WORLD BANK GROUP

TIMOR-LESTE ECONOMIC REPORT

From Resources to Results: Transforming Public Spending To High Growth

January 2025

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Timor-Leste Economic Report

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Acknowledgment

The Timor-Leste Economic Report (TLER) is a bi-annual World Bank report that assesses recent macroeconomic developments, outlook, and risks, as well as specific development challenges for the Timorese economy. In doing so, the TLER aims to inform the public policy debate and is geared towards a wide audience, including the general public, the government, the private sector, civil society organizations, and other domestic and international stakeholders.

The TLER is a product of the World Bank Jakarta and Timor-Leste office and receives strategic guidance from Carolyn Turk, Country Director for Indonesia and Timor-Leste. The report is prepared by the Macroeconomics, Trade, and Investment (MTI) Global Practice team, under the leadership of Lars Christian Moller (Practice Manager), Bernard Harborne (Resident Representative), and Habib Rab (Program Leader and Lead Economist). The first and second chapters were led by Amina Coulibaly and Yus Medina Pakpahan, with labor market analysis inputs from Flavia Capurro. The focus chapter was also prepared by Amina Coulibaly and Yus Medina Pakpahan, with contributions from John Nana Darko Francois, Paolo Di Lorenzo (EMFTX), Lander Bosch, Eko Setyo Pambudi, Jose Maria Tavares Mousaco (HEAH1), Patrick Umah Tete (EEAG2), Edgardo Mimica (Consultant), and Michael Graeme Osborne (EEAR2). Ana de Oliveira provided administrative support and coordinated the report's launch event. The report also benefited from comments provided by Alief Rezza, Csilla Lakatos, Kevin Cruz, Franz Ruch, and Erdem Atas.

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KEY INDICATORS	
Population (million)	1.3
GDP (USD billion)	1.6
GDP per capita (USD)	1,295
Poverty headcount ratio -national poverty line (percent population)	41.8
Poverty headcount ratio-USD 1.90 a day (2011 PPP, percent population)	22.0
Poverty headcount ratio-USD 3.20 a day (2011 PPP, percent population)	65.9
GINI index	28.7

Notes: Population and GDP data are for 2019. Poverty and inequality data are for 2014 (with revised PPPs)

Acronyms

ASEAN	Association of Southeast Asian Nations
BCTL	Central Bank of Timor-Leste
CIT	Corporate Income Tax
EAP	East Asia and Pacific
ESI	Estimated Sustainable Income
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HCI	Human Capital Index
HDI	Human Development Index
ICT	Information and Communications Technology
IF	Infrastructure Fund
IMF	International Monetary Fund
INETL	Institute National Statistics of Timor-Leste
MAPS	Methodology for Assessing Procurement Systems
NEER	Nominal Effective Exchange Rate
NEET	Not in Employment, Education, or Training
NQI	National Quality Infrastructure
PF	Petroleum Fund
PFM	Public Financial Management
PIM	Public Investment Management
PIMA	Public Investment Management Assessment
PIT	Personal Income Tax
REER	Real Effective Exchange Rate
SDP	Strategic Development Plan
UN	United Nations
VAT	Value added Tax
WHO	World Health Organization
WTO	World Trade Organization

Summary

Timor-Leste faces a defining moment in its economic journey. As the country seeks to transition from petroleum dependency to a more diverse and resilient economy, the stakes could not be higher. The Petroleum Fund, a lifeline that has sustained much of the national budget, risks depletion by 2035, based on recent Ministry of Finance estimates, unless there are urgent reforms. Ambitious national goals—such as upcoming ASEAN membership—reflect the country's aspirations to integrate globally and broaden its growth horizons. Yet, these opportunities are weighed down by significant fiscal challenges. More specifically, an expanding national budget that raises concerns about fiscal sustainability and the efficiency of public spending. The question is clear*: how can Timor-Leste spend better to fuel sustainable growth while preserving fiscal stability?*

1. Recent Developments: A Glimpse of Recovery Amid Challenges

Global economic growth stabilized at 2.6 percent in 2024, with the East Asia and Pacific (EAP) region outperforming the global average despite a slowdown in China. Advanced economies grew modestly at 1.5 percent, while emerging markets expanded by 3.3 percent, driven by strong domestic demand. Within the EAP region, growth slowed to 4.8 percent due to weaker performance in China. Excluding China, regional growth was a robust 4.7 percent, supported by recovery in trade, consumption, and tourism. Despite this, regional growth has yet to return to pre-pandemic levels, highlighting ongoing recovery challenges.

For Timor-Leste, 2024 was a year of economic expansion[1] driven by strong performance in the service sector. International arrivals grew by 23 percent compared to the previous year, reflecting renewed confidence in the post-pandemic period and contributing to the expansion of services such as hospitality and retail. Growth in telecommunications and transportation further bolstered the economy, while budget execution improved relative to 2023. Although public investment continues to support short-term economic growth, there are reasons to be wary of this development given the high level of public investment and concerns around its efficacy as discussed in the Special Focus of this report.

Nevertheless, structural challenges persist. Since 2014, economic growth has averaged just 1 percent per year, constrained by an overreliance on petroleum revenues and a weak private sector. The public sector remains the dominant employer, accounting for 77 percent of paid jobs, which limits private sector expansion and job creation. Additionally, skill mismatches hinder economic diversification, as highly educated workers are concentrated in government roles, leaving the private sector with a shortage of skilled labor.

Inflation eased but food inflation remained persistently high. A stronger US dollar has moderated non-food sector inflation, but local agricultural production struggles to meet demand, exacerbated by adverse weather conditions like El Niño. Government price stabilization measures helped mitigate some effects, but structural issues in food production remain unresolved.

External accounts deteriorated as the trade deficit significantly widened. A 33 percent decline in oil exports, driven by the near depletion of the Bayu-Undan gas field, and reduced coffee exports narrowed the country's export base. Simultaneously, a strong exchange rate further fueled import demand, increasing reliance on foreign goods. By mid-2024, the current account deficit reached USD 62.1 million or 8.6 percent of GDP.

[1] Revenue from oil and gas is not included in GDP for several reasons. The inclusion of oil and gas production in GDP statistics was triggered by the signing of the Maritime Boundaries Treaty with Australia, which delineated the maritime border and confirmed that the Bayu-Undan field—the only producing field—was located within Timor-Leste's Exclusive Economic Zone (EEZ). Before this, oil and gas revenues were primarily derived from the Joint Petroleum Development Area (JPDA), a zone of joint management between Timor-Leste and Australia, and these revenues were treated as fiscal income rather than domestic economic output. Furthermore, much of the production occurred offshore, with associated economic activities managed by foreign companies, making it challenging to classify oil production as part of Timor-Leste's domestic economy. Including oil GDP can distort the true picture of domestic economic performance. Excluding oil GDP allows for a clearer focus on the non-oil economy, which, while nascent and small, represents Timor-Leste's path toward sustainable and diversified growth.

Budget execution improved in 2024, but domestic revenue collection is estimated to have declined. The Government had spent 56 percent of its annual budget by the third quarter—up 5 percentage points from the previous year. Key areas such as social support and capital expenditure saw the most progress, reflecting efforts to meet rising demands. However, domestic revenue collection declined by 5 percent in 2024 for the same period, driven by the reversal of several tax measures. The fiscal deficit stood at 42 and 48 percent of GDP in 2023 and 2024 respectively.

The Petroleum Fund's balance remained stable but showed signs of strain. As of September 2024, the fund stood at USD 18.9 billion, approximately 10.5 times Timor-Leste's 2023 GDP. However, total assets only grew by 2.2 percent on a year ago, with net inflows in Q2 plummeting by 95 percent, largely due to reduced production at Bayu-Undan and higher budgetary withdrawals. Investment returns also dipped, with Q2 yielding a return of only 1.2 percent compared to 5.9 percent in Q4 2023. Continued excess withdrawals and minimal investment returns further eroded the Fund's sustainability, raising substantial concerns about its capacity to support future fiscal needs.

2. Outlook and Risks: Recovery with Risks

The economic outlook suggests continued but fragile recovery. Growth is projected to average 3.5 percent during 2025–2026, supported by infrastructure projects like road development. The anticipated conclusion of negotiations for the Greater Sunrise offshore gas field with Australia in 2025 could further enhance economic prospects. Tourism, remittances, and a growing digital economy, underpinned by the installation of a fiber-optic cable, are also poised to contribute to growth. However, the narrow export base, reliant mainly on coffee, and high dependency on imports constrain non-oil sector expansion.

Inflation is expected to decline, but external risks pose challenges. Inflation is projected to fall to 3.3 percent in 2024 and average 2.5 percent during 2025–2026. Nonetheless, external risks, such as climate-related disruptions and global commodity price volatility, particularly for rice, could add price instability. Timor-Leste's reliance on imports and its use of the U.S. dollar limits its ability to manage inflation through monetary policy, emphasizing the need for robust external risk management strategies and a stronger role for fiscal policy.

Fiscal challenges persist, with heavy reliance on the Petroleum Fund. Public expenditure is set to outpace domestic revenue in 2025, with the Petroleum Fund expected to finance 73 percent of government spending. The fiscal deficit is projected to reach 57 percent of GDP in 2025., underscoring the unsustainability of current fiscal practices. Urgent reforms are needed to diversify revenue sources and curb unsustainable spending patterns.

Significant risks could undermine growth and fiscal stability. Climate change and extreme weather events, particularly linked to El Niño, threaten agricultural output and food security. Geopolitical tensions could disrupt trade and energy markets, amplifying vulnerabilities. Domestically, weak public service delivery, underinvestment in education and health, and inefficiencies in infrastructure projects could stifle private sector growth and delay economic diversification efforts.

Improving public investment efficiency and fiscal management is crucial. To sustain growth, Timor-Leste must enhance budget execution and ensure infrastructure investments deliver long-term benefits. Prioritizing efficiency in public spending, especially in transport and digital infrastructure, will reduce costs for the private sector and foster competitiveness. Without these reforms, the depletion of the Petroleum Fund could jeopardize future growth, highlighting the urgency of fiscal and resource management improvements.

3. Special Focus: Making Public Expenditure Boost Growth

Timor-Leste's Unsustainable Fiscal Path: High Spending, Low Returns

Timor-Leste spends eight dollars for every dollar it collects, ranking among the highest globally in government expenditure as a proportion of GDP. Public expenditure averaged around 85 percent of GDP between 2013 and 2023. This exceptionally high spending, coupled with low domestic revenue collection—consistently below 12 percent of GDP—has placed immense strain on the Petroleum Fund. Frequent breaches of the Estimated Sustainable Income (ESI) rule, designed to cap annual withdrawals and preserve the Fund's longevity, highlight growing fiscal risks and the urgent need for improved fiscal management. Moreover, the projected depletion of the Petroleum Fund in 2035 based on the recent MoF's estimate[2], compounded by the uncertain development of additional reserves like Greater Sunrise, poses a significant threat to fiscal stability. Without immediate reforms, Timor-Leste will require a severe fiscal adjustment, potentially jeopardizing the delivery of essential public services and social cohesion.

High levels of government spending have failed to translate into sustained high economic growth and improved living standards. Between 2011 and 2023, GDP growth averaged just 1.3 percent annually—far below the 4 percent or more seen in peer countries with similar fiscal efforts. According to 2014 Living Standard Survey the poverty reduction has stagnated, with nearly 42 percent of the population living below the national poverty line. This lack of progress reveals deep inefficiencies in public spending and a disconnect between expenditure and outcomes.

Timor-Leste's fiscal strategy faces three interrelated challenges: weak fiscal discipline, inefficient resource allocation, and operational bottlenecks in public financial management. These issues have resulted in a low fiscal multiplier estimated at a mere 0.1–0.2, far below the average range of 0.5 to 1.4 for similar low-income countries. What this means is there is a limited economic impact of government spending. For each dollar the government spends it adds very little to the country's economic growth. This disconnect is more than a missed opportunity—it's a critical challenge**;** as it highlights severe inefficiencies in the allocation and execution of public funds, as well as structural challenges that constrain the economy's responsiveness to fiscal stimulus.

A significant imbalance in expenditure composition further exacerbates fiscal sustainability concerns. Recurrent spending, dominated by wages, subsidies, and social transfers such as social security and veterans' benefits, consistently exceeds 60 percent of GDP. This large allocation leaves limited fiscal space for capital investments, which are critical for long-term infrastructure development, education, and healthcare improvements. The government's role as a major employer inflates wage expenditures, while growing transfer costs entrench inefficiencies in resource allocation. Capital expenditure, although relatively high by international standards, suffers from delays, inefficiencies, and a lack of focus on high-impact projects. The dominance of recurrent spending dilutes the potential impact of capital investments, limiting Timor-Leste's ability to address long-term growth priorities.

High public investments are undermined by delays, cost overruns, and inadequate maintenance. A significant share of capital expenditure is allocated to infrastructure assets such as roads, bridges, and public buildings. However, delays in project execution, cost overruns, and insufficient maintenance have hindered their ability to contribute meaningfully to economic growth. Poor road maintenance, for instance, accelerates asset deterioration, increasing costs and reducing accessibility for communities and businesses. Weak project management and limited technical capacity within government ministries exacerbate these issues. The long-run multiplier for capital spending on infrastructure,[3] particularly roads, is estimated at just 0.10, reflecting its limited

[2] Timor-Leste General State Budget 2025
[3] Capital spending multiplier is calculating the impact of change in Government capital spending on economic growth.

economic contribution. With an IMF Mean Speed Score[4] below 40, Timor-Leste ranks among the lowest globally in road quality, trailing significantly behind its regional peers.

Similarly, significant spending on human capital has not delivered the anticipated improvements, with education and health outcomes lagging behind regional peers. Literacy rates remain stagnant at 68 percent, well below the regional average of 84 percent, and increased education spending has failed to improve learning outcomes. Health indicators are equally concerning; life expectancy stands at 69.1 years, far below Vietnam (74.6 years) and the EAP average of 76.2 years. Infant mortality remains high at 41 per 1,000 live births compared to 18.1 in Indonesia and 16.2 in Vietnam. Malnutrition persists, with Timor-Leste having one of the highest child stunting rates in the region. Social protection programs have had limited impact; for example, the Bolsa de Mãe program reduced poverty by only 0.9 percentage points, while the veterans' program, consuming 5 percent of GDP, reduced poverty by just 2.6 percentage points.[5] These outcomes highlight a high cost for minimal impact, emphasizing the need for efficiency and better targeting.

Timor-Leste's procurement and public investment management (PIM) systems suffer from critical inefficiencies. Outdated regulations and fragmented processes create inconsistencies, leading to project delays and cost overruns. Weak contract management and limited technical expertise further compound these challenges. A disconnect between procurement planning and budgeting undermines the timely execution of projects, while misalignment between strategic priorities and feasibility assessments results in poorly targeted initiatives. Top-down project selection reduces community input and relevance, further diminishing project ownership and impact. Many investments are delayed due to insufficient preparation, while inconsistent funding during project lifecycles leads to inefficiencies.

The Way Forward: Timor-Leste's Path to Fiscal Sustainability

To ensure fiscal sustainability and economic resilience, Timor-Leste must adopt a comprehensive strategy focused on three pillars: collecting more revenue, spending less, and spending better. While improving spending efficiency is critical, it alone cannot resolve the country's fiscal challenges. Public spending, at 85 percent of GDP, is unsustainable and far exceeds regional and structural peers. Timor-Leste must reduce spending to manageable levels by cutting inefficient or poorly targeted expenditures and reallocating resources to priority areas like human capital development. Boosting domestic revenue mobilization is equally critical. Reliance on the finite Petroleum Fund leaves Timor-Leste vulnerable to fiscal shocks and limits its ability to sustainably fund essential services. Expanding the non-oil[6] tax base, improving tax administration, and strengthening compliance are vital for creating a steady, diversified revenue stream. "Spending better" requires prioritizing quality and sustainability over quantity. For instance, improving efficiency in healthcare could deliver a "double dividend" by expanding the workforce while improving population health. Similarly, targeted spending in education, focusing on effective teaching, infrastructure, and equitable access, can maximize the impact of reduced budgets. Achieving sustainable growth and development will demand smaller, more effective budgets, coupled with a diversified economy, stronger fiscal management, and investments in human capital.

The 9th constitutional government has started taking steps toward a strategic reform agenda to improve public spending. Signaled by the Budget Bill for 2025 under the banner of "*investments in strategic infrastructure, strengthening the economy and improving the well-being of citizens,"* the Government has started a reform process. Key reforms include the introduction of an omnibus public procurement law and a new public financial management law. These will provide an opportunity to streamline processes, prioritize local suppliers, and accelerate project timelines. Complementary reforms in the financial sector, led by the Central Bank, aim to

[4] Mean Speed score is a measure developed by IMF to assess cross-country road quality and accessibility. Higher MS scores indicate better road quality and accessibility, facilitating more efficient movement of people and goods between cities.
[5] ADB, *Fiscal Incidence in Timor-Leste: Impact of Taxation and Public Expenditure on Poverty and Equality, ADB, 2024, accessed January 2025* https://www.adb.org/sites/default/files/publication/961366/fiscal-incidence-timor-leste.pdf
[6] Non-oil tax is referring to domestic tax revenue collection excluding revenue from Estimated Sustainable Income from Petroleum Fund

improve spending efficiency and create enabling conditions for economic diversification, such as a secure transactions law and advancing use of digital payments. These initial steps need further reinforcement as the government advances its reform agenda during the second half of its mandate.

As the Government develops its reform agenda, in line with ASEAN accession (anticipated this year), it will need to be holistic and comprehensive. A number of suggested reforms are outlined in the table below.

Improving the efficiency of public expenditure is a critical step toward achieving Timor-Leste's fiscal sustainability, but it cannot stand alone. A holistic approach is critical—one that not only enhances spending efficiency but also reduces overall expenditures while strengthening revenue collection. Aligning public spending with long-term development priorities, strengthening project preparation, and building technical capacity are essential steps. Efficient resource allocation in critical sectors such as infrastructure, education, and health can yield significant returns. For example, Timor-Leste spends 30–40 percent of GDP more on general services and economic affairs than its peers, indicating substantial potential for savings. Optimizing the wage bill is another area ripe for reform. Streamlining staffing structures, implementing performance-based evaluations, and controlling salary increments could save up to 5 percent of GDP. Additionally, procurement and infrastructure reforms could cut costs by up to 1.5 percent of GDP by addressing inefficiencies, reducing cost overruns, and improving project execution. Even modest reductions in public spending could unlock millions of dollars, ensuring fiscal stability and supporting Timor-Leste's transition to a diversified, self-reliant economy.

Timor-Leste is blessed with resources, through the Petroleum Fund, but these are not having the required impact to stimulate growth, create jobs and strengthen human capital. And those resources are running out and so the clock is ticking for Timor-Leste to implement transformative reforms. The time to act is now!

Table of recommendations

Priority Area Objective	Key Actions	Timeline
Reduce the public spending and raise non-tax revenues	- Introduce a value-added tax (VAT), while adopting complementary measures to ensure equity. - Improve revenue administration by modernizing the tax system and investing in capacity. - Produce regular reports on tax expenditures (while planning a gradual phasing out). - Gradually reduce the fiscal deficit through a binding commitment to the ESI, ideally in the context of a medium-term fiscal framework.	Short term
Improve resource allocation.	- Curb the budget for goods & services - Enhance the selectivity (and transparency) of public grants. Develop adequate pay and employment policies for the civil service and improve human resource planning.	Short-term
Enhance learning outcomes	- Expand access to quality pre-school education to improve readiness. - Invest in basic education, school infrastructure, remedial programs, and school feeding initiatives. - Enhance teacher training and performance incentives.	Medium-term
Ensure equitable access to healthcare	- Improve health budget planning and execution to reduce delays. - Decentralize governance with clearer municipal health service roles and central oversight. - Address regional disparities in healthcare access through workforce incentives.	Short-Medium term
Reduce inefficient expenditures	- Phasing out transfers and grants implemented during the pandemic and the period of high food and energy prices. - Rebalance the social protection spending toward poverty-targeted programs. - Improve Bolsa da Mãe targeting to reach the poorest households. - Implement a unified social registry and monitoring to reduce duplication. - Align programs with human capital development goals (early childhood, nutrition, education).	Short-term
Leverage PIM reforms to optimize resource allocation and spending efficiency.	- Strengthen project appraisal, selection, and monitoring processes to align investments with national priorities. - Enhance the framework for prioritizing high-impact public investments	Short-Medium term
Ensure efficient and sustainable use of public resources	- Adopt implementing texts of the new procurement law - Introduce conflict-of-interest declarations, structured complaint mechanisms, and performance monitoring using KPIs. - Enhancing financial reporting and auditing processes to ensure public funds are well managed.	Short-Medium term
Align fiscal spending with clear social and economic objectives.	- Implement program-based budgeting to align spending with objectives. - Develop a budget strategy statement for medium-term fiscal planning. - Set up real-time monitoring and evaluation mechanisms to improve performance.	Short-Medium term

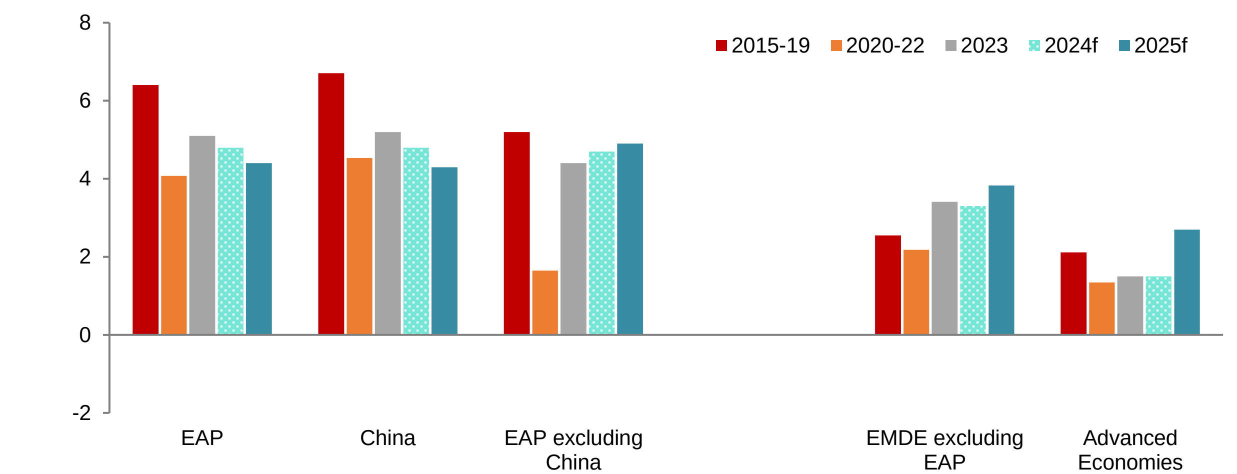
1. Recent Developments

1.1. Global Growth Stabilizes but Remains Below Pre-Pandemic Levels.

The global economy has stabilized in 2024, though growth rates continue to vary widely across regions. For the first time in three years, global growth has not declined, stabilizing at 2.6 percent compared to 2.4 percent in 2023. Advanced economies are expected to grow at a modest 1.5 percent, while emerging market and developing economies (EMDEs) are projected to achieve a stronger average growth rate of 3.3 percent. However, this stabilization is insufficient to significantly advance key development goals, as global growth remains below the pre-COVID-19 average of 3.1 percent. This mixed recovery highlights the varying growth rates across different regions and the challenges faced by policymakers in balancing economic recovery with the need to contain inflation and manage other economic pressure.

The EAP region continues to lead global growth, though its recovery has moderated compared to pre-pandemic levels. In 2024, the region's growth is estimated at 4.8 percent, a slowdown driven largely by weaker performance in China (Figure 1.1) Domestic activity in China has been hampered by low consumer confidence, a sluggish labor market, and a prolonged property sector downturn marked by declining investment and property prices. Nonetheless, export growth rebounded due to improved global trade conditions and precautionary inventory building. To counter these challenges, Chinese authorities introduced fiscal stimulus and monetary easing measures. Meanwhile, growth in EAP economies excluding China accelerated to 4.7 percent, buoyed by recovering global trade, a surge in tourism, and strong domestic demand.

Figure 1.1: The region continues to grow faster than the rest of the world but slower than before the pandemic
(percent)



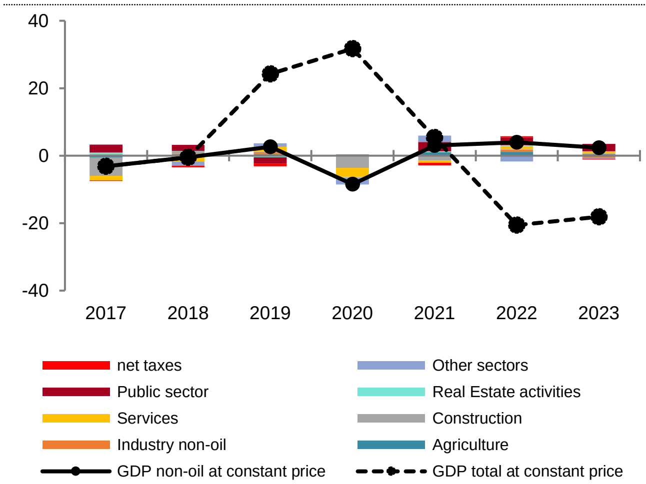
Source: EAP October 2024 Update

Inflation pressures eased globally in 2024, particularly in advanced economies, where tight monetary policies and falling commodity prices curbed price growth. Headline inflation in these economies declined from 7.8 percent in 2022 to 5.2 percent in 2024, while in emerging markets, inflation moderated to an average of 8.6 percent. Within the EAP region, inflation trends were mixed. Major economies such as China, Indonesia, and Thailand maintained inflation within or below central bank targets, supported by weak domestic demand and stable commodity prices. In China, headline inflation stood at just 1.0 percent, well below the 3.0 percent target, while core inflation hovered near zero, reflecting weak consumption. Deflationary pressures were evident, with producer prices falling by 2.5 percent year-over-year. In contrast, inflation remained alarmingly high in Lao PDR and Myanmar, reaching 30 percent and double digits, respectively, due to currency depreciations and supply chain disruptions

1.2. From Slowdown in 2023 to Recovery in 2024 Driven by Budget Execution and Service Sector Growth

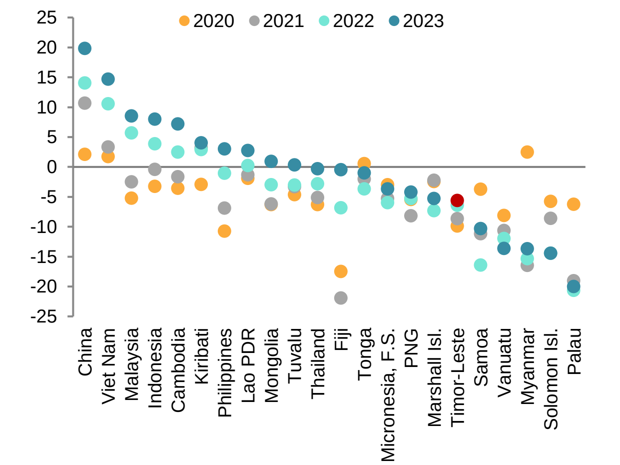
Economic Growth Slowdown Confirmed for 2023. Final data released in last October confirmed a slowdown in Timor-Leste's economic growth in 2023, with real GDP growth declining to 2.4 percent from 4.0 percent in 2022, driven by a combination of headwinds (Figure 1.2). Though having sustained growth after the Pandemic, Timor-Leste's per capita output remained below the Pre-pandemic level, like most of Pacific Island Countries (Figure 1.3). While the services sector, particularly tourism, showed partial recovery following resumed international travel, these gains couldn't offset broader economic challenges. Several key sectors experienced significant headwinds: agriculture faced unfavorable climatic conditions and supply chain disruptions after strong performance in 2022; the oil and gas sector struggled with price volatility and production halts; and construction was impeded by rising material costs. Manufacturing remained underdeveloped due to structural barriers, while increased import reliance and declining oil revenues further pressured the economy.

Figure 1.2: The economy slowed down in 2023…
(real growth of non-oil GDP, percent)



Source: INETL and World Bank Staff's calculation.

Figure 1.3:…and per capita output remain below the pre-pandemic level
(percent difference to 2019 Constant GDP per capita)



Source: World Economic Outlook and World Bank Staff's calculation.
Note: for Timor-Leste, the number represent non-oil GDP per capita

Retail and construction were the leading contributors to Timor-Leste's non-oil producing business output in 2023, though other industries faced significant hurdles.[7] Construction followed closely at 30.5 percent of IVA (Industry Value Added), with these two sectors together representing nearly two-thirds of total business output. Service industries, including health, education, and professional services, contributed 9.2 percent, while Transportation and Storage (3.7 percent) and Information and Communication (5.0 percent) made smaller contributions. Accommodation, Food Services, and financial activities showed post-pandemic recovery, though Manufacturing and Information sectors experienced declining output.

Despite challenging conditions, the non-petroleum business sector demonstrated resilience in 2023. Total profits reached $525.7 million, showing only a modest 1.7 percent decline from 2022, though rising operational costs impacted business margins. However, rising operational costs, including a 13.8 percent increase in labor expenses, impacted business margins. Construction generated 31.9 percent of total profits,

[7] Based on 2023 Timor-Leste Business Activity Survey, National Institute of Statistics Timor-Leste (INETL). The scope of this survey includes Private non-financial business (excluding agricultural production and petroleum producing business), private financial business, public non-financial and financial business, and not-for-profit institution.

while manufacturing and information sectors struggled with weak demand and high fixed costs, potentially limiting future reinvestment and innovation.

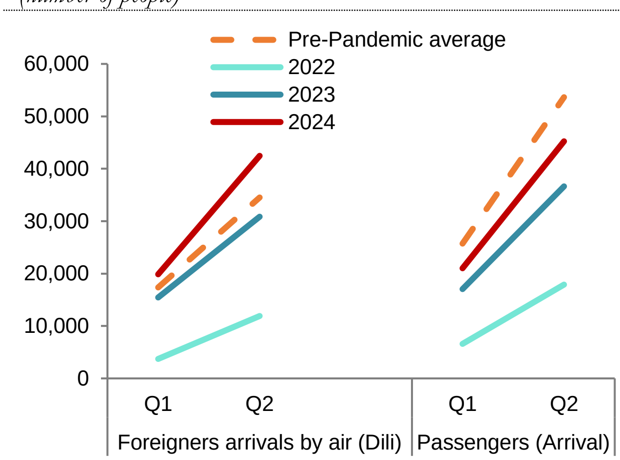
Capital expenditure emerged as a critical weakness in 2023. Spending on capital assets totaled just $16.1 million, reflecting a severe underinvestment in infrastructure and productive capacity. This severe underinvestment in infrastructure and productive capacity limits the country's economic potential. The World Bank B-ready survey (2024) highlighted this challenge, giving Timor-Leste a low score of 25 out of 100 in Financial Services areas (Annex 3) – the lowest among lower middle-income countries.

In the first half of 2024, Timor-Leste experienced mixed economic outcomes, with tourism growth balancing declines in exports and energy production. Increased foreign arrivals and renewed travel confidence positively impacted tourism (Figure 1.4) yet falling exports and rising imports widened the trade deficit, underscoring the economy's growing reliance on external goods and services (see section External imbalances deepen due to the halt of oil production and sluggish coffee output.).

The service sector has emerged as a key driver of Timor-Leste's economic recovery in 2024, with robust growth in tourism, telecommunications, and transportation. International tourists' arrivals saw a 23 percent increase (Figure 1.4), primarily from Australia and China. By mid-year, foreign arrivals at Dili Airport exceeded pre-pandemic levels, boosting hospitality and travel industries. Telecommunications expansion improved rural internet access and financial services, while steady vehicle registration growth indicated sustained transportation investment.

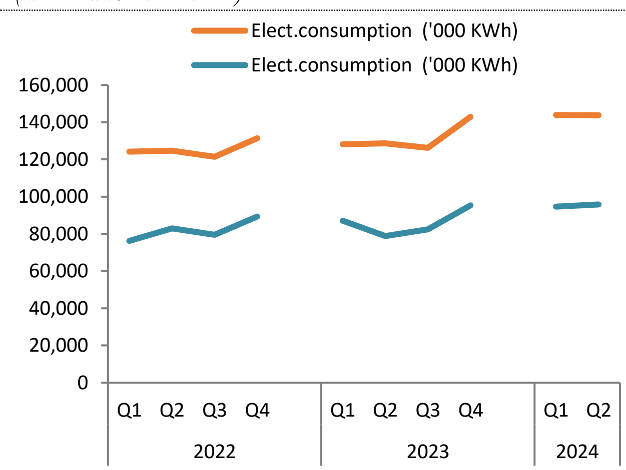
Electricity production stagnated in the first half of 2024, raising concerns about the energy sector's capacity to support economic growth. However, compared to previous year, electricity production improved slightly by 12 percent year on year in Q2 (Figure 1.5). Similarly, electricity consumption remained relatively stable for the first six months of this year but soared by 22 percent in Q22024, indicating a potential improvement in economic activity. According to World Bank B-Ready Survey report, the overall score of utility services of Timor-Leste is 60.19 out of 100, suggesting significant room for improvement particularly in areas of quality of governance and transparency in the provision of utility services which assessing the de facto provision of utility services (see Annex 57).

Figure 1.4: Both foreign arrivals by air and number of passengers increased for the first half this year
(number of people)



Source: INETL and World Bank Staff calculation.
Note: number of foreigners arrival in Q2 is the cumulative of Q1 and Q2.

Figure 1.5: Electricity production stagnated in the first half of 2024
(thousand kilowatt hours)



Source: INETL and World Bank Staff calculation.

Timor-Leste's early 2024 economic performance reflects improved public spending execution but persistent structural challenges. Budget disbursements exceeded 2023 levels, with capital spending reaching a post-pandemic high of 28.4 percent by September, driven by national event preparations. Transfer disbursements achieved 80 percent of allocations, effectively stimulating domestic demand. While improved budget execution boosted growth, particularly in the government-dependent construction sector, the impact of capital investments remained limited. Despite increased spending, infrastructure and human capital sectors struggled to deliver measurable outcomes. This gap between financial disbursement and tangible results highlights the need for fundamental reforms in public investment management to enhance development effectiveness.

1.3. Headline inflation continues to subside owing to currency appreciation, but food prices remained elevated.

Inflation has seen a continued decrease in 2024, largely due to falling non-food prices and government interventions, though food prices remain elevated. From January to September 2024, the average year-on year inflation rate was 2.8 percent, plunged from 8.3 percent in the same period of 2023 (Figure 1.6). The decline was largely due to price reductions in non-food items such as household goods, home maintenance supplies, and tobacco. A stronger U.S. dollar (Figure 1.10), reduced tobacco taxes, and government tax cuts on imports and sweet goods contributed to lower prices. Moreover, reduced shipping costs and declining global food prices further eased inflationary pressures. However, food prices, especially for staples like rice and vegetables, continue to drive inflation, reflecting the country's vulnerability to price fluctuations and its dependence on imports.

Figure 1.6: Since the start of the year, headline inflation has steadily declined, partly due to deflation in non-food prices
(percent contribution and change YoY)

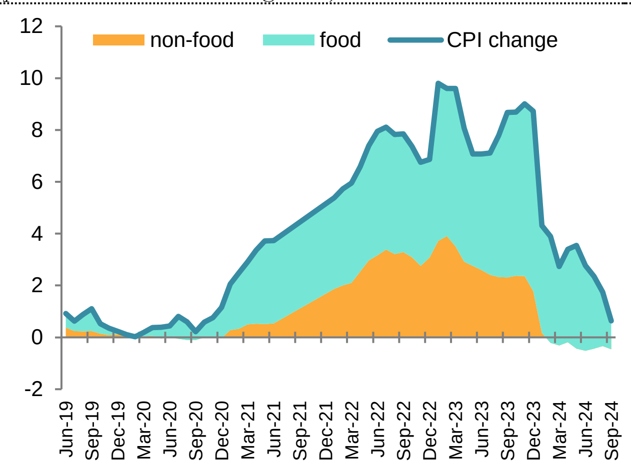
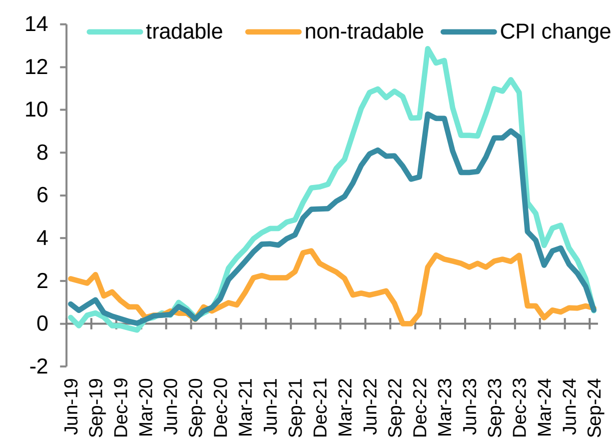


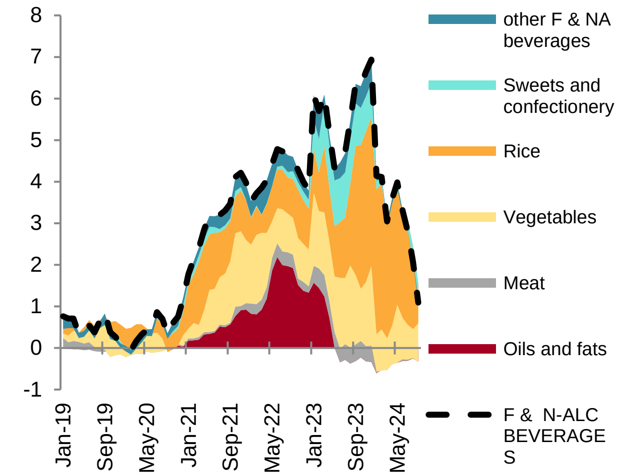
Figure 1.7: As tradable goods inflation eases, non-tradable goods add pressure on overall inflation
(percent, change YoY)



Source: INETL and World Bank staff calculation

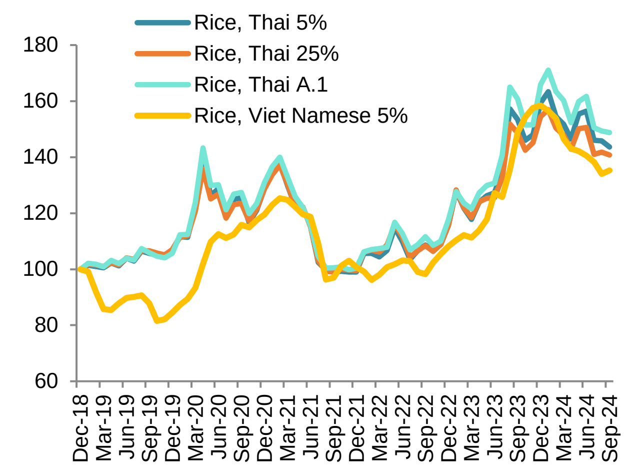
While inflation for tradable goods has slowed, non-tradable goods (Figure 1.7)—especially housing, utilities, and domestic services—continue to push overall inflation higher. By September 2024, fuel prices had dropped 10 percent year-over-year, and the rate of increase in imported food prices slowed to 5 percent, down from 15 percent in 2023. These improvements were supported by better global supply chains and lower energy costs. However, domestic costs for non-tradable goods, such as housing and utilities, rose substantially. Housing and utility prices together contributed 18 percent to inflation, with utility prices rising 12 percent year-over-year. To address these persistent inflationary pressures, Timor-Leste must implement policies to boost local food production, reduce import dependency, and improve infrastructure.

Figure 1.8: Consumer price inflation was driven mainly by rice and vegetable prices
(percent contribution and change YoY)



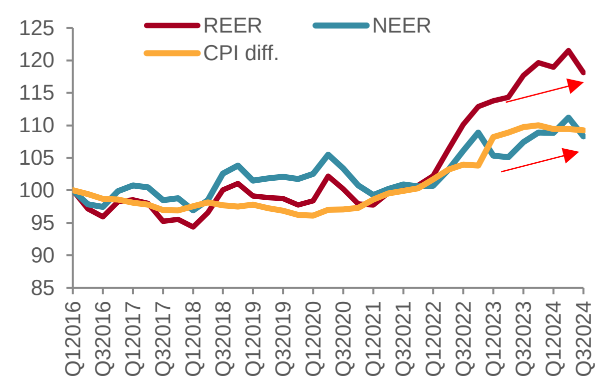
Source: INETL and World Bank staff calculation

Figure 1.9: Rising global commodity prices and Timor-Leste's heavy dependence on food imports increase inflationary pressures
(index, Dec 2018=100)



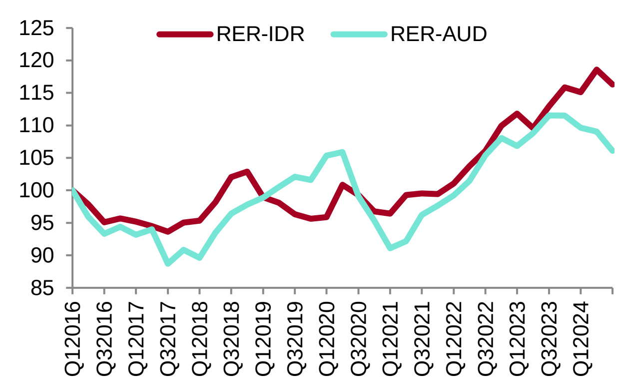
Source: World Commodity Prices Pink Sheet

Figure 1.10: While the REER and NEER stayed elevated yoy in Q3 2024, they saw a slight decline from the previous quarter, influenced by global economic growth and reduced inflation
(index, 2016Q1=100)



Source: BCTL
Note: REER: real effective exchange rate which measures the average of the bilateral RERs between the country and each of its trading partners along with each trade weights
NEER: Nominal effective exchange rate

Figure 1.11: The US dollar remained strong relative to the currencies of Timor-Leste's main trading partners
(index, 2016Q1=100)



Source: BCTL
Note: RER; real exchange rate indexes (adjusted with relative price of goods) between two countries i.e Timor-Leste with Indonesia or Timor-Leste with Australia

Food prices remained the most significant inflation driver, though their impact moderated slightly in 2024. Food inflation stood at 1.1 percent year-over-year by September 2024 (Figure 1.8), particularly affecting low-income households who spend over half their income on food. Rice contributed over 25 percent to inflation, with vegetables adding up to 20 percent during price surges. While government measures, including price stabilization policies and increased rice imports, provided some relief, locally produced rice remained scarce and expensive. El Niño impacts on agriculture worsened supply shortages, with cereal production falling significantly below average levels. Both external factors—such as global commodity price increases (Figure

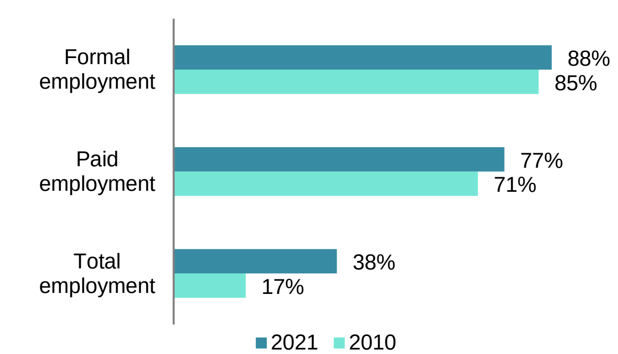
1.9)——and internal factors, including low agricultural productivity and climate vulnerability, sustained high food prices [8].

Both Real (REER) and Nominal (NEER) Effective Exchange Rates strengthened over the past two years, reflecting the U.S. dollar's stronger performance against Timor-Leste's major trading partners. The NEER increased 0.8 percent year-on-year but declined 2.8 percent quarter-on-quarter in Q3 2024 (Figure 1.10). while the REER appreciated 0.4 percent year-on-year but fell 2.6 percent quarter-on-quarter. These movements reflected changes in trade competitiveness, inflation differentials, and global economic conditions. While U.S. dollar appreciation enabled cheaper imports and eased domestic inflation, its relative depreciation in Q3 2024 against the Indonesian Rupiah and Australian Dollar (Figure 1.11), may offset these gains. Although a weaker REER can boost export competitiveness, it also raises import costs, potentially intensifying inflationary pressures in Timor-Leste's dollarized, import-reliant economy.

1.4. A Labor Market that is Over-Reliant on the Public Sector Amidst Fiscal and Productivity Challenges

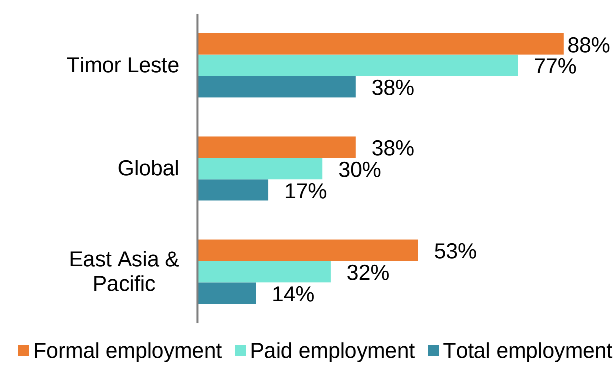
Timor-Leste's labor market faces significant structural challenges, marked by heavy reliance on public sector jobs, limited private sector growth, and declining productivity. From 2013 to 2021, the labor force participation rate stagnated at 30.5 percent—significantly lower than regional peers. Although employment grew by 23.5 percent, this was largely due to population growth rather than economic transformation. Labor productivity fell by 2.1 percent, reflecting a shift from agriculture to services, with agricultural employment dropping from 41 percent to 27 percent and services increasing from 45 percent to 59 percent. Public sector employment dominates, making up 77 percent of paid jobs and 88 percent of formal employment[9] (Figure 1.12) far exceeding regional and global averages (Figure 1.13). This overreliance on public sector jobs stifles private sector development, limits economic dynamism, and perpetuates inefficiencies, posing a challenge to long-term economic sustainability

Figure 1.12: Most formal and paid employment in Timor-Leste is in the public sector
(percent)



Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata

Figure 1.13: Public Sector Employment in Timor-Leste is high compared to peers
(percent)



Source: World Bank staff calculations

[8] The ongoing El Niño phenomenon, potentially one of the strongest on record, has resulted in significantly less rainfall than usual from October 2023 to January 2024. This dry spell, expected to continue until April 2024, further hinders agricultural production and exacerbates food price inflation.

[9] Based on Labor Force Survey 2021 report, formal employment is defined as the type of employment where the diversified set of economic activities, enterprises, jobs, and workers are regulated or protected by the government, have explicit or written contracts of employment, certain employment benefits (such as social protection coverage, severance pay, paid sick and annual leave) or for which labor regulations are applied and enforced.

The public sector's dominance exacerbates skill imbalances, with highly educated workers disproportionately concentrated in government jobs. Currently, 39 percent of public sector employees hold tertiary degrees, compared to just 7 percent in the private sector (Figure 1.14) This disparity highlights the public sector's ability to attract skilled workers, often at the expense of the private sector. Wage disparities further reinforce this imbalance: highly educated public sector workers enjoy a 42 percent wage premium, while those with only primary education face a 41 percent wage penalty. These wage dynamics reduce the private sector's ability to compete for talent, leading to inefficiencies and the underutilization of skilled labor.

Figure 1.14: Public sector employees are more educated compared to private sector employees
(percent of employee hold tertiary degrees)

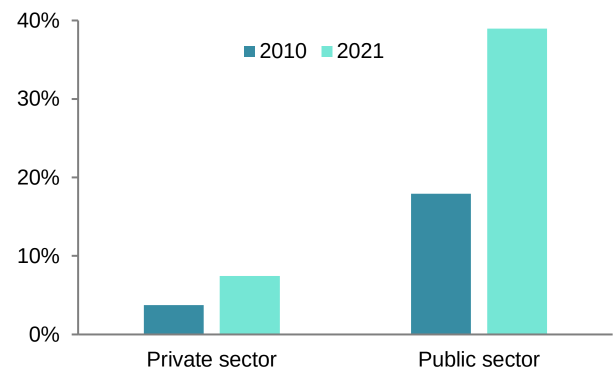
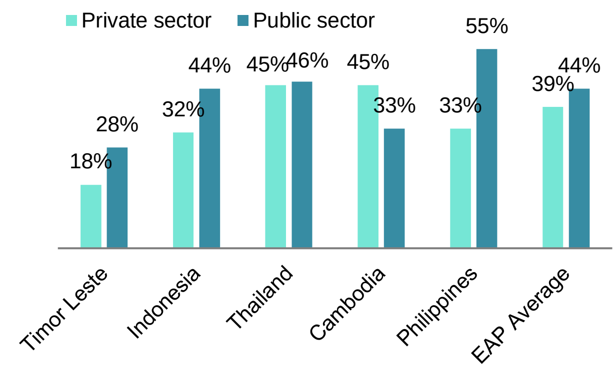


Figure 1.15: Gender disparities in Timor-Leste's labor market persists both at the public and private sectors
(percent of labor force)

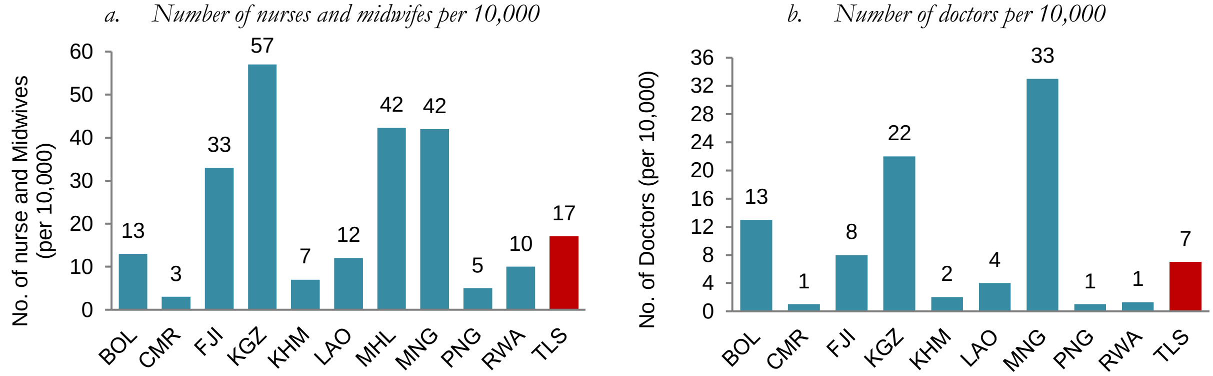


Source: World Bank staff calculations using INETL 2021 and 2013 TL-LFS microdata

Despite a growing public sector workforce, critical sectors such as health remain under-resourced and inefficiently managed. The public sector workforce in Timor-Leste is predominantly concentrated in education, which employs nearly 37 percent of all public sector workers. In contrast, the healthcare sector accounts for only 6 percent of the public sector workforce, which is lower than regional peers such as Indonesia, Cambodia, and Thailand. Staffing levels remain below the WHO-recommended ratio of 4.45 health workers per 1,000 people. Shortages of physicians, nurses, and other healthcare professionals limit access to and quality of services (Figure 1.16). The production of health professionals is largely driven by domestic private institutions, but a mismatch between workforce supply and demand has resulted in oversaturation in some roles and shortages in others. Rural areas are especially underserved due to inconsistently applied incentives for deployment. These inefficiencies highlight a misalignment between workforce growth and service delivery needs.

Figure 1.16: Lower workforce in health sector compared to peers

a. *Number of nurses and midwifes per 10,000* b. *Number of doctors per 10,000*



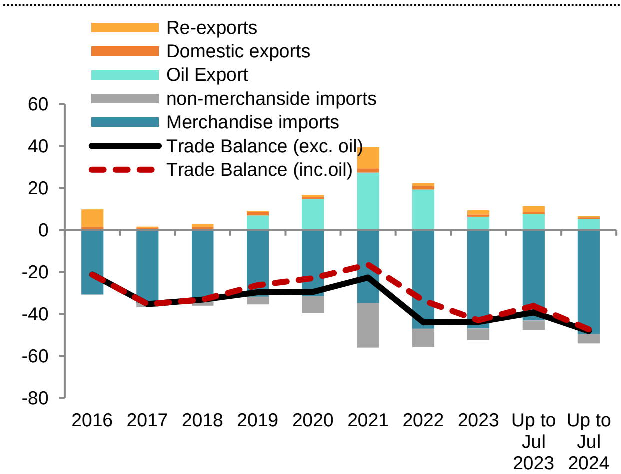
Source: World Bank Staff computations
Notes: All health resource indicators are measured in per 1,000 inhabitants. Timor-Leste (TLS), Bolivia (BOL), Cambodia (KHM), Cameroon (CMR), Fiji (FJI), Kyrgyz Republic (KGZ), Lao PDR (LAO), Marshall Island (MHL), Mongolia (MNG), Papua New Guinea (PNG), Rwanda (RWA), and Turkmenistan (TKM). Countries are excluded based on missing data.

Furthermore, gender disparities in Timor-Leste's labor market further constrain its growth potential. Women's participation rates are significantly lower than regional averages, comprising only 28 percent of public sector employees and 18 percent of the private sector workforce (Figure 1.15) While female representation in public sector roles has modestly increased since 2010, participation in the private sector has declined. Social, cultural, and economic barriers continue to restrict women's access to employment opportunities, limiting economic inclusivity and preventing the full utilization of the country's workforce.

1.5. External imbalances deepen due to the halt of oil production and sluggish coffee output.

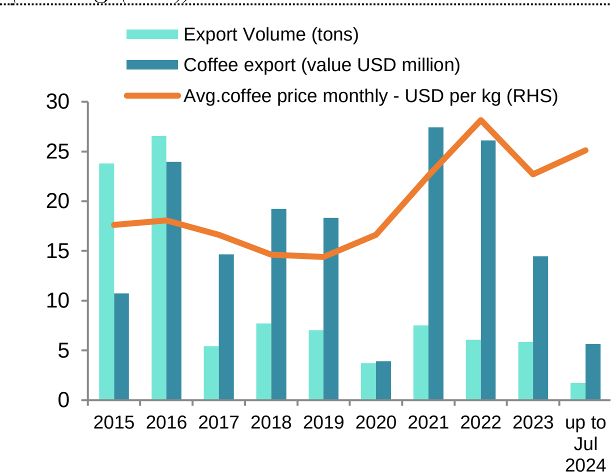
The external trade account remains in deficit due to much lower exports even after including oil exports. The export value of oil has continued to decrease after the last peak in 2021, due to both falling commodity prices and reduced oil production from the Bayu-Undan field. In the first seven months of this year, the oil export value was 33 percent below last year (Figure 1.17). Meanwhile, coffee exports, as the largest non-oil export commodity, declined further both in value and volume (Figure 1.18). Timor-Leste's coffee industry struggles with low productivity and quality issues. A major concern is low farm yields, which average under 200 kg of green beans per hectare, well below the global average of 880 kg. This is largely due to aging coffee trees and poor farm management practices.

Figure 1.17: Trade deficit has continuously deteriorated
(percent of non-oil GDP)



Source: Monthly Trade Report, INETL and World Bank Staff calculation
Note: 2024 GDP is estimated by taking the annual average GDP in 2021-2023

Figure 1.18: Up to July, Coffee exports were below last year's levels both in value and volume, for the same period
(volume (tons), export value (USD million), and coffee price (USD/kg) (RHS))

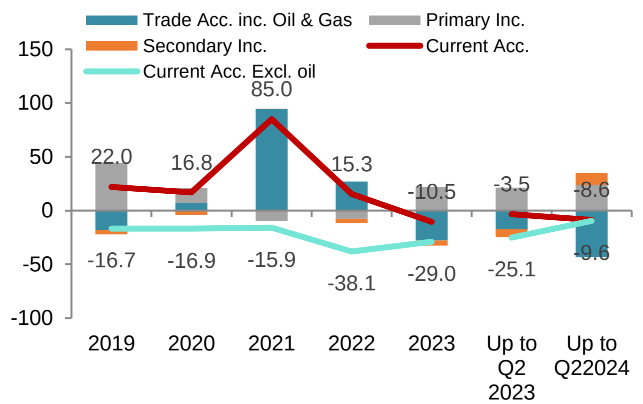


Source: Monthly Trade Report, INETL, World Bank Commodity Markets Reports, and World Bank Staff calculation
Note: Coffee price is taking the average price of Arabica Coffee in each respective year and the past 7 months in 2024

At the same time, for the past 7 months this year, total imports increased compared to the previous year due to higher merchandise imports. The total merchandise imports up to July 2024 increased by 10 percent. In part, this was driven by higher imports of food, electronic appliances, and machinery equipment. An appreciation of the US dollar and lower import duties contributed partly to higher imports. In addition, improved Government budget execution will have also accelerated imports. Imports are generally high, averaging 50 percent of non-oil GDP between 2020 and 2023.

By the end of Q22024, the current account remained in deficit, primarily driven by a persistent trade deficit in goods and services. Even after excluding the oil and gas sectors, the current account balance remained in negative territory, reflecting the structural challenges within the non-oil economy. When including the non-oil and gas sector, the current account deficit widened to 8.6 percent of non-oil GDP largely attributed to a sharp decline in oil & gas exports (Figure 1.19). On a more positive note, the current account pressures were partially alleviated by positive net primary income and net remittances.

Figure 1.19: Current account balance continue in deficit even after including oil transactions
(percent of non-oil GDP)



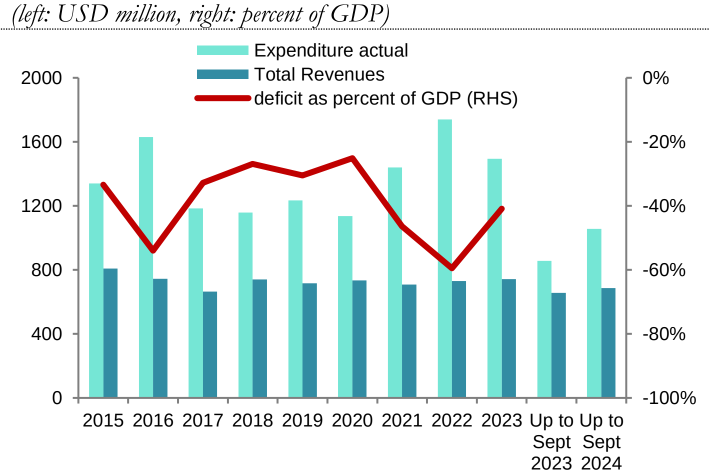
Source: Monthly Trade Report, INETL and World Bank Staff calculation
Note: 2024 GDP is estimated by taking the annual average GDP in 2021 and 2022

Meanwhile, Timor-Leste maintains robust external buffers, with foreign reserves at USD 793.4 million as of Q2 2024, covering approximately 8 months of imports - well above the traditional benchmark of 3 months coverage. The reserves represent about 44 percent of non-oil GDP, while the Petroleum Fund balance provides an additional substantial buffer, equivalent to 180 months of imports or 10 times the non-oil GDP. However, the Petroleum Fund faces a concerning decline due to two key factors: the cessation of new oil and gas revenue, and persistent excess withdrawals to finance large fiscal deficits. This trend poses significant risks, as the Fund's eventual depletion would leave Timor-Leste highly vulnerable, particularly given minimal exports and heavy import dependence. To ensure long-term financial stability, the country must pursue two critical strategies: economic diversification to reduce oil revenue dependence and strengthen non-oil exports, and fiscal consolidation to ensure sustainable resource management.

1.6. Budget execution improves whilst cancellation of revenue measures introduced in 2023 lead to a slowdown in collection.

The fiscal deficit widened in the first nine months of 2024 compared to same period last year, as spending increased while total revenue was stable. The fiscal deficit had reached USD 369 million up to September**,** up from USD 201 million in the previous year owing to higher expenditures with only a marginal increase in total revenue collection (Figure 1.20). To finance the gap, the Government relied heavily on additional withdrawals from the Petroleum Fund, financing nearly 90 percent of the deficit, which accounted for about 38 percent of the planned extra withdrawals as outlined in the budget document. However, this financing approach is unsustainable, as the Petroleum Fund balance has been diminishing due to reduced oil and gas production from the Bayu-Undan Project and withdrawals exceeding the sustainable generated income.

Figure 1.20: Fiscal deficit was wider by end of September compared to last year owing to higher Government spending
(left: USD million, right: percent of GDP)



Source: Ministry of Finance and World Bank staff calculations

By September 2024, government receipts from domestic non-oil and gas revenue fell below last year's level partly due to the cancellation of certain tax policies. Domestic revenue, including tax and non-tax revenues, grew by 7 percent in 2023 after a five-year decline, largely driven by increased tobacco and alcohol excises, higher import duties, and a new sugar tax. However, the newly appointed government repealed the new tax measures in the 2023 Rectification Budget. Total domestic revenue by September 2024 fell by 5 percent compared to the same period last year (Figure 1.21). Thus, it remains challenging to reduce the dependence on the Petroleum Fund to finance the state budget.

Figure 1.21: However, domestic revenues from tax and non-tax items were below last year's partly due to the revoking of some tax measures
(USD million)

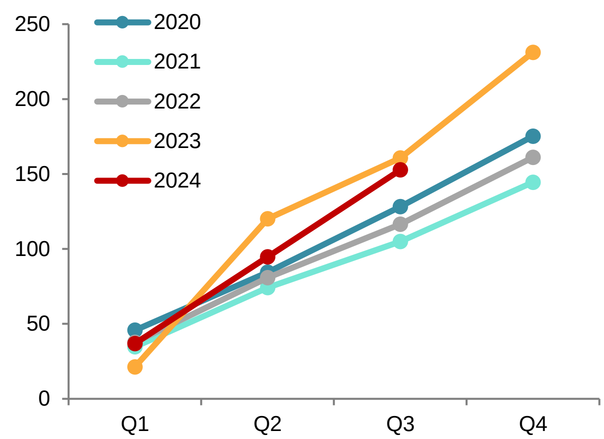
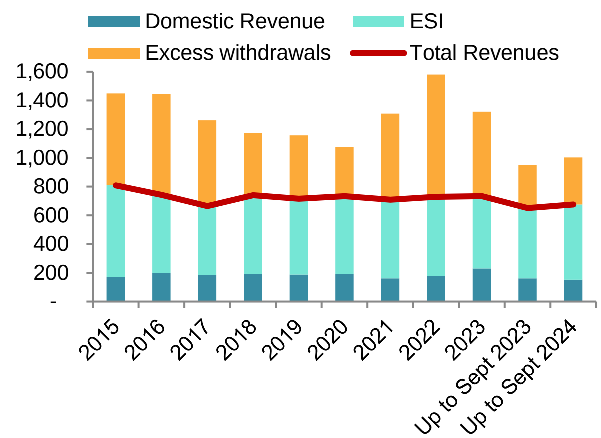


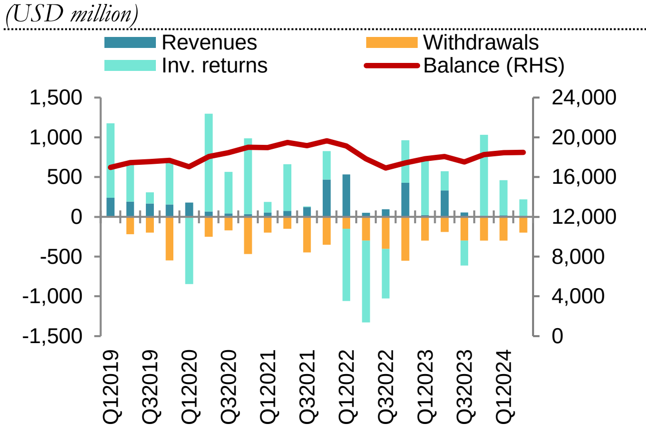
Figure 1.22: Total revenues including ESI up to September this year was slightly higher than last year for the same period owing to higher estimated return from PF
(USD million)



Source: Ministry of Finance and World Bank staff calculations

The Estimated Sustainable Income (ESI) from the Petroleum Fund accounted for 77 percent of government revenue up to September this year. The ESI increased by 7 percent compared to last year for the same period, driven by improved returns on the Petroleum Fund balance (Figure 1.22). In 2023, the average return on Petroleum Fund investments, forming the basis for the 2024 ESI, was about 10 percent—significantly higher than the 8 percent loss in 2022. However, the Petroleum Fund balance faces sustainability risks from withdrawals above its sustainable return to fund a large fiscal deficit, combined with lower revenue due to lower oil and gas production from Bay-Undan field. Government estimates indicate that the Petroleum Fund could be entirely depleted by 2035[10] if the current fiscal policies remain unchanged.

Figure 1.23: The balance of Petroleum fund has remained stable, but the net inflow is steadily diminishing
(USD million)



Source: INETL, World Bank Commodity Markets Reports, and World Bank Staff calculation

The Petroleum Fund balance remained relatively stable in the first six months of the year, despite a sharp decline in net inflows. By the end of June this year, the Petroleum Fund balance reached USD 18.5 billion, about 10.5 times of 2023 GDP. Compared to last year for the same period, the fund only grew slightly

[10] Ministry of Finance recent estimates.

by 2.2 percent which was slower since Q42023 (Figure 1.23). While the investment returns were still positive, the withdrawals from petroleum fund to finance the government budget has weighed on the net inflows[11]. The net inflow of the petroleum fund in Q2 this year decreased significantly by 95 percent compared to last year for the same period.

Meanwhile, budget execution improved towards Q32024, driven by higher capital expenditure and increased disbursements for social support programs. By the third quarter, the government had spent 56 percent of its annual budget, 6 percentage points increase from the same period in 2023 (Figure 1.24). Spending started slowly, with only 32 percent of the budget used by June, including just US$40 million (9 percent) on development projects. However, spending accelerated in the third quarter, largely due to preparations for Pope Francis' historic visit. By the end of September, total spending reached US$1.1 billion, with year-end projections of US$1.63 billion (86 percent of the budget)—9 percent higher than in 2023.[12] Social support programs showed strong execution at 80 percent of annual allocation by Q32023 (up from 66 percent in 2023) (Figure 1.25), while capital expenditure improved to 28 percent (from 20 percent) (Figure 1.26). Despite Goods and Services reaching only 40 percent execution by Q3, the projected overall year-end execution of 78 percent, though below the pre-pandemic average of 87.5 percent, demonstrates continued improvement in budget implementation capacity.

Figure 1.24: Budget execution until end of Sept 2024 was above recent trends…
(percent)

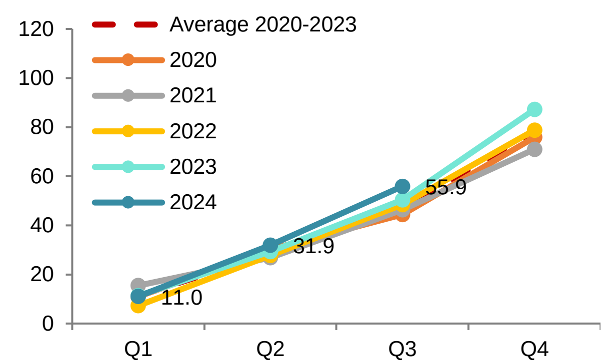
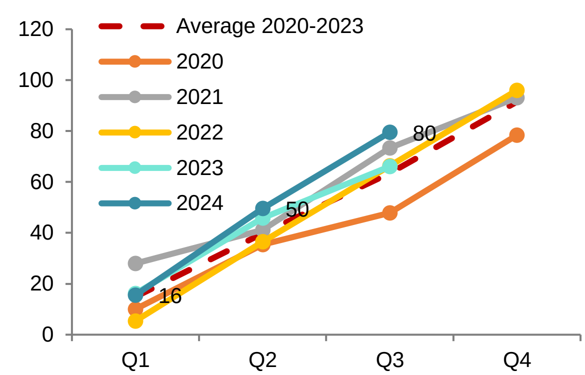


Figure 1.25: …mainly contributed by higher transfers spending
(percent)



Source: Ministry of Finance and World Bank staff calculations

Goods and Services execution rates have seen considerable shifts in the last five years. In prior years, execution rates ranged between 65 and 75 percent by year-end. However, 2023 marked a sharp divergence, with execution rates for Goods and Services dropping to 65 percent by the end of the fourth quarter—a notable decline from 75 percent in 2022 (Figure 1.27). This shift reflects the government's efforts to better align expenditures with their actual cost structures, improving fiscal classification and reporting accuracy. The reclassification in 2023 reassigned several key expenditure items from Goods and Services and Transfers to the Salaries and Wages category (Figure 1.27), including expenditures on National and International Advisors, employee travel and allowances, and the State's contribution to the Social Security Fund. As a result, the execution rate for Salaries and Wages rose from 95 percent in 2022 to 102 percent in 2023, while expenditure on Goods and Services decreased substantially.

[11] Net inflow to the Petroleum Fund is calculated by subtracting the total receipts from investment returns and oil and gas revenues with the transfers to the state budget either as part of estimated sustainable income (ESI) or excess withdrawals.
[12] General State Budget 2025 Report

Figure 1.26: …and higher capital spending
(percent)

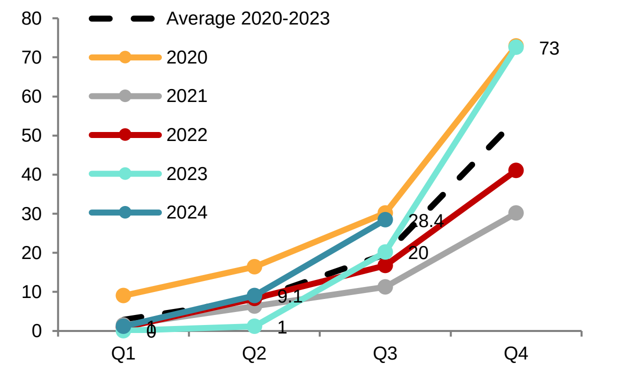
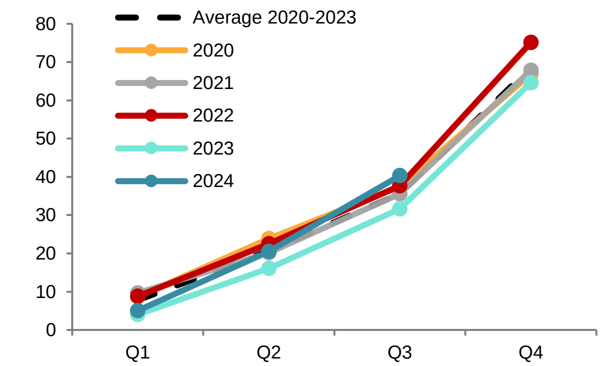


Figure 1.27: The reassignment of goods and services to wage and salaries reduced goods and services spending
(percent)



Source: Ministry of Finance and World Bank staff calculations

Timely budget enactment and PFM reforms have driven improved budget execution in 2024. Unlike 2023, when the budget was postponed by a month, the 2024 budget was enacted on December 22, 2023, enabling an early start to fiscal operations. Key PFM reforms, such as the expansion of program-based budgeting, have played a crucial role. The number of programs that has been rationalized and realigned with the five-year government program has increased from 52 in the 2023 rectified budget to 80 in 2024. By linking funds directly to programs, sub-programs, and activities, this reform focuses spending on measurable outcomes. Additionally, strengthened monitoring and evaluation mechanisms have improved the integration of planning and budgeting, ensuring that resources are effectively allocated to support strategic goals.

Figure 1.28: Overall budget execution almost reached the pre-covid average yet has not returned to its peak level in 2017
(USD million (LHS), percent (RHS))

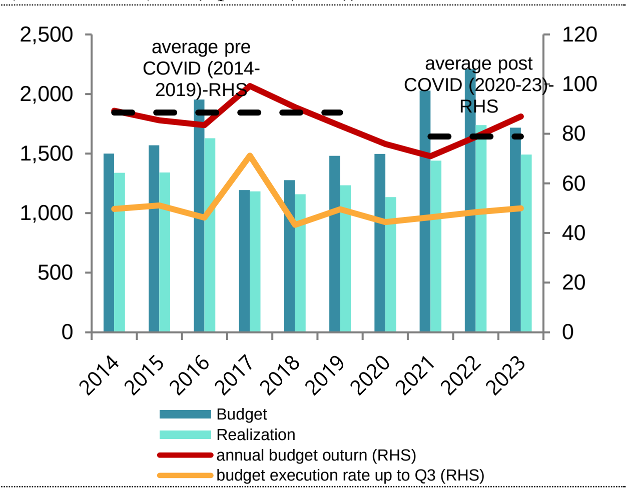
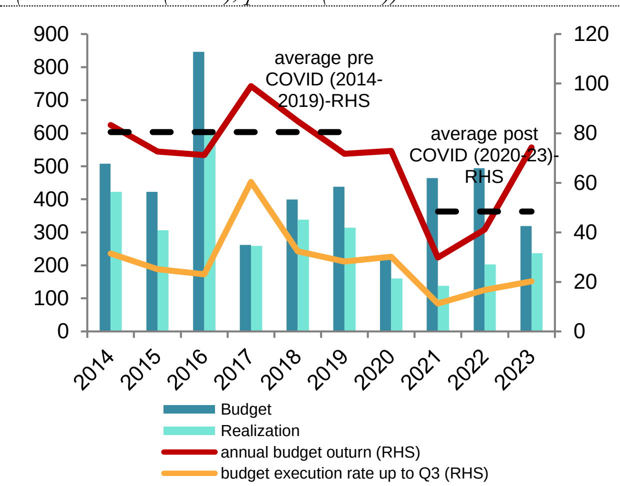


Figure 1.29: Capital spending disbursement continue to improve for the past two years yet remain below the pre-Covid level
(USD million (LHS), percent (RHS))

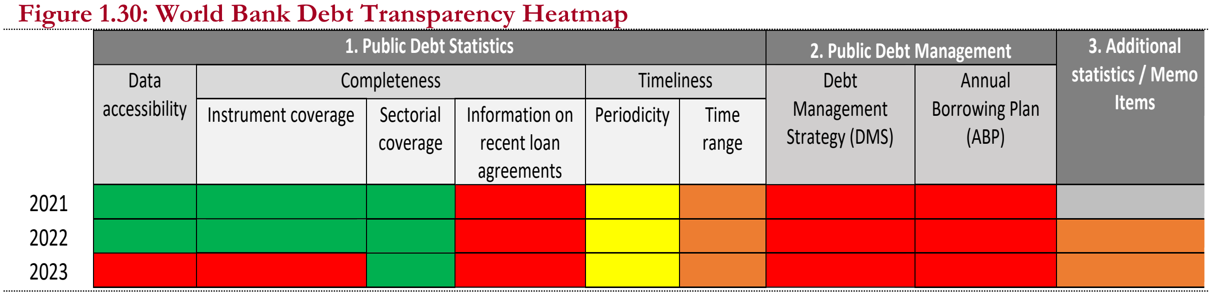


Source: Ministry of Finance and World Bank staff calculations

Despite progress, persistently low budget execution continues to impede Timor-Leste's economic performance, particularly given its reliance on government spending. The 2024 Budget Book highlights the government's goal to exceed a 90 percent execution rate, especially improvement in the execution of Capital and Development category. However, by end of September 2024, only 56 percent of the total budget and 28 percent of the Capital and Development budget had been utilized. While total budget execution slightly surpassed the pre-pandemic average of 52 percent during 2014-2019 (Figure 1.28), capital budget execution was still far below the same benchmark (Figure 1.29). Achieving higher execution rates is critical, though not a guarantee, for fostering the level of economic growth Timor-Leste aspires to achieve.

In the meantime, transparency in public debt reporting declines. In previous years, the government made strides in enhancing public access to debt-related information by publishing key documents, such as the Fiscal Risk Statement in the Budget Book. However, recent assessments, including the World Bank Debt Transparency Heatmap (Figure 1.30) have identified ongoing deficiencies in debt data availability and reporting standards. This decline is mirrored in Timor-Leste's Open Budget Survey score, which fell from 52 in 2021 to 37 in 2023. Timor-Leste's score in the 2023 Open Budget Survey saw a notable decline in transparency, falling to 37 from 52 in 2021. This drop reflects several weaknesses, including reduced comprehensiveness of the Executive's Budget Proposal, diminished information in In-Year Reports, and limiting the Year-End Report to internal use. While some improvements were made, such as timely publication of the Pre-Budget Statement and Mid-Year Review, the overall availability and accessibility of key budget documents regressed. These shortcomings pose significant risks, as incomplete debt reporting may lead to underestimating fiscal vulnerabilities and hinder effective debt management.

Figure 1.30: World Bank Debt Transparency Heatmap



Note. This heat map presents an assessment based on the availability, completeness, and timeliness of public debt statistics and debt management documents posted on national authorities' websites. Red=Insufficient, Orange=Limited, Yellow=Partial, Green=Full

1.7. Credit to the private sector accelerates rapidly but remains concentrated in household loans.

Despite an expansion in the monetary base, M2 contracted in the first half of 2024. Money supply (M2)[13] contracted by 9.5 percent year-on-year, dropping from $1,273 million in June 2023 to $1,152 million in June 2024. This decline was primarily driven by a 4.8 percent reduction in net foreign assets, mainly due to decreased holdings by commercial banks. In contrast, private sector credit grew by 30 percent, reflecting strong demand in key sectors such as manufacturing, tourism, and services, which played a significant role in the ongoing economic recovery.

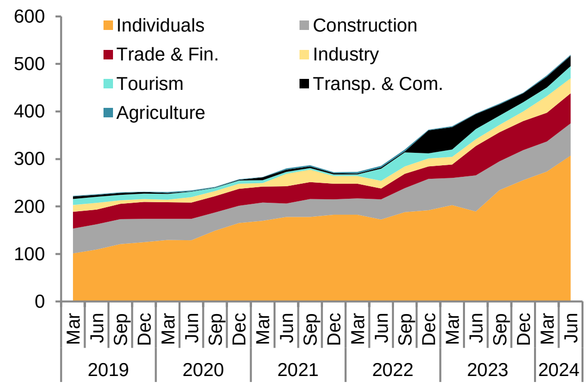
Credit is directed mostly toward individual lending rather than firms. Individual consumer credit remains the largest contributor, while lending to sectors such as transportation and communication has declined (Figure 1.31Figure 1.31). The construction sector ranks as the second-largest recipient of credit, supported by increased public investments in infrastructure and real estate development. Trade and finance have also seen steady growth in credit allocation, but critical sectors like agriculture and tourism receive comparatively smaller shares, limiting their growth potential.

The banking sector in Timor-Leste remained resilient in 2024, but challenges in credit access persist. Total assets grew by 6.6 percent year-on-year, driven by increases in loans, cash holdings, and other assets. Despite narrowing interest spreads due to declining loan and deposit rates, competition in the sector intensified, with net income rising by 8.2 percent, reflecting continued profitability. Loan quality remained robust, as

[13] M2 or total money supply is a measure of the total money available in an economy. It includes physical currency, checking accounts, savings accounts, and other liquid assets.

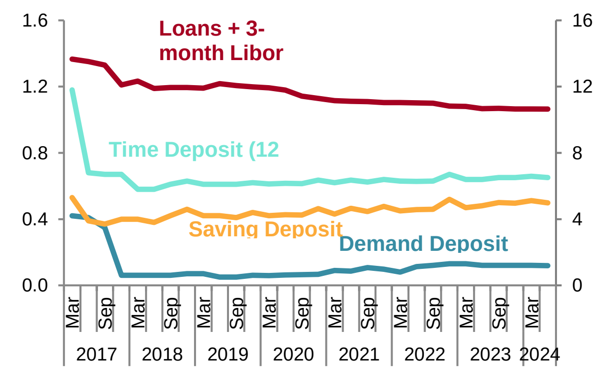
evidenced by a low non-performing loans (NPL) ratio of 2.3 percent. However, the loan-to-deposit ratio fell short of the Central Bank's target, underscoring limited credit access, particularly for businesses. High lending rates, with loans indexed to the 3-month LIBOR exceeding 10 percent, continue to deter borrowing, especially for long-term or high-risk investments (Figure 1.32). This cautious approach aligns with the limited credit allocation to sectors like agriculture and tourism, which are characterized by higher volatility and lower collateral availability. On the deposit side, time deposits offer yields of 6–8 percent, while returns on savings and demand deposits remain below 1 percent.

Figure 1.31: Private credit continued to grow but remains shallow, at only 29 percent of GDP
(USD million)



Source: INETL, World Bank Commodity Markets Reports, and World Bank Staff calculation

Figure 1.32: Lending rate is persistently high, with a big gap compared to deposit rate
(percent)



Source: BCTL and World Bank Staff calculation

2. Economic Outlook and Risks

2.1. Outlook

Global economic growth is expected to moderate to an average of 2.5 percent annually between 2025 and 2027, primarily due to labor market constraints and geopolitical tensions. Advanced economies, particularly the Euro Area and the United States, are projected to experience subdued growth, with performance falling below historical averages due to weaker investment and consumption. Meanwhile, EMDEs are forecasted to grow at a slightly higher rate of 3.2 percent annually, supported by recovering domestic demand, favorable demographic trends, and improving external conditions, though vulnerabilities to global uncertainties and external shocks persist.

Growth in the EAP region is projected to moderate in the coming years, reflecting diverging trends between China and the rest of the region. Overall regional growth is expected to slow to 4.4 percent in 2025 and 4.1 percent in 2026, driven largely by continued weakness in China, where the property market is projected to stabilize only gradually, and domestic demand remains sluggish. China's growth is forecast to slow to 4.3 percent in 2025. In contrast, growth in EAP economies excluding China is expected to rise to 4.9 percent in 2025, supported by robust domestic demand, easing financial conditions, and strong labor markets. The Pacific Island countries, however, are anticipated to see growth moderate to 3.4 percent in 2025, as the post-COVID-19 rebound dissipates.

Global inflation is expected to decline further, with advanced economies likely to meet inflation targets by 2026, while moderation in emerging markets, including the EAP region, will be more gradual. EAP inflation is forecast to remain subdued, largely within or below central bank targets, driven by declining global commodity prices and steady domestic demand. In China, inflation is projected to stay low due to economic slack and weak consumer confidence, with core inflation hovering near zero in the coming years. Other EAP economies, such as Indonesia, Malaysia, and Thailand, are expected to maintain well-anchored inflation within policy targets, supported by strong monetary frameworks and easing financial conditions. However, global supply shocks stemming from geopolitical tensions or climate-related events could lead to renewed price volatility.

Timor-Leste's economic recovery is projected to continue, driven primarily by government expenditure. Growth is projected to average 3.5 percent during 2025–2026, primarily fueled by significant government investments in infrastructure, including roads, which will boost non-oil GDP. The anticipated finalization of negotiations with Australia on a new offshore gas field in 2025 could further enhance economic momentum. Growth will also be supported by tourism and remittances, though non-oil exports are expected to remain limited due to a narrow export base centered on coffee and high import dependency. The completion of a fiber-optic cable installation will bolster digital economy growth and expand the service sector, contributing to economic diversification. Additionally, increased visitor arrivals from ASEAN engagement and steady remittance inflows will provide further support to the economy. To achieve these growth targets, Timor-Leste must enhance budget execution and public investment efficiency, addressing infrastructure gaps and reducing costs for the private sector.

Table 2.1: Economic Forecast
(percent)

	2020	2021	2022	2023e	2024f	2025f	2026f
Real non-oil GDP growth	-8.3	2.9	4.0	2.4	3.5	3.4	3.6
Private Consumption	-1.3	-2.7	14.0	3.0	4.1	5.5	6.0
Government Consumption	4.9	2.9	-0.2	3.1	5.6	2.5	-1.2
Gross Fixed Capital Investment	-46.9	-6.1	29.4	9.7	15.2	3.6	13.2
Public investment	-47.2	-14.9	29.7	12.0	18.3	3.2	15.1
Private Investment	-45.5	40.9	28.6	2.3	4.6	5.5	6.0
Export, Goods and Services	-47.3	79.3	30.3	5.0	2.0	2.5	2.5
Import, Goods and Services	-7.0	-9.0	22.8	4.9	8.8	9.8	10.8
Inflation (Consumer Price Index)	0.5	3.8	7.0	8.4	3.3	2.8	2.5
Fiscal Balance (percent of non-oil GDP)	-25.3	-47.0	-60.7	-43.8	-48	-57	-58
Current Account Balance (percent of non-oil GDP)	-17.8	9.7	16.3	-20.6	-47.1	-51.9	-56.1

Source: INETL, World Bank Staff Estimate and Forecasts

Timor-Leste must accelerate structural reforms and invest strategically in economic diversification to escape its low-growth trap and build a resilient economy. Strengthening non-oil sectors is essential to achieving the IX Constitutional Government's target of 5 percent annual growth for 2023–2028, as well as the Strategic Development Plan's earlier, more ambitious goal of 11.3 percent annual growth for 2011–2020. To meet these targets, the country must prioritize reducing its dependence on petroleum revenues, fostering private sector development, and implementing targeted policies that drive sustainable, long-term growth. However, inconsistent reform implementation undermines progress ( ). Delays and uneven execution erode the credibility and effectiveness of reform efforts, limiting their impact. These challenges are further compounded by political and institutional obstacles, which impede the pace of transformation.

Inflation is expected to moderate in the medium term, though external risks persist. Inflation is projected to decline to 3.3 percent in 2024 and average 2.5 percent during 2025–2026, supported by falling global commodity prices. While food prices are generally expected to decrease, rice prices may temporarily rise in 2024 due to supply concerns from El Niño and export restrictions in key markets like India. Timor-Leste's heavy reliance on imports makes it highly vulnerable to global price fluctuations. Furthermore, the use of the U.S. dollar limits the country's ability to implement independent monetary policies, and discussions on adopting a national currency are not expected to resume in the near term.

Fiscal deficit is projected to remain high, raising concerns about long-term sustainability. Without substantial fiscal reforms, the deficit is projected to remain high at 58 percent of GDP in 2025–2026, heavily reliant on withdrawals from the Petroleum Fund. The proposed $2.6 billion[14] budget for 2025 highlights these risks, with domestic revenue expected to cover only 10 percent of government spending, leaving 73 percent to be financed by the Petroleum Fund. While fiscal policy was essential in mitigating the pandemic's economic impact, current spending levels remain elevated. Without new revenue measures, the deficit will continue to grow, and the Petroleum Fund is on track to be depleted by 2037, jeopardizing fiscal sustainability and economic stability.

Similarly, the current account deficit is likely to widen due to high import dependence and a narrow export base. Exports remain heavily reliant on coffee, while limited domestic production capacity drives strong demand for imports to meet consumption and investment needs. This imbalance is exacerbated by a public sector-led economy, where significant government spending fuels import demand. Without diversification, external imbalances will persist, posing risks to external sustainability. However, Timor-Leste's expected

[14] This includes the social security fund and the reserve fund. Excluding these elements, Budgetary central government is about $2.125 billion.

accession to ASEAN and a potential tourism boost could partially offset these risks by opening new markets and attracting foreign investment.

Box 2.1: Timor-Leste's Reform Journey: Progress and Challenges on the Path to Sustainable Growth

Over the past decade, Timor-Leste has embarked on several reform initiatives to strengthen its economic framework and improve governance. Key focus areas include macroeconomic management, fiscal policy, and public financial management. Notable reforms include the adoption of the Concessional Loan Policy (2016) to improve debt management and the Tax Reform Plan (2018) to broaden the tax base and simplify administration. The SOE Reform Strategy (2022) seeks to bolster governance and financial performance in State-Owned Enterprises (SOEs), while the Public Procurement Law was enacted to improve transparency and efficiency in government spending.

Reforms in the financial sector have advanced with the National Payment System Law (2017), which modernized financial infrastructure and promoted financial inclusion. In governance, the Civil Service Act (2016), Municipalities Law (2016), and Decentralization Law (2019) have strengthened local governance and improved public administration. These laws aim to empower local authorities, enhance service delivery, and promote efficient governance structures. Additionally, the Anti-Corruption Law has played a pivotal role in increasing transparency and accountability in public administration.

Timor-Leste has made human capital development a priority, focusing on education and healthcare. The Basic Education Law (2015) and the National Health Sector Strategic Plan aim to improve literacy rates, expand educational access, and enhance healthcare services. These reforms align with the National Strategic Development Plan (NSDP) 2011–2030, which positions human capital as a cornerstone for inclusive growth and poverty reduction.

Efforts to foster private sector development have included the Investment Law (2017) and the Commercial Companies Law (2018), which provide incentives and simplify the establishment of businesses. The establishment of a One-Stop Shop for Business Registration has reduced bureaucratic hurdles, expediting registration and licensing processes. Reforms in land tenure and property rights aim to improve access to land, facilitating private investment.

Timor-Leste has made notable strides in transparency and accountability through its Anti-Corruption Strategy, the Anti-Corruption Law, and the establishment of the Anti-Corruption Commission (ACC). These efforts have contributed to the country's improved ranking on the Corruption Perception Index, rising from 93rd in 2019 to 77th in 2022. Financial crime prevention has also progressed, supported by a strengthened Financial Information Unit (FIU) and active engagement with the Asia Pacific Anti-Money Laundering Group (APG). In addition, judicial reforms, including expanded mediation services and greater access to justice.

Despite these reforms, implementation has been slow, hampered by institutional capacity constraints and insufficient interagency coordination. Timor-Leste's Country Policy and Institutional Assessment (CPIA) score remains low at 2.7[15] in 2023, reflecting delays and political instability. Frequent government changes and political instability have further disrupted reform continuity, delaying budget enactments and development financing. The Private Investment Law (2017) and Tax Reform Plan (2018) have faced implementation delays and regulatory inefficiencies, reducing their intended impact. This has left Timor-Leste heavily dependent on petroleum revenues, limiting fiscal sustainability, private sector development and economic resilience.

Sources: Timor-Leste Economic Report: Honoring the Past, Securing the Future, Timor-Leste - Pathways to Economic Diversification: Country Economic Memorandum 2023, Timor-Leste Economic Report : Steadying the Ship , Doing Business 2019 : Training for Reform – Timor-Leste

2.2. Risks

Timor-Leste's economic outlook faces significant downside risks from both external and internal factors, requiring careful policy management. Externally, El Niño-related climate impacts threaten food

[15] The World Bank's Country Policy and Institutional Assessment (CPIA) evaluates the quality of policies and institutional frameworks in countries, assigning scores ranging from 1 (low) to 6 (high).

security through disrupted rice production and imports, while global geopolitical tensions risk elevating food and energy prices. The country's high import dependence amplifies its vulnerability to trade disruptions and supply chain shocks. While ASEAN membership presents opportunities for market access and economic diversification, evolving U.S. trade policies toward ASEAN markets could introduce new challenges through changes in tariffs, trade preferences, and geopolitical dynamics. The economy's sensitivity to oil price fluctuations presents a double-edged sword - lower prices could strain Petroleum Fund revenues and fiscal stability, while higher prices might ease fiscal pressures but risk inflation. Internally, challenges persist in public service delivery and infrastructure development, potentially constraining private sector growth. Given that government spending remains the primary economic driver, improving public expenditure efficiency is crucial, particularly for infrastructure development and creating a competitive business environment. This is especially critical considering the Petroleum Fund's financing role, where inefficient spending could accelerate its depletion and threaten long-term fiscal sustainability. Addressing these vulnerabilities requires both immediate reforms in resource management and a robust fiscal framework to build economic resilience through effective resource allocation and diversification.

Achieving Timor-Leste's growth targets will require not only accelerated budget execution but also significant improvements in public expenditure efficiency. As government expenditure remains the primary driver of economic activity, optimizing the allocation and use of public funds is essential to ensuring that investments yield long-term benefits. Improving public investment efficiency is particularly critical for addressing infrastructure deficits and reducing private sector costs ( ), thereby creating a more competitive business environment. Given that the Petroleum Fund finances a large share of public spending, inefficient expenditure could accelerate its depletion, jeopardizing the country's ability to sustain growth. Immediate reforms to enhance resource management are crucial to bolstering Timor-Leste's fiscal and economic sustainability.

Box 2.2: Unlocking Private Sector Growth Through More Efficient Public Expenditure

Achieving greater efficiency in public expenditure is critical for Timor-Leste's private sector development. The B-READY 2024 report highlights significant gaps in public service efficiency that, if addressed, could unlock substantial private sector potential by translating public expenditures into improved business conditions and economic development. Timor-Leste currently faces major obstacles in building a robust business environment, which is vital for private sector growth and diversification. Ranking among the lowest in the East Asia and Pacific (EAP) region with a B-READY[16] score of 38.28, Timor-Leste's performance reflects an urgent need for reforms that create a more supportive business climate.

Key inefficiencies, particularly in infrastructure and utilities, inflate operational costs and undermine business competitiveness. Despite substantial public investment in essential services like electricity and water, operational inefficiencies and unreliable delivery systems continue to impede private sector growth. These challenges reduce the effectiveness of public expenditures, limiting their impact on economic diversification and development.
To address these inefficiencies, the B-READY report recommends the following measures:

- **Streamlining Procurement Processes: Enhancing transparency, accountability, and competition to ensure optimal resource utilization Improving Infrastructure Investment Efficiency:** Focusing on strategic resource allocation to enhance reliability in critical sectors such as electricity and water, reducing business operational costs.
- **Improving Digitalization of Public Services**: Introducing digital platforms for tax collection, procurement, and administrative processes to reduce bureaucratic hurdles and enhance public sector responsiveness.
- **Strengthening Monitoring and Evaluation**: Establishing robust oversight mechanisms to assess the effectiveness of public spending, particularly in key sectors like infrastructure, health, and education.

Source: World Bank, B-READY Timor-Leste report, 2024

[16] The Business Ready (B-READY) score, introduced in 2024, is the World Bank's new metric for assessing the business environment across various economies

3. Making Public Expenditure Boost Growth

Chapter 3 examines how Timor-Leste can make better use of its public spending to support sustainable economic growth. Despite being one of the world's highest spenders relative to its economy, the benefits of this spending often fall short, leaving many citizens without meaningful improvements in their lives. The budget is heavily skewed toward recurring costs like salaries, subsidies, and transfers, while even major investments in infrastructure and human development face delays, cost overruns, and mismatched priorities. Looming over these challenges is the country's deep reliance on its Petroleum Fund—a finite resource projected to run dry by 2037 if urgent reforms aren't made. This chapter provides recommendations to cut unnecessary spending, spending well, and build a sustainable fiscal framework for the country's future.

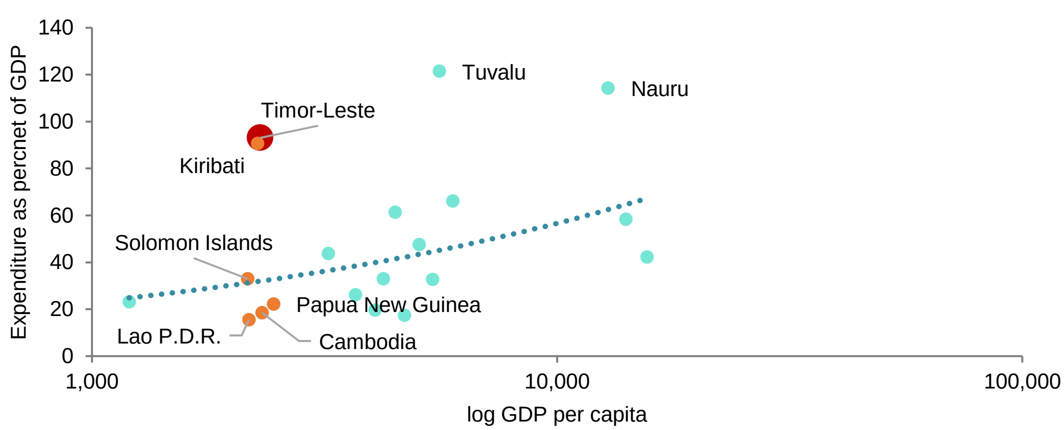
3.1. Introduction: Timor-Leste's Expenditure Landscape

Timor-Leste faces severe fiscal challenges due to unsustainable public expenditures, insufficient savings plans, and an urgent need for fiscal adjustments. The country's public spending, averaging 85 percent of GDP over the past decade, ranks among the highest globally, yet has yielded limited economic growth and social progress relative to regional peers. This fiscal imbalance is exacerbated by the country's heavy dependence on Petroleum Fund (PF) withdrawals to finance persistent budget deficits, which reached an alarming 40 percent of non-oil GDP in 2023. Projections indicate that, at the current pace, the PF—Timor-Leste's primary financial safety net—will be completely depleted by 2037. This looming "fiscal cliff" could force abrupt, painful cuts to essential services such as health, education, and social protection. Without a robust savings strategy or diversified revenue base, Timor-Leste risks a severe fiscal crisis that could undermine its economic stability and long-term development goals.

A decade of High expenditure but Low Returns.

Timor-Leste's public expenditure levels remain among the highest globally, reflecting a reliance on government spending to drive economic activity. Since 2007, public spending has averaged over 80 percent of GDP, reaching 85 percent between 2019 and 2023 as expenditure rose from $1.5 billion to around $1.8 billion (Figure 3.1). Despite lower GDP per capita, the country has relied on high public expenditure to support economic activity, particularly in construction and public services. This reliance has resulted in significant budget deficits, with domestic revenue contributing less than 12 percent of GDP. From 2019 to 2024, the fiscal deficit averaged 47 percent of GDP, peaking at 60 percent in 2022, and has been predominantly financed by excess withdrawals from the Petroleum Fund. However, this approach is unsustainable, underscoring the urgent need for fiscal reforms to ensure Timor-Leste's long-term economic resilience.

Figure 3.1: Timor-Leste's public expenditure levels remain among the highest globally

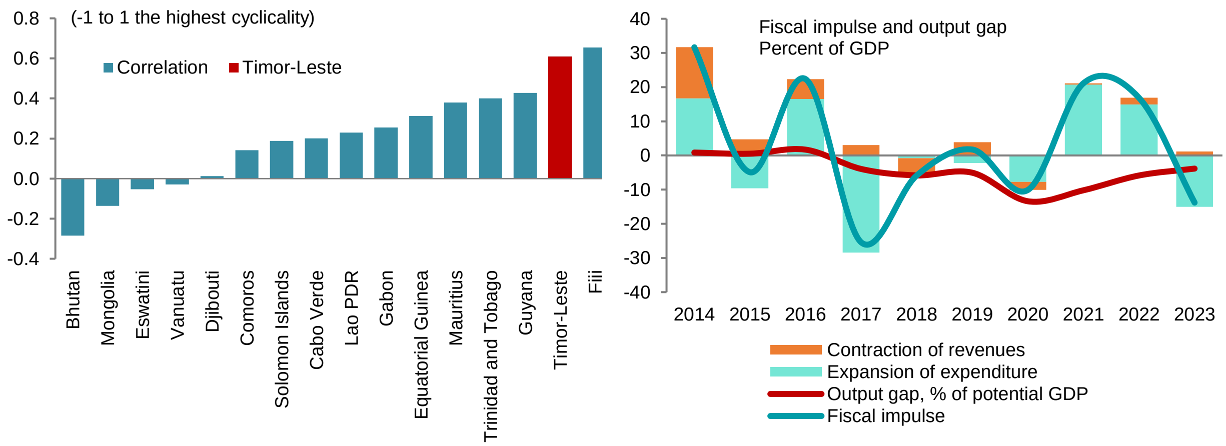


Source: World Development Indicators and World Bank staff's Calculations
Note: Average 2021 to 2023 for both axis

Timor-Leste's economy consistently underperforms its potential despite substantial fiscal stimulus. Public spending in the country exhibits a strikingly strong procyclical relationship with GDP, with a correlation coefficient of 0.6—one of the highest among its peers (Figure 3.2.a). Unlike peers such as Fiji and Trinidad and Tobago that maintain stable fiscal policies, Timor-Leste's heavy dependence on petroleum revenues makes public expenditures highly vulnerable to external shocks, as evidenced during the 2017-2020 political impasse when spending cuts severely impacted infrastructure and social services. The economy's performance during 2014-2023 further illustrates this vulnerability, with fiscal expansions in 2015 and 2022 failing to close the output gap, while revenue contractions in 2016 and 2023 amplified economic downturns (Figure 3.2.b). These patterns highlight critical weaknesses in the fiscal framework and underscore the urgent need for reforms to stabilize spending, improve efficiency, and protect the economy from revenue shocks.

Figure 3.2: Correlation between GDP and public spending cyclical components

a. Correlation between government spending and GDP growth | *b. Fiscal Impulse*



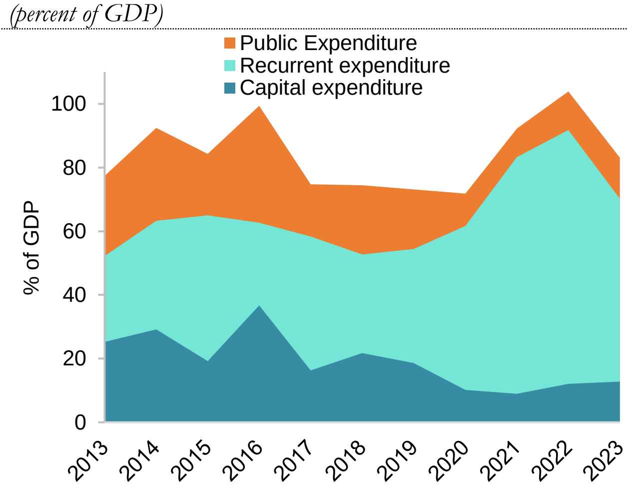
Source: World Bank staff's estimates | Source: World Bank staff's estimates

3.2. Overview of Public Spending

Timor-Leste's Government Expenditure Breakdown

Timor-Leste's expenditure composition is heavily skewed toward recurrent spending, raising concerns about its potential to drive long-term growth. Recurrent expenditure—including wages, subsidies, and operational costs—has consistently dominated public spending, rising from 75 percent of total expenditure in 2019 to 90 percent by 2021 and averaging over 60 percent of GDP over the past decade (Figure 3.3). This disproportionate level of recurrent spending not only places a heavy burden on fiscal resources. The impact of this imbalance is clear in the sharp decline in capital spending, which fell from 18.6 percent of of GDP in 2019 to 8.9 percent in 2021, with modest recovery since. Although Timor-Leste's capital expenditure remains relatively high compared to peers, the erosion of its share in

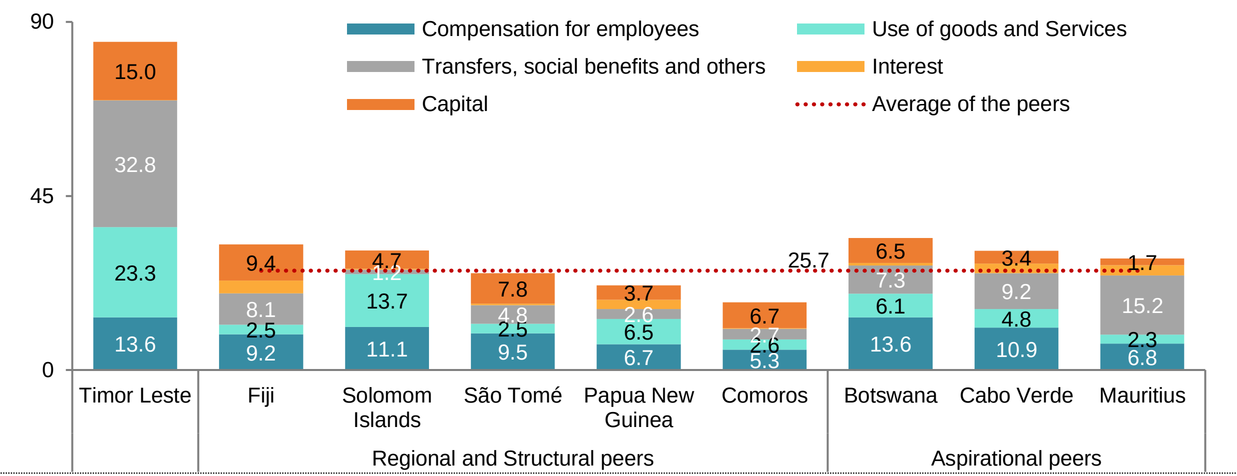
Figure 3.3: Allocation to recurrent is persistently high
(percent of GDP)



Source: Ministry of Finance and World Bank staff calculations the budget limits the country's ability to address pressing infrastructure gaps, boost productivity, and stimulate private sector activity.

Compared to regional, structural, and aspirational peers, Timor-Leste's public expenditure profile stands out. Transfers, social benefits, and other recurrent expenditures account for 32.8 percent of GDP, significantly exceeding the regional and structural peer average of 5 percent and aspirational peer average of 10 percent (Figure 3.4). Similarly, spending on goods and services (23.3 percent of GDP) and the wage bill (13.6 percent of GDP) are notably high, highlighting potential inefficiencies in public service delivery and unsustainable public spending. Capital expenditure, at 15 percent of GDP, exceeds that of many peers. Timor-Leste benefits from minimal interest payments, below 1 percent of GDP, reflecting its low reliance on debt financing. This contrasts with aspirational peers like Mauritius and Cabo Verde, which allocate a larger share to debt servicing. However, this fiscal advantage comes at the cost of heavy reliance on the Petroleum Fund, which is rapidly depleting and poses significant long-term risks.

Figure 3.4: share of expenses was allocated to goods and services purchases and subsidy and transfers
(percent of GDP, average of 2018-2022)



Source: Countries' IMF Article IV, World Bank

Government's spending priorities reflect its dual role as a significant employer and a key provider of social protection, but this comes at a high fiscal cost. Salaries and wages consistently accounted for a large share of total expenditure, averaging 19 percent between 2019 and 2023 and peaking at 30 percent in 2023 (Figure 3.5). This increase was driven by public sector hiring, with salary expenditures increasing by 27 percent from 2019 to 2022, prior to the 2023 reclassification. Timor-Leste's wage bill (5 percent of GDP)1 significantly exceeds that of regional peers such as Fiji and Papua New Guinea, where wage expenditures range between 9–10 percent of GDP (Figure 3.6:). Similarly, spending on goods and services has grown to support government institutions. Meanwhile, transfers—including social security, subsidies, and financial aid—rose sharply from 27 percent of total expenditure in 2019 to 37 percent in 2023. This increase underscores the government's focus on expanding social protection programs such as Bolsa da Mãe [17], which aim to alleviate poverty and support vulnerable populations.

[17] The universal cash transfer Bolsa da Mae Jerasaun Foun started implementation in 2022 in three municipalities (Ainaro, Bobonaro, Oecusse), and expanded to other three municipalities in 2023 (Covalima, Manatuto, Liquiça, Viqueque). The transfer amount was US$ 15 for pregnant women, US$ 20 for children, and an extra US$ 10 for children with disabilities and/or chronic illness. It has been paused in 2024.

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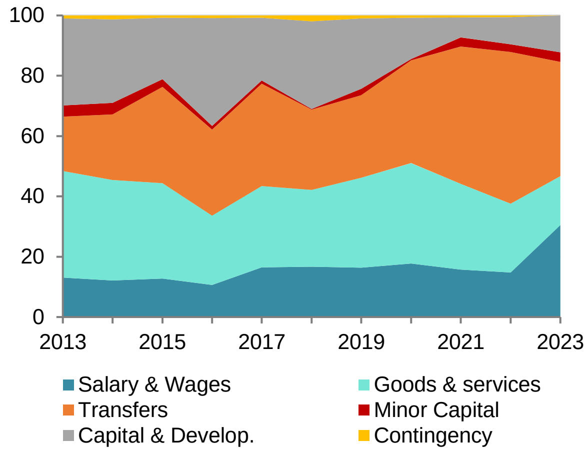
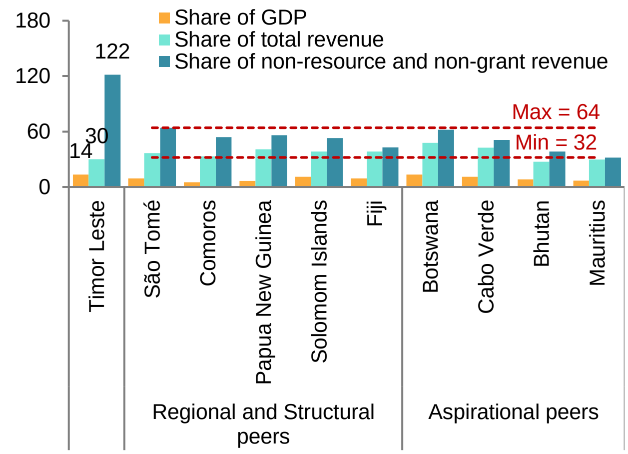
Figure 3.5: Following the pandemic, government spending priorities have shifted toward increased transfers
(percent)



Source: Ministry of Finance and World Bank staff's calculations

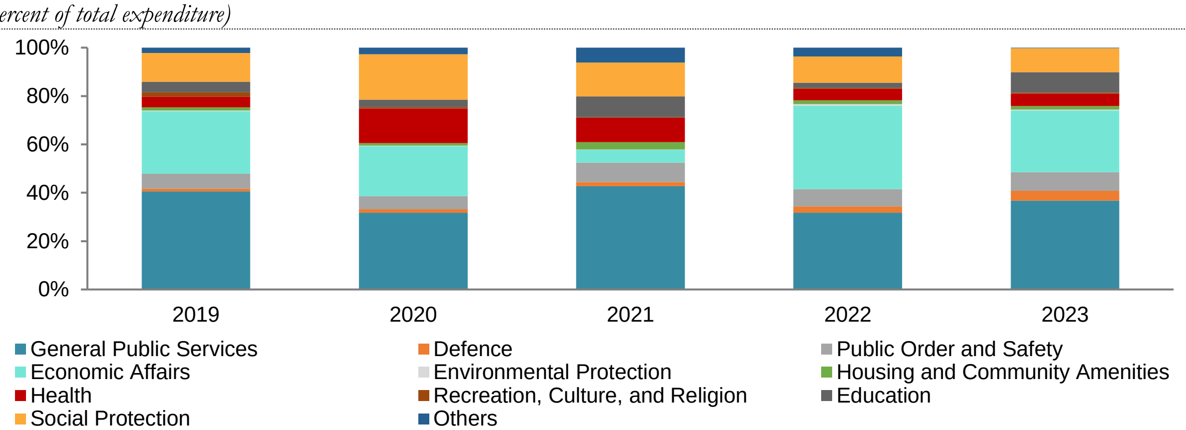
Figure 3.6: Compensation to employee is high, comparing to the non-resource and non-grants revenue
(percent, average of 2018-2022)



Source: Source: Countries' IMF Article IV, World Bank

The functional's allocation shows a clear focus on government administration and governance, while essential sectors for long-term development are underfunded. Between 2019 and 2023, spending on General Public Services—covering administrative costs—consistently took up 30–35 percent of the total budget (Figure 3.7). In comparison, health and education, which are critical for improving people's lives and boosting the economy, received much less, with health getting 5–10 percent and education 10–15 percent of total spending. Economic development sectors like infrastructure, transport, and agriculture received about 10–12 percent of the budget. However, key areas like agriculture and environmental protection, which are vital for supporting rural communities and tackling climate challenges, received only 3–5 percent and less than 3 percent, respectively.

Figure 3.7: Spending Dominated by General Public Services
(percent of total expenditure)



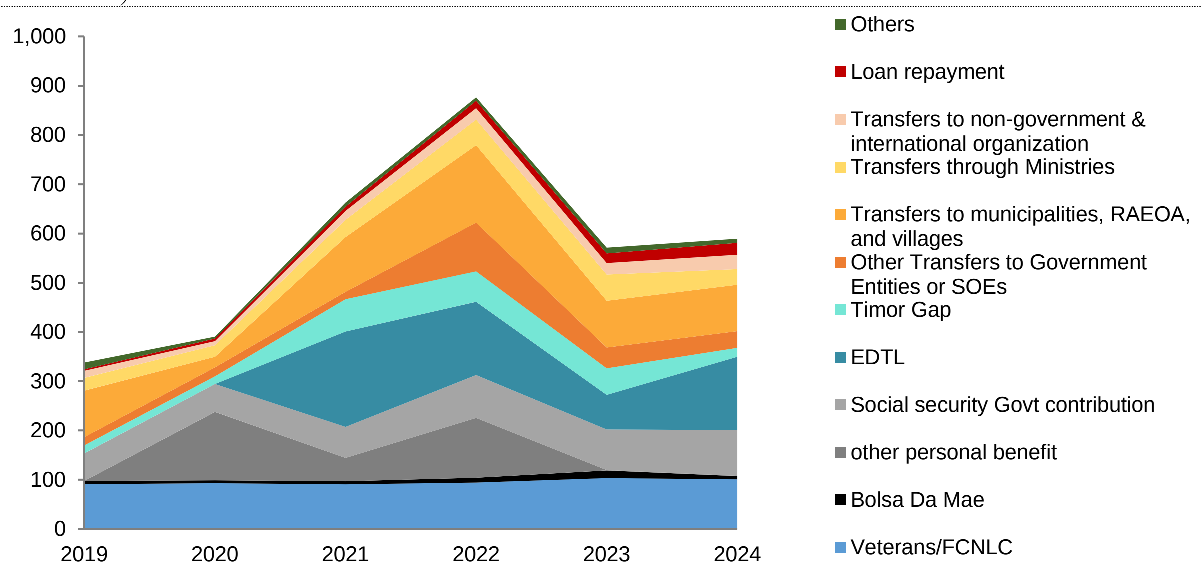
Source: World Bank staff calculation, General State Accounts

At the same time, the government has shown commitment to decentralization and local governance. Funding for municipalities and the Autonomous Region of Oecusse-Ambeno (RAEOA) increased significantly during this period. Municipal allocations rose from 5 percent of total expenditure in 2019 to about 8 percent in 2023, while RAEOA's funding doubled from 2 percent to 4 percent. These resources aim to improve service delivery, address specific regional needs, and support community-driven initiatives. These efforts are bolstered by capacity-building programs and the adoption of integrated financial management systems to enhance transparency and accountability at the local level.

Government transfers were predominantly directed toward veterans and the public electricity enterprise EDTL, which together absorbed a substantial portion of total transfers. Social security transfers, including payments to the elderly, steadily increased, reflecting a commitment to social welfare (Figure 3.8). Other notable transfers supported Timor GAP for energy sector initiatives. Health-related transfers peaked in 2020 due to COVID-19, while education and municipal funding underscored a focus on decentralized governance and human capital development. These transfer patterns highlight Timor-Leste's dedication to social support, infrastructure maintenance, and local development, with targeted increases during critical periods such as the pandemic.

Government transfers to state-owned enterprises (SOEs) in Timor-Leste have risen sharply, creating significant fiscal pressures and reducing domestic market competitiveness. Transfers to SOEs have increased from 4.6 percent of GDP in 2017 to nearly 12 percent in 2023. The largest recipient, EdTL, accounted for around 10 percent of GDP in 2023. However, many SOEs suffer from operational inefficiencies, poor governance, financial mismanagement, and overstaffing, which result in persistent losses and substandard service delivery. These issues undermine the efficiency of public spending, discourage private investment, and limit innovation. Heavy subsidies to SOEs distort market signals and often prioritize operational costs over capital investments, reducing their potential contribution to long-term economic growth. Additionally, SOEs dominate credit markets, restricting affordable financing options for small and medium-sized enterprises (SMEs), further stifling private sector development.

Figure 3.8: Transfers spending keep rising and predominantly for veterans and electricity subsidies
(USD million)



Source: Directorate of National Economic Policy, Ministry of Finance Staff Calculations from GRP , Budget 2025, September 2024

Budget Execution Performance: High in Wages, Lows in Development

Timor-Leste's budget execution between 2019 and 2023 highlights inefficiencies and fluctuations, particularly in development spending. Budget execution declined from 87.6 percent in 2019 to a low of 57.0 percent in 2022, recovering to 78.5 percent in 2023, with the sharpest declines in development categories (Table 3.1). Salary and Wages consistently exceeded 90 percent execution, reflecting a priority on recurrent expenditures tied to public sector employment. Transfers varied, dropping to 46.2 percent in 2022 before recovering partially in 2023. Execution rates for Goods and Services and Minor Capital fell below 80 percent in 2021, with slight improvement in 2023. Capital Development, essential for infrastructure and long-term growth, faced critical challenges, with execution rates plummeting to 35.7 percent in 2021 and 48.4 percent in

2022, improving only to 69.3 percent in 2023. These delays likely hampered economic progress by postponing key infrastructure projects. Contingency Expenses showed high variability, exceeding 100 percent execution in 2021 due to emergency responses to Cyclone Seroja and the COVID-19 pandemic.

Table 3.1: Timor-Leste's budget execution suggests inefficiencies and fluctuations
(percent of budget)

	2019	2020	2021	2022	2023
Salary Wages	93.7	96.9	92.1	94.3	91.5
Goods Services	87.0	84.4	73.5	81.7	78.3
Minor Capital	74	60	65	77	82
Capital Development	72	73	35.7	48.4	72
Transfers	93.2	78.4	93.4	46.2	69.3
Contingency expenses	71.0	87.6	112.3	74.6	
Total Expenditure	87.6	83.5	75.4	57.0	78.5

Source: Timor-Leste Budget Transparency Portal

3.3. High Human Capital Spending Dominated by Wages and Salaries

Timor-Leste's human capital spending—comprising social protection, education, and health—remains relatively high compared to peer countries. During the COVID-19 pandemic, social spending peaked at over 30 percent of GDP in 2020 and 2021, driven by emergency allocations for health and social protection. However, as pandemic-related pressures eased, spending has declined reflecting shifting budget priorities. Education spending rose from 3.4 percent of GDP in 2019 to 7.8 percent in 2023. Conversely, health expenditure has declined from a pandemic peak of 10 percent of GDP in 2020 to 6 percent by 2023. Social protection spending remains exceptionally high, primarily due to veterans' transfers. In 2023, public expenditure on social protection (excluding health) reached 9.7 percent of non-oil GDP, significantly exceeding the 2.5 percent average among lower-middle-income countries.[18] While these spending levels reflect Timor-Leste's strong commitment to human development, they raise concerns about sustainability given the country's limited fiscal space and heavy reliance on the depleting Petroleum Fund.

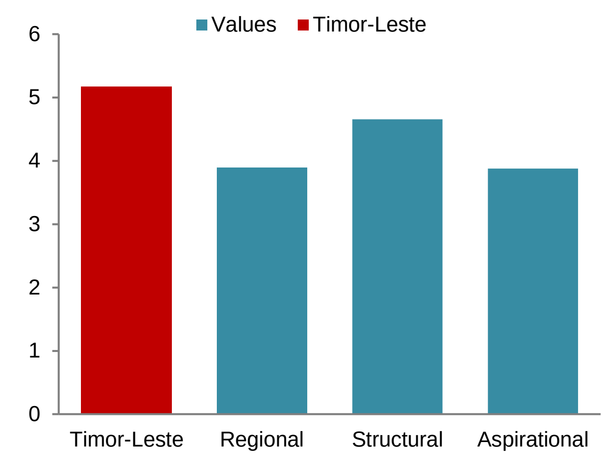
Wages and Salaries dominate Education and Health expenditures.

Timor-Leste's education and health sectors face significant resource allocation challenges, with recurrent costs consuming a disproportionate share of their budgets and constraining investments in critical development areas. In education, teacher salaries absorb 53 percent of total expenditure in 2023[19] (Figure 3.10), potentially crowding out essential investments in learning materials, infrastructure, and teacher training. This spending pattern is further complicated by a funding structure heavily skewed toward basic education at the expense of pre-school and secondary education, which rely primarily on private investment in urban areas, thereby exacerbating rural-urban educational disparities. Similarly, the health sector's budget is dominated by personnel costs, consuming over 50 percent of expenditures (Figure 3.12**)**, while achieving uneven workforce distribution with specialists concentrated in Dili and rural areas remaining underserved (Ministry of Health 2023). The remaining budget allocation - 25-30 percent for Goods and Services, variable Capital and Development expenditures, and minimal Transfers and Minor Capital - coupled with limited contingency funding, raises concerns about both the sectors' long-term sustainability and their capacity to respond effectively to emergencies or invest in critical development needs.

[18] Rita Maria De Sousa Fernandes, Carlos Alberto Coca Gamito; Policy Paper: Fiscal Space for Social Protection in Timor-Leste, Dili: International Labour Office, 2024

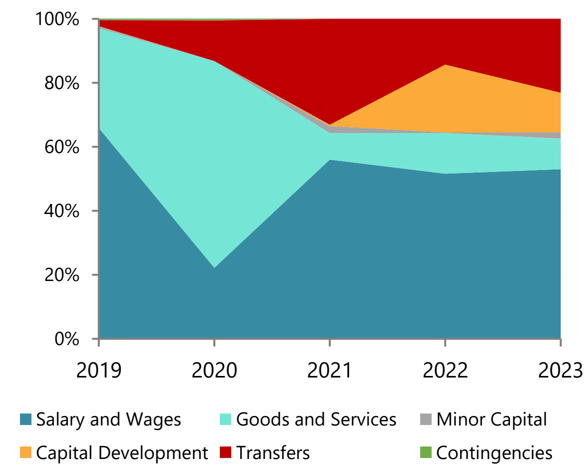
[19] Human Capital Review 2023.

Figure 3.9: High education expenditure compared to Peers
(Government expenditure in Education (% of GDP), Average of 2018-2022)



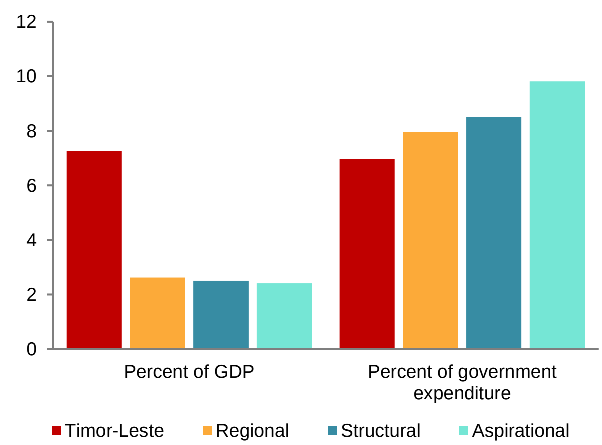
Source: WDI

Figure 3.10: …dominate by salaries and wages
(In % share of total education expenditure)



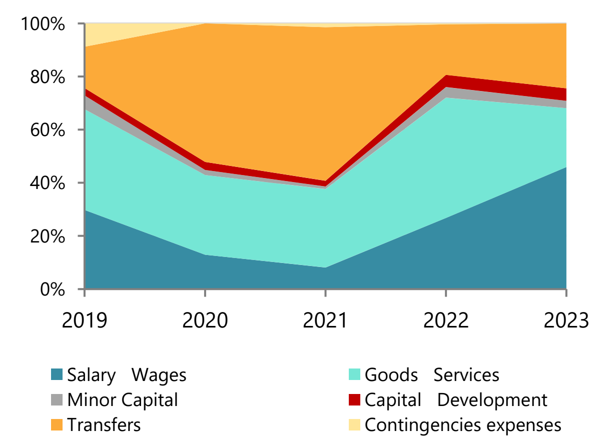
Source: Ministry of Finance and World Bank staff calculations

Figure 3.11: Health Expenditures Benchmarking
(Government health expenditure, percent (Average 2019-2022))



Source: WDI

Figure 3.12: Composition of Health Expenditure
(In % share of total heath expenditure)



Source: Ministry of Finance and World Bank staff calculations

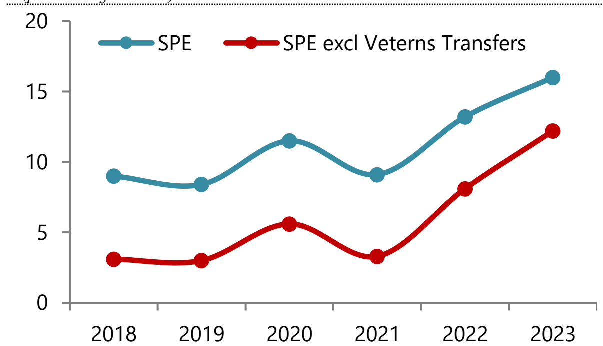
Capital expenditure on health infrastructure has steadily declined since 2016, further limiting access to healthcare in underserved regions. Investment in new facilities and infrastructure upgrades has been minimal, particularly in rural areas where expanded healthcare access is most critical (World Bank 2023). Low execution rates for capital projects exacerbate these issues, with unutilized funds frequently returned to the government. Strengthening project execution and management could enhance the impact of capital spending, advance universal health coverage (UHC) goals, and improve access to essential health services nationwide.

High and increasing social protection expenditure.

Government spending on social protection in Timor-Leste is among the highest globally, averaging 11 percent of GDP between 2018 and 2023, surpassing that of many peer countries. Since 2009, public expenditure on social protection has seen significant growth (Figure 3.13), especially in non-contributory programs like the Veterans' Pension. Public social protection spending rose from 10 percent of GDP (USD 109 million) in 2008 to 16 percent of GDP (USD 260 million) in 2023, exceeding levels observed in nations with similar population sizes and poverty rates. Notably, the Veterans' Pension constitutes a large portion of these expenditures, while other social assistance programs, such as food assistance and support for internally displaced persons, account for a smaller share and have seen significant budget reductions since 2010. Despite these substantial investments, Timor-Leste continues to grapple with persistent challenges such as poverty, hunger, and child malnutrition, highlighting the critical need for targeted and efficient resource allocation to address these issues effectively.

Figure 3.13: Social protection expenditure (SPE) 2018 –2023

(percent of GDP)



Source: Ministry of Finance and World Bank staff calculations

3.4. Spending More, Achieving Less: The Challenge of Timor-Leste's Budget Efficiency

Efficient public spending and strategic budget allocation are critical for building Timor-Leste's economic resilience and driving sustainable growth. While the government has made significant investments in infrastructure and social sectors, these efforts have yet to translate into stable or sustained economic progress. The BAS 2023 report highlights critical inefficiencies in budget execution, particularly in infrastructure-heavy sectors like construction and transportation, which undermine the government's ability to stimulate meaningful economic activity. Efficiency in this context entails two dimensions: allocative efficiency, which ensures resources are directed to sectors aligned with national priorities, and technical efficiency, which focuses on achieving outcomes with minimal waste.

Timor-Leste's public expenditure reveals significant gaps in both technical and allocative efficiency. With an overall expenditure quality index score of 0.35 (Table 3.2), Timor-Leste falls behind other regions and country groups, including lower-middle-income countries (LMICs) at 0.42, upper-middle-income countries (UMICs) at 0.51, and the EAP region at 0.48. Its score is only marginally higher than that of Fragile and Conflict-Affected Situations (FCV), which stands at 0.33. Furthermore, Timor-Leste's technical efficiency score is particularly low at 0.24, well below the LMICs (0.40), UMICs, and EAP (both at 0.50), signalling major inefficiencies in resource use. Allocative efficiency is also weak at 0.39, slightly below the LMIC average and far from the 0.51 observed in both UMICs and EAP. Empirical studies show that fiscal multipliers in small island developing states (SIDS) typically range between 0.2 and 0.4, compared to 0.5–1.4 for other low-income countries[20].

Table 3.2: Overall index for quality of expenditure

(the sum of the three objectives, in percentile rank, the higher, the more performing)

	TLS	LMIC	UMIC	EAP	FCV
Overall Score	0.35	0.42	0.51	0.48	0.33
Sustainability	0.47	0.45	0.51	0.51	0.41
Technical Efficiency	0.24	0.40	0.50	0.50	0.31
Allocative Efficiency	0.39	0.41	0.51	0.51	0.34

Source: World Bank, Quality of expenditure Heatmap
Note: Allocative efficiency reflects how well a country's budget supports its strategic objectives.
Technical efficiency is defined as the distance from the observed input-output combinations to an "estimated" efficient frontier.
Period of analysis, 2021

[20] Global Economic Prospects, June 2024

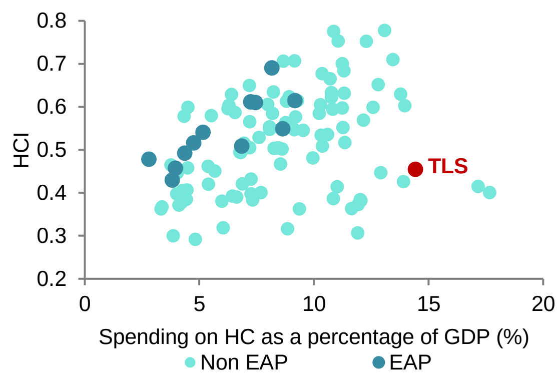
However, Timor-Leste exhibits an even lower multiplier of just 0.1 (2022 Article IV staff report) and 0.2 (World Bank 2021), below the typical range. These figures underscore substantial inefficiencies in both resource utilization and allocation within Timor-Leste's public spending.

For example, Timor-Leste's high wage bill, which consumes 37 percent of government expenditure in 2023, puts considerable pressure on the national budget. With approximately 40,000 civil servants, the government spends a large portion of its resources on salaries, with the public sector wage allocation reaching about USD 457 million in 2023. While these expenditures support a growing civil service, they also highlight inefficiencies and areas for potential reform. For context, Tonga, a smaller Pacific Island nation, allocates about 22 percent of its budget to wages, while the average wage bill in the EAP region is typically between 10-20 percent, with more efficient countries like Singapore keeping it at just 12-14 percent.

High Spending, Low Outcomes: The Inefficiencies in Timor-Leste's Human Capital Spending

High human capital expenditures in Timor-Leste have not translated into proportional improvements in human capital outcomes. Despite per capita spending of approximately USD 1,300 in 2023—exceeding the EAP regional average of USD 1,000, which includes high-income countries like Japan and Singapore—Timor-Leste's Human Development Index (HDI) ranked 155th globally (Figure 3.14). This is significantly below that achieved by developing countries. Human capital accumulation remains low (Table 3.3), with persistent challenges in health and education outcomes compared to regional peers with similar or lower spending levels.

Figure 3.14: High spending on human capital has not proportionally improved in outcomes



Source: World Bank HCI Database

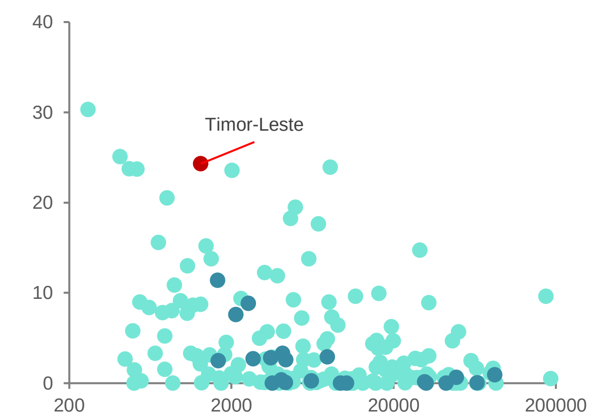
Table 3.3: HCI and HCI Component Scores for LMICs in the EAP Region

Country Name	HCI 2020	Probability of Survival to Age 5	Fraction of Children Under 5 Not Stunted	Expected Years of schooling	Learning-Adjusted Years of Schooling	Adult Survival Rate
Vietnam	0.69	0.98	0.76	12.90	10.70	0.87
Mongolia	0.61	0.98	0.91	13.20	9.20	0.80
EAP Average	**0.59**	**0.98**	**0.76**	**11.91**	**8.35**	**0.86**
Global Average	**0.56**	**0.97**	**0.77**	**11.31**	**7.81**	**0.85**
Philippines	0.52	0.97	0.70	12.90	7.50	0.82
Micronesia, Fed. Sts.	0.51	0.97	_	11.80	7.20	0.84
LMIC in EAP Average	**0.50**	**0.97**	**0.69**	**10.95**	**7.03**	**0.83**
Kiribati	0.49	0.95	_	11.20	7.40	0.81
Cambodia	0.49	0.97	0.68	9.50	6.80	0.84
Myanmar	0.48	0.95	0.71	10.00	6.80	0.80
Lao PDR	0.46	0.95	0.67	10.60	6.30	0.82
Vanuatu	0.45	0.97	0.71	10.10	5.60	0.87
Timot-Leste	**0.45**	**0.95**	**0.54**	**10.60**	**6.30**	**0.86**
Papua New Guinea	0.43	0.95	0.51	10.30	6.00	0.78
Solomon Islands	0.42	0.98	0.68	8.30	4.70	0.86
Global LMIC Average	**0.42**	**0.94**	**0.70**	**9.24**	**5.45**	**0.76**

Source: World Bank HCI Database
Note: Ordered by Descending HCI

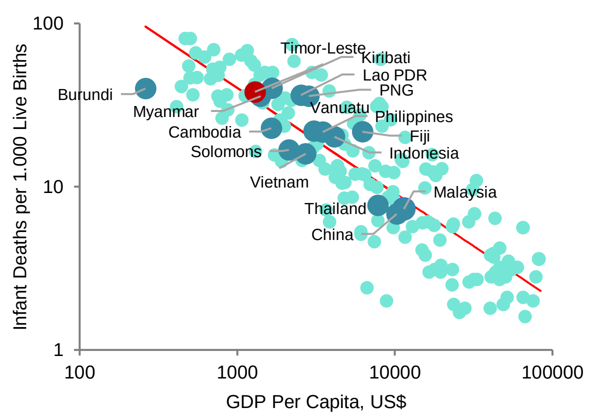
Timor-Leste's education and health sectors face persistent inefficiencies, with high spending failing to deliver proportional improvements in outcomes. In education, despite substantial investments, critical challenges persist, including low literacy rates, poor school completion, and subpar education quality. Countries like Vietnam, Indonesia, and the Philippines achieve better results in both health and education with similar or lower spending. Early literacy and numeracy scores remain among the lowest in the region, and preschool enrollment rates fall short of expectations. High repetition and dropout rates inflate costs without improving learning outcomes; for example, early-grade repetition increases per-student spending without tangible gains (Figure 3.15). The high dropout rate in secondary education further undermines the potential for long-term human capital development Similarly, while health expenditures have driven progress, Timor-Leste still lags regional peers like Cambodia and Vanuatu, which achieve better outcomes with comparable or lower spending. In 2022, life expectancy in Timor-Leste was 69.1 years, lagging Solomon Islands (70 years), Philippines (72 years), and Vietnam (74.6 years), while the EAP average stood at 76.2 years. Infant mortality is notably high at 41 per 1,000 live births (Figure 3.16), compared to 18.1 in Indonesia and 16.2 in Vietnam. Timor-Leste still faces high malnutrition rates, with the second-highest percentage of stunted children under five years old in 2020[21].

Figure 3.15: Repetition rate in Grade 1 of primary education, both sexes
(repetition rate (percent (y-axis), GDP per capita (USD, x-axis))



Source: World Bank HCI Database Source: WDI
Note: Ordered by Descending HCI

Figure 3.16: Infant mortality is notably high compared to peers
(infant deaths per 1000 live births (y-axis), GDP per capita (USD, x-axis))



Source: WDI

In education, systemic inefficiencies have hindered the ability to meet rising student enrollment and ensure quality learning environments. Although secondary school capacity has expanded, it remains inadequate, with overcrowded classrooms becoming the norm. Average class sizes increased from 46 students in 2011 to 57 in 2018 (World Bank 2021), reflecting the strain on facilities. Projections indicate a 23 percent rise in the student population by 2035, with secondary school enrollment expected to surge by 47 percent (UN 2017). Infrastructure investments have been insufficient to address these challenges, leaving 10 percent of classrooms in poor condition and basic amenities lacking—40 percent of basic schools have no drinking water, and 66 percent lack functional toilets. Despite high spending, limited attention to improving education quality compounds these systemic shortcomings.

In health care, investments have failed to translate into equitable access or significant health improvements[22]. Outdated primary care facilities, insufficient secondary and tertiary care capacity, and unequal resource distribution leave rural populations underserved. Weak management of resources, including medical supplies and personnel, exacerbates these gaps. For instance, shortages of essential equipment such as nebulizers and stethoscopes undermine care for critical conditions like lung disease and hypertension. While

[21] https://documents1.worldbank.org/curated/en/169421597377261674/pdf/Malnutrition-in-Young-Children-and-their-Mothers-in-Timor-Leste.pdf
[22] Human Capital Review 2023.

outpatient services have expanded with the construction of Community Health Centers (CHCs) and Health Posts (HPs), the stagnation in developing Referral Hospitals has left many municipalities without adequate secondary care facilities. Preventive care is underutilized, with limited screening and management of noncommunicable diseases (NCDs) leading to overburdened hospitals, poorer health outcomes, and higher costs.

Similarly, social protection spending, despite its scale, has achieved limited welfare impact. While these expenditures provide a range of benefits and services, their effectiveness is constrained by fragmented delivery systems and limited focus on poverty alleviation. The rapid rollout of social assistance programs, coupled with adequate operational guidelines and weak targeting mechanisms, has reduced their overall impact. For instance, Bolsa da Mãe has only reduced the poverty rate by 0.9 percentage points due to its low benefit levels and limited coverage of poor households. Similarly, the veterans' program, which accounts for 4.5 percent of non-oil GDP, has only prevented a 2.6 percentage point increase in poverty, despite its high cost[23]. A significant portion of social protection funds is directed towards veterans, with a large portion of the poor population not being reached by current targeting mechanisms. According to the Bertelsmann Transformation Index (BTI), most Timorese households depend on informal sector employment, making traditional social safety nets difficult to implement effectively.

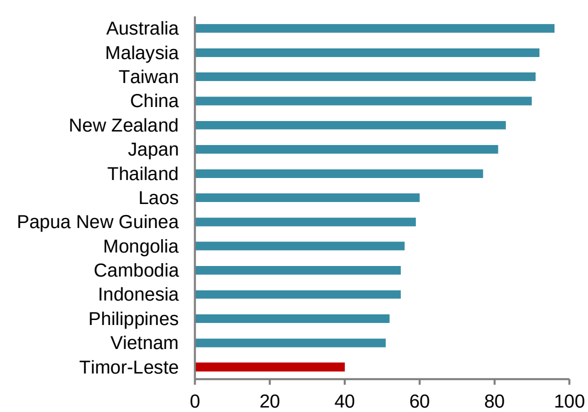
From Strategic Goals to Impact: Challenges in Timor-Leste's Investment Framework

Infrastructure development has been a top priority for Timor-Leste, with significant investments in roads, electricity, and irrigation between 2019 and 2023. Nearly 60 percent of infrastructure spending during this period was allocated to roads and electricity, reflecting the government's focus on improving connectivity, expanding energy access, and boosting agricultural productivity Alongside these initiatives, significant public funds have been directed toward large-scale projects, including the Tasi Mane oil and gas project on the southern coast and the ZEESM (Special Social-Economic Market Zone) project. In 2023, real estate investments surged to 16 percent of capital expenditure, signaling a shift toward urban development. However, limited funding for asset maintenance and contingency infrastructure exposes gaps in long-term planning and risk management. Minor capital expenditures, dominated by vehicle purchases (40–50 percent annually), and rising spending on digital equipment in 2023 also highlight growing interest in technological modernization.

Despite these substantial investments, their impact on economic growth has been modest. Capital expenditure consistently accounted for about one-third of total government spending; a high level compared to regional peers. The long-run multiplier for capital spending is just 0.10[24], indicating that the economic benefits of public investment are partially offset by negative factors such as the crowding out of private sector activity and reliance on imports. Moreover, the rate of return on capital has been declining since 2008, suggesting diminishing effectiveness of these investments in boosting output.

Project inefficiencies further compound these challenges. Despite heavy spending on roads and electricity, many projects suffered from cost overruns and delays, undermining their

Figure 3.17: Poor Road quality
(Mean Speed score)



Source: IMF 2022

[23] Andrews, Kathryn, Lander Bosch, Janssen Teixeira, Ilsa Meidina, and Somil Nagpal. 2023. Seizing Opportunities of a Lifetime: The Timor-Leste Human Capital Review. Washington, DC: World Bank. License: Creative Commons Attribution CC BY 3.0 IGO
[24] Timor-Leste Fiscal Sustainability ASA (P501000)

effectiveness. Timor-Leste's IMF Mean Speed Score[25] for road quality was below 40, ranking it among the lowest globally, lagging behind peers like Myanmar and Brunei (Figure 3.17). The country also ranked in the bottom five worldwide alongside Nepal, Bangladesh, Haiti, and Nicaragua. Poor road infrastructure quality reflects inefficiencies in planning, execution, and maintenance. Similarly, central electricity projects expanded access but resulted in excess capacity and high maintenance costs, while irrigation initiatives reached only a limited number of farmers[26].

PIM challenges lower capital spending efficiency[27]

Timor-Leste's Public Investment Management faces a critical disconnect between strategic and economic planning. Strategic planning prioritizes long-term national objectives, emphasizing alignment with development goals, while economic planning evaluates technical feasibility and value for money. Enhanced collaboration between strategic planners and economic analysts is necessary to align investment efficacy with efficiency.

Another key issue is the misalignment between Timor-Leste's annual budget cycle and the multiyear nature of project development. Large infrastructure projects and other significant investments require long timelines for preparation, design, and implementation. However, the government's one-year budget framework creates pressure to accelerate project readiness, often resulting in rushed appraisals and compromised quality. Decoupling these cycles is essential to allow sufficient time for thorough project preparation and appraisal.

Capacity constraints in line ministries further hinder the effective preparation and appraisal of investment projects. Currently, the Ministry of Planning and Strategic Investments (MPSI) centralizes most project preparation and appraisal activities, which is unsustainable as the volume of initiatives continues to grow. Strengthening technical expertise across ministries through capacity-building programs is critical, with technically advanced ministries like Public Works and Transportation serving as pilots for decentralization. Expanding knowledge of sophisticated appraisal techniques, such as cost-benefit analysis (CBA) and risk analysis, is equally important to ensure that investments deliver measurable economic and social benefits.

Governance challenges and institutional inefficiencies add another layer of complexity to PIM reform. Timor-Leste's PIM involves multiple institutions with overlapping roles, creating bottlenecks and inconsistencies in project preparation and management. The Ministry of Planning and Strategic Investments (MPSI) aims to consolidate PIM functions under a single unit to streamline project preparation, evaluation, and management. This unit will establish standards, guidelines, and training programs for managing public investments. Currently, several institutions under MPSI, such as the Major Project Secretariat (MPS) and the National Development Agency (NDA), play a role in managing public investments. The Ministry of Finance (MoF) also oversees key areas like budgeting, asset management, and external resources for development projects. The current fragmented structure of PIM has led to inefficiencies, and a more centralized approach is essential for improving project delivery.

Challenges in Procurement: A Barrier to Efficiency

Timor-Leste has undertaken comprehensive procurement reforms to improve economic performance, enhance transparency, and ensure fiscal sustainability. Key to these reforms was the establishment of the National Procurement Commission (CNA) in February 2023 under Decree-Law No. 3/2023[28]. The CNA was tasked with centralizing oversight, enforcing compliance, and standardizing procurement procedures across government institutions. Amendments introduced in December 2023 further strengthened the CNA's structure

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[25] Mean Speed Score, used by the IMF with the latest data of 2022, is a measure of cross-country road quality based on the travel time between large cities according to Google Maps. MS score correlates closely with the World Bank's Rural Access Index and the WEF's Quality of Road Infrastructure score, demonstrating its accuracy as a proxy for road quality and access.
[26] Timor-Leste Economic Report - Rebalancing Priorities to Harvest Prosperity (English), July 2023.
[27] IMF PIMA scores suggest that stronger PIM is correlated with higher public investment efficiency.
[28] https://timor-leste.gov.tl/?p=35402&lang=en

and authority, creating a unified procurement framework aligned with international best practices. These reforms represent a significant step toward better governance and more efficient public procurement.

Despite recent reforms, structural inefficiencies in Timor-Leste's procurement system continue to undermine budget execution and public expenditure efficiency. The absence of a centralized procurement framework and misalignment between procurement and budget cycles exacerbate delays, inflate project costs, and diminish the value of public investments. Outdated and fragmented procurement regulations result in inconsistent practices across government entities, leading to delays, cost overruns, and duplicated efforts. Weak market analysis and insufficient supplier performance monitoring limit the effectiveness of public spending (Methodology for Assessing Procurement Systems, (MAPS) Assessment 2023), while inadequate transparency mechanisms increase the risk of corruption and mismanagement. The 2018 PEFA assessment underscores the poor integration between procurement planning and budgeting, leading to inefficient resource allocation and frequent project delays.

Procurement inefficiencies are particularly acute in health sector, undermining budget execution and service delivery. Joint management of funds by the Ministry of Health and municipal authorities results in disjointed budget planning and spending that is often misaligned with health priorities. Although spending on medical supplies and pharmaceuticals remains significant, it is riddled with inefficiencies. Centralized procurement has helped keep prices relatively low, but weak forecasting leads to frequent stock-outs and significant waste from expired drugs. These inefficiencies undermine the Ministry's ability to deploy resources strategically. Poor procurement and inventory practices further compound the issue, resulting in frequent emergency purchases that inflate costs and disrupt planning. While centralized procurement offers cost control, reliance on short-term fixes and inadequate forecasting hampers efficiency and service delivery (WHO 2019).

3.5. From Expenditure to Growth: Reforming Public Expenditure for Better Outcomes

Improved efficiency: Timor-Leste's Savings Plan

Enhancing the efficiency of Timor-Leste's public sector can unlock significant fiscal savings, but achieving these reforms will require sustained effort, careful planning, and strong political will. Aligning spending on public services and economic affairs with regional and structural peers could free up approximately $600 million—equivalent to 30–40 percent of GDP[29] (Figure 3.18). Key areas for potential savings include gradual reduction of subsidies—particularly on fuel and electricity—which accounted for 5 percent of GDP in 2023. These subsidies are not only costly but often poorly targeted, benefiting wealthier households disproportionately. Reforming these programs to prioritize vulnerable groups could save millions annually while minimizing social impacts. Similarly, improving efficiency in the wage bill could save an estimated 5.3 percent of GDP[30]. (Figure 3.19). This would entail measures such as reducing redundancies, optimizing staffing levels, and introducing performance-based pay systems, with potential annual savings of $60–100 million. Aligning public sector compensation with regional benchmarks would further enhance efficiency and improve service delivery.

[29] 30 percent of GDP at the level of regional peers and 40 percent of GDP at the level of regional peers

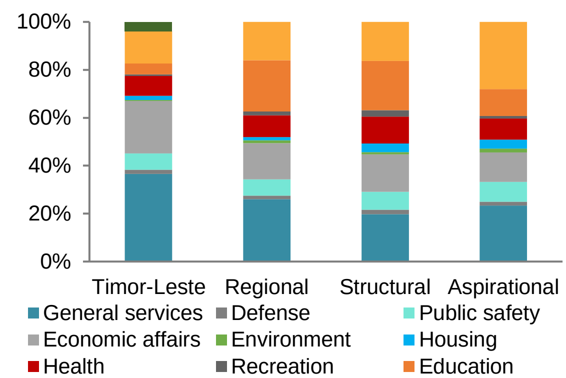
[30] The fiscal saving is computed as {1-structural component (as ratio)} *actual spending/GDP.

Box 3.1: Methodology of Wage Bill Analysis

The wage bill analysis employs regression-based methods to identify and isolate **rigid components** of the wage bill, such as **population size** and **demographic factors** like the **age dependency ratio**. These structural factors are largely beyond the government's immediate control and contribute to wage bill rigidity (wage bill rigidity work). By filtering out these elements, the analysis focuses on the **non-structural component**—the portion of the wage bill that remains after accounting for structural drivers.

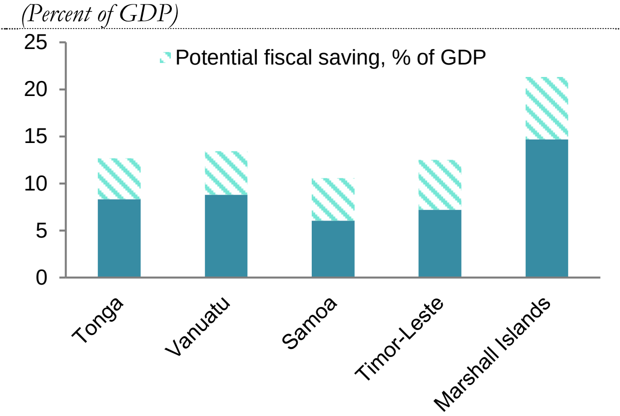
This **non-structural component** represents the part of the wage bill that the government can influence through **policy reforms**, such as adjusting staffing levels, optimizing salary scales, or implementing performance-based incentives. In essence, this component reflects the government's potential to implement cost-saving measures and enhance fiscal flexibility, as it is not inherently tied to structural demographic pressure.

Figure 3.18: Timor-Leste could save up to 40 percent of GDP by aligning general services and economic Affairs expenditure with peers.
(Percent of GDP)



Source: World Bank Staff Computations, Boost

Figure 3.19: Improving efficiency in the wage bill could save up to 5 percent of GDP (about $100 million)
(Percent of GDP)

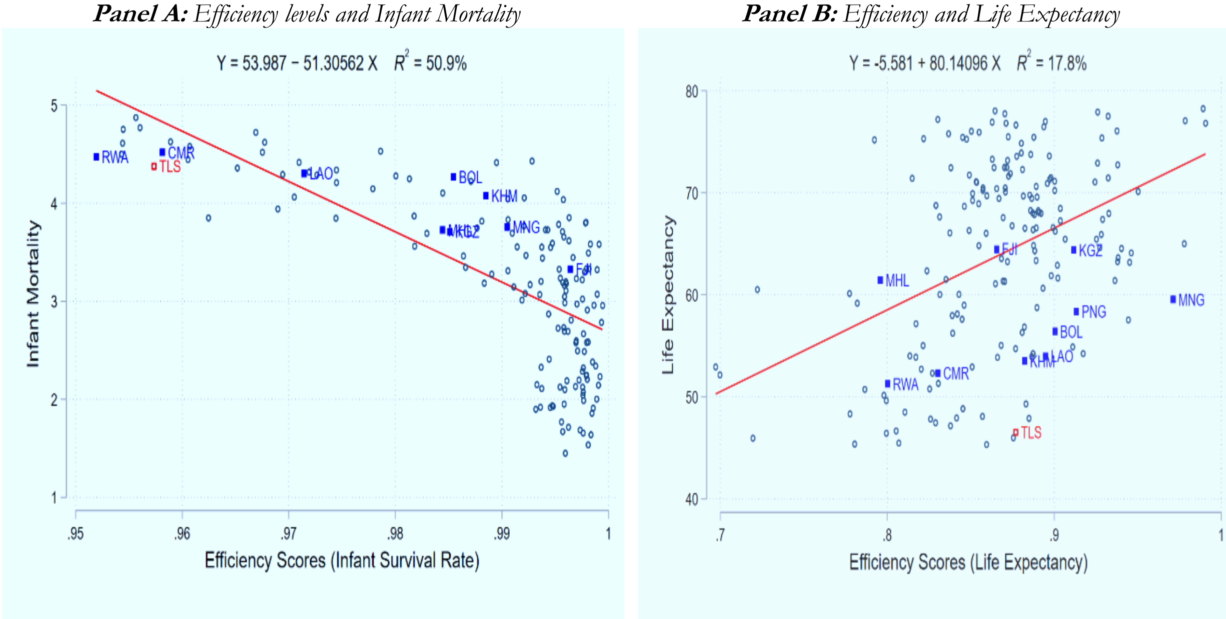


Source: World Bank Staff Computations. Original data on wage bills and pension is from World Economic Outlook, public investment is from IMF Investment and Capital Stock Dataset, and transfer in social protection and labor programs (SPL) is from ASPIRE.

Improving the efficiency of public health spending can significantly enhance health outcomes by expanding the health workforce and resources, without additional budget allocations. Countries like Kyrgyz Republic and Mongolia demonstrate how efficient spending translates into stronger healthcare outcomes, with higher efficiency strongly associated with lower infant mortality and higher life expectancy (Figure 3.20). Timor-Leste can achieve similar outcomes by addressing inefficiencies in its current health spending. Currently, Timor-Leste has an average life expectancy of 67.1 years and an infant survival rate of 94.9. By fully optimizing efficiency, life expectancy could increase by 9.1 years—or even 4.8 with partial improvements of efficiency to match high-performing peers (Figure 3.21). Similarly, its current infant survival rate could rise by 4.1 with partial improvements. These increases would directly enhance access to care, improve service quality, and support critical health outcomes. By unlocking this "double dividend"—more health workers and better outcomes—Timor-Leste can reduce maternal mortality, extend life expectancy, and expand universal health coverage. Efficiency isn't just smart budgeting; it's the key to a healthier, more resilient future for Timor-Leste

Figure 3.20: **Strong positive relationship between public spending efficiency scores and Health Outcomes**

Panel A: *Efficiency levels and Infant Mortality* ***Panel B:*** *Efficiency and Life Expectancy*

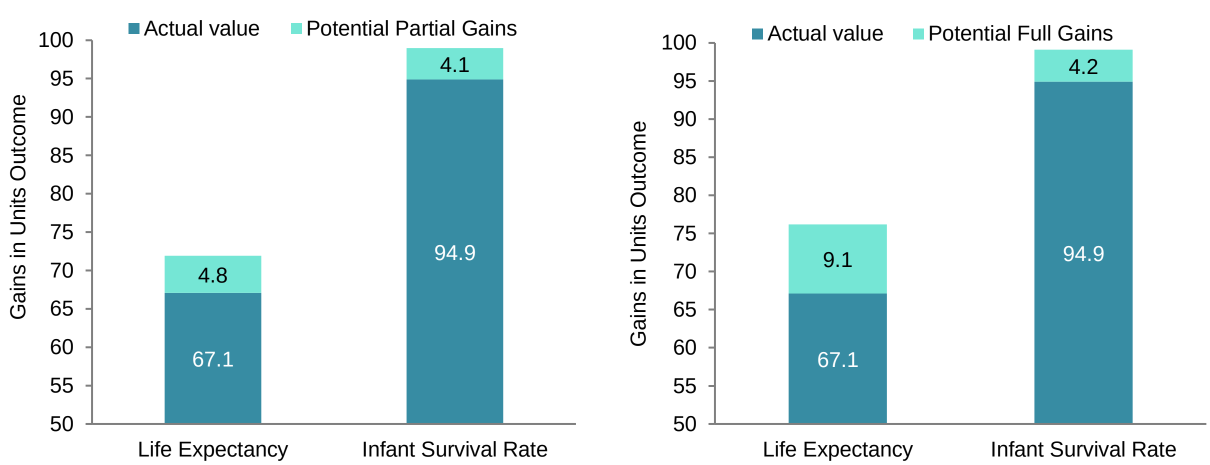


Source: World Bank Staff computations

Notes: All health resource indicators are measured in per 1,000 inhabitants. Timor-Leste (TLS), Bolivia (BOL), Cambodia (KHM), Cameroon (CMR), Fiji (FJI), Kyrgyz Republic (KGZ), Lao PDR (LAO), Marshall Island (MHL), Mongolia (MNG), Papua New Guinea (PNG), Rwanda (RWA), and Turkmenistan (TKM). Countries are excluded based on missing data.

Figure 3.21: **Potential Gains from Improving Public Spending Efficiency in Health Expenditure**

Panel A: *Partial Gains* ***Panel B:*** *Full Gains*



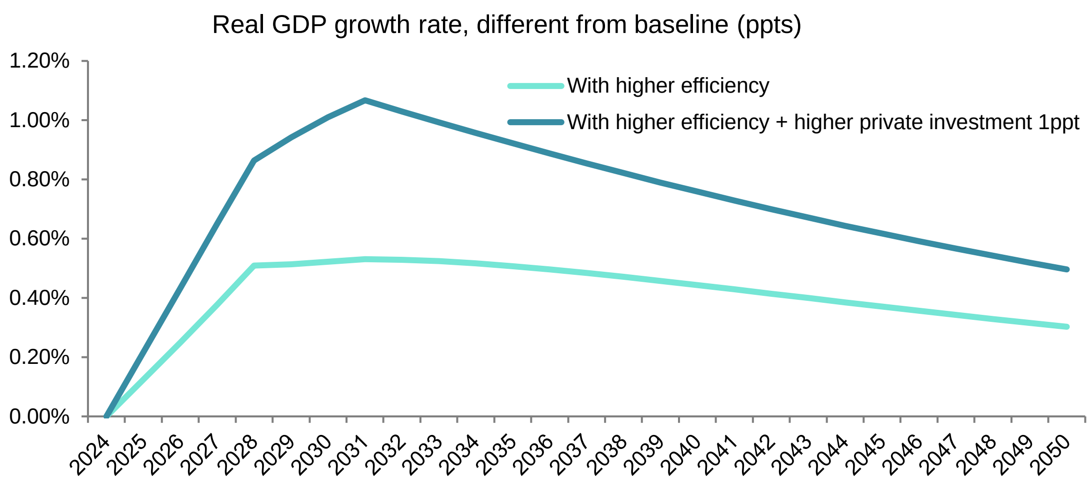
Source: World Bank Staff computations

Notes: The gains are calculated as output shortfalls from the efficiency scores. Number of physicians and Number of nurses and midwives are rescaled from per 1000 to 10,000 inhabitants for expositional purposes.

Investing for Growth: Reforming Timor-Leste's Public Investment Framework

Improving public investment efficiency could allow Timor-Leste to reduce spending without slowing GDP growth. Based on the Long-Term Growth Model (LTGM), enhancing public spending efficiency—whether through better investment management or resource allocation—could boost GDP growth by approximately 0.5 percentage points annually over the forecast period (2024-2050) (Figure 3.22). To achieve this, policymakers can implement targeted reforms to strengthen project appraisal and execution. Establishing a centralized unit within the Ministry of Finance for rigorous project evaluation and prioritizing high-impact investments in infrastructure, health, and education can maximize spending outcomes. Strengthening procurement systems, utilizing digital tools for real-time monitoring, and improving the capacity of line ministries to execute projects efficiently will help minimize delays and cost overruns. In an ambitious reform scenario, gradually reducing public investment from its current levels by 5 percentage points of GDP, reaching 10 percent by 2035, would not hinder medium-term growth if these efficiency gains are realized. Institutional reforms to enhance transparency, accountability, and public expenditure reviews are critical to sustaining these improvements. By optimizing how resources are allocated and utilized, Timor-Leste can adopt more sustainable fiscal policies, reduce reliance on the Petroleum Fund, and secure resilient economic growth for the long term.

Figure 3.22 : Impact of higher public capital efficiency on growth, different from baseline
(percentage points)



Source: World Bank staff calculations

Spending better for Sustainable Growth

Before considering spending more, Timor-Leste must focus on improving how public resources are allocated and utilized. Redirecting funds to high-impact sectors can better align fiscal policy with strategic growth goals. Currently, public spending yields limited economic returns, as evidenced by a low fiscal multiplier. Instead of increasing expenditure, enhancing its quality is crucial for improving human capital outcomes. Investments in targeted social protection and essential infrastructure could significantly enhance productivity and strengthen economic resilience. For example, poverty-focused social programs can stabilize household incomes, stimulate consumption, and promote inclusive growth. By emphasizing resource efficiency and prioritizing strategic investments, Timor-Leste can optimize public spending to support sustainable development and economic stability.

To improve education outcomes, Timor-Leste must prioritize smarter spending rather than higher spending. Expanding access to quality pre-school education is critical for school readiness and reducing early-grade repetition. Redirecting resources to basic education can close learning gaps, supported by investments in infrastructure to alleviate overcrowding and improve school environments. Programs such as remedial teaching and school feeding are essential for lowering dropout rates and retaining students. Enhancing teacher training and offering performance-based incentives will further improve classroom outcomes. Strengthening data systems like the Education Management Information System (EMIS) will ensure more effective resource allocation and monitoring, driving better education outcomes.

A comprehensive approach to health spending is necessary to align resources with national priorities and improve service delivery. Strengthening budget planning and execution will ensure predictable resource flows, reducing delays in operations and procurement. Consolidating fragmented health financing mechanisms and empowering municipal health services with clearer roles will promote decentralized governance. Equitably distributing health workers and revising incentives will improve access to care, particularly in underserved regions. Investments in primary health care (PHC) and improved infrastructure are essential to address disparities, while reforms in pharmaceutical procurement will reduce stockouts and ensure access to quality medicines. Establishing robust monitoring systems will support data-driven decision-making and accelerate progress toward Universal Health Coverage (UHC).

Timor-Leste's social protection system must be restructured to focus on the most vulnerable populations. Social expenditure should direct to poverty-targeted initiatives such as Bolsa da Mãe. Strengthening delivery systems through a unified social registry and integrated management tools, such as the Beneficiary Operations Management System (BOMS), will eliminate duplication and improve efficiency. Aligning social protection programs with human capital development goals—particularly in early childhood, nutrition, and education—will amplify long-term benefits. A robust monitoring framework is essential for ensuring resources are well-targeted and programs are impactful. Redirecting resources to initiatives with higher poverty alleviation potential will significantly bolster human capital and foster inclusive growth.

Getting the Most from Public Investment

Over the past decade, Timor-Leste has embarked on several reform initiatives to strengthen its economic framework and improve governance (As noted in Box 2.1). Key focus areas include macroeconomic management, fiscal policy, and public financial management. This track needs to be continued and strengthened for the Government to achieve its ambitious targets for economic growth and job creation. The passing of the laws on public procurement and public financial management by the 9th Constitutional Government are signals of such a reform agenda taking place. Three areas remain critical to better efficiency of public spending:

1. **Better public investment management is the backbone of Timor-Leste's sustainable growth[31] providing the framework for efficient and impactful use of public resources.** A top priority is integrating strategic and economic planning processes, utilizing tools like the Logical Framework Approach (Log Frame) to align long-term development goals with technical feasibility. Combining top-down leadership with bottom-up stakeholder engagement in the project generation process fosters community ownership, refines project concepts, and ensures alignment with both local and national priorities. Another essential reform is decoupling the multiyear project cycle from the annual budget cycle. This change would provide sufficient time for thorough project preparation and appraisal, enabling the development of a pipeline of high-quality, shovel-ready projects that can be efficiently allocated budget resources. Building capacity within line ministries is equally critical, with targeted training programs in advanced appraisal techniques such as cost-benefit analysis (CBA) and risk analysis. Decentralizing project preparation responsibilities to technically capable ministries, like Public Works and Transportation, can serve as a successful model for broader reform across sectors. Establishing a consolidated PIM Unit within the MPSI would be transformative. Such a unit, empowered to standardize processes, enforce methodologies, and provide continuous training, could act as the central hub for all public investment activities, ensuring consistency and accountability across government levels. Transitioning to a modernized PIM system requires a phased approach, prioritizing stakeholder engagement and continuous feedback mechanisms to address resistance and refine strategies.

[31] IMF (2024), https://www.imf.org/en/Publications/WP/Issues/2024/11/01/Public-Investment-Management-Bottlenecks-in-Low-income-Countries-556847 , Working paper

2. **Modernizing procurement is a game-changer for efficiency and sustainability in Timor-Leste.** The new procurement law[32] (Annex 4) aligns the system with international best practices recommended by the Methodology for Assessing Procurement Systems (MAPS). Reforms include strengthening legal frameworks to enhance transparency, value for money, and competitiveness. Key measures, such as conflict-of-interest declarations, structured complaints mechanisms, and performance monitoring through key performance indicators (KPIs), will promote accountability. To mitigate disruptions during the transition, the government must prioritize implementing the legal framework, secure strong leadership, and actively engage relevant stakeholders. Critical actions include developing practical tools such as updated regulations, guidelines, and standardized bidding documents to support the new system. Institutional clarity and coordination in public procurement will be strengthened through the establishment of clear roles and responsibilities among agencies. Furthermore, building the capacity of the public procurement workforce and developing a roadmap for professionalizing procurement roles are essential steps to ensure sustained improvements. A significant leap toward sustainability is the Green Public Procurement initiative, launched in 2024 with European Union support. This initiative incorporates environmental considerations into procurement processes, promoting eco-friendly practices and reducing the environmental impact of public projects. Collectively, these reforms promise to improve efficiency, enhance accountability, and embed environmental stewardship into Timor-Leste's procurement processes, setting a strong foundation for fiscal sustainability and responsible governance.

3. **Improved PFM will strengthen fiscal management**. Timor-Leste's new PFM law could be a blueprint for improving expenditure efficiency and fiscal sustainability. Program-based budgeting will link every dollar to measurable goals, ensuring resources go where they matter most. The law introduces a budget strategy statement to align medium-term planning with national priorities, ensuring the country stays on course. Real-time monitoring and evaluation will allow swift adjustments to keep projects on track and costs under control.

[32] On January 8th, 2025, Decree-Law No. 1/2025 was published, approving the new Procurement and Public Contracts Code.

ANNEX 1. Key Indicators

Table 1: Economic Indicators

	2018	2019	2020	2021	2022	2023	2024F	2025F	2026F
Real sector	***(annual percentage change, constant)***								
Gross domestic product (non-oil)	-0.5	2.7	-8.5	3.0	4.0	2.4	3.5	3.4	3.6
Final consumption expenditure	1.0	4.1	1.3	0.09	7.0	1.5	4.8	4.2	2.8
Gross fixed capital formation	-1.5	-17.4	-46.9	-6.1	27.0	11.5	15.2	3.6	13.2
Consumer price index, period average	2.3	0.9	0.5	3.8	7	8.4	3.3	2.8	2.5
Fiscal sector	***(percentage of non-oil GDP)***								
Total Revenue	48	42	46	45	44	41	39	38	36
Domestic revenue	12	11	12	10	10	13	11	11	12
Estimated Sustainable Income	35	31	34	35	33	28	28	27	24
Total expenditure	74	73	72	92	104	83	88	95	94
Recurrent expenditure	53	54	62	83	92	70	72	79	76
Capital expenditure	22	19	10	9	12	13	15	16	17
Fiscal balance	-27	-31	-25	-47	-60	-42	-48	-57	-58
Monetary and Financial sector	***(as stated)***								
Credit to the private sector (% growth)	-2.4	4.3	11.2	5.8	33	22			
Lending interest rate (%)	11.9	12.0	11.3	11.0	10.8	10.6			
Nominal effective exchange rate (index)	101.0	102.3	103.6	100.8	105.3	107.3			
Real effective exchange rate (index)	118.3	119.0	120.3	120.3	130.1	140.4			
External sector	***(percentage of non-oil GDP)***								
Current account	-12	8	-18	10	16	-21	-47	-52	-56
Goods and services	-59	-54	-52	-50	-60	-54	-60	-63	-66
Primary and Secondary income	48	63	34	59	76	34	13	11	10
Capital account	3	2	1	1	1	1	1	1	1
Financial account	16	-7	-27	-17	-10	19	50	52	55
Direct investment	3	-34	-41	-4	-2	-2	-2	-2	-2
Portfolio investment	12	29	17	-10	9	42	72	72	74
Other investment	0	-2	-4	-3	-17	-21	-20	-18	-18
Net errors and omissions	17	-15	-10	-46	-21	39	0	0	0
Change in reserves	-8.32104	1	0	-18	6	0	-96	-103	-110
Memorandum items	***(as stated)***								
Oil production (million BOE)	39	38	36	37	11.7	7			

Source: Ministry of Finance, BCTL
Starting from 2019, the BOP figures include the Export and Import Value from Oil activities

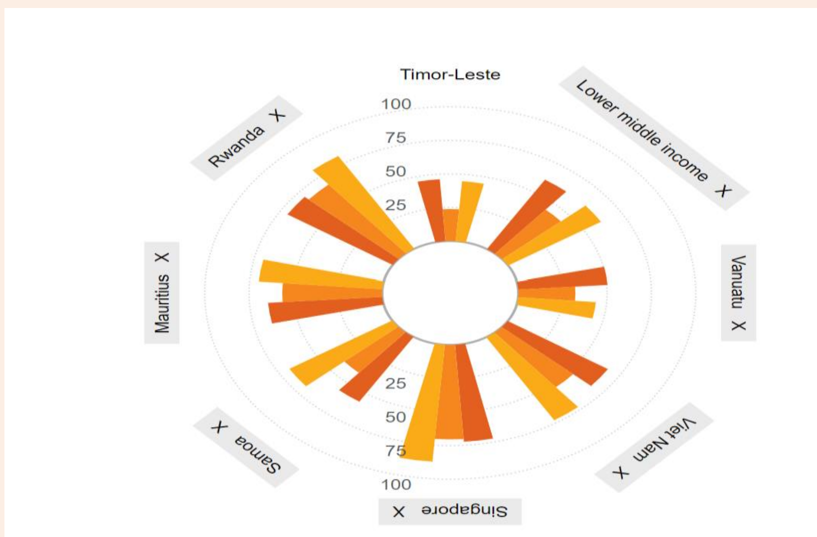
ANNEX 2. Summary of Policy Reforms in Timor-Leste (2013-2023)

Reform Area	Reform	Legal Instrument	Year of Adoption
Macroeconomic Management and Fiscal Policy	Use of concessional loans for infrastructure development	Concessional Loan Policy	2016
	Adoption of the Tax Reform Plan	Tax Reform Plan	2018
	Debt Management	Public Debt Law	2011
Public Financial Management	SOE Reforms to enhance governance and financial management	SOE Reform Strategy	2022
	Implementation of the Tax Reform Plan	Tax Reform Plan	2018
	Introduction of the PFM Reform Strategy	PFM Reform Strategy	2016
Financial Sector	Banking Sector Strengthening	Banking Law	2011
	Financial Inclusion	National Financial Inclusion Strategy	2017
Human Capital	Health Sector Reforms aimed at expanding access to primary healthcare	Health Sector Reform Act	2019
	Education Sector Reforms	Education Reform Act	2018
	Introduction of Social Protection Programs	Social Protection Programs Act	2017
	Healthcare System Development	National Health Sector Strategic Plan 2011–2030; Update 2020-2030	2011; 2020
Public Sector	Decentralization	Municipalities Law	2016
	Civil Service Reform	Civil Service Act	2016
Justice and Anti-Corruption	Promotion of mediation as an alternative dispute resolution method	Alternative Dispute Resolution Act	2023
	National anti-corruption strategy (No. 2/7/2020)	National Anti-Corruption Strategy	2020
	Establishment of the Anti-Corruption Commission	Anti-Corruption Commission Act	2016
Improvement of Business Environment & Private Sector Development	Accession to the World Trade Organization (WTO)	WTO Accession Agreement	2023
	Business Environment Simplification	Private Investment Law	2017
	Competition Policy	Competition Law	2017
Economic Diversification	Introduction of policies to enhance resilience to climate change and natural disasters	Climate Change and Disaster Management Policy	2021
	Expansion of Renewable Energy Initiatives and development of the National Energy Policy	National Energy Policy	2021
	National Strategic Development Plan (NSDP) 2011-2030	NSDP 2011-2030	2017
Labor Markets	Labor Market Policies	Labor Law	2012
Innovation	Research and Development (R&D)	Science, Technology, and Innovation Policy	2017
	Digital Economy Initiatives	National ICT Policy	2017
Infrastructure	Energy Sector Improvements	National Energy Policy	2017

ANNEX 3. Summary of Timor-Leste B-Ready's Performance

Timor-Leste: Business Environment Overview

- **Strengths**: Despite these challenges, Timor-Leste demonstrates potential in specific areas. The country scores highest in **Utility Services** and **Business Entry**, indicating that it has established regulatory frameworks that facilitate efficient utility connections and allow foreign businesses to enter the market with relatively few restrictions.
- **Weaknesses**: However, significant gaps exist in critical areas that hinder private sector development. The country exhibits low scores in **Business Insolvency**, **Market Competition**, and **Financial Services**, which are crucial for creating a thriving business ecosystem. The absence of an insolvency code prevents businesses from reorganizing effectively during financial distress, while the lack of competition laws and a competition authority stifles market dynamics. Additionally, inadequate financial services limit access to capital for businesses, impeding their growth and competitiveness.
- **Public Service Deficiency**: The assessment highlights a substantial gap between the regulations intended to improve the business environment and the public services necessary for their effective implementation. This deficiency undermines the positive impacts that well-designed regulations could have on the private sector and overall economic performance.



Pillar 1 = Regulatory Framework
Pillar 2 = Public Services
Pillar 3 = Operational Efficiency

Source: World Bank, https://www.worldbank.org/en/businessready/economy/timor-leste

ANNEX 4. Key Reforms and Features of the new Procurement Law

Enhancing public procurement in Timor-Leste involves improving efficiency, transparency, and accountability while supporting economic growth, sustainability, and alignment with international standards. Key reforms include introducing a preference regime for national suppliers, prioritizing Timorese businesses in government contracts. This policy aims to strengthen the local economy, build national business capacity, and reduce dependency on foreign contractors. Restricted tenders are reintroduced to allow selective bidding for specialized or smaller projects, improving efficiency and ensuring that contracts align with project-specific requirements.

A centralized State Supplier Registry will catalog and pre-qualify suppliers, enabling faster and more reliable procurement by providing government entities with a vetted supplier pool. The law also introduces framework agreements to guarantee the availability of essential goods and services, preventing supply chain disruptions. Additionally, grouped purchases will allow multiple agencies to consolidate procurement needs, reducing costs and maximizing public value in high-demand areas. Streamlined timelines are established to address procurement delays, enhancing budget execution and aligning with global best practices.

To better manage works contracts, the law separates them from the general procurement regime, applying specialized oversight and regulatory measures tailored to construction projects. This approach ensures more focused management, recognizing the complexity and significance of infrastructure development.

The law also strengthens governance by enhancing transparency and accountability, with clear administrative procedures, defined penalties for procurement-related offenses, and judicial guarantees for fair processes. Suppliers are provided with a clear pathway for redress, ensuring integrity and fairness in procurement. Sustainability is emphasized, with mandatory environmental and social criteria promoting eco-friendly and socially responsible procurement practices.

Finally, the law mandates a shift to electronic procurement, replacing traditional paperwork with digital platforms to enhance efficiency, transparency, and data accuracy. This digital transition ensures reliable tracking, accountability, and streamlined processes, supporting Timor-Leste's goals for sustainable and effective public spending.

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