

Population | 1.3 million

GDP per capita | 1,490 USD

Annual GDP growth | 3.1%

Govt. debt, % of GDP | 19.7%



Capital | Dili

Government | Unitary semi-presidential republic

TIMOR-LESTE

ISE Country Stocktaking

Key Findings, Future Scenarios and Critical Tasks for State Transformation
June 2022

ISE's country stocktakings present a view of a country to evaluate opportunities for reform during pivotal periods in its development trajectory. Stocktakings diagnose countries' "open moments" and pathways for reform by assessing the performance and capability of various state functions and citizens' view of the state while mapping the various international partners operating in the country and the alignment of key stakeholders around a potential reform agenda. Based on this assessment, ISE lays out the key medium-term issues facing the country, outlines potential scenarios for the future of the country and presents critical tasks that could bring about the best-case scenario.

The Current Reform Context

The Democratic Republic of Timor-Leste is the newest country in Asia and the world's second youngest nation. It declared independence from Indonesia just over two decades ago in 1999 and was internationally recognized as a state in 2002. As a young country emerging from a long history of colonial rule and occupation, beginning with Portuguese settlement in 1520 and concluding with the Indonesian invasion in 1975, Timor-Leste has accomplished significant development gains, but the process has been interrupted by violence and political tensions, the country's institutions remain weak and over-centralized, there are significant rural-urban divides and the economy is undiversified. The country also has high levels of out-migration, poverty and inequality, as well as poor public health systems.

Timor-Leste's assets and constraints are generally double-edged swords – complex issues that present both the opportunity for growth and the risk of significant backsliding. Six main development drivers present core opportunities and challenges. First, the country's hydrocarbon endowment, which has driven growth and sovereign wealth to date, is in a period of transition. Slow progress in operationalizing the anticipated Greater Sunrise project as a locus of production presents twin risks to the government in the medium term. Until commercial production begins in the Greater Sunrise fields, the government must draw down on its Petroleum Fund to prevent a recession, while the value of hydrocarbons risks declining as medium-term demand is undermined by the rapidly dropping price of renewable energy. These risks, combined with Timor-Leste's heavy reliance on the petroleum industry—it is one of the most hydrocarbon-dependent economies in the world—demonstrate that diversifying the economy will be an important step in continued development.

Timor-Leste's heavy reliance on hydrocarbons relates to a second issue: expanding economic opportunity, especially for the country's youth. The hydrocarbon industry provides notoriously low long-term employment and lacks secondary impacts for the economy. Yet Timor-Leste has the potential to harness a demographic dividend. As of 2017, 60 percent of Timorese were of working age and only 19 percent had jobs. Of these, 8 percent were employed in the public and private sectors, while the rest worked in informal markets. The government is currently aiming to create at least 60,000 new jobs per year, but the success of these efforts may be compromised by disparities between urban and rural areas. Most private sector activities are small, immature, and concentrated in the

capital of Dili, tourism makes up a tiny percentage of the economy and manufacturing is even more negligible. Diversifying industries, supporting youth jobs, and driving human capital development could help Timor-Leste leverage its demographic dividend and grow its economy.

Third, politics in the country still largely orbits around resistance identities, with certain leaders retaining almost cult-like status.

There has not been open conflict between factions in over a decade, but the old rivalry between former prime ministers Mari Alkatiri and Xanana Gusmão continues to generate political deadlocks, parliamentary reshufflings and uncertainty. There have been four different governments in the past six years, while the recent reconfiguration of the ruling coalition could also be considered a new government. Relative political stability born from ideological alignment has been a boon to development planning, but democracy remains fragile and is susceptible to populism and east-west tribalism that calcified during the resistance to Indonesian occupation.

Fourth, Timor-Leste's government remains highly centralized, and institutions often guard information and power from each other. While the gains in governance over the past two decades should be recognized, the rapid development of new, highly centralized governance structures, coupled with limited human capital in public administration has led to bureaucratic waste and entrenched interests. The granting of administrative and fiscal autonomy to subnational units introduces risks as well, particularly in the accountability and sustainability of local assets and finances. However, these risks could likely be managed through effective regulatory reforms.

Fifth, Timor-Leste is at the geographical and cultural crossroads between the South Pacific region to the east and the Southeast Asian region to the west. The country's location presents opportunities to leverage expertise and capital resources from neighboring countries. However, it also challenges Timor-Leste to rapidly upgrade its human and infrastructure capacity to become competitive in the marketplace and to carve a niche for itself.

Sixth, Timor-Leste must contend with the increasing impact of natural hazards due to global warming. As a mountainous island state, Timor-Leste is significantly exposed to climate risk exacerbated by poor agricultural practices and construction standards. The country could benefit from improved climate adaptation and land management practices. The March 2021 floods that occurred during

the COVID-19 pandemic are a stark example of how public health crises and natural disasters can compound to create widespread deprivation and destruction. Managing climate risks is also key to creating a sustainable economy.

Timor-Leste's Strategic Development Plan 2011 – 2030 presents a comprehensive vision for reform, although some have criticized the viability of the country's current development pathway. The Development Plan emphasizes four key areas: (1) social capital, (2) institutional frameworks and good governance, (3) infrastructure development and (4) economic development and diversification. It divides development goals into short-term priorities of one to five years, medium-term priorities of five to ten years, and long-term priorities of ten to twenty years. In 2020, the government also released the Economic Recovery Plan (2020-2023+), which updates and adapts the Strategic Development Plan to meet the current operating environment. The plan includes short-term temporary measures for the next one to two years and medium-term structural measures for the next two to three years. The Economic Recovery Plan is significantly more concrete in outlining a development pathway and associated commitments. For instance, it includes plans to double budget spending on health, education and nutrition. It also flags the need for revenue reform in 2025 as petroleum production drops. Overall, negotiating the transition from a focus on basic revenue generation and services to a more complex development strategy has proven difficult for Timor-Leste. General social and human development indicators are improving, but perhaps not at the rate one would expect based on the government's resources and commitment. Looking forward, Timor-Leste has the challenging task of balancing short-term stimulus measures that result in immediate gains against measures that support a longer-term transition to sustainability.

Performance of Core State Functions in Timor-Leste

The following section provides an assessment of core state functions in Timor-Leste, considering the assets, constraints and opportunities for reform to reach its development and economic goals.

Governance

Over the last two decades, Timor-Leste has made significant strides in establishing state institutions committed to good governance. However, Timor-Leste is a young democracy, and its institutions are not yet mature. Effective governance is undermined by unclear mandates among multiple overlapping and competing levels, as well as capacity issues partly caused by lenient hiring standards and a lack of accountability mechanisms. State institutions are also built on and susceptible to patronage-based political networks and the resulting insularity has allowed for corruption and further contributed to capacity issues, including a lack of education and training in the civil service. One notable exception is the Petroleum Fund, created in 2005, which has strong management and oversight capabilities that comply with international standards. This has helped Timor-Leste to avoid problems characteristic of other petro-states, such as leakage and the deterioration of sovereign wealth.

Timor-Leste is a unicameral, semi-presidential constitutional republic. Its federal structure is separated into three levels: the national, provincial and local, where *sucos*, or villages, comprise one or many *aldeias*, or hamlets. Though decentralization has been on the government's reform agenda since Timor-Leste restored

independence, the government has focused mainly on developing national governance structures, resulting in heavy centralization. Centralization has caused major development gaps between the capital of Dili and outlying municipalities, as inefficient processes constrain service delivery and municipal management. In 2016, Timor-Leste passed decentralization legislation that included agreements between line ministries and municipalities to delegate competencies. The legislation is being implemented in three phases, and phase one, which establishes administrative systems, human resources, materials and finances for municipalities is currently underway. Overall, however, the decentralization process remains stalled. Recent efforts to grant more power to local governments have been impeded by overlapping delegations, entrenched interests in the national bureaucracy and a lack of capacity to support *sucos*. Sub-district bodies have strong existing capabilities in community engagement, such as dispute resolution, but weak technical skills to effectively manage programs and budgets. At the same time, reforms, including the devolution of some civil service functions and the beginning of downward fiscal transfers, have met with bureaucratic resistance. As a result of intensive centralization, resources are supplied in response to demand, and front-level service delivery units must both request funding from the center and travel to access it. The implication is slow and ineffective delivery: funds and supplies from the central government must pass through several layers of bureaucracy to reach municipalities. This similarly complicates accountability and reporting processes that flow in the reverse direction, from municipalities to the central government.

Democratic accountability is well-established and is improving within the civil service, but accountability among political appointees remains a challenge. While the judicial system has been successful in trying and sentencing public officeholders for minor corruption crimes, the consensus is that large-scale corruption or corruption involving high-level officials is too sensitive to either bring to court or punish through sentencing. For example, in 2017 the Timorese minister of finance was able to flee to Portugal before his sentencing for corruption crimes. Partly due to the significant number of recent high-profile cases involving politicians and government officeholders, corruption has attracted increased attention from both institutional actors and civil society members. Parliament passed updates to anti-corruption laws in 2020 that became effective in 2021. Timor-Leste's Anti-Corruption Commission (CAC) investigates and prosecutes government corruption and is currently being supported by the U.N. and other technical advisors to fulfill the mandates set out in the 2020 laws. However, there is some concern about political interference in corruption cases given that the Commission's leadership is selected by the president and parliament and its budget is also determined by parliament.

Beyond addressing corruption, the government has made several efforts to increase democratic accountability. In 2015, it formed and funded a "social audit" program to involve CSOs in researching and reporting on the performance of government services. It also maintains an aid transparency portal, which publishes information on donor programs and spending, and annual government budget proposals. At the ballot box, democratic accountability is legally robust but practically more constrained. Citizens have the right to vote for the head of state, president and legislature, though in practice, personality politics within shifting ruling coalitions have somewhat undermined trust in government and constrained the political space.

Key governance issues for Timor-Leste include:

- » Continuing to build on significant post-independence progress in public administration, good governance and democratic accountability.
- » Improving central-periphery decision rights and bureaucratic processes to increase institutional capacity to deliver on mandates.
- » Meeting constitutional commitments on decentralization to improve inclusive governance and bridge urban-rural service delivery divides.

Security

Timor-Leste's approach to defense and security is integrated, meaning that there is no demarcation between internal and external threats and interests. According to its Strategic Development Plan (2011-2030), this integrated approach includes three fundamental elements: human security, or the safety and security of Timor-Leste's people; cooperative security, or security that addresses risks and threats requiring international cooperation; and homeland defense, or security against internal threats. The integrated approach also recognizes that economic development is intrinsically connected to the country's internal security and stability. The Strategic Development Plan assigns security forces a role in contributing to "national, regional and global stability and development." This aspect of the country's integrated approach may play an important role in future stability. According to some analysts, Timor-Leste is most threatened by domestic instability, driven by factors such as underdevelopment and unemployment.

Domestically, Timor-Leste's security has been improving since 2008. During the early years of its independence, from 2002 to 2006, the nation struggled to accelerate development progress, lacking much of the state apparatus, capacity and resources needed to do so. In 2006, what began as a conflict in the military between soldiers from eastern and western districts—soldiers from western districts of the country claimed they were being discriminated against by the military leadership from eastern districts because western districts had played a less prominent role in resisting the Indonesian army—expanded to protests and violence throughout the country fueled by east-west divides. In total, 150,000 people were displaced and an attempted coup resulted in the resignation of the then Prime Minister, Mari Alkatiri. An Australian-led International Stabilization Force (ISF) arrived at the request of the Timorese government in May of 2006, and a new UN peacekeeping mission (UNMIT) was established in August of the same year. Together, ISF and UNMIT helped to restore stability, allowing for presidential and parliamentary elections in 2007, which were conducted largely peacefully. In February 2008, a rebel group attacked the president and prime minister, but the attack was unsuccessful and most of the rebels surrendered by April 2008. Since that episode, Timor-Leste's domestic security context has been relatively stable. In late 2012, both the ISF and UNMIT departed the country. Recent disturbances have been mostly confined to small-scale conflicts between 'martial arts' gangs in urban areas.

Timor-Leste has a primarily defensive foreign security posture. At the crossroads of Southeast Asia, East Asia, the Pacific and Australia, Timor-Leste is proximate to global and regional powers and numerous resources. Its defense strategy relies on diplomacy and deterrence, as well as regional and international alliances and partnerships, which are vital due to the country's small size and

constrained resources. Timor-Leste sees Indonesia and Australia as integral regional security partners, followed by China, Japan and India. It also has partnerships and has conducted military exercises with Malaysia, New Zealand, the Philippines, and Portugal. The U.S. Membership to the Association of Southeast Asian Nations (ASEAN), granted in principle in 2022, is also a major development in the country's international standing. In the future Timor-Leste will likely have to contend with its status as a growing locus of geopolitical competition in the Indo-Pacific, especially as it maintains healthy relations with both China and Western-aligned states.

In recent years, the government has concentrated on security sector reform and on growing, strengthening and professionalizing its national military. Security sector reforms are oriented around building a professional national police force (Polícia Nacional de Timor-Leste, or PNTL) that upholds the rule of law and ensures safety. The reform program prioritizes building the necessary legal framework and security institutions, as well as core issues like civil protection, community policing and immigration. Due to its recent history of violence, Timor-Leste has also established early warning systems through a National Directorate for Prevention of Community Conflict and local-level community policing councils. To strengthen its military capacity, the government published "Force 2020" in 2007 which laid out plans to grow the Timor-Leste Defence Force (F-FDTL) to 3,000 personnel and develop land forces, light naval forces and support and service components. Force 2020 also focuses on solidifying the military's legal structures, other defense structures and institutions, and civilian oversight mechanisms. Government assessments predict that there is a low likelihood of conventional attacks against the country, and as a result, Timor-Leste has prioritized security sector reform based on unconventional threats, chiefly trafficking and smuggling. Timor-Leste and Indonesia maintain a joint Border Security Task Force to monitor their border, particularly the Oecussi Exclave area, which has been a locus of smuggling activity. Given their importance to Timor-Leste's economic development prospects, the government has also prioritized the ability to monitor and secure its territorial waters, which contain the country's lucrative oil and gas reserves.

Key security issues for Timor-Leste include:

- » Maintaining stability following a recent history of violence and conflict, especially through community engagement and early warning systems.
- » Continuing to transition the security sector from a singular focus on community-level violence to key areas such as smuggling and the security of maritime waters.
- » Establishing a strong presence in the international community to mitigate risks of growing geopolitical competition and regional contestation in the Indo-Pacific.

Rule of Law

When Timor-Leste gained independence in 2002—making it one of the world's youngest nations—the rule of law was not fully developed. The UN Transitional Administration for East Timor (UNTAET) helped build Timorese rule of law institutions to facilitate reform after Timor-Leste became independent, including four district courts in Dili, Baucau, Sua, and Oecussi. However, UNTAET oversight has been criticized for overlooking the local context and excluding Timorese people living outside the capital. Overall, Timor-Leste's rule of law regime continues to lack structure and clarity. The country has yet to establish a supreme court, and in

the interim, the Court of Appeals has assumed its functions. Legal clarity and certainty among government bodies is weak. Unless they are directly overridden by the National Assembly, laws originating from UNTAET or the Portuguese or Indonesian systems remain in effect. These laws sometimes overlap, and when there are conflicts between them, it is not always evident which takes precedence.

In addition to formal judicial institutions, traditional justice systems are still operative outside of the capital of Dili. Customary justice is based on the authority of local leaders and on retribution and collective responsibility. For example, a criminal's family might be expected to make a payment to the family of the victim. Most Timorese perceive the traditional justice system to be cheaper and more accessible compared to the formal system, especially in terms of travel distances. Recognizing the importance of these customary institutions, the government has attempted to merge new and old systems by allowing *sucos* (villages) to forge legal arrangements with the formal governance system, such as with the police force or district representatives of a ministry.

Because rule of law institutions are still being developed, public understanding of the legal system and access to justice remain weak. All justices and legal professionals are based in Dili; finding local justices in the provinces is difficult, as is asking Dili-based professionals to travel to the provinces. This results in the under-functioning of local courts. Legal proceedings are also conducted entirely in Portuguese, which is only spoken by roughly 10 percent of the population. The government has made progress in installing at least one interpreter in every court, but shortages of Portuguese interpreters still often force trials to adjourn prematurely. A lack of resources and trained personnel creates significant deficiencies in due process, which has led to large case backlogs in the past. However, this situation appears to be improving. Laws requiring prosecutors to handle more cases have helped to speed up proceedings, and, compared to previous years, courts are better complying with the requirement that detainees have a hearing within 72 hours of arrest.

Key rule of law issues for Timor-Leste include:

- » Continuing to build critical rule of law institutions, such as the supreme court, and bolstering their capacity.
- » Improving the accessibility of legal services, especially for rural communities, by addressing barriers to entry and engaging both local formal and traditional institutions.
- » Strengthening parliamentary institutional guardrails to promote healthy political competition.

National Accountability Systems: Public Finance
Timor-Leste has experienced mixed progress in improving its financial management and accountability systems in recent years. It has reduced perceived corruption while limiting public participation in, and external oversight of, the budget process. Public finance assessments against international standards illustrate volatile performance: budget credibility has gradually improved since 2007, but accounting, reporting, audit and execution mechanisms all remain relatively unaccountable and ineffective. At the beginning of self-administration, the government was reliant on international technical assistance and support from development partners. As institutions have increased their capacity, reforms in Timor-Leste have shifted from the establishment of basic public finance institutional structures to the creation of more accountable,

modern and performance-driven systems. The most recent reforms have sought to decentralize these gains alongside the administrative decentralization process initiated in 2013. Municipalities now produce their own budgets and local systems are integrated into a single public finance architecture.

Given the large share of market activity driven by public spending, continued accountability reforms are important for boosting state legitimacy and building markets. Total public expenditure driven by receipts from the Petroleum Fund averages well over 70 percent of GDP. Political change and uncertainty have also led to rapid fluctuation in spending decisions, and major under-execution of budgeted expenditure is a common constraint. There are in-year budget readjustments, despite a rigorous budget formulation process, driven by constant organizational shifts and the opaque, "whole of government" Infrastructure Fund, which constitutes 21 percent of public spending and is plagued by under-execution. In the past, the government revenues driven by the Petroleum Fund vastly exceeded economic outputs, but recent scaling back on the use of the Fund combined with declining tax receipts has put Timor-Leste's revenue collection on par with other lower-middle-income countries. Moving forward, it will be important for the government to consider its options for sustainable revenue streams for continued public expenditures and investment. A related challenge is policy-based and medium-term fiscal planning, which, despite strong development planning, remains an issue. Poor preparation systems and an unreliable budget calendar are some of the key challenges, although the National Directorate of Economic Policy (DNPE) has demonstrated an ability to develop effective macroeconomic forecasts for the medium-term planning of the Petroleum Fund, which could be expanded to the larger fiscal planning process.

Timor-Leste's anti-corruption systems are often constrained by limited human resources and capacity. Key issues include a lack of guidelines and resources for public sector ethics and asset declaration and weak whistleblower protections. The level of external audit is high, supported by rigorous alignment with standards and coverage, although follow-up recommendations raised by auditors are inconsistently implemented by the executive. Procurement is decentralized to various agencies, though agencies must submit annual action plans as part of budget planning. There is a centralized e-Procurement Portal managed by the Ministry of Finance for contracts, but it is not updated and thus does not offer enough coverage, which makes it difficult to know if procurement methods are effective and to provide public access to procurement information. Because of these weak procedures, it is unclear whether the system allows for evidence-based management of contracts based on performance. Despite these shortcomings, an increasing number of high-level corruption cases have been brought to the courts since 2010, and the capacity of relevant organizations, particularly the Anti-Corruption Commission, discussed in the "Governance" section above, is being supported by the U.N. and other technical advisors to fulfill their mandates.

Key public finance issues for Timor-Leste include:

- » Applying best practices from the management of the Petroleum Fund to the state's wider public finance institutions and capacities, such as budget preparation, macroeconomic forecasting and medium-term planning.
- » Determining a sustainable pathway for state revenue

generation beyond receipts from oil and gas production.

- » Strengthening accountability systems in areas outside of enforcement and prosecution, such as in the planning, procurement and management phases.

Asset Management

Timor-Leste has abundant natural, social and cultural assets.

While it has developed strategies to effectively leverage them, there is an opportunity for the country to further develop management approaches that both generate income and ensure sustainability. Timor-Leste occupies the eastern half of the island of Timor in the Timor Sea, which connects with the Pacific Ocean to the East, the Indian Ocean to the West and the South China Sea to the North via the Java Sea, and includes two additional small islands, Atuaro and Jaco, as well as Oecusse, a small coastal enclave in the western half of Timor Island. One-quarter of the country is classified as agricultural land, while only 2.5 percent is urban land. Forest currently covers 47 percent of the country, but forested areas have declined by more than 10 percent in the last 15 years due to deforestation practices, the degradation of forest ecosystems and illegal logging. Timor-Leste's most economically significant natural assets are its offshore oil and gas reserves in the Tasi Mane (Male Sea). Petroleum exports contribute 36 percent to GDP, 98 percent to exports and 91 percent to government revenues. Today, all of the country's oil is produced in the Bayu-Undan oil field in the offshore Joint Petroleum Development Area (JPDA), though there has been significant planning for development in the Greater Sunrise development area. In general, Timor-Leste has been effective at planning and managing its petroleum reserves. It directs a state-owned petroleum management company, Timor GAP, adheres to international transparency standards, and has built support for physical and human infrastructure. However, the depletion of oilfields has led to a slowdown in oil and gas production, which has left the country more vulnerable to financial shocks. There has also been considerable public debate about the increasing regularity of public expenditure exceeding the Petroleum Fund's estimated sustainable income targets, which makes future revenues less sustainable.

Beyond petroleum and natural gas, Timor-Leste has yet to fully recognize and effectively utilize its natural assets.

The island is part of the Wallacea biodiversity hotspot, which runs from northern Australia to Papua New Guinea and Samoa and is known for its rich plant and animal diversity. The region boasts over 41,000 plant species and more than twenty unique bird species. The coastal waters around Timor-Leste contain seascapes consisting of coral reefs, as well as some of the most extensive mangrove forests in the world. Approximately 42 percent of all sucos (villages) have a coastal border, and coastal resources are an important part of both culture and livelihoods. Developing management strategies for these resources will likely be an important step in ensuring their future sustainability. The National Development Plan (NDP) outlines strategies and initiatives for the environment as a whole, which it treats as a form of social capital. It includes targets to improve legal frameworks for environmental conservation, including the development of an extensive network of land and marine national parks. Mitigating the effects of climate change, from sea-level rise to flooding, drought and increasingly intense tropical cyclones—whose impact is especially acute for small island nations like Timor-Leste—will be pivotal to the long-term implementation of these natural asset management frameworks.

There is also ample opportunity to revitalize and build on the country's national brand and rich cultural asset base to generate income at both the national and community levels.

Timor-Leste's national identity is rooted in multiple indigenous groups and their associated cultural practices. Sixteen different languages are spoken in total, indicating the country's diverse and multi-ethnic past, geographical areas and centrality within the Asia-Pacific region. The capital, Dili, boasts a range of historical sites that survived the country's varied resistance periods, as well as its Portuguese, Dutch and Indonesian colonial pasts. Timor-Leste also possesses an idiosyncratic mix of museums, art galleries, libraries and cultural centers. The Strategic Development Plan (SDP) 2011-2030 outlines a set of initiatives and targets to showcase these assets through the development of cultural institutions, craft industries, art-focused companies and ecotourism. To reach these goals, the Plan includes targets for 2030 to develop regional cultural centers, open a national museum and library, establish a national theatre and dance company, develop the cultural tourist industry and increase employment in the creative industries sector. These plans are supplemented by Timor-Leste's national brand, "Explore the Undiscovered," which it conceptualized in 2015, and a National Tourism Policy, created in 2017. Despite some progress, political instability has hampered the implementation of these strategies. Timor-Leste announced its UNESCO membership in 2003, but the formation of the country's National Commission for the Recognition of Heritage Sites and Assets has been delayed, and as a result, it has not been able to fully develop robust and internationally recognized cultural sites. Additionally, the presence of UN peacekeeping missions, international development agencies and business travelers after Timor-Leste's independence created a false tourism economy that has disintegrated as these actors have left the country, depressing local economies.

Key asset management issues for Timor-Leste include:

- » Harnessing a rich natural, cultural, geographic and people-centered asset base to transition away from dependence on oil and gas.
- » Adapting to and mitigating the effects of climate change, specifically in sectors closely linked to local economies like water and coastal management and agriculture.
- » Translating institutional and strategic successes in the management and exploitation of petroleum and natural gas to other sectors to serve as a foundation for economic diversification.

Market Engagement

To overcome inconsistent growth driven by a reliance on petroleum revenues and government spending, Timor-Leste has developed clear plans to diversify and expand its economy, but implementation has been slow.

From a low level of development after independence, the country has advanced quickly with the aid of petroleum revenues. Still, recent economic growth has been inconsistent, despite stable macroeconomic and monetary management of inflation and debt stocks (supported by the use of the U.S. dollar as the country's currency). Timor-Leste's State Development Plan and National Planning Frameworks identify key sectors and goals, including improved agriculture production in rural areas and the development of the nascent tourism industry. While the government lacks a formal industrial policy, it has established six industrial zones throughout the country, each with its own sector-

level investment strategy. Timor-Leste's latest Economic Recovery Plan, drafted in response to the COVID-19 pandemic, also places a strong focus on import substitution, both to reduce reliance on imports and provide additional employment opportunities. The Recovery Plan highlights strategies for improving rural citizens' access to the market, such as the establishment of a chamber of commerce, industry and business incubators and decentralization of business service provision. While it seeks to diversify its economy, the Timorese government has also identified revenue reform across new sectors as a priority. Revenue reform will be crucial given the projected decreases in oil production in the coming years.

Engagement with the private sector has evolved rapidly since Timor-Leste's independence, and the barriers to market access and entry have been reduced—but firms are constrained by limited competition and crowding out by public sector spending.

The frontloading of capital investment and public spending by the government has helped spur local business development. Policy decisions, like state support for the dismantling of monopolies (i.e., in telecommunications), and a dollarized economy have made market entry by international and domestic firms attractive. Although there has been no privatization of state-owned enterprises, the government has shown interest in creating public-private partnerships and other licensing agreements as necessary to improve market outcomes. Domestically, however, firms in Timor-Leste tend to be small, young and burdened by high labor costs. Access to formal jobs and markets is also a major constraint to both firms and employees, and the informal economy constitutes a significant portion of the nation's economic output. However, these barriers to entry and the limited performance of domestic firms hide potential future productivity growth. Employment growth rates are improving, especially in manufacturing. Accession to the World Trade Organization (WTO), which is expected to occur in 2024, will also likely bolster opportunities for trade and investment in Timor-Leste.

Indirect, enabling mechanisms for market growth—despite strong government spending and reform—are limited, with private firms unable to navigate confusing, contradictory and constraining systems of labor market development, financial access and regulation.

Access to credit, property registration and contract enforcement are all critical issues. Timor-Leste introduced its first comprehensive framework for individual property rights in 2017 but is still saddled with the legacy of Portuguese legal rights and customary Timorese rights systems—making the framework confusing and contradictory. Limited labor opportunities outside of the oil sector, high-cost structures caused by government spending, and weak labor market intermediation all contribute to a feeble environment for firm growth. Unreliable and inequitable access to electricity and credit make start-up costs untenable for most Timorese.

Key market building issues for Timor-Leste include:

- » Executing sectoral and market building strategies to reduce dependence on imports and generate livelihood opportunities for communities, especially in underserved rural areas.
- » Decreasing reliance on government investments and contracting to spur economic activity by attracting more private investment.

- » Easing barriers to entering the formal economy outside of the oil sector and agriculture, which will be especially important for the country's young population.

Infrastructure

Timor-Leste experiences unique challenges related to developing infrastructure. Almost all of the country's infrastructure was destroyed or rendered practically unusable during its war of independence. Meanwhile, its geographic isolation results in increased construction costs while making more costly forms of transportation, like air, vital. Domestically, roads are Timor-Leste's most important infrastructure network, facilitating a vast majority of freight and passenger traffic, but they are of extremely low quality. The national road network is poorly maintained and often difficult to traverse, and newly restored or upgraded roads are sometimes seasonally washed out by heavy rains, creating a vicious build-rebuild cycle.

Electricity production and access have grown rapidly since independence, jumping from only 24 percent of population coverage under Indonesian rule to over 90 percent today.

While an impressive achievement, especially for an underdeveloped country coming out of conflict, rapid development has come at a cost. To expedite the development of new generation capacity, the government invested in two large thermal power plants in the early 2010s that are powered by light fuel oil (LFO), a crude oil distillate that costs three times more per kilowatt-hour than typical generation methods, such as hydropower. As the country's own vast petroleum reserves cannot generate electricity at these plants, the result is a peculiar form of circular trade with Singapore, whereby Timor-Leste exports crude petroleum to Singapore for refining, and then purchases back refined petroleum.

Ports are another vital means of connection in Timor-Leste, and despite recent attempts to expand capacity, they remain underdeveloped.

Timor-Leste's only major port is the Port of Dili, an older port with docking capacity for only three vessels and a limited cargo capacity. In 2016, the government concluded its first public-private partnership in history with a French logistics firm and a Chinese port operator to build Tibar Port, which opened in September 2022 and can handle up to 350,000 containers annually. As an island nation that is highly dependent on imports, further increasing port capacity could be an important and rewarding priority.

The government employs rapid, large-scale infrastructure financing as a means of stimulating economic development and growth in the short and medium terms, but implementation and management have a mixed record.

All stages of the infrastructure lifecycle in Timor-Leste are highly centralized, except for two community-driven development funds that provide financing for local infrastructure and environmental resilience projects at the municipal and village levels. While on paper Timor-Leste has strong infrastructure planning and management frameworks, in practice these processes suffer from several constraints. Project selection is prone to political interference, frequent use of "emergency" designations allows ministries to circumvent procurement and planning requirements, and maintenance budgets are insufficient leading to a "build, neglect, rebuild" cycle. Political decisions to rapidly increase infrastructure spending have led to consistently low infrastructure fund outturn rates as the benefits of frontloading investments remain unclear. While this strategy has produced clear benefits in some sectors—most notably rural electrification—it has also led to reduced quality-of-life outcomes and poor generation of

economic activity aside from government-contracted construction. It has also raised concerns about the long-term sustainability of public finances as a primary driver of investment.

Key infrastructure issues for Timor-Leste include:

- » Avoiding the “build, neglect, rebuild” cycle by improving infrastructure management capacity and investment strategies, including through private finance mobilization and public-private partnerships.
- » Continuing to harness maritime access and an advantageous geographic location by building enabling infrastructure for commerce and trade.
- » Improving strategies for building and maintaining the national road network, which is a foundational enabler of local economies and access to public services for underserved rural groups.

Human Capital

As a small island developing nation that suffers from outmigration, human capital, especially access to high-quality education and vocational training, remains a key challenge on Timor-Leste’s reform trajectory. Outmigration data suggests that the country is not meeting its citizens’ needs. Timorese people seek opportunities in countries like South Korea or Australia where remittances are consistently high. For example, Australia’s Seasonal Workers’ Programme (SWP) draws Timorese agricultural laborers. Nine years of primary education is compulsory, universal and free. While the government is obligated under law to provide pre-primary and secondary education services, student attendance is optional. Secondary education is divided into two paths: general, to prepare students for university, and technical, for workforce preparation. The government also provides recurrent education, a form of continuing education for those who have aged out of primary school. Net educational enrollment has significantly increased over the last decade, which has helped bridge gender disparity gaps in educational outcomes, however, academic achievement and productivity remain low compared to Timor-Leste’s Asian and Pacific neighbors. Urban-rural divides, associated costs and language barriers—as school instruction is only conducted in Tetum and Portuguese, not other indigenous languages—are key impediments to education attainment. The Ministry of Education’s strategic plan to address these shortcomings prioritizes improvements to educational access, the quality of instruction and professionalization, and retention and social inclusion. Exacerbating these issues are high instances of poverty – two in five people still live below the poverty line – in addition to a great urban-rural divide. While more information is needed on the labor market, it is clear that with a growing, youthful population and participation in education on the rise, policymakers will need to consider closely how skills developed in secondary and tertiary institutions align with opportunities in the market, particularly as the country seeks to develop services and industries to lessen its economic reliance on oil.

Like other key services in Timor-Leste, public healthcare has significantly improved since independence but still suffers from urban-rural divides and barriers to access. The government generally spends more on healthcare than its peers, and the number of medical personnel in the country has grown substantially, but budget execution stymies the effective provision of services. Delays in funding often result in weak procurement processes that lead to an unreliable stock of pharmaceuticals and other medical supplies

and hinder clinics’ ability to provide care. For rural populations in particular, long distances to healthcare facilities and travel costs pose critical accessibility issues. These challenges are compounded by problems such as high poverty levels and insufficient water and sanitation facilities, which have resulted in consistently poor health outcomes, especially in children. Rates of stunted growth and malnutrition are among the highest in the world. A government-run social assistance program, Bolsa da Mãe, supports poor and vulnerable households with children by providing monetary, educational, and healthcare-related assistance, but enhancements to the program could help further improve human capital outcomes related to poverty, health, and education. For example, increasing monetary transfer amounts from 5 percent to 10 percent of households’ budgets would reduce the incidence of poverty by 11 percent, as indicated by a recent study.

Key human capital issues for Timor-Leste include:

- » Reducing out-migration by fostering meaningful local educational and economic opportunities.
- » Building on success in increasing primary education enrollment by offering more robust secondary, technical and vocational options that are aligned to market demands.
- » Broadening the accessibility of healthcare services to address poor healthcare outcomes, especially for children and rural communities.

Citizenship & Social Policy

Overall, Timor-Leste has a robust system of rights guarantees and is committed to providing its citizens with social protections. However, inequality—largely linked to geographic divides—and implementation challenges related to institutional weaknesses pose major constraints to their full realization. These constraints create critical voids in the universe of rights and social protections that leave rural communities, laborers, women, children and the disabled particularly vulnerable. Timor-Leste’s 2002 Constitution guarantees a comprehensive set of rights, including protections against discrimination based on “color, race, marital status, gender, ethnic origin, social or economic status, political or ideological convictions, religion, education or physical or mental condition.” Special protections for children, the elderly, pregnant women and recent mothers, the war-disabled and orphaned children are provided, though people with disabilities are not specifically protected. The Constitution also enshrines political and civil rights—from freedom of political participation, religion, expression, movement and assembly, to the right to privacy and to personal data protection. The Constitution is intended to be interpreted in accordance with the Universal Declaration of Human Rights, to which Timor-Leste is a signatory.

Though Timor-Leste has a modern constitution that largely aligns with the international human rights system, feeble enforcement capacity, combined with cultural norms, makes it difficult to uphold some foundational legal and constitutional protections. While people with disabilities are protected against discrimination, a lack of resourcing and census data on the disabled population limits enforcement. The practice of child labor is widespread despite new initiatives to address it, including a National Child Labor Survey. As of 2019, 33.6 percent of children aged 10 to 14 were working with or without attending school, primarily in agriculture and fishing. Weak enforcement manpower and capacity, especially outside of

the capital of Dili, has also corroded the implementation of labor protections, which often do not effectively apply to family farming and other informal sectors. Domestic abuse is common, particularly against women and children, and cases of violence against children in the home and at school are both underreported and difficult to prosecute due to cultural beliefs that these incidents are private. Two out of three women aged 15 to 19 report experiencing violence, but these incidents are also underreported. Traditional inheritance excludes women from land ownership, and women face workforce inclusion obstacles: women generally have fewer qualifications and employment options and they face discrimination in hiring and during employment. Female participation in non-agricultural sectors is growing, but women's labor remains largely informal. Women's political participation has increased steadily but slowly, especially at the national level. Political participation is enshrined in the constitution, and the Law on the Election of the National Parliament—introduced in 2006 and amended in 2011—notes that there must be at least one female candidate for every three put forward by parties at the national level. In total, 40 percent of parliamentary seats are held by women, which is the highest percentage of women in parliament in the Asia-Pacific.

Timor-Leste has a comprehensive social protection system for its stage of development, but social policies and protection programs could be more strategically targeted and aligned with reducing inequalities and increasing access to essential services.

Guided by a 2018 Assessment-Based National Dialogue and the National Social Protection Strategy (NSPS), the government's social policies and programs have included broad-based cash-transfer schemes, social services to vulnerable groups and free public health and education services. For instance, the National Program for Village Development (PNDS), a village-level community-driven development program, provides grants to build small-scale infrastructure. Recently, in response to the COVID-19 crisis, the government announced a USD 150 million stimulus package that included 60 percent wage coverage for formal workers, waiving of utility bills, social security contributions for low-income households and a cash transfer program of two \$100 monthly payments to nearly 300,000 households—the largest such program in the country's history. Through these initiatives, Timor-Leste is making marked progress in addressing poverty and improving development indicators. Nevertheless, the country's social policy and protection programs are hampered by inadequate targeting, fragmentation and coordination concerns as well as generally limited service delivery to local levels. As reported by the ILO, non-poor households on average receive larger cash transfers (\$15 per month for households in the richest 10 percent) than poor households (\$7 per month in the poorest 10 percent). Significant disparities between urban and rural areas in resources and access mean that social services are much less effective in rural areas. While the government spends nearly 14 percent of its GDP on social protection, more than half of investments are made towards veterans' pensions, and the lack of an overarching and coordinated framework has resulted in gaps and inadequate support for the most vulnerable. The forthcoming NSPS may help resolve some of these issues, but there will continue to be challenges to the delivery of essential services and protections to local levels, including long delays and general institutional delivery weaknesses.

Key citizenship and social policy issues for Timor-Leste include:

- » Strengthening enforcement mechanisms for guaranteed legal and constitutional protections, particularly the rights of women and children.
- » Developing a clear strategic framework for social protection to improve coordination and meet service gaps.
- » Right-sizing investments and improving targeting to ensure that social protection schemes are reaching communities that are most in need.

Disaster Resilience

Timor-Leste's climate and geography make it susceptible to extreme weather and a range of natural disasters.

Its climate is prone to severe drought during the dry season and flooding and landslides during the wet season. Notably, in April 2021 Timor-Leste experienced some of the worst torrential rains and flooding in recent memory. The COVID-19 pandemic complicated relief efforts, and reports indicate that 13,554 people were displaced. As an island country, Timor-Leste is also susceptible to typhoons and monsoon rain, and historically, it has been greatly impacted by La Niña and El Niño climate events. The country's position near the intersection of three continental plates means that earthquakes and associated tsunamis are a continual risk. The country's vulnerabilities are exacerbated by poor agricultural practices and nondurable construction practices, especially for housing. A recent report found that among residential houses, 53 percent are constructed with bamboo walls, while only 19 percent are constructed with concrete or brick. Other factors contributing to vulnerabilities include wealth or access to income, livelihood diversity and the climate sensitivity of income.

Disaster resilience is the primary responsibility of the Ministry of Social Solidarity through the National Disaster Risk Management Directorate and Secretary of State for Social Assistance and Natural Disasters.

Timor-Leste submitted its first National Adaptation Plan (NAP) to the United Nations Framework Convention on Climate Change in 2021. The plan identified Timor-Leste's primary climate-related hazards as flooding and erratic rainfall, landslides and coastal erosion, among others. To implement the NAP, the government's National Climate Change Policy uses a multipronged approach, focusing on promoting sustainable land and water management practices, while also strengthening the management capacity of national, local and community institutions. Social inclusion and informed participation are key guiding principles of Timor-Leste's climate policy. These principles will likely be important as the government seeks to improve its effectiveness at implementing projects at the local level, especially in rural areas. The policy also notes the importance of pursuing conflict-sensitive strategies for climate adaptation that improve social cohesion.

Key disaster resilience issues for Timor-Leste include:

- » Improving local agricultural and construction practices that make communities more vulnerable to weather and climate shocks.
- » Developing strategies to improve national and community resilience to increasing flooding and other extreme weather events.
- » Developing institutions and management structures to implement the National Climate Change Policy.

Key Medium-Term Issues for Timor-Leste

Based on ISE's assessment of the performance and capabilities of core state functions, there is a set of key issues and trends that Timor-Leste will need to address in the medium term.

1. Taking the “next step” after notable rapid development progress:

Timor-Leste is at a critical juncture in its development. The transition out of “fragility” has brought improved public services, governance structures and economic opportunities to Timorese communities. However, like many other post-conflict states, good policies and programs on paper have not always been translated into practice, and there are signs that progress could be stagnating. This risk is compounded further by the government's looming resource constraints. Improving this institutional capacity to ensure the state can sustainably deliver on its mandate—backed up by strategic investments for economic diversification to avoid emerging financial and fiscal risks—will define the next phase of Timor-Leste's development.

2. Maintaining post-conflict stability: Amid a global landscape of increasing conflict, Timor-Leste is a rare case of a state successfully transforming from violent crisis to institutionalized stability. However, it will be important for Timorese policymakers to continue to be mindful of this recent history. Ongoing significant investments in markets, infrastructure and public services should be implemented in a manner that is conflict-sensitive and inclusive to mitigate the risk that unequal access or benefits widens societal cleavages.

3. Addressing geographic inequalities: The most significant barrier to Timor-Leste's development and reform has been bridging geographic divides. The country suffers from sharp urban-rural inequality, and many communities face geographic barriers to accessing a variety of public services. While this is not a challenge unique to Timor-Leste, considerable changes to the country's economy and standard of living over the last two decades have put this split in stark relief. As Timorese communities and leaders craft the next phase of their country's long-term transformation, they should be especially mindful of the inclusivity of state interventions and priority developments.

4. Securing a place in the region and the world: Timor-Leste's location in Southeast Asia, amid a vibrant region of innovation and commerce, brings many opportunities as well as challenges. There are ample opportunities to leverage the expertise and capital resources in the region to support upgrading Timor-Leste's human and infrastructure capacity and improve its competitiveness in the marketplace. Chief among these is membership in the World Trade Organization (WTO) and the Association of Southeast Asian Nations (ASEAN).

Scenarios for the Timor-Leste of the Future

Considering these assets, constraints and medium-term issues, Timor-Leste has the opportunity to accelerate development and achieve sustainability. However, the decay of hard-won gains following independence is also a risk.

» **Status Quo:** The country continues to operate in siloes, both internally and regionally, where levels of government act in a disjointed and opaque manner, and Timor-Leste does not successfully integrate into regional platforms.

» **Worst Case:** Extended political contestation supersedes inclusive development, where unhealthy political contestation and changing coalition persist and prevent effective governance and market development, including the opportunities to capitalize on hydrocarbon endowments.

» **Best Case:** The success of the Greater Sunrise project and economic diversification leads to improved livelihoods and markets, underpinned by strategic public investments for inclusive development and strengthened institutions.

Key Opportunities and Critical Tasks

Timor-Leste has seen significant development gains after seizing its post-independence open moment; the next stage of its development can be realized with a renewed focus on implementation and management. Moving forward, Timor-Leste and its partners will need to address key drivers (both assets and constraints) to realize its development vision. These include:

Effectively harnessing its hydrocarbon endowment

The Petroleum Fund is a well-regarded sovereign wealth fund and is central to Timor-Leste's long-term development. However, oil production is dwindling as operations transition from the Bayu-Undan field to the Greater Sunrise development area. The slow progress of this transition presents Timor-Leste with two key risks. Firstly, it requires the government to draw down on the Petroleum Fund during non-producing years to prevent a recession. Secondly, there is a risk that the value of the resource will deteriorate as medium-term demand is undermined by the rapidly dropping price of renewable energy. As a result, the government should also focus on diversifying its economy away from hydrocarbons. However, diversification is intrinsically intertwined with hydrocarbons as public spending from the petroleum-financed sovereign wealth fund dominates economic activity in Timor-Leste. Enhancing the quality of public spending is essential to improve the impact of fiscal policy on economic activity.

Maturing political systems

Politics in the country still largely orbits around resistance identities, with certain leaders retaining almost cult-like status. While the relative policy stability born from ideological alignment has been a boon to development planning, democracy remains fragile and is susceptible to populism and tribalism. Given the current global resurgence of populism and authoritarianism, a key challenge will be the transition from these aging leaders to an institutional, policy-based identity for political parties. Stakeholders from across the spectrum, but particularly high-level political actors, need to reaffirm their commitment to the country's key institutions and stable governing norms—namely its commitment to separation of powers, press and speech freedoms and fighting patronage networks. Maintaining this political stability is also key for all the government's core economic goals, especially driving private investment and establishing a more robust regional and international presence.

Improving inclusive governance and administrative capacity

Timor-Leste's government remains highly centralized, and institutions often guard information and power from each other. While the gains in governance over the past 20 years should be recognized, the rapid development of new highly centralized

governance structures, coupled with limited human capital in public administration has led to bureaucratic waste and entrenched interests. Timor-Leste's poor-quality infrastructure compounds the governance challenge. Decentralization also introduces risk, especially for the accountability and sustainability of local assets and finances but presents an opportunity to create better incentives for effective local service delivery and social protection programs.

Building resiliency to natural hazards and climate change

As a mountainous island state, Timor-Leste is significantly exposed to climate risk. The country's vulnerabilities are exacerbated by poor agricultural practices and construction standards. Timor-Leste will likely be increasingly impacted by natural hazards due to global warming. There is a clear need for improved climate adaptation and land management practices to protect citizens from disasters and protect investments in infrastructure. Managing these climate risks is also key to creating a sustainable economy. This includes improving the management and maintenance of enabling infrastructure for commerce and trade, especially the road network, and modernizing agriculture practices and land management practices.

Conclusion

Timor-Leste's rapid development following independence presents an opportunity for long-term transformation. Navigating out of conflict, the country has made meaningful investments—backed by its vital petroleum reserves—in public services and economic and connective infrastructure to make significant progress on reducing poverty and providing livelihood opportunities for its communities. However, like many contemporary successes in Timor-Leste, there are two sides to the equation. Dwindling oil and natural gas production means that the government must forge a new pathway for the island nation that provides the resources for effective governance while diversifying the economy and improving the delivery of public services, especially in rural areas. As a small island developing state, the country will also need to manage and adapt to climate-related risks while pursuing policies and programs that sustainably harness Timor-Leste's rich natural asset base. To achieve this goal, Timor-Leste's leaders will need to coalesce around shared commitments to reform that are founded on building the long-term capacity of its institutions to deliver on their promises to communities.