



# **Development Finance Assessment in support of the achievement of the Strategic Development Plan and Sustainable Development Goals in Timor-Leste**







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The members of the DFA Oversight Team were drawn from the leading government entities: Office of the Prime Minister and the Ministry of Planning and Finance, and from other government institutions. The *co-Chairs of the OT for the Timor-Leste DFA* were *Ms. Brigida Soares (UPMA, Office of the Prime Minister)* and *Mr. Alex Tilman (Office of the Prime Minister)*. *Mr. Arlindo Monteiro (Head of Development Partnership Management Unit, Ministry of Planning and Finance)* acted as the *Member-Secretary of the OT* and DFA focal point.

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## Disclaimer

The views presented in this report do not necessarily represent those of the Government of Timor-Leste or UNDP.

# Contents

<b>Executive Summary .....</b>	<b>9</b>
<b>1. Introduction .....</b>	<b>12</b>
<b>2. The Timorese sustainable development context .....</b>	<b>14</b>
<b>3. Assessment of Timor-Leste's financing framework .....</b>	<b>18</b>
The analytical framework .....	18
<b>3.1. Assessing financing trends .....</b>	<b>20</b>
Overall financing landscape .....	20
Domestic public finance .....	22
International public finance .....	29
Private finance .....	32
Summary .....	36
<b>3.2. Integrated planning and financing .....</b>	<b>37</b>
National planning functions .....	38
Finance policy functions .....	41
Leadership and institutional coherence .....	44
Public finance policies .....	45
Summary .....	55
<b>3.3. Public-private collaboration .....</b>	<b>56</b>
International public finance policy .....	56
Private finance policies .....	58
Sectoral policies .....	62
Coordination and collaboration .....	64
Summary .....	65
<b>3.4. Monitoring and review .....</b>	<b>66</b>
<b>3.5. Transparency and accountability .....</b>	<b>70</b>
<b>4. Recommendations and roadmap .....</b>	<b>72</b>
<b>Headline recommendations .....</b>	<b>72</b>
Establish a national investment promotion strategy .....	72
Establish an integrated financing strategy .....	75
Estimate the cost of priority interventions of the SDP .....	76
Establish an integrated infrastructure investment strategy .....	77
Explore the potential to establish a private sector reporting mechanism .....	78
<b>Further recommendations .....</b>	<b>79</b>
<b>Annexes .....</b>	<b>81</b>
<b>Annex 1. Internal Regulation on Timor-Leste Development Finance Assessment     and Terms of Reference for Oversight Team .....</b>	<b>81</b>

# Figures

Figure 1. Timor-Leste's population is set to continue growing rapidly.....	16
Figure 2. Extractives accounted for more than 30% % of GDP in 2016.....	16
Figure 3. Variation in GNI per capita is attributed from variation in oil prices and production.....	16
Figure 4. Non-oil sector contribution to GDP steadily rises while oil sector has been dropping.....	16
Figure 5. The DFA analytical framework.....	19
Figure 6. Trends in public finance – largely driven by petroleum receipts – have driven overall financing trends.....	20
Figure 7. Domestic public finance accounted for over 70% of financing in 2016.....	21
Figure 8. Extractives dominate domestic public finance, but revenues are falling.....	22
Figure 9. Government spending grew significantly lately and is drawing down on PF capital.....	23
Figure 10. Recurrent spending alone surpassed domestically generated revenue.....	23
Figure 11. Since 2015 excess withdrawals started exceeding the ESI.....	23
Figure 12. Non-oil domestic revenue is low relative to growing government spending and as a share of non-oil GDP.....	24
Figure 13. Tax revenue remains low relative to the selected LMIC South East Asia and Pacific countries.....	25
Figure 14. Roads rehabilitation programme constitutes more than half of IF spending followed by South coast development programme in 2016.....	26
Figure 15. Scenarios for the future balance of the Petroleum Fund: Extractives running out?.....	27
Figure 16. Grants is the largest share of international public flow, but is declining steadily.....	29
Figure 17. ODA grants contribute significantly toward human capital development.....	30
Figure 18 a&b. ODA is an important source of education and health financing, but is expected to fall.....	31
Figure 19. Private flows increased slightly with varying levels of foreign and domestic investment.....	32
Figure 20. Despite significant growth in public investment, private sector investment remains low.....	33
Figure 21. Domestic intended investment surpassed foreign intended investment by US\$64mIn in 2017.....	33
Figure 22. FDI remains low in comparison to other LMIC economies and regional peers.....	34
Figure 23. The number of newly registered firms is growing steadily, however financial intermediation remains weak.....	34
Figure 24. The largest share of private sector borrowing is in agriculture sector, followed by construction and individuals.....	35
Figure 25. Common elements of national planning and financing systems.....	38
Figure 26. Integrated planning, budgeting, monitoring and evaluation in Dalan ba Futuru.....	48
Figure 27. Integrated policy to promote Infrastructure finance in Indonesia.....	52
Figure 28. Schematic summary of economic vision of the SDP 2011-2030, the government's Program and the GRFE.....	59

# Boxes

Box 1. Bangladesh: comprehensive financing strategies with cost estimates.....	42
Box 2. Sin Tax in the Philippines.....	54
Box 3. SDGs Dashboard in Papua New Guinea.....	69
Box 4. Monitoring framework linking financing-related targets to national development outcomes in Philippines.....	69

# Acronyms List

<b>ADB</b>	Asian Development Bank
<b>AP-DEF</b>	Asia-Pacific Development Facility
<b>ASEAN</b>	Association of Southeast Asian Nations
<b>ATP</b>	Aid Transparency Portal
<b>BCTL</b>	Central Bank of Timor-Leste
<b>BRC</b>	Budget Review Committee
<b>BTP</b>	Budget Transparency Portal
<b>CAFI</b>	Council of Administration of the Infrastructure Fund
<b>CCI-TL</b>	Chamber of Commerce and Industry of Timor-Leste
<b>CoM</b>	Council of Ministers
<b>CSO</b>	Civil Society Organisations
<b>DFA</b>	Development Finance Assessment
<b>DG</b>	Director General
<b>DP</b>	Development Partner
<b>DPMU</b>	Development Partners Management Unit
<b>ESI</b>	Estimated Sustainable Income
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FRC</b>	Fiscal Reform Commission
<b>GDP</b>	Gross Domestic Product
<b>GNI</b>	Gross National Income
<b>GRFE</b>	Guide for Reform and Economic Growth
<b>IADE</b>	Institute of Support to the Entrepreneurial Development
<b>IF</b>	Infrastructure Fund
<b>IFC</b>	International Finance Corporation
<b>IMF</b>	International Monetary Fund
<b>LDC</b>	Least Developed Country
<b>LMIC</b>	Low Middle Income Country
<b>MAF</b>	Ministry of Agriculture & Fisheries
<b>MCIT</b>	Ministry of Commerce Industry & Trade
<b>MDB</b>	Multilateral Development Bank
<b>MDIR</b>	Ministry of Development & Institutional Reform
<b>M&amp;E</b>	Monitoring & Evaluation
<b>MECAE</b>	Minister of State, Coordinator of Economic Affairs
<b>MoPF</b>	Ministry of Planning & Finance
<b>MPS</b>	Mega Projects Secretariate
<b>MSME</b>	Micro, Small & Medium-sized Enterprises

<b>MTEF</b>	Medium-Term Expenditure Framework
<b>ND</b>	National Director
<b>NDP</b>	National Development Plan
<b>NGO</b>	Non-Governmental Organisation
<b>ODA</b>	Official Development Assistance
<b>OECD</b>	Organisation for Economic Cooperation & Development
<b>OOF</b>	Other Official Flows
<b>OT</b>	Oversight Team
<b>PF</b>	Petroleum Fund
<b>PIU</b>	Project Implementation Unit
<b>PM</b>	Prime Minister
<b>PPP</b>	Private Public Partnership
<b>PPPL</b>	PPP & Loans Unit
<b>SDG</b>	Sustainable Development Goal
<b>SDP</b>	Strategic Development Plan
<b>SME</b>	Small & Medium-sized Enterprises
<b>TITL</b>	TradeInvest Timor-Leste
<b>UNDP</b>	United Nations Development Programme
<b>UPMA</b>	Unit of Planning, Monitoring & Evaluation
<b>VAT</b>	Value Added Tax
<b>WB</b>	World Bank



## Executive Summary

This is an important time for a DFA in Timor-Leste. Following stabilisation and the consolidation of peace in the 2000s, the country developed a vision of their development path that it wants to follow in the Strategic Development Plan (SDP) 2030, which is now in its second stage of implementation. The government has significant resources to invest toward realising a sustainable economic and financing model over the long term through the wealth earned from the Petroleum Fund. Yet this wealth is finite, even if additional revenue from new oil or gas fields expands the fund and extends the length of time over which government can draw down on those revenues. Wider forms of financing remain scarce. The decisions and institutional structures put in place for managing the country's finances will have a significant impact on its long-term development path.

Within this context, the government of Timor-Leste initiated a development finance assessment (DFA) to analyse financing for the SDP. This report presents the findings of the DFA process, consultation and analysis, including a roadmap of recommendations for priority reforms to the government's financing framework that can be taken forward and analyse ways that the strategy for stimulating private sector development in particular can be strengthened. This assessment is one of the first among g7+ countries and can inform adaptation of the DFA approach among other members in the future.

Achieving the SDP and SDGs will require an integrated approach to financing in which a range of public and private actors invest, directly and indirectly, in the objectives it articulates. This DFA presents an analysis of the current trends in public and private financing, based on a wide-reaching data collection exercise to build as comprehensive a picture of financing as possible. And it analyses the policies, partnerships and institutional structures that are in place to mobilise and maximise the impact of public and private investments on the outcomes targeted by the SDP and SDG commitments.

The government's approach to financing is overall rooted in the SDP, which provides some direction over how the country's development is to be financed, including elements related to the public finance and the recognition of the potential role of different actors in contributing to development priorities. The frontloading policy, in which the reserves built up through petroleum revenues are invested in the short




term to stimulate and expedite a transition to longer-term economic progress, has driven significant public investment. There is room to develop more comprehensive guidance through an integrated long-term financing strategy that would support more focused, coordinated efforts to mobilise the public and private financing needed for the SDP. An integrated financing strategy could draw together policies in different aspects of public and private finance and provide overall strategic guidance about how investments in infrastructure and policy designed to stimulate investment in private finance will drive the desired economic transition. It would outline policy objectives across different areas of public and private financing, providing guidance for short and medium-term operations in each area of policy. Estimating the scale of investments required in priority areas can also support efforts to mobilise resources for the SDP and form a basis for targets for mobilising different types of resources and monitoring efforts.

The financing landscape in Timor-Leste is evolving and the country will face challenges and opportunities to mobilise the investments needed to realise the SDP and the SDGs. Public resources dominate financing, with ODA providing further 13%. Much of Timor-Leste's petroleum wealth has already been extracted. Private finance is growing slowly, and remains a comparatively low proportion of the overall resources scale.

This stands in contrast to the long-term objectives of the SDP, in which the need for private sector investment as a driver of economic development and job creation is emphasised. Transforming the private sector is a critical part of the transition to a sustainable overall model of financing over the long-term. Private sector investment and borrowing in the industries targeted by the SDP are low and show few signs of growth. There is a pressing need to stimulate greater private investment and a range of reforms, as well as significant investment in infrastructure, are underway to address the challenges that currently constrain it. Yet these reforms are fragmented and could be made more effective if they were brought together and targeted in a more coordinated manner. The DFA recommends establishing a coordinated Investment promotion initiative that focuses active efforts on kick-starting investment in the highest priority and highest potential industries. Strengthening the policy and regulatory framework that promotes the wider benefits of investment to society and the environment, and mitigates the risks, would be another important component of such an initiative.

Government finance is a dominant feature within the country's financing landscape overall, and plays a critical role in advancing the SDP. Yet public finance is primarily driven by petroleum receipts – barring any new extraction, new petroleum receipts are expected to cease by 2022. Relative to rapidly growing government spending domestic revenue from outside the petroleum sector on average funded only 13% of government spending during the last decade. The policy of frontloading expenditure from the Petroleum Fund (PF) to fund investment may lead to a complete runout of its reserves in the next 10 to 13 years. Rapid growth in spending means that domestically generated revenues now do not even cover government's recurrent spending. The DFA emphasises the importance of ongoing reforms designed to broaden the tax base, modernise tax policy and increase the efficiency of revenue collection. There are also opportunities to improve the efficiency of public investments and services in relation to the SDP, by further enhancing the mechanisms for selection and prioritization of investment projects around strategic priorities and government policies designed to realise them.

To date substantial infrastructure investments have been made and the government is committed to continue addressing infrastructure deficiencies and expand capital spending in the following years. However infrastructure development was mainly funded through transfers from the PF with concessional loans and PPP modalities financing a limited number of infrastructure with the first mainly focused on rehabilitation of national and regional roads. The DFA makes a recommendation for developing an



overarching infrastructure investment strategy bringing together a range of different finance sources and establishing policy mechanisms to encourage their use in the most appropriate aspects of infrastructure. It should act as a mechanism for prioritizing investments and determining the most appropriate modalities for their establishment and ongoing maintenance.

Development partners continue to play a critical role in financing for sustainable development in Timor-Leste. Though volumes of ODA grants have declined, they remain an important funder of investment in key social sectors such as education and health. The DFA recommends exploring various options of mobilising new sources of financing to fund specific social programmes, including the potential to establish a sin tax to finance investment in health. It also identifies ways to build stronger partnerships that leverage the strengths which different actors have to offer in relation to the SDP. Establishing a regular, multi-stakeholder follow-up forum on the SDP can foster greater dialogue and engagement between actors focused on financing different aspects of the agenda.

The aim of this report is to encourage dialogue on the country's financing needs and to build momentum around reforms that can strengthen financing the SDP and SDGs. The recommendations identified through the DFA can contribute to a more integrated approach to financing the SDP that leverages the strengths of a wide range of public and private resources.




# 1. Introduction

Timor-Leste is on an important phase in its history. Following stabilisation and the consolidation of peace in the 2000s, the country developed a vision of their development path that it wants to follow in the Strategic Development Plan 2030, which is now in its second stage of implementation. Timor-Leste has used the wealth of its natural resources to build considerable reserves. Yet the financing outlook in the country remains dominated by this resource wealth and the public finance that it supports – other forms of financing, particularly private sector finance, remain small. The way that the reserves which the country has built are invested will have a critical bearing over the country's future development path and the extent to which it is able to transition to a sustainable post-oil financing model, reap the benefits of a rapidly growing population, and achieve the vision of the SDP.

Within this context, the government of Timor-Leste has commissioned a development finance assessment (DFA) to analyse the financing context in the country and identify key reforms that can strengthen public and private financing for the SDP. The SDP represents a broad and ambitious vision that will require investments from a range of public and private actors if it is to be realised. It will require an integrated approach to financing, in which policy, collaboration and partnerships promote public and private finance flows that contribute toward the SDP outcomes according to their specific characteristics.

The DFA supports the government of Timor-Leste and other wider stakeholders across the private sector, development partners, civil society and other actors to identify and take forward steps that can strengthen such an integrated approach to financing of the SDP and the strategy for the implementation of the SDGs. It analyses the challenges and opportunities of the financing landscape as well as the policy and institutional structures used by government to manage and influence financing for the sustainable development of the country. And it identifies policy changes and reforms that can mobilise new forms of financing or enhance their impact, strengthen collaboration between actors and bolster government policies for managing and influencing financing.





The DFA process ultimately aims to build momentum on reforms that can be taken forward and implemented. A core part of this is engaging with a wide constituency of actors who have a stake in financing, and the analysis and recommendations presented in this DFA report have been shaped and refined through extensive consultation across government, the private sector and other stakeholders. In this way, the DFA seeks to demystify financing policy debates, broaden the constituency of actors engaged in these discussions and generate consensus for reform.

This report presents the findings of Timor-Leste DFA process. The first section presents a comprehensive analysis of current financing trends in comparison which is followed by analysis of the policy and institutional structures that government uses to engage with financing for the SDP and the SDGs. Following the DFA analytical approach it looks at integrated planning and financing, public-private collaboration, monitoring and review, and transparency and accountability. Finally, it presents a roadmap which outlines the recommendations developed through the DFA process. This section divides between headline proposals that are of the highest importance or respond to a specific opportunity for policy change, and further recommendations that remain important and can be considered for implementation.

The DFA process has engaged a wide array of actors that have a stake in financing the SDP and SDGs and it is hoped that the analysis and recommendations presented in this report can be a catalyst for positive policy reform as well as continued dialogue on sustainable development financing in Timor-Leste.



## 2. The Timorese sustainable development context

Timor-Leste has emerged from a context of conflict around its independence and a crisis in 2006, to rapidly secure an environment of stability and security. Building on the principle that there is no development without peace, the government has worked to lay the foundations for state building, economic growth and sustainable development progress for the future. The sustainable development context in Timor-Leste is one where progress in many areas sits alongside significant remaining challenges in others.

Following rising poverty in the early years of independence, poverty rates fell from 50.4% of the population in 2007 to 41.8% in 2014, using the national poverty line.<sup>1</sup> Yet rapid population growth means that this represents only a small decline in the number of people living below the poverty line, which totaled an estimated 507,000 in 2014.<sup>2</sup> Nearly 37% of the population lives below the international poverty line of \$1.25 USD a day.<sup>3</sup>

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1 Timor-Leste 2014 poverty report, Ministry of Planning and Finance / World Bank. The national poverty line is based on consumption of food, housing and other items and stood at \$46 a month nationally in 2014. It varies by district, ranging from \$38 a month in Liquiçá to \$56 in Dili. On average poor households countrywide are 13%, or \$6 a month, below the line.

2 Against the international \$1.90 poverty line used to measure progress against the MDGs and SDGs, the proportion of people living in extreme poverty fell from 47.2% to 30.3% between 2007 and 2014, with an estimated 367,000 people living in extreme poverty in 2014. The international poverty line is lower than the national poverty line.

3 World Population Review: Timor-Leste Population 2017. <http://worldpopulationreview.com/countries/timor-leste-population/>

Nutrition levels remain a significant challenge, with high prevalence of stunting in children under five years old at 50.2% in 2017, the highest in the region with an average of 33.8%.<sup>4</sup> The prevalence of wasting in children under five years old is 11% in 2016,<sup>5</sup> down from 19% in 2009.<sup>6</sup>

Child mortality rates are falling, with infant and under-five mortality rates halving during the Millennium Development Goal (MDG) period. Under-five mortality rates fell from 110 per 1,000 live births in 2000 to 53 per 1,000 live births in 2015.<sup>7</sup> Maternal mortality rates per 100,000 live births fell from 694 in 2000 to 215 in 2015.<sup>8</sup>

In education, enrolment levels have increased from 65.6% in 2007 to 95.6% in 2015,<sup>9</sup> though challenges in the quality of education remain. Literacy is improving, though 18% of under-15s are illiterate.<sup>10</sup>

Gender equality has seen some improvements, with increasing representation by women in parliament – 38.5% of seats held by women in national parliament in 2016, the highest in Asia-Pacific.<sup>11</sup> However, representation at a local level remains low – just 2% of suco leaders are women<sup>12</sup> – and challenges relating to domestic violence remain. Women's participation in the labour force also remains low.

Like many other g7+ countries, Timor-Leste did not fully meet any of the absolute targets of the MDG framework, though many individual targets were achieved, and significant progress made against others.

Demographic trends could be a defining feature of this period in Timor-Leste's history. Just over 50% of the population is under the age of 18 years old<sup>13</sup> and population growth is high. As this continues, there will be rapid growth in the working age population, which is projected to increase 40% between 2015 and 2030 (Figure 1) The investments made now in education, healthcare, nutrition and related areas will have a significant impact on society and the economy over the long term.

The Timorese economy remains dominated by oil (Figure 2), which accounted for more than 30% of value-added in 2016. Variations in oil prices and falling production have meant fluctuations in headline economic growth rates, with GNI per capita more than doubling between 2007 and 2012, then dropping back to its 2007 level by 2016 (Figure 3). Non-oil GDP per capita has risen steadily, growing an average 5% a year from 2006 to 2016 (Figure 4) when it stood at US\$1,336 per person.

4 World Health Statistics data Visualization Dashboard: Prevalence of stunting in children under 5. <http://apps.who.int/gho/data/node.sdg.2-2-viz-1?lang=en>

5 World Health Statistics data Visualization Dashboard: Prevalence of stunting in children under 5. <http://apps.who.int/gho/data/node.sdg.2-2-map-2?lang=en>

6 International Food Policy Research Institute; 2015 Global Nutrition Report: Timor-Leste. <http://ebrary.ifpri.org/utils/getfile/collection/p15738coll2/id/130067/filename/130278.pdf>

7 World Health Organization: Timor-Leste 2017 Health SDG Profile

8 World Health Organization: Timor-Leste 2017 Health SDG Profile

9 Timor-Leste: The MDG Report 2014 and UNESCO Institute for Statistics profile: <http://uis.unesco.org/country/tl>

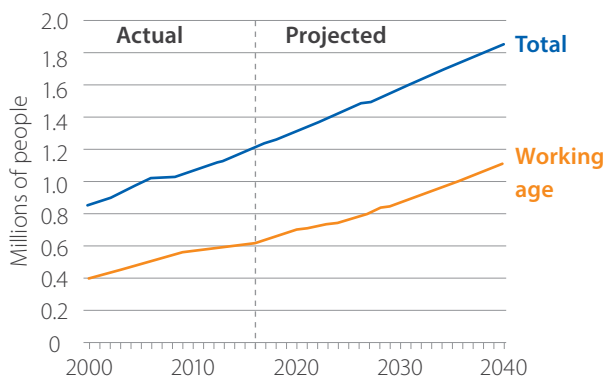
10 UNESCO Institute of Statistics Timor-Leste profile

11 UNdata: A world of information <http://data.un.org/CountryProfile.aspx?crName=timor-leste#Social>. Data for 2016

12 Timor-Leste: The MDG Report 2014 and UN Women article: Timor-Leste: 100 per cent Ready for Women in Leadership <http://asiapacific.unwomen.org/en/news-and-events/stories/2015/06/100-per-cent-ready-for-women-in-leadership>

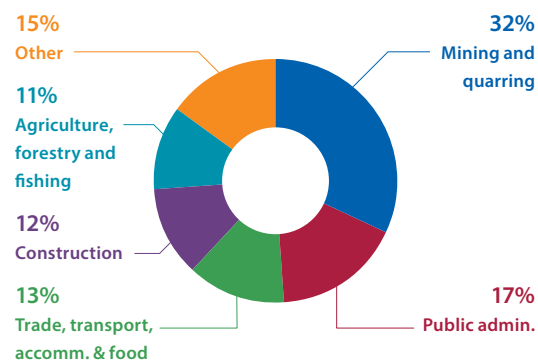
13 50.2% of the population was 18 and under in 2017. UNICEF Timor-Leste at a Glance 2017, [https://www.unicef.org/timorleste/22062017\\_Final\\_draft\\_At\\_a\\_Glance-June17\\_Timor\\_Leste.pdf](https://www.unicef.org/timorleste/22062017_Final_draft_At_a_Glance-June17_Timor_Leste.pdf).

**Figure 1. Timor-Leste's population is set to continue growing rapidly**



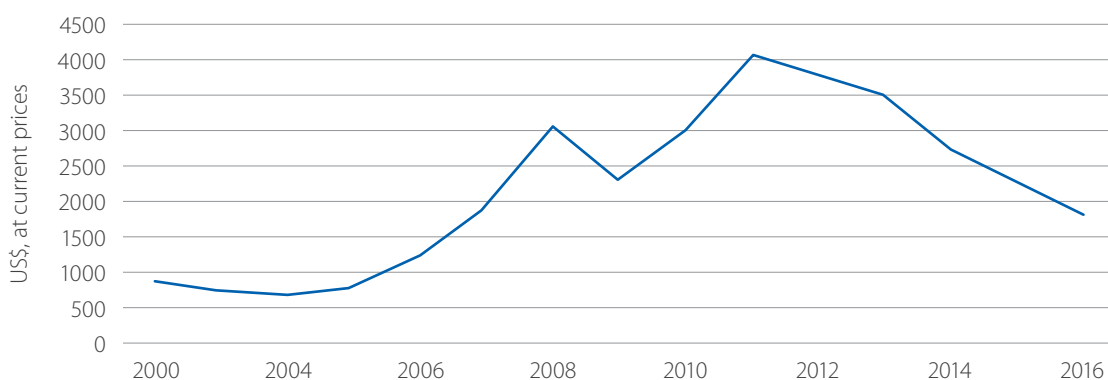
Sources: UN World Population Prospects

**Figure 2. Extractives accounted for more than 30% of GDP in 2016**



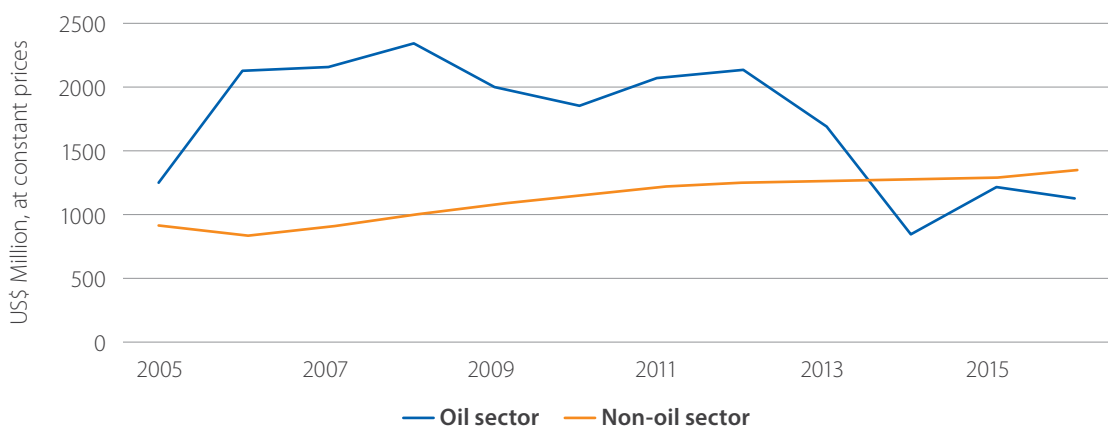
Sources: Timor-Leste National Accounts 2000-2016, Ministry of Planning and Finance, General Directorate of Statistics

**Figure 3. Variation in GNI per capita is attributed from variation in oil prices and production**




Source: Timor-Leste National Accounts 2000-2016, Ministry of Planning and Finance, General Directorate of Statistics

**Figure 4. Non-oil sector contribution to GDP steadily rises while oil sector has been dropping**



Source: Timor-Leste National Accounts 2000-2016, Ministry of Planning and Finance, General Directorate of Statistics



Timor-Leste is currently classified as a lower-middle income country (LMIC) according to World Bank classification and a least developed country (LDC) according to UN classification. Income group status is determined by GNI per capita, and one of the headline targets of the SDP is for the country to reach upper middle income country (UMIC) status by 2030. LDC status is determined by average income levels, human assets and economic vulnerability. Timor-Leste met the graduation criteria for upper middle income country in 2015 for the first time and will therefore be eligible for graduation in the short-term. Changing status against either classification system can have significant impacts on a country's ability to access concessional finance, export markets and other factors such as support for participation in international processes.<sup>14</sup>

Timor-Leste has applied for membership of ASEAN, was granted observer status at the World Trade Organization in December 2016. The country joined the World Intellectual Property Organization as of 12 September 2017.

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14 Reductions in international concessional finance can occur because classification as an LDC is used by a number of bilateral, multilateral or vertical fund organisations as a criteria for eligibility for and/or allocation of concessional finance resources. Many countries or economic blocs, such as the EU, use LDC status to determine eligibility for preferential market access for exports.





### 3. Assessment of Timor-Leste's financing framework

#### The analytical framework

The Development Finance Assessment uses a core analytical framework which analyses the elements a government may use to implement and instigate an integrated approach to financing the SDGs. It analyses the factors that link planning and finance and bring together actors for a more integrated approach to financing the SDGs. It looks at the strengths of existing systems and identifies opportunities where policy change or reform could further enhance integrated financing for the SDGs. The analytical framework is structured around **five dimensions of an integrated approach** to financing sustainable development (Figure 5):

1. **Assessing financing trends.** What opportunities and challenges does the financing landscape present for realising national sustainable development plans?
2. **Integrated planning and financing.** How are planning and financing systems connected to address financing trends and mobilise the resources needed to realise sustainable development plans?
3. **Public-private collaboration.** How does government create an environment that is conducive to growth in inclusive, sustainable contributions to development from private and public actors?
4. **Monitoring and review.** What systems exist for monitoring the use of public and private finance and how are these used to support policies that aim to deliver SDG outcomes?
5. **Transparency and accountability.** How do governments and other actors hold each other to account and engage in policy dialogue that supports greater effectiveness?

**Figure 5. The DFA analytical framework**



*Source: Development Finance Assessment Guidebook, UNDP, 2018.*

These are integral components of an overall integrated financing approach. They are all interconnected and weaknesses in one dimension can constrain the effectiveness of financing overall. If planning and finance systems are misaligned, for example, then it will be difficult to know whether current financing trends and planned reforms will be sufficient to realise national objectives. If businesses are not transparent about their impacts, then government's ability to support growth in positive areas and mitigate risks in harmful ones can be limited. If monitoring systems are weak or untimely it will be challenging to identify the most and least effective areas of policy. If the policy environment is not enabling for civil society then its role in holding others to account is reduced and effectiveness may be diminished.

The following sections of the report analyse five dimensions of the current financing framework of Timor-Leste, considering key aspects of each and using them to build up a picture about government's approach toward integrated financing for sustainable development of the country. They highlight the strengths of the current system and identify opportunities to further enhance the ability for the government of Timor-Leste and its partners to finance sustainable development. The assessment draws on information and expert analysis from a range of sources to build a unique holistic analysis of public and private financing for sustainable development. It aggregates information from a range of analytical sources, undertakes a rigorous data analysis, and uses interviews with key stakeholders as well as case studies of successful examples from other countries. This analysis forms the basis of Timor-Leste DFA roadmap presented in Section 4 of the report.

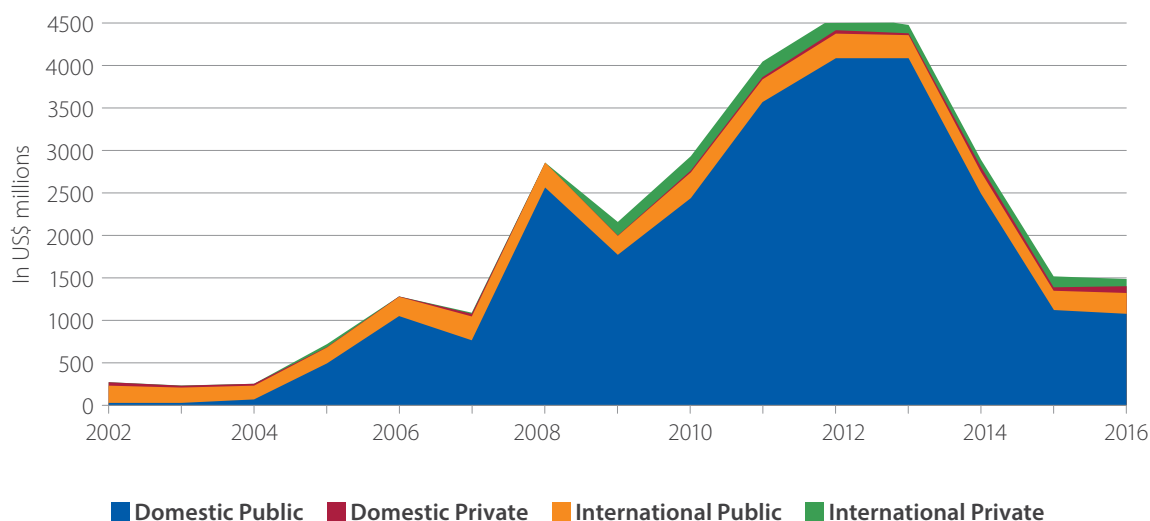
### 3.1. Assessing financing trends

The first dimension of the analytical framework analyses financing trends within the country. It builds as comprehensive and quantified a picture as possible of the public and private resources, flows and instruments present. This acts as the context for analysis in the rest of the framework and is analysed to identify challenges and opportunities that the country faces in mobilising financing for sustainable development. Forward-looking scenarios are an important component of this study and were built and used within a wider policy analysis, to facilitate a process of dialogue with the DFA Oversight Team in order to assess potential reforms and define the most pressing challenges and solutions for the Timor-Leste DFA roadmap.

#### Overall financing landscape

Analysis of the financing landscape of the country illustrates how the country's mix of resources has evolved over time. It highlights key issues related to the dominance of public finance funded by petroleum revenues, declining trends in development cooperation remaining an important funder of human capital development and notably small volumes of private sector investment as context for assessing the structure, priorities and potential reforms of the current government's financing framework (Figure 2).

**Figure 6. Trends in public finance – largely driven by petroleum receipts – have driven overall financing trends**



Sources: Timor-Leste National Accounts 2016, World Bank Open Data, Timor-Leste Ministry of Planning and Finance, OECD QWIDS. Domestic private figures are proxied as the difference between gross fixed capital formation by private corporations (GFCF) and FDI. The latter is available from 2005 only, before 2015 GFCF accounts for both domestic private investment and FDI. Note that domestic public finance is measured in this figure by revenues rather than expenditure – see further analysis on both revenue and spending below.



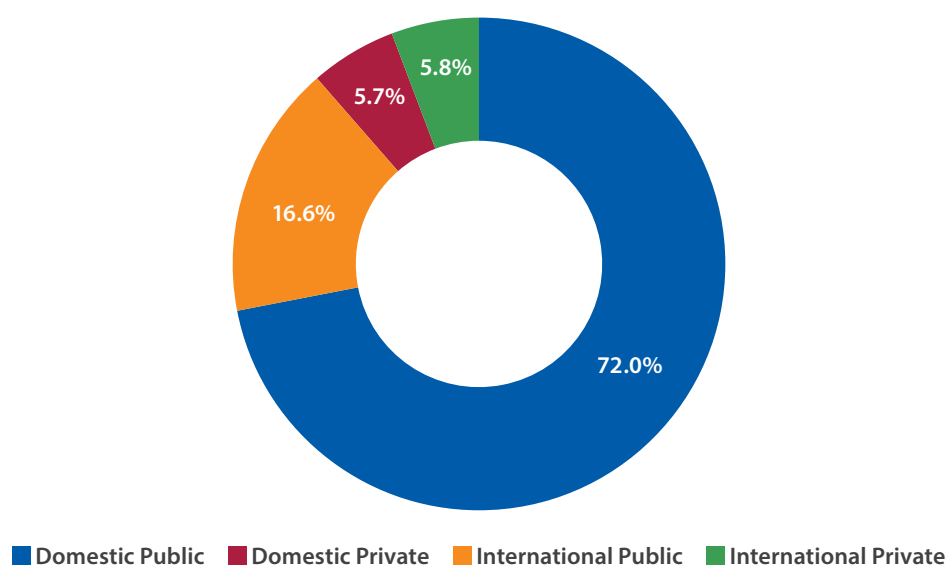
Public finance dominates the financing landscape of Timor-Leste, with petroleum revenues, tax and non-taxes together accounting for more than 70% of total financing in Timor-Leste in 2016 (Figure 7). International public finance including grants, concessional loans and other official flows is the second largest flow at 16.6% of total financing followed by private sector investment and other private finance each accounting equally for around 6% in 2016.

Largely driven by petroleum receipts flowing in the country over the past decade, domestic public finance grew significantly from US\$700mln in 2005 to its peak of US\$4bn in 2012. This was caused by off-shore petroleum production coinciding with peak global oil & gas prices. Receipts however fell sharply to around US\$1bn through to 2016 following drop in both volumes and the price of petroleum exports (Figure 6).

Official development assistance (ODA) was the most important source of finance in the early years of Timor-Leste's development, alone supporting more than three-quarters of government expenditure between 2002 and 2006. In the later years petroleum revenues overtook ODA and the latter became the second largest source of funding. Having fluctuated slightly over the years, ODA reached its high of US\$291 million in 2010. Volumes of ODA have since declined, though it remains an important part of the financing landscape overall. With introduction of concessional loans in 2012, international public finance is still mainly driven by grants, and by 2016 accounts for 16.6% of total country's financing.

Private sector investment and other private finance grew slowly from as low as US\$26mln in 2002 to US\$170mln in 2016. Yet, domestic investment by private corporations and FDI remained notably small throughout Timor-Leste's history in both absolute terms and as a proportion of the overall finance mix together accounting for as low as 6% of total financing in 2016, at US\$84 million and US\$5.5 million respectively. Other international private finance represents remittances from abroad and reached US\$80 million in 2016 accounting for 5% of total finance mix.

**Figure 7. Domestic public finance accounted for over 70% of financing in 2016**



Source: Timor-Leste National Accounts, 2016, Ministry of Planning and Finance, World Bank Open Data, OECD QWIDS

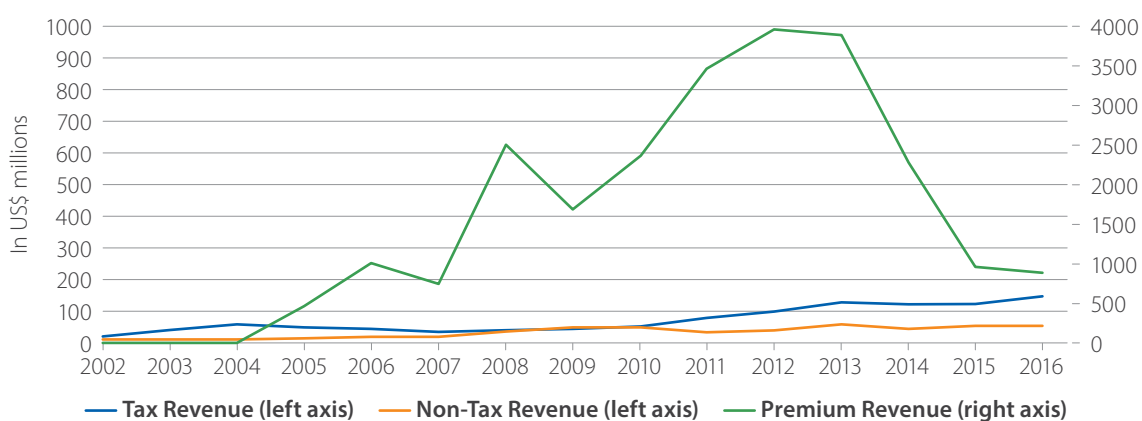
## Domestic public finance

Over the past decade petroleum receipts have been the primary source of public revenue. In 2016, petroleum revenue accounted for 81% of all domestic revenues, followed by tax revenue at 13% and non-tax revenue at 6% (Figure 8). Since the inception of off-shore petroleum production in 2005, oil revenues grew substantially and achieved its high of almost US\$4bn in 2012 benefitting from both growing production levels and global oil and gas prices peaks. However, since 2012 largely due to its producing fields going into decline and substantially lower global oil prices, oil receipts dropped more than 15-fold to US\$220mIn in 2016, depicting total petroleum revenues at US\$870mIn comprising mainly of investment returns on the Petroleum Fund capital (Figure 9). Petroleum receipts from the existing fields are expected to cease by 2022.

The potential of other oil fields, such as the Greater Sunrise fields, is still uncertain. Timor-Leste and Australia reached an agreement on delimitation of a permanent maritime border in the Timor Sea in August last year. The new boundary treaty was officially signed by both governments in October last year; this could potentially provide more than US\$30 billion of petroleum revenue to be shared between Australia and Timor-Leste. However, negotiations between the two countries are still ongoing as to where to process gas and oil. It is still unclear how long it will take before oil and gas resources in the fields are exploited and provide revenues for Timor-Leste.

Significant reserves have been built from the revenue already extracted to help finance the State Budget over the long-term and a policy of frontloading has been established. Under this policy the government has been making excess withdrawals above the estimated sustainable income (ESI)<sup>15</sup> to finance higher capital investment in the short-term with the aim of accelerating economic development in the medium to long term.

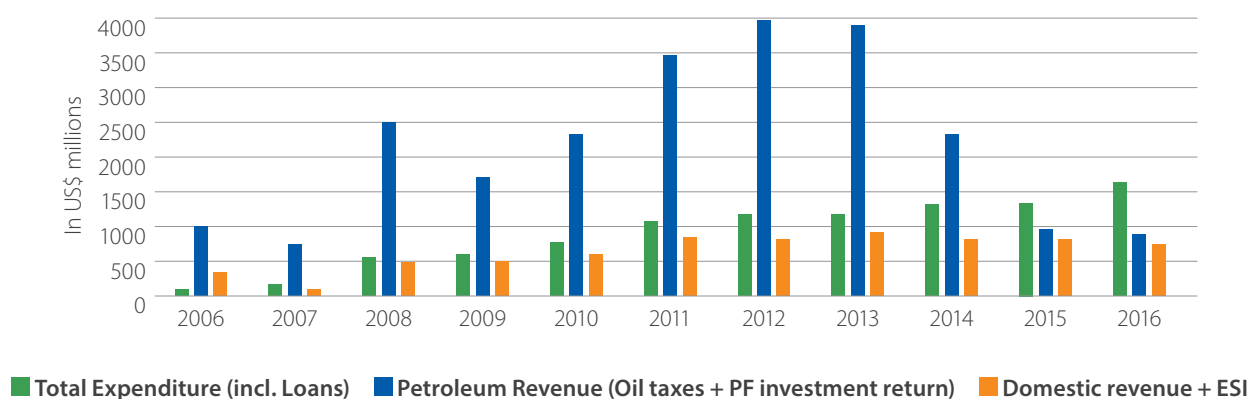
**Figure 8. Extractives dominate domestic public finance, but revenues are falling**



Sources: Timor-Leste Ministry of Planning and Finance

15 According to the Petroleum Fund Law of 2005 the Estimated Sustainable Income (ESI) is the value of the transfers from the Petroleum Fund that the Government can make, which is set at 3% of total petroleum wealth, thus preserving the underlying value of the Fund in perpetuity. The value is defined as the current balance of the Fund plus the net present value of future petroleum receipts. Article 9 of the Petroleum Fund Law stipulates that no transfers from the Petroleum Fund in excess of the ESI can be made in any fiscal year unless the Government presents in advance to the National Parliament a justification of the reasons that it is considered in the long-term interest of Timor-Leste – to transfer an amount greater than the ESI.

**Figure 9. Government spending grew significantly lately and is drawing down on PF capital**

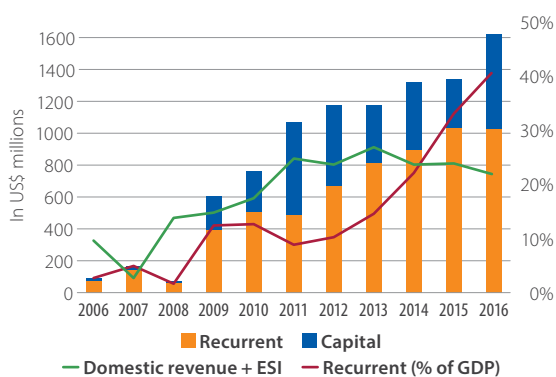


Sources: Timor-Leste Ministry of Planning and Finance

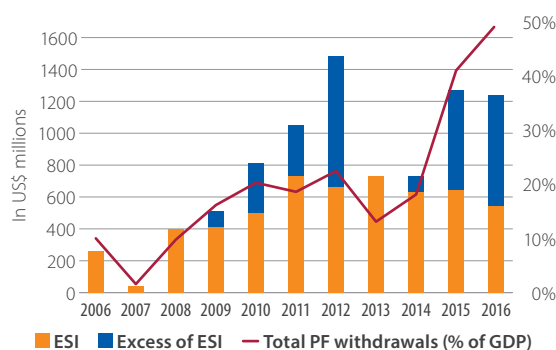
Petroleum receipts going into decline, high levels of government expenditure and thus growing non-oil fiscal deficit financed by withdrawals from the Petroleum Fund have all meant that since 2015 excess withdrawals started exceeding ESI and drawing down on the Petroleum Fund assets (Figure 10). To finance the 2016 budget the government withdrew US\$1,24bn from the Fund, of which US\$700mln was in excess of the ESI of US\$545mln for the year. The PF provided a total of US\$8,5bn in transfers to the State Budget since its establishment until the end of 2016 which exceeds the cumulative ESI through that period by US\$3bn. The PF closing balance experienced a decline for the second consecutive year totaling US\$15,8bn in the end of 2016.

As mentioned above, the Government introduced a frontloading policy in 2011 to finance significant capital investment with the aim of creating a conducive environment for strong growth in private sector investment. The frontloading of public investment government spending has also led to a significant increase in recurrent spending in the budget, which rose from 10.2% of GDP in 2012 to 40.6% in 2016. It has grown to the extent that it surpassed domestically generated revenues, i.e. ESI plus domestic revenues, in 2014 reaching a factor of 1.4 by 2016, indicating an unsustainable path (Figure 11).

**Figure 10. Recurrent spending alone surpassed domestically generated revenue**



**Figure 11. Since 2015 excess withdrawals started exceeding the ESI**

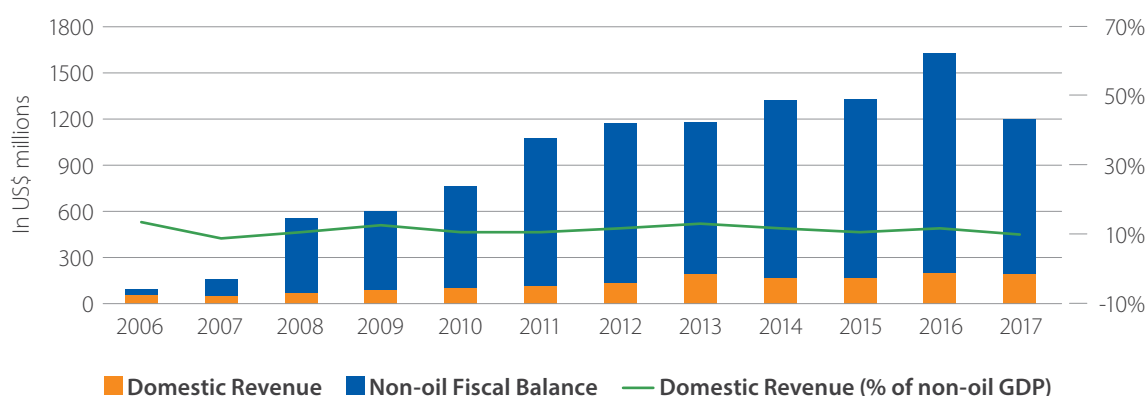


Sources: Timor-Leste Ministry of Planning and Finance

Going forward, as PF capital declines, the ESI will drop further requiring even larger capital drawdowns to finance both capital investment plans and budgeted recurrent expenditures. An unsustainable policy of spending from the Petroleum Fund now may lead to a complete runout of its reserves in the next 10 to 13 years (see Figure 15 below).

Non-oil domestic revenue, including tax and non-tax government revenue, experienced a steady constant growth throughout the whole period, though always remained very low. Before the inception and in early years of petroleum production domestically-generated revenue financed on average 80% of total government expenditure. Since then relative to rapidly growing government spending, domestic revenue on average funded only 13% of government expenditure between 2008-2016. It also remained low as a proportion of non-oil GDP at 11% on average during the same period (Figure 12).

**Figure 12. Non-oil domestic revenue is low relative to growing government spending and as a share of non-oil GDP**

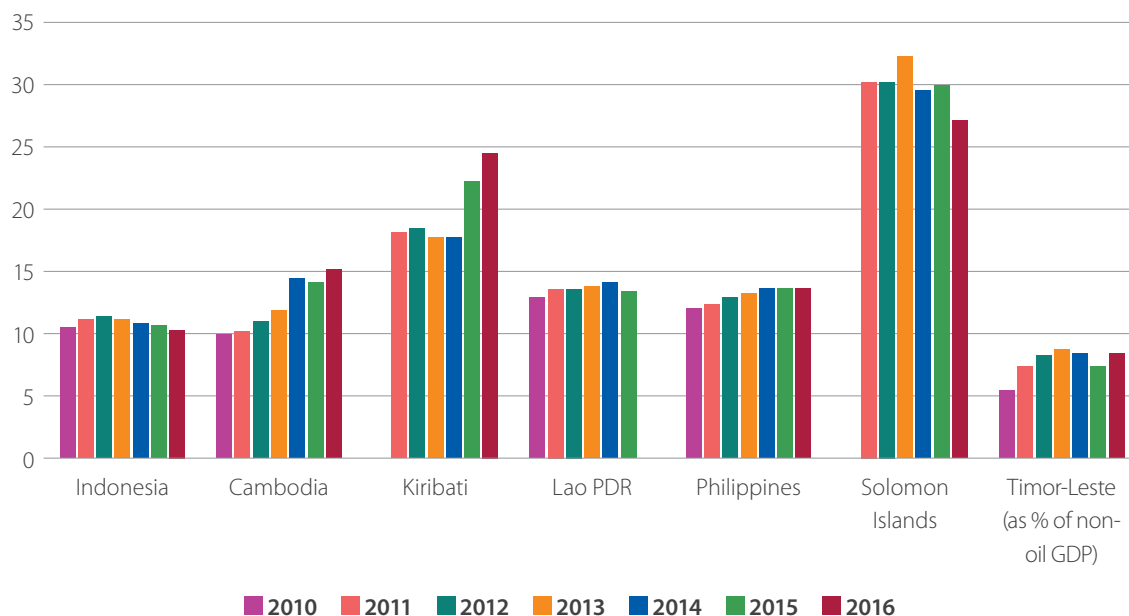


Sources: Timor-Leste Ministry of Planning and Finance

Non-oil taxes are by far the largest component and driver of gains in domestic revenue with 65% on average of the total and more than 70% of the total increase between 2006-2016. Non-tax revenues are mainly represented by fees with other charges being minor. There have been high growth rates for non-oil taxes, which increased an average 27% a year over 2008-2013 before falling slightly in 2014 and 2015 and then rising again in 2016 to around US\$144mIn. This most recent increase in tax revenues reflects the introduction of various reforms over the last 3 years aimed at streamlining processes and procedures and modernization of tax collection, in particular in Customs.

In 2015 Council of Ministers passed a resolution establishing the Fiscal Reform Commission with mandate of leading efforts in Domestic Revenue Reform and Expenditure Reform. Government's main target is to increase domestic revenue to 15% of non-oil GDP by 2020. The Reforms include: Tax Policy Reform, Fees and Charges Reform, Tax Administration Reform, Customs Administration Reform and Trade Facilitation. Current tax regime operates with low tax rates (10% for the new VAT in the draft law), and considerable exemptions, including tax exemptions for new large foreign and domestic investments, meaning that reforms overlooking the existing tax regime are unlikely to result in revenues increasing much in relation to non-oil GDP.

**Figure 13. Tax revenue remains low relative to the selected LMIC South East Asia and Pacific countries**



Source: Timor-Leste Ministry of Planning and Finance, World Bank Databank

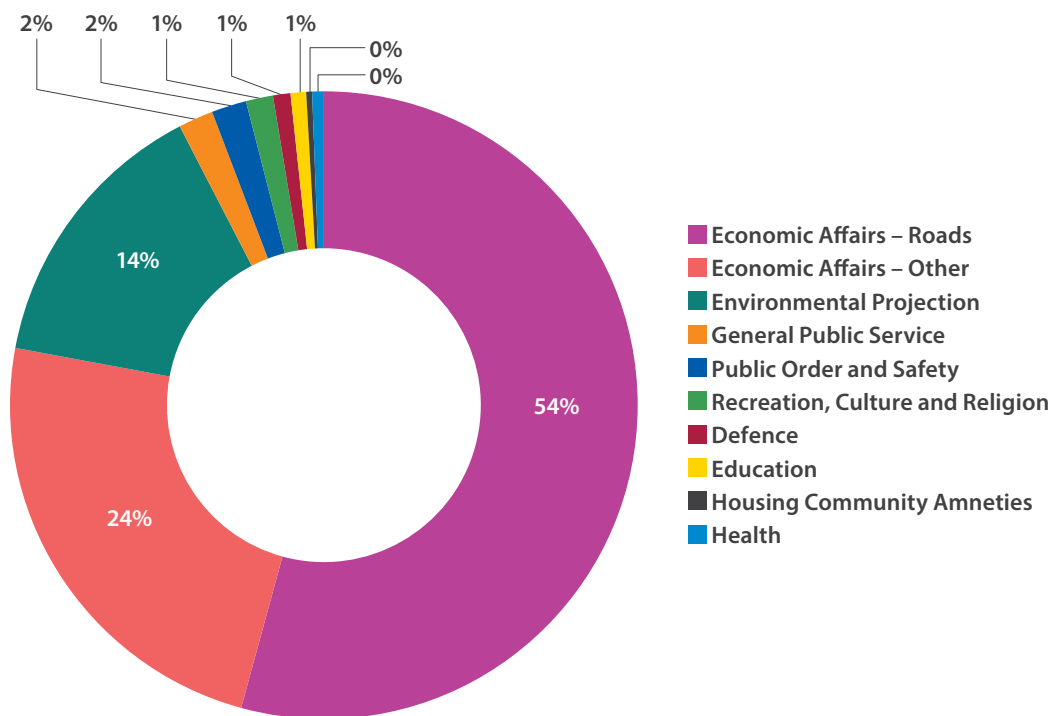
While ongoing reform on modernization of the Tax and Customs authorities have resulted in certain gains in tax collection most recently, tax revenue levels remain low in absolute terms at US\$113 per person in 2016 and in comparable terms relative to other lower middle-income countries in the region at 7% on average as a share of non-oil GDP over the last decade (Figure 13).

Looking ahead, since petroleum resources are likely to deplete within the next 10 to 13 years (see PF scenarios model in Figure 15), there is a need for immediate further improvement in domestic revenue mobilization capacity as an effective means of early domestic revenue expansion allowing the time needed for an economic transition to take place. Tax revenue, in particular, could benefit from ongoing and further fiscal reforms to address inefficiencies in tax administration, extensive tax exemptions, low tax rates, etc.

On the expenditure side, a large proportion of public resources are allocated to large infrastructure projects, in line with the frontloading policy, as well as social transfers and transfers to autonomous bodies, including electricity and water subsidies. Infrastructure Fund projects are taking a substantial share of government budget at around 60% of total capital spending and the autonomous region of Oecusse capital spending covering 33%.

National, regional and urban roads rehabilitation program is the largest single component constituting 54% of total Infrastructure Fund spending in 2016 followed by South coast oil and gas industry infrastructure development program at 23%, environmental protection (14.5%) being almost entirely the Dili Drainage project with the remaining 23% allocated to other sectors, including the construction of new public buildings, development of IT infrastructure, and other capital investments (Figure 14).

**Figure 14. Roads rehabilitation programme constitutes more than half of IF spending followed by South coast development programme in 2016**



Source: Budget Book 1, 2017, Ministry of Planning and Finance

Note: This figure represents Infrastructure Fund's allocation by sectors for the year of 2016.

### Scenarios for future spending levels in the State Budget and size of the Petroleum Fund

Petroleum revenue is managed by the Petroleum Fund<sup>16</sup>, which was set up in 2005 to invest the receipts from petroleum extraction and help finance the State Budget over the long term. It has grown rapidly, building assets worth over US\$16 billion in 2015, but then decreased to US\$15.8 billion in 2016.<sup>17</sup> An estimated sustainable income (ESI), equivalent to 3% of the value of the Petroleum Fund's assets<sup>18</sup>, sets the level of withdrawals that would be sustainable indefinitely. However, government has established a policy of frontloading – making excess withdrawals above the ESI to fund higher investment in the short term – with the aim of stimulating a transition to a diversified economy and financing model in the medium to long term. As envisaged in the 2017 state budget, to finance large-scale infrastructure investments total capital spending in 2018-2021 is planned to reach about US\$4.3 billion, or US\$1 billion on average annually. This scale-up in capital spending is assumed to be financed by transfers from the PF in the amount of US\$4.7 billion in excess of ESI contribution plus external borrowing<sup>19</sup>.

16 The Petroleum Fund was created under the provision of the Petroleum Fund Law No.9/2005, of August 3rd, as amended by the Law No.12/2011, of September 28th.

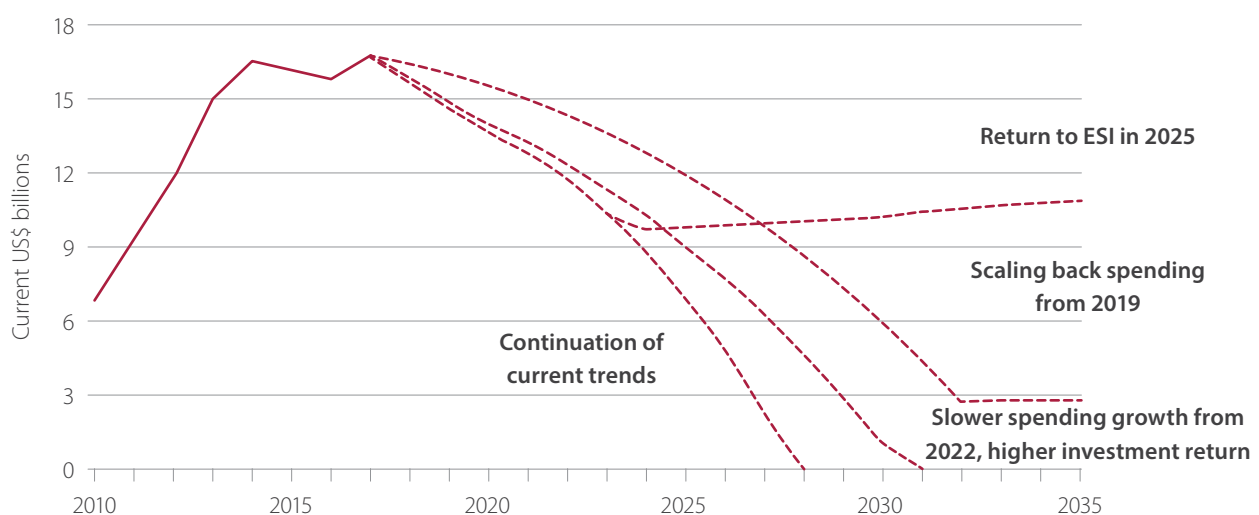
17 Source: Timor-Leste Petroleum Fund Annual Report 2016.

18 Including both investment assets and the net present value of petroleum still to be extracted.

19 The difference between the assumed excess withdrawals and capital spending planned for the period of 2018-2021 means that PF transfers in excess of ESI are needed to finance government recurrent spending.

Given the central importance of the Petroleum Fund and the frontloading policy, the DFA undertook some scenario modelling about the future trajectories of PF funds and government spending. Depending on the assumptions made about medium-term levels of government capital and recurrent spending, growth in domestic revenues, decisions about borrowing levels and the year when spending will return to sustainable levels<sup>20</sup>, as well as the returns on the Petroleum Fund's assets, the Petroleum Fund could run out in the next 10–13 years (Figure 15). The four scenarios explored below make assumptions about each of these factors and examine the likely trajectory of the Petroleum Fund and State Budget. They use actual figures for 2010–2017 and planned for 2018–2021 published in the 2017 State Budget, thus assumptions were made about each of the factors beyond 2022 (except for scenario 4) and do not include modelling for additional revenues from new oil or gas fields.

**Figure 15. Scenarios for the future balance of the Petroleum Fund: Extractives running out?**



Source: DFA technical team calculations. Note that this figure does not account for potential new revenues to the Petroleum Fund from extraction of the Greater Sunrise field.

The current trends scenario assumes:

- An ongoing 10% annual increase in government capital spending and 8% in recurrent spending after 2022 both assumed based on the actual trends from 2010 to 2017 and planned for 2018–2021 as per the 2017 State Budget<sup>21</sup>;
- A 10% acceleration rate applied to the assumed recurrent spending growth rate starting from 2023 to model the likely allocation of higher recurrent budget for operation and maintenance costs on the capital stock built following current and budgeted scaled-up frontloading of capital investment;

<sup>20</sup> Sustainable spending levels are defined as the sum of domestic revenue, borrowing and the estimated sustainable income. Scenarios including a return to sustainable spending levels assume spending reductions will be phased in over two years.

<sup>21</sup> Budget Book 1, State Budget 2017.

- A 13% annual increase in tax receipts assumed based on both actual trends over 2010–2017 and the government's forecast of mid-term growth rate in tax revenues as per 2017 budget<sup>22</sup>;
- A 5% annual growth rate in non-tax receipts also in line with the government's mid-term forecast in 2017 budget<sup>23</sup>;
- A depreciation rate of 5% applied to the assumed tax revenues growth rate starting from 2023 modelling the speed of the decline in the growth rate of tax revenue due to the fact that it is unlikely that high increase in annual growth rates in tax revenue can continue in perpetuity;
- A 5% annual increase in borrowing starting from 2022 assumed to be a stabilized rate of growth in government borrowing following a substantial growth trend in loans disbursements budgeted from 2018 to 2021<sup>24</sup>;
- And a 3.8% annual returns on the investment assets held by the Petroleum Fund based on actual historic investment income since 2005 reported in the Fund's 2016 annual report.

The first scenario represents a baseline trend in all factors applied from 2022 onwards and shows that if the current pace of annual growth in all factors continues, the PF reserves would fall increasingly quickly and run out in around 2028. Even if a slower spending growth is assumed post 2021 as well as a higher PF investment rate of return (as in the second scenario), this would still witness an increasingly quick erosion of PF capital and falling investment earnings and as a result extend PF only for 3 years more, which is 2031. This is assuming a reduced rate of growth in both capital and recurrent spending of 4% after 2021 (as opposed to 10% and 8% in the first scenario accordingly), a slower acceleration rate of 5% on recurrent spending growth rate, a higher return on the investment assets held by the Petroleum Fund of 4.5% (as opposed to baseline 3.8%) and keeping all other factors unchanged.

Alternatively, to see the effect of lowering government withdrawals from the Petroleum Fund to a level equivalent to the ESI a third option is considered. The third scenario models the government's aim of scaling back total expenditure and reducing excess withdrawals by the time when some of the SDP priority projects come to near completion, which is 2025<sup>25</sup>, keeping baseline trends in all other factors the same. The Fund will continue into perpetuity with continual budget financing accordingly, growing slowly from a balance of US\$9.8bn in 2025 onward. However, it should be noted that scaling back government spending to a sustainable level by 2025 will require cutting all budget expenditure by 60% at a time and strong fiscal restraint in line with the ESI policy further on which will most probably exert a negative impact on the economy largely driven by public spending and be disruptive for basic social service delivery. This is given that government spending constantly keeps upward trend before 2025 and comes back to a comparatively low ESI level at one point of time.

As opposed to that, moderate scaling back of planned government spending in earlier years (2018-2021) to a level of an average over the last 4 years – in 2018 and assuming 4% annual growth in total government spending<sup>26</sup> in the following years can extend PF life winning more time to grow domestic revenues. Raising domestic revenue is time-sensitive which underscores the urgency for improved

22 Accounts for a forecasted increase in withholding tax revenue on government contracts following current and planned scale-up in government spending.

23 Budget Book 1, State Budget 2017.

24 Budget Book 1, State Budget 2017.

25 Budget Book 1, State Budget 2017.

26 In line with projected 4% annual growth in non-oil GDP (Timor-Leste GDP is rather volatile due to the fluctuations in oil prices and the near depletion of the oil reserves). Taxes are assumed to grow at 6% following 2019.



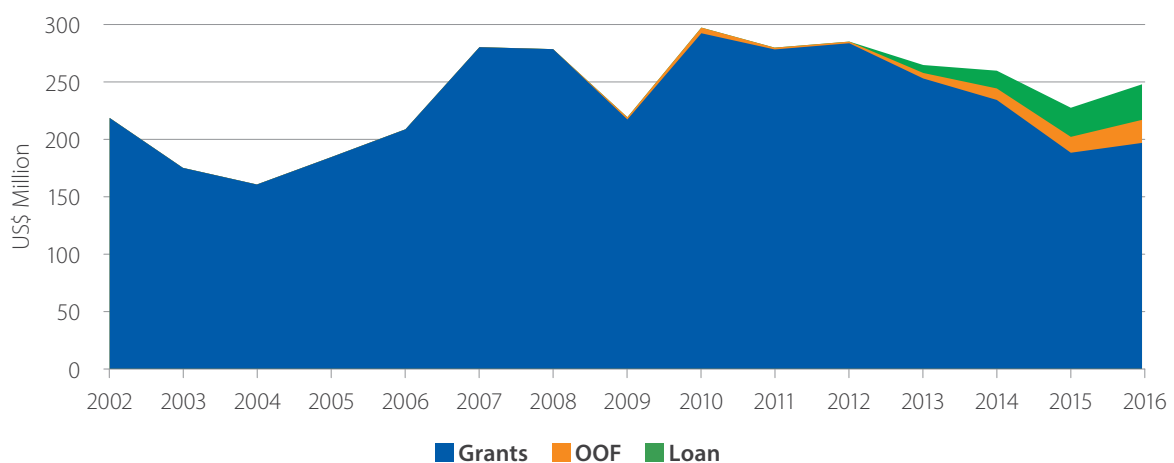
domestic revenue mobilization capacity, effective as well as balanced allocation of resources across the various economic and social sectors and reforms aimed at improved enabling environment for private sector growth while the economy develops.

Any new revenues to the Petroleum Fund from extraction of the Greater Sunrise field would extend the lifespan of the Petroleum Fund, though it is still uncertain when revenue from the field would be received. Once the investment decisions are taken, it is likely to take as long as seven to nine years to start production.

## International public finance

International public finance, including grants, concessional loans, and other official flows (OOFs) from international sources, accounts for 16.6% of total mix of sources in 2016 (Figure 7). Grants represent predominantly the largest share of international public flows and increased almost two-fold following the civil unrest in Timor-Leste in 2006 from US\$161 million to US\$279 million in 2009. Then its level plateaued up until 2012 and since then started declining steadily reaching US\$197 million in 2016. A contraction in the amount of donor funding in the recent years is a natural part of the development process as the country becomes more self-reliant and moves away from donor support. Yet, ODA grants<sup>27</sup> still remain large at 80% of total international public finance and 10% as a proportion of combined sources budget (Figure 16).

**Figure 16. Grants is the largest share of international public flow, but is declining steadily**



Sources: OECD QWIDS, Ministry of Planning and Finance

Both ODA loans and other official flows (OOFs) have also seen slow overall growth, with concessional borrowing rising from initial \$21,280 in actual disbursements in 2012 to \$28 million in 2017 and OOF – financing that is typically less concessional – increasing steadily from a very low basis in 2006 and totaling US\$19 million in 2016. However, both flows remain relatively small in the aggregate mix of total external public financing.

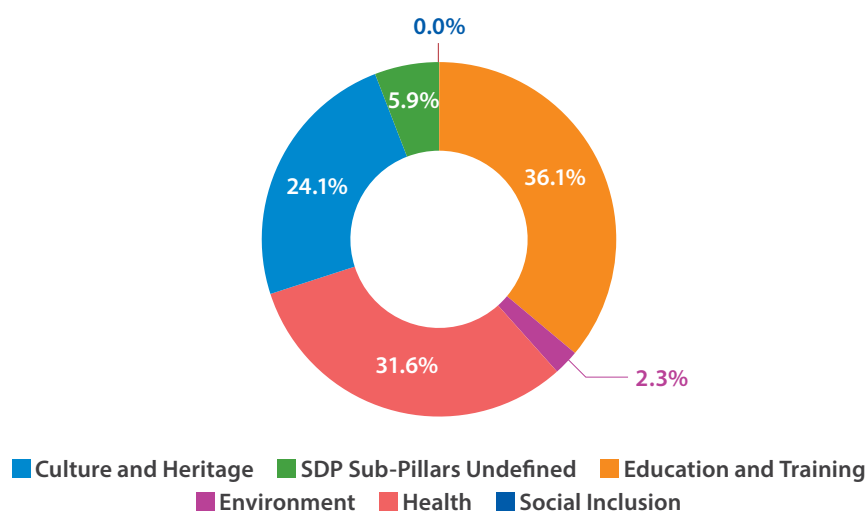
27 It is important to note that the grant category also includes projects that support Timor-Leste through Technical Assistance, thus this figure should not be thought of only as a cash or infrastructure equipment transfer.

By the end of 2017, to support strategic infrastructure projects 11 loan agreements were signed with the Asian Development Bank, the World Bank, the Japan International Cooperation Agency and China. Although, loan agreements were established for the total amount of \$355mln, to date the actual disbursements accounted for as low as \$105mln. As a proportion of combined sources budget external loans remained very low and financed only 2% of total government spending in 2017. As mentioned by PPP & Loans Unit (PPPL), the amount of actual loan disbursements is still limited because of the loan funds being disbursed directly depending on the project implementation progress and some of them were still in their early stages. The great majority of the loan packages taken on by the government are for the rehabilitation and upgrade of national and regional roads.

Overall, contracting concessional debt is considered by the government as a potential alternative source of financing for the construction of strategic infrastructure at less cost than the recourse of funds from the Petroleum Fund. IMF supports mobilizing more concessional financing for large infrastructure projects<sup>28</sup> to reduce the need for excess withdrawals in the coming years and as a means of knowledge transfer in capital project appraisal and implementation. However, this should be realized using prudent selection criteria, ensuring financial cost of borrowing<sup>29</sup> is lower than the return on the Petroleum Fund and ensuring a sustainable management of the country's external debt.

ODA grants from development partners to Timor-Leste play a significant role in contributing to the human capital sector and SDP, although this is projected to fall over the medium-term. In 2017, ODA grant support was structured across the SDP pillars as follows: Social Capital 47%, Economic Development 18%, Infrastructure Development 18%, and Institutional Framework 16%. The major recipients in terms of total highest share of spending at the Social Capital sub-pillar level are Education and Training – 36% and Health – 32% (Figure 17).

**Figure 17. ODA grants contribute significantly toward human capital development**



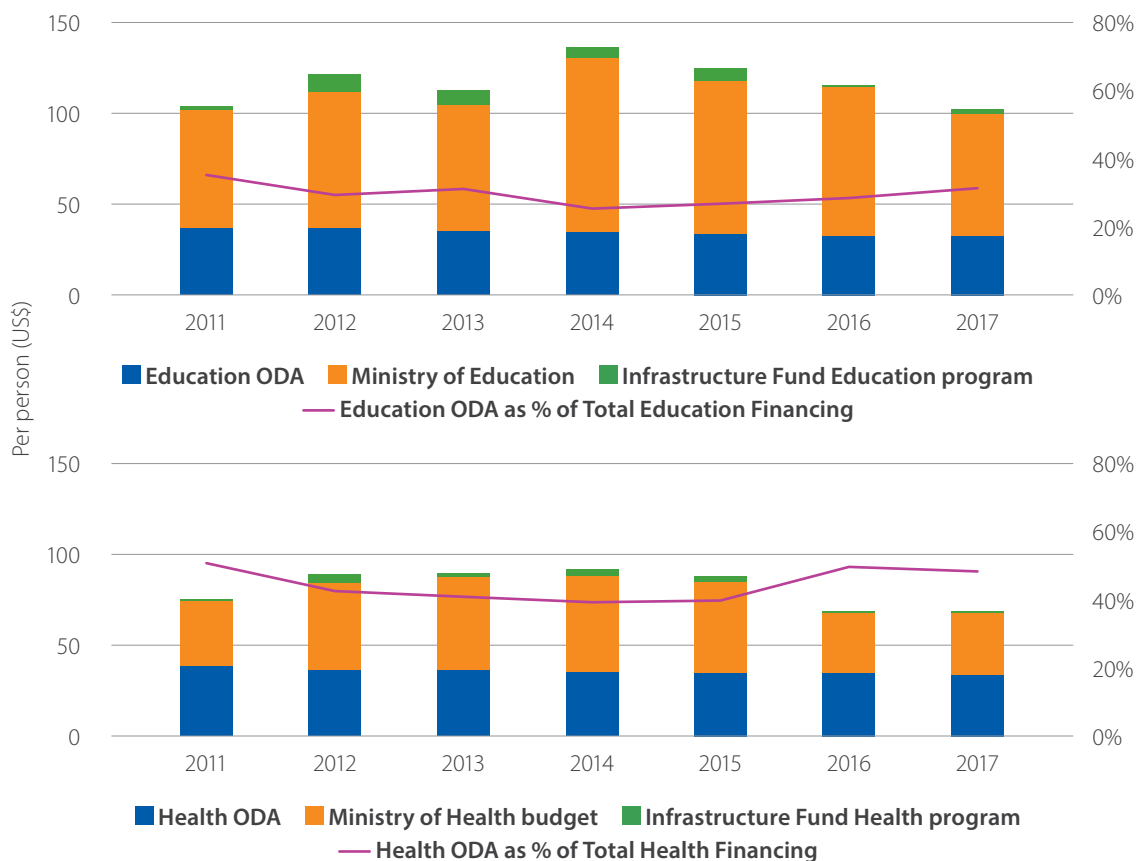
Sources: Timor-Leste Aid Transparency Portal, Ministry of Planning and Finance

28 IMF Article IV, 2017.

29 Some of the loans are not fully concessional. Source: Table 2.7.3.2. Loan Agreement Summary, p. 66 of the Budget Book 1.

The data from Aid Transparency Portal indicated that in the Education sector, ODA grants accounted for around 30% of total education spending on average during 2011-2017 with the Ministry of Education and Infrastructure Fund funding the rest. However, development partners' funding in education sector declined by over 50% from US\$40 million in 2011 to US\$18 million in 2017, and by 17% as a proportion of total education financing (Figure 18a). In Health sector, on the other hand, ODA grants accounted for a larger share in total health financing at 50% in 2016, while government health spending remains significantly lower than ODA (Figure 18b). Given that ODA grants are expected to fall in the medium-term as Timor-Leste continues its progression towards development, the challenge remains in mobilizing sufficient resources to compensate for the projected contraction in donor funding in order to avoid a scaling back of public services in those sectors, but achieve its medium-term goals on human capital development.

**Figure 18 a&b. ODA is an important source of education and health financing, but is expected to fall**



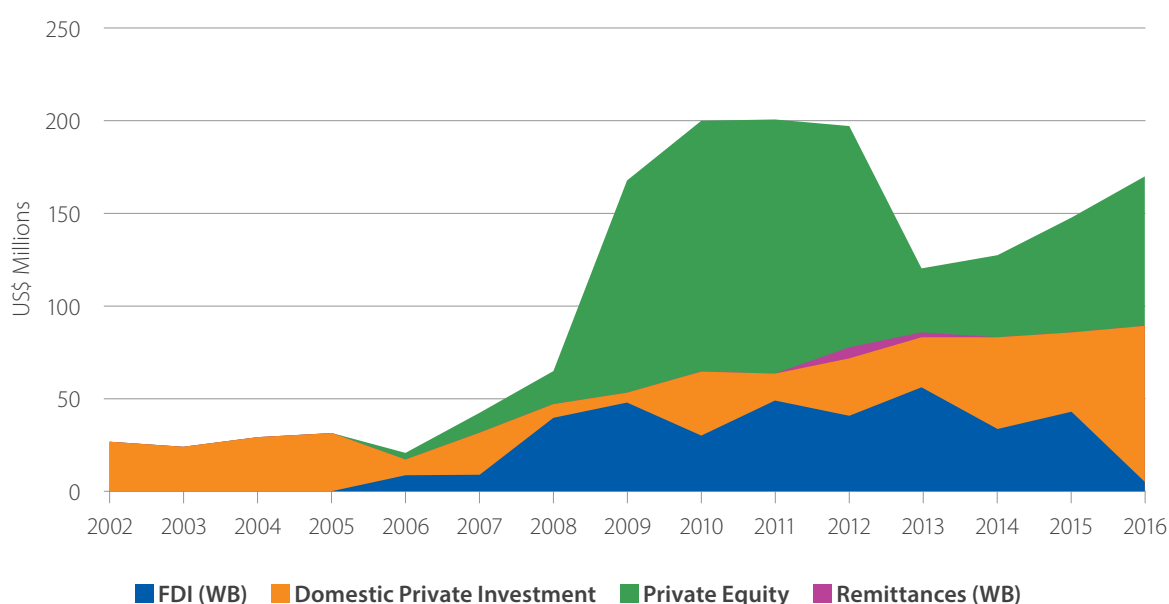
Sources: Budget Transparency Portal, Aid Transparency Portal, Ministry of Planning and Finance, OECD QWIDS

Timor-Leste recognizes the principles of good donorship and is itself a provider of financial and technical assistance internationally. To date, the financial assistance provided by the state is in excess of \$30mIn since 2008. This includes some so-called fragile-to-fragile support, including for other members of the g7+.

## Private finance

In the last 14 years, private sector investment remained weak relative to total fixed capital formation, however private flows increased slightly with varying levels of foreign and domestic investment. Private sector investment – measured based on gross fixed capital formation by private corporations – has more than tripled since 2002 from US\$26 million to US\$90 million in 2016 (Figure 19), and accounts for 6% of total mix of sources in 2016 (Figure 7).

**Figure 19. Private flows increased slightly with varying levels of foreign and domestic investment**

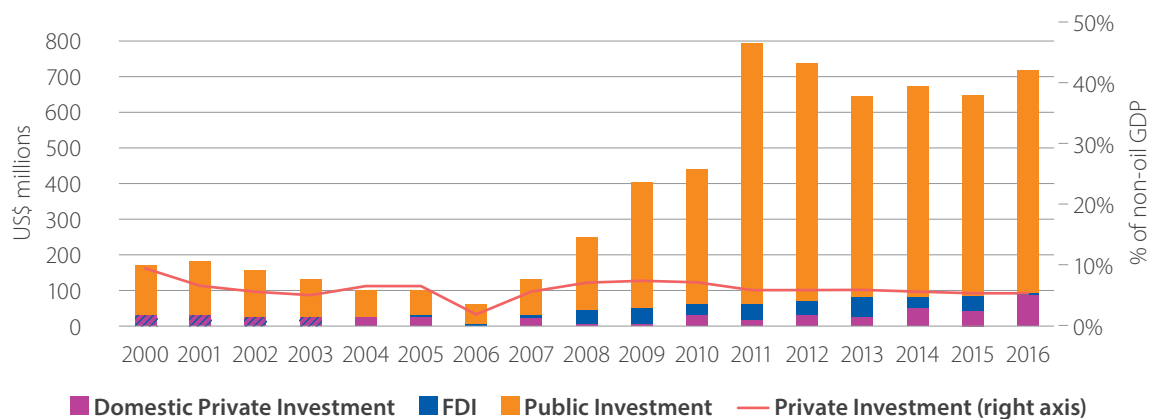


Sources: World Bank Open Data, 2006 to 2016, Timor-Leste National Accounts 2000-2016

As a proportion of non-oil GDP, domestic & foreign commercial investment fluctuated, but overall remained very low averaging 6% of non-oil GDP over the past decade (Figure 20). Despite significant growth in public investment – US\$202.2 million in 2008 to US\$629.84 in 2016 – private sector investment remains low demonstrating that there remain significant barriers to private sector growth.

International private finance – including remittances and private equity – accounts for 5% of total mix of sources in 2016 (Figure 7). International private finance to Timor-Leste is relatively small in volume and fluctuates during the period, from US\$11 to US\$80 million in 2007-2016 (Figure 19), with remittances inflows predominantly accounting for the largest share. In many developing countries in the South East Asian region including Timor-Leste, remittances are a huge source of income for many households. Given the relative significance this type of flows play in the whole landscape, their contribution towards sustainable development and SDP can be further assessed.

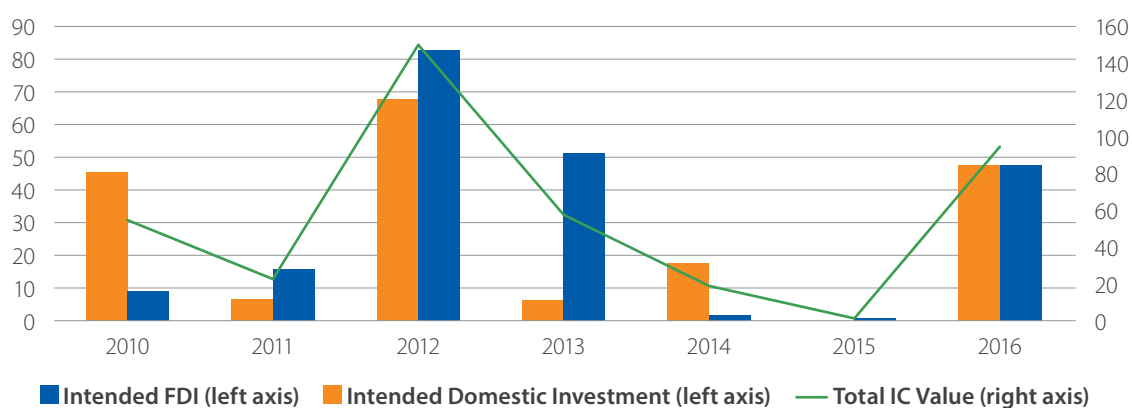
**Figure 20. Despite significant growth in public investment, private sector investment remains low**



Sources: Timor-Leste National Accounts, 2016, World Bank Open Data

There is lack of reliable data on investment flows in the country of both local and foreign origin. Trade Invest Timor-Leste (TITL) estimated that total value of 73 Investment Certificates issued to private investors during the period from 2010 to 2016 was about \$798 million (current USD). This value represents “intended” private investment in non-oil sectors of the economy<sup>30</sup> and is spread almost equally between local and foreign investors (Figure 21). During the selected period Timorese businesses planned to invest in the country’s economy a slightly higher amount (\$208 million) than foreign companies (\$190 million).<sup>31</sup>

**Figure 21. Domestic intended investment surpassed foreign intended investment by US\$64mIn in 2017**



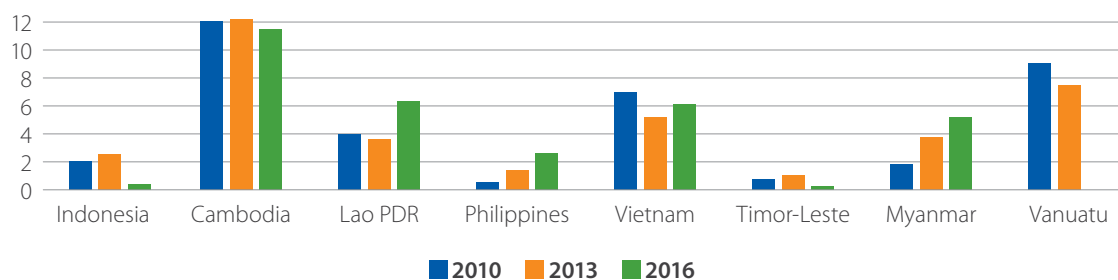
Sources: IC Database, TITL, 2017

30 The number excludes oil sector, FDI licenses for the oil and gas, and mining sectors are not issued by TITL.

31 An ongoing cement plant investment project is being undertaken by Timorese in partnership with foreigners and alone accounts for the most significant amount of \$400 million (for its relatively large amount it is excluded from the analysis presented in the Figures 9 below).

Although the country witnessed a steady FDI growth over time, one can see that as a share of GDP, FDI remains very low in comparison to other LMIC economies and regional peers (Figure 22).

**Figure 22. FDI remains low in comparison to other LMIC economies and regional peers**

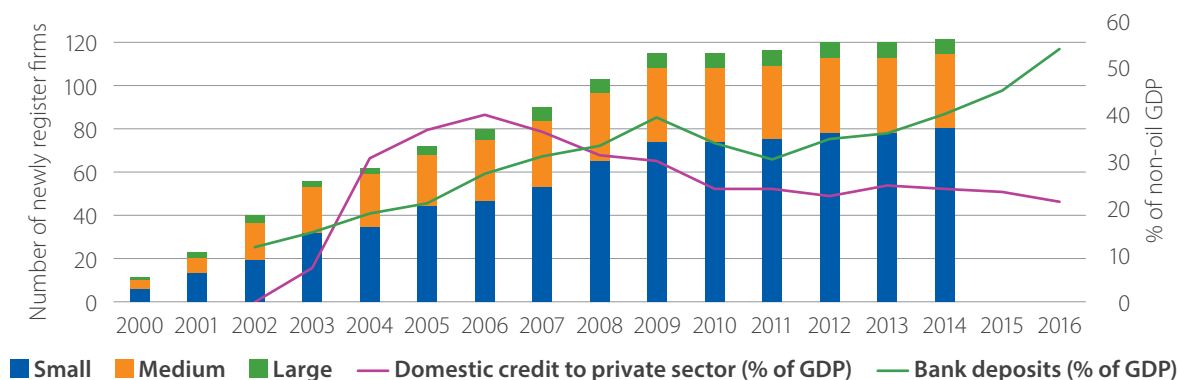


Source: World Bank Databank

The non-oil private sector in Timor-Leste is small and informal. According to the most recent Enterprise Survey by the WB, which covered 122 firms in Dili in 2014, 66% were small and medium enterprise (SMEs). Given the higher proportion of MSMEs, the development of Timor-Leste's private sector is highly dependent on the growth of these companies because it is where the bulk of economic activity and employment takes place.

Figure 23 illustrates the dynamics of annual registration of new businesses in Timor-Leste between 2000 and 2014<sup>32</sup>, labelled against the trend of domestic credit to private sector and bank deposits as a ratio non-oil GDP. During the period of 2002- 2006 both bank credit and deposits increased steadily up to 40% and 21% as a share of non-oil GDP respectively. However, since 2006 both indicators depicted reversed trends, while private sector credit declined reaching 21% of non-oil GDP in 2016, bank deposits increased significantly peaking at almost 54% of GDP in 2014. This results in a situation where banks maintain substantial excess liquidity that is placed abroad.

**Figure 23. The number of newly registered firms is growing steadily, however financial intermediation remains weak**



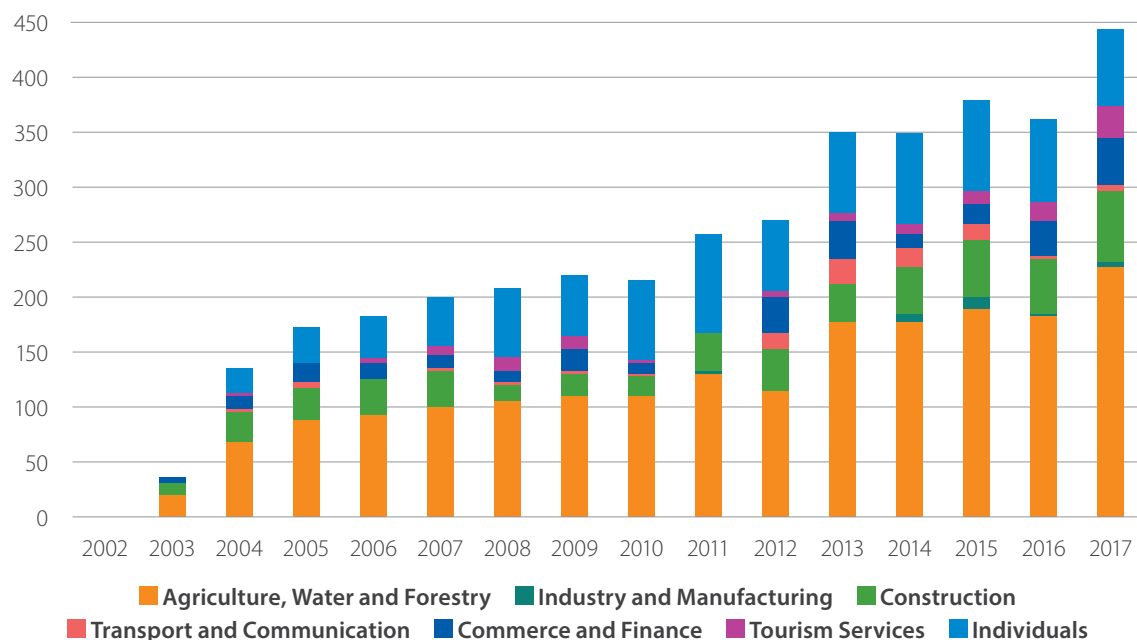
Source: World Bank Enterprise Surveys 2015, BCTL

32 World Bank Enterprise Survey, 2018.

This imbalance is largely attributable to banks' assessment of limited opportunities for sound lending in Timor-Leste. Up to 32% of MSMEs in Timor-Leste in 2017 were unserved or underserved by the financial sector, resulting in the estimated credit gap of \$408 million.<sup>33</sup> One of the main measures the government introduced recently to tackle this issue is the Credit Guarantee Scheme<sup>34</sup> designed by the Central Bank of Timor-Leste (BCTL) to unlock access to finance for MSMEs and support economic diversification. Given the substantial potential of domestic banking liquidity as available source of domestic financing towards private sector growth, achieving greater financial deepening and inclusion is a key priority.

The largest share of private sector bank credit is in the agriculture sector, where it grew from a very low base of US\$9.95 million in 2003 to \$227.3 million in 2017 (Figure 24). It is expected to scale up further with the potential increase in investment within the coffee sector. Bank credit to construction is the second largest share constituting of US\$65 million in 2017. This can be attributed to significant public investment during the last years and borrowing by private firms who benefit from public construction contracts. Domestic credit to individuals accounts for the third largest share accounting for US\$69.6 million in 2017, however this is likely to only benefit the capital city as most individuals in other districts lack access to banking services. In relation to manufacturing and tourism sectors which are seen to have the most potential in employment creation and increase in productivity, throughout the period of 2003-2017 the sectors received the smallest share of domestic bank credit, with US\$5.7 million and US\$27.8 million in 2017 accordingly.

**Figure 24. The largest share of private sector borrowing is in agriculture sector, followed by construction and individuals**



Source: BCTL, 2003-2017

33 IFC MSME Finance Gap 2017.

34 Credit Guarantee Scheme, Decree-Law no. 23/2017, of July 12th.

As for the Public Private Partnership (PPP) instrument, there is still much potential to further explore possible investments in key sectors in partnership with private companies. There are currently three projects in the PPP pipeline: Tibar Bay Port, Dili Water Supply, and Medical Diagnostic Service. The first PPP project, Tibar Bay Port, recently entered the implementation stage following the signing of the concession agreement between the government and Bolloré Consortium in June 2016. Two other projects in the water and health care sectors are under consideration and waiting for feasibility studies to be conducted. At present, PPP instrument is seen as an opportunity to mobilise private sector expertise and innovation, build capacity within the government to deliver high quality and more efficient investment projects and improve the standard in the provision of public services. Going forward, the government plans to place more emphasis on PPPs as an alternative infrastructure financing mechanism to reduce the fiscal burden and reduce the need for excess withdrawals from the PF. PPPL mentions that currently significant delays in the process of PPPs establishment exist due to constraints related to creation and/or adjustments to the legal environment necessary for the private sector to effectively operate a particular infrastructure and provide public service.

## Summary

This analysis of the financing landscape and trends highlights a number of challenges and opportunities for mobilising financing for the SDP. The most pressing issues regarding mobilising sufficient volumes of public and private financing are as follows:

- Public finance is a dominant feature of Timor-Leste's financing landscape, accounting for over 70% of total financing. Petroleum receipts are the primary source of public revenue, but are expected to cease by 2022. Relative to rapidly growing government spending domestic revenue on average funded only 13% of government spending during the last decade. An unsustainable policy of spending from the PF now may lead to a complete runout of its reserves in the next 10 to 13 years. Raising domestic revenue is time-sensitive which underscores the urgency for improved domestic revenue mobilization capacity, effective as well as balanced allocation of resources across the various economic and social sectors and reforms aimed at improved enabling environment for private sector growth while the economy develops.
- ODA was the most important source of finance in the early years of Timor-Leste's development. Having fluctuated slightly over the years, ODA reached its high of US\$291 million in 2010 and since then took a declining trend. With introduction of concessional loans in 2012, international public finance is still mainly driven by grants, and by now remains an important source of total country's financing at 16.6% in 2016. ODA grants from development partners to Timor-Leste play a really important role and account for a significant proportion of investment in key social sectors such as education and health. Given that ODA grants are expected to fall in the medium-term, the challenge remains in mobilizing sufficient resources to compensate for this projected decline in donor funding, if the government is to avoid scaling back of public services in those sectors, but achieve its medium and long term goals on human capital development.
- Domestic investment by private corporations and FDI remained notably small throughout Timor-Leste's history in both absolute terms and as a proportion of the overall finance mix together accounting for as low as 6% of total financing in 2016. Despite significant growth in public investment during the last decade, private investment remains low demonstrating that there remain significant barriers to private sector growth. Without a significant change in trends in private investment (both domestic and FDI) it will be very challenging to meet the central economic



diversification and job creation objectives of the SDP driven by a selection of priority industries. Given the strategy of the SDP, which aims to stimulate private-sector led growth as a means for economic development and for transforming financing model overall, this is a pressing financing issue for the country. The policy and institutional context of public-private collaboration is explored in more depth below and recommendations in this area are articulated in the roadmap.

- This is a critical phase in Timor-Leste's history and the decisions and institutional structures put in place for managing the country's finances will have a significant impact on its long-term development path. The government has significant resources to invest toward realising a sustainable economic and financing model over the long term through the wealth earned from the Petroleum Fund. Yet this wealth is finite, even if additional revenue from new oil or gas fields expand the fund and extend the length of time over which government can draw down on those revenues. The framework of policies and institutional structures that government has in place to develop and deliver an effective strategy for making a transformational shift will be an important determinant of its success. Further sections of the report examine the framework that government has in place in support of the government's long-term objectives and make recommendations about how it can be strengthened to develop and deliver an integrated financing strategy as a whole, with a particular focus on the strategy toward mobilizing private sector investment.

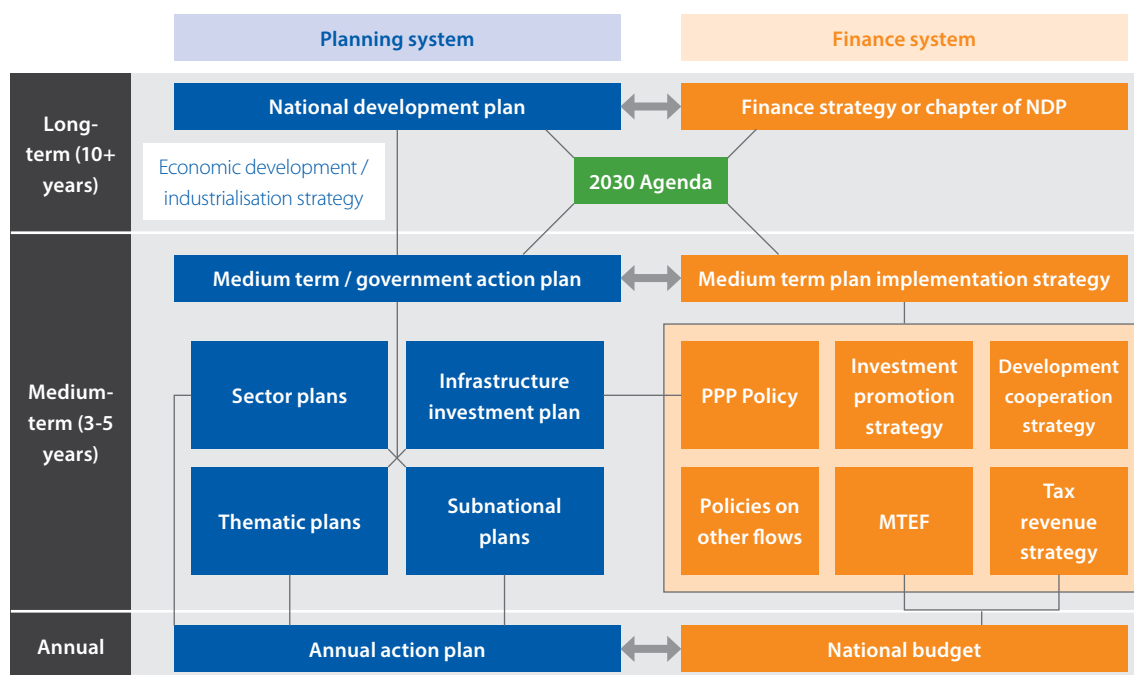
## 3.2. Integrated planning and financing

Achieving the vision of the SDP will require investments from a range of public and private actors that contribute directly and indirectly to the outcomes it targets. Mobilising the necessary resources, and maximising the contributions that different types of financing can provide towards SDP implementation demands an integrated approach to financing. This entails a policy framework, partnerships and collaboration that promote contributions from different types of financing according to their specific characteristics.

Government has a critical role to play in instigating an integrated approach to financing. The way it invests its own resources, the partnerships and collaboration it builds across sectors and the policy environment it develops have a powerful influence on the way other actors operate and invest their own resources. At the foundation of government's approach to financing for the SDP are the planning process and the policies that govern the approach toward different types of financing. This includes but goes beyond the budget, incorporating policies towards the private sector, development partners and other actors. The common elements of these systems are shown in Figure 25.

This section of the DFA examines the alignment between planning and finance policy functions and looks at how they respond to current financing trends. It looks at how budgets and financing policies draw from and contribute to national plans, how government estimates the costs of the investments required to realise national plans and how these compare to current financing trends. It looks at how this informs the design and management of policies related to different areas of financing and also looks at leadership for institutional coherence across planning and financing systems.

**Figure 25. Common elements of national planning and financing systems**



Source: Development finance assessment guidebook, UNDP, 2018.

Note that the red arrows highlight key points at which the planning and financing systems should be closely connected.

## National planning functions

The 2011–2030 Strategic Development Plan outlines Timor-Leste’s current developmental strategy and builds on the achievements of the 2002 National Development Plan (NDP) and “Timor-Leste 2020, Our Nation, Our Future”. The SDP was developed in 2010 through a highly participatory process, designed for the policy to capture and reflect the priorities of communities across the country, and to engender a sense of buy-in and ownership of the plan. The plan recognises the importance of ongoing consultation and participation by the Timorese people as central to its success.

The SDP provides a strategic vision for the future of the country as a trading hub and an open and diversified economy, based on efficient agriculture sector, expanding tourism industry and downstream industries in the oil and gas sector. The SDP aims to ‘transition Timor-Leste from a low income to upper middle-income country, with a healthy, well-educated and safe population by 2030’. The strategy prioritises large investments in infrastructure and improvements to human resource capacity and is built on three core pillars:

- social capital (health, education and social protection);
- infrastructure development (transport, telecommunication, power, water supply and sanitation);
- economic development (petrochemicals bringing about revenue to enable investments in education, health services and infrastructure and developed agriculture and tourism sectors driving private sector jobs and becoming new sources of public revenues beyond oil),

Which are supported by two cross-cutting themes:

- the institutional framework (improving the capacity and effectiveness of government institutions);
- economic context and macroeconomic direction (creating strong macroeconomic foundation).

The SDP is broken down into three implementation phases, corresponding to short, medium and long-term targets (2015, 2020 and 2030).<sup>35</sup> It sets out a total of 149 sub-goals across these pillars and cross-cutting themes to outline the direction and desired results in those areas. These sub-goals provide the basis for planning and target setting, both for more detailed long-term strategies in particular thematic areas, and for financing policies in the short and medium term. They also provide a reference point for the development activities of other non-state actors, such as civil society, religious organisations, non-governmental organisations, and development partners.

The SDP provides a comprehensive and coherent framework for development which is consistent with the aspiration and approach of the Sustainable Development Goals (SDGs). At the beginning of the SDGs era, Timor-Leste has taken a leading role and was one of the first countries to officially endorse the new 2030 Agenda and SDGs.<sup>36</sup> Internationally the country is a member of the High-level Group in support of Implementation of the 2030 Agenda and domestically, it has also established a working group on SDG implementation to provide alignment of country's planning and budget systems with the SDGs. The working group is chaired by the Prime-Minister's Office, with strong representation from the ministries and units responsible for planning, budgeting, monitoring and implementation of the SDP. The working group assessed the alignment of Timor-Leste's SDP with the Sustainable Development goals and targets and identified strong consistency and convergences.<sup>37</sup> Though some of the SDG targets are yet to be fully addressed in the current SDP, those along with the relevant national indicators will be considered and incorporated through the envisaged periodic review and update of the SDP.

While there is no national medium-term development plan which would provide a clear linkage between the long-term objectives of the SDP with the annual targets as well as SDG-related indicators guiding implementation of activities and projects annually and informing progress, the SDP outlines staging of actions across all sectors in the short, medium and long term. This sequencing of national priorities provides a basis for sectoral plans, annual line ministry plans, programmes and projects which are included in the short to medium-term financing policies (see sub-section on financing policy functions). The implementation of the annual plans proceeds through the government Programme which is laid out by each Constitutional Government for the duration of its term (usually 5 years). The SDP itself is divided into three stages. In infrastructure, a policy of focusing first on electricity, then roads and later water and sanitation has been used to guide the focus of the Infrastructure Fund. And regarding the SDGs, the government has prioritised three of the seventeen SDGs: namely, goals 2 (zero hunger), 4 (quality education) and 9 (industry, innovation and infrastructure), while paying attention to

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35 The focus of the first implementation phase, covering 2011–2015, was human resources development, infrastructure and strategic industries. The second phase, from 2016–2020, focuses on infrastructure, strengthening human resources and market formation. The third phase, from 2021–2030, will focus on eradicating extreme poverty, a strong private and cooperative sector and a diversified non-oil economy.

36 The Council of Ministers endorsed the SDGs even before the UN General Assembly did. Statement by the Prime Minister to the plenary meetings of the UN summit for the adoption of the Post-2015 Development Agenda, 25–27 September 2015. Available at: <https://sustainabledevelopment.un.org/content/documents/20598timor-leste.pdf>

37 For more information: Timor-Leste's Roadmap for the implementation of the 2030 Agenda and the SDGs, Government of Timor-Leste, 2016.

other human development goals in the short-term, including goals 3 (good health and wellbeing), 5 (gender equality) and 6 (clean water and sanitation).<sup>38</sup>

The individual annual plans are to be aligned with the SDP and the sectoral plans of the respective line ministries. The Unit of Planning, Monitoring and Evaluation in the Prime-Minister's Office (UPMA) undertakes the analysis of the annual plans and ensures their consistency with the SDP, the government's and sectoral programmes. Yet a clear link between the SDP and the sectoral and annual plans is still weak, not all line ministries have a consistently framed sectoral plan and the latter have varying timeframes. An evaluation of the targets met in SDP for the first implementation phase (2011-2015) conducted by UPMA indicates that the SDP is not being used for the purpose of operational planning or subsequent monitoring and evaluation due to the lack of hierarchical structure and causal relationship between the targets. Some of the SDP targets are broad with long-term perspective, expressed in terms of output rather than outcome or are not measurable. Besides establishing a 2016 baseline for ongoing SDP implementation, the evaluation report<sup>39</sup> also provides a framework for operationalization of the SDP in the next medium-term period. This exercise will assist in government's intention to update SDP with more specific and measurable medium-term goals and objectives<sup>40</sup> which can in turn help establishing clearer linkage with budgetary programmes and activities implemented on a yearly basis and related performance indicators informing progress on the SDP outcomes as well as SDGs.

Neither SDP, nor sectoral programmes are costed in detail, though SDP broadly refers to the envisaged priorities and roles for mobilizing resources across different types of financing (see sub-section on financing strategy). While detailed costing of development plans is usually a technically complex, resource-heavy exercise, estimates can enable assessments of the financing implications of identified priorities, including their affordability and the identification of financing gaps that may need to be filled by non-state actors. In this way, they help to bridge the aspirational and intervention-based nature of planning and financing processes respectively. It should be noted that there are examples where specific sector interventions were estimated with the support from development partners in Timor-Leste. For instance, an investment plan for the water supply and sanitation sector for the period 2018-2030 was developed with support from ADB to identify various options of institutional frameworks for the water sector with a view to initiate the implementation of the investment plan within the aforementioned period. Those can provide a good starting point for establishing estimates of the costs associated with key sectoral and thematic policies, and to develop processes so that this becomes a more standardized part of the policy development process. Investment estimates are strongest when they consider the scale of investments and services that both public and private actors can make to contribute toward that various objectives of the national development plan. They are needed to serve as basis for guiding resource mobilization efforts by the government as well as help to make implicit choices about prioritization explicit.

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38 In the medium term, the government will focus on goals 8,10, 11, 12 which are key to sustainable economic development and in the long term – on goals 7, 13, 14, 15 related to the environment. By achieving these goals, the government aims to ultimately achieve goal 1 (poverty eradication) and goal 16 (ensuring peace, stability and effective institutions). For more information: SDG working group report and memo, Government of Timor-Leste, 2016.

39 Source: Report on implementation of TL SDP to 2016, with recommendations on operationalization framework and medium-term targets to 2022, Government of Timor-Leste, 2017.

40 The report indicates that the effective implementation of the Phase 1 of the SDP started only at the end of 2012 meaning that the implementation of Phase 1 should be considered in the 2013-2017 timeframe. It therefore suggests to consider the implementation of the second phase from 2018 to 2022 accordingly and align the updated timeframe of Phase 2 to the term of the next coming Constitutional Government.

## Finance policy functions

There is no strategy that provides a comprehensive framework for long-term resource mobilisation plans that look beyond public finance, though the SDP gives some direction on some areas of financing. It outlines specific targets for non-oil domestic revenue and the use of the Petroleum Fund between 2011 and 2030. It articulates a policy of frontloading, whereby withdrawals exceeding the ESI are planned to be higher initially, falling to zero as the economy and the private sector expand and taxation and other forms of domestic revenue make a greater contribution to public financing.<sup>41</sup> This projected revenue target is set to facilitate investments in the areas of education, health, housing, food security and core infrastructure in Timor-Leste, yet the strategy does not specify how the total public expenditure is linked to specific elements of the SDP. In other areas, the SDP provides broad direction. Grants and concessional loans, as a favorable public financing option, are considered to support infrastructure programme, such as the rehabilitation of roads and bridges. The issuance of government debt is planned as an alternative funding source in the future, and as the financial sector develops and the economy expands. Public Private Partnerships are to be explored in the area of infrastructure programme of the SDP, whereas development partners' assistance will support achievement of country's development objectives in general. In relation to the private sector, the SDP provides guidance on the three sectors to be prioritised to achieve economic diversification beyond the oil and gas industry – agriculture, manufacturing and tourism – and within these sectors includes a number of actions and targets for private sector development. However, the SDP does not go as far as estimating the cost of interventions in specific areas or providing quantitative benchmarks for the scale of financing from non-state actors it aims to mobilise.

The foundations of the government's overall financing framework provided in the SDP provide a broad framework for an overarching approach toward financing the sustainable development from all resources. Further forward-looking guidance on the scale and contributions that different types of resources – public, private, domestic, international – can make toward implementation of the national development plan and SDGs could support developing a strategic approach to their mobilization, provide guidance on how to address the synergies, trade-offs and competing priorities that exist between different aspects of financing and clear objectives. It could provide guidance for financing policies and stimulate and guide prioritization or adjustments within the country's planning. Overall it could support more focused, coordinated efforts across government and partners to mobilise the range of resources needed to achieve the SDP.

### Considerations for policymakers – integrated financing strategy

A financing strategy that supports the national development plan can help to bridge and connect the long-term aspirations of planning processes with short and medium-term financing policies that are more incrementally-focused. A more holistic financing strategy that considers the roles that various types of financing can play in national development can provide clarity as to the objectives and outcomes that financing policies in different areas of financing should seek. In the case of Timor-Leste such a strategy could develop estimates and targets for the types of investments needed for the implementation of the country's long-term vision and provide an overarching framework within

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41 The total target revenues are equal to US\$28.1 billion between 2010 and 2030, of which non-oil domestic revenue accounts for US\$8.6 billion and Petroleum Fund withdrawals – for US\$19.5 billion. Source: Table 11, p. 204 of the SDP.

which specific financing policies to mobilise resources can be developed, aligned with each other and national plan objectives and operationalised. In relation to private sector financing specifically, this could guide the development of a more specific strategy to facilitate or stimulate investment in the priority sectors – for which funding gaps will be identified – for the achievement of national development targets and for poverty reduction through job creation. Such strategy could also define and establish an overarching coordination mechanism that oversees the planning, mobilization and use of resources, including and beyond government finance, in a holistic and integrated manner (see roadmap / recommendations section for more detail). It is this strategy that could then provide the basis for consistent, more focused policies on specific flows (such as MTEF, capital investment budget, PPPs, development cooperation and private investment policies, etc.).

Two important aspects to be taken into consideration relate to enhancement of participation of non-state actors in the whole process and costing of priority interventions (see a recommendation on estimation of costs of the SDP in Roadmap section). Visioning the role of different types of finance – public, private, domestic and international – will be most effective if developed in close consultation with representatives from those sectors. Strong, systematic dialogue between government and key stakeholders – including development partners, private sector and civil society – is a key to stimulating investment and action that contributes toward nationally identified sustainable development objectives. Without strong dialogue, it is difficult for government to develop realistic objectives about the contributions that other actors can make, or to build view of existing constraints and opportunities. Currently the TL Development Partners annual and quarterly meetings provide an effective basis for a regular dialogue on cooperation with development partners, yet an official platform is needed for multi-stakeholder dialogue to discuss the role of all non-state actors in both the overall sustainable development of the country and financing for its development. There is a need to establish stronger partnerships with actors from across society that contribute to the objectives of the SDP and raise awareness of the objectives, focus of the SDP, actions and investments needed (see a Roadmap section for more details).

Before an integrated resource mobilisation strategy can be fully developed, priority interventions could be costed (to the extent possible) – so that targets for mobilising different types of resources can be established and efforts monitored against them. The example from Bangladesh (see **Box 1. Bangladesh: comprehensive financing strategies with cost estimates**) shows how estimating costs can provide targets and strategic guidance on which operational policies can be based.

#### ***Box 1. Bangladesh: comprehensive financing strategies with cost estimates***

The Government of Bangladesh has developed a number of policies that support the alignment of planning and financing systems. The national development plan, Vision 2021, is supported by an implementation plan, the Perspective Plan of Bangladesh, that provides strategic guidance about various public and private flows that can be mobilised to realise the objectives articulated in the vision. Bangladesh is also one of the first countries in the world to have estimated the costs of achieving the SDGs.

##### ***Perspective plan***

Bangladesh's national development plan, Vision 2021, is supported by the Perspective Plan which articulates a strategy for how it can be realised and financed. It outlines the contributions that specific resources can make and identifies strategic actions to be taken to mobilise or enhance the impact of these flows.



Remittances, for example, are an important resource flow for Bangladesh and are an area of focus within the Perspective Plan. The Plan assesses the contributions that remittances make to sustainable development, in supporting poverty reduction at the community level and as an important source of foreign exchange at the national level. It presents a range of ongoing initiatives and proposes further strategic actions, such as the use of technology to improve remittance transfers and building skills for potential migrants to meet future demand for labour. In a similar way, the plan highlights specific sectors in which FDI is sought, and outcomes such as technology transfer that the government wishes to realise from it. Strategic actions are articulated, for example to encourage investment in specific industries from specific source countries and further develop vehicles such as joint ventures in order to realise these objectives for attracting FDI.

In this way, the Perspective Plan provides a framework for the outcomes sought from particular types in finance that can guide the design and objectives of operational financing policies. This is an important bridge between Vision 2021 and implementation through Bangladesh's five year plans and specific financing policies that tightens the link between planning and financing processes.

### ***SDGs financing strategy***

Since the development of the Perspective Plan and as part of Bangladesh's efforts to localise the SDGs, the Planning Commission has undertaken an exercise to estimate the costs of implementing the SDGs.<sup>42</sup>

The SDGs financing strategy, which was launched in 2017, quantifies estimates of how much the SDGs will cost to implement for specific resource types. The aim is to help identify key interventions and further develop the roadmap for realising the vision of long-term planning. The exercise uses a methodology that looks at the costs related to each SDG and broke these costs down into four types of resources – domestic public, domestic private, international public and international private. This is based on assumptions about how responsibilities can be divided among these actors in each aspect of the SDG agenda. Importantly, the strategy also accounts for the interlinkages between different aspects of the agenda. The approach taken is to look particularly at SDG 8, as well as SDGs 7 and 9, on the basis that economic growth is a key driver of development. The model used accounts for overlaps between the costs associated with these three SDGs and attempts to synchronise them. It also relates estimated costs to existing finance flows in order to approximate the level of additional resources that will be needed. The strategy estimates overall that Bangladesh will need to mobilise additional costs of more than US\$900 billion over the lifetime of the SDGs. Annually this rises from additional costs of \$32 billion a year between 2017 and 2020 to \$100 billion a year between 2026 and 2030.

The SDGs financing strategy provides an important link for strengthening the alignment of the planning and financing systems in Bangladesh. Cost estimates are a valuable foundation that can both ground national plans, and present targets for operational financing policies to work toward. They can prompt and help to make implicit choices about prioritisation explicit. In this way, they help to bridge the aspirational and intervention-based nature of planning and financing processes respectively.

These policies have helped strengthen the connection between Bangladesh's planning and financing systems. This in turn has stimulated action to address some of the major priorities. For example, the Perspective Plan and five year plans identify the significant contributions that will be needed from private sector actors. The five year plan quantifies this, estimating that over three-quarters of the total volume of financing will need to be mobilised from domestic and international private finance. In order to move forward in mobilising this a platform for public-private dialogue on sustainable development has been established. The platform aims to build trust between leaders in the public and private sectors and create a forum for discussing policy solutions that can unlock greater and more sustainable, inclusive private commercial investment. A new agency, the Bangladesh Investment Development Authority, was also established for this purpose in 2016.

*Source: Innovations for integrated financing, UNDP and ADB, 2018*

42 Planning Commission, Government of Bangladesh, 2017, *SDGs financing strategy*. Available at: <http://www.plancomm.gov.bd/sdgs-financing-strategy-final/>



## Leadership and institutional coherence

Leadership in relation to the overall development process as well as the advancement of national development goals stipulated in the SDP lies at the highest level of the State in Timor-Leste – i.e. the President of the Republic. The Prime Minister leads the Government and presides over the Council of Ministers (CoM) which has overall responsibility for the preparation and execution of the State Plans (SDP, SDGs strategy, Government Programme and Annual Plans) and the State Budget as approved by the National Parliament. The Budget Review Committee is particularly relevant to the financing aspects of development planning and is responsible for recommending levels and allocation of government spending (both current and capital) as well as setting the ceiling for spending on economic and social development and government debt service. The Ministry of Development and Institutional Reform is mandated to design and implement policies in the areas of economic and infrastructure development and coordinate planning of investment strategies and plans in cooperation with other relevant bodies. The Ministry of Planning and Finance (MoPF) is tasked to manage budgetary planning and together with other entities the state's financial policy<sup>43</sup>. The Planning, Monitoring and Evaluation Unit of the Prime Minister's Office has the mandate to coordinate the process of planning, monitoring and evaluation of all government policies and programmes and of the State Budget in conjunction with all government entities. The Development Partners Management Unit in the MoPF coordinates the role of development partners in contributing to the SDP. Beyond government, the development process is enriched by contributions of the Timor-Leste Chamber of Commerce and Industry, which is a recognized voice of business in processes involving government and international organisations.

Thus overall, the current institutional arrangements recognize the potential role of both private sector and development partners in financing priority projects and mandate different ministries and agencies to effectively deliver government's policies related to each type of finance. Though there is no lead institution or a formalized system for coordination across all financing policies with overall accountability toward the national development plan and the SDGs. Presently the development and implementation of different aspects of finance policy seem to be fragmented, e.g., there is no mechanism for coordination between infrastructure development planning and budgeting with efforts aimed at proactive targeting private investments or improving private sector enabling environment (for details see sections on financing policies below). A centralized leadership in development finance is needed to ensure coherency in mobilisation and use of all types of financing and to promote alignment and address synergies, trade-offs and competing priorities of different types of flows in relation to their contributions to development outcomes (see a recommendation on establishment of an integrated financing strategy in Roadmap section below).

### **Considerations for policymakers – an overarching coordination mechanism that oversees planning, mobilisation and use of resources, including and beyond government finance.**

The concept of an integrated strategic approach to finance emphasizes the need for a long-term vision and strategy for development finance and a centralized coordination mechanism to realise it. It will be necessary to generate a consensus at the highest level of the State of Timor-Leste to identify an efficient institutional solution for the implementation of an integrated finance strategy, which will exceed the mandate of a single government institution. DFAs in the region concluded

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43 Decree-Law No. 35/2017, of November 21<sup>st</sup>, Organic Law of the VII Constitutional Government.

that one of the common approaches is to allocate the principal responsibility for the development finance reforms to a high-level executive office. This mechanism is to ensure both 'vertical' alignment between the overarching, longer-term policies and operational policies, and 'horizontal' alignment between operational policies focused on different themes or financing types, to avoid contradictions and ensure complementarity (refer to Figure 25). In Samoa, for instance, the Prime Minister leads the Cabinet Development Committee, and the Ministry of the Prime Minister plays a crucial role in strengthening the whole of government approach to planning, monitoring and implementation. In Indonesia, a dedicated Cabinet-level ministry coordinates planning and policy for economic affairs. Another approach used by other countries is to grant responsibility for financing task to the Ministry of Finance under a presidential (or PM) mandate. However, multiple coordination activities required by different programmes will not correspond to the direct mandate of the usual MoF directorates. The purpose of an integrated approach to finance is to mobilise and coordinate approaches toward the finance needed to realise the national sustainable development plan and its remit covers the economic, social and environmental dimensions of sustainable development. MoF also have a shorter outlook – 5 years, in line with the horizon of medium-term planning. A third option used in other contexts is for integrated financing to be overseen by a committee with responsibility for overseeing progress toward the national development plan or SDGs. In the Solomon Islands, for example, it is to be overseen by the National Development Strategy Implementation Oversight Committee; a permanent-secretary-level committee including all key ministries. In some other countries a cabinet sub-committee is fulfilling this role.

## Public finance policies

The revenue process is managed by a directorate general in the Ministry of Planning and Finance (MoPF). A fiscal reform commission (FRC) was established in August 2015 to improve government's ability to collect domestic revenues, as part of efforts to increase domestic revenue to 15% of non-oil GDP by 2020 to cover the operational costs of the government. The FRC strategy includes the introduction of new sources of revenue, including the introduction of Value Added Tax expected in 2019, optimization of expenditure, and an improved collection and administration of Personal Income Tax, Business Tax and customs duties. The commission has five guiding principles: economic efficiency, fairness and equity, a level playing field, administrative simplicity and international compatibility. Overall results achieved so far are significant, including formulation and approval of new tax and customs policies and laws, set up of New Tax and Customs Authorities, introduction of new electronic customs clearance system and reform of audit functions. Yet, further improvement in fiscal consolidation will also require increasing efficiency of public expenditure and effective prioritization of investments.

The budget process is managed by the MoPF which is responsible for the creation and submission of the State Budget Law project proposal to the Council of Ministers (CoM), for approval before submission to the National Parliament. The Ministry is also responsible for budget execution. The current budget system allocates funds within an agreed fiscal envelope for a single year. Current budgeting process is aligned with planning through a comprehensive review of annual and sectoral plans (see below). Yet budget allocation and review for major capital projects is managed separately

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44 *Building Integrated National Financing Frameworks – a compendium of country experiences*, UNDP, 2017.

from the regular current budget process. Overall, there is no structured process for coordination of either current nor capital budgeting with medium-term fiscal planning, however reforms in this area are underway (see below).

The overall fiscal envelope is the total amount the State wants to spend within a budget year and is largely determined based on the national priorities in the Government's programme, non-oil revenue forecast and the ESI contribution from the Petroleum Fund<sup>45</sup>. The proposed overall envelope for the budget and ministerial envelopes are discussed during the budget workshop, known as "Budgeting Journey"<sup>46</sup> and subsequently approved by the final decision of the CoM. Yet, it should be noted that ministerial ceilings determined based on a binding resource envelope, include only current expenditure ceiling, the Infrastructure Fund budget ceiling is reviewed separately (see below).

UPMA reviews all annual action plans of the line ministries indicating their programmes and activities for the upcoming budget year to ensure they are aligned with the government's priorities and the SDP, later on annual action plans form the basis of the Budget Books 2/4a and 4b<sup>47</sup>. Once the fiscal envelope is agreed, the Directorate General of State Finances of the MoPF prepares a budget call circular summarising the government's strategy for the upcoming budget year which is distributed to all state institutions. The budget circular includes a request to submit budget proposals only for current type of expenditure and does not include neither capital project costs nor recurrent expenditure associated with capital projects. The Directorate General of State Finances and UPMA analyse budget proposals and prepare Green Briefs for each line ministry which include national priorities, current budget requests by programme, budget execution and results for the previous year, donors' commitments and recommendations for consideration by the Budget Review Committee (BRC)<sup>48</sup>. Capital projects are excluded from the above regular process of comprehensive analysis, review and recommendations to the BRC by MoPF and UPMA. The BRC reviews current budget proposals to ensure that the activities in the proposed submissions are aligned to the long-term national priorities and include the most important initiatives given the budget constraints. Further reviews by parliamentary commissions provide one more mechanism for ensuring alignment between annual budgets and long-term plans, as well as a space for input from civil society, business and other non-state actors.

To make it clear how the government strategy is carried out through the budget proposal or to effectively monitor the impact of government policy and spending, the government initiated a key reform to structure the planning process around programmes. Programme classification was introduced to link the programmes to the outcomes and overall vision of the SDP and relevant sectoral plans. The Decree Law 22/2015, of July 8<sup>th</sup>, on Planning, Budgeting, Monitoring and Evaluation established UPMA within the Prime-Minister's Office. UPMA has been supporting line ministries in implementation of programme budgeting approach which meant shifting from the current system of input-based budgets to results-based planning and monitoring. UPMA with technical support

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45 Considerable excess withdrawals from the Fund to finance major infrastructure projects were approved during the last four years on the basis of their expected contribution to the economic growth in the medium-term.

46 The workshop is held in late April and is attended by ministers, other senior civil servants and members of Parliament.

47 Budget Book 2 covers the Annual Plans, including the appropriations by programme, sub-programme and activity, while Budget Book 4 covers expenditure by entity, division and line item (economic category and purpose).

48 The Budget Review Committee includes the Prime Minister, Minister of Finance and other senior designated by the Council of Ministers.

and expertise from OECD developed a Budgetary Governance Reform Roadmap for Timor-Leste to envisage continuation of programme budgeting activities as one of the priorities. The latter lays out a strategy to strengthen the links across planning, budgeting and monitoring and accountability on a medium-term planning basis, to assist the government to establish more defined and targeted levels of responsibilities, introduce medium-term budgeting and identify priorities in an organised structure within a sustainable fiscal framework.

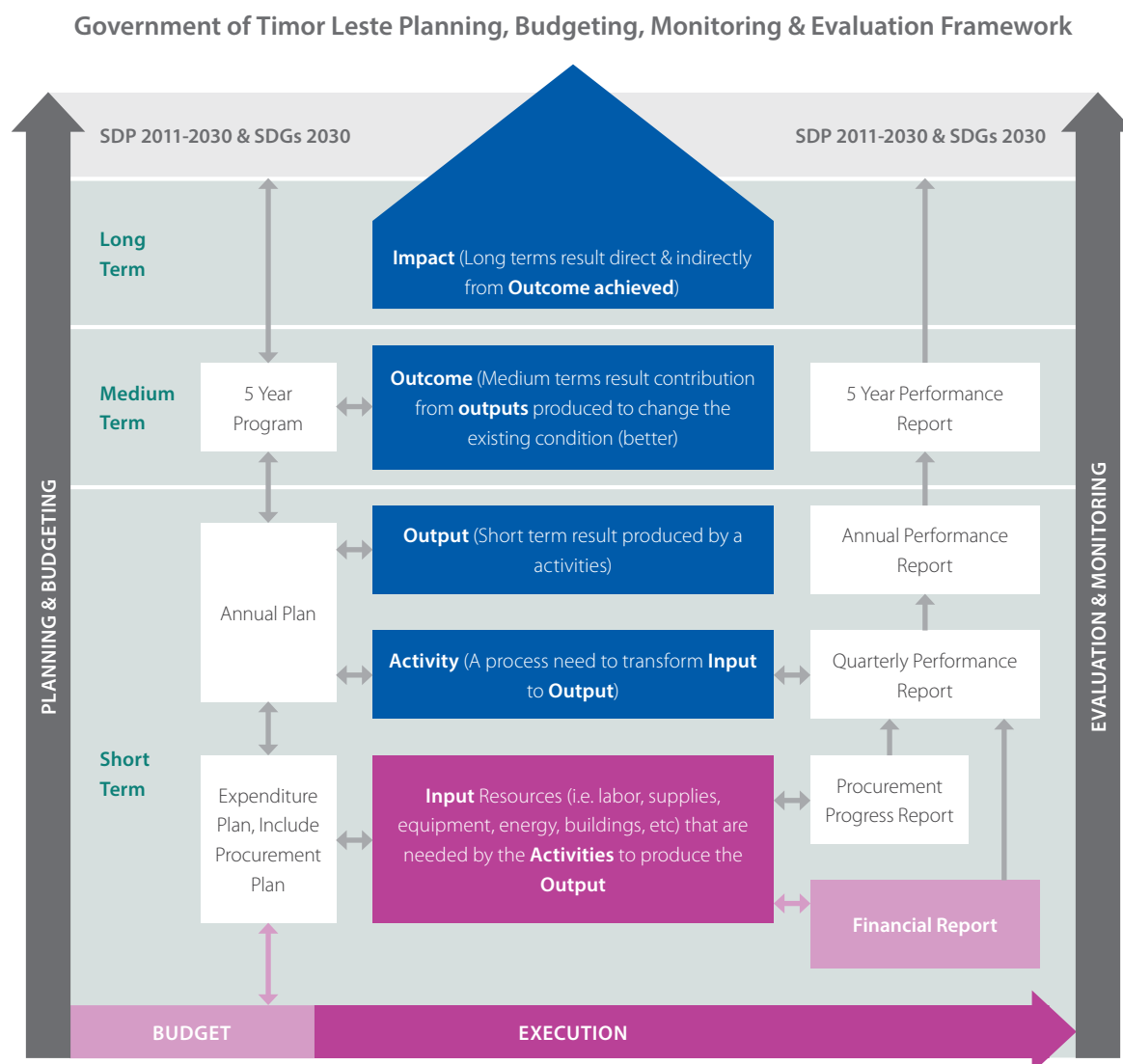
As a result of programme budgeting phase 1, programme structure was developed for ten line ministries and fifteen autonomous agencies<sup>49</sup> and presented for the first time in 2017 recurrent budget. 83 programmes across 25 entities were presented in the Budget Book 2 alongside with regular financial line item submissions contained in Books 4a and 4b of the budget. Since the beginning of 2017 UPMA has started implementation of programme budgeting phase 2 and has worked with all government entities that were not in the framework of Phase 1 and also focused to improve the programme budgeting structure for the Phase 1 entities. As reported by UPMA, the programme budget structures have been improved to enhance the link between programmes structures and SDP outcomes and outputs and clear and measurable indicators. The full annual budget for 2019 or 2020 (upon the establishment of the 8th Constitutional Government and the decision to merge Budget Books 2 and 4) will be based on programme budgeting classifications across the whole government. Yet, at present, the programme structure remains “presentational” and does not yet provide the basis for allocation of budget resources based on policy assessment and programmes prioritisation. Parliament discusses and approves the budget at the level of traditional economic category/line item by administrative divisions presented in Books 4a and 4b. Accordingly, government authorises approved appropriations of funds at financial line item level which, as mentioned through stakeholder interviews, provides a discretion for the ministries to move funds between programme areas.

The overall model of an integrated system for planning, budgeting, monitoring and evaluation that links these processes to the medium and long-term visions of the country is planned to be established in a web-based information system “Dalan ba Futuru Timor-Leste” (Road to the Future) as described in Figure 26.

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49 The initial group of government entities was selected based on their responsibility for key public service delivery (health, education, etc.). UPMA worked in collaboration with line ministries and agencies by producing clear guidelines and comprehensive framework and providing training on how to develop programme structure, costing, monitoring and evaluation.

**Figure 26. Integrated planning, budgeting, monitoring and evaluation in Dalan ba Futuru**



Source: UPMA

Although an effective medium-term budgeting process is yet to be in place, some foundations of medium-term budgeting exist in the current budgeting process. The State Budget presents estimates for the upcoming budget year along with estimates for the four outer years. Forecast expenditure estimates are based on categories of economic classification and represent a simple extrapolation of figures from previous year taking into account an annual increase in line with inflation forecast for recurrent spending and forecasts formulated by the Mega Projects Secretariat (MPS) for capital expenditure. As for revenue estimates, tax and non-tax revenue is projected by MoPF based on an annual increase in line with economic growth forecast (non-oil GDP) with adjustment for the expected effects of ongoing tax and customs reforms by Fiscal Reform Commission for the tax component and improvement and reinforcement of collection mechanisms in line ministries – for fees and charges.

The expected inflows from the PF comprise of two types of transfers to the budget – ESI and excess withdrawals – with the first set as 3% of the total petroleum wealth according to the PF Law and the latter together with external borrowing estimates set to underpin the projected capital expenditure and close the gap between the projected total government expenditure and domestic revenue estimate.

Effective medium-term budgeting complementary to programme budgeting, one of the key aspects of the government's budgetary governance reform, will allow greater alignment between long-term planning and budgeting processes. For that relevant improvements will be needed to medium and short-term plans and their costing, which should provide sound programmes that propose clearly defined objectives, performance indicators and prioritised costs. At the time of DFA report writing, UPMA and the MoPF have initiated formulation of a policy paper which will provide a framework to introduce a Medium-Term Expenditure Framework (MTEF) in Timor-Leste and a mechanism for implementation of rolling forward estimates. The MTEF formulation will be designed to provide forward estimates for each programme of the second phase of the SDP and relevant SDGs and aligned to the 5-year term of the coming government. Within the framework of MTEF the MoPF will also develop a mid-term resource envelope within a sustainable fiscal strategy.

Medium-term budgeting will support more effective alignment of public finance policies and spending to the SDP. It can strengthen the links between the objectives of short and medium-term spending and programmes with the longer-term objectives targeted in the SDP, for example with indicators that are aligned and intermediate targets that build cumulatively toward the SDP targets. By strengthening the link between the budget and the SDP, it can also support efforts toward a more integrated, holistic approach to financing overall. An integrated approach like that proposed above (see also recommendations below) would be built around an understanding of the types of investments that need to be mobilized to achieve the SDP and the ways that different public and private financing can fund investments in the SDP. Stronger, more results-focused links between public finance and the SDP is a central aspect to this and can help to identify and address the synergies between public finance policies (State budgets) and other financing policies at all levels. For example, as a means for maximizing the impact of public resources and stimulating economic growth in priority sectors, capital and recurrent public investments and spending can be effectively coordinated and aligned with development of private sector investment policies promoting private commercial investment as well as changes in regulations and policies addressing challenges in doing business (utilities, customs, etc.).

In the case of capital investments, Infrastructure Fund (IF) is the main fund and a key mechanism for implementing the frontloading policy. It manages major capital projects with a budget of over \$1 mln per infrastructure project. The IF was established in 2011 and is the main centralized governmental instrument to facilitate and provide financial resources for infrastructure development of the country through public funds and other alternative financing mechanisms, including external loans and PPPs. In 2016, IF was transformed into Autonomous Fund with the intention to protect investment budget for key infrastructure projects by being able to retain unused funds and automatically carry them over to succeeding years. The IF ceiling is decided based on the historical execution capacity of the line ministries who are the actual owners and the competent managers of all capital projects. The annual IF budget consists of ongoing contributions to the capital projects approved in the past and the list of new projects proposed for funding by line ministries and selected based on evaluation performed by the Major Projects Secretariat of the Ministry of Development and Institutional Reform (MPS). The objective of project appraisal is to prioritise and select capital projects using a unified

appraisal methodology<sup>50</sup> based on considerations of their support for growth in key sectors of the SDP, economic and social impact, and readiness for implementation. Based on recommendation from MPS, the Council of Administration of the Infrastructure Fund (CAFI)<sup>51</sup> makes final decision about investment projects selection and prioritization. The BRC makes assessment of the IF annual budget for alignment of selected new capital projects with the government's policy priorities and makes final consideration about budget funding. Central oversight of investment planning and scrutiny of all capital projects using a standard project appraisal procedure are positive aspects of the overall investment planning. However comprehensive review and synchronized reconciliation of budget proposals for both current spending programmes and capital projects with annual and sectoral plans and programmes could enhance the mechanism for allocation of resources around strategic priorities and government policies designed to realise them as well as provide consistency with overall fiscal objectives. This could also facilitate a stronger balance between capital and recurrent expenditures, including operation and maintenance costs, associated with investment projects.

While there are broad criteria for capital projects appraisal, international assessments in the area of capital investments in Timor-Leste indicate that there are no indications that capital project proposals are systematically subject to a cost-benefit analysis and risk assessment. As mentioned above, the evaluation by MPS represents a combination of appraisal and selection reviews, but there are no standard criteria for project selection. Quality decision making and policies in the area of core infrastructure investment should be informed by rigorous cost-benefit analysis conducted to international standards and involving all stages of the project cycle, from pre-selection, to mid-term review and post-project review. This information on capital project meeting certain standards for economic and social returns should be used for further decisions on inclusion in the budget and on the basis of the aggregate resource planning.

As noted through DFA interviews, there is currently no requirement for ministries to plan for or monitor progress on the impact of their infrastructure projects. Capital projects post-assessment evaluation and monitoring framework is another area in which reform is ongoing and a new guideline is being developed to require ministries to develop and monitor their projects in this way. The MPS is also planning to increase its capacity for monitoring and evaluation in order to support ministries with this process.

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50 The appraisal methodology is based on two key elements for project scoring and evaluation: importance for development and readiness for funding and uses a set of 8 multiple criteria for evaluation, including: (i) relation of the project or the project's sector to the Strategic Development Plan; (ii) economic impact as measured by the economic internal rate of return (iii) and effectiveness of investment; (iv) social impact as direct number of new jobs and indirect number of benefited population; (v) readiness for implementation as measured by required environmental license and other documents; (vi) dependence of the project on additional infrastructure for reasonable cost, (vii) readiness of the project for construction and availability of required documents such as concept design, feasibility study, detailed engineering design and other related documents, (viii) readiness of land for the project in terms of land availability for construction and assessment of requirements of possible resettlement under the project. Source: Budget Book 3A, 2017.

51 With technical and administrative support from MPS, CAFI is overall responsible for centralized infrastructure planning, budgeting and payment execution. It is composed of the Minister of Development and Institutional Reform, Minister of Finance and Minister of Public Works. Implementation of projects funded by IF involves also the National Development Agency (AND) and the National Procurement Commission (NPC). AND is responsible for technical verification, quality control and quality assurance inspection of the projects before payment recommendations and for review of design study and tender documentation before their submission to NPC. NPC's responsibility falls over procurement procedures and control. Source: Decree Law no. 13/2016, of May 8<sup>th</sup>, which regulates the Infrastructure Fund.



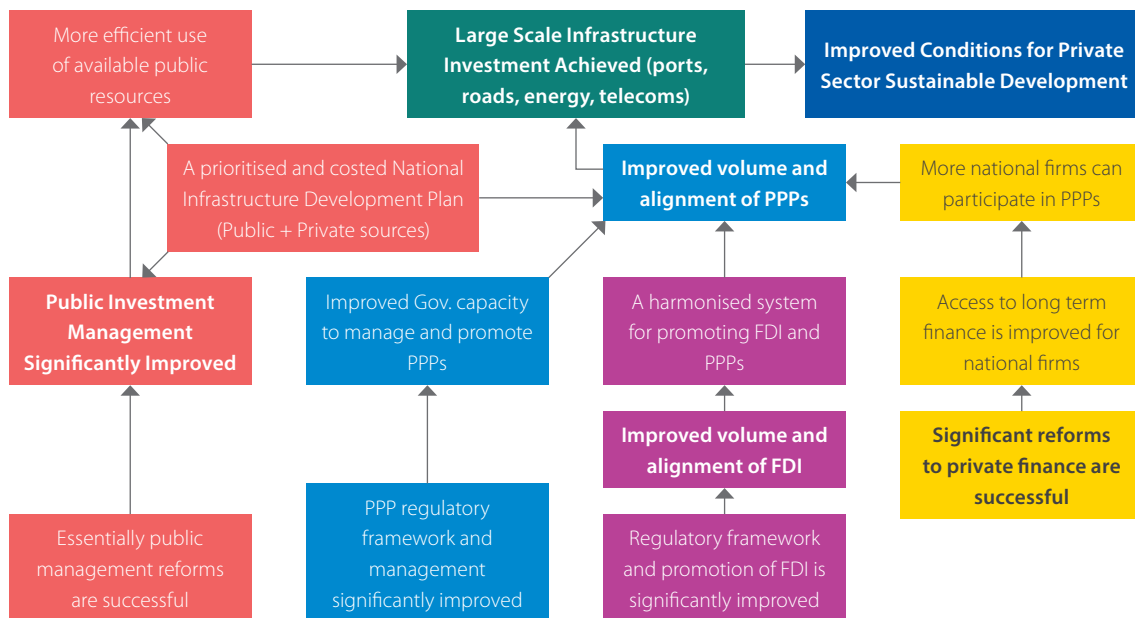
There is potential to address some of these challenges with infrastructure investment through a dedicated infrastructure investment strategy. It could bring together the IF with other modalities for financing infrastructure, establishing clear objectives linked to the goals of the frontloading policy and the SDP for developing infrastructure that promotes economic transformation.

### *Considerations for policymakers – infrastructure financing*

There is a need for significant investment in infrastructure in order to meet the infrastructure needs implied by the SDP. Infrastructure – including power and water supply, roads and bridges, airports, ports– will be a critical enabler of progress toward the economic and other objectives of the SDP. The major mechanism for investment in infrastructure is the Infrastructure Fund. This is financed from the Petroleum Fund for a significant proportion of the annual budget. External loans and PPPs are also being used to finance a limited number of large infrastructure projects, with the first being mainly focused on rehabilitation of regional and national roads. The need to mobilise finance for investment in infrastructure is a common challenge for many countries in the region and beyond. Some countries are developing more integrated approaches to mobilizing infrastructure finance in ways that incorporate a mix of public and private instruments.

**Indonesia** has developed an integrated policy to meet its finance needs (Figure 27). This was a key part of wider reforms that included the removal of costly fuel subsidies (creating an estimated US\$16 billion in fiscal space) and the development of an Infrastructure Sector Development Plan. The plan brought together various reforms designed to both increase and improve investment in infrastructure. With greater fiscal space, there was room for an increase in public investment in infrastructure. Investments were also made to improve public investment management, investing in institutional reform and giving the executive more direct oversight over the implementation of the Plan. Yet public investment was designed to account for only 40% of total finance, with private finance accounting for the majority. A number of mechanisms were deployed and expanded to mobilise this finance. PPPs were seen as a key instrument to mobilise finance from private sector actors as well as Multilateral Development Banks and bilateral institutions. Several reforms were implemented to promote FDI in infrastructure PPPs, including the loosening of regulations in areas such as foreign ownership limits, the development of one-stop integrated services and reforms to move certain permit applications online. A portfolio of large infrastructure PPPs was prepared and promoted. Reforms were also implemented in state owned finance institutions, boosting their access to international credit, increasing capitalization and encouraging increased access to finance for local SMEs to boost participation in small scale PPPs.

**Figure 27. Integrated policy to promote Infrastructure finance in Indonesia**



Source: *Building Integrated National Financing Frameworks – a compendium of country experiences*, UNDP, 2017.

In this way Indonesia planned to significantly boost investment in infrastructure by combining a range of public and private instruments into a single integrated financing strategy.

A number of aspects of the Indonesian approach could be considered for application in **the Timorese context**. While there is significant investment in infrastructure through the IF, there is no overarching infrastructure strategy that outlines strategic infrastructure priorities and ties the investments made to the priorities of the SDP, both economic and social. In a manner similar to the Indonesian approach, there is potential for different funding mechanisms – the PPPs, borrowing with Development Partners and Multilateral Development Banks and FDI in infrastructure – to be brought together in an integrated infrastructure investment strategy. An integrated approach to infrastructure financing could be built on an initial framework which MPS currently uses to determine potential sources of finance depending on the nature of an infrastructure project<sup>52</sup>:

- Basic infrastructure (e.g. power, roads, water systems, etc.) to be financed by public sources or external borrowing (only concessional modality);
- Economic infrastructure with potentially higher financial return – to be financed with public resources (if the scale is small or medium) and further considered for financing through PPP arrangement (if the scale is large);
- Social infrastructure (public schools, hospitals, etc.) with potentially lower financial return – financed with public sources.

52 IF regulation does not specify clear criteria for identification of capital projects to be financed by concessional loans and PPP arrangements, MPS noted during the DFA interview that in terms of different sources of finance it considers the above three potential categories of projects.

The current legal framework on PPPs<sup>53</sup> in Timor-Leste provides a comprehensive overview of the government's approach to PPPs' identification, assessment, procurement and operation. This includes principles and instruments for establishing partnerships between the government and private entities, including the key principle for risk sharing between the state and the private partner. The PPP process is overseen by Public-Private Partnership & Loans Unit of the MoPF (PPPL) that is responsible for application of PPP law provisions through the project cycle and provision of technical support to CAFI, through MPS. The law requires that all PPP projects undergo both a pre-feasibility study and a full feasibility study, as well as risk analysis and financial and legal studies before proceeding to procurement and development phases. It also ensures that the financial feasibility study includes detailed forecast of future payments and receipts for the term of the project and evaluation of the impact of PPP agreements on the budget deficit and public debt impact.

Financing through public debt is undertaken in accordance with the Public Debt Law no. 13/2011, of September 28<sup>th</sup>, which establishes the principles of rigor and efficiency in establishment, issuance and management of public debt. The law specifies that recourse to borrowing must be implemented only for the purpose of strategic investments, such as construction of strategic infrastructures for the country's development.

PPPs and external borrowing are being used on a relatively small scale to finance infrastructure, but could be expanded and used more systematically within a strong overall structure. There may be potential to explore PPPs covering both the initial financing and construction of infrastructure as well as its ongoing operations and maintenance – particularly in areas where infrastructure budgets execution is currently low. There is also the potential to develop and more actively market investment opportunities in a pipeline of infrastructure projects.

An integrated approach to financing infrastructure could be developed to bring together a range of different finance sources and establish policy mechanisms to encourage their use in the most appropriate aspects of infrastructure. It would build directly on the SDP and the infrastructure needs that it articulates and implies, while also helping to formalize and focus the frontloading policy. It would act as a mechanism for prioritizing investments and determining the most appropriate modalities for their establishment and ongoing maintenance (see roadmap / recommendations for more details).

### *Considerations for policymakers – social sectors financing*

The country's demographics is a defining feature of this period in Timor-Leste's history – with a projected 40% growth in the working age population by 2030, investments in human capital – particularly in education, training, healthcare and nutrition will have a significant impact on the society and the economy in the long-term. There is a need to increase investments in human capital and basic service delivery. As mentioned above, there are concerns related to the scale of the investment and infrastructure budget relative to health and education actual spending. This is furthered by the likely trends in development cooperation, which is an important funder in many areas of social expenditure, but is likely to fall in volume over time. As Timor-Leste continues its progression towards development, there is a need to effectively allocate available resources across priority goals of the SDP and the strategy for implementing the SDGs as well as mobilise new sources of finance to fund human capital and social

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53 The Decree-Law no. 42/2012 on Legal Regime on Public-Private Partnerships and the Decree-Law no. 08/2014 on Regulating the Legal Regime on Public-Private Partnerships.

programmes, if the government is to avoid scaling back of public services, but achieve its medium and long term goals on human capital development. Some countries around the world are exploring different options related to mobilization of new sources of domestic revenue to finance important investments. The Philippines provides a successful example of how earmarking domestic revenue generated from a 'sin tax' can be used to expand health coverage and how effective coalitions with civil society and community organisations can help to communicate and build buy-in to the reform package (see Box 2 below). The government of Timor-Leste could explore options for introducing a similar approach to mobilise new resources for a specific objective. This DFA recommends to consider establishing a sin tax to finance investment in health (see roadmap / recommendations for more details).

### **Box 2. Sin Tax in the Philippines**

In 2012 the Philippines passed a Sin Tax Reform bill designed both to reduce consumption of alcohol and tobacco products that are harmful to health and provide additional resources to fund service delivery including the implementation of the Philippine Universal Health Care programme.

The tax reform was designed within a context in which an average 240 Filipinos died every day as a result of smoking related diseases and in which key health programmes lacked the resources to reach the poorest and most vulnerable populations.<sup>54</sup>

The reforms have had immediate successes. The legislation governing the sin tax states that 85 percent of revenue generated will be allocated toward health spending while the remaining 15 percent toward programmes to help tobacco farmers and workers find alternative livelihoods.<sup>55</sup> Within the first year the sin tax raised US\$1.2 billion for health spending, funding health care for around 45 million Filipinos.<sup>56</sup> In 2017 this had risen to around US\$1.8 billion. Eighty percent of the health funding goes toward the provision of universal health care while 20 percent goes to medical assistance and the health enhancement facilities programme.<sup>57</sup>

Globally there is a large body of evidence on the impact of taxes designed to increase the cost of products such as tobacco that are harmful for health. Cross-country evidence shows that a 50 percent increase in the cost of cigarettes typically leads to a 20 percent decline in consumption.<sup>58</sup>

Advice from the World Bank based on experiences around the world highlights a number of key considerations in designing tax reform regarding tobacco, although many of these lessons could also apply to reform in other areas of taxation. It finds that countries are most successful when they focus on the health gains first and consider revenue benefits as an important secondary concern. This allows for careful design that reduces affordability of tobacco (as opposed to a slight price increase insignificant enough to alter behaviour on a large scale) combined with a prominent communication campaign designed to inform consumers of the changes and rationale behind them. Earmarking revenues for important investments or services, as in the case of the Philippines, can be a powerful mechanism for engendering public buy-in to the changes. And finally, as in the experience of the Philippines, building broad-based coalitions with actors such as civil society and community organisations can help to communicate and build buy-in to the reform package.<sup>59</sup>

54 WHO, 2015, "Sin tax" expands health coverage in the Philippines. Available at: <http://www.who.int/features/2015/ncd-philippines/en/>. Accessed May 2018.

55 UNDP, 2017, Philippines DFA: Financing the SDGs in the Philippines – using an integrated national financing framework to link resources to results.

56 WHO, 2015, "Sin tax" expands health coverage in the Philippines. Available at: <http://www.who.int/features/2015/ncd-philippines/en/>. Accessed May 2018.

57 Philippines Department of Health, 2017, Sin Tax Law – Incremental revenue for health, 2017 annual report.

58 World Bank, 2018, Tobacco tax reform: at the crossroads of health and development. Available at: <https://openknowledge.worldbank.org/handle/10986/28494>

59 Ibid.

## Summary

- The government's approach to financing overall is rooted in the SDP, which sets a clear long-term direction for the country's development path and has wide buy-in across government, communities, business, civil society and development partners. Direction over how this is to be financed is partially in place in the SDP, though there is room to develop more comprehensive guidance through an integrated financing strategy. There is a need for a further forward-looking guidance on the scale and contributions that different types of resources – public, private, domestic, international – can make toward implementation of the SDP and SDGs. This could provide guidance on how to address the synergies, trade-offs and competing priorities that exist between different aspects of financing and clear objectives for financing policies as well as, most importantly, stimulate and guide prioritization or adjustments within the country's planning.
- Overall, the current institutional arrangements recognize the potential role of both private sector and development partners in financing priority projects and mandate different ministries and agencies to effectively deliver government's policies related to each type of finance. Though there is no lead institution or a formalized system for coordination across all financing policies with overall accountability toward the national development plan and the SDGs. An integrated financing strategy should be developed and overseen by an appropriate coordinating body as part of the existing systems designed to manage the implementation of the SDP and SDGs.
- Although SDP broadly refers to the envisaged priorities and roles for mobilizing resources across different types of financing, it does not estimate the cost of interventions in different areas of development nor it provides quantitative benchmarks for the scale of financing it aims to mobilise. To analyse the financial capacity and financing priorities for achieving the SDP goals it is important to understand the nature and scale of investments that will be needed. Costing of priority interventions are needed so that targets for mobilising different types of resources can be established and efforts monitored against them. The example from Bangladesh shows how estimating costs can provide targets and strategic guidance on which operational policies can be based.
- An important consideration for the development of a strategic vision for the use of public funding is continuous improvement in the quality of public investment finance. There is room to further enhance the mechanisms for selection and prioritization of investment projects around strategic priorities and government policies designed to realise them. There is a need to consider a systematic approach to capital and current expenditure budgeting for the effective recognition of administrative and maintenance costs of capital projects and to improve appraisal and risk assessment standards and prioritization of infrastructure using uniform selection criteria tied with SDP priorities and on the basis of the aggregate resource planning.
- To date substantial infrastructure investments have been made in line with the frontloading policy and the government is committed to continue addressing infrastructure deficiencies and expand capital spending in the following years. Infrastructure development was mainly funded through transfers from the PF. Concessional loans and PPP modalities were also used to finance a limited number of large infrastructure projects with the first mainly focusing on rehabilitation of regional and national roads. There is also room to further explore possible PPPs in infrastructure development of the country. There is an opportunity to develop an overarching infrastructure investment strategy bringing together a range of different finance sources and establishing policy mechanisms to encourage their use in the most appropriate aspects of infrastructure. It could act as

a mechanism for prioritizing investments and determining the most appropriate modalities for their establishment and ongoing maintenance. It could support more efficient investment in this key area of the SDP, while also supporting a more focused, formalized frontloading policy.

- Another important aspect to be taken into consideration is systematic dialogue between government and key stakeholders – including development partners, private sector and civil society. Currently the TL Development Partners annual and quarterly meetings provide an effective basis for a regular dialogue on cooperation with development partners, yet an official platform is needed for multi-stakeholder dialogue to discuss the role of all non-state actors in both the overall sustainable development of the country and financing for its development. There is a need to establish stronger partnerships with actors from across society that contribute to the objectives of the SDP and raise awareness of the objectives, focus of the SDP, actions and investments needed.

### 3.3. Public-private collaboration

Achieving the vision of the SDP and SDGs requires investments and services from a range of public and private actors. A key objective of the frontloading policy is to use the resources that the country has to stimulate and expedite a transition to a sustainable, diversified economy and financing landscape in which the private sector is a key actor. Mobilising finance from actors beyond the government requires a policy and enabling environment that is conducive to sustainable, inclusive development of the private sector and civil society. It entails going beyond just stimulating growth in private investment, for example, to creating incentives that promote positive contributions to environmental sustainability and social progress. This requires a context in which there is effective collaboration between government and private stakeholders including dialogue on policy issues and active partnerships on specific projects. This dimension of the DFA looks at the context in which the private sector, development partners, NGOs, and other actors operate and invest resources. It looks at how the government creates incentives that encourage contributions from these flows that drive forward sustainable development outcomes. It analyses the nature of collaboration between public and private actors and opportunities and potential for deeper collaboration.

#### International public finance policy

Grants, including technical cooperation, have been the main type of external support to Timor-Leste since its independence, and will likely remain an important source of external assistance in the foreseeable future. While concessional loans and PPPs are the financing mechanisms that government plans to draw on in its strategic programming, most grants have been provided on a supply-side basis to finance projects executed by donors with their specific priorities and targets. The government recognizes that effective utilization of aid is imperative to achieving national priorities. It is a signatory to a number of international agreements acknowledging the importance of alignment of development assistance with the country's development vision as well as introduced its national aid policy aimed to ensure that aid is channeled through national systems and directed towards national priorities.

The Aid Management Effectiveness Policy of Timor-Leste published in March 2017 provides clear guidelines for planning, mobilization, implementation and monitoring of external aid in Timor-Leste and forms the basis for effective working partnerships with development partners. The policy is informed by the principles set forth in the New Deal for Engagement in Fragile States agreed in 2011



which outline a new global paradigm for international engagement in fragile states and is designed to accelerate its effectiveness through the promotion of inclusive country-owned and country-led pathways towards peace and resilience<sup>60</sup>. The Government of Timor-Leste and its Development Partners came to an agreement through the Dili Development Pact in 2011, establishing the SDP as the overarching framework for aligning future programmes and projects.

In practical terms, the line ministries as beneficiary institutions must ensure that SDP priorities and their operational plans form the basis of their identification of need for aid assistance. When planning and negotiating with development partners they are to promote the direct budget support modality. Budget support is the government's preferred method of development assistance and in line with the New Deal requires full alignment of government priorities, procedures, and systems. This modality is currently being followed by the European Union. To facilitate this modality, ministries are to establish the pre-conditions and fiduciary controls supporting budget support initiatives. The MoPF is overall responsible for compliance of development partnerships with planning, policy and financial considerations. On behalf of the MoPF, Development Partnership Management Unit (DPMU) in cooperation with the Ministry of Foreign Affairs and Cooperation and line ministries coordinates and follows up the process, from the first proposal through to the final grant agreement and submission to the CoM.

Development partners on their side are obliged through the national aid policy and international agreements to support the implementation of the national priorities and the SDGs and promote the New Deal principles in the formulation, implementation and monitoring of their country partnership strategies. Practical mechanisms providing the context for the implementation of this approach include: aligning aid priority programmes in a way to fit into the national programmes and sectoral development strategies in the design phase and monitoring of impact; increased use of government systems and procedures, including financial management, procurement and results monitoring/evaluation systems; leveraging the local CSO/NGO network to implement programmes; planning the reduced reliance on external Project Implementation Units (PIUs) integrating PIU functions into government institutions; annual reporting on the use of government systems, analyzing and reporting on progress, challenges and any exemptions from using such systems, etc. As mentioned by DPMU, DPs' use of country systems has improved in the past years, however according to donors' reporting it is still relatively low.

A range of forums and other mechanisms are utilized by all stakeholders to better inform harmonization of government and development partners' activities. These include bilateral meetings, development policy coordination mechanism<sup>61</sup>, Sector Working Groups and regular high-level forums for dialogue between the government and development partners. Annual Timor-Leste and Development Partners Meeting, with quarterly meetings in between, provide an opportunity to reflect on previous development successes and challenges and consider ways to strengthen and align future development activities.

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60 The New Deal represents the first aid architecture in history for conflict-affected states and features three interconnected pillars; five Peacebuilding and Statebuilding Goals (PSGs) and two guiding frameworks for implementation: (i) FOCUS, a new way of engaging (Fragility Assessment, One Vision One Plan, Compact, Use of PSGs to monitor, Support political dialogue and leadership) and (ii) TRUST, a set of commitments by donors and recipient countries alike (Transparency, Risk Sharing, Use and Strengthening Country Systems, Strengthening Capacities, Timely and Predictable Aid).

61 The Concept Paper on the Development Policy Coordination Mechanism was approved by the Council of Ministers in 2013 and provides framework for aligning ODA with nationally identified priorities.



The government is currently in the process of formulation of new national aid policy to further enhance harmonisation of aid priority programmes/activities with the government's processes and procedures to effectively support the implementation of the SDP and the SDGs. In this respect and in the view of the current falling external assistance trend and other challenges and opportunities discussed above, important considerations should be made in relation to the aid dependency vision of the country overall, especially in priority sectors, in line with the overall financing strategy of the country which will consider the scale of funding gaps and thus provide guidance for ODA financing policies and coordination. There is also scope to further strengthen mechanisms for better integration of donors' programmes with the national planning and resource allocation in line with the government's strategic priorities, to improve aid information predictability, and strengthen approach towards monitoring of impact in line with government set indicators. DPs have expressed their support for the New Deal principles and aid management and coordination efforts in Timor-Leste. Further progress could be achieved given improvements in human resources capacity, accountability and transparency and procurement reform by the government.

## Private finance policies

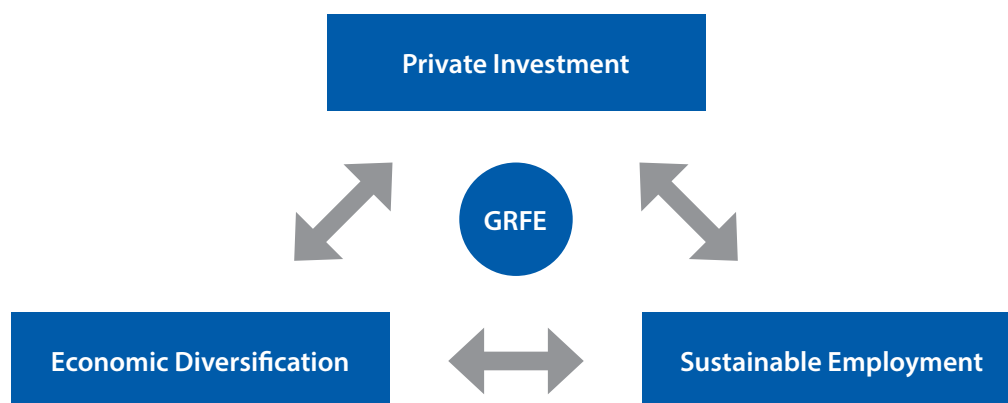
Private sector development is an important part of both the realisation of objectives within the priority sectors, and of the wider goals of long-term economic diversification and poverty reduction articulated in the SDP and targeted through the frontloading policy. Stimulating private sector development is critical for moving to a sustainable economic and financing model overall in the long term, once oil revenues have run out or declined significantly. This will require attracting greater volumes and diversity of private investment. As analysed in the financing trends section above, levels of private finance remain low and the country is yet to realise the kind of growth in private sector investment that can propel its medium to long-term objectives as articulated through the SDP and the frontloading policy. The resolution of certain outstanding constraints for businesses to start and operate more easily will be very important in this regard. These include, among others, improving the business enabling environment, improving the system of land titling and property rights registration, encouraging lending to small and medium businesses, easing the registration and licensing of businesses, etc. In order to prioritize and streamline the implementation of structural economic measures under the priority areas contemplated in the SDP and the government's Programme, the 6th Constitutional Government established a number of specific reform measures and actions under the Guide for Reform and Economic Growth for Timor-Leste 2015-2017 (GRFE). These measures included reforms in policies, laws and regulations, and sectoral and thematic strategies, across seven transversal interventions<sup>62</sup>, which among other included reform of the business environment and the private investment regime. The ultimate goal of the GRFE measures is transformational change in five priority economic pillars – three priority sectors as identified in the SDP (oil, agriculture and tourism) and two additional sectors (fisheries and manufacturing) as called to complete the model of the GRFE, given the potential of the latter 'as key complements to achieve the final goal of transforming the Timorese economy in a developed and competitive economy, led by private investment'.<sup>63</sup> The figure below illustrates how the GRFE is built on the foundations of the SDP by contributing to the economic vision with interventions having linkages between the SDP pillars of promoting private investment, economic diversification and poverty reduction through sustainable employment.

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62 Seven transversal interventions of GRFE include: 1) The Regulation of Land and Property, 2) Development of Economic Infrastructures, 3) Labour Regulation and Workforce Development, 4) Reform of Business Environment, 5) Tax Reform, 6) Reform of the System of Private Investment, 7) Reform and Development of the Private Sector.

63 P.9 of GRFE.

**Figure 28. Schematic summary of economic vision of the SDP 2011-2030, the government's Program and the GRFE**



Source: GRFE

This strategic economic policy was framed within the Programme of the 6th Constitutional Government and therefore adopted for a period of 2015-2017. It was led by the then Minister of State, Coordinator of Economic Affairs (MECAE)<sup>64</sup>, assuming the responsibility for oversight and coordination of the implementation of all policies in the areas of economic development and private sector development. A programme coinciding with the entire next government cycle or medium-term phase of the SDP will need to be considered to ensure continuity of the implementation of economic vision of the SDP and to assure that key challenges related to 'a rather unfavourable framework to encourage private investment, both domestic and foreign, so critical to the sustainability of the national economy' are being tackled in a sustainable manner.<sup>65</sup>

The alterations to the investment promotion regime under the GRFE resulted in the adoption of the new Private Investment Law in 2017<sup>66</sup> introducing more efficient investment procedures and giving preferential treatment to large investors, both foreign (minimum \$500,000) and national (minimum \$50,000), through a provision of an attractive package of incentives. The new investment law is aligned with the guidelines of the SDP for economic growth through development of priority sectors and special economic zones. With the new law, investors can apply for special benefits and conditions for projects through a Declaration of Benefits or Special Investment Agreement, including lease of state land up to 100 years, visas for specialized workers, and benefits for investing in development zones. Other terms of declaration of benefits, such as tax exemptions (0%) in incomes, sales, services tax and customs import duty for up to 10 years, can be granted to investors who present investment projects in the priority sectors of the GRFE (agriculture, forestry, fisheries, manufacturing and tourism).

64 In 2017, the mandate and functions of MECAE were transferred to the Ministry of Development and Institutional Reform.

65 P.7 of the GRFE.

66 Private Investment Law No.15/2017, of August 23<sup>rd</sup>.

The new Private Investment Law and the Private Investment Regulation<sup>67</sup> prescribes that the government entity responsible for the promotion, facilitation and monitoring of private investment and exports and also for issuing the declaration of benefits and negotiation of the special investment agreements is Trade-Invest Timor-Leste under the MDIR (TITL). The Institute of Support to the Entrepreneurial Development (IADE) is in charge of overseeing private sector development overall. And the Ministry of Commerce, Trade and Industry (MCTI) is the central agency mandated to coordinate the policy in the areas of economic, commercial and industrial activities and cooperatives sector.

New regulations demonstrate preferential treatment of private investments in priority sectors and development zones through a package of generous investment incentives conditional to the size of investment and its location. These investment schemes are aimed at reducing the costs and increasing the attractiveness for investors to invest in Timor-Leste. However the package of existing incentives could look to balance its role in reducing tax costs for businesses with other necessary business support measures. Critically, there is a need for careful use of tax breaks and tax holidays, which have a role in attracting new domestic and foreign investment, but have a negative impact on new tax revenues streams of the country in the medium to long term. Many governments introduce “sustainability-based” incentives that reward investment that contribute toward national development outcomes (job creation, training outcomes, environmental impact, etc.) to attract sustainable, inclusive private investment. Timor-Leste could consider exploring options for introducing similar approaches.

### *Considerations for policymakers – strengthen incentives for sustainable, inclusive private investment*

There is a clear need to attract increasing volumes of private sector investment that can drive growth in the industries targeted by the SDP. The frontloading policy has prioritized investment in infrastructure with the objective of stimulating economic transformation, though current levels of private investment remain low. A more coordinated approach that draws together efforts to improve the business environment and attract investment from across government and its partners may help to focus and align efforts. This could be developed through a national investment promotion strategy (see below).

To attract sustainable, inclusive private investment it is important to not only improve the economic attractiveness of this environment, but to develop an environment and incentives that promote sustainability and inclusiveness in investments. Many governments strengthen investment promotion measures to help draw out the wider benefits. Those measures, for example, include policies that help businesses manage their environmental impact or that provide targeted support to local SMEs that have the potential to grow and deepen value chains as international investors come in, through training, enhanced access to finance or other measures.

Policymakers use investment promotion incentives to attract particular types of investments, yet there are different ways to adapt and strengthen such schemes to further promote sustainable development outcomes from private sector investment. Incentive schemes which commonly incorporate initiatives such as tax breaks, preferential access to finance or even a transfer of resources can be conditional on firms meeting certain criteria; typically, these criteria are based on investment outputs that act as a proxy for outcomes that the government is trying to incentivise. For example, benefits may be given to

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67 Regulation of Procedures for Private Investment No. 2/2018.

firms that invest in a deprived region of the country with the hope that this will stimulate job creation, contribute to skills development and help reduce poverty rates.

The use of outcome-based contracting or ‘outcome-purchasing’ models of procurement has also been growing around the world. In these models a service or outcome is funded by government but the payment is not made until there is verification that the service has been delivered or the outcome has been achieved. It can be a powerful way to directly link government spending with the desired outcomes of a national development plan. It can also offer efficiencies, greater certainty about spending and the sharing of risk between government and partners.

However it should be noted that outcome based incentives packages will require having monitoring frameworks in place effectively linking financing investments / inputs to the outcomes of the national plans. With improvements in private sector reporting on outcomes in many contexts, many governments were able to identify opportunities where policies could more directly incentivize such outcomes<sup>68</sup>.

Within the ASEAN region, Cambodia’s Industrial Development Strategy 2015 aims to stimulate high levels of sustainable and inclusive growth, particularly in manufacturing and rural development, by bringing together a number of reforms that affect private sector development under a single policy; Thailand’s economic model puts economic goals alongside leaving no one behind and inequality-related targets, including tax incentives for investors in the 20 poorest regions of the country.

### *Considerations for policymakers – promoting social impact investment*

Social impact investment<sup>69</sup> offers potential to both provide sustainable models for investment and services in key areas of the SDP, and to act as a catalyst for progress among the wider business community. Policymakers around the region consider a range of options to help stimulate social impact investment and facilitating the transfer of its principles and practices to other ‘finance-only’ firms such as helping social impact businesses grow by offering targeted tax incentives, preferential access to credit and support capacity building, stimulate greater supply of capital for social impact businesses by providing early stage grant financing, establishing payment for outcome based models of contracting for government procurement, clarifying fiduciary rules and amending policy in related areas such as mandatory corporate social responsibility and other.<sup>70</sup>

This DFA considers that in the present context the starting point for Timor-Leste government would be to collaborate with the Development Partners that have experience in working with private investors in the industry, such as UNDP SDG impact fund<sup>71</sup> which mobilises institutional and

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68 Development finance assessment guidebook, UNDP, 2017.

69 Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments target a range of returns from below market to market rate, depending on investors’ strategic goals (<https://thegiin.org/tools/>). The growing impact investment market provides capital to address the world’s most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education. More information at: <http://www.undp.org/content/sdfinance/en/home/solutions/impact-investment.html>

70 Innovations for integrated financing, UNDP, 2018.

71 <http://undp.socialimpactfund/>

private investors to move grant-based projects to scalable market-based financing models. Another potential partner for collaboration is DFAT which has recently launched an Emerging Markets Impact Investment Fund supporting SMEs that generate positive social and development outcomes for poor communities in the region.<sup>72</sup>

## Sectoral policies

Using the matrix approach of the DFA, the following section considers sectoral policies that are critical for achieving the vision of the SDP. In particular, from the perspective of an overall financing framework it is important that priority sector plans in agriculture, tourism and manufacturing are built on the foundations of the SDP and long-term financing objectives of the country and establish strategies that cover the contributions that different financing types – public and private, domestic and international – can make toward long-term objectives.

### *Agriculture Sector*

The Agriculture Sector Strategic Plan 2014-2020 is a medium-term operational plan to guide stakeholders as they implement development interventions to achieve the objectives of reducing poverty, ensuring food and nutrition security, and promoting employment and economic growth in the agricultural sector. As such, Ministry of Agriculture and Fisheries' (MAF) Strategic Plan (SP) sets out a combination of legislation, policies, programs and projects across five mutually-reinforcing strategic objectives: (i) enhancing production and productivity; (ii) improving market access and value addition; (iii) creating an enabling environment; (iv) organizational strengthening; and (v) sustainable resource management.

As for the private sector in agriculture, the SP indicates areas (rural infrastructure development, transport, storage, manufacturing and processing, marketing, contract services and the supply of inputs) where private sector has a vital role to play in the development of agriculture. To facilitate the agricultural transformation process, the SP also focuses on creating enabling environment for private sector participation, facilitating public-private partnerships, and providing necessary skills and support. Yet, the plan does not provide a specific strategy for private sector development in agriculture.

As for financing, the SP proposes a development of a Five-Year Investment Plan (FYIP) which will be based on a Medium-Term Operational Plan (MTOP). The FYIP is supposed to guide the development of MAF's Annual Work Plans and Budgets. The aim of the FYIP is to ensure that costs of the planned activities are estimated accurately, and adequate funding support is allocated to ensure the provision of critical public goods and services to producer groups. The plan specifies that while every effort should be made to solicit more funding from government, MAF should identify innovative means to mobilize additional resources. In this respect, MAF is supposed to develop a resource mobilization strategy to be able to mobilize additional resources to facilitate the implementation of the SP and associated priorities and establish a mechanism for sustainable funding to reduce donor dependency for its operation. For the short and medium term, the plan specifies that funding possibilities will include annual government allocations, donor contributions, bilateral projects as well as non-tax revenues generated from MAF's goods and services. However, the strategy does not provide a

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72 See [https://foreignminister.gov.au/releases/Pages/2017/jb\\_mr\\_171114.aspx](https://foreignminister.gov.au/releases/Pages/2017/jb_mr_171114.aspx)

direction or guidance on mobilizing sustainable private finance to facilitate the implementation of strategic goals in agriculture.

Furthermore, the strategic plan underlines that although MAF is the responsible institute to develop rural sectors, support from other sectors (transport, water, health and education) through the close multi-sectoral inter-ministerial coordination with other line ministries is necessary to deliver the SDP. MAF has successfully founded the agricultural sectoral inter-ministerial working group, including the ministry of health and the MCTI, in addition to collaboration with development partners and civil society, however, engagement with the private sector is extremely limited.

The Agriculture SP sets specific sector production and other targets and results to be achieved from 2016-2020. It also specifies that a needs-based Monitoring and Evaluation (M&E) system will be developed and integrated into all stages of the plan implementation with progress in the programme-budgeting reform.

### *Tourism Sector*

The National Tourism Policy, titled as Growing Tourism to 2030, was developed by the Ministry of Tourism, and is an overarching policy framework with general principles (benchmarked against good international practices) placing tourism at the core of national socio-economic development and seeking collaboration from all stakeholders, including government, private sector and civil society, to work collectively towards development of the tourism sector. The objective of the policy is to position Timor-Leste as a location that offers a range of tourism experiences that take advantage of its natural beauty, culture and heritage. The tourism sector is considered as one of the main strategic priority areas supporting the economic development SDP pillar through job creation in the restaurant, accommodation and tourism related services, and poverty reduction pillar through the social inclusion of women and youth.

The tourism policy sets out specific targets to be achieved by 2030 related to aggregate job creation, gross value-added contribution and other sector output indicators. In terms of mechanism for collaboration with non-public actors, explicit proposals are provided regarding public and private partnerships, including a diverse portfolio of tourism products, from community based initiatives to foreign direct investment, and initiatives programs where managers act as mentors to entrepreneurs to encourage community-based ventures and knowledge sharing. However, the policy does not provide guidance on financing objectives covering contributions from different types of resources to develop the tourism sector and reach the target results set for 2030. It has also been noted through stakeholder interviews that challenges remain in the planning and coordination of government ministries implementing programs due to the lack of action-based medium-term strategy for tourism. There is no established mechanism for communication and dialogue between government and non-public actors, which means that feedback loop for policies and strategies is not provided.

### *Industrial and Manufacturing Sector*

Industrial Policy of Timor-Leste is being developed by the Ministry of Commerce and Industry at the time of writing. The policy will be mainly aimed at: achieving the economic growth rates as outlined in SDP; making industrialization the engine for growth of strategic sectors (agriculture, mining, tourism and construction); stimulating resource-based industrialization gradually shifting to non-resource-

based; developing new industries in manufacturing, etc. It is not yet known whether the policy will provide guidance on financing objectives covering contributions from different types of resources to develop the manufacturing industry.

## Coordination and collaboration

The analysis above shows that the government has established numerous sector plans and reform policies with the objective of promoting economic diversification, improving business environment and facilitating private investment as aligned with the SDP. Some are focused on improvements to the business environment in general while other target private sector growth and investment promotion in specific industries or geographic areas. While many aspects of the business environment are being addressed by these reforms, there are a number of additional steps that could be considered by government and partners to bolster proactive efforts to attract demand-driven investment in key industries. For more active international marketing of investment opportunities those could include the potential to host and participate in international investment forums, undertaking trade missions and building partnerships with outward investment agencies in countries that are or could be important sources of FDI, such as Australia, Singapore, Malaysia, Indonesia and Papua New Guinea.

One key consideration across all these reforms is coordination. Reforms and efforts to attract businesses are being undertaken by a large number of central and line ministries, government agencies, CCI-TL and development partners. However there is no central forum where these reforms can be aligned or coordinated. There exists no central operational strategy around which they are centred. Previously, efforts on contribution to economic development and promotion of national and foreign private investment among relevant entities and across agriculture, tourism and industrial sectors were coordinated by MECAE under the PM's Office and through the reform strategy outlined in the GRFE. However, the current political framework made these efforts appear to be fragmented and uncoordinated within the Government and at the operational level. There is potential for reforms to be coordinated and aligned for greater efficiency as part of an investment promotion initiative or strategy (see Roadmap). The risk otherwise is a fragmented overall approach that misses efficiencies which could be gained by aligning and focusing efforts in specific priority industries. Coordinating efforts and policies to develop incentives and proactively attract investment in priority sectors with efforts to address the challenges to doing business, including land reform, judicial reform, business registration and licensing, skills development could allow for an overall targeted effort to attract and stimulate private investment in key industries. For example, coordinating with IF would allow the development of infrastructure to support growth in particular industries / areas, with TradeInvest to promote particular investment opportunities, with financial institutions to promote financial literacy etc.

As for collaboration and coordination with private sector, NGOs and other actors the only institutional mechanism that government can use to engage in public-private dialogue and improve mutual understanding about priorities and challenges is the Chamber of Commerce and Industry of Timor-Leste (CCI-TL). Yet, concerns have been raised about the consistency and quality of that engagement between government and private actors. In the present situation, the government's engagement with the CCI-TL is limited to ad-hoc consultations on design of new policies and legislation as well as meetings facilitated on a demand-driven basis. Establishing regular forums or systematic platforms for communication with private sector and civil society is essential to strengthening coordination and trust between the government and domestic and international private sector representatives.



## Summary

- The SDP places central emphasis on growth in private investment as a means of transition to a diversified economy and a post-oil financing model overall and this provides the rationale for the policy of frontloading. The SDP identifies priority industries that have the potential for growth and which could drive forward the economy over the medium and long-term and create jobs and incomes for Timorese. Growth in agriculture, tourism and manufacturing will be driven by a growing stock of FDI, investments by new and established domestic businesses, including many SMEs. The SDP also recognizes the priority for MSMEs expansion and promotion of private domestic and foreign investments in priority industries to support job creation and poverty reduction as well as the need to involve private actors in financing the development of infrastructures through PPPs.
- Private commercial investment in Timor-Leste remains relatively low, and there are a number of elements of the business environment that contribute toward this context. Government has a number of ongoing initiatives to address those, including land reform, judicial reform, business registration and licensing, access to finance for MSMEs, skills development, etc. It has invested heavily in infrastructure in line with the frontloading policy. To promote private investment TITL issues the declaration of benefits and negotiates the special investment agreements with potential investors, MTCL coordinates the policy in the areas of commercial and industrial activities and cooperatives sector. Other reforms mentioned above are being led by MDIR, Ministry of Tourism, Ministry of Agriculture, Ministry of Public Works Transport and Telecommunication, Central Bank, Secretary of State for Youth and Employment and others.
- One key consideration across all these reforms and efforts being undertaken by a large number of central and line ministries, government agencies, private sector and development partners is coordination. Current efforts to attract businesses are fragmented and uncoordinated, there is no central forum where all above reforms can be aligned or coordinated. There exists no central operational strategy around which they are centred. Coordinating efforts and policies to develop incentives and proactively attract investment with efforts to address the challenges to doing business could allow for a well-coordinated, targeted effort to attract private investment in priority industries.
- New regulations demonstrate preferential treatment of private investments in priority sectors and special development zones as aligned with the SDP. However the package of current investment incentives among other measures for support includes generous tax breaks and holidays. Those have a role in attracting new domestic and foreign investment, but have a negative impact on new tax revenues streams of the country in the medium to long term. There is need for a careful use of tax breaks to balance with other support measures as well as strengthen the framework to promote inclusive, sustainable private investment.
- Underlying all this is a need for an investment promotion strategy that could coordinate a targeted effort to attract and stimulate private investment in key industries – agriculture, tourism, fisheries and manufacturing. This initiative would be managed by a core coordinating team including senior representatives from the ministries with responsibility for different aspects of the business environment and investment and exports promotion in key sectors as well as senior representatives of the private sector. Strengthening the policy and regulatory framework that promotes the wider benefits of investment to society and the environment, and mitigates the risks, would be another important component of such an initiative.

- One further important consideration is public-private dialogue and the need for a stable mechanism for continuous, constructive two-way communication between the government and private sector. Consistent dialogue with private sector on topics such as effectiveness and impact of government's policies and regulations aimed at improving business environment, effectiveness of current incentives schemes, identification and establishment of investment opportunities and development of demand-driven project pipelines could facilitate effective policy making in private sector development and promote investments.

### 3.4. Monitoring and review

Effective monitoring and review frameworks are a critical component of an integrated approach to financing. For public and private finance flows to contribute to sustainable development outcomes according to their specific characteristics requires planning, monitoring progress and adapting policies to promote and incentivise these contributions. Monitoring the direct and indirect outcomes that different flows contribute toward is the basis for understanding how the roles envisaged for them in plans and policies are playing out in practice. Monitoring systems provide valuable information for decisions about how to adapt policy design and incentives that enhance the positive contributions and mitigate the risks associated with particular forms of financing. Such monitoring extends to all aspects of a finance strategy, covering public and private finance flows and instruments.

The Government of Timor-Leste is committed to strengthening the linkage between planning, budgeting and monitoring in line with global best practices. Its long-term vision is to have an integrated system for planning, budgeting, monitoring and evaluation that strongly links these processes to the medium and long-term visions of the country. As mentioned in more detail earlier, a new Unit of Planning, Monitoring and Evaluation (UPMA) was established by the 6th Constitutional Government to lead the implementation of programme budgeting reform. To date the programme budget structures have been developed across all government entities to provide the link between programmes structures and SDP outcomes and outputs and performance indicators. The next step will be moving program budgeting towards a more results based approach. UPMA is currently in the process of clearly linking the program outcomes and sub-programs outputs to the SDP and SDG outcomes, identifying a set of key indicators that will become the annual and mid-term indicators, which will be set for the medium term with annual targets for annual planning monitoring. There is an opportunity to incorporate objectives related to mobilizing private investment in SDP outcomes in the indicators that are developed, linking them to the indicators within the SDP M&E framework (see recommendation below).

Programme-budgeting is a very useful tool for accountability on the performance and budget transparency of the public administration. Yet, it requires effective tools to measure the intended impact of the interventions, and this is therefore linked to the need to improve the data collection systems and use of data on progress toward SDP outcomes. With performance information, policymakers can make more informed budget decisions. Additional challenge would include improving the collection and use of data on financing (what is being invested, where and how) and other opportunities to link financing with outcomes. E.g., indicators linked to SDP and SDG-related outcomes should be incorporated in the monitoring framework of the IF capital projects.

As for development assistance, to better inform government's budgeting and monitoring processes the Aid Transparency Portal (ATP) established in 2011 tracks donors' programmes data and information.

In particular, donors are required to submit timely and accurate information on all their spending contributions, including actual disbursements and 3 to 5-year projections detailed at the activities level and by DPs, beneficiary institutions, sector, SDP pillars and sub-pillars. Information and data from the Aid Transparency Portal (ATP) form the basis for preparation of the Combined Sources Budget, which represents the combination of general state budget and external assistance provided by donors. However, future revenues from donors do not form part of the budget allocations and appropriations approved by the Parliament and presented in the general state budget (Budget Book 4). This is limiting the possibility for integrated planning of resources around strategic priorities. The development budget is presented separately in the Budget Book 5 and provides details about the donor funded projects. There is also a limitation related to the ability of donors to provide credible multi-year aid projections<sup>73</sup>. The absence of accurate information on donors' funding expectations for medium-term perspective will pose additional challenges to informing effective medium-term planning of the government and advancing toward medium-term budgeting. As for monitoring, when donors work directly with line ministries, those ministries report back on their overall results within their annual action plans review process, including for those joint programmes. However, currently with the help of ATP the government tracks development assistance spending, but there is a need to strengthen the approach towards monitoring of its outcome and impact. The existing ATP-based monitoring framework could be further strengthened to harmonise the data collected from development partners with government set indicators and integrate ODA in the scope of the regular budgeting process. This will support a more results-oriented approach to their mobilisation and use.

Effective measurement and monitoring of the outcomes that private sector actors contribute toward can support the establishment of an integrated approach to planning and monitoring government's efforts in mobilizing necessary resources and the results that such resources contribute to. The Philippines is in the process of introducing a system of targets and indicators in its medium-term development plan to monitor government's efforts in mobilising private sector resources and the outputs and impact that this financing contribute to (see **Box 4. Monitoring framework linking financing-related targets to national development outcomes in Philippines** with example on monitoring framework in Philippines). As mentioned above (see section on public-private collaboration), private sector investment results-based monitoring can also offer significant potential to inform more targeted policy design and dialogue with private sector actors as well as support in moves toward more sustainable, inclusive investment outcomes. However, in the present context the framework for monitoring of private financing in Timor-Leste is limited to the analysis of data on aggregate fixed capital spending by private corporations collected and published within the framework of National Accounts compilation. Stakeholders mention that apart from the national statistical systems, there are no other separate systems or mechanisms maintained officially by any other stakeholders to track private investment and spending. It is not possible to measure the outcomes of private investments and spending.

There are also certain weaknesses in the data sourced from the national system. For example, as the analysis of financing landscape was compiled, the DFA technical team came up against a number of limitations in the data on private sector investments. The main proxies for private sector investments are gross fixed capital formation and data on credit outstanding. Data on gross fixed capital formation

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73 As reported by donors, this happens due to a combination of reasons, such as single year budget cycles on many of the donors' projects, misreporting, or cautious reporting by some of the donors.

by private corporations from the National Accounts could not be disaggregated neither by domestic and foreign, nor by business size groups, the same constraint was encountered with data on banking sector lending from the Central Bank. The national statistical systems could be further improved by adapting survey questions to incorporate more detail on financing by private actors and enable clearer links between financing and measurement of outcomes or incorporate tracking of expenditure on cross-cutting issues. Those changes should be accompanied with the appropriate capacity building in compiling and analyzing statistics.

In a number of other countries in the Pacific and wider Asia-Pacific region, private actors are voluntarily developing their own systems collating information about the contributions towards national development objectives and SDGs by private firms (see the Papua New Guinea example in the **Box 3. SDGs Dashboard in Papua New Guinea** 3). The Business Council in Papua New Guinea, a private sector organisation, has launched an SDGs dashboard that incorporates information about the contributions that private firms are making toward the SDGs. It aims to facilitate stronger dialogue with government about reforms that affect businesses in the country. Such an initiative of voluntarily led reporting in Timor-Leste could be supported by development partners or under the leadership of CCI-TL (see a recommendation in Roadmap section below).

Other examples across the region for effective monitoring of private financing and outcomes include strengthening capacity and norms for private sector reporting, such as raising awareness of the benefits of sustainability reporting, partnering with champions who can build norms and standards, and building technical capacity among firms to undertake sustainability reporting. This may also be supported through collaboration with actors such as CCI-TL or development partners.

The creation of a framework for private sector reporting can lead onto a number of benefits for both private sector actors themselves and for public policy. It is conducive to more effective public-private dialogue and can help businesses better communicate the challenges they face to government. It can inform more targeted, nuanced policy toward private finance as governments are better informed about the types of outcomes that can be realized with different types of support, as well as more targeted interventions that mitigate the risks of private sector development. In some contexts established private sector outcome monitoring systems can support businesses' ability to attract international investment and formed the basis for moving toward more outcome-focused private sector policy in areas such as investment incentive schemes.

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74 For example in Thailand many companies produce sustainability reports which have been promoted by the stock exchange to attract a growing body of investors who want to understand ESG information about the firms in which they invest.

### **Box 3. SDGs Dashboard in Papua New Guinea**

Businesses in Papua New Guinea have come together through the Business Council of Papua New Guinea to develop a reporting mechanism, an SDGs dashboard, that captures their contributions toward sustainable development. The businesses were motivated in part by a desire to engage in deeper dialogue with the government about how the private sector can contribute to national development priorities and how to unlock those contributions through closer public-private collaboration. It was prompted particularly by the process to develop a national medium-term plan that links annual government operations with the national long-term vision to 2050.

The dashboard which, at the time of writing is in its first phase, has been designed with specific reference to the SDGs. While some of the companies involved in the development of the dashboard publish sustainability reports using ESG frameworks, there was a motivation among businesses to build something that captures contributions to SDGs systematically. It is structured to present data aggregated at the national level that can be disaggregated by individual companies. Sustainable development data for the country is presented alongside survey data on the sustainability practices of individual companies, mapped against the SDGs. Individual companies are given a sustainability score that assesses how effectively their work is contributing to the SDGs. Data are gathered through a survey that has been designed specifically for the SDGs in the Papua New Guinea context and which is tailored for individual sectors.

*Source: Innovations for integrated financing, UNDP, 2018.*

### **Box 4. Monitoring framework linking financing-related targets to national development outcomes in Philippines**

Building on the results matrix accompanying the Philippines Development Plan (PDP) which included yearly targets as well as SDG-related indicators the government of Philippines introduced monitoring frameworks linking financing investments/inputs to the outcomes of the PDP. This is being implemented through introduction of financing-related indicators at four levels: firstly, at the input level government efforts to mobilise resources are monitored through, for example the frequency and quality of public-private dialogue or the impact of various government policies on the business environment. Secondly, at the output level the scale of resources mobilised are monitored, for example volumes of private investment against identified funding gaps in the PDP. Thirdly, at the outcome level the outcomes generated by these investments are monitored: e.g. job creation, skills development; finally, at the impact level the contribution of those outcomes are monitored against PDP objectives and goals: e.g. the contribution of job creation to poverty reduction or reduction in inequality.<sup>75</sup>

*Source: Financing the SDGs in the Philippines: using an integrated national framework to link resources with results, UNDP, 2017*

75 Financing the SDGs in the Philippines: using an integrated national framework to link resources with results, UNDP, 2017.

### 3.5. Transparency and accountability

Transparency and collective accountability between government, the private sector, civil society and development partners is important for building trust that promotes collaboration and as a mechanism for boosting effectiveness. Transparency and accountability are two-way responsibilities. Mutual accountability and transparency support effective partnerships, strong monitoring and enable greater effectiveness in the impact of financing.

Parliamentary budget oversight is relatively well-specified in the Financial Management Law. The government must submit the proposed budget to the National Parliament by the 15th of October. It is then subject to an in-depth scrutiny by parliamentary committees followed by budget plenary sessions. The budget is debated in National Parliament normally during December. Once the budget is passed, it is sent to the President of the Republic to be promulgated.

The government encompasses multiple mechanisms and platforms for publishing information on the way it raises and uses finance. The examples include publication of Budget Book 1 – Budget Book 6 in Tetun, English and Portuguese on the Ministry of Finance Transparency Portal. The Budget Books contain extensive information in an accessible manner. In addition, the government publishes a simplified, non-technical overview of the budget, known as the Citizen's Guide to the State Budget.

However, according to the 2017 Open Budget Survey, Timor-Leste was scored 40 on budget transparency meaning that it is providing insufficient budget information to enable the public to engage in budget discussions in an informed manner. It also reached only 9 points out of 100 on public participation and 56 on budget oversight by legislature and audit. The main recommendations for improving budget transparency and public participation include publishing a Year-End Report and producing and publishing Pre-Budget Statement and a Mid-Year Review. The government was also recommended to pilot mechanisms for members of the public and executive branch officials to exchange views on national budget matters during both the formulation of the national budget and the monitoring of its implementation to improve public participation. These mechanisms could build on participatory budgeting and social audits.

Other examples of information sharing platforms established by the government include Budget Transparency Portal (BTP), Aid Transparency Portal (ATP), the E-Procurement Portal and Government Results Portal. The Transparency Portal has been established since 2011 in order to allow citizens of Timor-Leste to hold government into account in relation to public finance planning and spending. The BTP is an interactive online platform that allows citizens and all members of the public to access and collect complete financial information on how the national budget is spent both historical and real-time data, and monitor progress of budget execution across all state entities in Timor-Leste. It gives a breakdown of spending down to item-level of spending and is updated regularly. The Results Portal provides outcomes information for the most important government goals, projects and programmes. The E-Procurement Portal, is a platform where vendors and contractors of service providers can access advertised tenders and request for quotes advertised by the government, and where one can access and review all awarded tenders. The Government plans to transition to a full e-procurement portal, whereby service providers can submit tender proposals directly on-line, these changes are supportive of wider procurement reforms and anti-corruption efforts.

Development partners in Timor-Leste also have the responsibility to publish information on their activities and commitments, in accordance with the Addis Ababa Agreement. The ATP was established in 2011 to enable the government to hold development partners into account in contributing to the country's sustainable development. The ATP carries similar objectives and functionalities as the BTP in terms being accessible to all members of the public, however the accountability is on development partners to provide accurate and timely data on commitments, which is used in the publication of Budget Book 5, Development Cooperation Report and Budget Book 1. Development partners are given the responsibility to ensure that collaboration with the government is aligned with government's objectives, procedures and systems, and the information on the alignment is also reported and accessible to all members of the public. The ATP additionally enables efficient harmonization and coordination between development partners because actors are more informed of activities from other development partners and their contributions towards specific goals.

The harmonization, coordination and partnerships of development partners and government is further enhanced with regular meeting forums, such as the Quarterly Development Partnership Meeting and the Annual Development Partnership Meeting Timor-Leste. Within those forums, development partners, civil society organizations and some private sector representatives are able to discuss issues that arise in the development landscape, reflect on previous development successes and challenges and consider methods of strengthening future development activities, at higher level policy discussion in the annual meetings and at technical level discussion in the quarterly meetings.

With regard to transparency and accountability, and mechanisms for collaboration and engagement of government and private sector, there are currently no mechanisms that are used systematically. In the present context, the only institutional mechanism that the government can use to engage with private sector, NGOs and other actors is the Chamber of Commerce and Industry of Timor-Leste (CCI-TL). The CCI-TL was established in 2010 to bring together and represent private sector actors, and consists of 34 associations of private groups. The government recognises the CCI-TL as an official partner, however the government's engagement with the CCI-TL is limited to top-down consultations and ad-hoc meetings facilitated on a demand-driven basis. Concerns have been raised around the lack of structure in how private sector voice is incorporated in the design and implementation of new and current policies and strategies.

Meaningful dialogue is essential to help government understand the challenges and constraints that private actors face, and to set realistic ambitions for the size and scope of private contributions to national development objectives. Government will need to use effective, results oriented and strategic dialogue and accountability systems to support corporate sustainable, inclusive private investment (see Recommendations and roadmap section).





## 4. Recommendations and roadmap

The DFA aims to support government and its partners in reforms that can mobilise and enhance the impact of public and private financing for the SDP. The analysis presented above highlights the key challenges and opportunities that the country faces in this regard, and this section identifies key steps that can be taken to advance this agenda. This roadmap highlights the recommendations of the DFA that can be further refined and taken forward for implementation by the appropriate actors. It is divided between headline recommendations, which respond to the most pressing issues identified in the DFA, and further recommendations.

### Headline recommendations

#### **Establish a national investment promotion strategy**

The SDP places central emphasis on growth in private investment as a means of transition to a diversified economy and a post-oil financing model overall, and this is the rationale behind the policy of frontloading. The SDP identifies priority industries that have the potential for growth and which could drive forward the economy over the medium and long-term and create jobs and incomes for Timorese. Growth in agriculture, tourism and manufacturing will be driven by a growing stock of FDI, investments by new and established domestic businesses, including many SMEs.

However current levels of domestic and foreign investment as well as private sector borrowing are very low and there are few current signs of growth in targeted industries, such as agriculture, fisheries, tourism and manufacturing. There are a wide range of reasons for this, including the business and regulatory environment, among which most notable are enforcement of contracts, registering property, personnel capacity, access to credit and other factors such as quality of infrastructure and governance quality. Nevertheless, there is potential for these industries if some of these challenges are overcome.

Given the centrality of private-led growth in the strategic approach of the SDP, this is perhaps the most significant financing challenge for the country to address. There are a range of initiatives underway to try and address the challenges that currently constrain private investment and large investments in infrastructure in particular. These are being led by different parts of government and other actors and focus on a variety of factors (see the public-private collaboration section above). However, current efforts to address the challenges of growing private investment are presently fragmented and uncoordinated. As yet they are not realizing the results they desire. The overall effort could be more efficient and effective if the key players aligned their reforms. A well-coordinated, targeted effort to attract sustainable, inclusive investment in priority industries could help kick-start the growth that is central to the strategy of the SDP. It could help to formalize and focus the investments being made under the frontloading policy.

The DFA recommends the creation of an investment promotion initiative that coordinates a targeted effort to attract and stimulate private investment in key industries – agriculture, tourism, fisheries and manufacturing. This initiative would be managed by a core coordinating team including senior representatives from the ministries with responsibility for different aspects of the business environment and investment and exports promotion in key sectors as well as senior representatives of the private sector.

The aims of the initiative would be to:

1. Enhance coordination and efficiency of efforts to improve the business environment
2. Actively target investment in SDP priority industries
3. Strengthen the framework for sustainable, inclusive investment

The initiative would develop an investment promotion strategy, but the emphasis would be on coordinating efforts in practice rather than the creation of a new policy. The strategy and coordinated efforts would seek to advance the objectives above and exploit potential opportunities such as the country's potential accession to ASEAN. The initiative would encompass activities including the following:

**Improving the business environment.** The strategy would coordinate ongoing initiatives aimed at resolution of outstanding constraints to business investments, such as reforms in the areas of land titling and property rights registration, lending to small and medium businesses, business registration and licensing, infrastructure investment and utilities, skills development and etc. This will involve coordination across different government ministries and agencies responsible for the implementation of the above reforms, including MDIR, TITL, MCIT, Ministry of Tourism, Ministry of Agriculture, Ministry of Public Works Transport and Telecommunication, Central Bank, Secretary of State for Youth and Employment and others.

**Actively promoting investments in priority industries.** Activities to proactively promote demand-driven investment in key industries would include developing a portfolio of bankable projects, coordinating access to infrastructure, land, utilities and other business requirements, developing targeted investment incentives and international marketing.

The package of existing investment incentives could look to balance its role in reducing tax costs for businesses with other business support measures such as guarantees, preferential access to credit or utilities, removing other existing constraints to effective set-up and operation of the business.

Critically, there is a need for careful use of tax breaks and tax holidays, which have a role in attracting new domestic and foreign investment, but have a negative impact on new tax revenue streams of the country in the years to come. Carefully designed incentives can make TL a more attractive place for business investment if combined with effective coordination on all above aspects of business environment and investment promotion and establishment of strong dialogue for mutual trust and accountability between the government and investors (see further recommendation on establishing mechanisms for stronger dialogue with private sector).

International marketing will build on and expand ongoing investment promotion activities by TITL and will seek active promotion of investment opportunities from the pipeline internationally, hosting and participating in international investment, trade and industry forums and building partnerships with outward investors from key investing countries. It could also involve undertaking trade missions and establishing formal links between TradeInvest and outward investment agencies from the countries that are or could be important sources of FDI, such as Australia, Singapore, Malaysia, Indonesia and Papua New Guinea.

**Strengthen the framework for sustainable, inclusive investment.** To attract sustainable, inclusive private investment it is important to not only improve the economic attractiveness of this environment, but to develop an environment that promotes sustainability and inclusiveness in investments. Many governments strengthen investment promotion measures to help draw out the wider benefits. Two suggestions for taking this forward in the present context of the country have been identified:

- **Work with development partners to introduce some pilot impact investments.** Social impact investments are growing around the world and an increasing number of development partners are piloting and working to establish social impact investment models in the countries in which they are present.<sup>76</sup> They are seen as a way both to provide sustainable models for investment and services in key areas of sustainable development, and act as a catalyst for progress among the wider business community. The UNDP SDG impact co-financing platform<sup>77</sup> mobilises institutional and private investors to move grant-based projects to scalable market-based financing models and one of Timor-Leste's largest development partners, DFAT, announced in late 2017 that it would be scaling up support for impact investing.<sup>78</sup>
- **Design a more holistic policy framework to promote sustainable, inclusive investment.** A private investment promotion strategy should focus not only on promoting investment with its economic benefits, but also on ensuring that investments are beneficial to objectives of social progress and environmental sustainability. Coordination between policies that are designed to promote investment and efforts to promote environmental sustainability, and draw out the social benefits of private sector development, are key. There may be both regulatory elements to this, such as strengthening enforcement of environmental standards and technical regulations and aspects of supporting policy. For example, as investment in a particular industry is promoted, targeted support may be provided for local SMEs, in areas such as training and increased access to credit, that have the potential to connect with larger businesses and deepen value chains.

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76 For more on this see Innovations in integrated financing, UNDP, 2018.

77 <http://undp.socialimpact.fund/>

78 See [https://foreignminister.gov.au/releases/Pages/2017/jb\\_mr\\_171114.aspx](https://foreignminister.gov.au/releases/Pages/2017/jb_mr_171114.aspx)

## Establish an integrated financing strategy

Timor-Leste has set an ambitious sustainable development agenda in its SDP as well as committed to implementing SDGs. To finance the national development strategy and the SDGs the government will need to mobilise a wide range of public and private finance flows. The State has significant resources available in the short and medium term, but wider forms of financing remain low. A key challenge is the need to mobilise the necessary volumes and right type of investments while ensuring complementary across them. The government's approach to financing is overall rooted in the SDP, which sets a clear long-term direction for the country's development path and provides some direction over how this is to be financed, including elements related to the public finance and the recognition of the potential role of different actors in contributing to development priorities. The policy of frontloading has also been a key driver behind the way public investments have been made, with large investment in infrastructure. However there is room to develop more comprehensive guidance through an integrated long-term integrated financing strategy. Such a strategic framework would outline policy objectives across different areas of public and private financing, providing guidance for short and medium-term operations in each area of policy as well as processes for review and alignment between budgets and other existing and new policies and to the national plan objectives. Such a strategy will serve as a bridge between the SDP and short and medium-term financing policies.

A **financing strategy** that identifies the investments that will be needed to achieve the country's long-term vision and develops estimates and targets for the types of investments needed can provide the overarching framework within which specific short/medium-term financing policies to mobilise resources can be strengthened, aligned with each other and national plan objectives and operationalised. In relation to private sector financing specifically (see recommendation on national investment promotion strategy above), this could guide the development of more specific private investment strategy to facilitate or stimulate investment in strategic sectors of the SDP – for the achievement of economic diversification objective and poverty reduction through job creation.

Such a strategy could be integrated in the SDP through cost estimates and funding gaps analyses, or developed as a separate document that would accompany it. It is this strategy that would then provide the basis for consistent, more focused policies on specific flows (public current and capital investment, PPPs, development cooperation, private investment, private sector borrowing, MDBs, etc.).

**Institutional responsibilities** need to be identified in order to ensure that there is clarity about roles and functions. An overarching coordination mechanism that oversees the planning, mobilisation and use of resources, including and beyond government finance, in a holistic and integrated manner should be established. A centralized leadership in development finance is needed for coordination across all financing policies with overall accountability toward the national development plan and the SDGs. It will be necessary to generate a consensus at the highest level of the State of Timor-Leste to identify an efficient institutional solution for the implementation of an integrated finance strategy, which will exceed the mandate of a single government institution. In some contexts within the region the principal responsibility for the development finance reforms is allocated to a high-level executive office. In Samoa, for instance, the Prime Minister leads the Cabinet Development Committee, in Indonesia it is a dedicated Cabinet-level ministry. Another option used in other countries is for integrated financing to be overseen by a committee with responsibility for overseeing progress toward the national development plan or SDGs, such as National Development Strategy committee,

including all key ministries, in Solomon Islands or permanent cabinet sub-committees, such as Financing for Development Cabinet Cluster in Philippines. This DFA recommends Timor-Leste to follow the second option and for this role to be fulfilled at the level of Council of Ministers which has overall responsibility for the implementation of the SDP or to institute a dedicated sub-committee.

An important aspect to be considered is **participation of non-state actors** in the whole process and **costing of priority interventions** (see recommendation on estimation of costs below). Visioning the role of different types of finance – public, private, domestic and international – will be most effective if developed in close consultation with representatives from those sectors. Without strong dialogue, it is difficult for government to develop realistic objectives about the contributions that other actors can make, or to build view of existing constraints and opportunities (see further recommendation below).

The next steps to take this recommendation forward will include:

- Perform an assessment and present options on how to structure a financing strategy to meet the objectives of the SDP and the SDGs and provide initial analysis to inform such a strategy about the types of finances that can be mobilised in order to realise the objectives of the SDP;
- Consult at Council of Minister's level to agree on an efficient institutional solution for the implementation of an integrated finance strategy, this needs to exceed the mandate of a single government institution.

## Estimate the cost of priority interventions of the SDP

The focus of the SDP is setting broad direction for the results that the country wants to achieve. However, it does not go as far as estimating the cost of interventions in different aspects of the national development plan or providing quantitative benchmarks for the scale of financing it aims to mobilise. To analyse the financial capacity and financing priorities for achieving the SDP goals it is important to understand the nature and scale of investments that will be needed.

While detailed costing of development plans is usually a technically complex, resource-heavy exercise, in some contexts in the region estimating costs enabled assessments of the financing implications of identified priorities and helped to guide resource mobilization strategies. In Bangladesh for example (see Box 1) the Planning Commission developed an SDGs Financing Strategy which assessed the financing needs of the SDGs and analysed public and private responsibilities related to each individual SDG. Aggregating these together allowed to arrive at an estimate of the total additional volumes of public and private, domestic and international resources that were required. This is being used as the basis to map the options for financial strategies to mobilise the necessary resources and it supported initiatives such as the creation of a platform for public-private dialogue and collaboration with development partners.

The DFA recommends taking steps to better understand the costs of the SDP and its sectoral and thematic priorities. A starting point may be to establish estimates of the costs associated with key sectoral and thematic policies, and to develop processes so that this becomes a more standardized part of the policy development process. Cost estimates should assess the requirement on public resources (both capital and ongoing recurrent costs) as well as outlining the necessary type and potential scale of private sector and all other types of investments that need to be mobilized in order to achieve policy targets.

## Establish an integrated infrastructure investment strategy

There is a need for significant investment in infrastructure in order to meet the infrastructure needs implied by the SDP – this is recognized as a priority and significant investments have been made in line with the policy of frontloading. Infrastructure – including power and water supply, roads and bridges, airports and ports – is considered to be a critical enabler of progress toward the economic and other objectives of the SDP. To date substantial infrastructure investments have been made and the government is committed to continue addressing infrastructure deficiencies and expand capital spending in the following years. To date infrastructure development was mainly funded through transfers from the PF. Concessional loans and PPP modalities were also used to finance a limited number of large infrastructure projects with the first mainly focusing on rehabilitation of regional and national roads. There is also room to further explore possible PPPs in infrastructure development of the country. In the light of falling petroleum revenues there is a need to reduce withdrawals from the PF and boost the potential of other funding mechanisms to finance infrastructure investments. Infrastructure Fund is the main governmental instrument to facilitate and provide central oversight of investment planning and scrutiny of all capital projects using a standard appraisal procedure. However there is room to further enhance the mechanisms for selection and prioritization of investment projects around strategic priorities and government policies designed to realise them. To improve the efficiency and effectiveness of public spending there is also a need to consider a systematic approach to capital and recurrent expenditure budgeting for the effective recognition of administrative and maintenance costs of capital projects and to improve appraisal and risk assessment standards.

The DFA recommends establishing an overarching infrastructure investment strategy bringing together a range of different finance sources and establishing policy mechanisms to encourage their use in the most appropriate aspects of infrastructure. It would build directly on the SDP and the infrastructure needs that it articulates and implies, and would help to formalize and focus the frontloading policy. It would act as a mechanism for prioritizing investments and determining the most appropriate modalities for their establishment and ongoing maintenance.

An integrated infrastructure strategy would encompass the following:

1. **Identify the key infrastructure needs articulated in or implied by the SDP.** This will provide an overarching infrastructure strategy that would outline strategic infrastructure priorities and link the investments to the priorities of the SDP encompassing both economic and social outcomes.
2. **Estimate the costs of the necessary investments.** An analysis of costs should include upfront capital costs and ongoing recurrent (operational and maintenance costs). Indicative costing should also consider necessary institutional building (e.g. the creation of new capacity, functions or even new entities<sup>79</sup>) as well as capacity building activities in each specific sector.
3. **Prioritise infrastructure investments according to contributions to SDP goals.** Standard targeted selection and prioritization criteria should be developed and implemented to ensure projects are prioritized according to their contribution to the strategic goals of all aspects of the SDP and all commitments under the SDGs.

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79 For example, the creation of a water utility company has been proposed to manage investment and service delivery in water and sanitation.



4. **Establish a stronger framework for using a range of different finance types.** PPPs could be considered as an instrument to mobilise finance from private sector actors (FDI, domestic and SMEs for small scale PPPs), as well as borrowing from Development Partners and Multilateral Development Banks, including a transparent mechanism for determining the most appropriate financing modality for particular investments for both creation and ongoing operations and maintenance. Develop and more actively market investment opportunities in a pipeline of infrastructure projects.
5. **Outline what capacity needs to be developed to manage all the above instruments** – for example some such as PPPs are complex to establish and manage effectively, and require a detailed, current knowledge of key factors such as contract design, risk sharing and costs if they are to be successful.<sup>80</sup>
6. **Establish a monitoring framework that tracks the investments being made and their contributions toward SDP outcomes.**

## Explore the potential to establish a private sector reporting mechanism

The extent and way in which private sector development occurs will have an important impact on the extent to which many of the objectives of the SDP are realized. Understanding the scale and nature of private sector investments and the contributions they make toward SDP outcomes is vital for designing and implementing responsive, targeted policymaking. However there are no systematic mechanisms for understanding the impacts of private investment and even basic information on private investment is lacking.

The DFA recommends exploring the potential to establish a private sector reporting mechanism that can deepen the understanding of private sector development and its relation to the SDP, and facilitate deeper dialogue between the government and the private sector. Enhanced private sector reporting can benefit both private sector actors themselves and government. Sharing information can be conducive to more effective public-private dialogue and can help businesses better communicate the challenges they face to government. It can inform more targeted, nuanced policy toward private finance as governments are better informed about the types of outcomes that can be realized with different types of support, as well as more targeted interventions that mitigate the risks of private sector development.

Other countries in the region, such as Papua New Guinea, have developed mechanisms for voluntary reporting that may provide a model that could be adapted to the Timorese context (for the example in the Box 3). These have helped businesses to engage with key government policies and have typically been led by a Chamber of Commerce or Business Council (institutions similar to CCI-TL), often with the support of development partners.

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80 When poorly designed, these instruments can lead to an escalation of costs that in some cases has been substantial. For example, the repayments on Lesotho's first PPP, which was setup to build a hospital, were at one point costing the government more than half of its health budget while the private firm running it made substantial profits. Source: A dangerous diversion, Oxfam, 2014. Available at: <https://www.oxfam.org/sites/www.oxfam.org/files/bn-dangerous-diversion-lesotho-health-ppp-070414-en.pdf>



## Further recommendations

### *Consider establishing a sin tax to finance investment in health*

Preliminary data on progress toward the human capital development objectives of the SDP reveals relatively poor performance in this field and points to the need to increase investments in human capital and basic service delivery. With a projected 40% growth in the working age population by 2030, investments in human capital – particularly in education, healthcare, nutrition and related areas – will be needed. The need to expand sources of financing for human capital investment is amplified by potential future trends in ODA, which is an important source of education and health financing, but is likely to decline over time. There are also concerns related to the scale of the investment and infrastructure budget relative to health and education spending. As Timor-Leste continues its progression towards development, the challenge remains in relation to both (i) balanced allocation of available resources across priority goals of the SDP and the strategy for implementation of the SDGs and (ii) mobilisation of new sources of financing for social sectors, if the government is to avoid scaling back of public services in those sectors, but achieve its medium and long term goals on human capital development.

DFA recommendations in this respect are two-fold. First, in line with a recommendation on infrastructure investments above there is a need to establish an overarching infrastructure investment strategy which will act as a mechanism for prioritizing investments and determining the most appropriate modalities for their establishment and ongoing maintenance as well as improve efficiency and effectiveness of public spending overall. Secondly, the government could consider exploring various options of mobilizing new sources of domestic revenue to fund specific social sector programmes. For example, The Philippines introduced a Sin Tax Reform which was designed both to reduce consumption of alcohol and tobacco products that were harmful to health and provided additional resources to fund service delivery including the implementation of the Philippine Universal Health Care programme (see Box 2). The Philippines provides a successful example of how earmarking domestic revenue generated from a 'sin tax' can be used to expand health coverage and how effective coalitions with civil society and community organisations can help to communicate and build buy-in to the reform package. The government of Timor-Leste could explore options for introducing a similar approach.

### *Strengthen and establish mechanisms for private investment monitoring*

While the SDP places private-sector led growth at the heart of the strategy for achieving the SDP, it is difficult to understand the role that private investment is making in practice. There are opportunities both to strengthen the systems and data that government uses to monitor private sector development, and to assess the feasibility of establishing a private-sector led reporting initiative.

Government uses an M&E performance framework to monitor investments in and progress toward the SDP, and it is developing programme budgeting structures to plan for and monitor a more results-based approach to budgeting. However the components of the SDP M&E performance framework that look at financing to date focus on public finance and development cooperation. The M&E performance framework can be broadened to include monitoring trends in various types of private financing and can capture the available information on the outcomes that these flows generate. The next steps in the process of establishment of a results-based programme budgeting system can also

incorporate objectives and monitoring of private financing. A linked set of indicators that track the volumes of finance being invested as well as key outcome indicators could be established within these related monitoring frameworks (see the Philippines example in the Box 4). In this way the government and its partners will develop a more comprehensive understanding of the investments being made and the contributions they can make toward the SDP that can inform more responsive policy design and nuanced dialogue between public and private actors.

### *Establish an SDP follow up forum*

Strong, systematic dialogue between government and key stakeholders – including development partners, private sector and civil society – is key to stimulating investment and action that contributes toward nationally identified sustainable development objectives. Currently the TL Development Partners annual and quarterly meetings provide an effective basis for a regular dialogue on cooperation with development partners, yet an official platform is needed for multi-stakeholder dialogue to discuss the role of all non-state actors in both the overall sustainable development of the country and financing for development. There is a need to establish stronger partnerships with actors from across society that contribute to the objectives of the SDP and raise awareness of the objectives, focus of the SDP, actions and investments needed.

To this end a regular multi-stakeholder symposium could be established to review progress toward the SDP and its financing, discuss ways forward. The objectives would be to strengthen links between actors who are contributing directly and indirectly toward SDP, facilitate information sharing and be conducive to new partnerships and policy innovations. It would also aim to build mutual trust and accountability between actors so the focus would not be only on what government is doing to realise the SDP, but on what all actors are and can do to realise it.

Such a forum could be held every 1-2 years and potentially linked to the publication of the official SDP implementation review. It would bring together a range of actors including key ministries, subnational government actors, private sector and industry representatives, development partners, NGOs, CSOs, think tanks, churches and community leaders.

### *Enhance mechanisms for public-private dialogue*

Presently, the only institutional mechanism that government can use to engage in public-private dialogue and improve mutual understanding about priorities and challenges with private sector, NGOs and other actors is the Chamber of Commerce and Industry of Timor-Leste. Yet, there is a room to further strengthen the consistency and quality of that engagement between government and private actors. Currently the government's engagement with the CCI-TL is limited to ad-hoc consultations on design of new policies and legislation as well as meetings facilitated on a demand-driven basis. Establishing regular forums or systematic platforms for communication with private sector and civil society is essential to strengthening coordination and trust between the government and domestic and international private sector representatives. A consistent dialogue with private sector on topics such as effectiveness and impact of government's policies and regulations aimed at improving business environment, effectiveness of current incentives schemes, identification and establishment of investment opportunities and development of demand-driven project pipelines can facilitate effective policy making in private sector development and promote more sustainable and inclusive private investments.

In this respect, this DFA recommends adapting policy processes to facilitate consistent participation in dialogue by representatives of national CCI-TL, key potential foreign investor associations as well as other CSOs throughout the process of designing, implementing and reviewing policies. This could allow shaping policies that are more responsive, innovative and around which there is greater ownership outside government. There is a need to formalize mechanisms for collaboration and dialogue with key potential investor countries or bloc of countries, such as dedicated chambers of commerce or outward investment agencies from those countries. Other systematic platforms for public-private dialogue can include set-up of an International Investment Council under the Prime-Minister as a forum for discussing priorities, challenges and policy solutions that can unlock greater and more sustainable, inclusive domestic and foreign investment.



