Fiscal Space for Social Protection in Timor-Leste

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Policy Paper

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January 2024

ISBN 9789220404737 (print)
9789220404744 (web PDF)

Also available in Portuguese version: *Espaço Orçamental para a Proteção Social em Timor-Leste*, ISBN (9789220408315 (impresso); 9789220408322 (pdf web)

Printed in Timor-Leste

Acknowledgement

This policy paper has been prepared by Rita Maria de Sousa Fernandes (Sr. Social Protection Technical Officer, ILO) and Carlos Alberto Coca Gamito (International Consultant) as main authors. Rogerio Fernandes (National Consultant) assisted with some of the data compilation and summary. It has benefited from valuable contributions from Helmut Schwarzer (Head PFACTS Unit, SOCPRO, ILO), Pascal Annycke (Social Protection and Public Finance Technical Officer, ILO), Mariana Pereira (Junior Professional Officer, ILO) and Nuno Castro (Coordinator of ACTION/Portugal, ILO).

This policy paper was funded by the Federal Ministry for Economic Cooperation and Development (BMZ) of Germany under the ILO-GIZ cooperation agreement as part of the Programme "Social Protection Innovation and Learning (SPIL)" and by the Strategy and Planning Office of the Ministry of Labour, Solidarity and Social Security of Portugal under ACTION/Portugal project "Strengthen social protection systems in the PALOP and Timor-Leste". Its contents are the sole responsibility of the authors and do not necessarily reflect the views of Germany and Portugal.

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List of Acronyms and Abbreviations

ABND	Assessment-based National Dialogue
ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
AMUSSOL	Mutual Association of Solidarity Services
BM	Bolsa da Mãe
CIF	Cost, Insurance, and Freight
C102	Social Security (Minimum Standards) Convention, 1952 (No. 102)
COFOG	Classification of Functions of Government
CoV	Coefficient of Variation
COVID-19	Coronavirus disease 2019
CNPS	National Council for Social Protection
CPLP	Comunidade dos Países de Língua Portuguesa
CPI	Consumer Price Index
CPMF	Contribuição provisória sobre movimentação ou transmissão de valores e de créditos e direitos de natureza financeira
CT	Corporate Tax
DAC	Development Assistance Committee
EAP	East-Asia and Pacific
ESSP	Executive Secretariat for Social Protection
ESI	Estimated Sustainable Income
FAT	Financial Activities Tax
FDI	Foreign Direct Investment
Fed	US Federal Reserve
FERs	Foreign Exchange Reserves
FOREX	Foreign Exchange
FSC	Financial Stability Contribution
FTT	Financial Transaction Tax
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GFI	Global Financial Integrity
GNI	Gross National Income
IATA	International Air Transport Association
IATF	Inter-Agency Task Force
ID	Identification
IFFs	Illicit Financial Flows
IFIs	International Financial Institutions
ILO	International Labour Organization

IMF	International Monetary Fund
INSS	National Institute of Social Security
ITC-ILO	International Training Centre of the International Labour Organization
LDCs	Least Developed Countries
LICs	Low-Income Countries
LMICs	Lower Middle-Income Countries
M0	Monetary Base
MEJD	Ministry of Education, Youth and Sports
MF	Ministry of Finance
MACLN	Ministry of National Liberation and Combatant Affairs
MS	Ministry of Health
MSMEs	Micro, Small, & Medium Enterprises
MSSI	Ministry of Social Solidarity and Inclusion
NEF	New Economics Foundation
INE	National Institute of Statistics
NMW	National Minimum Wage
NSSP	National Strategy for Social Protection
ODA	Official Development Aid
OECD	Organisation for Economic Co-operation and Development
GSB	General State Budget
OOFs	Other Official Flows
OPEC	Organization of the Petroleum Exporting Countries
PAYG	Pay-As-You-Go
PF	Petroleum Fund
PIT	Personal Income Tax
RAP	Rapid Assessment Protocol
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
R&P	Royalties and Profits
SaT	Sales Tax
SeT	Service Tax
SEAFAs	Serviços e Entidades com Autonomia Financeira Alargada
Sd	Standard Deviation
SDGs	Sustainable Development Goals
SDP	Strategic Development Plan
SPT	Supplemental Petroleum Tax
SSCs	Social Security Contributions
SSRF	Social Security Reserve Fund
STGs	Specialized Technical Groups

TL-LFS	Timor-Leste Labour Force Survey
UMICs	Upper Middle-Income Countries
UN	United Nations
UNICEF	United Nations Children's Fund
UN Women	United Nations Entity for Gender Equality and the Empowerment of Women
VAT	Value Added Tax
WIT	Wage Income Tax

1. Introduction

Timor-Leste's commitment to social protection is enshrined in the country's constitution and national policies. Significant progress has been made since gaining independence in 2002, with notable strides in building citizenship, associating obligations with social rights, and safeguarding vulnerable individuals and families. Additionally, efforts have been directed towards protecting workers through a contributory social security regime. Over the years, investment in social protection has materialized in a combination of social assistance and social insurance benefits, establishing a comprehensive national social protection system.

Timor-Leste has embraced the transformative Agenda 2030 for Sustainable Development Goals (SDGs), with a particular focus on "leaving no one behind." Target 1.3 of this agenda aims to "implement nationally appropriate social protection systems and measures for all, including floors, and by 2030 achieve substantial coverage of the poor and the vulnerable." This commitment underscores the pivotal role of social protection in poverty prevention, human development, political stability, and inclusive growth. By ensuring income security and facilitating access to social services, individuals are empowered to capitalize on economic opportunities, thereby enhancing domestic demand, supporting economic transformation, promoting decent work, and fostering inclusive and sustainable growth (*Ortiz et al, 2019*).

Timor-Leste's dedication to implementing a Social Protection Floor is reflected in the development of the National Strategy for Social Protection (NSSP) 2021-2030. This strategy, according to its guiding principles, aims to cover the entire population and progressively improve benefit levels according to the country's capacities. The key objectives include ensuring access to essential healthcare, including maternity care; providing basic income security for children; offering income support for working-age individuals facing challenges such as sickness, unemployment, maternity, and disability; and ensuring basic income security for older persons.

Despite the advancements made over the last two decades, social protection remains a human right not yet realized for the majority of the Timorese population. According to the International Labour Organization (ILO) World Social Protection Report 2020-22, 30.6 per cent of the population is covered by at least one cash benefit of social protection, while a significant 69.4 per cent remains without any form of protection. Timor-Leste lags behind in terms of effective coverage rates when compared to Asian and Pacific countries (44.1 per cent on average).

Timor-Leste shows one of the highest levels of public expenditure on social protection in developing countries, primarily due to generous payments to veterans (WB 2022). It is estimated that public expenditure on social protection (excluding health) reached 9.7 per cent of non-oil Gross Domestic Product (GDP) in 2023. This surpasses the 2.5 per cent of GDP average across lower-middle-income countries (*ILO, 2021*). Despite these high levels of investment, deficits in social protection persist, evident in low effective coverage rates and benefit levels.

The economy of Timor-Leste is expected to continue recovering in the medium term, supported by public consumption and investment. However, there are concerns regarding the sustainability of the economy and the social protection system, especially with the depletion of the Petroleum Fund (PF) foreseen by 2034. This depletion poses risks to long-term macroeconomic stability, the continued use of the US dollar as legal tender, and the provision of basic public services.

To foster non-petroleum economic growth, Timor-Leste must expand the labour force, invest in workforce skills, create jobs (particularly for youth), promote private sector development, and enhance competitiveness in critical sectors like agriculture. Addressing the country's skills gap is also urgent, which is noticeable by Timor-Leste's low ranking on the World Bank's Human Capital Index. Social protection can play a crucial role in improving access to education, health, and nutrition for vulnerable populations, thereby unlocking their full potential (*ILO and UNICEF, 2023*).

There is a global consensus, especially within the United Nations (UN) system and International Financial Institutions (IFIs), that fiscal space exists in all countries. The argument that spending on social protection is unaffordable is deemed unacceptable. Finding fiscal space for critical investments is crucial for achieving the SDGs, sustaining human development, and fulfilling the human rights of Timorese citizens, particularly considering the current global context of multiple shocks and crises stemming from high inflation, high interest rates, risk of debt distress, natural disasters, along with the impact of COVID-19 (*ILO, 2023*).

While the COVID-19 pandemic has emphasized the importance of social protection investments as socioeconomic and political stabilizers, it has also intensified discussions on resource distribution in a competitive international environment affected by climate change and other external shocks. The need for comprehensive, flexible, and sustainable social protection systems is underscored.

It is estimated that at least a basic level of income security and access to healthcare for all in line with the Social Protection Floors Recommendation, 2012 (No. 202) would require lower-middle-income countries to invest an additional US$362.9 billion, or 5.1 per cent of GDP, to close the annual financing gap required to achieve the SDG targets 1.3 and 3.8 (*ILO, 2021*). It is urgent that countries find fiscal space to develop and maintain comprehensive, adequate and sustainable social protection for all and, ultimately, attain the SDG targets. However, there is no one-size-fits-all approach to extending fiscal space for social protection. Instead, ILO Recommendation No. 202 suggests that countries can consider different ways of mobilizing the required resources.

In this policy paper, fiscal space is understood as the resources available to a government derived from actively exploring and using all its possible revenue sources (*Ortiz et al., 2017*). This is based on definitions by the ILO, United Nations Children's Fund (UNICEF), and United Nations Entity for Gender Equality and the Empowerment of Women (UN Women). This concept of fiscal space expands the International Monetary Fund's (IMF) definition. Fiscal space is described as the room in a government's budget that allows the allocation of resources for a desired purpose without jeopardizing financial sustainability or economic stability (Heller, P. 2005), or the room to raise spending or lower taxes relative to a pre-existing baseline, without endangering market access and debt sustainability (*IMF, 2018*).

This paper is structured into four sections. Following this introduction, Section 2 presents eight financing options, discussing their fiscal effects in terms of increasing or reallocating revenues for sustainable financing of social protection in Timor-Leste. The financing options include expanding social security coverage and contributory revenues, increasing tax revenues, eliminating illicit financing flows, re-prioritizing public expenditures, tapping into fiscal and foreign exchange reserves, managing debt through borrowing or restructuring, adopting a more accommodating macroeconomic framework, and increasing aid and transfers. This section provides quantitative information and arguments to assist various stakeholders, including the government, social partners, civil society, academics, and development partners, in influencing policy discussions on extending social protection in Timor-Leste. Section 3 offers an overview of the national social dialogue required on fiscal space options to find optimal solutions within the context of Timor-Leste. Finally, Section 4 provides a summary of potential sources of financing for social protection in Timor-Leste.

2. Options to finance social protection

This section provides an analysis of the options for creating fiscal space and its implications. Eight options for generating potential government revenue are discussed in detail. Of the eight options, six increase the overall size of Timor-Leste's public budget: (2.1) expanding social security coverage and contributory revenues; (2.2) increasing tax revenues; (2.3) eliminating illicit financing flows; (2.6) managing debt: borrowing or restructuring debt; (2.7) adopting a more accommodating macroeconomic framework; (2.8) increasing aid and transfers. The other two options concern reallocating existing resources between policy areas to improve effectiveness of the existing fiscal envelope: (2.4) re-prioritizing public expenditures; (2.5) tapping into fiscal and foreign exchange reserves.

2.1. Expanding social security coverage and contributory revenues

Social Security Contributions (SSCs) are one of the most important ways of financing social protection. ILO (2017) defines social contributions as prior payments directly linked to the acquisition of rights and entitlements through insurance mechanisms. SSCs are collected from employees, workers and employers, linking them to the branches of social protection.[2]

In Timor-Leste, the Contributory Social Security System was established in 2016 by Law No.12 of November 2014 comprehending, among other provisions, a Pay-As-You-Go (PAYG) defined-benefit public pension system.

The contributory system comprises a mandatory general scheme for all formal employees and employers of the private and public sectors, including individual business owners (the latter from December 6, 2022, onwards). For all other workers (including from the informal sector) who are not eligible for the mandatory scheme, there is a voluntary scheme[3] to ensure their right to social security. Foreign workers who work temporarily in the country are also covered by the social security scheme, unless there is evidence that they are contributing to an overseas social security scheme.

The general rate for SSCs is ten per cent over earnings, which is shared by the employee (four per cent) and the employer (six per cent). Workers registered in the voluntary social security scheme contribute ten per cent of the chosen contribution incidence base (indexed to the value of the Social Pension), which can be selected among 20 income thresholds. Workers can select a contribution incidence base that can vary from two times to up to 200 times the value of the social pension[4], currently ranging between US$114 and US$11400 per month (Table 1). This means that a worker's social security monthly contribution can vary between US$11.4 and US$1140. However, workers aged 50 or over have to pay ten per cent of a minimum contribution base equivalent to the 5th lower threshold, adding to five times the value of the social pension (currently US$285), that is, a social security contribution of US$28.5.

2 SSCs can be linked to the nine branches of social protection, including child and family benefits, maternity protection, unemployment support, employment injury benefits, sickness benefits, health protection, (medical care), old-age benefits, invalidity/disability benefits, and survivor's benefits. For further details, see ILO C102 (1952) on social security minimum standards at https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:C102

3 Optional registration is open for the self-employed, including in the informal sector (national citizens or foreigners), domestic service workers (national citizens or foreigners), managers and directors of companies (national citizens or foreigners), national citizens working abroad, unemployed workers with at least three years of social security contributions (national citizens or foreigners).

4 The amount of social pension was $57 in 2023.

In Timor-Leste, SSCs are linked to legal entitlements, enabling workers, that meet the eligibility requirements, to access social benefits that include protection against many eventualities, namely:: maternity, paternity, adoption, medical risk during pregnancy, termination of pregnancy, partial invalidity pension, full invalidity pension, old-age pension, death grant, reimbursement of funeral expenses, and survivor's pension.

Table 1: Social security contributions for workers under the voluntary scheme

Bracket	Contribution incidence base (CIB)	CIB in 2023	Monthly social Security contribution (10% x CIB) in 2023
1st	2xSP	2xUS$57= US$114	US$11.4
2nd	2,5xSP	2,5xUS$57=US$142.5	US$14.25
3rd	3xSP	3xUS$57= US$171	US$17.1
4th	4xSP	4xUS$57= US$228	US$22.8
5th	5XSP	5xUS$57= US$285	US$28.5
6th	6xSP	6xUS$57= US$342	US$34.2
7th	7xSP	7xUS$57= US$399	US$39.9
8th	8xSP	8xUS$57= US$456	US$45.6
9th	9xSP	9xUS$57= US$513	US$51.3
10th	10xSP	10xUS$57= US$570	US$57.0
11th	15xSP	15xUS$57= US$855	US$85.5
12th	20xSP	20xUS$57= US$1140	US$114
13th	30xSP	30xUS$57= US$1710	US$171
14th	40xSP	40xUS$57= US$2280	US$228
15th	55xSP	55xUS$57= US$3135	US$313.5
16th	70xSP	70xUS$57= US$3990	US$399
17th	95xSP	95xUS$57= US$5415	US$541.5
18th	125xSP	125xUS$57= US$7125	US$712.5
19th	160xSP	160xUS$57= US$9120	US$912
20th	200xSP	200xUS$57= US$11400	US$1140

SSCs play a critical role in financing social security in many countries of the world. According to Calligaro, F. and Cetrangolo, O. (*2023*), social security contributions have remained a relatively stable source of financing in the 21st century. Globally, SSCs accounted for 18.8 per cent of total taxation or 5.7 per cent of GDP in 2019. In the Asia and the Pacific region, SSCs represented 7.5 per cent of total taxation or two per cent of GDP. In lower-middle income countries, social contributions were 10.6 per cent of total tax revenues an equivalent of 2.6 per cent of GDP. Some countries finance nearly all of their social protection expenditure through social contributions. Since SSCs usually are paid by employers and workers, they also have very strong linkages with the functioning of labour relations at the national level, as well as with labour legislation, employment policies, and income distribution.

SSCs present several advantages when compared to other options to extend fiscal space for social protection. Social contributions are managed through insurance mechanisms, aiming at promoting risk pooling and sharing, which in turn increases social cohesion and strengthens the sustainability of the whole fiscal system (*Packard et al., 2019*). As Calligaro, F. and Cetrangolo, O. (*2023*) explain, "this approach pursues vertical and horizontal redistribution since it allows for poverty prevention, income redistribution and risk pooling within and between generations". Additionally, social assistance programs usually support the individuals who are not part of the contributory scheme or whose entitlements are below a minimum threshold.

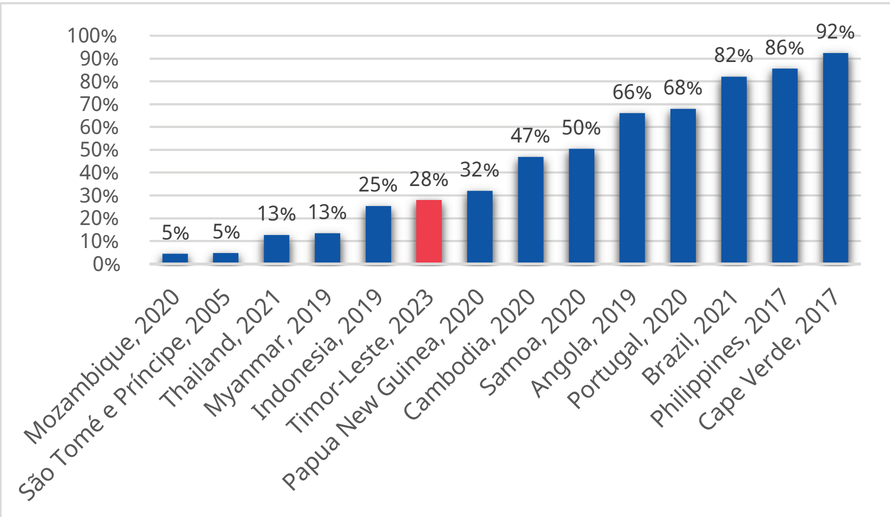
In general, old-age insurance represents the largest expenditure among the branches of social security. As Calligaro, F. and Cetrangolo, O. (*2023*) point out "the pension systems have responded to the central concern of ensuring consumption-smoothing across the life cycle by reducing consumption while individuals are economically active to allow them to keep consuming during retirement". According to the same authors, pensions have also changed the perceptions and attitudes of younger people in the labour market, increasing economic growth and reducing income inequalities.

Old-age pensions, unemployment insurance, and other social benefits have also positive effects on macroeconomic stabilization by acting as automatic stabilizers. Higher net replacement rates indicate a more generous social benefit system and thus stronger automatic stabilization. During economic recessions, when unemployment increases, wages are lost or reduced, the payment of social benefits provide income security, protect against material deprivation, uphold household expenditures, and, as a consequence, support internal demand, avoiding sudden decreases in the GDP and preventing further corporate shutdowns and layoffs (*Calligaro, F. and Cetrangolo, O., 2023; ILO, 2014; Capaldo and Izurieta, 2013*).

Since SSCs are earmarked and create legal entitlements to receive social benefits, workers are likely to comply more with their social contributions' obligations than with taxes (*ITC-ILO, 2010*). In addition, SSCs finance the provision of specific insured-based benefits that are often thought of as merit goods that contribute to improvements in the standard of living, preserving workers' health, and better matching worker's skills and employer's requirements (ILO, 2001).

SSCs are at the heart of social security systems and play a critical role in financing these systems and, as a consequence, in ensuring and sustaining the human right to social security. Therefore, social protection expenditure and its financing are critical to sustaining universal social protection, social development and social justice. In many countries, including developing countries, SSCs cover a large share of social protection expenditure. This is not the case in Timor-Leste with SSCs covering only 28 per cent of the total social protection expenditure (Figure 1). Timor-Leste is ranked ninth out of 14 selected countries in the context of *Comunidade dos Países de Língua Portuguesa* (Community of Portuguese Speaking Countries, CPLP) and the Association of Southeast Asian Nations (ASEAN) countries. Countries where social contributions cover more than 50 per cent of the expenditure in social protection include Cape Verde (92 per cent), Philippines (86 per cent), Brazil (82 per cent), Portugal (68 per cent) and Angola (66 per cent). These proportions are often positively linked to the share of contributory benefits in total expenditure.

Figure 1: Social security contributions (SSCs) as percentage of total public social protection expenditure excluding healthcare (last available year) in selected countries



Source: ILO World Social Protection Database; IMF Government Finance Statistics; World Bank World Development Indicators and, Timor-Leste Budget Transparency Portal – expenditures 2023

Note: Social protection expenditure for Timor-Leste was estimated as the total of: MSSI public transfers and goods & services under social inclusion; MACLN public transfers and; INSS by public transfers.

Considering that SSCs revenues usually originate from employers' and workers' contributions, it is important to look at the linkages with the labour market and its conditions at the national level. Table 2 shows the key indicators of the labour force in Timor-Leste, indicating a relatively low share of working-age population in total population, high levels of informal and low quality employment, which are not the most favorable conditions for raising revenue from SSCs.

Labour force[5] participation rates are very low, especially for women. According to the 2021 Timor-Leste Labour Force Survey (TL-LFS), women's participation in the labour market is 12.7 percentage points lower than that of men. This is often explained by unpaid care work at home. Only 30.5 per cent of the adults of working age actively participate in the labour market, with a significant gender differences between men (36.9 per cent) and women (24.2 per cent).

The share of informal employment reveals the poor quality of employment in Timor-Leste. Informal employment accounted for 77.3 per cent of all employment in 2021, with a higher rate for working women (80.4 per cent) than working men (75.3 per cent). Informal work together with the high labour underutilization rate[6] of 28.9 per cent overall (25.8 per cent male, 33.3 per cent female) places these workers in a higher risk of working in precarious conditions, which may also affect their ability to contribute to the social security system and, consequently, limits their potential social security benefits. Women are disadvantaged as they are more exposed to informal work and also tend to earn less than men.

The gender pay gap is high, with women earning on average around 6.6 per cent less per month than men (US$240 vs US$257 per month). As a consequence, women tend to contribute less to the social security system, and receive lower lifetime benefits due to unpaid care responsibilities and many others.

Timor-Leste's current labour market environment, characterized by high levels of informality and scarce employment opportunities, makes it very challenging to extend social security coverage. It would also require ad-hoc or a specific set of targeted measures, particularly towards atypical workers, to also ensure a fairer distribution of costs and responsibilities, while promoting gender equality. Specific provisions to enable women to combine work with raising children and other unpaid care need to be part of the social security debate. Maternity and pregnancy benefits are a good example of such measures in Timor-Leste.

However, Timor-Leste has a large share of youth, which indicates that the working-age population will likely increase in the future. To overcome informal and vulnerable situations, labour market reforms are vital. For instance, reforms should include new social security mechanisms to cover new forms of employment, including those workers in the informal economy, as well as certain specific groups of difficult coverage, and facilitating just transitions from informal to formal work arrangements, for example, through new technologies.[7]

Table 2: Key labour market statistics disaggregated by gender, 2021

	Male	Female	Total
Working-age population, aged 15+	403,600	405,800	809,400
Labour force	148,900	98,100	247,000
Labour force participation rate (%)	36.9	24.2	30.5
15-24	10.2	8.2	9.2
25-64	55.0	34.3	44.5
65+	20.1	15.3	17.6
Employment	142,000	92,300	234,300
15-24	13,064	9,507	22,571
25-64	122,688	77,901	200,589

5 Labour force includes women and men that are either employed or unemployed.

6 Labour underutilization comprises persons in time-related underemployment, unemployment and the potential labour force.

7 For further information of transitioning to the formal economy through technology, or E-formality, see at https://www.ilo.org/employment/areas/e-formality/lang--en/index.htm

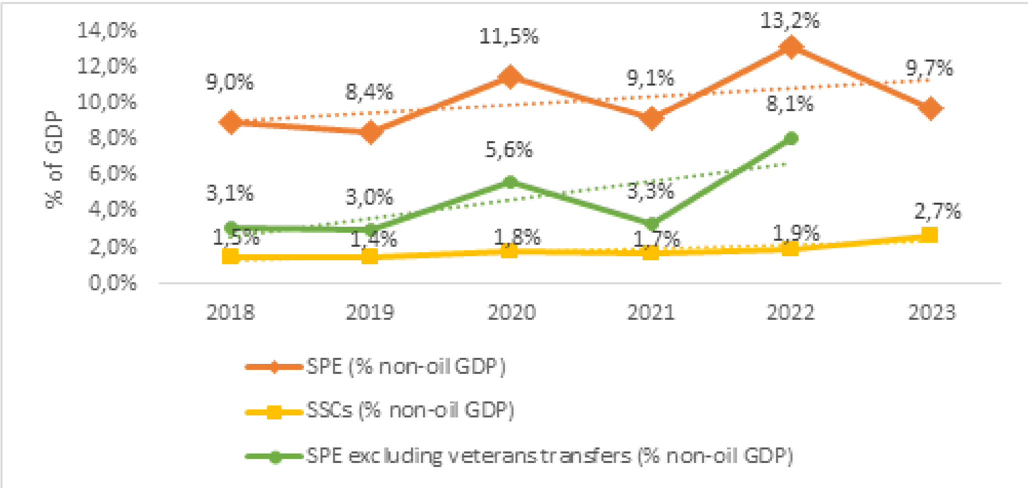
	Male	Female	Total
65+	6,390	4,892	11,282
Employees	84,064	29,075	113,139
Employers	1,988	646	2,634
Own-account workers	37,772	44,304	82,076
Contributing family workers and others	18,176	18,275	36,451
Informal employment, share over total (%)	75.3	80.4	77.3
15-24	95.3	91.7	93.8
25-64	72.4	78.7	74.8
65+	91.2	86.3	89.1
Unemployment rate (%)	4.6	5.9	5.1
15-24	7.4	12.4	9.6
25-64	4.5	5.2	4.7
65+	1.4	3.5	2.3
Labour Underutilization Rate (%)	25.8	33.3	28.9
Average monthly wage in main job of employees (US$)	252	236	248
Agriculture, forestry and fishery	319	198	298
Industry	237	144	230
Services	250	241	247
Average monthly wage in main job of self-employed (US$)	174	114	142
Agriculture, forestry and fishery	77	58	68
Industry	220	89	156
Services	256	158	198
Employers	1,485	425	1,227
Own-account workers	109	111	110
Contributing family workers	88	71	79
Average monthly wage (US$)	256.7	239.8	252.2

Source: Timor-Leste Labour Force Survey, 2021

Despite the challenging labour market conditions in Timor-Leste, Figure 2 indicates that the SSCs as a share of non-oil GDP has increased from 1.5 per cent in 2018 to 2.7 per cent in 2023 since the introduction of the Contributory Social Security System.

At the same time, social protection expenditure in terms of non-oil share has slightly increased from 9 per cent in 2018 to 9.7 per cent in 2023 with expenditure peaking in 2020 (11.5 per cent) and 2022 (13.2 per cent) (Figure 2). The highest levels are associated with the COVID-19 cash transfers paid in 2020[8] and the one-off payments for vulnerable households at the end of 2022[9]. Also, the implementation of a new universal cash transfer called *Bolsa da Mae Jerasaun Foun* implemented in 2022 and 2023[10]. Timor-Leste's social protection expenditure has increased in nominal terms from US$140 million to US$198 million between 2018 and 2023, indicating an increase of 41 per cent. Excluding the veterans' payments, the social protection expenditure would have been much lower as shown by the figure below.

Figure 2: Social protection expenditure (SPE) and social security contributions (SSC) revenue, 2018–2023 (in % of GDP)



Source: Author's calculation based on Data from Ministry of Finance and National Institute of Social Security

2.1.1. Extending legal coverage of social security schemes

Timor-Leste has made significant progress in extending the social security legal coverage and reinforcing the national social protection system. The general Contributory Social Security System was established by law in 2016 and is based on the fundamental principles of the primacy of political responsibility, equality, equity, protection of acquired rights, positive differentiation, self-financing, contributory, intergenerational cohesion, of selective adequacy, information and judicial guarantees.

The general system is applicable to all workers, from both public and private sectors, and is flexible so it can adapt to the labour market conditions in the country, particularly to the high levels of informal employment through voluntary registration. Furthermore, Timorese working abroad can also register and contribute to the system.

The Timorese social security system comprises two types of SSCs: mandatory contributions, paid by employers and employees, and voluntary contributions for all persons able to work who are not covered by the mandatory scheme. For the voluntary scheme, the law specifies certain groups of national citizens or foreigners, namely self-employed, domestic service workers, managers and company managers, national citizens working abroad, and unemployed workers with at least three years of SSCs, that can register and contribute to the general scheme. The law also states

8 A COVID-19 cash transfer amount of US$100 per month was paid in May and June 2020 to 313,442 households, which was equivalent to an expenditure of approximately US$63 million (MSSI, 2021).

9 One-off payment of US$200 was paid to 313,436 households in December 2022, corresponding to an expenditure of approximately US$63 million (MSSI, 2023).

10 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. This programme will be discontinued in 2024 as per the government decision at the Council of Ministers on 6 of December 2023.

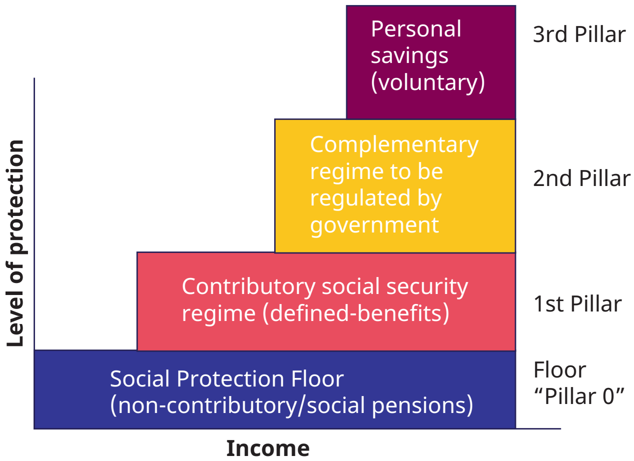
that the government can extend mandatory or voluntary contributions to other groups of citizens to ensure their social security coverage, particularly groups of workers of difficult coverage.

The social security system provides certain cash benefits which cover income losses or reductions in cases of maternity, invalidity, old-age and death. A cash benefit in case of sickness is also under discussion and in the process of approval. Each of the contingencies have a legal basis. Table 2 below presents the list of legal instruments approved, which are mostly laws and decree-laws. Both are legislative acts with the same value, which are approved by the legislative bodies, in accordance with the powers conferred by the Constitution of the Republic of Timor-Leste. Acts approved by the National Parliament are called laws and those approved by the Government are called decree-laws.

The system also includes a non-contributory social pension for old-age and invalidity, aimed at providing a minimum income standard for all citizens and, consequently, preventing and reducing poverty. These benefits were established in 2008, initially as a subsidy for the elderly and invalids, that were transformed into social pensions in 2022.

In the future, the general system might be supplemented by other complementary systems, that can be solidarity-based or capitalization systems. The complementary system (the so-called 2nd pillar of social security, illustrated below) is yet to be regulated by government.

Figure 3: Evolution of the Timorese social security system



Source: INSS

Table 3: Legislation on Social Security

Contingencies	Legal instrument	Description
General	Constitution of the Republic of Timor-Leste	Establishes the right to social security in article 56
	Law No. 6/2012 of 29 February	Approves a transitional social security regime for State workers (old-age, disability and survivor pensions)
	Law No. 12/2016 of 14 November	Creates the Contributory Social Security System
	Decree-Law No. 47/2016 of 14 December	Creates the National Institute of Social Security
	Law No. 1/2022 of 3 January	Approves the 2022 State Budget Law and introduces the first amendment to Law No. 12/2016

Contingencies	Legal instrument	Description
	Law No. 2/2022 of 10 February	Approves the Framework of the State Budget and introduces the first amendment to Decree-Law No. 47/2016 and the second amendment to Decree-Law No. 55/2020
	Decree-Law No. 34/2022 of 19 May	Approves the third amendment to Decree-Law No. 55/2020
Social Security Reserve Fund	Decree-Law No. 55/2020 of 28 October	Establishes the Social Security Reserve Fund and defines the respective management model
	Decree-Law No. 33/2021 of 15 December	Publishes the first amendment to Decree-Law No. 55/2020
Parental (maternity, paternity and adoption)	Law No. 8/2004 of 16 June	Approved the Statute of the Civil Service
	Decree-Law No. 40/2008 of 29 October	Establishes the Leave and Absence Benefits for Public Administration Workers
	Decree-Law No. 21/2011 of 8 June	The First Amendment to Decree-Law No. 40/2008 of 29 October
	Law No. 4/2012 of 21 February	Establishes the Labour Law
	Decree-Law No. 18/2017 of 24 of May	Approves the Legal System of Maternity, Paternity and Adoption Protection under the Contributory Social Security System
Old-age and Invalidity	Decree-Law No.19/2008 of 19 of June	Creates a Subsidy to Support the Elderly and Invalids
	Joint Ministerial Diploma MSS/MF/2010	Increases the amount of the Support Subsidy for the Elderly and Disabled persons
	Decree-Law No. 17/2017 of 24 May	Approves the pensions for the elderly and disabled under the Contributory Social Security System
	Decree-Law No. 28/2021 of 1 December	The First amendment to Decree-Law No. 17/2017, and Decree-Law n. 19/2017, of 24 May 2017, approves, respectively, the legal system for invalidity and old-age pensions and for death benefits, under the Contributory Social Security System
	Decree-Law No. 31 /2021 of 15 December	First Amendment to Decree-Law No. 19/2018, which approves the support subsidy for the elderly and invalids
	Decree-Law No. 51/2022 of 20 July	Approves the minimum amounts of invalidity and old-age pensions under the Contributory Social Security System

Contingencies	Legal instrument	Description
	Decree-Law No. 52/2022 of 20 of July	Creates the invalidity Verification System for the social security general system
	Decree-Law No.53/2022 of 20 of July	Approves the social pension of invalidity and old-age under the non-Contributory Social Security System
Survivors	Decree-Law No. 19/2017 of 24 of May	Approves Survivor Benefits under the Contributory Social Security System
	Decree-Law n. 28/2021 of 1 December	First amendment to Decree-Law no. 17/2017, of 24 May 2017, and Decree-Law no. 19/2017, of 24 May 2017, which approve, respectively, the legal system for invalids, old-age pensions and for survivor benefits, under the Contributory Social Security System

Despite the positive evolution, only five out of the nine branches of Timor-Leste social security are legally established. Contributory-based benefits that are not yet offered by the national system include sickness, unemployment, work injury, and family benefits.

There are also non-contributory social assistance programmes without a comprehensive or sufficient legal basis, operating based on organic law, ministerial dispatches, or national action plans. This is true for social programmes targeting victims of gender-based and domestic violence, child protection related programmes, as well as support for persons affected by natural disasters and social conflicts.

Legal coverage refers also to social security programme coverage in terms of population categories that are entitled to protection and benefits. Despite the established legal framework, the current social security scheme does not cover a majority of workers in Timor-Leste, particularly informal workers which are a large share of the labour force given the high level of informality in the country. A review and adaptation of laws and regulations, as well as financing mechanisms, is necessary for certain groups of informal workers who have limited resources and very low incomes and are unable to pay social security contributions. The same is true for those who have variable incomes depending on the work they do and have difficulty paying their contribution for a particular month in which they had little income (or no income at all). This is especially the case for farmers or fishers who are very dependent on the climate and whose incomes are not on a regular monthly basis.

During the tripartite training workshop on “How to Extend Social Security to Groups of Difficult Coverage Through Formalization Policies” conducted by the ILO with the support of the ACTION Portugal programme in Dili in July 2023, five groups of informal workers were identified as facing challenges in accessing the social security scheme, namely: domestic workers, taxi drivers, street vendors, farmers, and fishers. Therefore, reforming the regulations is important to ensure the groups listed above and other new population groups can be effectively included. Any reforms should ensure and create mechanisms for systemic coherence, coordination and participatory collaboration between the government, social partners, civil society organizations, professional associations, and other stakeholders so implementation and compliance can be guaranteed.

Furthermore, the ratification of international conventions on social security, particularly ILO Convention on Social Security (Minimum Standards), 1952 (No. 102), can provide an important reference for the country to progress towards a more comprehensive social protection system aligned with internationally agreed principles and minimum benchmarks. The ratification of the C102 can be also a contribution to the extension strategy of social protection. From the financing point of view, it entails very important principles. For instance, “the cost of the benefits provided in compliance with the Convention, and the cost of the administration of such benefits, shall be borne collectively by way of insurance contributions or taxation or both in a manner which avoids hardship to persons of small means and takes into account the economic situation of the Member and of the classes of persons protected” (number 1, art. 71)[11].

11 See details at https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:C102

Countries usually prepare a comparative report between the requirements of C102 and their national legal framework and practice, convey a national tripartite workshop to validate the results of the report, and jointly decide on a way forward, before ratifying the convention. The ILO, upon request and jointly with the Government of Timor-Leste is finalizing a comparative study between the requirements of C102 and national legislation and practice in Timor-Leste, and is planning a national tripartite workshop to validate the conclusions of the report. The government with the support of the ILO is also planning the next steps of adjusting and improving the national social security system, as well as launching national campaigns towards the promotion and ratification of C102.

2.1.2. Extending effective coverage, which increases the contributions' collection base

Once legal coverage is guaranteed, the next challenge is to ensure that coverage becomes effective, ensuring that employers and workers comply with their obligations, but also that those who have fulfilled the legal requirements for benefits are effectively receiving them. In Timor-Leste, the difference between legal and effective coverage is high, mostly due to the high levels of informal employment nationwide and low taxation compliance.

Two indicators can be used to understand the implementation of statutory schemes: active contributors as a percentage of the working-age population, and active contributors as a percentage of the labour force. In 2022, it is estimated that 15 per cent of the working age population contribute to a pension scheme,[12] which is significantly lower than the average in Asia and the Pacific (32.9 per cent) as per ILO (2021)[13]. It is also estimated that 43 per cent of the labour force contribute to a pension scheme[14] and can expect to receive a contributory pension upon retirement, which compares to over half of the labour force (54.7 per cent) in Asia and the Pacific (*ILO, 2021*). These figures provide an indication of future pension coverage for those who are economically active and those of working age who are contributing to existing contributory pension schemes.[15]

Over the years, there has been a remarkable increase in the number of workers and employers registered under the general social security regime which, according to INSS, indicates a greater confidence in the social security system and institutions (*INSS, 2022*). The number of workers registered rose from 51,647 in 2017 to 134,039 in 2022[16], while the number of employers registered expanded from 240 in 2017 to 4,479 in 2022. The COVID-19 crisis contributed significantly to an increase in the number of registrations due to the high demand for protection under the national social security system. The number of workers and employers registered increased 23 per cent and 99 per cent respectively between 2019 and 2020.

Despite the significant progress, there are still workers who aren't registered in the social security system. It is estimated that 57 per cent of the labour force is not covered by the social security national system, but it is possible to extend social security coverage to more workers.

Table 4 presents the estimates for potential revenues from extending social security coverage to all employed persons (Scenario 1). Increasing from the current number of workers registered in the social security (134,300 workers in September 2023) to cover all the 234,300 employed persons based on the Labour Force Survey 2021 (additional 100,000 workers) would represent an increase of 55 per cent in the collection of SSCs. This would represent a significant rise in revenues from the current 1.9 per cent of non-oil GDP to 2.9 per cent of non-oil GDP.

12 Calculated as the ratio between the number of workers registered in the Contributory Social Security System in 2022 (134,039) and the working age population based on the Population and Housing Census 2022 (874,000). If the denominator is based on the Labour Force Survey 2021 (809,300), the effective coverage increases from 15% to 17%.

13 See World Social Protection Report 2020-22 at https://www.ilo.org/global/research/global-reports/world-social-security-report/2020-22/lang--en/index.htm

14 Calculated as the ratio between the number of workers registered in the Contributory Social Security System in 2022 (134,039) and the labour force based on the Population and Housing Census 2022 (313,700). If the denominator is based on the Labour Force Survey 2021 (247,000), the effective coverage increases from 43% to 54%.

15 For further information see at https://www.social-protection.org/gimi/ShowWiki.action?id=629

16 There were 134,300 workers registered in September 2023.

Table 4: Estimated impact on revenues from extending social security coverage to all employed persons

Scenario	No. of contributors	SSCs Total Collection (US$)	SSC (% non-oil GDP)	Additional SSC (% Current SSC)
Status Quo (September 2023)	134,300	34,782,814	1.9	N/A
1.- Fully closing coverage gap	234,300	53.741.527 (i)	2.9	54.5

Source: Author's calculations based on Timor-Leste Labour Force Survey 2021, INSS administrative data, 2024 Budget Book (Volume I), and IMF non-oil GDP2022 estimates

Note: (i) SSCs Total Collection is estimated as the total social contributions of all workers, both formal and informal workers. This includes social contributions paid by employees, employers, own-account workers and contributing family workers. For employees and employers, the estimates are based on the number of employees and employers, multiplied by their respective average monthly wage in main job (US$248 and US$1,227, respectively), and a contribution rate of 10%. For own-account workers and contributing family workers, the social contributions are estimated based on the assumption these workers choose to pay the minimum social security contributions, which is currently US$11,40.

Extending the effective coverage would require addressing bottlenecks that are related to a number of factors. This includes the following aspects: legal exclusion; limited contributory capacity to participate in social security systems by certain groups of workers; lack of incentives for contributions (for example, employers and employees may avoid paying contributions if existing enforcement measures are seen as weak and/or if the economic gain associated to non-compliance is perceived to be greater than the financial cost through imposed penalties or sanctions); the lack of adequate administrative procedures for enrolment and collection of contributions, or for receiving the benefits; the lack of an efficient IT system, which is critical to address issues related to under-reporting of earnings, evasion and fraud; insufficient public information on rights and obligations; and a low level of organization of workers, among others (*Ortiz et al., 2019*).

Timor-Leste's high informal employment (77.3 per cent) is one of the main challenges to widening social security coverage and, thus, enhance public revenues based on SSCs. Despite offering optional registration for informal workers, certain groups of workers with limited resources and very low incomes, or those with inconsistent incomes, find it difficult to pay their SSCs regularly, and may see the existing system as not fitting their needs.

Also, the private sector's formal employment share of total employment (1.9 per cent) is very low. The formalization of employment and enterprises goes along with the extension of social security. As more companies enter the formal sector of the economy, the collection of taxes and social contributions tend to increase, leading to increased fiscal space (*Ortiz et al, 2019*). Strengthening compliance and improving the collection of SSCs are both very relevant measures that should be emphasized in the revised Strategic Development Plan (SDP) for the 2023-2038 period.

In certain countries, such as in Latin-America, the collection of SSCs is associated with the introduction of innovative measures to incentivize the formalization of the labour market. For instance, the Monotax scheme in Brazil is a simplified tax collection or payment scheme for small contributors, which has helped to unify taxes and contributions into a unique tax payment for small contributors. Generally, micro- and small-enterprises have lower wages and revenue than medium and large companies, which lead to smaller number of contributions to be collected. By requesting lower tax and contribution amounts than for workers in the formal sector, Monotax is also adapted to the low contributory capacity of workers in the informal economy. This type of scheme is very important to promote the formalization of SMEs and their employees. The formalization of SMEs can result in an increase of their productivity and greater survival chances, and therefore more economic growth and more jobs in the long term, which is of interest to social security. One of the challenges is to design the incentives supporting the growth of micro- and small-enterprises in such a way that the tax and contribution amounts established by the monotax are not a barrier, but a step further.

The formalization of micro- and small-enterprises has contributed to improved employment conditions and increased effective social security coverage. It has also proven to be effective in reducing gender inequality because of the higher share of women among self-employed and informal workers. Monotax is based on the classification of contributors according to the size of the company. Monthly taxes and contribution amounts are calculated using progressive contribution rates based on classification, and a fixed monthly contribution is possible for the smallest contributors. The Revenue Authority collects the due amounts and transfers to the Social Security Institute the share corresponding to SSCs.[17] It is important that the revenue collected is transferred to the social security institution and is sufficient to

17 For further details see Experiences from Simples National, the monotax regime for own-account workers, micro and small entrepreneurs in Brazil (2019) (ilo.org) at https://www.ilo.org/empent/Publications/WCMS_715864/lang--en/index.htm

actuarially cover the costs of the additional affiliates. Therefore, if there is a subsidy to SMEs, it should be at the expense of the part that refers to the taxes (in the unified monotax), but not to the social security contributions' part. If the social security institution doesn't receive the necessary and correct proportion of the revenue, the monotax regime increases the social security imbalance (accumulating financial imbalances to the regime instead of the expected net gains of increasing the coverage and the revenue).

There is a broad consensus that in general the centralization of contribution collection methods generates economies of scale and facilitates the coordination of audits and record-keeping activities. In Timor-Leste, the INSS administers the social security system under a legal and institutional framework that gives the INSS clear competencies and responsibilities, including the collection of contributions. A well-designed and robust information and financial management system is under development to support the delivery of the social security system. Digital administrative procedures for registration, enrolment, collection of contributions, receiving payments or benefits are critical to closing coverage gaps and to adapt social security to changing circumstances and demands. An effective digitized MIS system is also critical to address issues related to under-reporting of earnings, evasion, and fraud.

Below is a list of selected suggestions that can be examined in order to improve the expansion of effective coverage in Timor-Leste:

- **Short term**
  i. Increasing awareness campaigns for employers, employees, and workers, with a special focus on informal workers;
  ii. Integrate/coordinate labour and social security inspections and allow labour inspectors to also check the compliance of enterprises regarding SSCs;
  iii. Creating a list of the names and amounts of contributors with outstanding debts with the INSS and restricting their capacity to contract with the broader public sector and receive fiscal benefits;
  iv. Strengthening the role of social partners to advocate and help their members to understand and access information on the social security system and comply with their obligations.

- **Medium term**
  i. Extending the compulsory affiliation to self-employed workers, applying specific collection mechanisms that take into account the irregularity of incomes and other practical barriers. For instance, for farmers, fishermen or street vendors who face a high volatility of income on a daily or seasonal basis, the contributions could be based on quarterly or annual or at a time when their income is highest rather than monthly incomes, contribution collection schedules may be spaced over time to account for variability of their economic activity, as well as payments mechanisms such as using mobile phones can bring flexibility.
  ii. Promoting intensive use of information technology by replacing paper-based documents with digital documents, as well as making information available through a portal for social security, and allowing online access to certain types of services such as registration, payments, and applications for benefits;
  iii. Requesting certificates of compliance with tax and social security obligations as an indispensable condition prior to the approval of work in procurement/contracts with the government;
  iv. Establishing a complaints mechanism that can help employees to report the lack of compliance with SSCs obligations by their employers.

- **Long term**
  i. Ensuring a unified registration and payment process for the entry of data on both taxes and social security;
  ii. Establishing the mechanism of withholding SSCs at the source in subcontracted sectors, such as construction and security, meaning medium and large companies would retain their SSCs for the smaller subcontracted companies;
  iii. Enforcing companies to collect contributions on behalf of the self-employed that they contract to provide services in the cases when they are not yet affiliated.

2.1.3. Adjusting social security contribution rates

Another strategy to increase fiscal space is increasing, where feasible, social security contribution rates, which is an important determinant of total social security revenue. The ILO Social Security (Minimum Standards) Convention, 1952 (No. 102) establishes conditions for the distribution of social security financing via SSCs between employers and workers. The contribution rate is established at a specific level for all employees and for all employers and is defined as a percentage of wage or payroll. SSCs are normally collected over gross wages with employers paying at least half, as promulgated by ILO Convention 102, while a smaller contribution is paid by employees, automatically deducted from their salary and taxable as part of their wages (*Ortiz et al., 2019*). In addition, according to the C102 the total of the insurance contributions borne by the employees/workers protected shall not exceed 50 per cent of the total of the financial resources allocated to their protection as well as their families.

In Timor-Leste, social security is relatively new, and the contribution rate was set at a level considered acceptable so it could attract the largest number of potential participants, both employers and workers. At the time the Contributory Social Security System was established, a total contribution rate of 10 per cent (6 per cent for employers and 4 per cent for employees), was decided based on a participatory national dialogue promoted by the government, in which representatives of employers and representatives of workers were part of the discussion and agreed on the proposals sustained by actuarial studies presented by INSS. The first registrations in the general Contributory Social Security System, followed by the payment of SSCs, took place in 2017.

The actuarial studies developed long-term demographic and financial projections from 2017 to 2045. The existing study was based on a contribution rate of 15 per cent to ensure the long-term sustainability of the general scheme. According to the actuarial study, the financial stability of the regime is ensured for the period under analysis, i.e., until 2045. The study shows an increasing trend in annual balances because of the small number of beneficiaries reaching pension age and lower pension amounts, a result of short contributory careers, corresponding only to the minimum guarantee periods required for accessing the old-age pension. However, from 2030 onwards, there will be a decreasing trend in annual balances that is explained by the increasing pension amounts, and the yearly increase in the stock of pensioners.

INSS ran sensitivity tests to understand the elasticity and robustness of the defined SSC rate of 15 per cent and examined the sustainability of the system. Two different contribution rates were analyzed for the entire period of study: (i) a SSC rate of 11.75 per cent and; (ii) the introduction of a gradual increase of the contribution rate, starting at 5 per cent and increasing over the years until reaching 15 per cent in the eleventh year. According to the study, annual balances and accumulated balances remain positive in the period of analysis. According to the INSS, the results from the tests conducted indicate that the reduced rate, at the initial stage and as long as it is temporary, guarantees the sustainability of the regime.

There are significant variations in social security contribution rates and institutional arrangements across regions and countries. At the global level, the total average rate is 15.8 per cent with 9.5 per cent for employers and 6.3 per cent for employees. The European countries and the Organization for Economic Co-operation and Development (OECD) countries have the highest rates which reflect their solid and comprehensive social protection systems. In the Asia-Pacific region the total average is 13.6 per cent with 8 per cent for employers and 5.6 per cent for employees (*Ortiz et al., 2019*). Asia has generally lower SSC rates due to their interest in keeping tax rates low to attract foreign investment. However, evidence shows that positive productivity and the social stability impact of a comprehensive universal social protection system may be more encouraging for investment than tax concessions. Any changes to SSC rates should be implemented gradually to avoid negative impacts on the economy and SSCs that are not in line with productivity growth (*Ortiz et al., 2019*).

The SSC rates in Timor-Leste are lower than both the global and regional average. Figure 4 shows that Timor-Leste's SSC rates are below the minimum for most of ASEAN countries, excluding Myanmar, Malaysia, Cambodia, and Thailand[18] and, below the maximum rates with the exception of Myanmar.

18 Thailand reduced the SSC rate of employers and employees from 5% to 1% of applicable wages for three months starting from May until July 2022, to help reduce the cost of living for employees and costs for employers through the Social Security Fund system. See https://insightplus.bakermckenzie.com/bm/employment-compensation/thailand-new-relief-measure-for-the-social-security-fund-approved-by-the-cabinet

Figure 4: Social Security Contribution Rates in ASEAN Countries, 2022

Source: KPMG (2013) and PWC at https://taxsummaries.pwc.com/

Table 5 below presents a proxy for the impact on revenues from increasing the social security rate in Timor-Leste from the current 10 per cent to 15 per cent, following one of the scenarios included in the existing actuarial studies, which assumed the additional financing can strengthen the sustainability of the Contributory Social Security System without jeopardizing the competitiveness of the economy. Increasing the SSC rates by five percentage points would raise the SSC's total collection from US$34.8 million to US$57.8 million, an increase of 66 per cent. In terms of the share in non-oil GDP, this would represent an increase from 1.9 per cent to 3.1 per cent.

Table 5: Estimated impact on fiscal space from adjusting social security contribution rates from 10 per cent to 15 per cent in Timor-Leste

Scenario	No. of contributors	SSCs Total Collection (US$)	SSC (% non-oil GDP)	Additional SSC (% Current SSC)
Status Quo (September 2023)	134,300	34,782,814	1.9	N/A
2. Increase SSC rate to 15 per cent	134,300	57,796,427(i)	3.1	66.2

Source: Author's calculations are based on the Timor-Leste Labour Force Survey 2021, INSS administrative data, 2024 Budget Book (Volume I), and IMF non-oil GDP 2022

Note: (i) SSCs Total Collection is estimated as the total social contributions of all workers, both formal and informal workers, registered in the contributory social security regime. According to INSS, formal workers represented 91 per cent of the total workers registered while informal workers corresponded only to 9 per cent of the total workers registered in September 2023. For formal workers, the estimate is based on the number of workers, multiplied by an average monthly of US$230, and a contribution rate of 15%. For informal workers, the estimate assumes these workers choose to pay the minimum social security contribution (15%*(2xSP)), which would be US$17,10 per month.

If an increase in the SSC rate (Scenario 2) is combined with the extension of social security coverage to all employed persons (Scenario 1), it is possible to estimate the impact of a broader and integrated reform (Scenario 3). As shown in Table 6 below, it is estimated that total revenues would go up to approximately US$80.6 million or 4.3 per cent of non-oil GDP. This would represent an increase of 131.8 per cent in total SSC collection.

Table 6: Estimated impact on fiscal space from adjusting the social security contribution rate and reducing the coverage gap in Timor-Leste

Scenario	No. of contributors	SSCs Total Collection (US$)	SSC (% non-oil GDP)	Additional SSC (% Current SSC)
Status Quo (September 2023)	134,300	34,782,814	1.9	N/A
3. Fully closing coverage gap (Scenario 1) and Increase SSC rate to 15 per cent (Scenario 2)	234,300	80.612.291 (i)	4.3	131.8

Source: Author's calculations are based on Timor-Leste's Labour Force Survey 2021, INSS administrative data, 2024 Budget Book (Volume I), and IMF non-oil GDP 2022

Note: (i) SSCs Total Collection includes contributions of all workers from public and private sectors, based on average monthly wage in main job of employees, employers, own-account workers and contributing family workers, and a contribution rate of 15%.

SSCs Total Collection is estimated as the total social contributions of all workers, both formal and informal workers. This includes social contributions paid by employees, employers, own-account workers and contributing family workers. For employees and employers, the estimates are based on the number of employees and employers, multiplied by their respective average monthly wage from their main job (US$248 and US$1,227, respectively), and a contribution rate of 15%. For own-account workers and contributing family workers, the estimate assumes these workers choose to pay the minimum social security contribution (15%*(2xSP)), which would be US$17,10 per month.

An update of the actuarial analysis is required to support any adjustment of the SSC rate, or other policy changes, to minimize risks and its financial impact. The actuarial model needs to be updated with most recent demographic, labour market, social and economic data available from the Population and Housing Census 2015, the Labour Force Survey 2021, and national accounts. The actuarial study will update the demographic and financial projections for a longer period, assess effects of the COVID-19 pandemic in the labour market and serve as the basis to expand the protection to new risks by the general regime, in particular the sickness benefit that the government is planning to implement from 2024 onwards.

In Timor-Leste, a gradual increase of SSCs rate would also benefit from innovative mechanisms, particularly the ones that can support informal workers to register and comply with their obligations. An example of an innovative mechanism is the establishment of trade union-supported associations to facilitate access to a contributory social security system for self-employed workers, low-paid workers, and other categories of vulnerable workers, like the Mutual Association of Solidarity Services (AMUSSOL) in the Dominican Republic (WSM, 2016). The AMUSSOL operates as a "virtual employer" to allow workers and employees in the informal economy to access the social security system. The affiliates pay their monthly contribution to AMUSSOL, which is then channeled to the national treasury. The affiliates then become members of the Dominican System of Social Security and enjoy their rights. This is a great example of how social partners can play a role in the extension of social security coverage.

A national debate around the increase of the SSC rate, supported by an actuarial study, would be very important to ensure adequate tripartite social dialogue at the national level and generate a well-informed social consensus. Social partners should be involved in the discussion and negotiation of the increases and in the rollout strategy in order to contribute with the necessary resources as the social security system matures, and the economy can support the extension of the contributory capacity.

To support policy makers and the national dialogue, a strong campaign on the extension of social security should be at the top of the development agenda. It is important to explain that: i) "SSCs are linked to legal entitlements that protect individuals from their short-sightedness (e.g. pension protects from old-age poverty) and support social equity through redistribution, essentially reducing inequality"; (ii) "SSCs should be considered a deferred wage and a social and economic investment rather than a simple labour cost item"; (iii) SSCs contribute to many positive social and economic implications, including “promoting social cohesion and stability, individual security and inclusive development, as well as supporting human capital investments and workforce productivity while acting as an automatic stabilizer by smoothing consumption and aggregate demand” (*Ortiz et al., 2019*).

2.2. Increasing tax revenues

Taxation is the dominant source of public financing for most countries and is particularly used to finance public goods and services that benefit all citizens. Total tax revenues account for more than 80 per cent of total government revenue in about half of the world and more than 50 per cent in almost all countries (*Ortiz et al., 2019*).

Achieving the SDGs requires a significant and sustainable boost in tax revenue. Tax revenues can also contribute to decrease foreign aid, reduce the fiscal effects of trade liberalization, and promote national ownership of development strategies in many countries (*Ortiz et al., 2019*). However, developing countries typically collect lower shares of their GDP in tax revenues than OECD countries (11.7 per cent compared to 15.4 per cent respectively, considering 2010-2020 average). This is also the case of economies highly dependent on extractive industries and affected by fragility and post-conflict environments, such as Timor-Leste. As shown in Figure 6, in Timor-Leste, average taxes represent 7.8 per cent of non-oil GDP (2010-2020), positioning the country at the very bottom of the ranking of ASEAN and CPLP countries. Only two other countries under analysis have a lower weight of taxes than Timor-Leste: Brunei Darussalam, a country very dependent on oil exports, and Myanmar, a country that has been strongly hit by political violence and conflict in recent years.

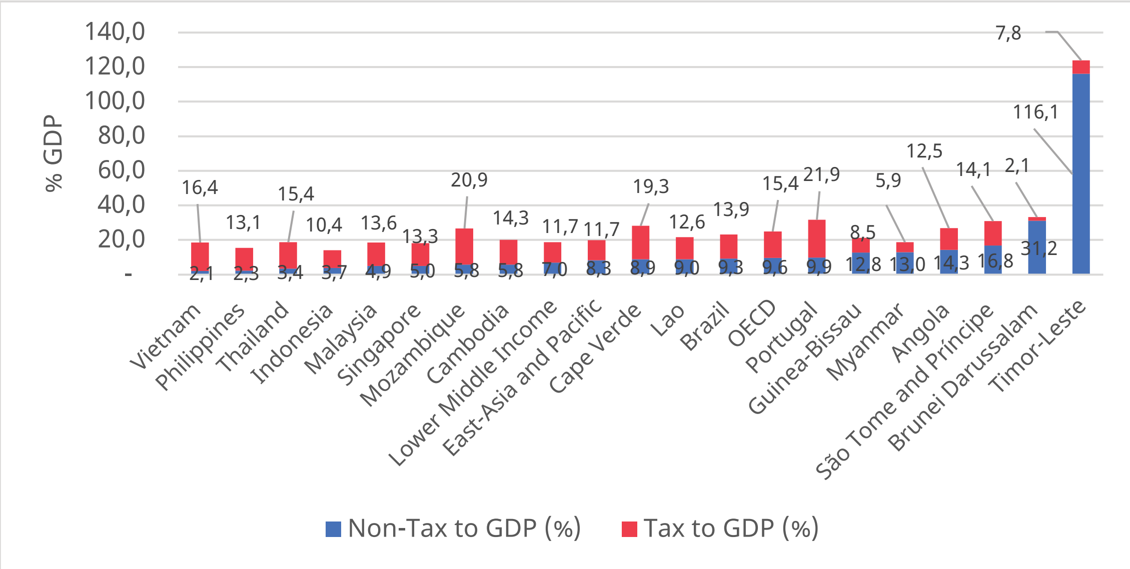
In terms of the global weight of taxes, the tax-to-GDP[19] ratio has increased from 14.4 per cent to 15.3 per cent between 2010 and 2020 in OECD countries, and has risen from 11.6 per cent to 12.2 per cent in Lower Middle-Income Countries (LMICs) between 2010 and 2018. On the contrary, as a faster growing region, the East-Asia and Pacific (EAP) region has seen its tax-to-GDP ratio decrease from 12 per cent to 11 per cent between 2010 and 2020. The percentage change in the tax-to-GDP ratio in ASEAN countries ranges between -31.1 per cent (Vietnam) and +78.8 per cent (Cambodia) for the 2010-2020 period. In terms of the CPLP countries, the percentage change in tax-to-GDP ratio varied between -39.2 per cent (Angola) and +48.2 per cent (Mozambique) in the same period. Mozambique is an example of how a fragile and post-conflict country was able to develop its tax system successfully in the aftermath of a conflict. Timor-Leste increased its tax-to-GDP ratio from 6.9 per cent in 2010 to 7.3 per cent in 2020, though still below the regional benchmarks and at the lower-band of the ASEAN and CPLP country range.

It is important to highlight that many LMICs tend to compensate lower tax-to-GDP ratio with higher non-tax to GDP ratio[20], particularly when compared to the practice in OECD countries. This is the case for Timor-Leste over the last 10 years, with an average non-tax to GDP ratio of 116.1 per cent. The Timorese economy has been fueled by large revenue inflows from the oil extractive industry and the royalties that the state accrued from it for over a decade. Countries in a similar situation are Brunei (31.2 per cent), Angola (14.3 per cent), and São Tome e Príncipe (16.8 per cent). Although evidence shows that resource-rich countries have performed better than non-rich ones in terms of increasing their revenue in the recent past, the reliance on the extractive activities entails risks, including dependency, corruption, rent-seeking behaviors, pollution, unsustainable exploitation of natural resources, and volatile revenues due to the variation of commodity prices in the international markets (*Ortiz et al., 2019*)

19 All calculations presented for Timor-Leste use the non-oil-GDP.

20 This refers to government revenue not generated from taxes, such as fees and charges, as proportion of GDP.

Figure 5: Tax-to-GDP ratio and non-tax to GDP ratio in CPLP and ASEAN countries (2010 – 2020 average)



Source: World Bank, Data Bank, IMF WoRLD, and IMF GFS databases

Note: The Timor-Leste ratio is calculated using tax revenue from Budget Transparency Portal and the non-oil GDP at current prices from TL National accounts. Brunei's tax revenue data has been extracted from the Department of Economic Planning and Statistics website. Guinea-Bissau's tax revenue data has been extracted from the MoF-DGPEE Tchintchor Macro-Economic Model and the 2021 Budget Execution Report. Due to limited data availability different time periods have been used to calculate the average Non-Tax to GDP for some countries for Angola (2010-2019), Myanmar (2012-2019), São Tome e Príncipe (2010-2018), Timor-Leste (2010-2019), Vietnam (2010-2019), LMIC (2010-2019), and EAP (2010-2019). Different time periods were used to calculate the average Tax to GDP for Angola (2010-2019), Myanmar (2012-2019) and LMIC (2010-2018) due to limited data availability

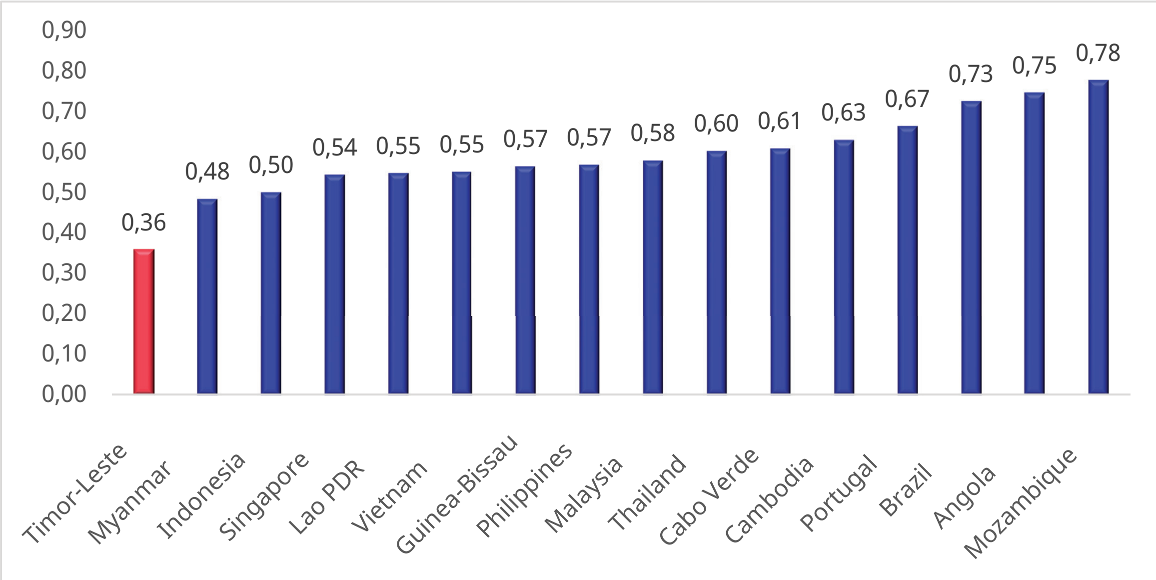
Changes to tax-to-GDP ratios evolve slowly over time and are usually linked with socio-economic development, economic growth and formalization of economies as enabling factors to conduct fiscal reforms, broader tax bases, raise tax revenues and improve collection and compliance through more effective tax administration. Increases in the tax-to-GDP ratio also occurs in some low to middle income countries, especially those with a strong political will to address tax-related issues such as tax evasion or poor tax collection. Timor-Leste is well positioned to continue progressing on increasing tax compliance and/or raising tax rates, investing in the capacity of the tax administration, and bringing more people and businesses into the formal economy, which would boost tax revenues.

Timor-Leste's tax collection effort[21] score was 0.36 in 2015, placing its tax effort below the CPLP and ASEAN countries (Figure 6). This means that the country collects US$0.36 out of each US$1.0 that it could collect. Closing the tax collection gap would have resulted in an additional US$209 million in 2020 or an increase in tax revenue of 177 per cent.[22] In general, CPLP countries score better than ASEAN members in terms of tax collection capacity. Angola and Mozambique are at the top of the ranking, as they have improved mechanisms for a more effective tax administration in recent years. Tax collection and tax inspections, particularly of multinational corporations, can be areas of improvement, which will contribute to increased tax and collection capacity. Timor-Leste has a great opportunity to coordinate with other ASEAN members and explore ways of strengthening tax cooperation, particularly taking into account that members have traditionally had low levels of, and downward trending, tax collection efforts. Average tax collection in ASEAN has varied between 0.48 in Myanmar and 0.63 in Cambodia. Five out of nine ASEAN countries decreased their tax collection effort between 2010 and 2019, with Myanmar presenting the largest reduction (47.3 per cent).

21 Tax collection effort is defined as an index of the ratio between the share of the actual tax collection in GDP and the predicted taxable capacity, which indicates the tax effort that a country puts into collecting its tax revenues, considering the available tax handles. Tax capacity refers to the tax potential, i.e., the ability of people to pay tax and the ability of the government to collect (while the tax effort reflects the degree to which taxable capacity is used). The tax ratio (of total tax revenue to GNP) reflects, however, both tax capacity and effort, the latter influenced by the level of government expenditure and availability and use of non-tax resources (Le et al., 2012).

22 Calculated as Potential Revenue Collection in 2020 minus Actual Revenue Collection in 2020. Potential Revenue Collection is the result of dividing the Actual Revenue Collection by the Tax effort score, 0.36. Actual Revenue Collection in 2020 was obtained from the Pre-statement Budget 2023-Ministry of Finance Timor-Leste.

Figure 6: Average tax collection effort in ASEAN and CPLP countries, 2010 – 2019 (or latest year available)



Source : Author's calculations are based on the methodology presented by Le et al.(2012)
Note: Data for tax collection effort in Timor-Leste is limited to 2015

Taxation is, by and large, the most important source of domestic revenue in almost all countries,[23] and evidence shows that the level of tax revenue normally rises with economic development as the demand for public services increases (*Ortiz et al., 2019*). The available data for Timor-Leste shows that the country has kept its levels of taxation relatively stable over the last ten years (Figure 7). Tax revenues depend significantly on indirect taxes, representing 62 per cent of total tax revenue in 2022. This presents a challenge from a sustainability point of view since indirect taxes are levied on goods and services rather than on income or profits, which will likely more affect household consumption, and will have a stronger impact on the poor, because of its regressive nature, consequently increasing inequality. In contrast, Timor-Leste revenues from direct taxation (e.g., taxes on incomes, taxes on profits and capital gains, and property taxes) are much lower.

Tax reform aiming to increase sustainability would need to promote a shift from the current revenue model and focus on the importance of direct taxation. The direct taxes can promote equity through progressive taxes where those with high incomes pay proportionately higher income taxes than those with lower incomes, narrowing the gap between rich and poor households and reducing income inequality (*ILO, 2011*). Direct taxes also lower the cost of collection, are flexible, and tend to expand as the economy grows.[24] Increasing the fiscal space for social protection would have to combine increasing revenue collection with enhancing the redistributive capacity of the tax system, thereby ensuring that those in lower income deciles are not worse off after the increase. It is also critical that Timor-Leste improves its tax administration systems, and implement tax withholding at source effectively, in order to raise compliance.

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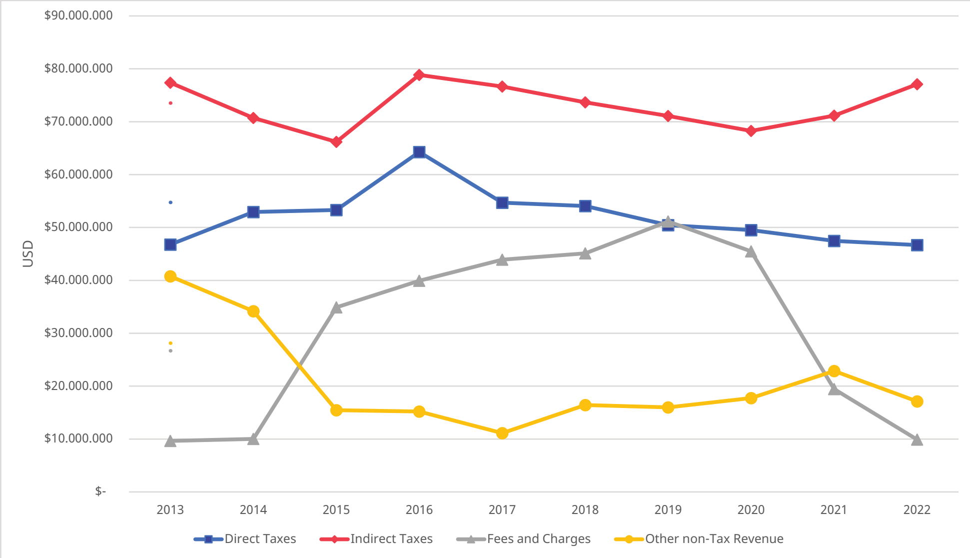
23 According to the most recent estimates from the International Centre for Tax and Development, total tax revenues account for more than 80 per cent of total government revenue in about half of the countries in the world – and more than 50 per cent in almost every country. See https://ourworldindata.org/taxation

24 Advantages and disadvantages of direct taxes at https://www.economicsdiscussion.net/taxes/advantages-and-disadvantages-of-direct-taxes-discussed/1950

Figure 7: Evolution of sources of Domestic Revenue in Timor-Leste from 2013 to 2022



Source: Ministry of Finance, Budget Books 2013-2022

2.2.1. Personal Income and Corporate Tax

In Timor-Leste, there are two direct tax instruments according to the 2008 Taxes and Duties Act: Personal Income tax (PIT) and Corporate Tax (CT).

Wage Income Tax (WIT) rates are levied on monthly taxable wages received by an employee in Timor-Leste. Resident individual taxpayers are subject to a WIT rate of 10 per cent on monthly wages in excess of US$ 500, while the first US$ 500 is not taxable. For non-resident individuals, a flat rate of 10% is applied to the total monthly wage. Employers are legally obliged to withhold income taxes from their employees' wages and transfer them to the Tax Revenue Authority.

The PIT rates are applicable on other income, including business income, property, lottery prizes or awards, tax payment refunds previously deducted as expenses, and any other amount that increases the economic capacity of the taxpayer. The PIT is calculated when the annual income tax form is submitted, which includes information on income and any expenditures that can be deducted against that income. Individual resident taxpayers are subject to a PIT rate of 10% on annual taxable income of more than US$6000. The first US$6000 is tax free. The income tax rate for taxable income earned by a non-resident individual is a flat rate of 10 per cent for all Timor-Leste sourced taxable income. Other exemptions and deductions are allowed, such as exemptions related to inheritances, dividends, and contributions to approved pension funds. Although the general exemption intends to make the WIT more progressive, in practice this hasn't been optimized since the marginal tax rate increases faster than the average tax rate. The deductions and exemptions under the PIT likely favor the wealthiest and capital owners, making the tax system not as progressive as intended.

The CT applies to corporate revenue, which is generally subject to a flat rate of 10%. However, there are industry-related CT tax rates for oil and gas contractors. The CT rate for oil and gas contractors is 30%, though sub-contractors are subject to a flat rate of 6 per cent.[25] There are also specific taxes applied to oil and gas contractors, and other specific tax arrangements applied to other petroleum joint activities. The PIT represents a small part of domestic revenue in Timor-Leste (14 per cent in 2022),[26] which is common in other LMICs (Benedek et al., 2022), but has increased between 2013 and 2022 (Figure 8). This is mainly the result of deductions and exemptions, as well as the predominance of the informal economy in the country. While the CT corresponds to a higher proportion of the domestic revenue (21 per cent in 2022) when compared to the personal income taxes, the direct taxes collected from corporations have decreased over the last years, despite the absence of changes to the tax rates and applicable exemptions and deductions.

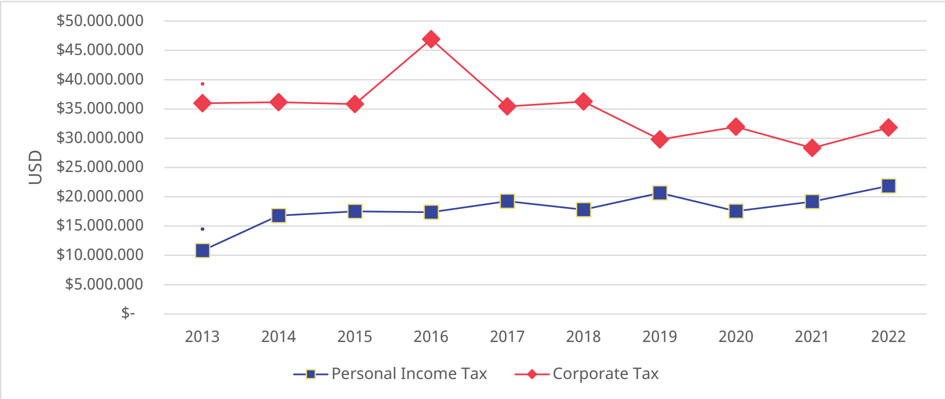
This is explained by the general arguments that granting tax benefits and lowering taxes to corporations would attract FDI (Foreign Direct Investment), particularly in the context of ASEAN where countries impose more fiscal pressure on

25 PWC worldwide tax summaries at https://taxsummaries.pwc.com/timor-leste/corporate/taxes-on-corporate-income.
26 Calculated based on the General State Budget (Actual) 2022.

corporations than Timor-Leste. But FDI is driven by multiple factors, including political stability, trust in institutions and regulatory environments, availability of infrastructure, and a skilled and productive labour force. Therefore, eliminating or reducing concessions to corporations do not necessarily make the country more attractive. Instead, it would be important to review tax benefits of corporations holding private investor certificates, including the exemption from the payment of income tax and indirect taxes for up to 10 years. Moreover, taxing corporations can promote the free market, particularly when oligopolies tend to dominate the economy, give the government an important tool to tax foreign owners, and compensate for the weak capacity to tax personal income.

Finally, as the economy grows and opportunities for businesses arise while promoting the formalization of the economy and increasing the number of micro-, small-, and medium-enterprises (MSMEs) as the main economic agents, the revenue from corporate taxes is expected to rise. The increase in the statutory income tax and corporate tax rate, which are among the lowest in the world, have been recommended by the IMF (*IMF, 2021*).

Figure 8: Annual Revenues from Personal Income Tax and Corporate Tax in Timor-Leste, 2013 - 2022



Source: Ministry of Finance, Budget Books 2013-2022

Note: Withholding Tax that applies to the outsourcing of some business activities was included under the Corporate Tax.

PIT can be a useful instrument to raise important amounts of revenue in an equitable way. In addition to bringing additional revenues, increasing the progressiveness of taxes can contribute to reducing inequality in the short run[27] and are usually well accepted by the population regardless of their income. Table 7 presents an estimate of revenues that would result from an introduction of more progressive PIT brackets in Timor-Leste. As a calculation exercise, the estimate is based on five personal income tax brackets: (i) 0 per cent for income between US$0 and the National Minimum Wage (NMW); (ii) one per cent for income above the NMW and below US$500.01; (iii) five per cent for income above US$500 and below US$1,500.01; (iv) ten per cent for income above US$1,500 and below US$5,000.01, and (v) 15 per cent for income above US$5,000. This change would lead to a positive impact on both collection and redistribution by increasing revenue from personal income taxes by 12.9 per cent. As a percentage of non-oil GDP, the PIT revenue collection would increase from one per cent to 1.2 per cent. The tax-to-GDP ratio would also grow from 6.8 to 7 per cent. The changes proposed would have the biggest impact at the level of the top personal income brackets, bringing an additional 35.3 per cent of revenue. The fiscal pressure would be lower for those in the third and fourth personal income tax brackets, whose contribution to the system would fall by 35 per cent and 24.5 per cent, respectively. Finally, individuals in the second personal income tax bracket (i.e., earning between the NMW and US$500 per month) would contribute only 0.5 per cent of their annual wage. The introduction of a symbolic one per cent tax rate for lower incomes can bring more people into the fiscal system, address the informality of the economy, and promote a paradigm shift while raising awareness among all citizens as to the relevance of paying taxes.

27 This is highlighted in the 2022 World Bank Poverty and Shared Prosperity Report at https://www.worldbank.org/en/publication/poverty-and-shared-prosperity that shows results on how taxes, transfers and subsidies impact inequality across countries.

Table 7: Estimated impact on fiscal space from introducing more progressive personal income brackets in Timor-Leste, 2023

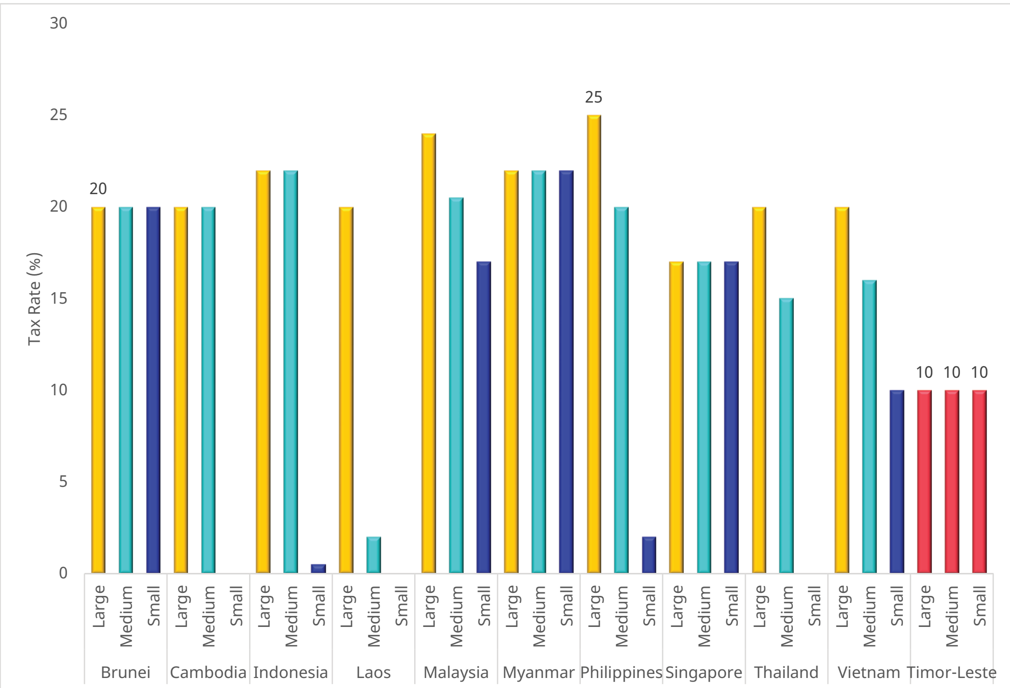
Scenario 4. Adjustments of Income Brackets (US$/month)	Tax Rate at the Margin (%)	Revenue Variation (%)	Revenue collection (% non-oil GDP)	Tax-to-GDP ratio (%)
0 – NMW	0	0	0	0
NMW - 500	1	0.5	0.1	5.9
500.01 – 1,500	5	-35.0	0,1	5.9
1,500.01 – 5,000	10	-24.5	0.2	5.9
5,000.01 and more	15	35.3	0,8	5.9
All		**12,9**	**1.2**	**7.0**

Source: Author's calculations are based on 2021 INSS databases, 2021 MF payroll database, and 2021 TL-LFS.

Notes: INSS data, the MF payroll database, and the 2021 TL-LFS to identify number of workers in each bracket, their individual salaries, and the corresponding tax liability before and after the reform. The simulation takes account the NMW is set at 135 US$/month and that wages are indexed to the NMW. In this proposal no-resident in the last income bracket are charged a 15% tax rate over their whole income.

Asia has the lowest average statutory CT rate among all other regions at 19.52 per cent,[28] with the deductions, exemptions, and subsidized rates varying significantly across countries. As shown in Figure 9, the Philippines has the highest general CT rate (25 per cent), except for its CT rate for small businesses (two per cent). Other ASEAN countries also offer low taxation for small businesses, such as Cambodia, Laos and Thailand (0 per cent) and Indonesia (0.5 per cent). In Timor-Leste, all companies belonging to the non-oil sector are taxed at a flat rate of ten per cent.

Figure 9: Corporate Tax Rates in ASEAN countries, 2022.



Source: KPMG (2013), PWC Worldwide Tax Summaries at https://taxsummaries.pwc.com/

28 Corporate tax rates around the World, 2022 by Tax Foundation: https://taxfoundation.org/data/all/global/corporate-tax-rates-by-country-2022/

Table 8 presents an estimate for revenue resulting from an increase in CT for all companies. Increasing the CT rate between one and five percentage points would increase revenue approximately between US$3.5 and US$17.4 million. Raising the corporate rate from 10 per cent to 15 per cent would also position Timor-Leste closer to other ASEAN countries. Increases in the CT rate usually result in more efficient allocation of economic resources. The proposed policy option would raise the revenue from CT from the current 1.2 per cent[28] up to 2.6 per cent of the non-oil GDP and the Tax-to-GDP ratio up from the existing 6.8 per cent[29] to 8.2 per cent. This would represent a significant improvement, although with a proportion still below the average of 11.7 per cent in LMIC and ASEAN countries.

Table 8: Estimated impact on fiscal space from increasing the CT rate in Timor-Leste, 2023

Scenarios	CT (Avg 2013-2022) (US$)	CT after rate increase (US$)	% non-oil GDP	Tax-to-GDP ratio (%)
5.- Increase CT Rate to 11%	34,838,085	38,321,893.78	1.9	7.5
6.- Increase CT Rate to 12%	34,838,085	41,805,702.31	2.0	7.7
7.- Increase CT Rate to 13%	34,838,085	45,289,510.83	2.2	7.9
8.- Increase CT Rate to 14%	34,838,085	48,773,319.36	2.4	8,0
9.- Increase CT Rate to 15%	34,838,085	52,257,127.88	2.6	8,2

2.2.2. Financial Transaction Tax

Financial sector tax schemes can provide another revenue option for scaled up social investments. A Financial Transaction Tax (FTT) is a small tax levied on various types of financial instruments such as shares, bonds, foreign currency transactions, derivatives, and bank deposits and credits, and other types of banking services (Ortiz et al., 2019). Several different tax instruments are referred to generally as FTT.[31] Taxes on the financial sector usually aim to ensure that the sector can make a fair and substantial contribution to public finances by raising revenues, and to discourage financial transactions which do not contribute to the efficiency of financial markets, or the real country economy, and has little social value.

Many countries have experimented with different financial sector tax schemes or tried to introduce a special type of tax.[32] As an example, the EU has been discussing the introduction of an FTT for over a decade together with finding alternative sources of revenue. An EU-wide FTT was first proposed by the European Commission in 2013 with a proposal of a minimum 0.1 per cent tax rate for transactions in all types of financial instruments, except for derivatives which would be subject to a minimum 0.01 per cent tax rate.[33] The debate around the proposal has been long and controversial, so many countries have developed their own domestic FTT since then, such as France, Italy, and Spain.[34] Belgium and Greece already had a domestic FTT in place. The EU can act somewhat as a comparison for the ASEAN economic community despite the existing historical and economic differences between the two.[35] The existing rates vary between 0.00001 per cent and 2.0 per cent and they are easy to administer as the development of technological

29 Preliminary estimate based in Budget Books

30 Preliminary estimate based in Budget Books

31 For details see IMF Paper on Taxing Financial Transactions: Issues and Evidence see https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Taxing-Financial-Transactions-Issues-and-Evidence-24702; Barros, Ana Rute Costa de (2015) "O imposto sobre as transações financeiras : uma iniciativa europeia não consensual". Dissertação de Mestrado, Universidade de Lisboa. Instituto Superior de Economia e Gestão. https://www.repository.utl.pt/handle/10400.5/11648;

32 For a global overview of the Financial Transaction Taxes see https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/emea/global-view-of-financial-transaction-taxes.pdf.coredownload.pdf

33 See European Parliament's legislation at https://www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-financial-transaction-tax

34 For an overview of the FTT in these countries see https://www.ashurst.com/en/news-and-insights/legal-updates/financial-transaction-taxes-in-the-eu---an-overview/

35 For the most important policy debates centred on financial transaction taxes during the last decades see Pekanov, A. and Schratzenstaller, M. (2019), A Global Financial Transaction Tax – theory, practice, and potential revenues at https://www.econstor.eu/bitstream/10419/207155/1/166860552X.pdf

solutions facilitate tax collection and to consequently raise significant revenues (*Ortiz et al., 2019*). For example, in Brazil in 2007 an FTT - *Contribuição provisória sobre movimentação ou transmissão de valores e de créditos e direitos de natureza financeira* (CPMF) – collected the equivalent of 1.4 per cent of GDP, which covered the total cost of a programme similar to Bolsa da Mae Jerasaun Foun (BM-JF) and other social assistance programmes.

Timor-Leste has a small financial system and does not have a tax on financial transactions. Considering only the financial flows from remittances abroad (BCTL, 2022), the application of an FTT would raise revenue between US$9.4 million (0.46 per cent of GDP) at a flat rate of 0.5 per cent, and US$37.6 million (1.84 per cent of GDP) at a flat rate of 2.0 per cent (Table 9). Thus, an FTT could increase the tax-to-GDP ratio to 8.7 per cent by taxing remittances from abroad at a 2.0 per cent rate. This would be more than the revenue from the reform on corporate tax rates presented previously.

Table 9: Estimated impact on fiscal space from introducing a FTT on remittances abroad in Timor-Leste, 2023

Scenarios FTT rates	Remittances Abroad (2021) (US$)	FTT (US$)	% non-oil GDP	Tax-to-GDP ratio (%)
10.- 0.5% rate	1,878,000,000	9,390,000	0.46	7.3
11.- 1% rate	1,878,000,000	18,780,000	0.92	7.8
12.- 2% rate	1,878,000,000	37,560,000	1.84	8.7

Source: Author's calculations are based on BCTL (2022)

Taxing the value-added created by the financial sector through a Financial Activities Tax (FAT), levied on the sum of the profits and remunerations of financial institutions, is another policy option. The FAT can also be coupled with a Financial Stability Contribution (FSC), which is a contribution paid by financial institutions to capitalize a fund that is used to inject liquidity into the financial system when adverse market conditions or non-performing loans threaten the sustainability of the financial system and with it, individual savings. This can be linked to a resolution mechanism providing insurance against the long taking on of risk by systemic financial institutions.

Table 10 presents an estimate of additional revenue as a result of introducing an FAT on banking sector profits and remunerations at two different rates (2.0 per cent and 4.0 per cent). Currently, the banking system shows a Return on Equity (ROE)[36] equal to 10.6 per cent and a Return on Assets (ROA)[37] of 0.78 per cent, meaning that the banking system is highly profitable. If an FAT is introduced, the ROE and the ROA would decrease to 9.41 per cent and 0.69 per cent, respectively, without putting the profitability of the banking system at risk. The introduction of a FAT tax at a rate of 2.0 per cent and 4.0 per cent would generate a revenue of US$0.8 million (or 0.04 per cent of non-oil GDP) and US$1.6 million (or 0.08 per cent of non-oil GDP), respectively. This option would enlarge the tax base while contributing to diversifying public revenue sources. Nevertheless, the introduction of a FAT to the banking system profits and remunerations would have no significant impact on the tax-to-GDP ratio, which would remain low at 6.9 per cent.

36 According to Investopedia, the term Return on Equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE is considered the return on net assets.

37 According to Investopedia, the term Return on Assets (ROA) refers to a financial ratio that indicates how profitable a company is in relation to its total assets. Corporate management, analysts, and investors can use ROA to determine how efficiently a company uses its assets to generate a profit. The metric is commonly expressed as a percentage by using a company's net income and its average assets.

Table 10: Estimated impact on fiscal space from introducing a FAT on banking sector profits and remunerations in Timor-Leste, 2023

Scenarios	Gross Operating Result (US$)	FAT collected Revenue (US$)	% non-oil GDP	Tax-to-GDP ratio (%)	ROE (%)	ROA (%)
13.-Rate 2%	40,200,000	804,000	0.04	6.9	10.00	0.74
14.-Rate 4%	40,200,000	1,608,000	0.08	6.9	9.41	0.69

Source: Author's are calculations based on BCTL (2022)

2.2.3 Property Tax

Property tax is often seen as an efficient, equitable and stable source of revenue, which has sparked interest in many countries. In developing countries, property taxes generate a revenue representing around 0.6 per cent of GDP (*Ortiz et al, 2019*). This proportion increases up to 2.1 per cent in OECD countries, suggesting a huge potential for increases in property tax revenues in developing countries.

There are no taxes on property in Timor-Leste. To realize potential property tax revenue Timor-Leste, as do other developing countries, would have to undertake strategic adjustments, integrate policy and administrative reforms including establishing a recording structure to capture all properties, registering property valuations, and enhancing both the collection and the enforcement of the tax.

Property taxes are relatively easy to administer and difficult to evade, which are two important advantages to be considered by the Timorese tax administration. Property taxes have a stabilizing effect as it can protect against housing sector bubbles and speculation in real estate investments, which are two risk factors as the Timor-Leste economy develops and becomes more open to foreign investments, including in the tourism sector.

In addition, property taxes are usually progressive with higher taxes falling on those with higher incomes. For instance, in urban environments property taxes can be combined with progressive personal income taxes to compensate for the impact of their introduction on the disposable income of the middle-class.

In addition, property taxes are generally collected and administered by local governments, since they are in the best position to identify owners and their assets, which can contribute to the developmental goal of promoting decentralization while building the capacity of municipalities.

Two simulations of property taxes are presented in Table 11 below. First, a circulation tax on light and heavy vehicles is proposed and second, a tax on agricultural land and residential properties is introduced.

The circulation tax is proposed as an environmental tax intended to charge annually a lump-sum to each vehicle, depending on their technical specifications and CO_2 emissions. At least two categories can be taxed, and their simulated impact estimated: a tax of US$15 /year on light vehicles (motorbikes) and a tax of US$25 /year on heavy vehicles (cars, vans, trucks and angunas). The introduction of a circulation tax would raise an additional 0.06 per cent of GDP in 2023 and would generate a tax-to-GDP ratio of 6.9 per cent.

Table 11: Estimated impact on fiscal space from introducing a circulation tax on light (US$15/year) and heavy vehicles (US$25) in Timor-Leste, 2023

Scenario 15. Introduction of an annual circulation tax	Number of vehicles 2015	Number of vehicles 2022	Revenue (US$)	% non-oil GDP (2023)	Tax-to-GDP Ratio (%) (2023)
US$15 on Light vehicles	48,267	58,986	884,792	0.04	6.9
US$25 on Heavy vehicles	13,211	16,145	403,623	0.02	6.8
All vehicles	61,478	75,131	1,288,415	0.06	6.9

Source: Author's calculations are based on the 2015 and 2022 Timor-Leste Population Census

Taxes on agricultural land and residential properties are also introduced as progressive taxes levied on the number of square meters of the property. The tax on land is usually seen as an incentive to use land more efficiently, especially in the case of agricultural land, and promote investments to increase productivity, while ensuring a more equal distribution of land. The tax on residential property is certainly more challenging to implement due to the lack of an estate registry and difficulties in registering and recognizing land titles in Timor-Leste. However, if administration systems are improved, a way of effective collection of this type of tax could be for instance through electricity bills once a year.

Table 12 presents revenue estimates as a result of introducing an agricultural land tax, a residential property tax and a general tax on real estate assets. The introduction of these three property taxes would increase Timor-Leste public revenue by 2.3 per cent of GDP and raise the Tax-to-GDP ratio up to 9.2 per cent.

An introduction of a progressive land tax would be levied annually at a rate of US$13.1 /ha on properties between 1.0 and 9.99 ha, US$65.5 /ha on properties between 10 and 49.99 ha, US$131 /ha on properties between 50 and 99.99 ha, and US$196.5 /ha on those over 100 ha. Properties below one ha would be exempted (Hitomi et al., 2022).[38] This type of tax would collect around 0.8 per cent of GDP.

A similar annual tax could be levied on residential property owners at a rate of US$1.0/sqm for urban estates below 65 sqm, US$2.5 /sqm for urban estates above 65 sqm but below 110 sqm, US$5.0 /sqm for urban estates above 110 sqm but below 155 sqm, US$10.0 /sqm for urban estates above 155 sqm but below 185 sqm, and US$15 /sqm for urban estates of 185 or more square meters. Rural estates under 155 sqm would pay half the lump sum of urban estates. Such taxes would generate revenue of 1.4 per cent of GDP.

A general tax on real estate asset transactions, i.e., on the transfer of the ownership of property rights, could be further introduced once the Timor-Leste Land and Property Commission is operational and the new Land Registration Code is approved. A proposal would be to tax the buyer with a five per cent charge on the final value of the transaction.[39] Unfortunately, there is no data on the number of purchases and prices for real estate sales in Timor-Leste. Nevertheless, data from the Timor-Leste publication of figures (DG Statistics, 2019) was used to estimate the amount of tax collected only from the sale of brand-new houses. This type of tax is estimated to be 0.1 per cent of GDP.

38 ActionAid International Briefing on property taxes at https://actionaid.org/sites/default/files/publications/property_taxes.pdf

39 The proposal was presented by the Tax Revenue Authority Legal Department on 13 February 2023 during the workshop 2023 Tax Law: Presentation of the main Legislative Policy Options.

Table 12: Impact on fiscal space from introducing different types of property taxes in Timor-Leste, 2023

Scenarios	Incidence Base (Ha/Sqm/Value)	Revenue (US$)	% non-oil GDP (2023)	Tax-to-GDP Ratio (%) (2023)
16. Land Tax	264,690,568	17,198,280	0.8	7.7
17. Residential Property tax	13,096,126	28,060,392	1.4	8.2
18. Alienation Tax	51,656,345	2,582,817	0.1	7.0
All		47,841,490	2.3	9.2

Source: Author's calculations are based on the 2015 and 2022 Timor-Leste Housing and Population Census, 2019 Agricultural Census, and World Bank data bank.

2.2.4. Taxation of natural resources or extractive industries

Taxation of natural resources or extractive industries 'rents'[40] are seen as a very attractive tax base. The Timor-Leste revenue model is based on taxation of the oil and gas industry, which is channeled into the PF, which was established in 2005 as a savings and stabilization fund. The industry has a specific tax system that affects the CT and the Value Added Tax (VAT) applied to their activities.

Different tax arrangements apply to the taxation of petroleum operations in Timor-Leste. Oil and gas contractors are generally subject to a corporate income tax rate of 30 per cent, while sub-contractors are subject to a 6 per cent flat rate.[41] Additionally, a Supplemental Petroleum Tax (SPT), imposed on accumulated net receipts, is charged to oil and gas contractors as well, which can be deducted from the CT incidence base. There are many specific fiscal clauses, exemptions, and ad-hoc provisions applied to the sector. However, the Bayu-Undan oil and gas field has recently closed after finishing its reserves, meaning that there will be no more tax revenue from it, at least for the near future.

The tax revenue sources fueling the PF can be divided into three groups. First, the government of Timor-Leste receives a share of the oil and gas production through royalties before cost recovery. Royalties of five per cent apply to gas and oil field concessions. Royalties are collected when production starts, independently of whether contractors are making profits or not, being a more reliable source of revenue than profit-based taxes.

Second, the government participates at a 40-50 per cent on the profits obtained by contractors after discounting their exploration and development costs. This resource rent tax maximizes revenues without compromising future revenues or the investments needed to keep the industry viable.

Third, oil companies pay the CT and the SPT for profitable projects that exceed a set rate of return. In this way, Timor-Leste follows the IMF advice of combining royalties and taxes targeted on rents, on top of the corporate income tax, to ensure revenue from the beginning of production and that revenues are tied to commodity prices, making the fiscal system more sustainable.

Figure 10 shows that the PF's balance increased 32.2 per cent between 2013 and 2021, but it is expected to lose 85 per cent of those gains by the end of 2023.[42] The gains in 2013 were from large Royalties and Profits (R&P) of US$1.9 billion and petroleum taxes of US$1.2 billion. But these two revenues dropped significantly between 2013 and 2016 to US$127 million for R&P and US$90 million for petroleum taxes. Revenues slightly increased between 2017 and 2022, with an average of US$344 million for R&P and US$289 million for taxes.

The expected depletion of Timor-Leste's oil and gas fields together with a less positive outlook for the fossil fuel market explains the collapse in revenue, which is expected to be as low as US$82 million for R&P and US$69 million from taxes in 2023. Apart from the ending of gross petrol revenue income, continuous and increasingly excess

40 Considered the excess of revenues over all costs of production, including those of discovery and development, as well as the normal return on capital.

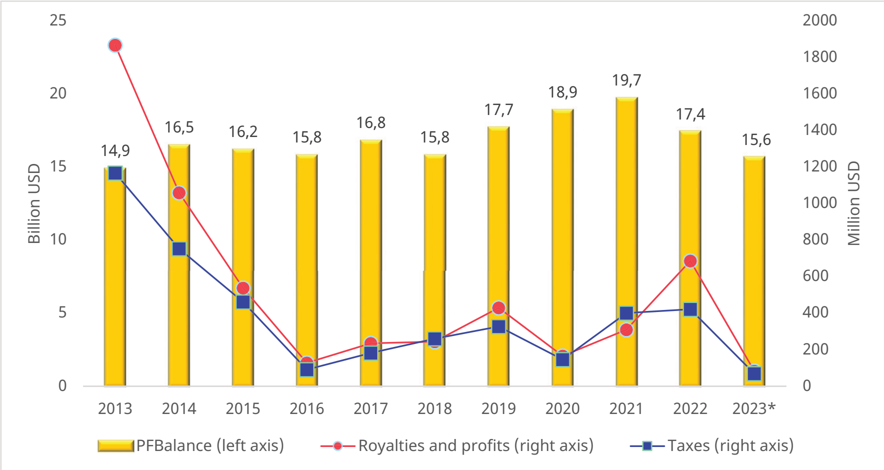
41 PWC worldwide tax summaries: https://taxsummaries.pwc.com/timor-leste/corporate/taxes-on-corporate-income

42 Between 2013 and 2021 the PF balance increased in 4.8 billion US$ (19.7-14.9) but if the period is extended until 2023, the gain equals only 0.7 billion US$. 4.1 billion US$ out of the original 4.8 billion US$ are, hence, lost between 2021 and 2023, or in other words 85% of the original gain ((4.8-0.7)/4.8).

withdrawals beyond the Estimated Sustainable Income (ESI)[43], and the contraction in capital markets, will contribute to the depletion of the PF, expected to be in 2034 if investment returns average three per cent, and in 2038 if investment returns average five per cent.[44] The depletion of the PF will lead the country to a fiscal cliff that will likely impose a sudden drop of the fiscal deficit by more than 30 per cent of non-oil GDP (*IMF, 2022*), which will vastly impact the provision of basic public services.

In this context, the government of Timor-Leste is supporting the exploration of new oil and gas fields through ongoing projects and is setting up a public company to explore options of collecting revenue from mining. However, any additional revenue from natural resources or extractive industries have to back a fiscal consolidation and structural reforms to secure fiscal sustainability while supporting a smoother transition to alternative renewable energies and stimulate the productive capacity of the domestic economy that can mobilize additional resources to the social sectors, including the social protection.

Figure 10: Evolution of Petroleum Fund Balance, Tax Revenue, and Royalties and Profits, 2013 - 2023



Source: Petroleum Fund Annual and Quarterly Reports 2013-2022, Ministry of Finance
Note:* 2023 is forecasted

2.2.5 Consumption taxes, VAT

The Value-Added Tax (VAT) is a major source of revenue in many countries. More than 160 countries raise, on average, over 30 per cent of their total tax take. As a share of GDP, VAT accounts for four per cent in low-income developing countries and for more than seven per cent in advanced economies.[45]

The main purpose of a VAT is to enforce a broad-based tax on final consumption by households. In general, only private individuals are involved in the consumption at which a VAT is targeted. However, in practice, VAT also applies to all previous transactions in the supply chain between businesses, requiring a crediting mechanism for businesses to credit VAT paid on their business' inputs (input VAT) against the VAT collected on their sales (output VAT). "The nature of the VAT ensures its importance in domestic trade as an economically neutral tax. The full right to deduct input tax through the supply chain, except by the final consumer, ensures the neutrality of the tax, whatever the nature of the product, the structure of the distribution chain, and the means used for its delivery (e.g., retail stores, physical delivery, Internet downloads). As a result of the staged payment system, VAT thereby "flows through the businesses" to tax supplies made to final consumers" (*OECD 2017*).

In trade across borders, the neutrality of the tax is attained by the application of the destination principle, which says exports are free of VAT and imports are taxed on same basis and at the same rates as domestic supplies (OECD 2017).

43 The Estimated Sustainable Income (ESI) is a guideline for how much money Timor-Leste should spend from its Petroleum Fund each year. The 2005 Petroleum Fund Law defines it as «the maximum amount that can be appropriated from the Petroleum Fund in that Fiscal Year and leave sufficient resources in the Petroleum Fund for an amount of the equal real value to be appropriated in all later Fiscal Years.» The ESI was set at 3% of total Petroleum Wealth in the Petroleum Fund Law. However, the government has been overspending.

44 The depletion of the Petroleum Fund by 2038 assumes an annual investment return on the Petroleum Fund of five per cent, in line with historical average annual returns. If the investment return is three per cent, then the Petroleum Fund is depleted in 2034 (IMF, 2022).

45 Value-Added-Tax continues to expand: https://www.imf.org/en/Publications/fandd/issues/2022/03/b2b-value-added-tax-continues-to-expand.

Timor-Leste does not have a VAT yet and only applies a 2.5 per cent sales tax (SaT) on imported taxable goods and a five per cent service tax (SeT) applied to certain services, namely hospitality, food and beverage, as well as telecommunication related services, whose monthly turnover exceeds US$500.

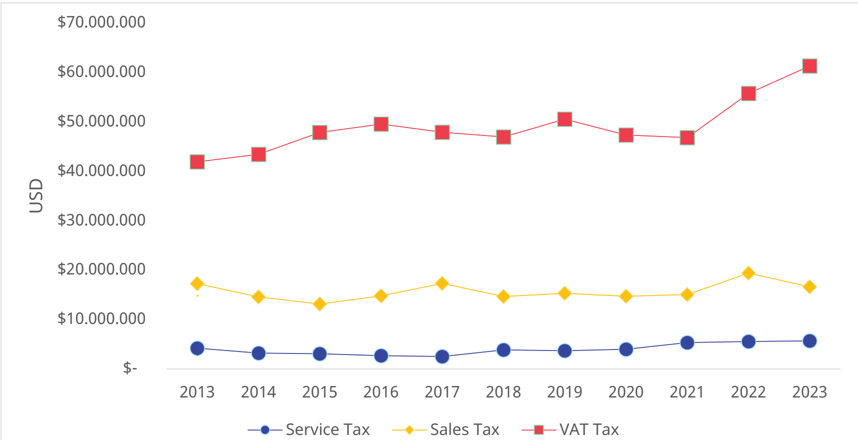
Recently, the IMF recommended the Government of Timor-Leste to replace the current SaT with a VAT. According to the IMF, the introduction of a VAT could generate additional revenue equal to three per cent of GDP and increase domestic revenue to 13 per cent of non-oil GDP by 2028 (*IMF, 2022*). The government has requested technical assistance to support the design of a VAT implementation plan.

Figure 11 shows the revenue estimates as a result of replacing the current sales and services taxes with a VAT in Timor-Leste. The introduction of a VAT could collect 151 per cent more revenue than the sales and service taxes combined, or an additional US$30 million a year between 2013 and 2023, approximately. This would take the tax-to-GDP ratio up to 8.7 per cent in 2023. The replacement of current taxes with a VAT would increase the revenue from 1.1 per cent to 3 per cent.

However, it is important to consider the distributional impact of introducing a VAT. The price changes can potentially decrease real household income and thus increase poverty. Contrary to progressive taxes, universal taxes on goods and services are regressive as they don't discriminate between high-income and low-income consumers. Individuals with lower incomes spend a higher share of their income on VAT than higher income individuals.

Establishing a VAT can only be prudent if targeted to the products mostly used by wealthier individuals, such as luxury goods. The regressive nature of a VAT can be downsized if the basic goods that many lower-income individuals depend on are exempted and the VAT on luxury goods is set at higher rates. A reform strategy therefore requires a careful analysis of the impacts of the proposed changes on real household incomes and the distribution of these across households, in particular on the poorest households, to mitigate any adverse effects.

Figure 11: Evolution of Timor-Leste Service and Sales Taxes (2013-2023) and estimated impact on the revenue from replacing with VAT



Source: Author's calculations are based on data compiled from the Ministry of Finance's Transparency Portal

2.2.6 Excise duties and trade taxes

Excise taxes are another source of revenue in developing countries as they have significant revenue potential and usually can be administered at low cost. However, many countries decide to reduce or eliminate excise taxes when they introduce a VAT. From a revenue point of view, excise taxes present multiple advantages when compared to other consumption taxes, mainly because their buoyant base, small number of contributors resulting in lower administrative costs, inelastic demand, and large sales volumes (*Ortiz et al, 2019*). Excise taxes are normally levied on quantities leaving the factory or arriving at ports, which simplifies measurement and collection, ensures coverage, reduces evasion, and improves monitoring.

In Timor-Leste, excise taxes apply on certain goods and services, typically those that are considered luxuries or harmful to society.[46] In accordance with the 2023 State Budget (Law 15/2022), the government applies excise taxes to sugar and confectionary, beer with an alcohol content of more than 4.5 per cent, and cigarette lighters. Excise rates for vehicles are applied using different value bands. The Government of Timor-Leste expects to collect 2.2 per cent of the nation's non-oil GDP from excise taxes in 2023, above the average of 2.0 per cent observed in LMICs and below the average of 3.0 per cent in high-income countries (*Ortiz et al, 2019*).

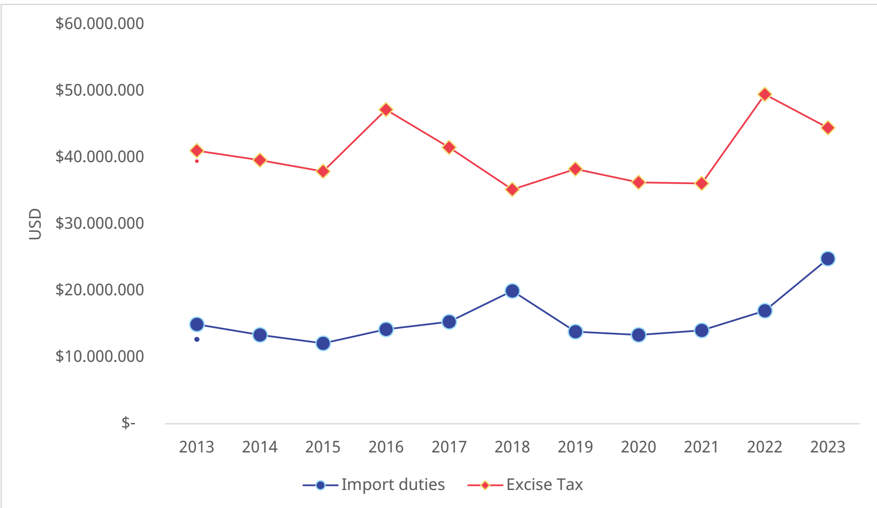
In accordance with the 2023 State Budget (Law 15/2022), import duties were set at 5.0 per cent (increased from 2.5 per cent previously). Import duties apply to imported goods (except for specifically exempted goods) at the 'customs value' of the goods. Customs value is the fair market value, including cost, insurance, and freight (CIF), as stated in the General Agreement on Tariffs and Trade (GATT) rules. Tariffs are still a traditional source of finance for development despite the increase in multilateral and bilateral free trade in the last decades.

Timor-Leste does not have any significant trade agreements with other countries, which limits its capacity to impose tariffs on imported goods. The Government of Timor-Leste expects to collect only 1.2 per cent of the country's non-oil GDP from import duties. Since Timor-Leste has not yet joined the World Trade Organization, it does have room to use trade tariffs as a financing option.

However, the amount of goods produced in the country is very limited, so many imports consist of basic consumption goods, including basic elements of the Timorese diet such as rice. This means that any increase in import duties should take into account the country context and assess the distributional impact, particularly on the most vulnerable and poorest.

Figure 12 shows the evolution of import duties and excise taxes in Timor-Leste over the last ten years. The government estimates that the approved reforms in the 2023 State Budget will increase revenues from import duties by 46.1 per cent and decrease the revenues from excise taxes by 10.1 per cent between 2022 and 2023. The additional revenues are expected to bring the tax-to-GDP ratio to 6.8 per cent in 2023.

Figure 12: Evolution of Import Duties and Excise Taxes in Timor-Leste, 2013 - 2023



Source: Ministry of Finance's Transparency Portal

46 Import Duties and Taxes for 2023 in Timor-Leste at https://customs.gov.tl/wp-content/uploads/formidable/2/ENG-Booklet-Import-Duties-and-Taxes-2023.pdf

2.2.7. Innovative taxes

New innovative taxes on certain goods and services are also a path to revenue for many countries. Three types of taxes are briefly analyzed here: sin taxes, carbon taxes, and airline, hotel and tourism taxes. Sin taxes are applied on goods and services that are socially harmful. Increasing their prices is intended to discourage their production or consumption. While sin taxes support public or social policy objectives, they also contribute to boosting state revenue. Sin taxes are usually well accepted by society, leading to self-enforcement. Support from civil society and advocacy groups is fundamental to passing tax reforms that might not be supported by powerful companies or economic lobby groups, such as the tobacco and alcohol industries. If there is no opposition, certain industries will continue to be very protective of their business regardless of their negative impact.

In Timor-Leste, excise taxes on goods considered harmful to society, in particular on cigarettes, sugary beverages, sugar and sweats, alcoholic beverages, and oil derivatives, began being implemented in 2023. Despite the revenue accrued from the new excise taxes not yet being earmarked for social objectives, the fall in consumption of those goods will likely deliver a net social benefit to all the Timorese. For instance, the cost of health care will likely be reduced if citizens are consuming less or no harmful products. Further analysis on consumption and prevalence patterns, and understanding the behavior changes in consumption and explain its associations, would be required to assess the impact of the new excise taxes.

Carbon taxes and taxing products with negative externalities are also innovative sources of finance which could significantly increase fiscal space for social protection. A carbon tax is seen as an effective way to achieving emissions reductions without discouraging tourism. A carbon tax could be the action needed to control rising greenhouses gases as they are responsible for major climate changes over time, higher temperatures, rising sea levels, and sudden variations in the weather and ecosystems, which are negatively impacting agriculture, the environment, and public health.

Timor-Leste is projected to experience a rise in the frequency of extreme high temperatures, which represent a central threat to its population and ecosystems.[47] Air temperatures and sea surface temperatures are projected to increase by 2030 and increase more than 2.5°C by 2090 as a result of greenhouse gases in the atmosphere. A similar rate of warming is projected for the ocean surface, considering the close relationship between surface air temperature and sea-surface temperature. Increases in the intensity and frequency of extreme heat and drought, and extreme wet season rainfall are expected. In addition, an estimated sea rise of between 5–15 cm by 2030 is expected, with increases of 20–60 cm indicated by 2090 under the higher emissions scenarios.

Timorese are very dependent on agriculture, which its people more vulnerable to negative impacts on production caused by increased seasonal temperatures, rainfall, and abrupt weather changes. As extreme weather events and higher sea levels are projected to increase in intensity and duration, there will be more threats to social and economic development gains, which will ultimately affect people’s lives and their livelihoods.

The introduction of a carbon tax could discourage the use of fossil fuels, enforce a shift to less-polluting fuels and promote renewable energy sources. Carbon taxes can also promote a more sustainable environment and individual health, particularly by reducing respiratory diseases caused by air pollution (*Parry, I. 2019*). The additional revenue from carbon taxes could be used by the government to fund productive investments in social protection and reduce poverty and inequality.

Airline taxes, hotel taxes and taxes on tourism are other types of innovative taxes that can be analyzed. Many countries have increased taxes charged at airports or on the sale of airline tickets while others have also implemented a “solidarity” levy on air tickets “that is charged to all passengers taking off from their national airports.[48] An example of a discriminatory tax on the air transport industry was introduced by the French Government in 2006 with a solidarity tax designed to support aid to developing countries. Combined with the French Solidarity Tax, an Eco Tax was recently applied to commercial flights departing from French airports.[49] In Portugal, a flat carbon tax of ~US$2.2 per passenger

47 Brief description of Timor-Leste, its past and present climate as well as projections for the future. At https://www.pacificclimatechangescience.org/wp-content/uploads/2013/09/East-Timor.pdf

48 https://en.wikipedia.org/wiki/Solidarity_tax_on_airplane_tickets; https://www.iata.org/contentassets/a72d8d3cfaf84529bcdef6b2dc59f224/solidarity-tax.pdf; https://www.transportenvironment.org/wp-content/uploads/2021/07/2018_12_CE_Delft_7L14_A_study_on_aviation_ticket_taxes_DEF.pdf

49 The tax entered into force on 1 January 2020, with rates ranging between EUR2.7 (~ US$2.9) per ticket on domestic and intra-European flights in economy class to EUR63.1 (~ US$67.5) per ticket for business class flights to destinations outside of the EU. See at https://www.iata.org/contentassets/a72d8d3cfaf84529bcdef6b2dc59f224/solidarity-tax.pdf

has been levied for departing flights from all Portuguese airports since 2021.[50] In some regions, taxes now account for up to 26 per cent of the cost of a US$200 ticket.[51]

Some countries follow European best practices while others oppose the solidarity tax. The International Air Transport Association (IATA) is strongly against these tax initiatives for many reasons, including discouraging passenger traffic, and preventing the air transport industry's ability to drive economic development to its full potential. IATA also argues that airlines and their passengers should not pay for the state funding of social programmes. However, one of the main arguments in favor of taxing aviation is that air transport has created adverse environmental externalities. As pointed out by Keen, M. and Strand, J. (*2006*), most existing taxes are low, but they are important for accounting the significant damage to environment, including air pollution and noise, caused by airline travel and to address the negative impact of greenhouse gases.

The simulation conducted for Timor-Leste includes three tax options: a fixed lump-sum tax on airplane and boat tickets for visitors (non-residents) coming from other countries; a solidarity tax levied on passengers arriving in the country; a daily fixed lump-sum tax per stay at hotels. The fixed lump-sum tax on airplane and boat tickets for visitors is estimated at two scenarios, one at a US$10 tax and another at a US$20 tax. This type of tax has the advantage of being easier to collect and having a lower administrative cost, as there would not be many people needed for collecting and transferring the revenue to the government. Also controlling airline and ship companies tax liability declarations arising from such a tax could be easily done by crosschecking immigration data collected at the border, with only a few entry points. One potential negative effect could be that the cost of the tax falls entirely on visitors who might then reduce their visits to the country. The solidarity tax of US$20 would be levied on passengers arriving in the country. The introduction of a daily fixed lump-sum tax of US$2.5 per night of stay at a hotel or other accommodations would be levied on residents and non-residents. Even if the cost on customers would likely be more accepted, it is important to consider the administrative costs, including the human resources needed to monitor the collection.

Table 13 presents the different scenarios and estimated revenues. The option that would increase the revenue most would be the solidarity tax levied as a lump-sum of US$20 on the plane tickets of each passenger flying into Timor-Leste. This would collect 0.1 per cent of GDP and place the tax-to-GDP ratio at 6.9 per cent. However, tourists with other destination options would be watching the prices closely. Adding another increment to existing airline or airport taxes could potentially reduce a country's competitiveness. But earmarking the tax to specific development objectives would certainly be better accepted by mindful tourists and at the international level. For instance, Cape Verde has a tourist tax whose revenue is used to fund projects aiming at reducing poverty[52]. The tourist tax is approximately €2.5 per person per night for a maximum of ten nights that applies on every tourist over the age of 16. It a compulsory tax that all accommodations establishments are required to collect. It is important that the country takes time to reexamine its options in light of its experience and evolving national fiscal situation.

Table 13: Estimated impact on fiscal space from introducing airport and hotel taxes in Timor-Leste, 2023

Scenario	Incidence Base (US$)	Revenue (US$)	% non-oil GDP (2023)	Tax-to-GDP ratio (%) (2023)
19.- Non-Residents Tax US$10	75,776	757,757	0.0	6.9
20.- Non-Residents Tax US$20	75,776	1,515,514	0.1	6.9
21.- Solidarity Tax US$20	108,251	2,165,020	0.1	6.9
22.- Stay Tax US$2.5/night (Big Hotels)	62,127	155,318	0.01	6.8
23.- Stay Tax US$2.5/night (All operators)	370,609	926,521	0.1	6.9

Source: Author's calculations are based on 2019 Timor-Leste in Figures, DG Statistics

50 The Portuguese Carbon Tax was initially implemented in 2021, applying solely to passengers departing from Portuguese airports on commercial flights, but the tax scheme has extended in 2023 to include non-commercial business jet flights. See at https://www.fccaviation.com/regulation/portugal/carbon-tax#:~:text=The%20Portuguese%20Carbon%20Tax%20was,business%20jet%20flights%20as%20well.

51 Solidarity tax at https://www.iata.org/contentassets/a72d8d3cfaf84529bcdef6b2dc59f224/solidarity-tax.pdf

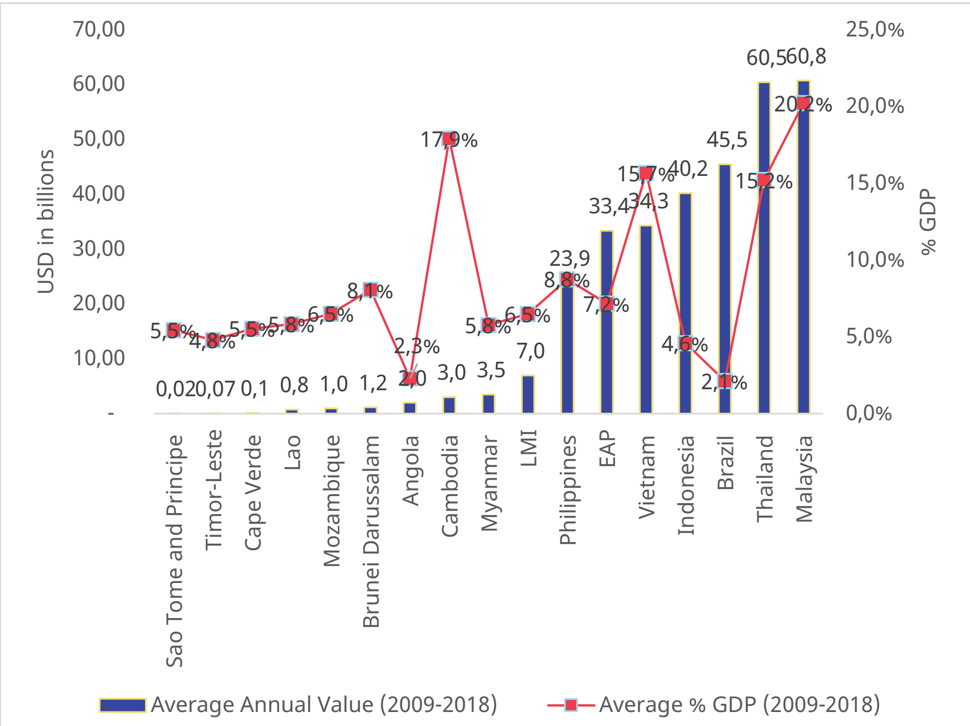
52 Tourist Tax in Cape Verde at https://www.discover-cape-verde.com/tourist-tax-increase/

2.3. Eliminating Illicit Financing Flows

Illicit Financing Flows (IFFs) deprive countries of vital resources as they are crimes aimed at transferring financial capital out of a country in violation of national or international laws. IFFs are very diverse and can include transfers generated by private individuals to offshore accounts to evade taxes or complex international criminal schemes that use multi-layered and multi-jurisdictional organizations to hide assets. According to the OECD (2014a; 2014b), IFFs are related to funds initiated by crimes or intending to commit them (bribery, terrorist activities, or conflict financing), funds associated with tax evasion, funds related to trade (improper invoicing and pricing), transfers by/for entities subject to financial sanctions, transfers which seek to evade anti-money laundering or counter-terrorist financing measures or other legal requirements. The Addis Ababa Action Agenda on Financing for Development has established a consensus about the need to combat IFFs.

The cross-cutting nature of IFFs requires decision makers to have a strategic overview of IFFs and to analyze the potential trade-offs and intersectoral collaborations for more effective interventions. The Global Financial Integrity (GFI) calculated the trade-related illicit flows in Timor-Leste and other CPLP and ASEAN countries for the 2009–2018 period. GFI performs partner-country analyses to compare the differences between any two countries in order to identify value gaps, or mismatches, in the reported data (GFI, 2021). Timor-Leste has the second lowest gap (around US$70 million) among CPLP and ASEAN of countries (Figure 13) with IFFs representing a significant proportion of its GDP (4.8 per cent). However, Timor-Leste is in a better position when compared to average EAP (6.5 per cent) and LMIC (7.2 per cent) trade related IFFs. Only Brazil, Angola, and Indonesia present lower average IFF-to-GDP ratios than Timor-Leste for the 2009-2018 period.

Figure 13: Value Gaps in trade(*) between ASEAN and CPLP countries and their global trading partners, averages 2009–2018



Source: World Bank databank 2009-2018 and Global Financial Integrity 2021 Report

Note: (*) Value gaps correspond to the mismatches identified between what any two countries had reported to regarding their trade with each other. Trade misinvoicing is one of the largest components of measurable illicit financial flows (IFFs). Global Financial Integrity examines the international trade data officially reported by governments to the United Nations in order to estimate the magnitude of trade misinvoicing activity occurring within the global commercial trading system.

IFFs are a very significant disruptor of sustainable development as they are related to many obstacles including corruption, weak domestic resource mobilization and poor governance that prevent governments from effectively using and mobilizing national resources. The losses and negative impact of IFFs can be larger than the Official Development Assistance (ODA) for many countries as shown in Table 14 below.

Timor-Leste showed the lowest average IFF as a percentage of ODA (30 per cent) between 2009 and 2018 in the selected countries. Timor-Leste also performs better than the average of LMICs and the EAP region, where IFFs represent respectively 817 per cent and 3,939 per cent out of the ODA net revenues.

In Timor-Leste, a value corresponding to 30 per cent of the ODA received flowed illicitly out of the country (US$73,5 million), while the country received an average ODA of US$245 million between 2009 and 2018. For every development-targeted dollar entering Timor-Leste in the period, US$0.3 exited illicitly. Indonesia gives back over US$116 via illicit outflows.

Table 14: Average Net ODA in US$ million and Average IFF as % Net ODA for CPLP and ASEAN selected countries, 2009-2018

	Average Net ODA, in US$ million (2009-2018)	Average IFF as % ODA (2009-2018)
Thailand	$18	329253%
Sao Tome and Principe	$ 49	32%
Cape Verde	$ 197	50%
Angola	$ 240	834%
Timor-Leste	$ 245	30%
Philippines	$ 315	7573%
Indonesia	$ 345	11674%
Lao	$ 438	175%
Brazil	$ 743	6122%
Cambodia	$ 748	406%
Myanmar	$ 1,288	272%
Mozambique	$ 1,944	50%
Vietnam	$ 3,196	1074%
Lower to Middle Income	$ 861	817%
Asia and Pacific	$ 861	3939%

Source: Author's calculations based on Global Financial Integrity 2021 Report

Although IFFs in Timor-Leste are lower than its peers, resources could be increased for additional financing if illegal activities were better controlled. As shown in Table 15, a five per cent recovery target from IFFs would mean additional funding of US$4.9 million (0.24 per cent GDP), out of which US$ 1.0 million (0.05 per cent of GDP) is related to trade with advanced economies. A more ambitious recovery target of 30 per cent would collect additional revenue of US$29.4 million US (1.44 per cent of GDP), out of which US$6.1 million (0.3 per cent of GDP) is related to trade with advanced economies.

Table 15: Estimated impact on fiscal space from recovering and combatting IFFs in Timor-Leste

Scenario	Recovery goal (% of trade-related illicit flows)	Recovery amount (US$)	% non-oil GDP
Global Trading Partners			
Scenario 24	5	4,903,200	0.24
Scenario 25	20	19,612,800	0.96
Scenario 26	30	29,419,200	1.44
*Advanced Economies**			
Scenario 27	5	1,021,500	0.05
Scenario 28	20	4,086,000	0.20
Scenario 29	30	6,129,000	0.30

Source: Author's calculations based on Global Financial Integrity 2021 Report
Note: (*) 36 countries included

IFFs prevents all countries, but developing countries in particular, from mobilizing additional resources required for inclusive and sustainable development. Tax evasion and tax avoidance schemes narrow the national tax base, which can potentially lead to regressive tax measures, such as consumption taxes and other indirect taxes, to compensate for revenue shortfalls. These types of taxes increase the price of basic goods, and negatively affect the most vulnerable and poorest in particular.

Combatting IFFs and offshore tax havens could provide substantial revenues to support the extension of social protection to all Timor-Leste citizens. Tackling IFFs could have also a multiplier effect on sustainable development since it is correlated with forces hindering it like crime, corruption, weak domestic revenue mobilization, overexploitation of natural resources, poor governance and institutional fragility, and inequality (*Ortiz et al., 2019*).

However, implementing counter-IFF and offshore tax haven strategies requires significant effort and comes with high administrative costs. For example, preventive measures like verifying the identities of financial services' customers would negatively affect the most vulnerable Timorese as they might not comply with certain requirements such as having an ID. The government could mitigate this negative impact by rolling out unique electronic IDs and setting out minimum thresholds for verification policies. At the same time, financial institutions could be more selective in terms of who they do business with and minimize any negative impacts on the vulnerable and poor. There is also the risk of creating unfair situations and losing support from compliant citizens if the government uses voluntary tax compliance programmes to prevent tax evasion and partially recover IFFs.

Timor-Leste can strengthen its national inter-agency co-ordination mechanisms to combat IFFs and adopt effective and coherent policies by identifying and raising awareness of the types, magnitudes, and risks of IFFs; evaluating the contextual factors that facilitate IFFs, and integrating national and international normative frameworks, among other preliminary actions. A series of recommendations to combat the different sources of IFFs can be considered (*OECD, 2014a*):

- Reduce IFFs related to money laundering by compelling the agents that might facilitate it to conduct customer due diligence and requesting from them information about beneficial owners.
- Join information exchange networks, strengthen systems and institutions, and prosecute tax evaders.
- Develop institutional and regulatory mechanisms to uncover offenders, including the establishment of penalties, the prosecution of bribe payers, and the protection of whistle-blowers.

- Establish a special unit to investigate stolen assets and prosecute offenders. Seizure, recovery, and repatriation of stolen assets could be an additional source of funding. With this aim, the government could share information on asset recovery cases with other jurisdictions, accept foreign confiscation orders, establish recovery by civil trials, and assist foreign jurisdictions on the base of reciprocity.

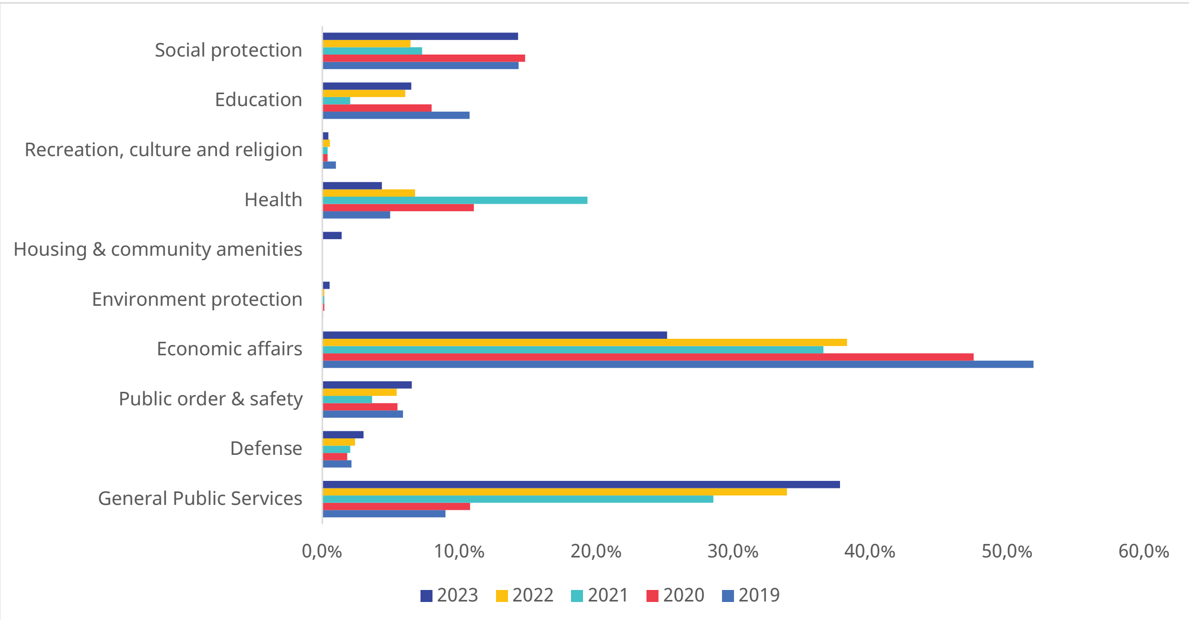
2.4. Public expenditure reprioritization

Expenditure reprioritization does not create new fiscal space in the overall budget, but it is an option to increase the share of government spending on social protection by suspending less relevant activities or high-cost programmes, discontinuing low-impact investments with others with higher benefits and positive impacts for people. The redefinition of priorities by assessing the sector specific allocations within the current budget can increase or protect social protection expenditures, even when the overall budget is declining.

In Timor-Leste, the total national budget increased 78 per cent or US$946.6 million between 2019 and 2013. Three quarters of these additional resources were allocated to general public services, which increased by US$706 million, or 649 per cent in the analysis period.[53] In 2023, this type of spending absorbed 38 per cent of the total national budget, assuming its role in supporting the delivery of government programmes at national and deconcentrated levels. Another two functions that increased state budget allocations are Public order and safety, and Defence. Public order and safety grew from 2.1 per cent in 2019 to 3.2 per cent in 2023, while Defence increased from 5.9 per cent to 6.9 per cent.

However, as a share of the national budget, the social sector (social protection, education, and health) has decreased in relative importance despite an increase in absolute terms (Figure 14). The spending on health decreased from 4.9 per cent to 4.3 per cent between 2009 and 2023. The education sector declined from 10.7 per cent to 6.5 per cent in the same period. Economic affairs also saw a significant reduction of its share, from 51.9 per cent in 2019 to 25.2 per cent in 2023, although it is still the second largest spending type. Social protection expenditure as a share of the national budget was 14.3 per cent, both in 2009 and 2023. Despite investment in the sector not having increased as a share of the national budget, it did increase from approximately US$174 million in 2009 to US$308 million in 2023, representing the third largest investment aligned with government priorities in the sector.

Figure 14: Public spending in Timor-Leste by Classification of Functions of Government (COFOG) division as a share of national budget, 2019-2023

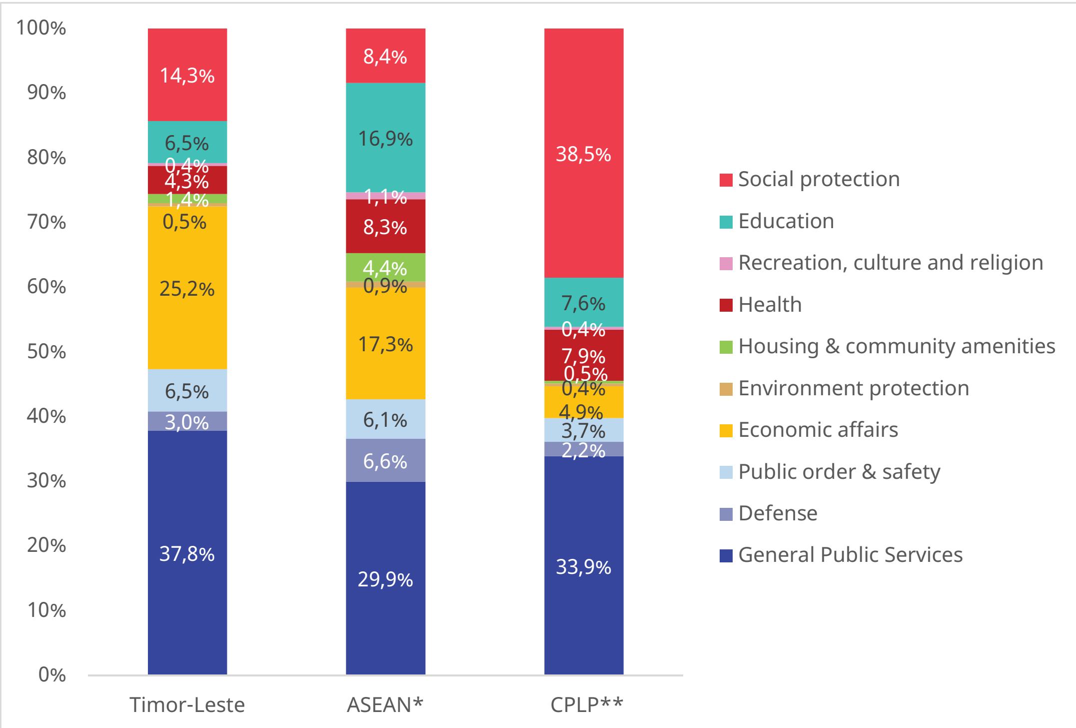


Source: Ministry of Finance Budget Books 2019-2023

53 The COFOG was used to compare Timor-Leste's expenditures with expenditures in CPLP and ASEAN countries. For more details on COFOG methodology see at https://ec.europa.eu/eurostat/web/products-manuals-and-guidelines/-/ks-gq-19-010

As shown in Figure 15 below, there are two relevant features when comparing the relative size of government functions in Timor-Leste to ASEAN countries and the CPLP. First, the social sector in Timor-Leste is given a lower importance in the overall national budget than the social sectors in ASEAN and PALOP countries. While education, social protection and health in Timor-Leste represent 25.1 per cent of the national budget, the same sectors represent 33.6 per cent of the total expenditure in the ASEAN and 54 per cent in the CPLP. Second, Timor-Leste's programme administration is relatively more expensive than that of its peers, considering that general public services accounts for 37.8 per cent of the national budget compared to 29.9 per cent of total expenditure in ASEAN and 33.9 per cent in the CPLP. Timor-Leste also allocates more resources to economic affairs (25.2 per cent) than ASEAN, (17.3 per cent) or the CPLP (4.9 per cent). This international comparison indicates that there is room for Timor-Leste to reallocate resources to increase or maintain social protection spending. For instance, transferring funding from economic affairs to other areas such as employment and job creation would be important to assess in terms of reallocating general public expenditure towards social protection.

Figure 15: Public spending by different functions as a share of national budget in Timor-Leste (2023), ASEAN (2019) and CPLP (2019) countries



Source: Timor-Leste Ministry of Finance Budget Book 2023, IMF Government Finance Statistics

Note: Budget allocations defined as a share of national budget for Timor-Leste while for ASEAN and CPLP countries public spending as a share total public expenditure. The ASEAN group does not include Brunei, Laos, Cambodia, and Vietnam since they do not apply COFOG, while CPLP include all Lusophone countries for which COFOG information was available, i.e., Cape Verde, Mozambique, Angola, Brazil, and Portugal

As shown in Table 16, adopting the ASEAN model as a benchmark for allocation targets for General public services and Economic affairs would free up US$339.6 million (16.6 per cent of GDP) in 2023 which could be reallocated to social protection and other sectors with potentially higher social impact. If the CPLP model is used as a reference, US$520.4 million (25.5 per cent) would be available for investment in social sectors.

Moreover, if the funding allocated to Defence, and Public order and safety is downsized to 2019 levels, an additional US$108.3 million (5.3 per cent of GDP) could be reallocated towards the social sector. For example, Thailand was able to expand its universal social health protection by cutting military expenditures from 25 per cent of its total public expenditure in 1970 to 15 per cent in 2000 and 7.62 per cent in 2015 (*Ortiz et Al. 2019*).

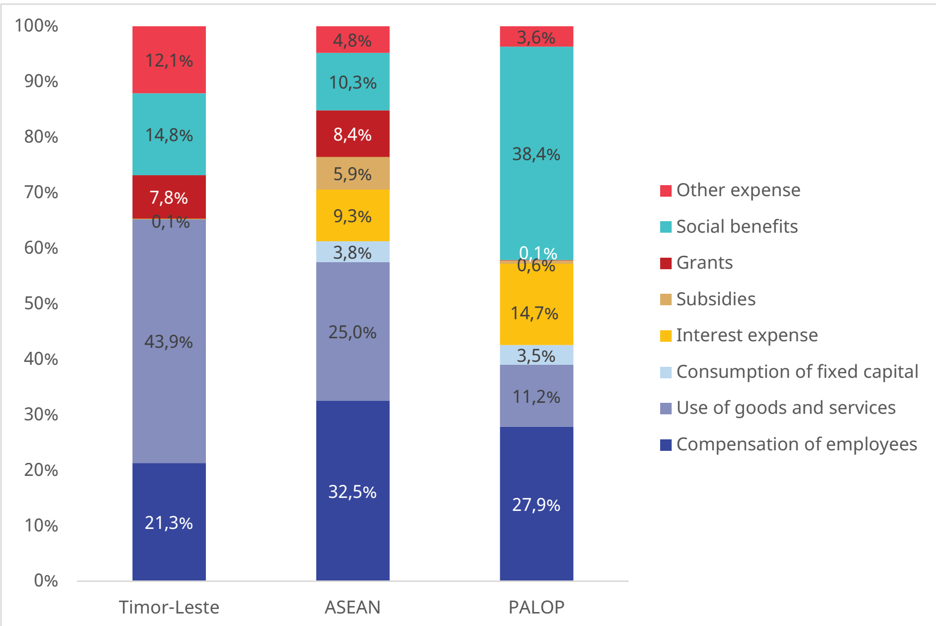
Table 16: Estimated impact on fiscal space from reprioritizing public expenditure in Timor-Leste, 2023

Scenario	Free to reallocate (2023) (US$)	% non-oil GDP (2023)	% General State Budget (2023)
30.- Adopting ASEAN as a benchmark (General public services 29.9%; Economic affairs 17.3%)	339,646,345	16.6	15.8
31.- Adopting CPLPs as a benchmark (General public services 33.9%; Economic affairs 4.9%)	520,450,755	25.5	24.1
32.- Reducing Defence and Public Order & Safety to 2019 levels	108,396,387	5.3	5.0

Source: Author calculations based on Timor-Leste Ministry of Finance Budget Book 2023 and IMF Government Finance Statistics

From the point of view of spending categories, Timor-Leste spends less than ASEAN and the CPLP on employee compensation[54] (Figure 16). The wage bill also goes to pay teachers, doctors, social workers, and other civil servants whose work is paramount to delivering quality public goods and services. Socio-economic development depends significantly on qualified human capital. Hence, cutting public sector wages can lead to increased inefficiencies, foster absenteeism, and reduce the overall delivery of public services. Efficiencies and cost-savings could be achieved by reducing duplications in public sector job positions and clarifying roles and responsibilities, as well as increasing the average compensation to employees. The government would need to recruit qualified people, give older people the opportunity to retire, have younger people assume more relevant roles, and enhance investment in vocational and life-long training of the labour force. Because Timor-Leste spends disproportionately on procuring goods and services, strengthening procurement governance and management would result in cost savings and free up resources for investments in the social sector. In addition, spending reallocation could also come from programmes with low impact to others with better social outcomes.

Figure 16: Spending by economic categories as a share of national budget in Timor-Leste, ASEAN, and CPLP, 2019.



Source: Timor-Leste Ministry of Finance Budget Book 2019 and IMF Government Finance Statistics

Note: The ASEAN group does not include Brunei and Vietnam since their data was not retrievable. São Tome e Príncipe data is from 2018

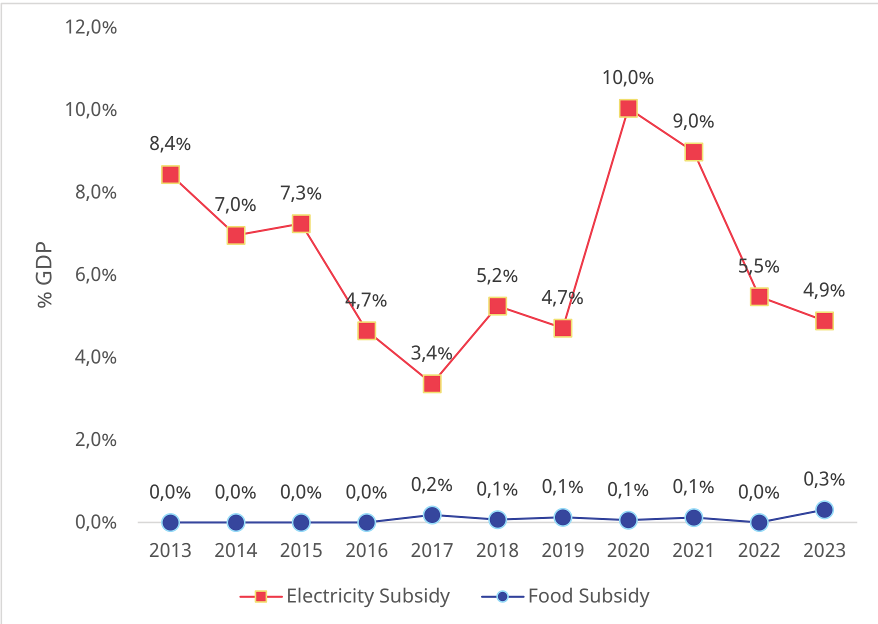
54 According to OECD, compensation for employees has two components: gross wages and salaries payable in cash or in kind, and the value of social contributions payable by employers.

Reducing subsidies, particularly on fuel, electricity, and food, is a common policy considered by many developing countries. Figure 17 shows the evolution of electricity and food subsidies over the last ten years in Timor-Leste. The electricity subsidies are a substantial part of the GDP with 4.9 per cent in 2023 compared to 8.4 per cent in 2013. Electricity subsidies have averaged 6.3 per cent between 2013 and 2023, which represents 5.9 per cent of the government expenditure in ASEAN and 0.6 per cent of government expenditure in CPLP countries.

Important improvements have been achieved in terms of access to electricity in Timor-Leste, which is comparable to ASEAN standards.[55] But the electricity distribution network is in poor condition with voltage drops and frequent service blackouts, including in the capital city. Phasing out electricity subsidies usually raises the cost of electricity, which would likely increase production costs, and families would see their energy bills increase substantially. The reduction of fuel subsidies is often supplemented by other cash transfers as a way to compensate the poorest so they can meet their daily essential energy needs.

Examples from other countries can inspire reform in Timor-Leste. For instance, the New Economics Foundation (NEF) recommended the UK government to provide a basic safety net of cheap or free essential energy for the average household's daily essential energy needs.[56] In Timor-Leste, a reform could guarantee that half of the essential energy needed is offered for free, and the other half is priced at a fixed low rate. Additional energy needs by households could be charged at higher prices, and those households using the most energy could be charged a carbon-busting premium tariff to make it more attractive for them to invest in energy-reducing measures such as domestic solar panels. Households with workers contributing to social security could be exempt from this carbon-tariff, regardless of energy use.

Figure 17: Evolution of Electricity subsidy and Food subsidy as percentage of the non-oil GDP in Timor-Leste, 2013-2023



Source: Timor-Leste Budget Books 2013-2023

55 In 2020, 96.1% of the Timorese population had access to electricity while 95.5% of the ASEAN population had according to the World Bank data at https://data.worldbank.org/indicator/EG.ELC.ACCS.ZS

56 Example from the ongoing reform in UK at https://neweconomics.org/2023/04/govt-could-reduce-bills-for-almost-90-of-households-with-a-national-energy-guarantee

2.5. Use of fiscal and foreign exchange reserves

Fiscal and foreign exchange reserves present possibilities for governments to add fiscal space for social protection. Fiscal reserves are accrued through government budget surpluses, profits of state-owned companies, privatization receipts or other government net income (such as royalties and rents from natural resources). Timor-Leste has accumulated significant fiscal reserves from the rents and royalties accrued from the exploitation of oil and gas fields. The government has also created some new public companies, particularly in the water, sanitation, electricity, and mining sectors, whose profits have not been included in Timor-Leste's Sovereign Wealth Fund, the PF.

As the PF is expected to be depleted by 2034,[57] income flows will not be as much as in past years. Budget surpluses and privatization revenues will unlikely contribute to the accumulation of more fiscal reserves in the foreseeable future. Therefore, it is important to consider the country's essential fiscal reserves to implement counter-cyclical fiscal policies if needed during a crisis, given the volatility of commodity markets and the low levels of domestic revenue mobilization.

However, it is important to invest at least some of country's excess reserves into closing its development deficits, including expanding social protection coverage and enhancing the universal healthcare and education system, that can make a positive impact on social development. This investment would result in better returns than investing in low return foreign treasury bonds.

The Timor-Leste PF was established in 2005 and is divided into a low-risk liquidity portfolio invested in US$ cash and short-term T-bonds, and a high-return growth portfolio invested in corporate equities and other government bonds (*PFPMO, 2022*). The government started a frontloading strategy using the fund's wealth to finance mainly infrastructure projects expected to produce monetary returns in the medium- and long-term. A lower proportion of this wealth has gone to finance social investments despite the evidence that human capital is equally or more important than physical capital to ensure inclusive economic growth and sustainable development.

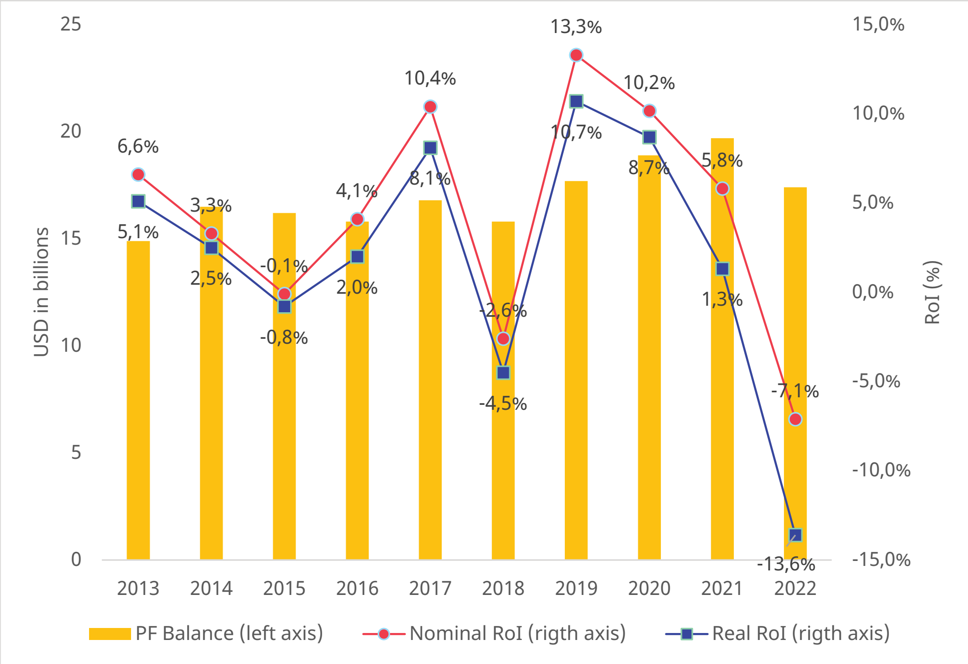
The growth portfolio of the PF is diversified across companies, countries, and economic sectors to reduce its risks, but Timor-Leste remains exposed to the potential economic shocks and financial crisis that might hit the developed countries where the investment is made. The advantage of investing in developed countries' capital markets that it offsets the inflationary pressures from the excess liquidity created by oil and gas capital inflows. Stabilizing the revenue stream from natural resource exploitation also helps to diversify the economy. The PF would gain higher returns than the Central Bank would if it was kept as foreign exchange reserve, and contribute more to the country's sustainable socio-economic development by supporting long-term capital growth.

In this context, the PF strategy to achieve balance in the trade-off between investing in development needs and accumulating capital savings for the future is based on the concept of ESI. The ESI is set to be three per cent of the total Petroleum Wealth. The investment strategy of the fund aims to achieve a three per cent real return through its dual portfolio division, 65 per cent for fixed interest and 35 per cent for equity, and the diversification of assets to mitigate risks. Although limiting the PF annual financing for development to three per cent of its wealth ensures the preservation of the funds' real value, such amount is not enough to cover Timor-Leste current need to guarantee income security throughout the life of its citizens, universal health care, and quality public education.

Figure 18 shows that the PF balance increased from US$14.9 to US$19.7 billion between 2013 and 2022, representing an increase of 17 per cent in nominal terms. Returns on investment (RoI) were consistently above three per cent in 2019. RoI showed losses in only three out of ten years. However, since 2022 there has been a significant fall in the RoI, dropping to -7.1 per cent (nominal) and -13.6 per cent (real). Further net current income flows from petroleum taxes, royalties, and profits are unlikely to occur in the near future.

57 The depletion of the Petroleum Fund by 2034 assumes an annual investment return on the Petroleum Fund of 3 per cent, in line with historical average annual returns.

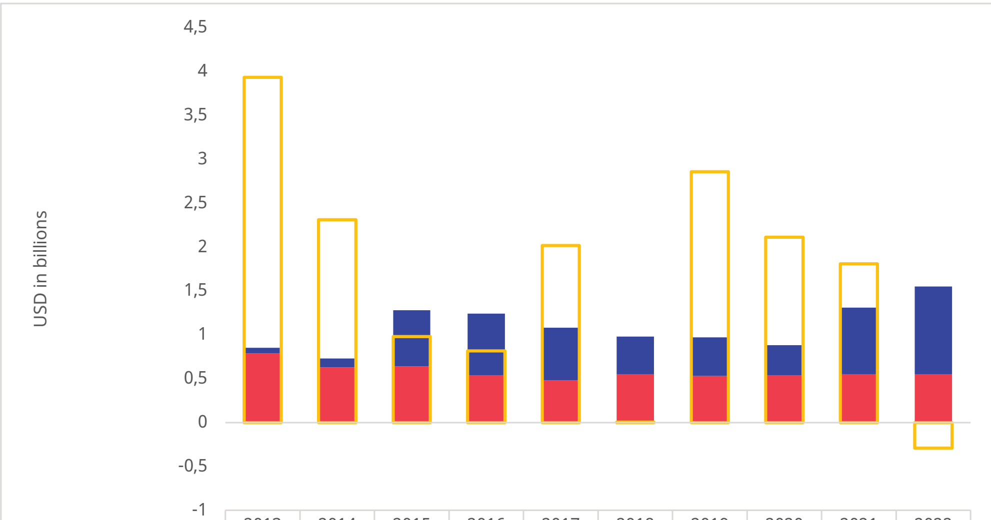
Figure 18: Evolution of the Petroleum Fund balance, nominal RoI, and real RoI, 2013-2022



Source: Petroleum Fund Annual Reports 2013-2022 and Budget Books 2013-2022

Figure 19 shows that the PF total revenue, including taxes, royalties, profits, and capital revenue, has been frequently above the withdrawals made by the government. In 2022, the total revenue was negative for the first time in 10 years. On average, every year total revenue represented US$1.7 billion, while withdrawals were of US$1.1 billion, out of which 53 per cent accounted for three per cent ESI. The government has had available an additional US$600 million every year (or 27.8 per cent of 2023 non-oil GDP) to address social development needs without reducing the PF balance in nominal terms.

Figure 19: Total revenue, ESI and Excess withdrawals from the Petroleum Fund, 2013-2022



	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Excess Withdrawals	0,06	0,1	0,64	0,7	0,6	0,43	0,44	0,34	0,76	1
ESI	0,79	0,63	0,64	0,54	0,48	0,55	0,53	0,54	0,55	0,55
Total Revenue	3,9	2,3	1,0	0,8	2,0	0,0	2,9	2,1	1,8	-0,3

Source: Petroleum Fund Annual Reports 2013-2022 and Budget Books 2013-2022

Foreign exchange reserves (FERs) are foreign private or public securities, foreign currencies, and other assets in foreign currencies, such as derivatives or equity futures, that central banks accumulate through export earnings, remittances, borrowings, and foreign aid (*Ortiz et al, 2019*). The IMF (*1993*) defines FERs as "assets that are readily available to and controlled by monetary authorities for direct financing of external payment imbalances and to intervene in the exchange markets." A Central Bank uses these assets to finance balance of payments deficits and intervene in the FOREX (Foreign Exchange) markets, normally following exchange rate and low inflation targets, and to counteract sudden and large capital inflows and outflows (*Akyuz, 2014*).

Central Banks need to keep FERs to implement their policy mandates. For example, defending a certain exchange rate target or meeting external debt obligations requires keeping some level of FERs. However, this doesn't apply to Timor-Leste as the country does not have an independent monetary policy.

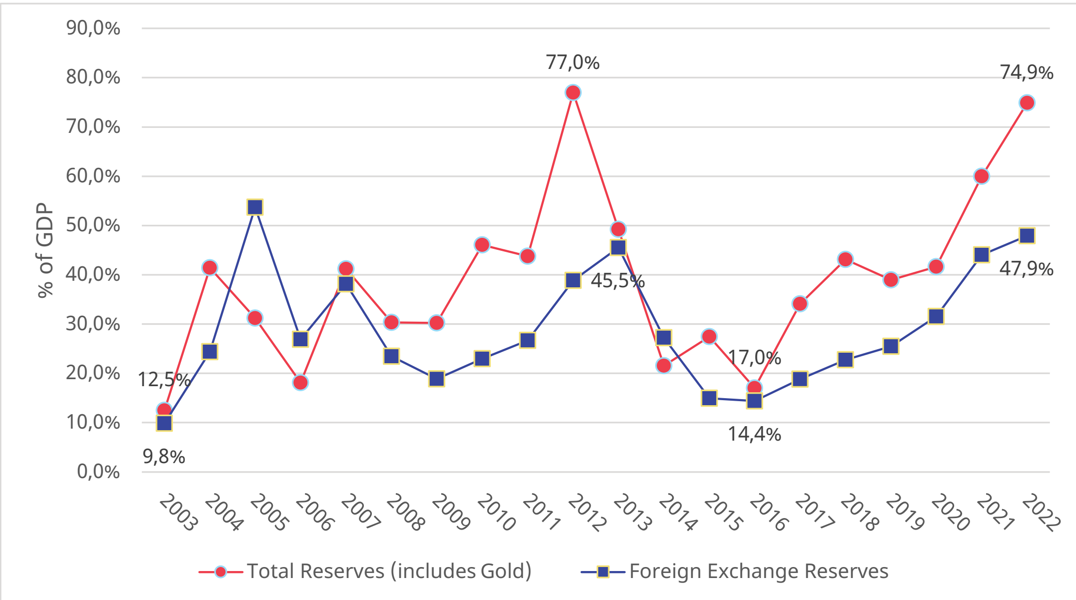
Central Banks also hold foreign assets to generate financial gains through investments. FERs are typically invested in low return, highly liquid assets, like US Treasury Bills, when they could finance social investments through better yielding, though still safe, financial instruments. Indeed, it is argued that keeping reserves has a social and opportunity cost (Rodrik, 2006) as they could finance current development needs or be used as a collateral against loans.

Timor-Leste's Central Bank still holds FERs for protection against liquidity losses. It uses reserves to limit the country's vulnerability against natural disasters, but also to mitigate the risk of a liquidity crisis. Because the country cannot issue US dollars, it needs to ensure a sufficient flow into the economy to facilitate daily transactions and to reduce its credit risk, so that lenders do not overcharge debt premiums anticipating a future default.

The country might be accumulating FERs in excess at the expense of high development opportunity costs. Figure 20 shows that both total reserves, including gold, and FERs have substantially increased their share in GDP since independence. In 2003 total reserves represented 12.5 per cent of GDP and FERs 9.8 per cent, but in 2022 they amounted to 74.9 per cent and 47.9 per cent of GDP, respectively.

Despite the increase, there have been some significant variations. Total reserves and FERs reached a high of 77 per cent of GDP in 2012 and 45.5 per cent in 2013, respectively. Total reserves and FERs were their lowest in 2016 with 17 per cent of GDP and 14.4 per cent of GDP respectively.

Figure 20: Evolution of Total Reserves, including gold, and Foreign Exchange Reserves in Timor-Leste as % of the GDP, 2003-2022



Source: Timor-Leste Central Bank 2003-2022 and World Bank Databank 2003-2022

However, there is not a one-size-fits-all solution to define the adequate level of FERs and binding metrics are not straightforwardly available (*ECB, 2012; Greenspan, 1999; Moghadam, Ostry & Sheehy, 2011*). Table 17 presents a summary of the impact on fiscal space as a result of using fiscal and foreign exchange reserves based on four options depending on the criteria adopted. The Triffin criteria establishes that FERs should cover at least three months of imports (*Ortiz et al., 2019*). In the last five years, Timor-Leste reserves covered an average of 8.3 months of imports. This means that reserves were held in excess of the Triffin criteria for a value equal to 22.2 per cent of GDP. Extrapolating that for 2023, reserves with a total value of US$452.9 million could be leveraged for social protection investments.

The Greenspan-Guidotti rule proposes that reserves should equal the stock of short-term debt. If that criterion applies, Timor-Leste could have a larger portion of its FERs to allocate to social investments. On average during the last five years, Timor-Leste has kept reserves for 522 per cent of its short-term debt obligations. This means Timor-Leste held in excess reserves equivalent to 28 per cent of its non-oil GDP. If these proportions are kept in 2023, US$572.5 million could be withdrawn from the Central Bank's FER account to invest in current development needs.

Another debt-related metric, the Brown criteria, argues that reserves should allow the country to repay 40 per cent of its total foreign debt balance. On average, FERs have covered 313 per cent of Timor-Leste's total foreign debt balance during the last five years, representing an excess of reserves equal to 30.2 per cent of its non-oil GDP. This means that in 2023 the country could use up to US$617.8 million of its FERs without compromising the timely management of its debt obligations with the rest of the world.

Finally, the Machlup criteria relates to prudential macro-financial management and advocates holding reserves between 5-10 per cent of the M2 monetary supply[58] in countries with a floating exchange rate regime (*Ortiz et al., 2019*). Timor-Leste has held reserves amounting to 64.1 per cent of its M2 monetary supply on average during the last five years. This means that there is potential to obtain funding up to US$597.9 million in 2023, or 29.3 per cent of GDP, from FERs without damaging macroeconomic stability.

Table 17: Estimated impact on fiscal space from using Fiscal and Foreign Exchange Reserves in Timor-Leste, 2023

Scenario	FERs Benchmarks	Average FERs over the last 5 years (% short-term debt obligation	Reserves in excess (% of non-oil GDP)	2023 Funding estimate (US$)
33.-Triffin criteria	3 months	8.3*	22.2	452,921,719
34.-Greenspan-Guidotti rule	100%	522	28.0	572,558,979
35.-Brown criteria	40%	313	30.2	617,789,367
36.-Machlup criteria	5%-10%	64.1	29.3	597,872,907

Source: Author's calculations are based on Timor-Leste Central Bank Trade Statistics, Monetary Aggregates, a Central Bank Survey, and World Development Indicators.

Notes: (*) Months of imports

However, caution is needed before deciding how much of the FER is to be used to increase revenues as, contrary to other financing options, FERs constitute a one-off source of funding. Once the country decides to leave the levels of its reserves at some threshold related to the indicators mentioned previously, the accumulation of additional reserves that could further finance social investments will take a long time. Also, any needs related to balance of payment interventions, import dynamics, borrowing needs, and the macro-financial environment should be carefully assessed before deciding the minimum level of reserves that should be kept for the foreseeable future.

58 M2 consists of M1 plus (1) small-denomination time deposits (time deposits in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (2) balances in retail money market funds (MMFs) less IRA and Keogh balances at MMFs. M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (3) other liquid deposits, consisting of other checkable deposits (or OCDs, which comprise negotiable order of withdrawal, or an automatic transfer service, or ATS, accounts at depository institutions, share draft accounts at credit unions, and demand deposits at thrift institutions) and savings deposits (including money market deposit accounts). See at https://www.federalreserve.gov/releases/h6/current/default.htm

After considering all factors, the FERs can be allocated to social and economic investments through different mechanisms, including allocating the FERs to *Serviços e Entidades com Autonomia Financeira Alargada* (SEAFAs) by implementing new investment programmes following the budget cycle. Another option would be to use the FER as collateral to lower the cost of foreign loans financing national development projects. Timor-Leste could also target longer-term investment returns using its FERs to create a national development bank, or increase its share in regional development banks, such as the Asian Development Bank (ADB), or ASEAN specific investment funds.

2.6. Borrowing or restructuring debt

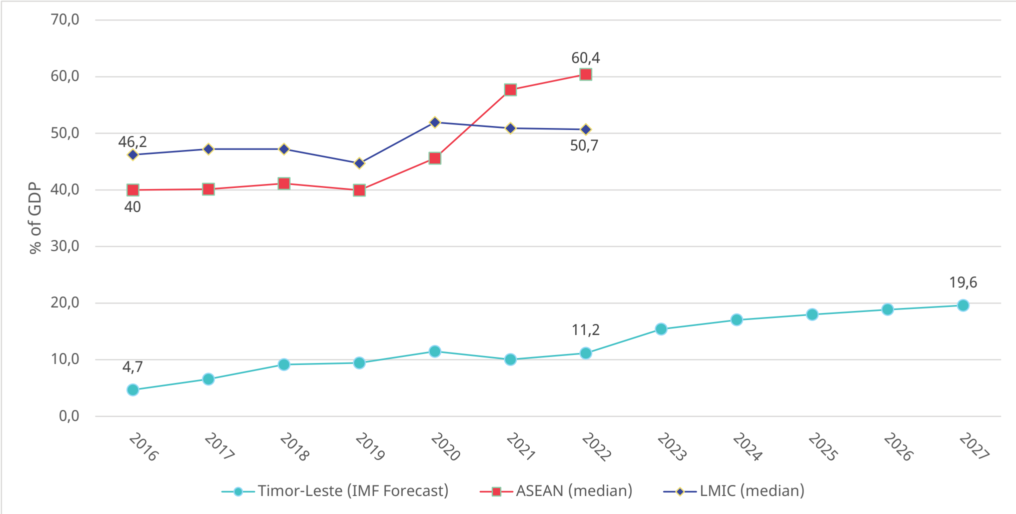
Debt management, including borrowing and restructuring debt, are important options to expand fiscal space for socio-economic investments with positive impacts on people's lives. Increasing public debt stocks can be critical, especially when the economy is not at full capacity, so public debt is unlikely to contribute to higher inflation, interest rates or current account deficits. Increasing levels of public debt does not necessarily call for future increases in taxes if the funding contributes to accelerating economic growth and the debt-to-GDP ratio shrinks over time (*Domar, 1944*). The key element to consider is that borrowing additional funds to finance quality expenditures such as cost-effective social policies and programmes have long-run positive impacts on socio-economic development.

Sustainable levels of public debt are not fixed. The IMF's 40 per cent long-term debt-to-GDP benchmark proposed as a ceiling for developing countries (*IMF, 2002*) should not be interpreted as the only criterion (*Ostry et al., 2010*). The IMF acknowledges that there is an 80 per cent probability that debt ratios over 40 per cent will not hinder macroeconomic stability nor fiscal sustainability. The sustainability of public debt is determined by multiple factors including whether the debt interest rate is below the GDP growth rate, and whether primary deficits are not structural and permanently exceed the level for which the indebtedness rate does not change over time (*Paniagua Soto and Navarro Pascual, 2010; UNCTAD, 2011*).

As shown in Figure 21, Timor-Leste has been increasing its debt-to-GDP ratio since 2012, when its first foreign loan agreement was signed. The debt-to-GDP ratio has increased from 4.7 per cent in 2016 to 11.2 per cent in 2022, and it is expected to reach 19.6 per cent by 2027. However, the level of public indebtedness in Timor-Leste has been lower than in LMIC. Between 2016 and 2022, Timor-Leste showed the lowest average debt-to-GDP ratio among LMIC (8.9 per cent), followed by the Solomon Islands (11.6 per cent) and Micronesia (18.7 per cent). ASEAN countries have accumulated large levels of public debt compared to the growth of their GDP, increasing from a median debt-to-GDP of 40 per cent to 60.4 per cent between 2016 and 2022. Excluding Brunei, Cambodia is the ASEAN country with the lowest average debt-to-GDP ratio (32 per cent), in the same period, which is approximately three and a half times higher than Timor-Leste.

Timor-Leste's current level of public debt is far below the 35 per cent debt-to-GDP ratio threshold recommended by the IMF for sustainability purposes (*IMF, 2022*). While the country's GDP growth rate has averaged 7.7 per cent between 2016 and 2022, interest rates have never reached 1.0 per cent in terms of payments over the total debt. Although this would argue in favour of the country's capacity to borrow more, this requires careful analysis as only 18.5 per cent of the national budget has been funded on average from the ESI and other non-oil regular revenues, with 57.7 per cent being funded from excess withdrawals from the PF.

Figure 21: Evolution of public debt to GDP ratio in Timor-Leste (2016-2027), ASEAN and LMIC (2016-2022)



Source: IMF Economic Outlook October 2022
Note: 2023 onwards is forecasted

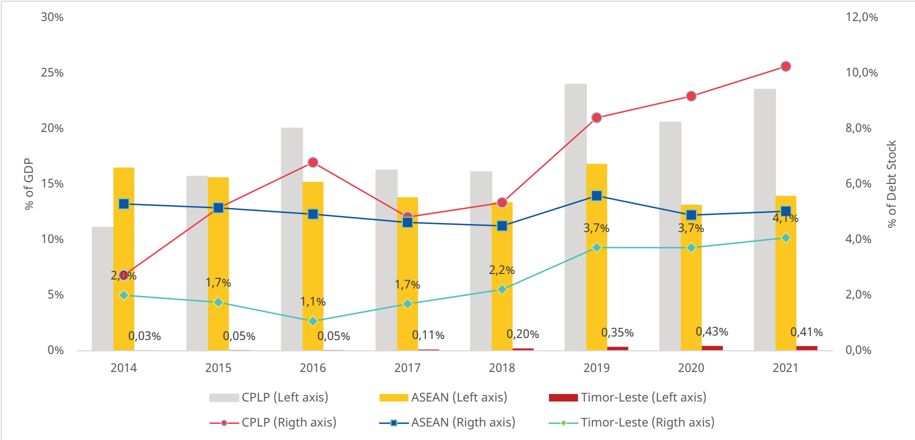
In Timor-Leste, the debt service hasn't brought an excessive burden on the economy despite the upward trend (Figure 22). The country's debt service increased from 0.03 per cent of GDP in 2014 to 0.41 per cent of GDP in 2021, significantly better than its regional and development peers. In CPLP countries, debt service as a percentage of GDP increased from 11 per cent in 2014 to 24 per cent in 2021. In ASEAN countries, debt service represented 14 per cent of the GDP in 2021 despite the downward trend.

A similar conclusion can be drawn if looking at the relative cost of the debt, as measured by the percentage that the debt service represents over the debt stock. Despite the rising trend, Timor-Leste presents a lower debt service ratio over the debt stock than the CPLP and the ASEAN. The ratio grew from two per cent in 2014 to 4.1 per cent in 2021, while over the same period in the CPLP it increased from 2.7 per cent to 10.2 per cent. In ASEAN, the relative cost of debt was stable at around five per cent for the 2014-2021 period. Timor-Leste FER can well cover the cost of its debt, keeping the spectre of default away.

However, in the global context, the interest rate hikes of the past two years aimed at slowing down inflation have substantially increased the cost of debt servicing and securing new debt. Public debt bills will likely continue to be very sensitive to further interest rate hikes, and remain high for longer around the world,[59] while governments divert more tax revenue to pay off their debt.

59 The Economist Briefing "Markets think interest rates could stay high for a decade or more:" https://www.economist.com/briefing/2023/11/02/markets-think-interest-rates-could-stay-high-for-a-decade-or-more

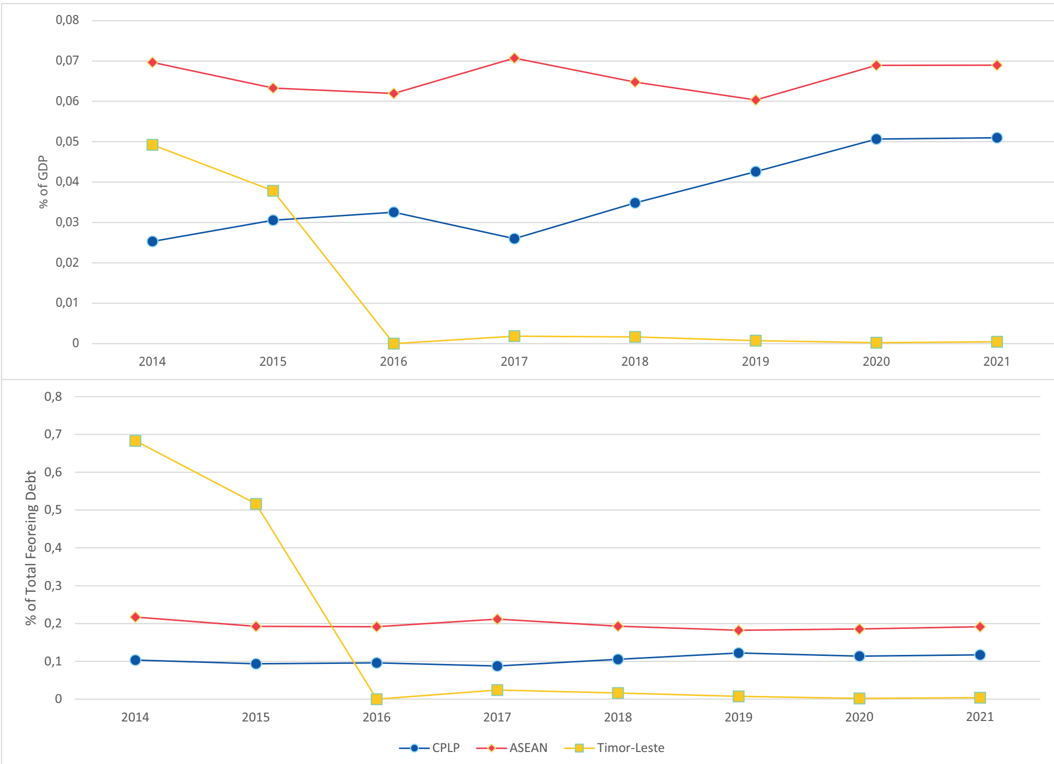
Figure 22: Evolution of public debt service as % of non-oil GDP and % of Foreign Debt Stock in Timor-Leste, CPLP and ASEAN countries, 2014-2021



Source: World Bank Databank and IMF Economic Outlook October 2022
Note: CPLP does not include Portugal. ASEAN does not include Singapore, Malaysia, nor Brunei Darussalam

Despite the global trends, Timor-Leste is far from a liquidity or suspension of service crisis given its foreign short-term debt accumulation as shown in Figure 23 below. Either measured by short-term debt obligations as a percentage of GDP or as a percentage of total foreign debt, it has represented a small share (under two per cent) since 2016. CPLP foreign short-term debt has been relatively stable at around 10-12 per cent of the total foreign debt in the 2014-2021 period, although its weight over GDP has increased from 2.5 per cent to 5.1 per cent in the same period. ASEAN's short-term debt is a higher proportion of GDP at seven per cent, and 20 per cent of foreign debt.

Figure 23: Evolution of short-term debt as a percentage of GDP (top) and of Foreign Debt Stock (bottom) in Timor-Leste, CPLP, and ASEAN, 2014-2021



Source: World Bank Databank and IMF Economic Outlook October 2022
Note: CPLP does not include Portugal. ASEAN does not include Singapore, Malaysia and Brunei Darussalam

The government of Timor-Leste still has space for using additional public debt to finance social development needs. Table 18 presents two scenarios for the debt-to-GDP ratio. First, if Timor-Leste follows the IMF (2023) forecast, the debt-to-GDP ratio would be 19.6 per cent by 2027 and the country would have an average additional funding of US$49.5 million each year between 2023 and 2027, or the equivalent to 2.1 per cent of GDP. Second, considering the IMF's debt sustainability analysis threshold for Timor-Leste is at 35 per cent for the present value of public debt-to-GDP ratio, the country could borrow an additional US$131.5 million per year on average, corresponding to 5.6 per cent of its GDP.[60]

Table 18: Impact on fiscal space from restructuring debt in Timor-leste

Scenario	Average Annual Additional Funding (US$) (2023-2027)	Additional Funding as % of non-oil GDP
37.- Debt-to-GDP ratio of 19.6% by 2027 as per the IMF forecast	49,458,294	2.1
38.- Debt-to-GDP ratio of 35% as per IMF benchmark	131,459,670	5.6

Source: Author's calculations based on World Bank Databank and IMF Economic Outlook October 2022

Timor-Leste would need to mobilize different sources of financing if it were to borrow between 2.1 per cent and 5.6 per cent of its GDP annually. Different options could be explored, although international commercial loans should be seen as a last resource due to their very high fees and interest rates when compared to other options. Usually, commercial loans are only contracted in crisis or emergency situations that require an immediate response.

One of the best options would be concessional loans, which can be requested from development multilateral banks such as the World Bank, and the ADB, or specialized funds such as the Organization of the Petroleum Exporting Countries (OPEC) Fund for International Development, or the Arab Fund for Economic and Social Development, and bilateral loans from donor countries. Concessional loans typically carry very low interest rates, long grace periods of up to 10 years, and very long repayment periods of up to 40 years (*Ortiz et al, 2019*).

Under such conditions and considering its debt carrying capacity as presented above, Timor-Leste could consider borrowing over the next five years an annual average of between US$49.5 and US$131.5 million without compromising its debt capacity or affecting its economy. This would allow the capital repayments, which is the bulk of the debt service under concessional borrowing, to be delayed up to 10 years. Allocating additional funding to high-return human development and job creating investments including social protection, active labour market policies, and private sector development programmes, would ensure that in ten years the government would have recovered the bulk of the capital, and be able to repay the principal without resorting to other revenue streams. In addition, the RoI of the PF was 4.33 per cent from its inception until March 2022, while concessional loans in Timor-Leste cost 1.57 per cent annually.[61] This means that annual interest payments could be financed with PF returns, thereby avoiding decapitalization of the fund through withdrawals, which would also be cheaper than using PF withdrawals, while ensuring sustainability.

Another option would be the issuance of medium- and long-term government securities and bonds. This would require addressing the country's key challenges before leveraging this type of financing. Also, the lack of an independent monetary policy in Timor-Leste increases the credit and liquidity risks associated with government bonds because the US Federal Reserve sets official interest rates, and the government would need to keep enough US dollar reserves to comply with its bonds obligations. In addition, the Timor-Leste Central Bank would need to increase its internal staff capacity to issue bonds and manage the government's securities policy. In addition, there is neither a structured domestic market to purchase government issuances nor the national private sector with the purchasing capacity/ savings to provide financing at scale.

60 "Timor-Leste's debt carrying capacity is assessed as weak according to the Composite Indicator index of 2.69, which is calculated based on the April 2022 World Economic Outlook and the 2020 Country Policy and Institutional Assessment. The Composite Indicator is based on a weighted average of the country's real GDP growth, remittances, international reserves, world growth, and the Country Policy and Institutional Assessment score. Accordingly, debt sustainability analysis thresholds applicable for Timor-Leste are: 30 per cent for the present value of external debt-to-GDP ratio, 140 per cent for the present value of external debt-to-exports ratio, ten per cent for the external debt service to-exports ratio, 14 per cent for the external debt service-to-revenue ratio, and 35 per cent for the present value of public debt-to-GDP ratio." See at IMF Country Report No. 22/307 https://www.elibrary.imf.org/view/journals/002/2022/307/002.2022.issue-307-en.xml?rskey=Ck0L5B&result=3

61 Timor-Leste's Government states that concessional loans have a cost of 1.57% per year in http://timor-leste.gov.tl/?p=30897&lang=en&n=1

While the financial cost for the Government of Timor-Leste is uncertain in terms of securities and bonds issuances, this type of financing would also be more expensive than concessional loans. Table 19 shows that in the context of ASEAN countries, bond yields range between a minimum of 2.1 per cent for Thailand's one-year to maturity securities, and 7.2 per cent for Indonesia's 30-years to maturity securities.[62] The large amount of FER, mainly in US dollars, held by the Timor-Leste Central Bank and PF could be used as collateral to lower the financial costs of its public bonds. Issuing bonds in US dollars would also have other advantages including reducing financial costs by eliminating lenders' exchange rate risk. Further research is required to assess how different factors – credit risk, liquidity risk, foreign exchange risk, market features, among others – would impact the total financing that Timorese's bonds could leverage and their financial cost.

Table 19: Bond yields in ASEAN countries

Maturity / Yield	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
1 month or less	4.6	2.8	4.2	4	N/A	N/A
1 year	6.3	3.2	5.6	3.9	2.1	4
5 year	6.6	3.7	6.2	3.3	2.2	4.1
10 year	7.1	4.1	6.6	3.4	2.5	4.5
20-30 year	7.2	4.5	6.9	2.8	3.1	5.1

Source: https://www.investing.com/rates-bonds/asian-pacific-government-bonds consulted on 07 of March, 2023

Social Impact Bonds can be analysed as another interesting debt option for Timor-Leste (*Ortiz et al., 2017; de la Pena, 2014; Gustafsson-Wright et al., 2015*), considering that investors can fund a programme upfront and get paid a return based on achieving outcome targets by a defined date. If the service provider does not meet the targets, the government does not incur any financial loss. Such approach has been a financing option for employment generation, child welfare, education, and health programmes in developed and some developing countries (*Ortiz et al., 2017; de la Pena, 2014; Gustafsson-Wright et al., 2015*).

However, it is important to note that the issuance of such bonds would require partnering with international financial or multilateral development organizations to attract enough investors. This type of approach must be analysed carefully to avoid the privatization of social programmes financed under this modality and have an independent third-party monitor and evaluate the results.

2.7. Adopting a more accommodating macroeconomic framework

An accommodative macroeconomic policy framework creates an enabling environment for exploring options such as using monetary and fiscal policies, higher levels of public borrowing, and scaling-up of aid, which will likely increase the budget or fiscal space. The adoption of a more accommodating macroeconomic policy framework implies moving away from a narrow concept of stability focused on meeting certain nominal targets for budget deficits, debt-to-GDP ratios, and inflation rates (*Growth Commission, 2005*). A more flexible macroeconomic framework can support countries to achieve multiple development goals such as economic growth, poverty eradication, employment creation, more equal societies, and a stable business cycle, without jeopardizing price stability. The IMF acknowledges that fiscal adjustments might be counterproductive to long-term sustainability and the resilience of the fiscal system to future shocks (*IMF, 2003*). Macroeconomic stability should not be misunderstood as only minimizing fiscal deficits at the expense of compromising future growth and worsening poverty (*Growth Commission, 2005*).

Loosening fiscal and monetary policy to finance quality investments on infrastructure, social protection, education, health and nutrition, which contribute to economic growth, poverty and inequality reduction, does not necessarily compromise macroeconomic stability even when nominal monetary and fiscal targets are not met. Too strict

62 Asian Pacific government bonds at https://www.investing.com/rates-bonds/asian-pacific-government-bonds consulted on 07 of March, 2023.

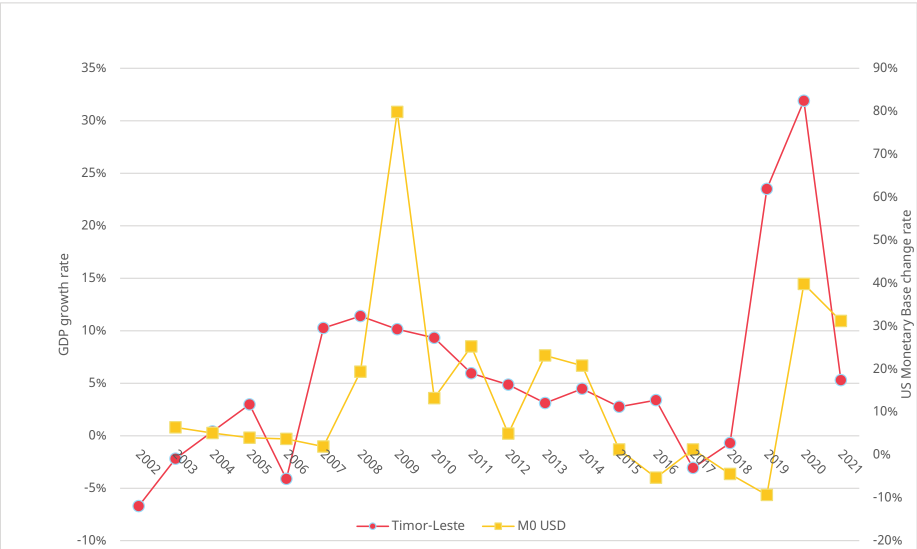
macroeconomic policies can bring more problems than benefits if they favour pro-cyclical budgets, exacerbating downturns and the impact of shocks on employment (*Ortiz et al., 2019*). For instance, strict macroeconomic policies in Timor-Leste could produce perverse effects in the context of aid management, impeding the government to use unforeseen aid windfalls, which might then result in exchange rates or inflation hikes. Indeed, the current Public Financial Management Law of Timor-Leste allows the government to increase total budget expenditure to accommodate unplanned aid flows (*LEO, art.97*).

Currently, Timor-Leste does not have a stabilization programme that has been agreed with the IMF. This type of programme can be attractive, particularly in terms of providing technical assistance and short-term financing, but it is not advisable to exchange this short-sighted aid for austerity or fiscal consolidation as it can limit the independency of the country to use fiscal and monetary policies in a way deemed best for the public. It can also create a negative socio-economic impact given Timor-Leste's current fiscal position, low debt, and abundant foreign currency reserves (*Blyth, 2013*).

Timor-Leste's adoption of the US dollar as legal tender has contributed for the macroeconomic stability, which is a condition that has facilitated economic growth. IMF (2022) pointed out at least three advantages: i) stable value by eliminating exchange rate volatility, ii) wide international use, and iii) facilitator of trade in an economy in which the export base is concentrated in a few volatile commodities, including oil and coffee, that are priced in US dollars. The Timor-Leste's economic growth has moved in tandem with the US monetary base (M0), under direct control of the US Federal Reserve (Figure 24). Between 2003 and 2021, the correlation coefficient between the US GDP growth rate and the MO change rate was -0.6, indicating that the US Federal Reserve tends to adopt a countercyclical monetary stance. To put it simply, this means that in the short-run when the US Federal Reserve (Fed) expects economic activity to slow down, it tries to improve output and employment by increasing the money supply. In general, such intervention puts pressure on interest rates and promoting growth in relevant sectors, including consumer durables. The Fed does the contrary when it perceives an escalation of inflation. In this situation, the Fed limits the growth of money, which tends to increase the interest rates.

In this context, one challenge for Timor-Leste is that its business cycle does not align with the US business cycle, as indicated by a correlation coefficient of -0.54. Consequently, the Federal Reserve's efforts to influence interest rates for the purpose of impacting economic activity and inflation may, in practice, yield the opposite effect on the Timor-Leste economy. The utilization of the US dollar presents certain disadvantages, notably the absence of monetary policy as a tool for macroeconomic stability, the foregone seigniorage revenue resulting from the monopoly power to print money, and the inability to employ exchange rate policy to alleviate the adverse effects of external shocks, such as the recent rise in food prices. This limitation hinders the adjustment of the real exchange rate and the restoration of external equilibrium without inducing domestic deflation (*IMF, 2022*).

Figure 24: Evolution of the Timor-Leste GDP growth rate and US Monetary Base change rate, 2002-2022

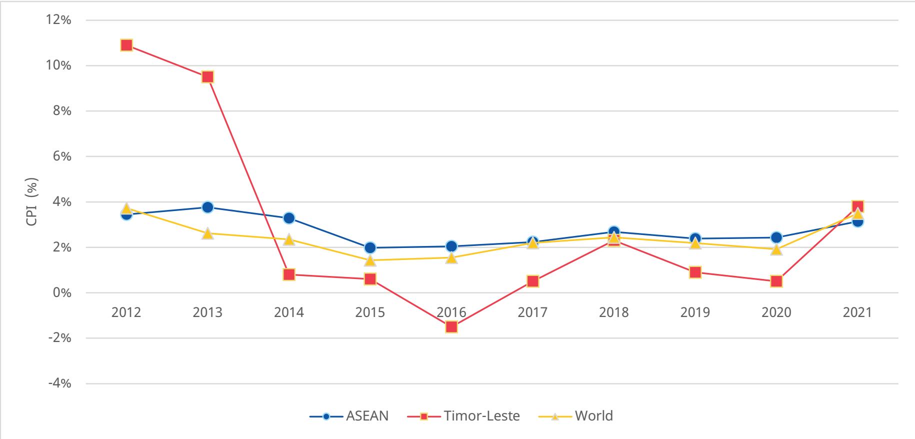


Source: FRED economic data, and World Bank Databank

There are many studies assessing the threshold beyond which inflation negatively impacts economic growth (*Ortiz et al. 2017*). Most of the studies set that threshold between 10 per cent and 15 per cent. Figure 25 shows that Timor-Leste has been mostly below the ten per cent threshold, except for 2012 (10.9 per cent). Deflation occurred in 2016 (-1.5 per cent), but for most of the analysis period, Timor-Leste experienced lower inflation than other ASEAN countries and the world, except for 2012 and 2013. Since 2021 under an increasing inflationary environment due to the rebound in world oil price,. Timor-Leste's inflation rate moved up to 8.7 per cent in 2023, surpassing the ASEAN (7.7 per cent) and World (8.0 per cent) averages.

While the 10-15 per cent threshold is a rough guide, country specific conditions need to be considered before adopting a monetary stance that is more accommodative to development needs and economic growth. In Timor-Leste, wages, and social benefits, as well as other sources of income are not indexed to inflation and, hence, even moderate price increases can cause social havoc if they are not followed by large increases in employment levels (*Ortiz et al., 2019*). Also, the government cannot directly and effectively adopt a more accommodating monetary stance in the absence of independent monetary policy.

Figure 25: Evolution of inflation measured by Consumer Price Index (CPI) variation in Timor-Leste, the ASEAN, and the World, 2012-2021



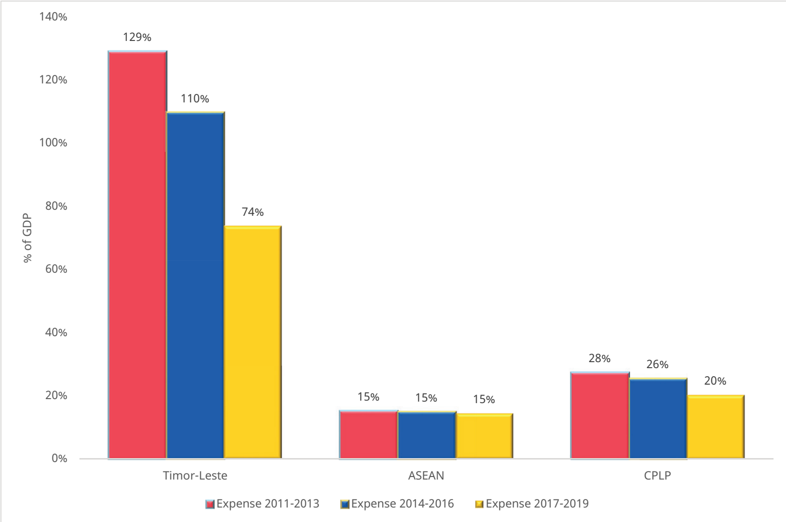
Source: Timor-Leste Ministry of Finance, National Institute of Statistics, I.P, World Bank Databank, and IMF World Economic Outlook

Timor-Leste's options to develop a more accommodative macroeconomic framework are limited by its fiscal policy. An expansionary fiscal policy that focuses on infrastructure and human capital investments, like social protection and employment programmes, can have positive impacts on poverty reduction and employment-friendly economic growth. Nevertheless, the impact of expansionary fiscal policies on the economy and people's lives needs to be backed up by good governance and strong institutions, which ensure the quality of the expenditure. Large fiscal deficits not directed to strengthening productivity and stimulating economic growth can put public finances under stress and compromise future macroeconomic stability and the availability of funding for future generations.

The public expenditure level has been very high in Timor-Leste over the last decade (Figure 26), at 100 per cent of non-oil GDP between 2011 and 2016. Since then, it has fluctuated significantly. Public spending was reduced to an average of 74 per cent of non-oil GDP between 2017 and 2019, although it remains very high by international standards. High levels of public spending reflect structural economic weaknesses, including large capital outflows and high import-dependency, that generate leakages and result in a low fiscal multiplier (*IMF, 2022*). Scaling up of spending was largely allowed by petroleum revenues, but regional comparisons indicate that some countries have been able to improve average incomes with lower levels of spending. ASEAN countries spent 15 per cent of their GDP on public expenditure between 2017 and 2019, while the public expenditure of CPLP countries was slightly higher than the ASEAN countries at 20 per cent during the same period.

While the low returns of government spending on overall growth reveals inefficiencies, expenditure on public spending shouldn't be drastically reduced in the short-term. Instead, an analysis of how budgetary resources can be reallocated to programmes that support GDP growth, human capital accumulation, social protection and employment generation should be a priority.

Figure 26: Public expenditure (% GDP) in Timor-Leste, ASEAN, and CPLP, 2011-2019



Source: World Bank Databank, Timor-Leste Ministry of Finance, and IMF Government Finance Statistics

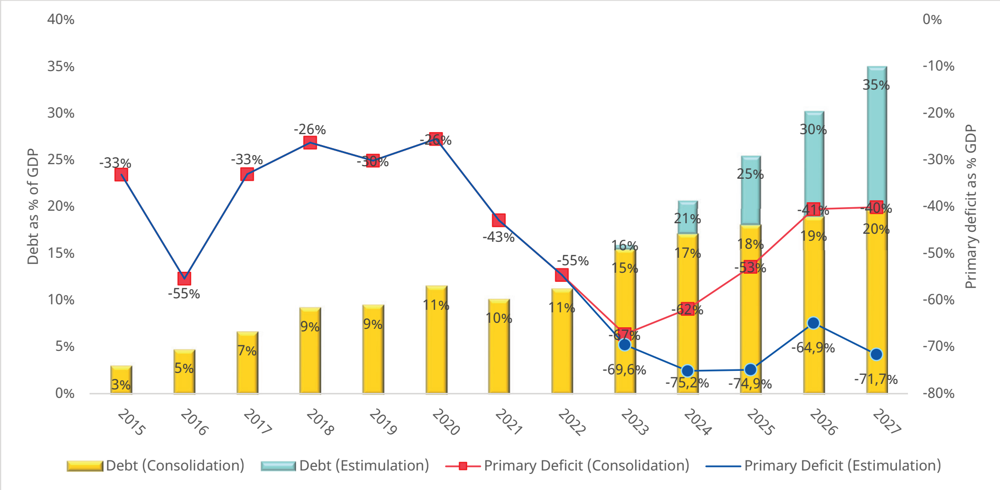
Note: Data is not available for Brunei nor Vietnam in the ASEAN and only partial data is available for Mozambique, Cape Verde, Guinea-Bissau, and Sao Tome e Principe

The high levels of public spending in Timor-Leste have not resulted in excessive debt (Figure 27). Between 2015 and 2021 debt increased from 2.9 per cent to 10 per cent of GDP, despite incurring large primary deficits over the period (averaging -35.2 per cent of GDP). The IMF forecasts primary deficits to reach a peak of -67.4 per cent of GDP in 2023, after which the IMF recommends progressive fiscal consolidation reform to bring the primary deficit back to -40.1 per cent by 2027. This would result in debt reaching 19.6 per cent of GDP by 2027, which is below the 35 per cent threshold recommended by the IMF as being compatible with macroeconomic stability and sustainable growth. Following the IMF threshold, Timor-Leste has the space to increase its primary deficit to 69.6 per cent in 2023, 75.2 per cent in 2024, 74.9 per cent in 2025, 64.9 per cent in 2026, and 71.7 per cent in 2027.

While increasing the primary deficit can be seen as an option under the country's macroeconomic policy space and strategy, its financing should come from borrowing additional debt until the marginal cost of withdrawing from the PF equals the marginal cost of borrowing. Only when that equilibrium is reached, could the government consider withdrawing from the PF beyond the ESI. Additionally, if primary deficits are invested in high-return infrastructure and human capital investments, the macroeconomic stability would be at less risk and growth would be promoted, employment would be improved and poverty would be reduced, as well as the sustainability of the fiscal system and the service of debt ensured. For instance, the additional fiscal space could increase the investment on social protection by 42.7 per cent, on health by 140.3 per cent, or on education by 93.8 per cent, if the 2023 budget allocation was considered.

In addition, fiscal expansionary policy should be combined with a more active management of capital flows in order to strengthen the quality of public spending, raise Timor-Leste's fiscal multiplier, and avoid leakages (Ostry et al., 2011). If the government would introduce a two per cent tax over remittances abroad to disincentivize the repatriation of profits and other capital outflows, it would be able to collect an additional revenue of 1.84 per cent of GDP. This is apart from increasing the capacity of the Central Bank to influence credit allocation to social sectors and the capacity of the government to borrow without being affected by pressure from financial speculators.

Figure 27: Public debt and primary deficit as % GDP in Timor-Leste, 2015-2027



Source: IMF Economic Outlook October 2022, IMF Fiscal Monitor October 2023, and author calculations
Note: 2023 onwards is forecasted

2.8. Increasing aid and transfers

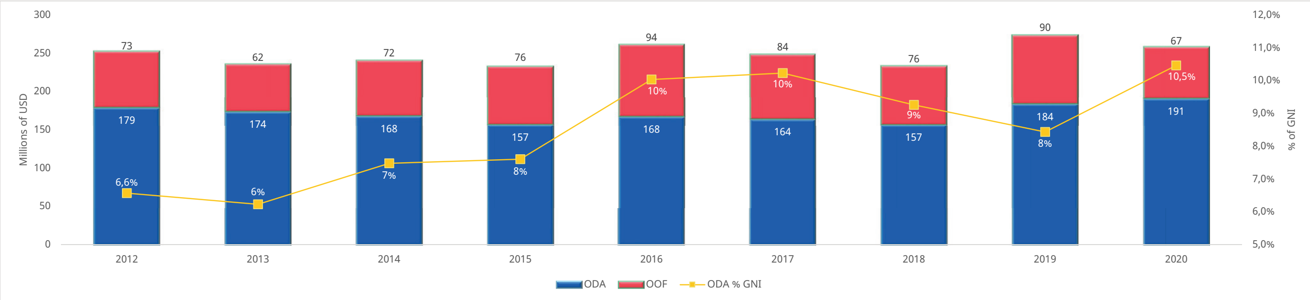
Foreign financial aid in the form of ODA is an important source of funding to build fiscal space, especially in the Least Developed Countries (LDCs) or Low-Income Countries (LICs). ODA is a tool for North-South funding, which has been gradually complemented by South-South transfers, allowing a broader range of financial sources and development cooperation partnerships for developing countries.

The variety of ODA instruments has increased over time and has left behind the narrow understanding of North-South ODA grants to embrace South-South transfers, concessional loans, debt relief for poverty initiatives, and include triangular cooperation schemes. But the availability of funding has become more limited and uncertain under the current global fiscal consolidation context and emergencies in many countries around the world.

Figure 28 shows the ODA and Other Official Flows (OOFs) received by Timor-Leste between 2012 and 2020. The total amount of ODA and OOFs has increased very little from US$253 million in 2012 to US$258 million in 2020, although it has improved significantly as a share of Gross National Income (GNI) from 6.6 per cent to 10.5 per cent in the same period. The latter can be partially explained by the decline in GNI that has followed the fall in income from oil and gas exploitation. Aid flows are also usually affected by their volatility and lack of predictability, but in Timor-Leste the ODA has not been very volatile during the analysis period (Sd US$11 million, CoV 6.4 per cent) compared to OOFs (Sd US$9.8 million, CoV 12.6 per cent). Importantly, OOFs represent around 31 per cent of total inflows. Regarding the lack of predictability, the EU committed US$284.7 million in aid between 2011 and 2022, of which it disbursed 90 per cent.[63] Uncertainty regarding EU aid flows led the government to plan for only US$170.9 million in disbursements, 33.1 per cent less of what was actually disbursed.[64]

63 Timor-Leste Aid Transparency Portal: https://www.aidtransparency.gov.tl/portal/
64 *Idem*

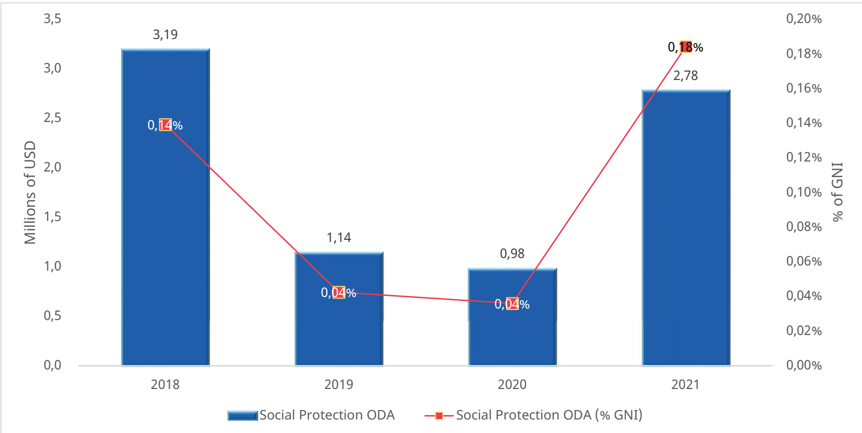
Figure 28: Evolution of received Timor-Leste Official Development Aid (ODA) and Other Official Flows (OFF), 2012-2020



Source: World Bank Data Bank, OECD Statistics 2023

The OECD Development Assistance Committee (DAC) measures ODA devoted to social protection through its CRS code 16010[65], which was reaffirmed as the right measurement for social protection ODA by the UN Inter-Agency Task Force (IATF) on Financing Social Protection Floors, led by the ILO (*Ortiz et al., 2019*). In Timor-Leste, between 2018 and 2021, the disbursed ODA for social protection averaged US$1.64 million (or an average of 0.1 per cent of GNI) (Figure 29). This represents an average of 0.8 per cent of the total ODA to Timor-Leste[66] between 2018 and 2021, while the government allocated on average 15.3 per cent of the total national budget to social protection[67] in the same period.

Figure 29: Evolution Official Development Aid (ODA) for Social Protection in Timor-Leste, 2018-2021



Source: World Bank Data Bank-2023 https://data.worldbank.org/indicator/NY.GNP.PCAP.CD, OECD Statistics 2023 https://stats.oecd.org/Index.aspx?ThemeTreeId=3

Figure 30 shows the distribution of planned ODA and the General State Budget allocations in 2022 by sectors included in the SDP. Social protection is included in the social inclusion category, for which the planned ODA disbursement was US$6.7 million (or 4.2 per cent of total ODA) in 2022. Three sectors received 62.4 per cent of the total ODA planned disbursements: health (21.5 per cent), agriculture (20.9 per cent), and education and training (20.1 per cent). The broader sector of social capital – health, education and training, social inclusion, the environment, and culture and heritage – was expected to receive 47 per cent of the total ODA (or US$75 million). Economic Development was the second sector in terms of planned ODA disbursements for 2022, with 32 per cent of the total, followed by infrastructure development and the institutional sector, with ten per cent each. One per cent of the ODA goes to projects that are not defined in the SDP.

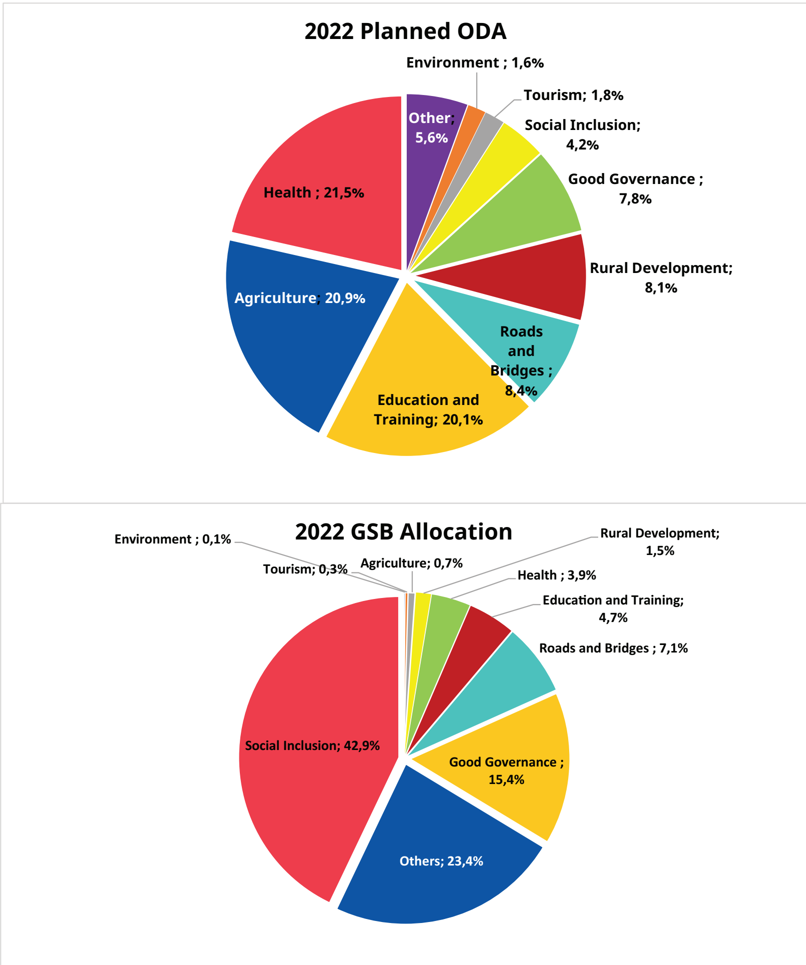
65 The OECD DAC CRS code 16010 includes ODA for the following areas: Social legislation and administration; institution capacity building and advice; social security and other social schemes; special programmes for the elderly, orphans, the disabled, street children; social dimensions of structural adjustment; unspecified social infrastructure and services, including consumer protection (source: OECD DAC)

66 OECD Statistics: https://stats.oecd.org/Index.aspx

67 Calculation based on the data available using the COFOC Classification

Comparing the 2022 ODA and 2022 General State Budget allocations, there was a lack of alignment between donors and country priorities. In the 2022 General State Budget (GSB), social inclusion was the government's first priority with 42.9 per cent of the total budget, followed by good governance (15.4 per cent) and roads and bridges (7.1 per cent). These three subsectors absorbed 65.4 per cent of the national total budget. The health sub-sector was the top priority for donors, but the fifth for the government, receiving 3.9 per cent of the national budgetary resources, or 21.5 per cent of the ODA. Agriculture was the second highest priority for donors with 20.9 per cent of the planned ODA, and the 19th highest for the government, with 0.7 per cent of budget allocations. Finally, education and training, the third priority for donors, was the fourth for the government, receiving 20.1 per cent of the ODA, but only 4.7 per cent of the budget. Among the SDP sectors, social capital was also the first funding priority for the government, with 51.8 per cent of the budget, but economic development was the second largest ODA recipient, while ranked at the bottom in terms of budget allocation, with only 7.7 per cent.

Figure 30: Distribution of planned ODA and GSB allocations by sectors of the Timor-Leste Strategic Development Plan 2011-2030, 2022

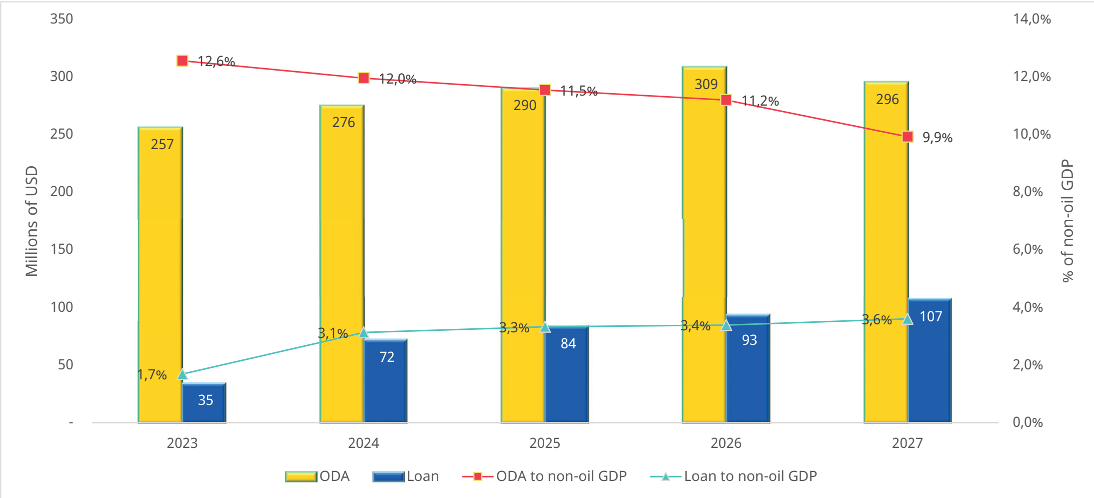


Source: Pre-Budget Statement 2022 and Dalan Ba Futuro

According to IMF estimates on future ODA flows, including grants, concessional loans, and debt relief, the prospects for Timor-Leste are positive. It is expected that ODA flows will rise from US$257 million in 2023 to US$309 million in 2026, followed by a slight decline to US$296 million in 2027. Following the IMF's assumption that new loans would have a grant component of 40.5 per cent over the same period of time, and under the scenario that Timor-Leste would reach a 35 per cent debt-to-GDP ratio by 2027, loans disbursements would steadily increase from US$35 to US$107 million over the same period. As the Timorese economy develops, ODA flows would tend to decline as a percentage of non-oil GDP, which is estimated to decrease from 12.6 per cent to 9.9 per cent, while loan disbursements would tend to increase from 1.7 per cent to 3.6 per cent between 2023 and 2027 (Figure 31).

In this context, it is important for Timor-Leste that ODA can be predictable, less discretional, and less volatile, and require donors to adopt longer term commitments and adapt to the country's programmable aid. At the same time, the Government of Timor-Leste would need to make efforts to increase transparency in its management of aid, strengthen good governance, and build institutional capacity with a qualified labour force across all sectors.

Figure 31: Forecasted ODA flows and loans received by Timor-Leste, 2023-2027



Source: IMF 2022 Article IV and IMF World Economic Outlook October 2022

Finally, it is important to highlight that Timor-Leste can explore non-traditional modalities of ODA as a strategy to increase its fiscal space. South-South transfers were on the rise before the Covid-19 pandemic up to the point that they represented 8.4 per cent of total global development cooperation (*OECD, 2014c*). Brazil and Angola, with which Timor-Leste shares some ties, are potential partners with whom Timor-Leste could reinforce cooperation, explore opportunities for additional grants, credit lines, and technical assistance. Moreover, as an observer of ASEAN, Timor-Leste can discuss new modalities of finance and cooperation in its future membership status, and collaboration with countries like Thailand, Vietnam, and the Philippines. These countries are among the ten more active partners in triangular cooperation schemes, a non-traditional development cooperation modality that involves northern donor financing programmes and projects that are implemented by southern countries. Portugal and the UN are also active in triangular cooperation and have traditionally been partners with whom Timor-Leste could leverage cooperation. Triangular cooperation can be especially attractive to build capacities in the social protection, health, and education sectors. For instance, Timor-Leste is currently benefitting from ACTION Portugal to strengthen its social protection systems. The project is triangular as South-South activities among CPLP and Timor-Leste countries take place and are financed by the Portuguese Ministry of Labour, Solidarity and Social Security, as well as implementation by the ILO Timor-Leste.[68]

68 For further information on triangular cooperation and good practices see https://www.ilo.org/pardev/south-south/lang--en/index.htm

3. Social dialogue for fiscal space options

Previous sections have demonstrated that there is capacity to generate national revenue and finance socio-economic development in Timor-Leste. All the options presented earlier should be carefully further analysed, including the analyses of any potential risks and trade-offs related to each option, in a participatory and open way with all stakeholders involved to ensure transparency and national ownership.

National social dialogue, with the government, employers, and workers, as well as civil society, UN agencies and others, is vital to ensure the political will to look at all the optimal fiscal space options in terms of public policies for social protection and jobs. The public policies must agree with national social dialogue because these policies have a significant impact on individuals and families' lives.

The ILO has a comprehensive working definition of social dialogue that reflects the practices and experiences of different countries which includes "all types of negotiation, consultation or simply exchanges of information between, or among, representatives of governments, employers and workers, on issues of common interest relating to economic and social policy".[69] The national dialogue can be a tripartite process with the government as the official partner to the dialogue or it can be a bipartite process between workers and employer organizations, in which the government may or may not be involved. Regardless of the approach, social dialogue aims to achieve consensus in a democratic manner among the main stakeholders, which has proven to be an effective tool for solving collective challenges and realizing development outcomes.

The ILO and UN agencies working as One-UN developed a methodology called the Assessment-based National Dialogue (ABND) to enable national dialogue on social protection policy grounded in a multipartite discussion that involves all stakeholders in the social protection in a national context (*ILO, 2017a*). The ABND methodology is linked to the Social Protection Floor Recommendation No. 202 mandate, and the SDG 1.3, as has been used in many countries.

In Timor-Leste, between 2016 and 2018, several institutions, including government agencies, social partners, and UN agencies, worked together through the participatory ABND methodology. The initiative was led by the MSS with technical assistance from the UN through the ILO ACTION Portugal project, which was a participatory process for analysing the social protection context and supporting the development of Timor-Leste's first NSSP. It was used to identify policy gaps and operational issues, develop recommendations to extend the social protection floor to all citizens, and estimate the cost of proposed reforms.

The ABND process followed a five-step methodology based on working groups, which included Specialized Technical Groups (STGs), a Document Drafting Committee, an Extended Consultation Group, and a Decisions Committee. The ABND included more than 50 bilateral meetings to collect information and exchange knowledge, 20 STG meetings, and three workshops for all actors participating in the process. The concluding workshop was held on March 22, 2018.

Figure 32 presents a summary of the ABND methodology used in Timor-Leste. The process started with a Vulnerability Assessment, which analysed national data on poverty and vulnerability, and produced a diagnosis of the country's social protection situation.

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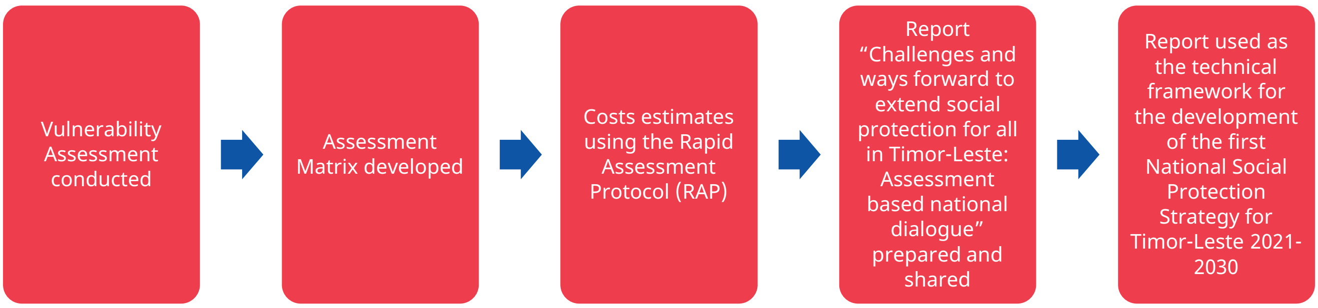
69 ILO Social Dialogue at https://www.ilo.org/ifpdial/areas-of-work/social-dialogue/lang--en/index.htm)%20%20a#:~:text=What%20is%20Social%20Dialogue,to%20economic%20and%20social%20policy.

In the second step, an Assessment Matrix framework was developed based on the four Social Protection Floor guarantees, which looked at the existing social protection system, and identified gaps in policy design, issues in programme implementation, and provided recommendations on how to advance social protection in the country. In total, 24 programmes from six government institutions were identified and analysed within the national social protection system.

The third step estimated the costs of the recommendations by using the Rapid Assessment Protocol (RAP), which is a tool developed by the ILO to estimate the costs of social protection provisions, and projecting them over a 15-year period. In total, the cost estimates of 64 reforms were developed with an additional microsimulation exercise to estimate the potential poverty reduction impacts of each recommendation. The cost estimates aim to support government budget discussions, the availability of fiscal space, and to help prioritize social protection policy options and recommendations.

The results of these steps were then organized and structured in a report, which was shared among the stakeholders. The report, "Challenges and Ways Forward to Extend Social protection for All in Timor-Leste: An Assessment based national dialogue," was launched in 2018 (UN, ILO and MSS, 2018).[70] The report served as a source of information and provided the technical framework for the development of the first National Social Protection Strategy for Timor-Leste 2021-2030, approved in 2021.

Figure 32: Assessment-based National Dialogue (ABND) process in Timor-Leste, 2016-2018



The effective implementation, monitoring and evaluation of the NSSP 2021-2030 assumes a firm commitment from the MSSI, other government institutions with responsibility for social protection, and all implementing partners. Such commitment also requires effective mechanisms for cooperation, national dialogue, coordination and participation at all levels and all stages of the process.

The NSSP foresees the creation of a National Council for Social Protection (CNPS), which will be the inter-ministerial body responsible for political and strategic deliberation, and the establishment of an Executive Secretariat for Social Protection (ESSP), which will be responsible for operational and technical aspects of the Strategy. The ES will lead the development of annual implementation plans, including timing, coordination of different activities, mobilization of resources, monitoring implemented actions, and regular evaluation of results. In addition, it is important that development partners, civil society and social partners are represented in both structures to contribute to transparency, accountability, and effectiveness in addressing collective challenges, while facilitating constructive interaction that can lead to social consensus and commitment among stakeholders.

As a follow-up to the financial assessment conducted during the ABND process, the cost estimate for the policy reforms approved under the NSSP 2021-2030 was updated by the ILO in 2023, and will be included in the forthcoming NSSP Annual Implementation Plan 2024-2025. This costing exercise can provide a good basis for national dialogue by policy makers in Timor-Leste about the affordability of social protection policies. This can also support discussions on fiscal space, inform government on the need for budget reallocations and assist in the prioritization of social protection policy options.

To reinforce capacity in this area, the ILO conducted two days of participatory workshops on "Updating the Cost Estimates of the NSSP 2021-2030 through the ILO RAP" on the 22nd and 23rd of August 2023. The training seminar aimed at strengthening technical capacity of participants in understanding, applying, and analysing the RAP, with a

70 See at https://www.ilo.org/jakarta/whatwedo/publications/WCMS_638103/lang--en/index.htm

focus on updating estimates and projections of costs, and a number of beneficiaries resulting from changes introduced since the approval of the ENPS in Timor-Leste. This training was delivered to 13 participants from the MSSI, INSS, Ministry of Education, Youth and Sports (MEJD), Ministry of Health (MS) and National Institute of Statistics (INE).

Successful social dialogue structures and processes have great potential to find solutions for economic and social development challenges, as well as promote good governance, peace, and stability. For social dialogue to continue, the following conditions are required:[71]

- Strong, independent worker and employer organizations with the technical capacity and access to relevant information to participate in social dialogue;
- The political will and commitment to engage in social dialogue on the part of all parties;
- Respect for the fundamental rights of freedom of association and collective bargaining; and
- Appropriate institutional support.

Therefore, the government of Timor-Leste has to strengthen the enabling environment, provide administrative support, and create strong independent institutions. The role of social partners, civil society, academics, UN agencies and other national stakeholder organizations are fundamental to educate, build capacity and create awareness related to matters of common interest, support informed national dialogue, as well as prepare all parties for collective negotiation. The involvement of all stakeholders through national dialogue in Timor-Leste can help build agreements on national development strategies and their financing sources.

71 ILO Social Dialogue: https://www.ilo.org/ifpdial/areas-of-work/social-dialogue/lang--en/index.htm

4. Summary and conclusions

This paper demonstrates that there is national capacity to expand financing of social protection, to achieve the SDGs for sustained human development, and for fulfilling the human rights of all citizens in Timor-Leste.

- **Finding fiscal space options is aligned with the policy positions and most recent debates by the UN and IFIs.** Eight financing alternatives for financing social protection were analyzed in detail in previous sections of this paper, namely: (i) expanding social security coverage and contributory revenues; (ii) increasing tax revenues; (iii) eliminating illicit financing flows; (iv) re-prioritizing public expenditures; (v) tapping into fiscal and foreign exchange reserves; (vi) managing debt: borrowing or restructuring debt; (vii) adopting a more accommodating macroeconomic framework; and (viii) increasing aid and transfers.
- **Table 20 presents a summary of the main financing options and its fiscal effects, showing the extensive variety of revenue choices.** This provides the government of Timor-Leste with a relevant list of possible resources to fund social protection and realize human rights. By exploring and carefully analyzing each of the options, in dialogue with national social partners and stakeholders, the government can mobilize significant resources for public investment in social protection and succeed in attaining a virtuous cycle of sustained growth, which will generate additional and continuing resources.
- **Expanding the collection of social security contributions is the most reliable way to finance social security coverage, and social protection.** Information on social security contributions indicate that only 28 per cent of total social protection expenditures were covered by social security contributions in 2023. This low level shows that there is room for extending social security coverage, and increasing the collection of social contributions, connected to policies on formalization of the highly informal economy. Extending the effective coverage of the social security system to all employed persons, i.e., 234,300 persons engaged in paid jobs or in market-oriented activities as self-employed, would increase the current revenue from 1.9 to 2.9 per cent of non-oil GDP. An increase of the SSC rate from 10 per cent to 15 per cent could also be considered as an important long-term sustainability measure, which would increase revenue from 1.9 to 3.1 per cent of non-oil GDP. The combination of these two measures would raise revenue to 4.3 per cent of non-oil GDP. An update of the existing actuarial study with latest demographic, labour force and economic data would be necessary to produce reliable medium-term and long-term projections.
- **Regarding tax revenues, Timor-Leste has a great opportunity to shift from the current revenue model and focus on potentially new taxes**. Timor-Leste has a low tax-to-GDP ratio (7.3 per cent in 2020), which tended to be compensated with the high non-tax to GDP ratio of 116.1 per cent over the last decade. The Timorese economy has been fueled by large revenue inflows from the oil extractive industry and the royalties that the state accrued from it. With the future decrease of this type of revenues, Timor-Leste should explore options such as relying less on consumer taxes, which tend to be regressive (e.g., VATs), and expand other types of taxation on corporate profits, financial activities, personal income, property, tourism, trade, etc., without damaging employment-generating investments. These types of taxes can generate revenues that can vary between 0.04 per cent of non-oil GDP (e.g., FAT) and 2.6 per cent of non-oil GDP (e.g., CT) as shown in the table below. For instance, implementing excise-taxes on luxuries such as vehicles and harmful goods (sugar, alcohol, tobacco,) is generally used to discourage or reduce consumption patterns that pose health and other adverse risks. It is estimated a revenue of 2.2 per cent of non-oil GDP can be gained from this alternative source of financing in Timor-Leste. It is important to combine the reform of different types of tax rates with strengthening the

efficiency of tax collection methods and general compliance. This is particularly important considering tax revenue is usually the main source of funding for non-contributory social programmes targeted at those who cannot contribute to the Contributory Social Security System, particularly the poor and most vulnerable.

- **In terms of government spending, Timor-Leste can consider reprioritizing public expenditures from areas of high-cost and low-impact investments to those with greater socio-economic impacts that benefit the most vulnerable and the poorest.** For instance, reducing expenditures related to General public services and Economic affairs, as well as Defense, Public order and safety, and aligning it with regional standards can free up significant resources to finance social protection. It is estimated that adopting ASEAN or CPLP benchmarks for spending in those two areas can free significant budget amounts, respectively 16.6 per cent of non-oil GDP or 25.5 per cent of non-oil GDP.

- **Eliminating or recovering part of the illicit financing flows that evade taxation every year counts.** Annual IFF is estimated at 30 per cent of the ODA received by Timor-Leste. Policy makers should be stricter in making people and companies comply with the rules so illegal activities can be prevented by the government, and more revenues can be accumulated and channeled for social and economic development of the country. It is estimated a revenue of between 0.24 per cent to 0.30 per cent of non-oil GDP can be achieved by recovering five to 30 per cent of illicit financing flows.

- **In terms of foreign exchange reserves, the Central Bank of Timor-Leste appears to hold excess foreign exchange reserves that could be used to increase the financing of social protection.** Considering the most prudential macro-financial management criteria that advocates holding reserves between five and ten per cent of the M2 monetary supply, Timor-Leste has held reserves equivalent to an average of 64.1 per cent over the past five years. This means there is the potential to obtain funding of up to 29.3 per cent of non-oil GDP without damaging macroeconomic stability. However, caution is required before deciding how much of the foreign exchange reserves should be used to increase revenues as it is a one-off source of funding.

- **Regarding debt, there is still room for the Government of Timor-Leste to review strategies to increase payments through debt restructuring.** Timor-Leste's total debt service was 0.41 per cent of non-oil GDP in 2021, which is below the ASEAN and CPLP regional estimates of 24 per cent and 14 per cent, respectively. Timor-Leste's risk of debt distress was assessed by the IMF as "moderate" with limited space to accommodate shocks, including natural disasters, due to very small exports and revenue bases, and therefore, very high exposure to debt service payment risk, particularly without PF assets. However, it is estimated that the present value of debt will not exceed more than 25 per cent of the projected value of the PF until 2036, or close to 44 per cent by 2036 under a most extreme case scenario (i.e., primary balance shock). The debt-to-GDP ratio was 11.2 per cent in 2011 and it is expected to reach 19.6 per cent in 2027. It is estimated that the debt sustainability analysis thresholds set by IMF for Timor-Leste of 35 per cent for the present value of public debt-to-GDP ratio can generate revenue equivalent to 5.6 per cent of non-oil GDP. If that threshold is reduced to 19.6 per cent, as per the IMF 2027 forecast, additional revenue would decrease to an estimated 2.1 per cent of non-oil GDP.

- **Foreign financial aid in the form of ODA is an important source of funding to generate fiscal space, though it has become more limited under the global fiscal consolidation.** The ODA and OOFs received by Timor-Leste represented 10.5% of GNI in 2020. As the Timorese economy develops, ODA flows as a percentage of non-oil GDP are estimated to decrease from 12.6 per cent in 2023 to 9.9 per cent in 2027, according to IMF estimates on future flows. It is important for Timor-Leste that donors can adapt their development assistance to the longer-term development commitments set out by Timor-Leste and that ODA can be more predictable, as well as less discretional. In addition, it is important to combine ODA traditional with non-traditional forms, including grants, soft loans, and technical assistance, and to strengthen cooperation modalities with ASEAN and CPLP members. Triangular cooperation can be especially attractive to provide technical assistance and build capacities in social protection.

The financing alternatives presented require a participatory and open discussion with all the relevant stakeholders to ensure a good understanding of each option, its potential risks, and associated trade-offs, as well as to guarantee transparency and national ownership of the measures to be adopt. National social dialogue with the government, employers, and workers, as well as civil society and UN agencies, among others, is the best inclusive negotiating mechanism to influence or shape decision-making, and is fundamental to progress steadily towards the adoption of the best solutions for the sustainable funding of social protection.

Table 20: Options to finance social protection and estimated impact on revenues as percent of on-oil GDP in Timor-Leste, 2023

Financing options	Measures	Fiscal effects (% of non-oil GDP) Current	Reform
Expanding Social Security coverage and contributory revenues			
	Full coverage of employed persons (234,300 engaged in jobs in exchange for pay or in market-oriented activities as self-employed)	1.9	2.9
	Increase SSC rate from 10% to 15%	1.9	3.1
	Combining full coverage of employed persons with an increase in the SSC rate to 15%	1.9	4.3
Increasing tax revenues			
Personal Income Tax (PIT)	Introduction of five progressive income tax brackets of 0% for US$0 to $115; 1.0% for US$115.01 to US$500; 5% for US$500.01 to US$1,500; 10% for US$1,500.01 to US$5,000; 15% for US$ 5,000.01 and more)	1	1.8
Corporate Tax (CT)	Increase the corporate tax from 10% to 15%	1.2	2.6
Financial Transaction Tax (FTT)	Introduction of a financial transaction tax varying between 0.5% and 2.0%	0	0.5 – 1.8
Financial Activities Tax (FAT)	Introduction of a financial activities tax on banking profits and remunerations varying between 2.0% and 4.0%	0	0.04 -0.08
Property Tax (PT)	Introduction of a property/circulation tax on light (US$15/year) and heavy vehicles (US$25/year)	0	0.06
	Introduction of a progressive land tax varying between US$13.1/ha and US$196.5/ha, depending on the land size.	0	0.8
	Introduction of a residential property tax varying between US$1.0 /sqm and US$15 /sqm for urban estates depending on the square meter total. Rural estates under 155 sqm are taxed on half the lump sum of urban estates.	0	1.4
	Introduction of an alienation property tax of 5% on the final value of the transaction	0	0.1
Consumption taxes, VAT	Replace Service tax and Sales tax with a Value-Added Tax (VAT)	1.1	3
Excise duties and trade taxes	Implement an excise tax on luxuries and harmful goods (vehicles, sugar, alcohol, tobacco)	0	2.2

Financing options	Measures	Fiscal effects (% of non-oil GDP) Current	Reform
	Implement import duties	0	1.2
Innovative taxes	Introduction of a fixed lump-sum tax on airplane and boat tickets for visitors (non-residents) of US$20	0	0.1
	Introduction of a solidarity tax of US$20 levied on passengers arriving in the country	0	0.1
	Introduction of a daily fixed lump-sum tax of US$2.5 per night stay at hotels	0	0.1
Public expenditure reprioritization			
	Adopting ASEAN as the benchmark for spending 29.9% on General Public Services and 17.3% on Economic affairs	0	16.6
	Adopting CPLP as the benchmark for spending 33.9% on General Public Services and 4.9% on Economic affairs	0	25.5
	Reducing Defense and public order & safety spending to 2019 levels	0	5.3
Eliminating illicit financing flows			
	Recover 5% to 30% from illicit financing flows	0	0.24 – 0.30
Use of fiscal and foreign exchange reserves			
	Using a benchmark of 5% to 10% of fiscal and foreign exchange reserves under the prudent macro-financial management criteria	0	29.3
Debt restructuring			
	Adopting the Debt-to-GDP ratio of 19.6% as per the IMF forecast for 2027	0	2.1
	Adopting the Debt-to-GDP ratio of 35% as per the IMF's debt sustainability recommended threshold	0	5.6
Increasing aid and transfers			
	Lobbying for increased aid and transfers considering the expected decrease	12.6 (2023)	9.9 percent of GNI (2027)

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This policy paper was funded by the Federal Ministry for Economic Cooperation and Development (BMZ) of Germany under the ILO-GIZ cooperation agreement as part of the Programme “Social Protection Innovation and Learning (SPIL)” and by the Strategy and Planning Office of the Ministry of Labour, Solidarity and Social Security of Portugal under ACTION/Portugal project “ Strengthen social protection systems in the PALOP and Timor-Leste”.

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