduation and achieving the Sustainable Development Goals are broadly defined in the country's strategic development plan 2011–2030 in which the vision is to transform Timor-Leste to an upper-middle income country with a healthy and educated population by 2030. To operationalize the strategic development plan, the Government has formulated a five-year plan (2018–2023), adopted the 2030 Agenda for Sustainable Development and approved a road map for achieving the Sustainable Development Goal (SDGs), and prepared the sustainable development cooperation framework 2021–2025. Successful implementation of the strategic development plan and the achievement of the Goals would ensure that Timor-Leste graduates from LDC status in the near future.

The road map for implementation of the 2030 Agenda and the achievement of the SDGs in Timor-Leste is based on the strategic development plan. Under the road map,

plans, strategies, systems and institutional structures required to achieve sustainable development are articulated. In addition, the ecosystem of sustainable development in the country, including highlighting an enabling environment for achieving the 2030 Agenda. Is examined.

Key enablers for Timor-Leste to progress towards sustainable development are (a) inclusion, awareness and engagement: building a strong social solidarity to further empower young people, women and marginalized groups in the national development; (b) effective institution and decentralization: efficient public service delivery at national and subnational levels or at municipalities; (c) integrated planning, budgeting and monitoring: implementing programme budgeting to strengthen alignment of national investment with the strategic development plan; (d) financing a framework for the future: economic diversification with the private sector serving as the engine for future growth; and (e) transformative partnership: engaging private sector and civil society in national development and advocating the 2030 Agenda globally through the G7+ network of exchange experience and support via “fragile to fragile” cooperation.¹

The strategic development plan is an integrated package of strategies and policies aligned with the Millennium Development Goals and SDGs. It is being implemented in three phases. The first phase was implemented over the period 2011–2015 with the focus on development of infrastructure, human resources and institutions – as they are prerequisites for development of productive sectors. The

¹ Timor-Leste is one of the founding nations of G7+, which is a group of conflict affected and fragile States

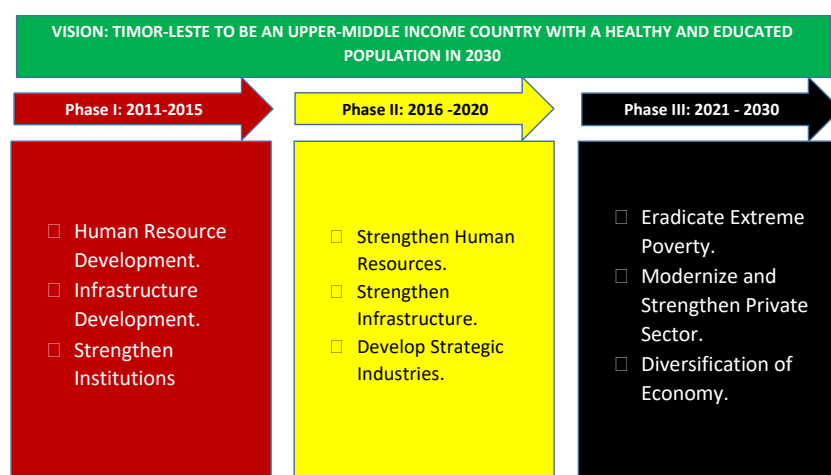
second and third phases are timely and aligned with 2030 Agenda, under which the underlying strategies and policies are to continue to build infrastructure and enhance the capacity of human resources and institutions to enable efficient service delivery and underpin private sector development, economic diversification, and poverty reduction efforts (see figure 1).

Economic diversification efforts in Timor-Leste focus on the development of agriculture, tourism, manufacturing and petrochemical industries. These sectors were selected based on endowed resources and their potential to reduce poverty and contribute towards inclusive and sustainable development through the creation of employment and livelihoods for all population segments, in particular the growing young population.

Strategic priorities for development of these sectors to diversify the economy outlined in the strategic development plan are the following: (a) transforming the existing subsistence agriculture to commercial

farming to provide food security and livelihoods and boost rural development, and develop export-oriented niche agricultural products; (b) taking advantage of naturally endowed tourism, such as the country's natural beauty, culture and heritage, and rich history to develop niche tourism services, such as eco and marine services, historic and cultural experiences, adventure travel and sports, and religious tourism products that respond to international tourists demand; (c) developing low-skill and low-capital requirements for manufacturing processes, such as coffee processing and handicraft for tourism, and high value export oriented industries, such as establishment of a liquified natural gas (LNG) plant and refinery to add value onshore downstream to the oil and gas industry; and (d) developing downstream in the South coast to capture the full value of petroleum resources through direct and indirect benefits, such as income generation, jobs creation and growth of new businesses. The petrochemical industry is expected to generate more revenue for the Government to be used to develop other sectors

Figure 1 : Implementation phase of the strategic development plan



Source: Strategic development plan, Timor-Leste (2021)..

Timor-Leste was eligible to graduate from LDC status for the first time in 2015 based on its gross national income (GNI) per-capita of \$3,767, which was three times higher than

the \$1,242 graduation threshold at that time. At the 2018 triennial review, Timor-Leste confirmed its graduation eligibility with a lower per-capita income (\$2,656), which, was still higher than the threshold. It also met the

human development index (HAI) criterion with a score of 66.6 – marginally exceeding the threshold of 66.0.

In the 2021 triennial review, Timor-Leste once again confirmed its graduation; the country's GNI per-capita income and HAI score of 69.5 exceeded the \$1,274 and 57.6 thresholds, respectively. On the other hand, the country had yet to meet the Environmental Vulnerability Index threshold, attaining a score of 38.7, exceeding the maximum graduation threshold of 32.0.

Notably, Timor-Leste has met the GNI per-capita income threshold since the 2015 triennial review, but the number has declined substantially, owing to the downturn in oil revenue and slow growth of the non-oil sector. Meanwhile, HAI has marginally increased, increasing approximately three percentage points in 2021 compared to 2018 due to a reduction in under-five and maternal mortality rates and incremental increases in the gross secondary school enrollment ratio and adult literacy rate. Failure to meet the Environmental Vulnerability Index EVI threshold reflects the country's vulnerability to disaster, low agriculture productivity and concentration of its exports on organic coffee (see annex 1).

Timor-Leste was not recommended to graduate from LDC in the 2021 triennial review. Recommendation for graduation is deferred to the 2024 triennial review due to continued concerns about the country's ability to ensure sustainable development. The concerns are caused in particular by the country's declining GNI per-capita income, uncertain future prospects in view of the expected depletion of oil and gas fields currently in production, possibility that future eligibility under HAI could be affected

by the impact of the COVID-19 pandemic – as the margin is small because of the high incidence of stunting, and the country's vulnerability to shocks and disasters due to limited economic diversification and quality infrastructure.

As an LDC, Timor-Leste is entitled to benefit from international support measures (ISMs) such as development finance, trade, technical assistance, and technology, to help overcome structural limitation of productive capacity and progress towards sustainable development. Since independence in 2002, the country has benefited greatly from official development assistance (ODA).² In the early years of independence, grant supports were critical for development of human resources, institutions and productive sectors, such as agriculture, to facilitate structural transformation and economic diversification. Furthermore, since the signing of the first concessional borrowing in 2011, the Government has continued to take advantage of its low debt to gross domestic product (GDP) ratio to access more concessional borrowing for infrastructure development to facilitate structural transformation for sustainable development. On the other hand, according to Valenzuela and Gunasekera (2020), duty free and quota free market access to developed economies is the most salient support measure of exclusive non-reciprocal trade preferences. Timor-Leste receives unilateral preferential market access from more than 10 major economies, including the Europe Union and the United States of America, but the country has yet to fully maximize the benefit of this; production capacity remains limited and its export structure is highly concentrated on oil and gas.

² Overseas development assistance was tied with the country's LDC status and also to support the entire State-building process of the country.

It is obvious that LDCs, including Timor-Leste, are concerned that graduation will result in loss of ISMs benefits. However, many perceive that graduation is associated with a positive economic investment climate, and as a result, it catalyses economic growth, trade and employment (Valenzuela and Gunasekera, 2020). Based on a review of various empirical studies on LDC graduation, Drabo and Guillaumont (2018) have found that there are no significant negative impacts of graduation to graduated countries' economies. They further have found that in spite of substantial remaining vulnerability, graduated countries are neither at risk of regressing into the LDC category nor is there any indication that their pace of development slows after graduation.

Graduated countries' experience and the socioeconomic characteristics and development stage of Timor-Leste provide extensive references to the Government to better formulate strategies and policies for maintaining sustainable LDC graduation and development. Hence, the focus of the remaining sections of this paper are on structural transformation and economic diversification to underpin preparation for a sustainable LDC graduation and progress towards sustainable development.

The paper has nine main sections and is structured as follows: the first section provides the Guillemot introduction, section two presents a review of the implementation framework of the 2030 Agenda and the strategic development plan while a brief snapshot on gender equality and women empowerment is presented in section three. Section four contains a review of underlying concerns on economic diversification and sustainable development for LDCs. The benefits of ISMs and the impact of the COVID-19 pandemic are outlined in section five and six, respectively. Progress and challenges of infrastructure development is

presented in section seven and section eight contains a description of the country's strategies for regional cooperation to promote economic integration and trade. The report concludes with a discussion on priority areas and policy actions required for LDC graduation and progress towards achieving the SDGs.

4. Review of the implementation of the 2030 Agenda and strategic development plan framework

The United Nations Sustainable Development Cooperation Framework 2021–2025, which reflects the shared commitment of the Government of Timor-Leste and the United Nations development system, presents an opportunity for a continued partnership to address structural challenges and develop an inclusive and sustainable Timor-Leste.

This entire section, therefore, provides highlights of the vision of Timor-Leste for sustainable development, progress towards implementing the 2030 Agenda, challenges in achieving the SDGs and the cooperation framework with a focus on outcomes that are catalysts for structural transformation and economic diversification, such as nutrition, food security and sustainable agriculture, sustainable economic opportunities and decent work for all, and access to quality of education and life-long learning outcomes and skills.

2.1 Country's vision for sustainable development

The 2030 Agenda was adopted by the Government of Timor-Leste two days after it was adopted internationally at the United Nations Sustainable Development Summit.

The SDGs were subsequently ratified by a resolution of the National Parliament. The Government uses a whole-of-government approach to implement the 2030 Agenda at the country level. A road map for the implementation of the strategic development plan and 2030 Agenda framework was created in 2017. Since then, the framework has been used as a basis for a government programming exercise, while oversight of its implementation is carried out by the SDGs working group – chaired by the Office of the Prime Minister

Although the strategic development plan predates the formulation of the SDGs, it is the country's primary vehicle for achieving the Goals. Under the strategic development plan, Timor-Leste is envisioned to become an upper-middle income country with a healthy and educated population by 2030. The strategic development plan is comprised of four main pillars: social capital; infrastructure; economic development, and institutional framework. Gender equality and youth development are included as cross-cutting issues. The plan has a three-phased implementation, which has been sequenced and aligned with SDGs, as shown in figure 2. The utmost objective the SDGS is to eradicate poverty in all forms and dimensions.

Figure 2: Strategic Development Plan and Sustainable Development Goals Alignment



Source: Modified by the author based on the Government of Timor-Leste strategic development plan 2030 Agenda framework, 2017.

To accelerate implementation of the 2030 Agenda, the Government has identified five key steps: (a) increasing public understanding and encouraging active participation of citizens in implementing the 2030 Agenda; (b) integrating SDGs into Government budgeting, policies, and programmes of line ministries to inform medium-term planning and expenditure frameworks; (c) enhancing government capacities for data collection, analysis and monitoring; (d) piloting an integrated mechanism for national reporting to various United Nations agencies; and (e) strengthening existing and new partnerships and advocating financing for sustainable development as part of the exit strategy for the LDC graduation of Timor-Leste.

2.2 Progress towards achieving the Sustainable Development Goals

Timor-Leste has made substantial development gains over the past 20 years, but fully achieving any of the SDGs by 2030 is

unlikely under the current pace of progress. Substantial progress has been made in the area of education, health and well-being, with the main gains in school attendance, child and maternal health and electricity access.

To make further progress towards LDC graduation and implementing the strategic development plan and achieving the SDGs consolidation and rapid acceleration of supporting actions are required. Areas where Timor-Leste is lagging are the high poverty level in all forms and dimensions; inequality in accessing quality services and opportunities; and the vulnerability to marginalization of rural communities, women, adolescent girls and boys, children under five years old, and persons with disabilities.

Key progress and challenges in achieving the SDGs are highlighted below:

- **Social** – significant reduction in poverty has been made over the past decade, with the number of people living under the national poverty line declining by almost ten percentage points to 41.8 per cent in 2014. However, the pace of reduction is not rapid enough, and the recent consecutive economic recessions and the COVID-19 pandemic have added to the challenges in achieving this goal by 2030. Moreover, poverty reduction has been uneven among geographic areas, gender, and different age groups. Timor-Leste has a 45.8 per cent multidimensional poverty rate – the highest in the South-East Asia.

Despite considerable progress in strengthening health delivery systems and improving health outcomes (children who die before their fifth birthday declined from 64 per 1,000 live births in 2010 to 46 in 2016, maternal mortality rate fell by 80 per cent — to 195 maternal deaths per 100,000 live births in 2016, the fertility rate declined rapidly from 7.0 in 2005 to 4.5 in 2016, and zero-incidence of malaria was achieved in 2016), Timor-Leste is unlikely to achieve SDG 3: good health and well-being, if no significant effort and an acceleration in progress are made to strengthen the health system, reduce health inequalities and address the determinant of health – in particular for non-communicable disease, nutrition, sexual and reproductive health – as the maternal and child health status are still high and among the poorest in the subregion.

Improvement in primary school attendance is the most notable progress made in education, increasing from 65 per cent in 2001 to 92 per cent in 2015. There are, however, areas where the country is

still lagging, such as attendance rate at pre-school, secondary, and tertiary levels, resulting from, for example, insufficient school facilities, limited quality of teaching and a poor learning environment.

- **Economic** – while progress has been made in tackling malnutrition, it remains one of the highest in the world – 36 per cent of the population suffer from chronic food insecurity and 46 per cent of the children under-five years was stunted in 2016.³ Agriculture provides the backbone to a majority of the country’s households. However, the sector’s productivity is low due to lack of sectoral infrastructure, such as irrigation, and unsustainable farming. Timor-Leste will likely not achieve SDG 3 under the current pace of progress; the high incidence of malnutrition also has negative impacts on making progress in health, education, and economic outcomes.
- **Institution and infrastructure** – the country has made substantial progress in service delivery and infrastructure over the past few years, with the main gains being the prudent and transparent management of the Petroleum Fund – as measured by the Extractive Industry Transparency Initiative, decentralization of power and the budget to municipal authorities, 78 per cent of the population has access to clean water facilities, 54 per cent of households have access to basic sanitation, more than 85 per cent of the population has access to electricity, nearly 500 km of national and 950 km of municipal roads have been constructed and rehabilitated, and 97 per cent of the country is covered with signal range. However, reaching the SDGs will be difficult if significant efforts are not taken

³ Despite this, the rate declined from 58 per cent in 2010.

to address issues, such as inefficient bureaucracy and service delivery, unequal distribution of utility services among the rural and urban population, limited use of renewable energy, shortage of funding and inefficient management of roads and other infrastructure assets, and low speed of Internet connectivity.

- **Environment** – despite making some progress in building disaster resilience and protection and managing the country’s coastal and marine ecosystem, Timor-Leste remains among countries with the highest disaster risks and vulnerability to natural hazards, and the country’s coastal and marine ecosystem continues to be threatened by destructive fishing practices illegal fishing, overfishing, pollution, erosion, land degradation and climate change. The latter is likely to exacerbate disasters, environmental degradation and water scarcity, and disproportionately affect food security and the livelihoods of the poor.

2.3 Implementation of the 2030 Agenda and the overall challenges

The National Voluntary Review (2019) identifies that challenges to the implementation of policies and reforms towards achieving SDGs are lack of availability of accurate and timely disaggregated data and analysis, technical and institutional capacity constraints to implement reforms and use financial resources, limited sector-budget allocation, poor policy coherence and limited sectoral coordination, the absence of an institutionalized structure to conduct regular monitoring and oversight, and lack of partnership and citizen participation. The Government needs to work with development partners to address these challenges for efficient implementation of the 2030 Agenda framework.

Recent economic recessions and the impact of the COVID-19 pandemic are likely to have deepened poverty and inequalities and threaten the country’s LDC graduation and sustainable development aspirations. Timor-Leste has the opportunity to accelerate the LDC graduation process and progress towards achieving sustainable development, and significantly reduce poverty, if its economic transformation were to entail creation of sustainable and inclusive economic opportunities, and human capital development leads to a healthy, educated, skilled and well-informed society grounded in gender equality and women’s empowerment that guarantee a minimum living standard for all citizens.

2.4 Partnership framework and priority outcomes

The sustainable development cooperation framework, which entails the shared objectives under the United Nations development system, is committed to support national priorities outlined in the strategic development plan and the Government’s medium-term priorities to make progress towards achieving the SDGs. The support will help develop capacities and systems of Timorese institutions and empower the most marginalized segments of society, including women, children, the poor and rural communities. Table 1 presents a summary of the partnership framework to be implemented and the priority outcomes to be achieved over the next four years.

Policies to accelerate economic diversification and inclusive development are essential for LDC graduation and to achieve sustainable development. An economic diversification process based on development of productive and labour-intensive sectors, such as agriculture, tourism, and manufacturing, would provide decent work and productive employment and sustainable

income, particularly to young people and women. Investing in climate resilient crop and livestock production, forestry and fisheries would create productive employment and income for female farmers in rural areas and young people involved in the agrifood production system. Furthermore, it would contribute to efforts to tackle food insecurity and malnutrition. Development of community-based tourism and low-skill manufacturing processes, such as handicraft, would create more employment opportunities for women.

More rapid progress in developing human capital is critical. While substantial progress has been made in the area of health and education, one fifth of the population is chronically or moderately food insecure, 50

per cent of under-five children suffer from chronic malnutrition, and one third of the rural population does not have access to safe water. These deficiencies prevent people from growing healthy and having the optimal cognitive capacity to learn and be productive. Increasing food production and access to diverse and nutritious food are needed. In addition, access to quality learning for the early years is necessary as only 22 per cent of children under-five are attending pre-school, and equipping young people with the skills required to transform the economy are essential as unemployment among young people is high, at 21 per cent.

Table 1: Partnership framework and priority outcomes 2021–2025.

COOPERATION FRAMEWORK	DRIVERS OF CHANGE	2025 TARGET
Nutrition, food security and sustainable agriculture	<ul style="list-style-type: none"> - Increased access to nutrition service. - Productive climate smart/resilient. agriculture, livestock, forestry and fisheries. - Value added to smallholder crops, livestock and fisheries' production. - Increased access to safety management of drinking water, and basic sanitation and hygiene. - Cross sectoral policy partnership and coherence between health, agriculture, social protection and health sectors. 	Nutrition, food security and agricultural productivity improve for all, irrespective of individual ability, gender, age, socioeconomic status and geographical location.
Sustainable economic opportunities and decent work for all	<ul style="list-style-type: none"> - Institutional and regulatory framework for business environment and strengthen labour rights. - Conditions and incentives for diversified and sustainable entrepreneurship and private sector growth. - Life-long learning, competencies and skills development. 	People throughout Timor-Leste, especially women and young people, benefit from sustainable economic opportunities and decent work.
Access to quality education and life-long learning outcomes and skills	<ul style="list-style-type: none"> - Access to and completion of quality basic and secondary education. - Alternative pathways and life-long learning. - Increased access to early childhood education and development. 	All people of Timor-Leste, in particular excluded and disadvantaged groups, have increased access to quality formal and innovative learning pathways (from early childhood through life-long learning) and acquired foundational, transferable, digital and job-specific skills.
Quality health care and well-being	<ul style="list-style-type: none"> - Increased accessibility and quality of primary health care services. 	The people of Timor-Leste increasingly demand and have access to gender-responsive equitable, high-quality, resilient and inclusive primary health care and

	<ul style="list-style-type: none"> - Evidence-base decision-making and digital system. - Health financing and budgeting. - Increased social accountability for behavior change. 	strengthened social protection, including in time of emergencies”
Accountable, inclusive and participatory governance and quality public services.	<ul style="list-style-type: none"> - Representation and participation of citizens at all levels. - Increased access to justice and security. - Effective public administration. - Prevention of and response to violence against women and children. 	The people of Timor-Leste, especially the most excluded, are empowered to claim their rights, including freedom from violence, through accessible, accountable and gender-responsive governance systems, institutions and services at national and sub-national levels.
Sustainable management of natural resources and resilience to climate change	<ul style="list-style-type: none"> - Improved sustainable management of terrestrial, costal, and marine ecosystems. - Development of policies, programmes, and capacities in disaster risk reduction and climate change adaptation/mitigation at all levels. - Establishment and delivery of safe and climate-resilient infrastructure, systems, and human settlements for targeted communities. 	National and subnational institutions and communities (particularly at-risk populations, including women and children) in Timor-Leste are better able to manage natural resources and achieve enhanced resilience to the impacts of climate change, natural and human-induced hazards, and environmental degradation, inclusively and sustainably.

Source: United Nations Sustainable Development Cooperation Framework 2021–2025,

2.5 Gender equality and women empowerment

With nearly half (49.2%) of the total population being female (GDS, 2015d), ensuring gender equality and women empowerment would promote equitable development and contribute towards the ambition to leave no one behind. Timor-Leste has made significant improvement in gender equality, including women in politics and decision-making, as measured by the number of parliamentarians (35%) and village council member (33%) who are women; gender mainstreaming in the Government’s programme-based budgeting; and the greater number of women, particularly those in rural areas, having access to cash transfers from the Government for their socioeconomic development.

Despite the achievements, progress towards reaching the gender equality goal by 2030 remains challenging. The challenges are gender equality is viewed as only a cross-cutting issue and not a priority in public resource allocation, collective social norms

lower women’s status, high-level violence against women and girls (a quarter of all women aged 18-49 experience sexual violence by age 18), less participation of women in the labour force, owing to family responsibility and lower education and skills, women are engaged in less productive agricultural activities, and limited data available to underpin the design of well-targeted initiatives.

Building on progress been made on gender equality and women empowerment, moving forward, the Government needs to ensure that all woman count in all investment and opportunities through the following proposed actions:

- (a) Enhance gender responsive programme-based budgeting with clear indicators and targets for efficient monitoring, and provide more fiscal space to scale up and expand cash transfer programmes to support socioeconomic development of women.

- (b) Promote women in business and employment for inclusive economic development. This could be done through establishing a regular dialogue mechanism with women business associations, giving them access to credit and financial services – in particular targeting micro, small and medium-sized enterprises owned by women, facilitating market access to product and services, facilitating access for established and/or potential women entrepreneurs to more business networks, and helping girls and women access appropriate education and skill development to encourage their participation in the labour force.

- (c) Promote rural women’s economic empowerment by ensuring efficient implementation of the agreement signed by nine Government institutions in 2017 to help rural women, particularly young women, attain access to employment and skill development programmes and to the country’s improved health care and clean water.

- (d) Enhance efficient implementation of the national action plan to prevent gender-based violence through a multi-sectoral coordinated approach by providing services that give victims access to justice and coordination on monitoring and evaluation.

5. Review of underlying concerns on economic diversification and sustainable development for least development country graduation

As already noted, Timor-Leste met two graduation criteria (GNI per-capita⁴ and HAI) in the 2018 and 2021 triennial reviews and was eligible for graduation, but recommendation for graduation was deferred to the 2024 triennial review over continued concerns about the sustainability of the country's development progress.

3.1 The downturn in per-capita income and overall government revenue

The prospect for the country's sustainable development is uncertain in view of a significant decline in revenue from the Bayu-Undan field;⁵ the Government has yet to successfully use oil revenue to develop productive sectors, such as agriculture and fisheries, tourism, and manufacturing, to diversify the economy; and the country's high vulnerability to shocks and disasters, including to the unprecedented, devastating and multifaceted impacts of the COVID-19

pandemic, which has resulted in a deep economic contraction in 2020 (General Directorate of Statistic of Timor-Leste, 2021a), and ultimately undermines people's living standard.

Since the inflow of oil revenue to the Petroleum Fund⁶ in 2005, the fund accounts for more than 80 per cent of the Government's annual expenditure – placing Timor-Leste among countries that are highly dependent on oil revenue for its public expenditure (see figure 3). Fiscal sustainability is at risk due to a significant downturn in oil revenue from the Bayu-undand field – although recent successful infill drilling is expected to provide additional revenue and extend the field's production life a few more years (see figure 4); development of onshore drilling at Greater Sunrise⁷ are uncertain; domestic resource mobilization remains at a low pace, owing to inefficient tax administration and a low tax-base as a result

⁴ Timor-Leste has been meeting the GNI per-capita threshold since the 2015 triennial review.

⁵ Bayu-Undan is the only oil and gas field that is currently in production and contributes most of the oil revenue.

⁶ The Petroleum Fund is the country's sovereign wealth fund from which all oil revenues (profit, royalties, and taxes) and investment returns are saved and managed.

⁷ The Sunrise and Troubadour gas and condensate fields, collectively known as the Greater Sunrise fields, are approximately 150 kilometers south-east of Timor-Leste and 450 kilometers north-west of Darwin, Australia.

of limited economic diversification; and excess withdrawals from the Petroleum Fund since 2009 is undermining the sustainability of the fund. As the economy is still driven by

public expenditure, fiscal sustainability is vital to ensure macroeconomic stability and sustainable development in Timor-Leste.

Figure 3: Expenditure and financing source (\$m).

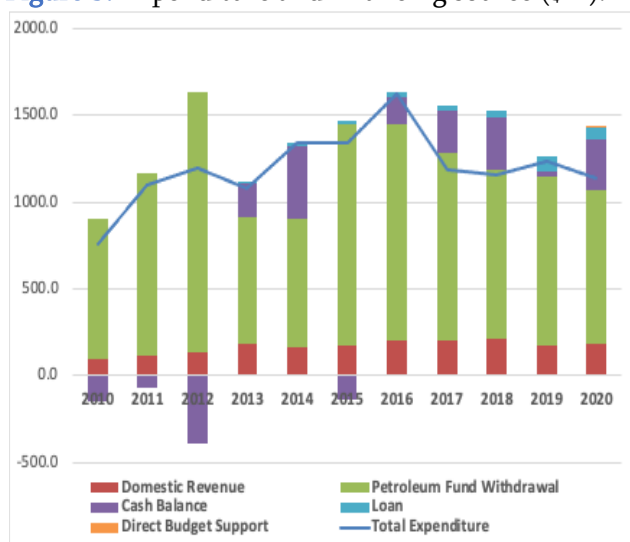
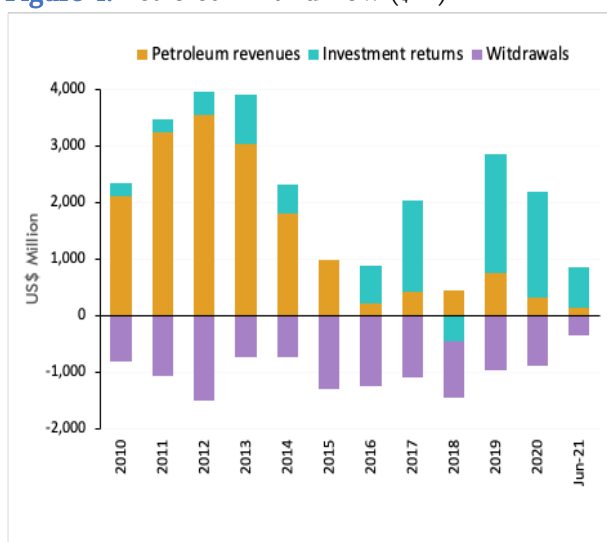


Figure 4: Petroleum Fund flow (\$m)



Source: Timor-Leste, Ministry of Finance (2021)

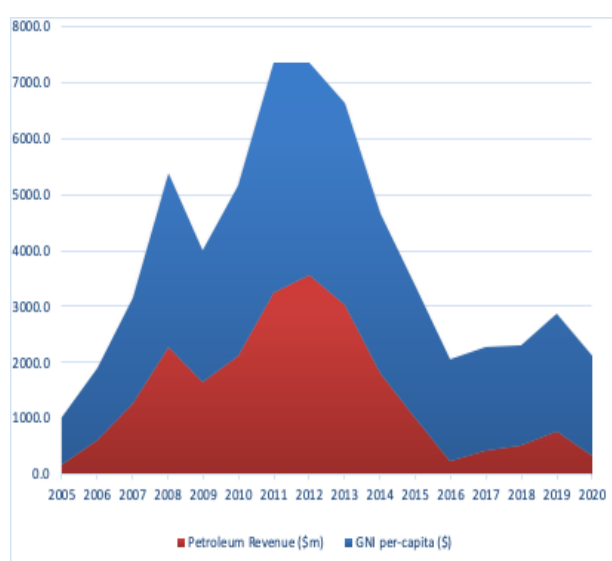
The overall pattern of GNI per-capita and oil revenue over the past 15 years indicate a strong correlation between the them. As shown in figure 5, GNI per-capita and oil revenue were on an upward trend over the period 2005–2012. The highest GNI per-capita reached was \$4,115 in 2011 – a year in which oil revenue was peaking. Since then,

GNI per-capita declined to \$1,807 in 2020 as the result of lower inflow of oil revenue. The corresponding GNI per-capita and GNI level to changes in the oil price and the volume of production were also correlated. The pattern shows that the high oil price in 2011 resulted in an increase in the volume of production and a high GNI. However, oil price and

production volume have not always been positively correlated. For instance, production was lower between mid-2012 and mid-2013 even though the oil price exceeded \$100 per barrel during that period (see figure 6 and annex 2).

Oil prices and the volume of production are two key factors that determine oil revenue. Consequently, volatility of the oil price and the downward trend of the production level

Figure 5: Oil revenue and GNI per-capita



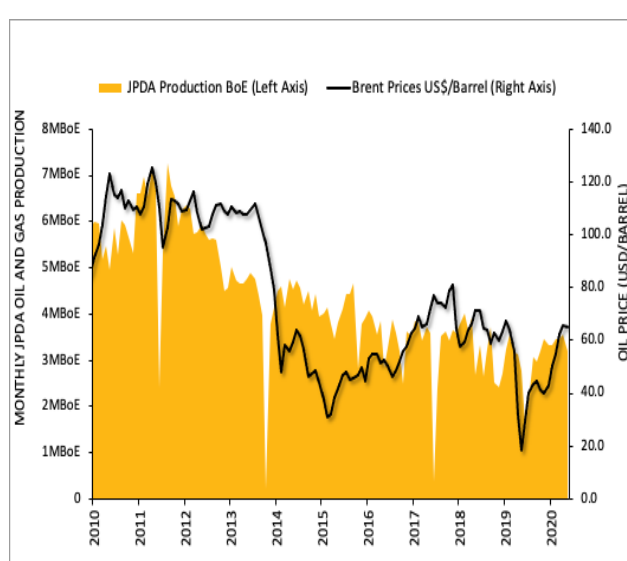
Source: Ministry of Finance, 2021

3.2 Limited economic diversification

Over the past 10 years, government expenditure to GDP averaged 81.3 per cent, which is considerably high (see annex 3). However, the high expenditure has to date, failed to successfully translate into strong and sustainable economic growth. This is because growth remains driven by government and household consumption instead of by investment, whereas household consumption to some extent depends on government expenditure. Recurrent expenditure averaged 56 per cent to GDP, contributed by large spending on salaries of civil servants and public transfers to pay war veterans and social

create uncertainty and risk for sustainable income and development in Timor-Leste. Notably, however, the Petroleum Fund, which serves as the key instrument for counter-cyclical fiscal policy, provides assurances for budget stability amid price and production volatilities. According to Timor-Leste, Ministry of Finance (2021a), under the current level of withdrawal, the Petroleum Fund can sustain Government spending until 2037.

Figure 6: Oil price and production



protection schemes. Average capital expenditure to GDP accounted for less than half of the total recurrent expenditure.

Vulnerability of economic growth to Government expenditure is high. For example, the budget contraction in 2017 and 2018 due to a political impasse that resulted in failure by the Parliament to pass the Government's budget proposal contributed to two consecutive economic recessions of -3.1 per cent and -0.7 per cent economic growth, respectively. Furthermore, a significant downturn in overall revenue and the continued excess withdrawal of the Petroleum Fund has reduced fiscal space for

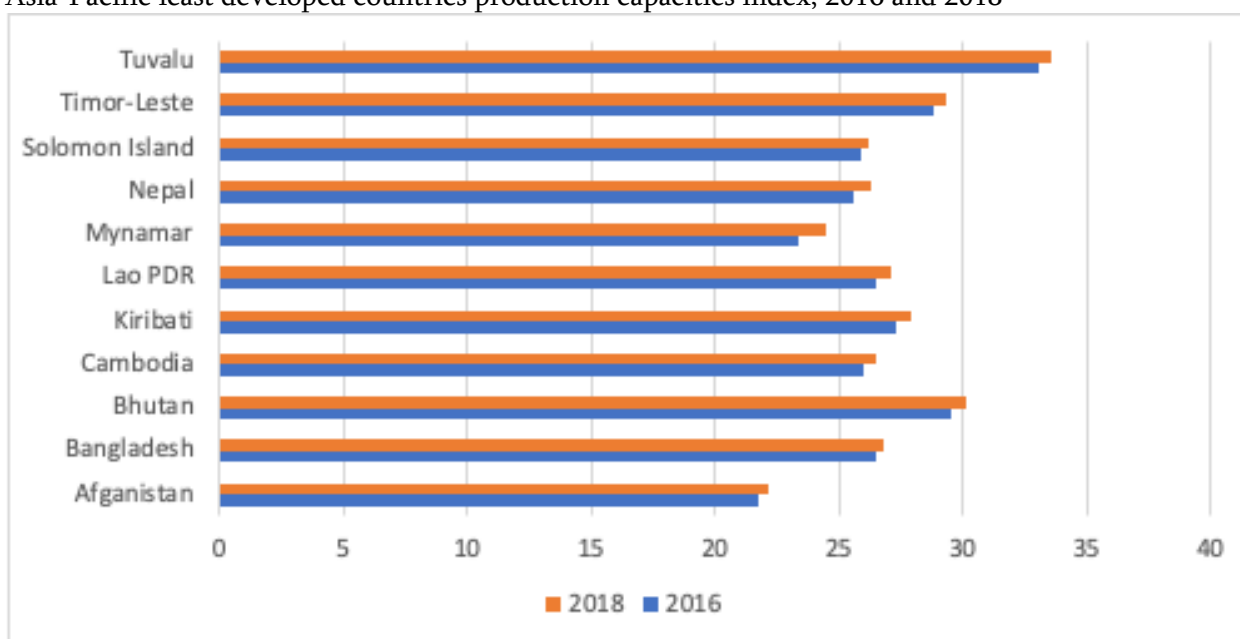
development of infrastructure, human resources, and productive sectors to facilitate structural transformation and economic diversification.

Economic diversification remains challenging and is a concern for sustainable growth and development. Limited economic diversification is reflected in the underdeveloped agriculture and low share of tourism, manufacturing, and private investment to economic growth (GDS, 2021a), and persistent trade deficit (BCTL, 2021a).

According UNCTAD (2021), while the production capacity of Timor-Leste has improved, it remains below some other LDCs in Asia and the Pacific. As shown in figure 7, the production capacities of Timor-Leste in 2018 was only 29.28, compared to 35.55 and 30.11 for Tuvalu and Bhutan, respectively. This suggests that the ability of Timor-Leste to produce goods and services to grow and develop is less compared to these two countries. Productive sectors that have been identified to diversify the economy are agriculture, tourism and manufacturing. The potentials, performance, and challenges of each sector are highlighted below.

Figure 7

Asia-Pacific least developed countries production capacities index, 2016 and 2018



Source: UNCTAD (2021).

Agriculture: More than half of households' livelihoods depend on agriculture.⁸ This sector is one of the main drivers for economic growth (GDS, 2021a). Over the period of 2001–2020, Agriculture accounted for, on average, 23.3 per cent of GDP. This share has been declining since 2006, owing to

subsistence agriculture in which the production heavily depends on weather and is unsustainable,⁹ and increased contributions from other sectors, such as public administration, wholesale and retail operations and real estate.

⁸ According to the 2019 Agriculture Census, 66 per cent of households depend on agriculture.

⁹ Due to limited infrastructure and technologies used in agriculture.

The underperformance of the agriculture sector with regard to economic diversification are attributed to various factors, including, among others, insufficient public resource allocation to address sectoral infrastructure constraint; farmers lack of skills and adoption of technology, and accessibility to credit; and limited market opportunities and private sector investments. Along with agriculture, Timor-Leste also has the potential to develop the fishing industry as the country has a 72,000 km² area designated as an exclusive economic zone full of rich marine resources. However, fishing resources are untapped because 60 per cent of households engaged in fishing are for consumption with traditional equipment and fishing licences yet to be granted for the purposes of commercial fishing.

There is no evidence of the transformation of the economy from the traditional sectors, such as agriculture to tourism and manufacturing sectors, as agriculture remains the dominant contributor to GDP and employment, while raising shares of tourism and manufacturing have been proven to be difficult over the past 20 years. Figure 8 shows that shares of tourism and manufacturing to GDP are among the lowest despite their potential and greater emphasis placed on them.

Tourism: The country has natural beauty and rich culture and heritage, offering potential for tourism development. Given its endowed resources, the sector has been identified as one of the key sectors to be developed for economic diversification. Currently, its contribution to GDP remains very small. According to a recent national account publication,¹⁰ the share of “export travel”¹¹ to GDP was only 1.5 per cent in the last two decades and the COVID-19 pandemic has hit

the sector very hard. The underdeveloped nature of the tourism sector is due to systemic challenges, such as inadequate supporting and sectoral infrastructures, lack of skilled labour, limited niche market-oriented promotion, and the use of the United States dollar as the legal tender of the country.

Strategies to develop the tourism sector focus on mitigating and recovering from the impact of the COVID-19 pandemic and responding to the global tourism market’s quest for new and authentic offerings. The country is developing a niche market based on the “little latino” and the “blue and green economy” concepts to provide a unique tourism experience involving eco and marine services, and historic, cultural, adventure, sports, and convention tourisms. To support the tourism sector amid travel restrictions to contain COVID-19, the Government works with communities and the church to develop tourism sites across the country and promote services for local tourists.

Manufacturing: Although the Government has selected manufacturing as one of the key sectors to diversify the economy, its contribution to GDP is very low – below 2.0 per cent annually over the past two decades. However, the sector’s annual growth was almost 3.0 per cent over the period 2001–2020. The period with the highest growth in manufacturing was 2014–2019 – when Heineken invested in a brewery plant. The growing trend of the manufacturing sector ended in 2020 due to the COVID-19 pandemic. In 2020, manufacturing contracted by 12.7 per cent and its share of economic growth declined marginally. The share of the manufacturing sector to GDP recorded at \$39 million and 2.1 per cent, respectively. The ongoing manufacturing activities are beer and beverage production by Heineken, cement

¹⁰ 2020 National Account.

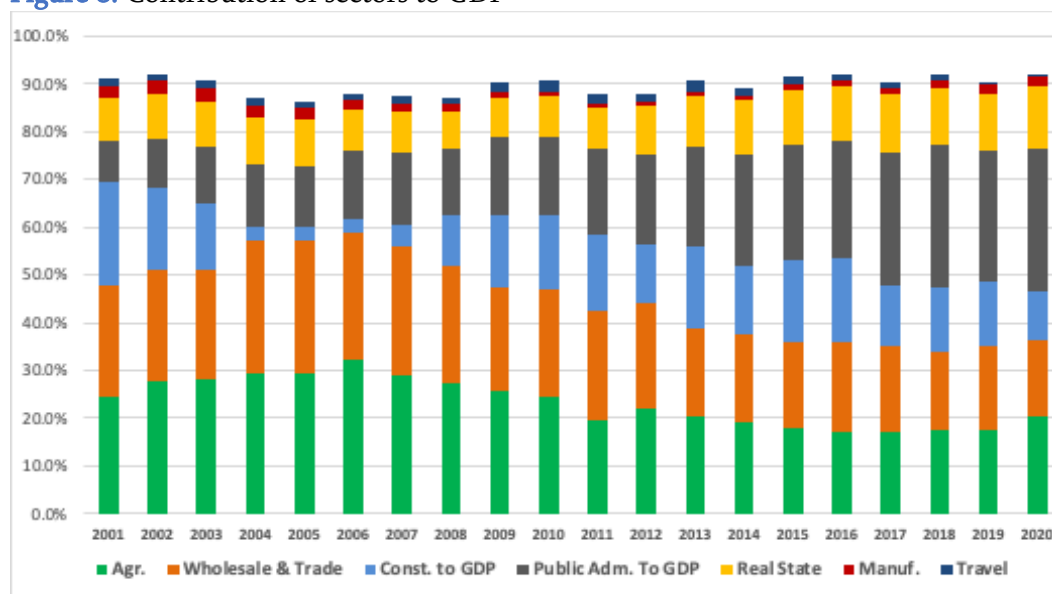
¹¹ “Travel of export” is used as a proxy variable to estimate the tourism sector’s contribution to GDP.

packaging, agribusiness – coconut and candlenut oils, and small-scale furniture and traditional weaving.

The low share of manufacturing to GDP requires a more appropriate policy approach that focuses on assisting private sector investment and promoting domestic

production through a “made in Timor” initiative. The Government has identified several potential products for home-industry manufacturing, including, among them, coffee, soy beans, coconut and candlenut oils, cocoa, spices, furniture from teak wood and bamboo, and handicrafts for the tourism industry.

Figure 8: Contribution of sectors to GDP



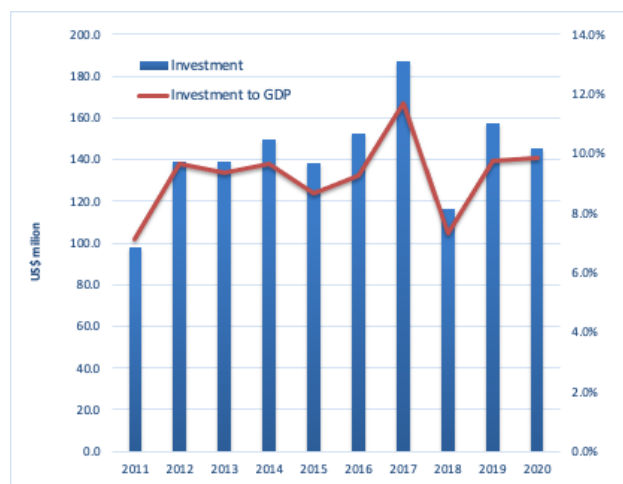
Sources: NA, GDS, Ministry of Finance, 2021.

3.3 Slow progress of private sector development

Private investment to economic growth is still low. As shown in figure 9, the level and contribution of private investment to GDP over the past 10 years averaged \$142 million and was less than 10 per cent. In 2020, the low private investment contracted further to 8 per cent, partly because foreign direct investment

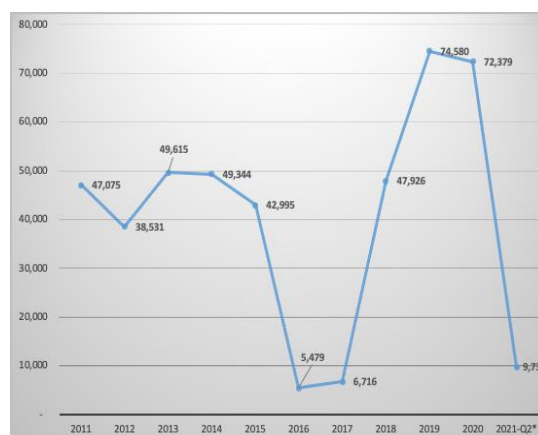
(FDI) declined by 3 per cent (see figure 10). Although the Timor-Leste investment law and tax and duty act provide an incentive package that includes, for example, a holiday and low corporate income tax (see annex 4), the country is not attracting a significant amount of private investment due to such factors as small market size, regulatory gaps, inefficient bureaucracy and recent political instability.

Figure 9: Private investment and contribution to GDP



Sources: NA, GDS, Ministry of Finance, 2021.

Figure 10: Foreign investment to Timor-Leste (\$m)



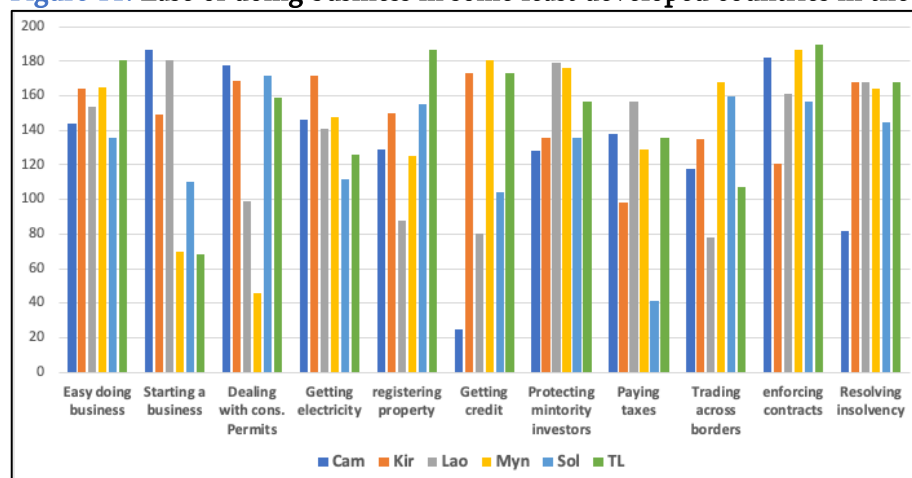
Sources: Central Bank of Timor-Leste (2021a)

The private sector in Timor-Leste has operated in a poor business environment and during three economic recessions over the past four years,¹² which have pushed many inefficient firms out of business (SERVE, 2020). while the onset of the COVID-19 pandemic in early 2020 aggravated the situation. In the 2020 World Bank Ease of Doing Business report, Timor-Leste was ranked 181, with data showing the country did not rank in the top 60 for any dimensions. The non-conducive business environment

can be attributed to inefficient service delivery and regulatory gaps associated with contract enforcement, registering property, getting credit, and resolving insolvency. Figure 11 shows that the process of registering a property in Timor-Leste is lengthy, time consuming, and costly, compared to the process in other LDCs. Furthermore, infrastructure constraints and limited skilled labour contributes to the high cost of doing business in the country.

¹² -3.1 per cent in 2017, -0.7 per cent in 2018, and -8.6 per cent in 2020.

Figure 11: Ease of doing business in some least developed countries in the Asia-Pacific region



Source: Ease of doing business, World Bank, 2020.

Notes: Cam, Cambodia; Kir, Kiribati; Lao People's Democratic Republic; Myn, Myanmar; Sol, Solomon Islands, TL, Timor-Leste.

3.4 Weak trade performance

The country's merchandise exports are highly concentrated with an export concentration index of 0.39.¹³ Even though oil and gas exports are declining, they remain the leading export products, while coffee is the major non-oil merchandise export. On the other hand, travel accounted for more than half of total service export, but it has declined since 2016 and a substantial downturn in travel occurred in 2020 following the restrictions of movement of people to contain COVID-19 (see annex 5). Major export trading partners of Timor-Leste are mainly in Asia and the Pacific, such as Singapore, China, Indonesia, and Australia (GDS, 2020b).

Vibrant private investment in export-oriented manufacturing processes are needed to improve the Timor-Leste trade performance and get rid of the persistent trade deficit. The country has recorded a non-oil trade deficit over the past two decades at an average of \$946.2 million. This can be

attributed to less diversification of merchandise and services to export and its high dependence on imports (BCTL, 2021). Since 2017, the country's trade deficit has improved slightly while in 2020, it made further gains on the back of a substantial downturn in imports (see figure 12). Disruption in international trade due to COVID-19 pandemic has weakened both imports and exports.

The Timor-Leste trade deficit narrowed by 15 per cent in 2020 – largely due to a sharp decline in service imports. The country recorded a trade balance deficit of \$785 million (equivalent to 53 per cent of GDP) in 2020 and \$199 million in the first half of 2021 owing to lower imports – especially of services – but exports also fell considerably. Imports of services declined by 30 per cent, as travel and construction services declined by 42 per cent and 52 per cent, respectively. Imports of goods also declined by 11 per cent. Exports underperformed in 2020 – export volume declined to \$57 million, largely as

¹³ The concentration index of exports indicates that the country relies on a limited group of commodities as its primary source of foreign exchange income. It ranges

from 0 (perfect diversification) to 1 (concentrated on a single product).

travel services plummeted by 64 per cent and the export of goods fell by 33 per cent.

Trade is an integral part of the country's strategy for developing the economy and improving living standards. Under the strategic development programme, Timor-Leste is envisioned to be a dynamic and open trading economy that is integrated with regional and global value chains by 2030. The country has the opportunity to balance trade by stimulating local production for import substitutions and exports. The export sector could be developed by producing merchandise and services in cases in which Timor-Leste has a comparative advantage – such as organic coffee, candlenut and coconut oil, fish and animal husbandry products, and marine and eco-tourism.

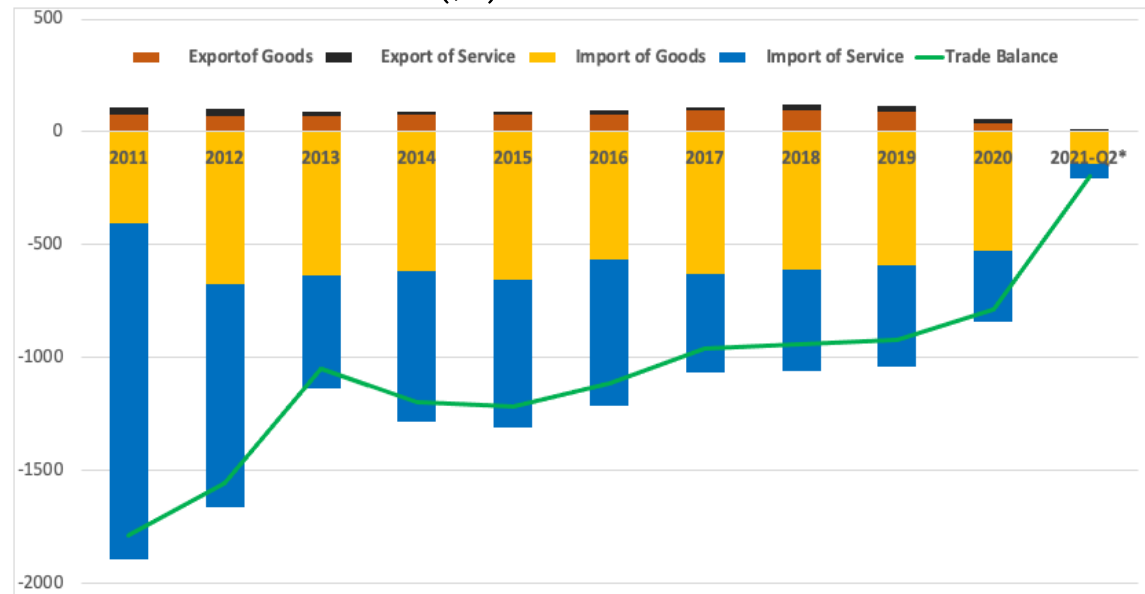
Timor-Leste has 62 exporters, of which 37 per cent engage in the agriculture industry, 31 per cent in the processing industry, 10 per cent each in tourism and aquaculture, and 6 per cent in the livestock and horticulture sectors. The agriculture industry includes businesses in production and supply of coffee, vanilla, candlenut, coconut, konjac and spices; the processing industry includes businesses in clothing (textile), home industry for marmalade and chips production; the tourism sector includes businesses in arts and crafts production and supply; the

aquaculture sector includes businesses in fish farming, crustacean and seaweed production and supply; the livestock sector includes businesses in chicken farming and egg production; and the horticulture sector includes businesses in organic and fresh vegetables and fruits production and supply (TradeInvest 2021).

The Government is set to continue to maintain the current open policies for trade and investment while pursuing reforms to improve overall competitiveness. Economic integration such as accession to the World Trade Organization (WTO) and the Association of Southeast Asian Nations (ASEAN), membership to the community for Portuguese speaking countries, and the Timor-Leste-Indonesia-Australia Triangle Cooperation are key tools for opening up trade and investment opportunities. These must be complemented by more and efficient investments to upgrade core infrastructure and productive human resources, improve TITL's investment promotion and facilitation and Service of Registration and Verification of Enterprise's (SERVE) services to reduce transactional costs for the private sector, and targeted support for modernizing traditional sectors, such as agriculture, manufacturing and niche tourism services, to produce products and services for export.

Figure 12

Timor-Leste non-oil trade balance (\$m)



Source: Central Bank of Timor-Leste (2021a).

6. Benefits of international support measures for Timor-Leste

Deferral of recommendation to graduate from LDC implies that Timor-Leste will remain entitled to ISMs. Despite providing some benefits, graduation will not significantly affect the Timor-Leste economy.¹⁴

4.1 Non-lending financial support

Least develop country graduation would not make any significant difference to ODA to Timor-Leste as development partners do not use LDC preference for extending support.

Development partners' support was significant in the early years of the country's independence, but the support has declined since 2012. Over the period 2002–2006, ODA accounted for 75 per cent of the revenue used for government spending. Since then, petroleum revenue has become the main source of revenue for public spending, accounting annually for 80 per cent of the total spending. The Ministry of Finance recorded that over the period 2011–2020, total actual financial disbursement of grants, technical assistance and loans accounted for an average of 14.6 per cent of GDP annually. However, actual disbursement of ODA declined from \$276.0 million (equivalent of 19 per cent of GDP) in 2012 to \$192 million (equivalent to 12 per cent of GDP) in 2019 Timor-Leste, Ministry of Finance (2021a).

¹⁴ Non-lending and lending financial supports are not LDC specific, but are intended to help the entire State-building process.

¹⁵ Direct budget support occurs when grant support is integrated into the central Government Financial

Management and Information System. Thereby, the support is a financing source for the government budget and can be used directly by relevant government agencies.

Despite the downturn, the contribution of ODA remains significant for the development of agriculture, education and health.

The non-lending financial support for the LDC specific was \$814 million or almost 50 per cent of the total non-lending support over the period 2011–2019. The support was for development of productive agriculture, investment in quality of education, enhancing quality of health services, and improving accessibility to clean water and sanitation (see annex 6).

While the country's economy is growing, grants and technical assistance from development partners is declining even though Timor-Leste is still categorized as a LDC. As shown in figure 13, the actual disbursement of non-lending assistance declined substantially over the nine-year period 2011–2019, from \$260.3 million in 2011 to \$162.3 million (equivalent to 10 per cent of GDP) in 2019. In 2020, the support increased to \$183 million, which can be attributed to international assistance to contain COVID-19 pandemic.

Most of the non-lending assistance is implemented directly by donors and their implementing agencies; only a limited amount of support is channelled through direct budget support.¹⁵ Currently, direct

budget support is extended by the European Union and the Department of Foreign Affairs and Trade of Australia (DFAT), totalling \$10.1 million in 2020 and \$9.1 million in 2021.

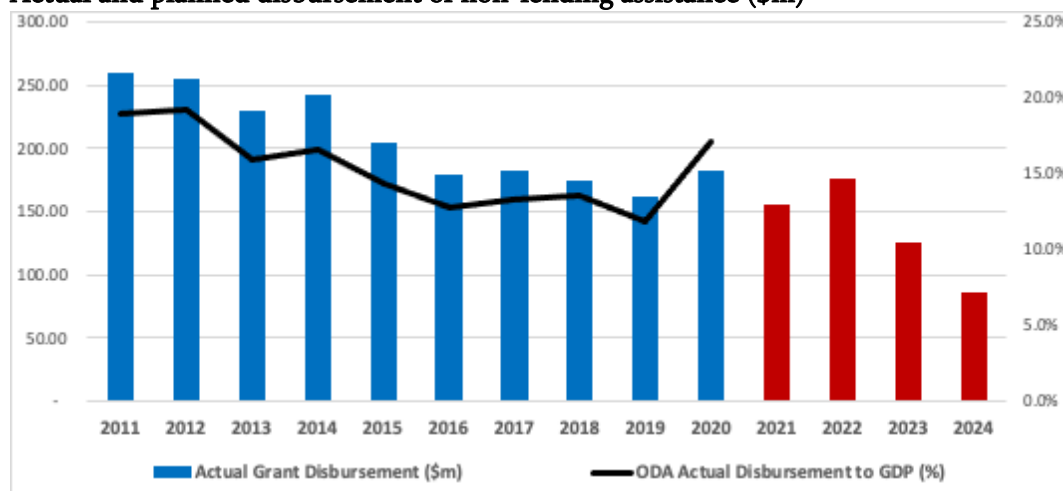
The Government of Timor-Leste has established a foreign aid policy to encourage more development partners to participate in a direct budget support initiative for efficient management of grant support under the “new deal” principles of country-owned, country-led, and using country system. The top five non-lending assistance providers are Australia, Japan, agencies of the United Nations, the European Union and Portugal (see annex 6).

The main development partners, such as Australia, Brazil, China, Indonesia, Japan, New Zealand and Portugal, have confirmed plans to continue to assist the country after graduation provided that their cooperation is

based on a number of conditions, including welfare, good governance, human rights, and regional stability (Timor-Leste, Ministry of Finance, 2021c). According to WTO (2020), most bilateral and multilateral donors do not use LDC criteria in resource allocation. Hence, risk to losing ODA after graduation is limited.

For the Government of Timor-Leste to continue to maintain good cooperation with development partners for the continued inflow of support and efficient management of resources, the Ministry of Finance and Ministry of Foreign Affairs and Cooperation as leading government institutions, need to promote implementation of the country’s foreign aid policy, particularly focusing on ensuring implementation of “new deal principles”. Moreover, Timor-Leste needs to actively expedite specific LDC funding (such as the green climate fund) to finance its development agenda.

Figure 13
Actual and planned disbursement of non-lending assistance (\$m)



Source: Timor-Leste, Ministry of Finance, 2021.

*Actual disbursements are for the period 2011—2020 and planned disbursements are for the period 2021—2024.

6.2 Concessional lending support

Multilateral development banks, such as the World Bank and the Asian Development

Bank (ADB), do use the LDC category as part of their lending rules. Instead, they consider an income classification based on GNI per capita with annual adjustments and

creditworthiness to determine eligibility for concessional loans and special funds. For instance, under the ADB lending policy, Timor-Leste is an ordinary capital resources blended¹⁶ developing member country. Accordingly, Timor-Leste could remain eligible for concessional loans even after graduation if its income level stays within a specified range set by ADB.

Timor-Leste benefits from concessional borrowings extended by bilateral and multilateral financial institutions to finance its development. Since the signing of the first concessional borrowing with the Japan International Cooperation Agency (JICA) in 2011, the loan has increased substantially to a cumulative total of \$696.6 million (Timor-Leste Ministry of Finance and ADB, 2021). The country's external debt to GDP ratio is relatively small, approximately 15 per cent in 2020. It is expected to increase to 21 per cent in 2022. The low external debt to GDP ratio is due in part to the limited government capacity to prepare infrastructure projects for loan financing, and the existing public debt law that limits the Government to only mobilize concessional borrowing with an interest rate below the opportunity cost of the long-term average of the Petroleum Fund investment return.

The World Bank, ADB and JICA provide concessional borrowing to finance infrastructure projects – mostly for the

development of road networks. By definition, concessional borrowing has two main characteristics: a low interest rate; and a long grace period, when compared to interest rates and grace periods of commercial loans.

Multilateral development banks typically provide a specific country allocation of concessional borrowing every year to the poorest and most vulnerable countries facing high and moderate debt distress risk. In addition, these borrowers, can also access available concessional resources on top of the specific country allocation if outperformed in their specific country allocation. For example, ADB, through the Asian Development Fund and concessional ordinary capital resources lending, provided \$214 million worth of concessional borrowing (representing 47.2 per cent of total borrowing from ADB), while 89 per cent of the borrowings from the World Bank is concessional, which is provided through the International Development Association (IDA). Concessional borrowing accounts for 57.7 of the country's total loans (see table 2). These concessional borrowings have made a substantial contribution to infrastructure development, in particular for the construction of national road networks. In recently signed borrowings, a large portion of the concessional resources will help to build infrastructure for clean water and Dili international airport.

¹⁶ Ordinary capital resources blended are developing member country that need some concessionality and are in need of least some concessionality

Table 2

Loans of Timor-Leste (\$m, %)

IFIs/Program	Amount (US\$ million)	Currency	Maturity (years)	Grace period (years)	Interest rate (%)
Asian Development Bank					
COL	214.02	USD, SDR	25.5	5.2	2
OCR	239.63	USD, SDR	25	5	2.2
Total	453.65				
World Bank					
IDA	119.2	USD, SDR	32	7.5	1.5
IBRD	15	SDR	28	8	3
Total	134.2				
JICA					
ODA	68.7	JPY	30	10	0.61

Source: Timor-Leste, Ministry of Finance, 2021.a

Notes: COL, concessional ordinary resources lending; OCR, ordinary capital resources; IDA, International Development Assistance; JICA; Japan International Cooperation Agency; ODA; overseas development assistance.

6.3 Preferential market access

Preferential market access for LDCs is mainly in the form of duty-free and quota-free market access or preferential tariff and preferential rules of origin. LDCs do not need to be members of WTO to benefit from preferential market access. Approximately 20 countries around the world provide non-reciprocal arrangement with LDCs for trade of goods (CDP, 2018). According to Razzaque and Tateno (2021), the impact of losing preferential market access of export for a graduating country's depends on several factors including, among them, their current export structure, export destinations, existing tariff preferences and the degree of preference utilization.

Timor-Leste qualifies for preferential access to a range of developed economy markets through the generalized system of preferences (GSP) for LDCs. This includes access to the GSP schemes of Australia, Japan, and New Zealand, and the Everything but Arms scheme for LDCs of the European Union. These schemes do not require Timor-Leste to grant reciprocal access to its own market.

Countries in South-East Asia account for a majority of the trade and investment flows of Timor-Leste. Excluding the oil and gas sector, Timor-Leste is a net importer of goods and services. It has received very limited inflows of FDI. Non-oil exports are heavily concentrated in a small number of goods and services, reflecting that Timor-Leste is still in the early stages of economic development.

Diversifying merchandise and services of export by assisting existing businesses and new investors to improve overall economic competitiveness and accelerate development of key sector and subsectors to increase domestic production are essential for the country to take advantage of LDC preferential market access. To enhance its specialization in the production of goods and services, Timor-Leste could leverage its unique potential in the areas of fisheries, livestock, cash crops, edible oils, furniture from bamboo and teak wood, and high value-added petroleum products

The impact of losing preferential market access is likely to be insignificant given the country's current export structure (less

diversified merchandise and service exports) and export destinations (mostly to markets in Asia and the Pacific). Addressing supply-side constraints and accelerating WTO and ASEAN accessions are vital.

7. Impact of COVID-19 pandemic to preparation of least developed country graduation

The COVID-19 pandemic has produced devastating and multifaceted impacts to the overall development of Timor-Leste, including to the country's preparation for LDC graduation, and structural transformation and economic diversification process. Since the onset of the pandemic in March 2021, the Government has implemented several containment measures under a state of emergency. The measures, which were mainly intended to limit mobilization of people and goods, have resulted in loss of jobs and income and business closures.

5.1 Impact to economic growth and per-capita income

Prior to the COVID-19 pandemic, Timor-Leste was experiencing a period economic hardship – registering two economic recessions¹⁷ in the last three years, resulting from the combination of public expenditure and private investment constraints. The unprecedented economic recessions continued in 2020, during which economic growth contracted 8.6 per cent, the deepest economic recession ever experienced by Timor-Leste (see figure 14). The recession in 2020 was due to a significant downturn public

and private investments and aggregate consumption.

Economic growth was expected to bounce back to 1.6 per cent growth¹⁸ in 2021 and is expected to expand by 3.8 per cent¹⁹ in 2022. However, the downside risk of heavy floods in April, the lockdown – particularly in the capital Dili for almost the whole year, and low absorption of the government budget²⁰ may have distorted the growth expectation for 2021. Economic recovery in 2022 depends on a successful COVID-19 vaccination roll-out, the level and quality public expenditure, and political stability.²¹

Gross national income declined by 14.4 per cent in 2020 (see figure 15). GNI per-capita has declined since 2011 in tandem with the decline in oil revenue. The COVID-19 pandemic has further worsened the prospects for Timor-Leste to graduate from LDC based on concerns about the declining per-capita income.

The Government should consider adopting a prudent expansionary fiscal policy to end the economic hardship period and restore macroeconomic stability. Fiscal policy interventions must address consumption and investment constraints and improve all

¹⁷ -3.1 per cent in 2017 and -0.7 per cent in 2018

¹⁸ Estimation from the Ministry of Finance.

¹⁹ Indicated in the IMF's Article IV mission report (IMF, 2021).

²⁰ Up to 23 October 2021, the Government only spent 55.8 per cent (equivalent to \$1.03 billion) of total the

budget. The Timor-Leste fiscal year is January-December.

²¹ The next election for the president of Timor-Leste is in 2022.

necessary conditions (i.e., soft and hard infrastructures) to transition the economy with the development of a vibrant private sector led by economic growth. In addition,

an expansionary fiscal policy should not undermine sustainability of the Petroleum Fund.

Figure 14 : GDP level (\$m) and growth (%)

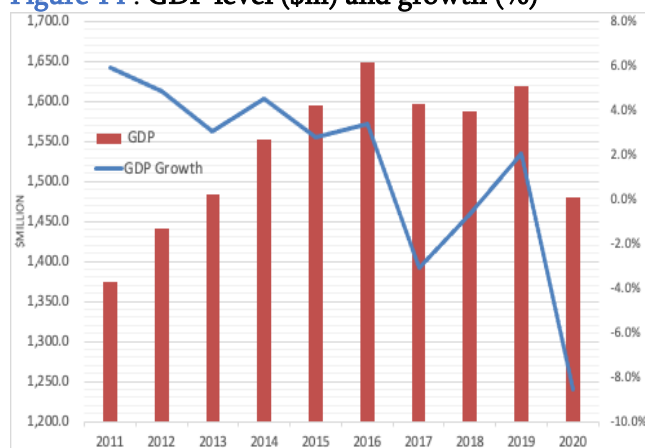
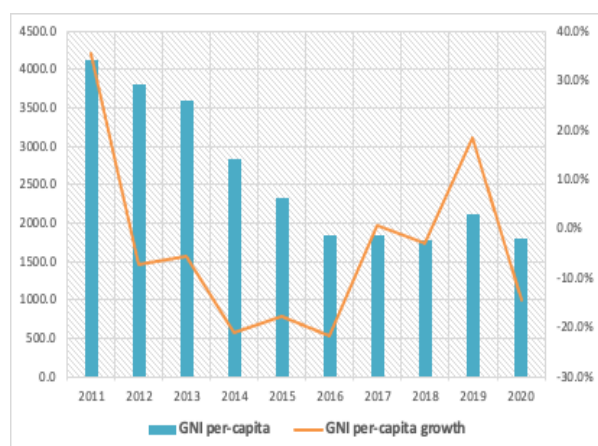


Figure 15: Gross national income per-capita (\$) and growth (%)



Sources: NA, GDS, Ministry of Finance (2021).

5.2 Impact to economic diversification

The COVID-19 pandemic led to the deterioration of the economic diversification process, particularly regarding the development of the agriculture, tourism, and manufacturing sectors.

Private sector development is slow and private investment is still relatively small in relation to the country's economic growth. As

shown in figure 16,. private sector consumption and investment contracted by 5.4 per cent and 7.6 per cent in 2020, respectively. Three components of private sector consumption, compensation of employees, expenditure on goods and services, and consumption on fixed capital, contracted even though the Government implemented several emergency responses measures to address them (see figure 17). The downturn in private investment and

consumption is due to business closures of tourism value chain businesses and micro, small and medium-sized enterprises. The United Nations Development Programme (UNDP) COVID-19 impact assessment conducted in 2020 indicates that micro, small and medium-sized enterprises were the most affected businesses by the pandemic, experiencing substantial income losses during imposition of the state of emergencies due to limited access market, supply chain disruption, and changes in demand.

Amid the COVID-19 pandemic, the agriculture sector grew by 5.0 per cent with the level of contribution to GDP being approximately \$300 million in 2020. Despite the solid performance of the sector, food production and food security were not safeguarded during the outbreak. Several impact assessments surveys found that a substantial number of households experienced lack of food and nutrition, and agriculture value chains were massively interrupted during the implementation of the state of emergencies (Asia Foundation, 2020). A total of 70 per cent of domestic rice consumption needs is imported, making Timor-Leste a food deficit country (FAO, 2020). The Government's emergency response measure to buy local products for a universal food basket programme has stimulated production. However, unsustainable supply has been experienced along the implementation process. The low production capacity has also failed to respond to the Government's demand for 30,000 tons

of rice worth over \$16.0 million for the national stock.

Tourism development is limited, as it has been one of the most affected sectors by the COVID-19 pandemic. The potential development of tourism for economic diversification is still limited due to low private-sector investment and systemic challenges. The sectoral infrastructure and the dollarized economy makes Timor-Leste expensive and less competitive relative to its neighbouring competitors. The Timor-Leste tourism value chain (restaurants, hotels, souvenir shops, tour and transport operators, and farmers) have suffered significantly, as demand for their products and services have declined substantially – in most cases, tourism and hospitality associated micro, small- and medium-sized enterprises are struggling to remain solvent and retain their staff. Visitor arrivals in 2020 declined more than 75 per cent and only slightly improved in 2021 after the Government relaxed travel restrictions in the second half of the year.

The growing trend of the manufacturing sector ended in 2020 can be attributed to the COVID-19 pandemic. Prior to contracting by 12.7 per cent and a marginal decline in the sector's share to economic growth during the pandemic, the highest expansion in manufacturing occurred in 2017. The level and share of the manufacturing sector to GDP remains very small – only accounting for \$39 million or 2.1 per cent in 2020, respectively.

Figure 16: Household and private consumption (\$m)

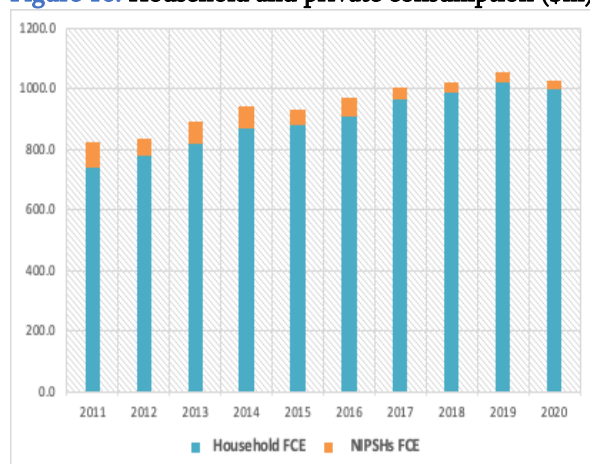
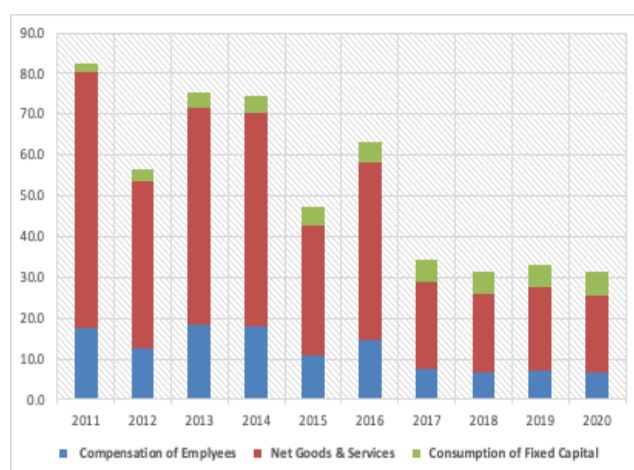


Figure 17: Components of private consumption (\$m)



Sources: NA, GDS, Timor-Leste, Ministry of Finance (2021)

5.3 Impact to jobs and consumption level

Aggregate household consumption declined by 2.4 per cent in 2020, owing to loss of jobs and income of household and individuals. The Government’s response measures, in particular conditional cash transfer to households and universal food baskets, have supported household consumption in the short term. A reduction in household consumption amplifies the concern about sustainable and inclusive development, making it necessary to continue to assist the most affected and vulnerable households, while promoting sustainable jobs and income in the medium to long-term.

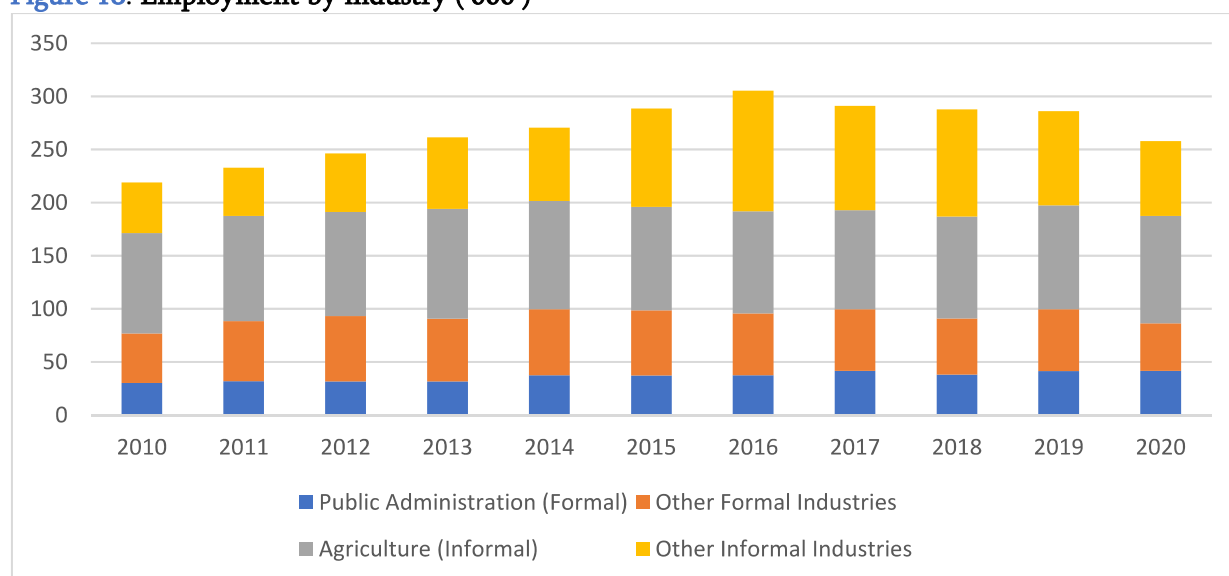
The pre-existing labour market conditions of limited job creation, limited skilled labour resulting from skills-gap and mismatching issues, and the growing young population had made job losses attributed to the COVID-19 pandemic somewhat significant. According to the Ministry of Finance, despite the introduction of the wage subsidy measure aimed at protecting jobs, formal and informal employment are estimated to have fallen in 2020 by approximately 13 per cent and 8 per cent, respectively (Timor-Leste, Ministry of Finance, 2021b). On the other hand, employment in public administration, other formal industries, namely construction,

banking and insurance, and, has remained relatively unchanged over time. Informal employment, mainly in services, such as retail and taxis, are the main factors driving changes in employment figures (see figure 18).

There is limited participation of the working-age population and women in the labour market due to limited availability of jobs. This situation deteriorated during the COVID-19 pandemic. The 2020 impact assessment of UNDP found that some businesses – in

particular micro, small- and medium-sized enterprises, reduced working hours and laid off some of their staff due to low business activities and difficulty in paying their salaries. In addition, in approximately 25 per cent of households, one member had lost his or her job. Although job loss is a great consequence of the outbreak, surprisingly it was a less commonly identified as a problem to communities and individuals, compared to health and political issues (Asia Foundation, 2020).

Figure 18: Employment by industry ('000')



Source: Ministry of Finance, 2021.

5.4 Responding and managing the impact

The Government established a COVID-19 fund and a three-year economic recovery plan to respond to and recover from the pandemic. The COVID-19 fund was established in April 2020 to finance emergency response measures – for prevention and mitigation. The emergency recovery plan has two distinct implementation stages, which are intended to sustain the economy from the impact of the COVID-19 pandemic and to transform the economy to be more resilient in the future.

The COVID-19 fund has received financing that exceeds \$300 million since it was set up in April 2020. The fund finances public health-related prevention and mitigation and economic response and recovery measures. The measures include the establishment of facilities for quarantine and isolation, acquisition of medical supplies and equipment, credit lines for businesses, cash transfers to households, and a universal food basket.

The largest measures financed by the COVID-19 fund include one that exceeds \$65 million for a conditional cash transfer – in which approximately 315,000 households with a monthly income below \$500 have benefited from the programme; \$45.3 million for an employment support initiative and \$34.5 million to the Ministry of Health to finance a vaccination programme, quarantine facilities, purchase of personal protective equipment and contact tracing initiatives. Funds are also allocated to offer subsidies to frontline workers and support a universal food basket programme.

National consensus on the establishment of the COVID-19 fund indicates a strong political institution and governance that consider COVID-19 pandemic as a national threat that needs to be addressed. It also shows the importance of the Petroleum Fund in its potential roles as a fiscal buffer for the Government when needed. Hence, policy actions that promote efficient management of the COVID-19 fund and sustainability of Petroleum Fund are encouraged.

The economic recovery plan measures to help the economy recover in the short term include those that aim to prevent more business closures and job and income losses, and support families to sustain their consumption level and living standards. The universal food basket is the most notable short-term measure of the economic recovery plan. Implementation of it began in the last quarter of 2020. The programme stimulates the local economy and helps to sustain the consumption level of people through involvement in the domestic private sector production and distribution related to food item production and distribution.

While for the medium to long term, the economic recovery plan is aimed at building a resilient economy with measures that focus on addressing structural challenges, such as malnutrition, low productivity of labour, a poor business environment to attract private investment, inequality in income distribution, limited supporting and sectoral infrastructure, and inefficient public services.

Development partners' support to Timor-Leste to fight and recover from the COVID-19 pandemic is notable. The Ministry of Finance recorded commitments totalling \$40 million in non-lending assistance from development partners in 2020 to support COVID-19-related activities, including for the brand-new initiatives and/or adjustment of the existing activities. Timor-Leste relies on the technical and financial support of development partners for the COVID-19 vaccination programme and to improve the capacity of the health sector to provide better quality public health services, and to help the economy recover in the short to medium term. With effective cooperation, Timor-Leste is on track to reach its 80 per cent per-capita vaccination target, which is essential for economic development

With the petroleum fund serving as a fiscal buffer, including to the COVID-19 fund and to finance the economic recovery plan, and successful implementation of the plan with support from development partners, the country's economy can become more sustainable, which would underpin the LDC graduation process and contribute towards progress in achieving the SDGs.

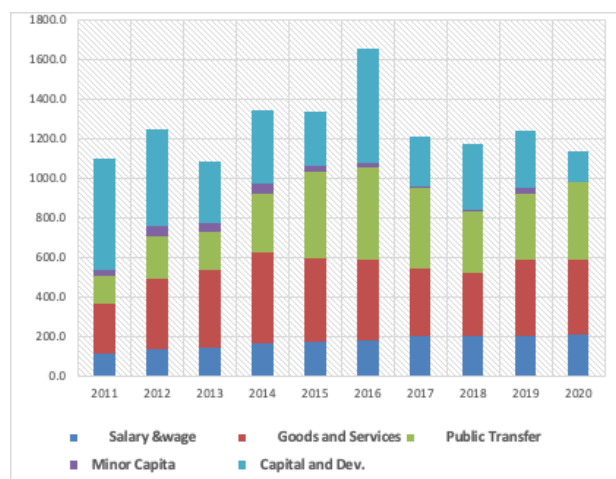
6 Infrastructure development: progress and challenge

A key government priority is infrastructure development for a growing, productive, and connected Timor-Leste. The strategy is to continue to build and maintain core and productive infrastructure to promote connectivity and underpin sustainable economic growth and social inclusion.

The Government established an infrastructure fund in 2011 to finance large infrastructure projects. The financing sources of the infrastructure fund are mainly petroleum revenue and concessional loans that are channelled through the annual

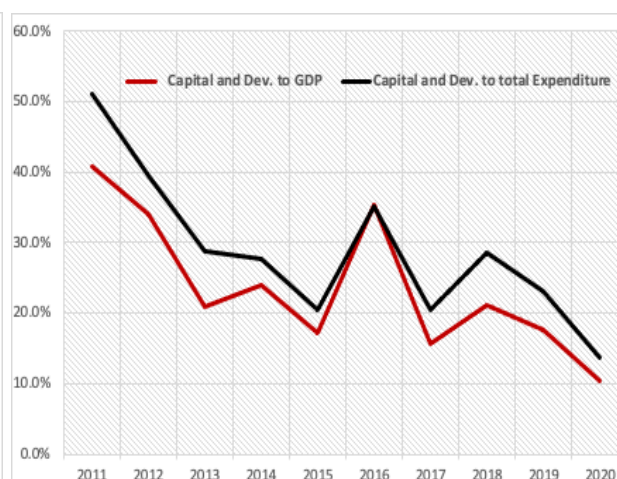
budget. Over the period 2011–2020, the Government spent more than \$4 billion on infrastructure; the expenditure to infrastructure and infrastructure expenditure to GDP averaged \$333.5 million and 22.3 per cent, respectively (see figures 19 and 20). The largest expenditure in a single year was recorded in 2016, totalling \$581 million. The funds were used to finance development of national road networks and electricity distribution lines. As a result, the northern corridor of national road network is almost complete and more than 85 per cent of all households have access to electricity

Figure 19: Expenditure by category (\$m).



Source: Ministry of Finance (2021).

Figure 20: Infrastructure expenditure to GDP (%)



Although expenditure on infrastructure has declined since 2016, infrastructure assets have grown exponentially over the last ten years. Continued investment in core and resilient infrastructure, such as roads, the Dili international airport, water and sanitation, are needed to facilitate private investment and sustain productivity.

Signatory investments in infrastructure that have been made include the establishment of two diesel power plants and energy distribution networks across the country, development of national road networks, a highway and airport for downstream petroleum industry development in the South coast, construction of the Tibar port – the country’s largest cargo port, and development of the required infrastructure for the special economic zone in enclave Oe-cusse. Upgrading the Dili international airport will be a key infrastructure investment to connect Timor-Leste with the rest of the world.

Energy and transport infrastructure accounted for 76 per cent of the spending of the infrastructure fund over the past 10 years. Of the expenditure, 36.4 per cent was directed to develop infrastructure for the energy sector, including power plants and distribution networks. The combined expenditure on roads, bridges, a port, and the airport accounted for nearly 40 per cent of the expenditure of the infrastructure fund and 12 per cent of the funds was allocated to the development of the required infrastructure for downstream petroleum industry in the South coast. Investment in productive and social sectors were limited as each sector agriculture and tourism, received less than 2.0 per cent of the funds and the combined expenditure for education, health and water and sanitation only slightly exceeded 1.0 per cent (see figure 21).

The Government needs to rebalance infrastructure spending by taking into account economic diversification strategies and aspirations to achieve the SDGs. as more than 20 per cent of the population lack access to basic water facilities and almost half of the households do not have access to basic sanitation. Due to the uneven distribution between rural and urban areas, and low agriculture productivity, owing to lack of infrastructure facilities, the Government needs to extend more fiscal space for infrastructure development of these sectors.

There is a need to capitalize on the establishment of “Bé Timor-Leste” state-owned enterprise²² made in 2020 and build on the momentum from the recent agreements with ADB and the World Bank to provide more than \$80 million in concessional borrowing for infrastructure development of water and sanitation to improve the efficiency of utility services and mobilize more financial resources for development of this sector.

Greater allocation of the budget from the infrastructure fund for infrastructure development in the agriculture and tourism sectors are needed. Priority infrastructure for agriculture are water reservation facilities/dumps and irrigation. The Government could ask for technical assistance and financial support from multilateral financial institutions, such as ADB, the World Bank and AIIB, that have shown interest to invest in such projects. Upgrading the Dili international airport with the objective to promote tourism should be accompanied by more financing for tourism infrastructure development. The Government needs to prioritize the development of municipal tourism

²² “Bé Timor-Leste” is the state-owned enterprise for water and sanitation set up to provide efficient services to clients and population in general.

information centres and infrastructure of potential tourism sites.

Mobilization of concessional loan and private sector financing through public-private partnerships (PPPs) to infrastructure development are notable. Total concessional loans and private financial resources that have been mobilized totals \$936.6 million – representing 23 per cent of the total infrastructure fund budget over the last 10 years. Concessional loans resources are provided by ADB, World Bank, and JICA. ADB provides almost half of the resources to invest in the development of road networks, water and sanitation and the Dili International Airport. Also of note, foreign private sector resources are provided for the Tibar international cargo port development under a PPP scheme (see figure 22).

Efficient management of public investment is limited owing to capacity constraint on preparation and supervision of projects and underfunding of operational and maintenance of infrastructure assets. Concessional loans are typically attached with technical assistance to help the Government prepare and supervise projects. To prepare for PPP projects, the Government relies on the assistance from the International Financial Cooperation (IFC) and other development partners. Management of infrastructure assets needs to be improved, in particular, funding for operation and maintenance of the assets. The Government spent an average of less than \$5.0 million annually on the operation and maintenance of infrastructure assets over the past five years. It should allocate between 5 and 10 per cent of the total budget for infrastructure development annually for the maintenance of infrastructure assets.

Figure 21
Infrastructure fund (\$m)

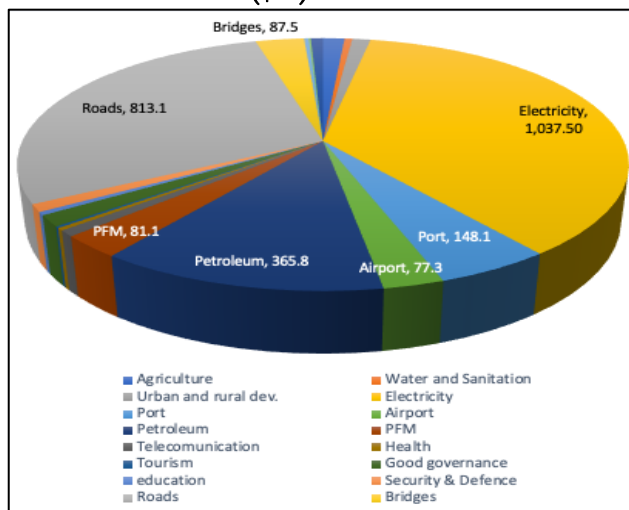
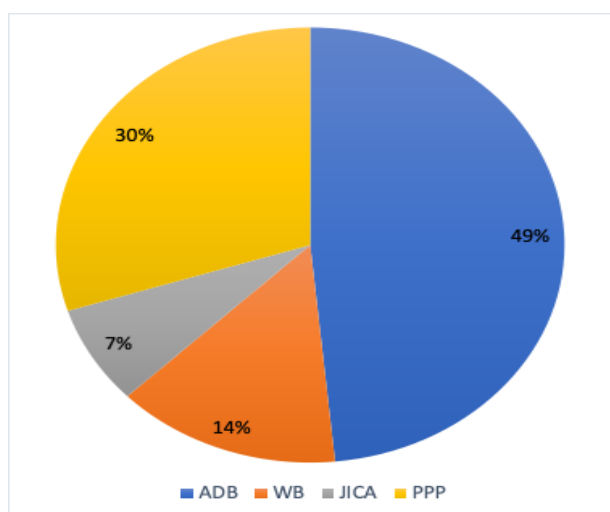


Figure 22: Loans and public-private partnerships financing on infrastructure



Source: Ministry of Finance (2021).

Notes: ADB, Asian Development Bank, JICA, Japan International Cooperation Agency; PPP, public-private partnership.

More financial resources are needed for the development of infrastructure in the medium-term. The Ministry of Finance estimates that more than \$2.7 billion is required over the next four years to continue investing in core infrastructures, such as roads, electricity, port, airport, fiber-optic, water and sanitation, irrigation, school buildings, and clinics and hospitals. Financing resources are expected from the petroleum fund withdrawals, external loan resource mobilization – preferably concessional loans, and from the private sector through PPPs (Ministry of Finance, 2021).

Timor-Leste can capitalize on the Belt and Road Initiative to develop its infrastructure for connectivity and regional integration. This opportunity is grounded by the location of Timor-Leste in South-East Asia. The Government sent a high-level delegation to attend the first Belt and Road Initiative Forum for International Cooperation, held in 2017, where it signed a memorandum of understanding for cooperation in implementing the initiative, became a permanent member of Asian Infrastructure Investment Bank (AIIB), and country's big

infrastructure projects are mostly implemented by Chinese contractors. It is estimated that more than \$1.0 billion of infrastructure projects in energy, land transportation, and port development have been implemented by contractors from China since 2011.

Timor-Leste needs to capitalize on AIIB membership to access more financial resources for infrastructure development. Since joining AIIB in November 2017, Timor-Leste has yet to implement a project with AIIB. There are three fundamental reasons why Timor-Leste has not implemented project under the Belt and Road Initiative: (a) failure to agree on a \$50 million borrowing from the Exim Bank of China in 2015 because the creditor required the Government to use the Petroleum Fund as collateral, which is not allowed under the legislation. Sentiment from the Ministry of Finance indicated that the same requirement still prevails for Belt and Road Initiative projects; (b) borrowing from AIIB is at the commercial rate, while the Ministry of Finance prioritizes that external borrowing focus on mobilization of concessional and/or blended resources; and

(ci) AIIB does not have an office in Timor-Leste, making it difficult for regular communication. This is important because the Government lacks the institutional capacity to prepare projects and typically requires assistance from the lender. ADB and the World Bank have a comparative advantage on this as they have staff on the ground.

The Ministry of Finance needs to discuss with AIIB about financing for infrastructure projects, in particular for roads, ports, and airport development to promote connectivity and economic integration. Stand-alone or joint projects with Indonesia, in particular on development of international road networks that connect Timor-Leste with West Timor are opportunities that also need to be considered.

7 Regional cooperation to promote economic integration and trade

7.1 Trade policy

The world trades and invests across borders more now than at any time in history. While recently, there has been challenges to cooperation and rising protectionist sentiments in some parts of the world, South-East Asia, has become one of the most economically dynamic regions in the world. With ASEAN as its platform, the countries in the subregion continue to deepen their economic integration through development of the ASEAN Economic Community (AEC) and agreements the association has made with key partners, such as Australia, China, Japan, New Zealand, the Republic of Korea and the United States.

Deepening international trade is an important part of the country's strategy to grow and diversify its economy. Its vision for trade and investment is that by 2030, the country will have a dynamic and open trading economy that is integrated into regional and global value chains. Growing trade and investment would help foster a structural transformation, provide access to international markets, assist in acquiring technologies, remove the impediments imposed by the limited size of the domestic market, extend new opportunities for employment and drive growth of productive sectors and new export industries.

Timor-Leste has liberal trade policies, minimal non-tariff barriers and no formal quantitative restrictions on merchandise trade. Over the period 2002–2008, a uniform tariff of 6 per cent was applied to all goods on

tobacco, alcohol, and a limited number of luxury goods. In addition, a sales tax of 6.0 per cent was levied on the value of imported goods (including duty and any excises), resulting in an effective tax on imports of at least 12.4 per cent of the import value. In 2008, the ad valorem tariff and sales tax rates were reduced to 2.5 per cent each, and some excises were eliminated. The cumulative effect of these changes was to reduce the minimum effective tax on imports from 12.4 per cent of the import value to 5 per cent. This rate is relatively low compared with the import tariffs that ASEAN members levy on non-ASEAN members, or that some small island economies apply to countries qualifying for “most favored nation” treatment under WTO rules. Trade in services has also been relatively liberal, as there are few explicit restrictions on the provision of services by foreign businesses.

The ongoing customs administration reform will lay a strong foundation for more efficient trade facilitation. The Government started to implement fiscal reform in 2015 to modernize the customs administration with the objective to improve border management and make cross-border trade more efficient. Progress made in improving border management includes approval of a new customs code by making it more efficient through automatization of customs procedures and establishing a national single window platform. Despite this progress, Timor-Leste is still at a relatively early stage in strengthening trade facilitation and lags most ASEAN members in that regard (ESCAP 2015). The Government has established a

national trade facilitation committee to coordinate trade-related reforms, but further work is required to operationalize the committee and develop a prioritized work programme.

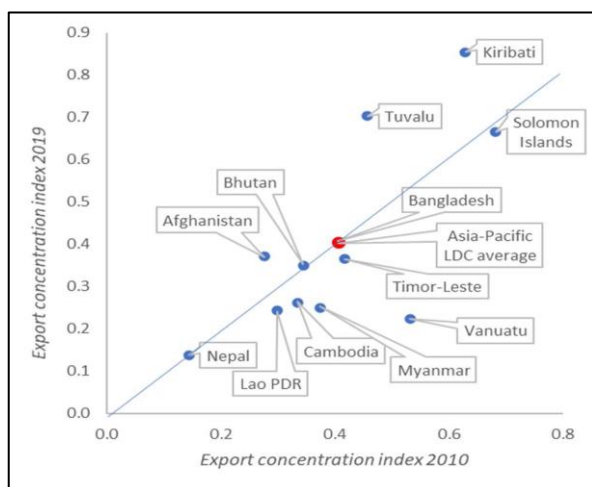
7.2 Trade flows

The country's trade in goods and services has expanded significantly since independence, from less than \$500 million in 2006 to more than \$1.1 billion in 2019. However, as shown in figure 25, the growth in trade was mostly driven by a surge in imports linked to increases in public spending. More than half of the country's imports were from the ASEAN region, with most being from Indonesia. For instance, in 2020, ASEAN members, such as Indonesia, Malaysia,

Singapore and Viet Nam, accounted for 57 per cent of the total imports of Timor-Leste (GDS, 2020b).

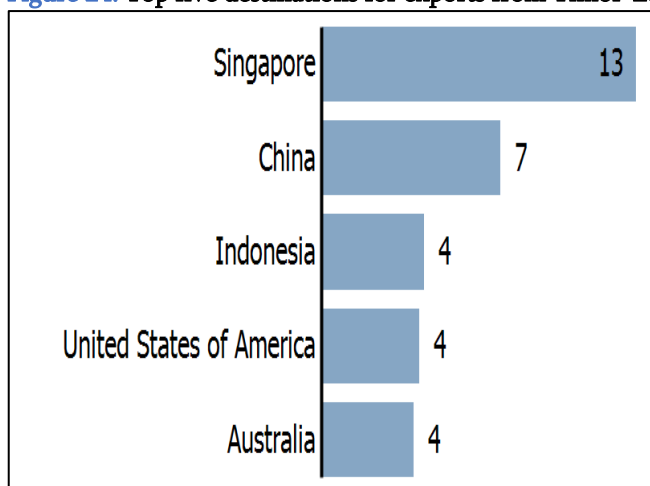
Exports from Timor-Leste are small and highly concentrated (see figure 23). Merchandise and service exports grew by less than .5 per cent over the last ten years. Oil and coffee are the main export merchandise, while travel is the main service export. Supply-side constraints is the main factor impeding export growth. The country needs to tackle these constraints, particularly to increase its productive capacity to take advantage of the potential of such sectors as agriculture, tourism and manufacturing, and develop targeted niche products, such as candlenut and coconut oils, and eco and marine tourism services.

Figure 23: Least developed countries' export concentration index



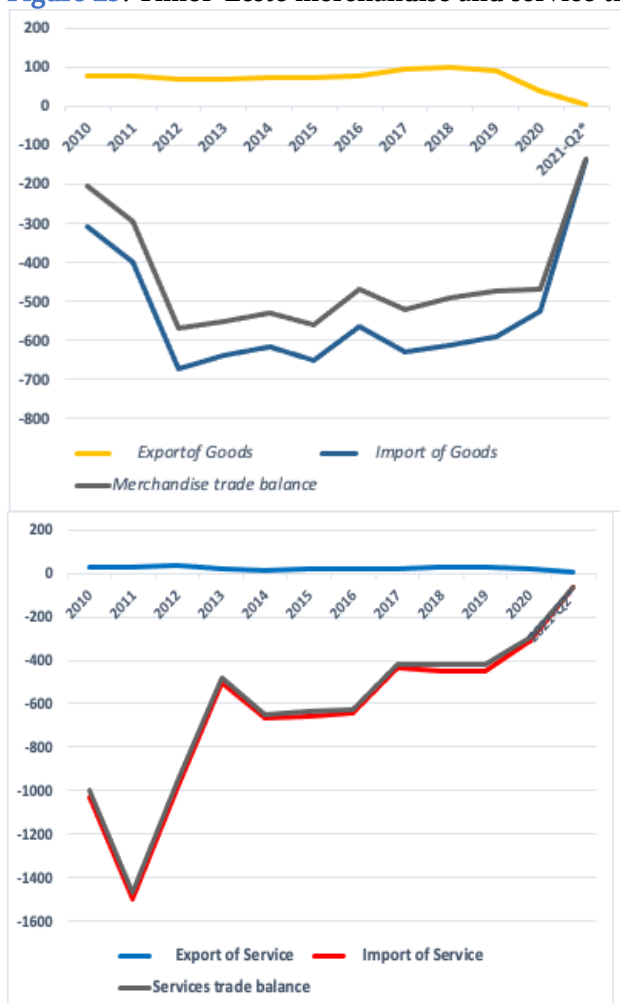
Sources: ESCAP and UNCTADstat.

Figure 24: Top five destinations for exports from Timor-Leste



Source: UNCTAD (2020).

Figure 25: Timor-Leste merchandise and service trades (\$m)



Source: Central Bank of Timor-Leste (2021a).

7.3 World Trade Organization and Association of Southeast Asian Nations accession process

To achieve the vision of its trade policy, Timor-Leste committed to join ASEAN and the ASEAN Economic Community (AEC) 10 years ago, while the process for the country to join WTO began in 2015. Memberships in WTO and ASEAN is a sensible objective for Timor-Leste, but careful strategic planning is needed to define the country's negotiating objectives and make the most of the opportunities that come with the memberships. This means that it is important for Timor-Leste to have a clear sense of its own priorities before beginning to negotiate the terms of its accession.

Joining WTO and ASEAN would be important milestones in the development of the country. To become members of these organizations, Timor-Leste must agree to making binding commitments in a range of areas, including, among them, trade policy and intellectual property rights. In exchange for these commitments, Timor-Leste will gain secure access to export markets, and impartial and rules-based mechanisms to settle trade disputes.

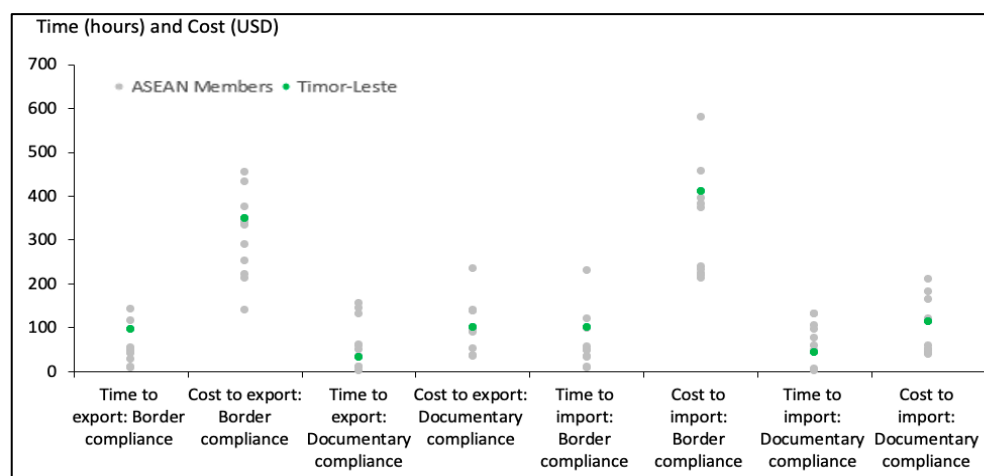
Membership in WTO will require Timor-Leste to comply with a core set of agreements regulating the trade in goods, trade in services, and trade-related to intellectual property. However, as a LDC, Timor-Leste should retain significant flexibility in its tariff policies after completing the accession process; the specific conditions for accession will be negotiated with other WTO members.

Timor-Leste has made significant progress in its accession to WTO, which includes the submission of the Memorandum of Foreign Trade Regime, submission of replies to members' questions, with prior endorsement of the Council of Ministers; completion of a checklist on implementation and administration of the Customs Valuation Agreement; and development of the Legislation Action Plan and submission of it to the Working Party, together with the Q & R document. In this effort, Timor-Leste has also completed several translations of the legislations.

Joining ASEAN and the AEC is the foremost objective of Timor-Leste economic integration and is supported by a strong political consensus. Economic integration with ASEAN and its regional partners would provide new opportunities for Timorese products and services, new inbound foreign investment, and help accelerate the process of product and service diversification in the Timorese economy. Since officially filing a membership application in 2011, Timor-Leste has made great strides in preparing for accession to AEC, including holding of a virtual meeting between Timor-Leste officials and ASEAN senior economic officials in December 2020. At the meeting, the Timor-Leste delegation (senior government officials and officials of the Chamber of Commerce) presented and updated the country's preparation to joining AEC. Even though Timor-Leste is not a member of AEC, it should be noted that most of the country's trade is with countries in South-East Asia and its management of cross-border trade quite is similar to that of ASEAN member States (see figure 26)

Figure 26

Time and cost of cross-border trade – Association of South-East Asian and Timor-Leste



Source: Easy doing business, World Bank (2020).

Timor-Leste needs to significantly boost its institutional capabilities for accession to WTO and ASEAN and to negotiate other bilateral and multilateral trade and investment agreements. As an LDC, Timor-Leste can access specialized technical assistance for pre- and post-WTO accession capacity development through the WTO's Enhanced Integration Framework while for the ASEAN accession, Timor-Leste is benefiting from substantial technical support from ADB.

As Timor-Leste is an LDC, for the trade of goods, the requirements for average bound rates are far above the current import tariff of 5 per cent. The bound rates for specific tariff lines can vary. For ASEAN, Timor-Leste must negotiate the timeframe for eliminating tariffs on imports from ASEAN members, and any exclusions for goods in which tariff liberalization will not be required. The country will also need to follow WTO and ASEAN standards for sanitary and phytosanitary protocols, customs valuation, and trade facilitation.

For trade in services, Timor-Leste needs to negotiate with interested WTO members on subsectors that are defined in the General

Agreement on Trade in Services assigned for “national treatment” — but will not be required to provide more extensive national treatment than what is given to other WTO least developed country members. In the case of ASEAN, Timor-Leste will probably be required to match the commitments that ASEAN members have made with each other through the ASEAN Framework Agreement on Services. This includes liberalization of trade in business and professional services, construction, distribution, telecommunications, tourism, and maritime transport services.

Accession to WTO and ASEAN will provide Timor-Leste with a range of benefits. As a WTO member, Timor-Leste would retain any preferential market access received through the Generalized System of Preferences programmes, and access to the markets of all WTO members on a “most favored nation” basis. As an ASEAN member, Timor-Leste would have tariff-free access to the markets of the other ASEAN members and could also negotiate for accession to the free trade agreements. In addition to securing and enhancing access to export markets, accession would also support improvements in the

policies and institutions of Timor-Leste for managing trade.

7.4 Addressing supply-side constraints

As an LDC, Timor-Leste needs to address a wide range of issues in order to meet the requirements for WTO and ASEAN memberships to make the most of the resulting opportunities. Some of the country's supply-side constraints to export growth are its trade policy, transport connectivity, labour costs and financial sector development and the limited availability of its skilled and aspects of the business enabling environment, such as business registration, contract enforcement and registering property.

Timor-Leste has made substantial progress in addressing some of these challenges. For instance, roads corridors linking Dili with coffee-producing municipalities, such as Ermera, Ainaro and Aileu, and to the Indonesian borders have been upgraded, a new port is being developed close to Dili to provide ample capacity for containerized cargo shipping, new international airport were built in enclave Oecusse to facilitate the establishment of a free economic zone and in Suai municipality to underpin high-value added downstream oil industry development. As stated earlier, progress has also been made regarding policy and institutional reform to facilitate trade and investment, including the transformation of customs to a new semi-autonomous agency, introduction of the new custom code, implementation of new customs business processes and information management systems, and implementation of the single window. However, much work remains to be done, including improving connectivity, promoting efficient legislation, facilitating easy access to credit – particularly for local exporters, making public service delivery more efficient and encouraging greater coordination between stakeholders (Government, private sector, and development partners) for the planning and

implementation of policies and programmes aimed at developing export industries.

In the country's strategic development plan, the overall framework for economic diversification is based on the development of agriculture, tourism, manufacturing and the petroleum industry. The plan recognizes the need to develop realistic strategies to address sector-specific constraints to increase trade and investment. The agriculture sector continues to have great potential for export growth and poverty reduction. The main subsectors being developed are coffee, high-value horticulture products, fisheries, livestock, forestry, and industrial crops. Increasing agricultural production would underpin the development of light manufacturing, including food processing and furniture production.

The oil and gas sectors are centred on the Tasi Mane project to develop hubs for LNG production, oil refining and logistics support on the South coast. Successful development of the Greater Sunrise field, discovery of new commercial resources within the Timor-Leste exclusive economic zone, and successful development of onshore oil and gas processing and logistics would result in large exports of oil and gas products. It would also create significant spillovers into other sectors, such as construction, transport and logistics, maintenance and repair services, and light manufacturing.

8 Priority areas and policy recommendations.

Policy actions outlined in this section were developed based on lessons learned from the previous development process and the emerging developments, such as COVID-19 pandemic and the decline in oil revenue, which are affecting the development landscape of Timor-Leste. The proposed programmes of actions will coincide with the last nine years of the 2030 Agenda. Accordingly, the core focus of the policy actions are structural transformation and economic diversification for LDC graduation and progress towards achieving the SDGs.

Priority policy actions for the short term are intended to respond efficiently to COVID-19 pandemic and enhance implementation of the development framework. The medium to long-term policy actions focus on building institutional capacity to enhance efficient service delivery, improve production capacity and structural transformation, and mobilize tax and domestic resources.

8.1 Efficient response to the COVID-19 pandemic

Economic development cannot be unlinked from the COVID-19 vaccination. The countries that have lifted lockdown measures and opened up their economies are those that have successfully carried out a vaccination campaign. Timor-Leste recently relaxed its lockdown requirements, supported in part by the high per-capita COVID-19 vaccination. The Government needs to set up a minimum per-capita COVID-19 vaccination target and relax all containment restrictions, which

have downside effects on the economy once the target has been met. The target should be set based on the applied standard recommended by competent authorities, such as the World Health Organization (WHO) or the Ministry of Health. The vaccination is the main solution for the “new normal” of life and to protect people’s health from COVID-19 and prevent further learning opportunities loss, which are essential for attaining productive and sustainable economic development.

Timor-Leste suffers from a pre-existing high poverty incidence, in particular in rural areas and has a limited number of jobs for the growing young population and women. The COVID-19 pandemic has exacerbated these hardships. Accordingly, the Government needs to design temporary well-targeted social protection schemes for the most affected and vulnerable people to support their consumption needs and prevent them suffering from severe human development conditions. The measures should be formulated based on the objective to promote inclusiveness and the principle of leaving no one behind, and not by political factors.

8.2 Enhancing implementation of the development framework

The country’s broad development objectives are well articulated in the strategic development plan and the 2030 Agenda. Adding new dimensions to these planning frameworks perhaps is not needed. Instead, the following needs to be done:

- Deepen partnerships with all stakeholders and reinvigorate country-specific initiatives.
- Integrate LDC graduation aspirations into the country's medium-term development framework.
- Establish a national LDC graduation committee to prepare LDC graduation strategies, exploit the existing LDC-specific international support measures, negotiate with major trading partners to extend the transition period and/or provide alternative support measures in the post-graduation era; coordinate with Government departments and other relevant stakeholders for businesses associated with LDC graduation, safeguarding donors support for preparation of LDC graduation and beyond and monitoring post-graduation impacts.

8.3 Building institutional capacities to enhance efficient service delivery

The Government needs to enhance the implementation of the public administration reform that was initiated in 2015 to improve good governance, transparency, accountability, rule of law and efficiency of public service at national and subnational levels through the following actions:

- Improve the capacity of the public service workforce through appropriate education and regular training programmes and base selections and promotions on merit.
- Improve infrastructure and facilities of public institutions across the country.
- Centralize power and resources to authorities at subnational levels.
- Enhance e-government services across all levels of services.

It takes time for the entire impacts of reform to take effect. However, improvements in good governance, service delivery and, resources absorptive capacity have already been observed. Institutional development is an ongoing process. Accordingly, continued attention to it should be given.

8.4 Improving production capacity and structural transformation

A fundamental requirement for Timor-Leste is to prepare for LDC graduation and efforts aimed at achieving the SDGs should be to prioritize productive capacity development and structural transformation. Timor-Leste is meeting GNI per-capita and HAI graduation thresholds, but very little progress has been made related to productive capacity and structural transformation for economic diversification despite strong emphasis placed on them. Tangible and more practical actions for structural transformation that are suited to the country's priorities and context should be stressed. A new approach for economic diversification that puts private investment and trade at the centre of development of potential sectors need to be introduced. The following are proposed policy actions for economic diversification:

A. Diversify the economy by promoting agriculture, tourism and manufacturing

- The current policy objectives for agriculture development as outlined in the strategic development plan are for Timor-Leste to have at least four niche cash crops by 2020 that can be exported on a consistent basis; improved management of coastal and inland fisheries to attain a vibrant commercial and sustainable industry in the exclusive economic zone; and enhance commercial livestock and

animal farming to provide nutrition, job creation and exports. To achieve these policy objectives, the Government should continue to do the following:

- (a) Focus on transforming subsistence farming to commercial agriculture through greater investment in sectoral infrastructure, such as irrigation, and water catch and storage facilities.
 - (b) Improve farmers' capacity to carry out technological adoption.
 - (c) Enhance credit accessibility.
 - (d) Encourage private sector investment in the sector to develop niche agricultural products, such as value-added coffee and edible oil products, and livestock and fishing products for the domestic market and exports.
- To attain a sustained recovery and develop the tourism sector in medium to long term, it is necessary to continue to do the following:
 - (a) Provide training to equip staff with the appropriate skills and professional attitudes for hospitality services.
 - (b) Address infrastructure bottlenecks, including, for example, by upgrading the Dili international airport, and telecommunication services, such as fiber optics, to reduce tourism service-related costs.
 - (c) Build on the country branding of "discover the undiscovered" to prepare promotional packages and use it as a theme for international major events to promote investment.
 - (d) Facilitate investments of the private sector in soft and hard infrastructure,

including for micro, small- and medium-sized enterprises to provide community-based tourism services.

- To take advantage of the strategic geographic location of Timor-Leste for international value chains and the its low-skilled cost-competitive labour market, the Government should offer incentives for investment supported by laws and regulations, and macroeconomic and political stability. It should also focus on the development of low skills and capital requirements for manufacturing processes, while accelerating the establishment of industrial zones for high- value products with to be exported. including for high valued-added downstream oil and gas products.

B. Enabling a business environment for private sector growth and development

The country's private sector's contribution to economic development and the creation of formal jobs is limited because of structural challenges, which hamper private investment. Some of the some of the challenges to overcoming this are inadequate laws and regulations, and infrastructure, and lack of skilled labour. Comprehensive private sector development reform with the objective to transform the "oil economy" to a private sector led economy is required. The Government should continue to implement the policy reforms related to public administration, legislation and fiscal and public financial management to make the bureaucracy more efficient, provide legal certainty and facilitate structural transformation and promote economic efficiency to underpin private sector development for economic diversification. The followed are proposed key actions for private sector reform: :

- Because the country's economy is driven by public expenditure, expenditure constraints in 2017, 2018 and 2020 resulted in economic recessions and macroeconomic instability during those years. Accordingly, going forward, the Government should adopt a prudent expansionary fiscal policy to help the economy recover quickly. Political instability, which leads to expenditure constraints, should be avoided in the future as Timor-Leste needs to mitigate its high country risk with a stable macroeconomic environment to attract FDIs to develop and diversify the economy.
- Accelerate implementation of the ongoing public administration reform to promote efficient bureaucracy through the following:
 - (a) Enhance the services offered by TITL related to investment promotion and the business registration process of SERVE with an electronic registration system.
 - (b) Set up a single window platform to facilitate trade across borders.
 - (c) Improve electronic tax payment services.
 - (d) Promote a whole-of-government approach to discuss business environment issues, coordinate mutual efforts to address challenges, and monitor and oversee progress to ensure efficient coordination between government departments that would contribute to the reduction of transactional costs for the private sector.
- Accelerate the implementation of the ongoing legislative reform is needed to

address laws and regulatory gaps, in particular with regard to contract enforcement, registering property and insolvency to provide legal coverage to private investment and help reduce high capital costs. In addition, reforms are needed to review and harmonize the existing tax and duty act, and the investment law to align them with fiscal incentives offered to attract private investment and boost revenue collection.

- The ongoing fiscal and public financial management reform to rationalize expenditure by prioritizing investment in infrastructure, human capital and productive sector is expected to underpin structural transformation and facilitate private-sector investment.

C. Economic integration and trade

The WTO and ASEAN memberships would provide opportunities to access new export markets and attract investments for the development of productive sectors and new export industries. A whole-of-government approach is needed to formulate the country's negotiation objectives and strategies to make the most of the opportunities that come with these memberships, tap available technical assistance support to develop institutional capacities, and address supply-side constraints, particularly those related to creating an enabling business environment for maintaining macroeconomic stability by promoting efficient legislation and bureaucracy, and developing productive infrastructure and workers. It is also equally important to target sectors and develop products for export, such as candlenut and coconut oils, fishery and livestock products, and eco and marine tourism services.

D. Infrastructure development to facilitate structural transformation

Innovate financing for infrastructure development through greater mobilization of concessional and private sector resources is needed. Because of the country's relatively low loan to GDP ratio and low risk of debt distress, the Government can work with multilateral development banks to identify and prepare projects for concessional loan financing. Building from the experience of the PPP Tibar port project, the Government should consider working with IFC and other institutions to select and prepare potential infrastructure projects for PPP. Moreover, government participation in the equity of private investment could also be an alternative to mobilizing more private sector resources to invest in Timor-Leste.

Efficient management to the growing infrastructure assets would ensure socioeconomic returns on investment in the long term. The Government needs to increase expenditure and/or establish proper funding (such as a road fund) to operate and manage infrastructure assets. Preparing projects through design, built, operation, and transfer would help address capacity constraints related to the preparation of projects and operation and maintenance of the assets.

E. Human capital development

In the strategic development plan and 2030 Agenda, human resource development is viewed as an essential prerequisite to diversify the economy and make progress towards attaining sustainable development. The current government policy objectives for human capital development are for the people of Timor-Leste to be literate, knowledgeable, skillful and healthy, live long and have productive lives to participate actively in economic, social and political development and to promote social equity and national unity (Strategic development plan, 2011).

Although Timor-Leste has made substantial

progress with regard to attendance rates of pre and primary school, attendance rates for secondary and tertiary education levels are still lagging, and the quality of education and vocational and skill development programmes have not improved. This is resulting in skill gaps and mismatching issues. Lack of employment opportunities due to low productive capacity and limited economic diversification, along with the poor quality of education and lack of demand-driven skill training facilities and programmes are the underlying causes of unemployment, particularly to the growing young population.

Policy adjustment on increasing fiscal space and efficient public resource allocation on education and training with a focus on improving accessibility to quality education and training programmes, along with creation of employment opportunities, particularly to the growing young population and women, are essential for Timor-Leste to attain sustainable and inclusive growth.

8.5 Tax and domestic revenue mobilization

- The Petroleum Fund is the only financial asset of the country that provides a fiscal buffer to the Government's budget. It is also the main source of financing for the fiscal deficit. However, the decline in oil revenue as the existing oil and gas field dry out, accelerated by the excess withdrawal since 2009 raises concern about the sustainability of the Petroleum Fund. The Government needs to reduce the excess withdrawal and apply strong fiscal rules on the withdrawals. For instance, the excess withdrawal should be limited to 60 per cent of the estimated sustainable income and the fund should only be used for investment in infrastructure and human capital development, as these investments will produce intergenerational returns. The

sustainability of the Petroleum Fund is critical for country's fiscal and macroeconomic stability in the long term.

- Collection of tax and non-tax revenues are very limited, at an average annual rate that only slightly exceeds 11 per cent over the past ten years. The Government began implementing fiscal reform in 2015 with the intention to increase the domestic revenue to GDP ratio to the minimum threshold of 15 per cent by 2023. This target will likely not be reached because of the three economic recessions experienced in the last four years, the adverse effects of the COVID-19 pandemic and that no significant effect of the reform has been observed to date. Reform is, therefore, needed to continue to promote economic efficiency and competitiveness, broaden the tax base and diversify revenue collection through improving the operations of revenue collection agencies, such as the Tax Authority and Customs Authority, and revising tax policies to make them more competitive and contribute to more revenue collection. For instance, one option would be to change the existing 10 per cent flat rate of corporate income tax with a progressive tax rate that is competitive and protects the poor, as the current rate is way below the average corporate income tax of ASEAN members States, and introduce a value added tax.
- Although ODA has declined since 2012, it is still an important source of financing for development in Timor-Leste. Actual grant disbursements in 2020 accounted for \$183 million, equivalent to 12 per cent of the country's GDP (Timor-Leste, Ministry of Finance, 2021). The Government and development partners

approved a foreign aid policy in 2019 to streamline the management of aid resources based on the new deal principles of "country-owned, country-led, and using a country system. Enhancing the foreign aid policy, promoting a regular dialogue to address challenges and establishing a proper monitoring and oversight framework are critical to ensure efficient management of ODA resources to support the shared development objectives and priorities, particularly those that help the country to have a sustainable recovery and make progress towards achieving the SDGs.

- Timor-Leste needs to take advantage of its low external debt to GDP ratio to access more concessional borrowing for investment in productive infrastructure to facilitate structural transformation and economic diversification. This could be done through the Belt and Road Initiative and/or connectivity and economic integration initiatives that are promoted by multilateral financial institutions, such as ADB and the World Bank. The Government should enhance its partnerships with development partners and creditors to help tackle capacity constraints related to project preparation and to identify projects that qualify for loan financing. The Government should also consider establishing fiscal rules on the public debt to manage the risk and ensure debt sustainability in the long term, limiting the maximum debt to GDP ratio to 60 per cent,²³ and benchmark the costs of borrowing to the opportunity cost of the Petroleum Fund investment return. The Ministry of Finance uses a minimum of 3 per cent as the average long-term Petroleum Fund investment return.

²³ Based on the fiscal rule policy paper of the Ministry of Finance.

- With the assistance of IFC as the transaction advisor, Timor-Leste was able to implement its first PPP project for construction, operation and management of the Tibar International cargo port. The total project exceeds \$400 million and the private sector holds the majority share of the financing. The Government is leveraging the momentum of this by identifying and preparing more potential PPP projects in sectors such as tourism, health, affordable housing and management of infrastructure assets. To carry this forward, the Government must ensure the introduction of efficient regulations and institutional capacity to facilitate more PPP resource mobilization. The existing legislation needs to be updated and expanded, and the PPP unit in the Ministry of Finance needs to be upgraded with more responsibilities and mandates.
- Another way to mobilize private resources is through equity participation. Given the small economy and market size but high-risk profile, private sector investments, particularly FDI sometimes require government participation in to mitigate country risks. The Government should review such investment proposals and consider participation if they are socioeconomic and financially viable. Participation could be channeled directly from the Treasury or through State-owned enterprises, depending on the legislative framework and the arrangement. Priority could be given to investment in productive sectors, such as agriculture, tourism, manufacturing and renewal energy, that would underpin economic diversification and contribute to effort aimed at achieving sustainable development.
- Stronger Institutional capacity and promotion of the efficient legislation is needed to tap into resources from innovative financing. To support the ongoing reform on fiscal and legislation, the Government, particularly the Ministry of Finance and the Central Bank, should request support from development partners, such as the International Monetary Fund (IMF), the World Bank, -ESCAP or ADB to develop their institutional capacity and introduce legislation for bond markets. The government should also expand the existing credit guarantee scheme targeting to cover more micro, small- and medium-sized enterprises – particularly those engaged in the agriculture, tourism and manufacturing sectors.

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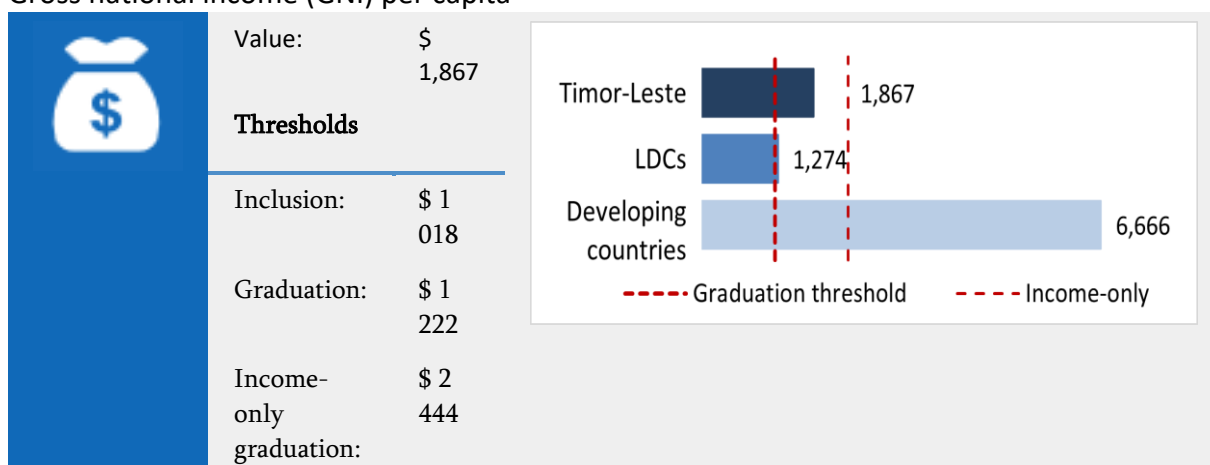
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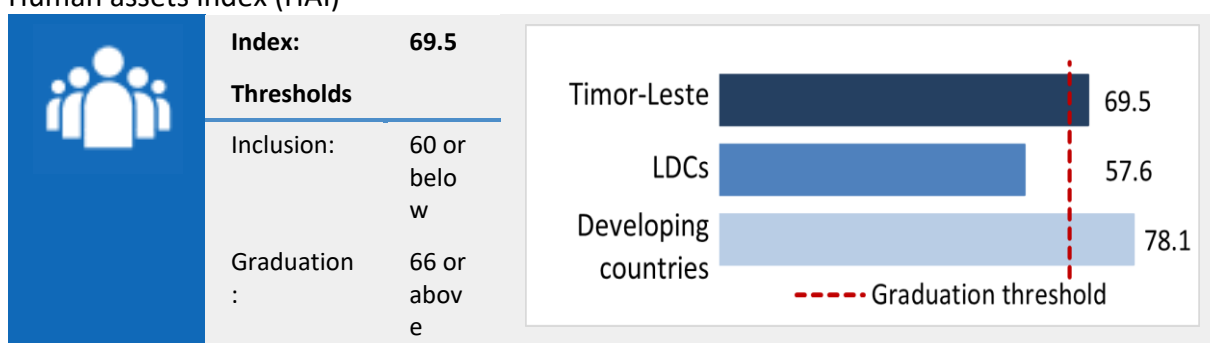
10 Annexes

Annex 1: Least development country graduation criteria and the results of the 2021 triennial review.

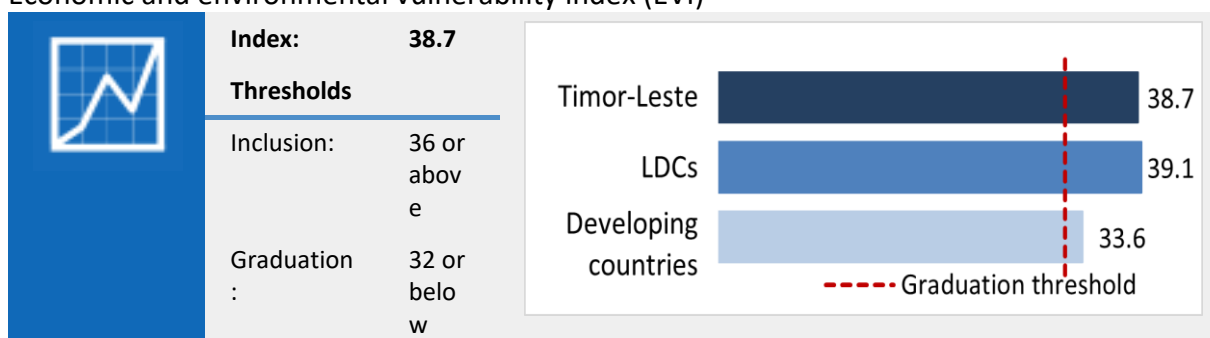
Gross national income (GNI) per capita



Human assets index (HAI)



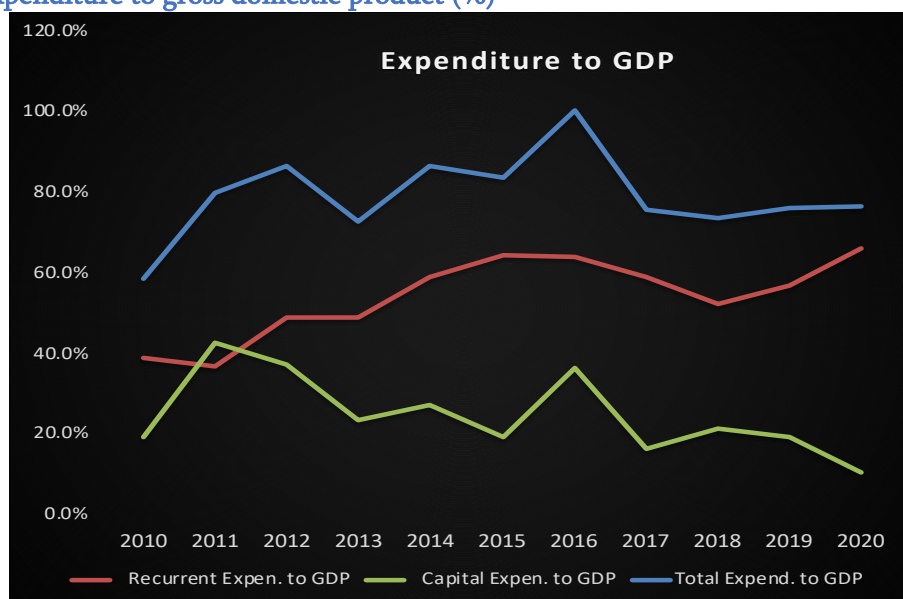
Economic and environmental vulnerability index (EVI)



Annex 2: Correlation between oil revenue and gross national income (oil revenue and gross national income are in \$million, and gross national income per-capita is \$)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Oil Revenue (\$m)	2 161	3 285	3 603	3 085	1 860	1 047	267	465	554	800	326
GNI (\$m)	3 324	4 581	4 318	4 152	3 338	2 793	2 231	2 288	2 264	2 731	2 383
GNI per-capita (\$)	3 040	4 115	3 811	3 600	2 842	2 334	1 829	1 841	1 785	2 112	1 807

Annex 3 Expenditure to gross domestic product (%)



Annex 4: Timor-Leste major non-oil export of goods and service (US\$m)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Export of goods										
Crops & vegetables	24.86	51.15	26.44	15.17	10.73	24.03	9.74	14.03	14.13	8.30
Edible fats & oils	0.03	0.08	0.10	0.13	0.26	0.09	0.08	0.18	0.13	0.12
Export of services										
transport	0.77	0.69	0.58	0.79	1.54	1.82	1.77	2.24	3.44	0.74
Travel	26.44	27.05	36.68	25.19	28.11	20.68	15.43	14.13	8.57	3.82
Telecom & Information services	6.66	7.37	18.24	24.41	5.06	2.32	1.87	1.17	0.90	0.99

Annex 5: Top six sectors by non-lending assistance (\$m) and top 10 grant support by donors, (\$m, %), 2011–2019

