GROWING THE NON-OIL ECONOMY

A PRIVATE SECTOR ASSESSMENT FOR TIMOR-LESTE

ASIAN DEVELOPMENT BANK

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Printed in the Philippines.

ISBN 978-92-9257-006-4 (Print), 978-92-9257-007-1 (e-ISBN)
Publication Stock No. RPT157462-2

Cataloging-In-Publication Data

Asian Development Bank.
Growing the non-oil economy: A private sector assessment for Timor-Leste.
Mandaluyong City, Philippines: Asian Development Bank, 2015.

1. Private sector. 2. Timor-Leste. I. Asian Development Bank.

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This is a Pacific Private Sector Development Initiative (PSDI) publication, with input from the Asian Development Bank's (ADB's) Timor-Leste Resident Mission. The report was prepared under the supervision of ADB's Pacific Liaison and Coordination Office in Sydney, Australia. PSDI is a regional technical assistance facility cofinanced by ADB, the Government of Australia, and the New Zealand Government. This report does not necessarily reflect the views and policies of either government.

Note: In this publication, "$" refers to United States dollars, unless otherwise stated.

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ABBREVIATIONS

ADB	Asian Development Bank
ADN	Agência de Desenvolvimento Nacional (National Development Agency)
AEI	Agência Especializada de Investimento (Specialized Investment Agency)
ANC	Autoridade Nacional de Comunicações (National Telecommunications Authority of Timor-Leste)
BCTL	Banco Central de Timor-Leste (Central Bank of Timor-Leste)
BNCTL	Banco Nacional de Comércio de Timor-Leste (National Commercial Bank of Timor-Leste)
CGD	Caixa Geral de Depósitos
CSO	community service obligation
DNSA	Direcção Nacional dos Serviços de Água (National Directorate for Water Services)
DNSB	Direcção Nacional de Saneamento Básico (National Directorate for Basic Sanitation)
DNTPSC	Direcção Nacional de Terras, Propriedades e Serviços Cadastrais (National Directorate of Land, Property and Cadastral Services)
EDTL	Electricidade de Timor-Leste (Timor-Leste Electricity)
ESI	estimated sustainable income
FDI	foreign direct investment
GDP	gross domestic product
GSP	generalized system of preferences
ha	hectare
IFC	International Finance Corporation
IMF	International Monetary Fund
INDMO	Instituto Nacional de Desenvolvimento de Mão-de-Obra (National Labor Force Development Institute)
JPDA	Joint Petroleum Development Area
Lao PDR	Lao People's Democratic Republic
MPS	Major Project Secretariat
MW	megawatt
NPC	National Procurement Commission
NPL	nonperforming loan
NQF	National Qualifications Framework

ODTI	other deposit-taking institution
PPP	public–private partnership
PSA	private sector assessment
PSDI	Pacific Private Sector Development Initiative
REER	real effective exchange rate
SDP	strategic development plan
SEAPRI	Secretária de Estado de Apoio e Promoção do Sector Privado (State Secretariat for the Support and Promotion of the Private Sector)
SEPFOPE	Secretária de Estado para a Política de Formação Profissional e Emprego (Secretariat of State for Vocational Training Policy and Employment)
SERVE	Services for Registration and Verification of Entrepreneurs
SOE	state-owned enterprise
TVET	technical and vocational education and training

FOREWORD

This private sector assessment (PSA) investigates Timor-Leste's potential to develop a vibrant economy that is sufficiently stable and diversified, and not dependent on oil revenues. To achieve this, the Government of Timor-Leste needs sound policies, effective legislation, and the stamina to implement challenging reforms across a wide range of areas, including the private sector, banking and finance, agriculture, infrastructure, and the judiciary.

The government shows promising appetite for reform, and their willingness to engage the private sector in developing alternative investment options to attract business to the country is commendable. Yet, the country also faces significant challenges in rebuilding institutions and infrastructure, and implementing good governance principles to ensure that those institutions are managed effectively for the good of all its citizens.

Timor-Leste has a wealth of untapped opportunity. Its working age population is youthful; if the government gets the mix of education, training, good business practices, strategic investment, and progressive policy development right in the early stages, there is plenty of scope for the country to further develop and become a true player in the region.

The government needs to continue its commitment to working closely with the private sector to design and deliver workable, long-term solutions. These include making the country a more attractive, easier place in which to invest and do business; developing undersold sections of the economy, such as tourism; and focusing on developing a diverse range of marketable products and services beyond the oil economy. There is plenty to do; this PSA offers a systematic way to approach areas for improvement which have most potential benefit, and recommends areas on which to focus reform efforts.

The Asian Development Bank (ADB) has been working closely alongside the Government of Timor-Leste to deliver positive development outcomes for the country and its people. I wish to thank the government, individual ministries, and institutions for supporting and contributing to this report's analysis. I also thank private sector stakeholders for their consultations and willingness to openly engage in discussing measures to boost the development of Timor-Leste's private sector.

This PSA was produced by the Pacific Private Sector Development Initiative (PSDI), with valuable inputs, strategic insights, and significant support provided by ADB's Pacific Liaison and Coordination Office and Timor-Leste Resident Mission.

Its recommendations provide a sound platform for further discussion and targeted action, toward driving Timor-Leste's economic growth and positioning the private sector for greater involvement in maximizing and diversifying the country's potential.

I look forward to continued and close collaboration with Timor-Leste on its path to prosperity.

Xianbin Yao
Director General
Pacific Department
Asian Development Bank

EXECUTIVE SUMMARY

Timor-Leste gained independence in May 2002, after more than 4 centuries of Portuguese colonial rule, and 24 years of Indonesian government. The latter period was characterized by constant violence. Following further unrest and displacement in 2006, Timor-Leste has built a more inclusive political coalition and increased tangible services to its people. The resulting political stability—and increased confidence in the state—provides a strong foundation for growing the economy, creating jobs, and raising incomes. Developing the country's private sector is fundamental to improving quality of life. Following are overarching economic challenges and recommended actions to encourage greater private sector investment.

Overarching Economic Challenges and Recommended Actions	
Diversify the economy	The oil sector dominates the country's small economy. Yet, oil revenues from existing fields are declining, and new prospects are uncertain. Private investment and activity in the non-oil sector have focused on serving the direct and indirect demand created by public spending. Private investment in productive economic sectors is needed to generate new sources of income, and to create jobs for the country's underemployed and expanding population.
Increase productivity	Skills shortages constrain public sector service delivery and business development. Labor costs are also high (relative to productivity), making it difficult for the country to establish the conditions necessary to be internationally competitive. Particularly, Timor-Leste needs to increase workforce skills levels, improve infrastructure services, and strengthen the business regulatory environment.
Improve rural livelihoods	The majority of the population lives in rural areas and depends on subsistence agriculture for their livelihoods. These households suffer from high levels of seasonal food insecurity, low agricultural productivity, and high poverty rates. The causes are complex, multidimensional, and often location-specific. The problem needs to be tackled in an integrated manner by developing functioning agricultural markets.

THE WAY FORWARD

Timor-Leste needs a vigorous private sector to grow and diversify the economy, and provide improved livelihoods for its citizens. The Government of Timor-Leste has introduced several initiatives to improve the investment climate, including establishing an open trade and investment regime, opening the telecommunications market to competition, and streamlining the business registration process. However, much more needs to be done. Suggested priorities over the short to medium term follow.

Ensure public spending is sustainable and delivers quality infrastructure services

The government has adopted a strategy of transferring amounts from the Petroleum Fund of Timor-Leste (the Fund), well in excess of the estimated sustainable income. Unless addressed, this policy will eventually require significant cuts to future public spending that could destabilize the economy. Recognizing this issue, the government adopted the "Yellow Road" framework in 2013. The framework establishes an expenditure ceiling, enabling the Fund's long-term fiscal sustainability. Unfortunately, budgeted expenditures over the period 2015–2018 are above the Yellow Road ceiling.

High levels of public investment have focused on establishing core infrastructure services related to power and roads. While continued infrastructure improvements in these areas are needed—as well as in others including ports (sea and air), and water and sanitation—limited public investment management capacity has constrained delivery of quality projects.

Timor-Leste uses the United States dollar as its national currency. Still, the economy experienced high inflation between January 2011 and May 2013—levels that were much higher than those experienced in other economies using the United States dollar. This has been attributed to sharp increases in recurrent government spending. In turn, high inflation levels have undermined international competitiveness.

Improve basic education outcomes

A large proportion of Timor-Leste's population has not received any formal education. Basic education (developing skills such as literacy, numeracy, communication, and problem solving) is a necessary foundation, both for further learning and making productive contributions to society. It has important long-term implications for improving the quality of human resources. The government has made significant progress in increasing primary school enrollment; however, the quality of instruction and learning outcomes continue to lag. Children's success at school is also undermined by poor nutrition, particularly in their early years.

Provide business with better access to skilled labor

Access to skilled labor is a major concern for businesses operating in the country. Workforce development is a high political priority, but the system's capacity to deliver results remains weak. This results in high demand on business to use foreign workers to address skills gaps. However, the system for issuing visas and permits lacks transparency, involves several agencies, and is time consuming. It also treats all foreign workers equally, regardless of their skills level. Application of the system to foreign investors is similarly problematic. Also, the country's large public sector—coupled with a high minimum wage relative to other countries—requires businesses to pay more for their labor than market rates, given locally available skills levels.

Increase women's participation in the formal economy

Women are underrepresented as owners of formalized businesses, and as wage earners. Addressing the gender gap requires overcoming a range of challenges, including traditional social norms that encourage high fertility rates and heavy female household responsibilities, persistent and pervasive gender-based violence, and educational disadvantage. Effective change needs action to redefine social norms and institutions to ensure that they are gender sensitive, and that resources are provided equally to women and men.

Introduce land legislation

Timor-Leste has a tumultuous history, characterized by various waves of population displacement. This has created several layers of overlapping land claims based on different sources of legitimacy: (i) Portuguese land titles, (ii) Indonesian land titles, (iii) customary claims of authority over land, and (iv) long-term occupation. Since independence in mid-2002, some land-related legislation has been approved. However, this legislation has yet to establish a clear legal framework that untangles the layers of land claims, and determines "original" land rights.

Strengthen contract enforcement and address other gaps

In 2011, the government introduced legislation which supported making and enforcing contracts. Yet, the court system lacks capacity to settle commercial disputes in a timely or cost-effective way. There is also limited use of alternative dispute resolution processes to complement the formal justice system.

The creation of Services for Registration and Verification of Entrepreneurs (SERVE) streamlined the business registration process, and significantly reduced the number of business activities requiring a license. However, the Commercial Companies Law No. 4/2004 still contains problematic features such as minimum capital requirements; and business registration is still paper-based. In addition, the processes for issuing the remaining licenses lack clear rules, and are time-consuming.

Other gaps include the lack of a policy for managing state-owned enterprises (SOEs), an absent competition framework, and uncertain site development processes.

Improve the financial system's functioning and inclusiveness

Timor-Leste's financial sector is at an early stage of development. The number and range of financial service providers, products, and services are small. Financial intermediation is undeveloped, and long-term finance is lacking. In particular, a clear framework enabling the use of movable assets as collateral is lacking, and the bankruptcy framework is outdated. Financial sector outreach and participation are also low, and the payment system is inefficient. As a result, households and businesses have limited access to finance and financial services. Those on low incomes cannot save securely to invest, pay bills, or move beyond subsistence living. Entrepreneurs and firms cannot finance investment and productivity improvements.

Refocus investment promotion

The country's tax regime imposes a smaller tax burden on business than many other countries. Despite Timor-Leste's already low rates, additional tax incentives are offered. These incentives do little to attract foreign investment; they also consume available institutional capacity due to their discretionary nature. The emphasis on incentives means little attention has been devoted to basic investment promotion services such as investment facilitation. Research suggests that this can be a potent tool for attracting foreign investment.

Build agricultural markets

Well-functioning agricultural markets are critical to translate agricultural growth and increased productivity into improvements in rural household incomes. Yet, Timor-Leste lacks formal markets for most food crops. Crops such as rice and coffee have not substantively increased production levels, despite having received significant support from the government and donors. Creating better functioning agricultural markets in the predominantly subsistence-based rural areas requires a realistic understanding of local circumstances. Complex challenges require improved coordination among different players involved in supporting the sector's development.

Agree on practical steps to grow tourism

The country's tourism sector is in the early stages of development. It faces a range of constraints, including limited and expensive air links; poor in-country transportation links; limited accommodation and tourism activities outside the capital, Dili; and lack of skilled hospitality workers. The Ministry of Tourism, Arts, and Culture has limited capacity, which means that it is without a clear strategy to appropriately and realistically develop the sector.

Enhance dialogue on investment climate issues

Communication is vital for private sector development. A government is more likely to design credible and workable reforms when its ministries work together in a coordinated way, and when it engages with the private sector. The Government of Timor-Leste has neither an effective mechanism for discussing investment climate issues across government agencies, nor a formal way to engage with the private sector on these issues.

KEY RECOMMENDATIONS

The table below presents the priorities that Timor-Leste should focus on, and the key actions recommended to achieve balanced, sustainable growth in the non-oil economy.

Priorities	Key Recommendations
Ensure public spending is sustainable, and delivers quality infrastructure services	• Scale back public expenditures in line with the Yellow Road framework to re-establish long-term fiscal sustainability of the Petroleum Fund. Focus on reducing recurrent public spending, while ensuring capital expenditures are well planned and implemented. Consider lowering the annual inflation target to 2%–4% • Continue to improve the availability and quality of core infrastructure services. Achieve this in a sustainable and cost-effective way by – strengthening economic planning and analytical capacity to ensure that sector strategies and planned infrastructure projects are integrated and deliver positive economic returns; – using competitive procurement processes when awarding government contracts; – ensuring annual recurrent budgets allocate sufficient funds to effectively maintain infrastructure-related assets, once built; and – exploring the use of public–private partnerships (PPPs) to deliver core infrastructure services, whenever possible. This will require strengthening the new PPP Unit within the Ministry of Finance, and introducing an efficient and effective mechanism to manage how PPP contracts are implemented.
Improve basic education outcomes	• Reduce student repetition and dropout rates in the primary school system (particularly the first 3 years), and increase student learning achievements in foundational skills such as literacy and numeracy. This requires – improving early childhood nutrition to maximize children's learning potential, and – improving teacher qualifications and increasing opportunities for them to upgrade skills.
Provide business with better access to skilled labor	• Strengthen implementation of the existing workforce strategy by – improving coordination among ministries and agencies with skills training responsibilities; – enhancing the quality and relevance of the secondary school system; – expanding the National Qualification Framework to cover all vocational training providers (both informal providers and technical secondary schools); – developing (with private sector assistance) regular, credible assessments of the demand for skills within the country; and – improving the quality of training providers' offerings, in line with market demands.

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Priorities	Key Recommendations
	• Review the existing policy and legislation surrounding visas and permits for foreign investors and workers, to enhance the system's transparency and efficiency and make it more welcoming to foreign investors and employers. Explore consolidating the entire process within one agency, and introduce a more strategic approach that provides employers with streamlined access to highly skilled workers • Review the legislated minimum wage to bring it more in line with competitor countries and local circumstances • Reduce the total size of the public sector over time, and limit increases to public sector wages
Increase women's participation in the formal economy	• Continue efforts to mainstream gender concerns into government policies and programs • Effectively implement the National Strategy and Action Plan for Gender and Private Sector 2014–2017
Introduce land legislation	• Strengthen the legal framework and institutional capacity for land administration by – introducing land legislation that provides a way to settle land disputes and determine original title. Legislation should (i) recognize customary land tenure and provide state-managed negotiation frameworks, including voluntary registration, that facilitate access to customary land for economic development while minimizing the risk of land conflict; (ii) provide a legal foundation for developing a comprehensive land register of land titles and dealings; and (iii) establish clear procedures for expropriating land for a public purpose; – introducing an active monitoring process alongside the new land laws, enabling their amendment and further development as issues arise; and – continuing to build capacity within the Direcção Nacional de Terras, Propriedades e Serviços Cadastrais (National Directorate of Land, Property and Cadastral Services) to implement its land administration responsibilities, particularly in expanding the land claim process, efficiently processing land transactions, and working with rural communities to register their land for economic development purposes.
Strengthen contract enforcement and address other gaps	• Strengthen capacity for resolving and enforcing commercial contracts by – increasing public awareness on the use of contracts in commercial transactions; – continuing to build capacity within the justice system to credibly and more efficiently deal with commercial cases; and – introducing alternative dispute resolution legislation, and developing a local pool of mediators and arbitrators to settle disputes. • Review the Commercial Companies Law No. 4/2004 to bring it in line with good international practice, and establish an online electronic business registry system

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Priorities	Key Recommendations
	• Review business licenses and permits—particularly in key sectors such as agriculture, tourism, manufacturing, and trade—to ensure that they are efficiently administered using simple and transparent implementing regulations • Develop a state-owned enterprise (SOE) policy. It should include – guidelines to ensure that proposals for establishing new SOEs are carefully assessed against private sector alternatives; – clear expectations for SOE financial performance, along with a transparent corporate governance framework to help prevent political pressure from distorting SOE priorities and managerial decisions; and – a clear framework for dealing with community service obligations, including allowing for private sector participation, where possible. • Develop a framework for effectively regulating infrastructure services and promoting competition within the economy • Introduce legislation and build capacity to enable development of land use plans, and develop clear implementing guidelines for conducting environmental impact assessments
Improve the financial system's functioning and inclusiveness	• Introduce a secured transactions framework to support the effective use of movable assets as collateral for loans, and work with lenders to design new financial products • Introduce an effective insolvency and bankruptcy regime • Review the credit registry information system to increase functionality and coverage • Subject to licensing criteria, be open to licensing additional financial institutions—particularly nonbank financial institutions—to encourage financial sector competition • Assess the role of a national development bank within a wider, competitive banking system • Convert manual social welfare payments to bank accounts, where feasible • Introduce a national payment system law and effectively implement the real-time gross settlement system, and encourage interbank interoperability • Gradually develop the financial sector regulatory regime in response to innovations and emerging risks • Prepare a national antimoney laundering and countering the financing of terrorism strategy, and national risk assessment, to comply with international standards
Refocus investment promotion	• Review existing fiscal incentives with aim of reducing and redefining them. If incentives are to be offered, they should be aimed at achieving clear objectives, performance-based, and issued automatically through the tax code.

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Priorities	Key Recommendations
	• Focus the newly established Agência Especializada de Investimento (Specialized Investment Agency) solely on providing effective investment promotion services, complemented by professional staff with private sector experience
Build agricultural markets	• Develop integrated, locally-based rural development programs as a strategy for building agricultural markets. This requires – fostering close coordination between government ministries, districts, and *sucos* (or villages), as well as donors, nongovernment, and private sector organizations; – developing community buy-in to encourage subsistence farmers to adapt their production practices; – focusing programs on improving crop quality, productivity, and supply consistency (for crops with obvious market demand and where production surpluses can be generated); and establishing the entire supply chain linking producers to consumers; – ensuring price incentives and land tenure arrangements support farm investment and increased production; and – ongoing research to better understand constraints to markets expansion within the country and develop appropriate solutions.
Agree on practical steps to grow tourism	• Improve tourism data collection, including market perceptions of Timor-Leste as a tourism destination, visitor numbers, and in-country experience • Develop a concise policy and associated strategy for developing the sector, in close consultation with tourism stakeholders. Due to expected ongoing capacity constraints within the Ministry of Tourism, Arts, and Culture and the Associação de Empresas de Turismo de Timor-Leste (Association of Tourism Companies of Timor-Leste), ensure that agreed actions can be realistically implemented. Where feasible, contract activities to the private sector using a transparent tendering process.
Enhance dialogue on investment climate issues	• Establish a high-level interministry working group to discuss investment climate issues, and ensure that policy reforms are coordinated and mutually supportive • Create opportunities for dialogue with private sector representatives • Solicit assistance from the donor community to facilitate and support the dialogue process, and strengthen capacity within the Câmara de Comércio e Indústria de Timor-Leste (Chamber of Commerce and Industry of Timor-Leste) to engage on investment climate issues

IMPLEMENTING REFORMS

This private sector assessment (PSA) provides a snapshot of Timor-Leste's investment climate. It is intended as a starting point from which a reform program can be designed, implemented, and monitored.

Given the wide range of issues covered in the PSA, it is not feasible to expect that all recommendations can be implemented immediately. Several reform recommendations—such as introducing a secured transactions framework for movable assets, and a real-time system for interbank clearing and settlement of electronic payments—are already being pursued. However, others need further discussion before action is taken.

Moreover, given capacity constraints within the government and the business community, a careful review of the PSA's findings is necessary to ensure that reform initiatives make the most productive use of available resources.

The establishment of the Minister of State and Coordinator for Economic Affairs by the new government in February 2015 presents an opportunity to build a sustainable constituency for investment climate reform in Timor-Leste. Achieving this goal will require an ongoing mechanism through which key ministries and representatives of the private sector can work together in a coordinated way. The new institution can play a valuable role to facilitate this.

A public–private sector roundtable forum to discuss the challenges outlined in this report would be a good way to initiate the process. Such a forum could help establish reform priorities, as well as a structure for continued dialogue. Once priorities have been agreed to, reforms can be designed based on an in-depth diagnosis of the current situation.

It will be important that reforms are not limited to drafting new policies and laws, but are ultimately focused on improved results on the ground. This will require establishing a mechanism to monitor reform implementation, to ensure that the reforms are achieving their intended effects.

1 INTRODUCTION AND OVERVIEW OF THE ECONOMY

The Government of Timor-Leste faces tremendous challenges as it seeks to improve its citizens' quality of life. The country needs inclusive, sustainable private-sector-led economic growth to achieve this aim. This private sector assessment (PSA) reviews Timor-Leste's environment for private sector development, and identifies key areas that constrain business formation and growth. The PSA is based on a review of the government strategies related to private sector development; available economic reports; and discussions with government officials, donors, and representatives of the private sector and civil society.

Emerging from conflict

Timor-Leste is a new nation, gaining independence in May 2002 after more than 4 centuries of Portuguese colonial rule, followed by 24 years of Indonesian government. The latter period was characterized by constant violence, estimated to have caused more than 200,000 deaths. An overwhelming vote for independence in August 1999 was followed by widespread violence, population displacement, and property destruction. A majority of public and private property was destroyed during this time, including the electrical grid, water supply systems, schools, and health clinics. As a result, the country was faced with the daunting task of rebuilding its institutions and basic infrastructure from the ground up.

Timor-Leste suffered further violence and displacement of people in 2006 because of complex, interwoven issues, including a collapse in state security due to institutional weaknesses within the security forces, unresolved divisions within the national political leadership, and massive social and economic disruptions remaining from the 1999 postreferendum violence. However, in the near-decade since 2006, the country has managed to build a more inclusive political coalition and increased tangible services for the population. This has created political stability, eliminated violent conflict, and generated new confidence in the state.

Surveys indicate that most Timorese believe the government is doing a good job and the country is heading in the right direction.[1] However, investors have long memories. The prolonged period of instability, uncertainty, and destruction heightens the perception of risk. To allay investors' concerns regarding the future requires consistent, long-term, business-friendly policies.

Economy remains highly dependent on an uncertain oil sector

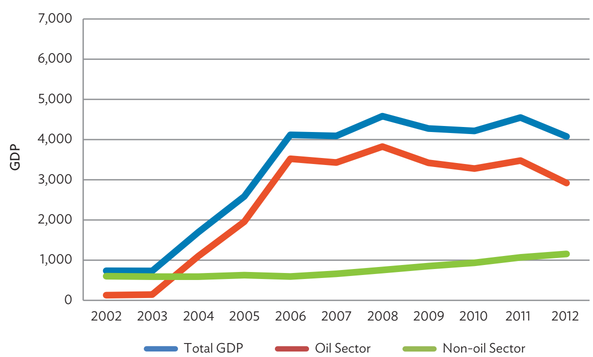
The oil sector dominates Timor-Leste's small economy. Although modest by international standards, production from the Joint Petroleum Development Area (JPDA) in the Timor Sea has contributed an average of 80% of total gross

[1] The Asia Foundation's 2014 national survey found that 73% of respondents were positive of the country's direction, up from 47% of respondents surveyed in 2013. The surveys also indicated a growing satisfaction with government—in 2014, 90% felt government was doing a "very good" or "somewhat good" job, up from 77% in 2013. Sources: The Asia Foundation. 2013. *Timor-Leste Public Opinion Poll—September 2013*. Dili; and The Asia Foundation. 2015. *Timor Tatoli Survey—November 2014*. Dili.

domestic product (GDP) over 2006–2012 (Figure 1). This oil wealth has provided the government with a source of funds with which it has been able to promote development and achieve the current period of stability.

However, oil revenues from the existing field are now declining and expected to end by 2021. The prospects for the development of new oil fields are uncertain.[2]

Figure 1: Timor-Leste Gross Domestic Product at Constant Prices, 2002–2012 ($ million)



GDP = gross domestic product.

Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014b. *Timor-Leste National Accounts 2000–2012*. Dili. http://www.statistics.gov.tl/wp-content/uploads/2014/07/National-Account-2012.pdf

A young, fast-growing population and high poverty

Timor-Leste's population was 1.066 million in 2010. Approximately 70% live in rural areas and rely on farming for survival. Despite the country's small size, it has more than 20 languages, including Portuguese and Tetum (the official languages), Indonesian and English (working languages), and 15 indigenous languages.

Much of the population is young—over 44% was below 15 years old in 2010. The country also has a high fertility rate (5.3 births per woman in 2012).[3] This means an estimated 470,000 individuals are expected to enter the labor market by 2030.[4]

In 2010, the economy created formal jobs for about 75,000 individuals, or 12% of the working-age population.[5] Many of these jobs were in the public sector.[6] Total non-oil private sector employment was only 46,400 people. The non-oil private sector has grown since 2010 levels and, in 2012, was estimated to employ 63,200 people.[7] While this growth in private sector employment is positive, there is a critical need to continue building capacity within the sector. This capacity

2 In this PSA, "oil" includes both raw natural gas and natural gas liquid. Overall production from the JPDA is estimated to have peaked in 2012 and will likely end by 2021. Another potential offshore field in the Timor Sea, called the Greater Sunrise area, has been identified, but remains undeveloped. The Treaty on Certain Maritime Arrangements in the Timor Sea became effective in 2007, and provides a legal basis for production and revenue sharing without a final delineation of the maritime border. In 2013, Timor-Leste initiated international arbitration to have this treaty revoked. If successful, this would open the way for new negotiations, which could also include the position of the border. Until the dispute has been resolved and an approved development plan established, the government does not include potential contributions from the Greater Sunrise area in its revenue projections.

3 The total fertility rate represents the number of children that would be born to a woman if she were to live to the end of her childbearing years and bear children in accordance with age-specific fertility rates. Although Timor-Leste's fertility rate has fallen over the past decade (it was 7.1 births per woman in 2000), it is the highest in the Asia-Pacific region. Source: Asian Development Bank (ADB). 2014c. *Key Indicators for Asia and the Pacific 2014. Special Chapter—Poverty in Asia: A Deeper Look*. Manila.

4 N. Umapathi and M. Velamuri. 2013. Labor market issues in Timor-Leste: current state, prospects and challenges. *Working Paper 80229*. Washington, DC: World Bank.

5 Formal jobs are defined here to include paid employees and employers who engage one or more employees on a continuous basis. Source: Democratic Republic of Timor-Leste, Ministry of Finance; and Secretariat of State for Vocational Training Policy and Employment. 2010. *Timor-Leste Labour Force Survey Report 2010*. Dili.

6 Public sector employment in 2013 was estimated to be about 27,000, and total government employment was close to 43,000 (includes civil service and state-owned enterprise [SOE] employees, as well as persons engaged by the government on temporary contract basis). Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics; and Secretariat of State for Vocational Training Policy and Employment. 2015. *Timor-Leste Labour Force Survey 2013*. Dili.

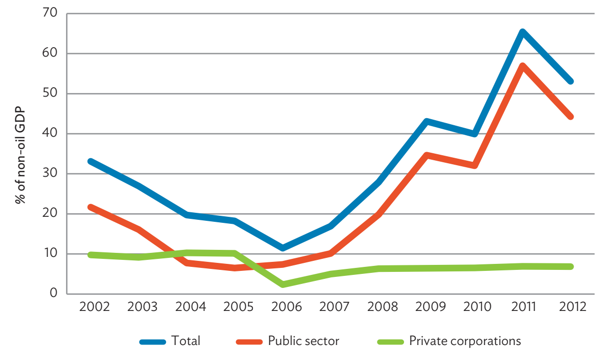
is needed to absorb the large numbers of existing unemployed and underemployed people, along with new workers who will join the labor market in the coming years.

Despite a lack of data, poverty levels in the country appear to remain high. The national headcount poverty rate increased from 36% in 2001, to 50% in 2007. In this period, poverty rose in all regions and its depth increased significantly. One third of the population was classified as living in extreme poverty in 2007;[8] and, despite expansion of the economy since that year, poverty levels remain high. While a detailed poverty analysis has not been done on the Household Income and Expenditure Survey 2011,[9] more than 40% of the national population is thought to still fall below the poverty line, while in rural areas it is thought to be above 50%.[10]

Fledgling private sector focused on demand created by public sector spending

Economies grow and create jobs as a result of productive investment. This can come from public sources, as well as private businesses. Timor-Leste has experienced very high levels of investment since 2007, predominantly from the public sector (Figure 2). Private sector investment has been relatively flat, averaging 6% of non-oil GDP over 2007–2012. As public sector investment levels

Figure 2: Investment Levels in Timor-Leste, 2002–2012 (%)



GDP = gross domestic product.

Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014b. *Timor-Leste National Accounts 2000–2012*. Dili. http://www.statistics.gov.tl/wp-content/uploads/2014/07/National-Account-2012.pdf

begin to fall in the future, economic growth will increasingly depend on greater levels of investment by the private sector.

To date, private sector investment and activity in the non-oil sector has focused on serving the direct and indirect demand created by the rapid increase in government spending.

The non-oil business sector comprises approximately 10,000 registered business entities; the majority is small, locally-owned, one- and two-person shareholder companies. These businesses

7 While a labor force survey was completed in 2013, methodological changes limit comparisons with earlier surveys. The 2013 labor force survey estimated the total number of employed people at 190,000 in 2013, up from 144,000 in 2010. Employed persons include formal jobs (paid employees and employers), as well as own account workers and contributing family members. Sources: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014a. *Business Activity Survey of Timor-Leste 2012*. Dili; and Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics; and Secretariat of State for Vocational Training Policy and Employment. 2015. *Timor-Leste Labour Force Survey 2013*. Dili.

8 Democratic Republic of Timor-Leste, Ministry of Finance, National Statistics Directorate. 2008. *Final Statistical Abstract: Timor-Leste Survey of Living Standards 2007*. Dili.

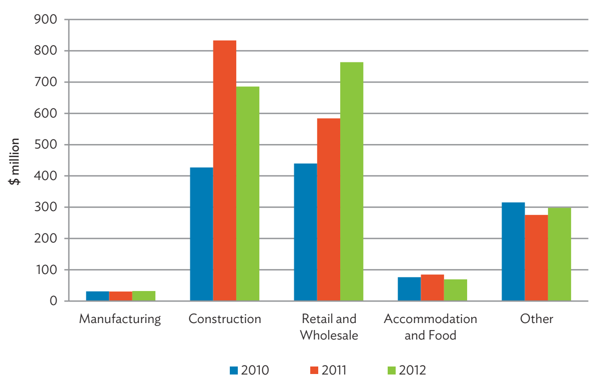
9 Democratic Republic of Timor-Leste, Ministry of Finance, National Statistics Directorate. 2011. *Timor-Leste Household Income and Expenditure Survey 2011*. Dili.

10 World Bank. 2012. A 2009 update of poverty incidence in Timor-Leste using the survey-to-survey imputation method. *Working Paper 66681*. Washington, DC.

are based primarily in Dili, and are mainly involved in retail, wholesale, and construction activities. Combined, these sectors accounted for 78% of total business income and 62% of total business employment in 2012 (Figures 3 and 4). Similarly, most recent capital investment has been made by businesses within these two sectors, much of it related to government contracts.[11]

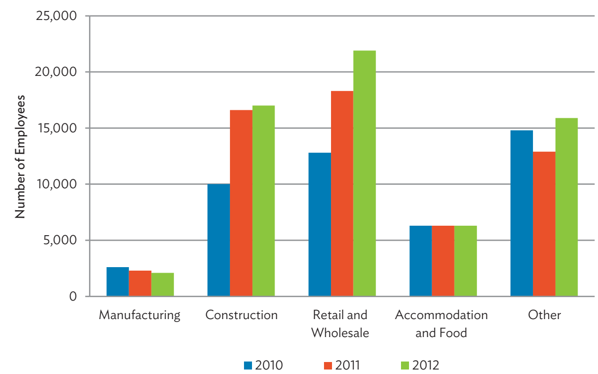
For value added output, the construction, and retail/and wholesale industries are also the largest industry sectors in the economy; these have grown the most since 2006 (Figure 5). Substantive growth also occurred in the information technology and communications and real estate sectors, although from smaller bases. However, the agriculture, forestry, fisheries, and manufacturing sectors' output declined between 2006 and 2012. While the agriculture sector remains a large component of the economy, its potential is not realized. Rather than acting as a source of new jobs and incomes, the majority of rural households continue to rely on subsistence farming, and food insecurity remains a serious concern.

Figure 3: Total Income by Industry, 2010–2012 ($ million)



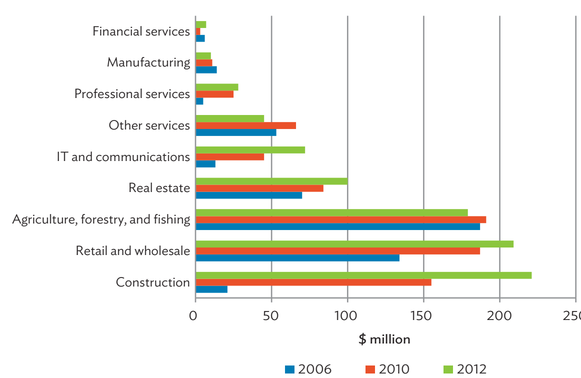
Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014a. *Business Activity Survey of Timor-Leste 2012*. Dili.

Figure 4: Total Private Sector Employment by Industry, 2010–2012



Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014a. *Business Activity Survey of Timor-Leste 2012*. Dili.

Figure 5: Value Added by Non-Oil Industries for Selected Years, 2006, 2010, and 2012



IT = information technology.

Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014b. Timor-Leste National Accounts 2000–2012. Dili. http://www.statistics.gov.tl/wp-content/uploads/2014/07/National-Account-2012.pdf

[11] The 2012 business activity survey indicates that the retail, wholesale, and construction sectors accounted for more than 75% of all capital expenditures made by businesses over 2010–2012. The majority of construction activity is underpinned by government contracts. Source: Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014a. *Business Activity Survey of Timor-Leste 2012*. Dili.

Coffee exports and net travel receipts represent Timor-Leste's primary sources of non-oil foreign exchange. Combined, they amounted to just $66 million in 2013—a small fraction of the country's imports and service payments.[12]

Timor-Leste is not a member of any multilateral or regional trade arrangement, although it has submitted a formal request to join the Association of Southeast Asian Nations. Despite the lack of trade arrangements, international market access is not a major issue because Timor-Leste receives preferential access to most high-income markets.[13]

Need to catalyze private sector investment into productive, export-oriented sectors that will create jobs and income—leading to a reduction in poverty

While the situation in Timor-Leste remains fragile, the stability and absence of conflict provides an opportunity to accelerate private-sector-led growth.

To date, the economy has been driven by oil revenues. High levels of public spending, fueled by the country's oil wealth, have focused private sector attention on pursuing government contracts, and on the import and resale of goods. There has been limited investment in, or growth in output from, productive sectors such as agriculture and manufacturing. To prepare for a future of potentially declining oil revenues, Timor-Leste urgently needs to diversify its economy and sources of revenue, and expand its exports of non-oil goods and services.

Further, given the high levels of poverty, unemployment, and underemployment, it will be critical for future private sector investment to extend into rural areas, and generate new job and income opportunities.

[12] Excluding oil and official grants, Timor-Leste runs a significant current account deficit. Merchandise exports were estimated at $37 million in 2013, of which coffee represented 90% of the total. The total estimated value of imported goods in 2013 was $769 million—approximately 20 times the value of exports. While still small, exports of services have increased faster than merchandise exports. Total services receipts were estimated at $86 million in 2013, of which net travel receipts represented approximately 30%. However, total estimated services payments in 2013 were $1,090 million, about 13 times that of service receipts. Source: International Monetary Fund (IMF). 2013. Democratic Republic of Timor-Leste: 2013 Article IV Consultation. *IMF Country Report No. 13/338*. Washington, DC.

[13] Developed and major developing members of the World Trade Organization grant "most favored nation" treatment to nonmember least developed countries (LDCs). In addition to nondiscriminatory tariff treatment LDCs, such as Timor-Leste, are also granted preferential access for their exports. For example, Timor-Leste has had duty free access to Australia since 2003. In 2006, it was granted LDC special status in Japan's generalized system of preferences (GSP) scheme and, in 2007, GSP status by the United States. Since 2011, Timor-Leste has benefited from the European Union's GSP scheme (the Everything but Arms program).

2 POLICY FRAMEWORK TO ENCOURAGE INVESTMENT

The State's role in developing a nurturing environment for private sector development

Success in developing a vibrant private sector depends heavily on a well-functioning state that encourages competition and specialization; and provides institutions and public goods that minimize the costs of establishing, operating, and closing a business. It needs macroeconomic stability, provision of basic services (such as education, health, and law and order), an open trade and investment policy, stable political institutions and policies, and a structure for private business activity that supports investment and entrepreneurship without the state's direct involvement.

A policy framework for private investment is outlined in Appendix 1. It describes important policy issues that governments should consider when trying to create an environment attractive to investors. Key areas where the state is expected to play a role include

- establishing and protecting property rights, and providing a mechanism for the resolution of property disputes;
- providing law and order, and a safe environment in which to invest and do business;
- establishing an environment in which contracting can be done with confidence, requiring a sound legal framework of commercial law, and mechanisms for adjudicating contract disputes and enforcing legal judgments;
- ensuring that transactions costs associated with starting, operating, and closing a business are low;
- promoting access to finance by providing ways for lenders to reduce their risks; and ensuring that the laws on pledging collateral promote effective lending, and at low cost;
- promoting competition by ensuring that markets are competitive, minimizing intervention (including preventing state-owned enterprises [SOEs] from crowding out private sector activity), and effectively regulating monopolies;
- ensuring that the infrastructure framework supports the development of the economy by opening infrastructure provision through public–private partnerships (PPPs), contracting out, and outright privatization where appropriate; and not directly by government or state-owned businesses; and
- ensuring that the public sector exists to provide services to the whole population, not to entrench the interests of either government or SOE employees.

Successful implementation of these elements requires effective governance. This means developing stable policies with sufficient credible commitment to assure private investors that policies will not undergo sudden reversals or unexpected change, and that rules governing business will be transparently applied.

A capacity to deliver high quality public goods is also required. Recognizing the importance of public goods for doing business and identifying weaknesses that negatively affect property rights, legal systems, and the business regulatory framework is vital. Finally, it requires a technically and administratively capable public service to supply these public goods.

This is a challenge in any country—and especially so in Timor-Leste, having recently emerged from a protracted conflict situation, with low overall human resource capacity and poor infrastructure.

Government recognizing its challenges and actively encouraging private-sector-led growth

The Government of Timor-Leste conducted a participatory planning process to design the Timor-Leste Strategic Development Plan 2011–2030 (SDP).[14] The SDP provides a vision, targets, and indicators to achieve private-sector-led growth over the 2 decades to 2030, and become an upper- to middle-income country. It addresses the following four pillars:

(i) **Social issues.** Invest in human capital through improved access to and quality of health, education, and skills development while protecting the vulnerable.

(ii) **Infrastructure.** Use oil wealth to fund catalytic infrastructure (roads, water and sanitation, electricity, seaports, and airports).

(iii) **Economic issues.** Encourage private sector investment and diversification of the economy (focusing on agriculture, tourism, and petroleum) to sustain growth and employment.

(iv) **Institutions.** Continue to build the foundations of good governance and institutional effectiveness.

The government elected in 2012 subsequently prepared a 5-year action plan to implement the SDP. The most recent government, sworn into office in February 2015, has been structured to enable interministerial coordination for the SDP's four pillars.[15] While a progress report on SDP implementation had yet to be completed at the time of writing, the government recently prepared a fragility assessment report. The assessment confirmed that, while the country has made significant progress in improving political stability and security, its economic foundations remain weak, and the justice system still faces severe shortcomings.[16]

The remainder of this private sector assessment examines the business environment in Timor-Leste to identify factors constraining the growth of a more diversified, inclusive, and export-oriented private sector.

[14] Democratic Republic of Timor-Leste. 2011. *Timor-Leste Strategic Development Plan 2011–2030*. Dili.

[15] Democratic Republic of Timor-Leste, Minister of State and of the Presidency of the Council of Ministers and Official Spokesperson for the Sixth Constitutional Government. 2015. *Program of the Sixth Constitutional Government presented in National Parliament*. 24 March. http://timor-leste.gov.tl/wp-content/uploads/2015/03/Program-of-the-Sixth-Constitutional-Government-presented-in-National-Parliament.pdf; and Democratic Republic of Timor-Leste. Program of the VI Constitutional Government 2015-2017 Legislature. http://timor-leste.gov.tl/?p=11688&lang=en&lang=en#prog0

[16] Democratic Republic of Timor-Leste, Ministry of Finance. 2013b. *Summary Report: Fragility Assessment in Timor-Leste*. Dili.

3 ISSUES RELATED TO THE MACROECONOMY

Recommendations:

- Scale back public expenditures in line with the Yellow Road framework to re-establish long-term fiscal sustainability of the Petroleum Fund. Focus on reducing recurrent public spending, while ensuring capital expenditures are well planned and implemented. Consider lowering the annual inflation target to 2%–4%
- Continue to improve the availability and quality of core infrastructure services. Achieve this in a sustainable and cost-effective way by
  - strengthening economic planning and analytical capacity to ensure that sector strategies and planned infrastructure projects are integrated and deliver positive economic returns;
  - using competitive procurement processes when awarding government contracts;
  - ensuring annual recurrent budgets allocate sufficient funds to effectively maintain infrastructure-related assets once built; and
  - exploring the use of public–private partnerships (PPPs) to deliver core infrastructure services, whenever possible. This will require strengthening the new PPP Unit within the Ministry of Finance, and introducing an efficient and effective mechanism to manage how PPP contracts are implemented.

Sustained and inclusive economic growth requires a stable macroeconomic foundation. Large swings in economic activity, high inflation, unsustainable spending or debt levels, and exchange rate and financial market volatility negatively affect private sector investment decision making. Stable, low inflation is important in maintaining price competitiveness for exporters and domestic businesses facing competition from imports. Maintaining steady growth and price stability also helps keep interest rates low, and encourages consumer and business confidence.

The size of Timor-Leste's economy has grown substantially since 2006 (Figure 1), as a direct result of its offshore oil fields. Oil revenues rose from $993 million in 2006, to an average of $3.4 billion between 2010 and 2013. Moreover, the government has earned a reputation for transparent, effective, and accountable governance by establishing a best practice petroleum fund (Box 1) to translate these temporary gains into future benefits. Public spending is funded almost entirely from wealth accumulated in the country's Petroleum Fund (Table 1).

Box 1: The Petroleum Fund of Timor-Leste

The Petroleum Fund of Timor-Leste (the Fund) was established in 2005 to manage the country's petroleum resources, and is an account maintained at the Banco Central de Timor-Leste (Central Bank of Timor-Leste). It is intended to act as a budget reservoir to smooth variable petroleum inflows and limit overheating of the economy. The Fund had assets of $16.5 billion at the end of 2014. Outflows from the Fund are transferred to the government budget, in accordance with the appropriated amount approved by Parliament through the annual budget law. An estimated sustainable income (ESI) is calculated each year, as 3% of the sum of the Fund balance and the present value of expected future petroleum receipts from oil fields in production. To preserve the real value of the country's petroleum wealth, withdrawals from the Fund are guided by the ESI. Potential income from oil fields not yet in production (such as the Greater Sunrise area) are not factored into the ESI calculation. Withdrawing more than the ESI requires government to provide Parliament with a detailed explanation of why the larger withdrawal is in the country's long-term interests. The Fund's design is considered international best practice.

Sources: Democratic Republic of Timor-Leste, Central Bank of Timor-Leste. 2014e. *Petroleum Fund of Timor-Leste Quarterly Report.* Volume 10, Issue XXVII. Dili. http://www.bancocentral.tl/Download/Publications/Quarterly-Report38_en.pdf; and A. McKechnie. 2013. *Managing natural tesource revenues: The Timor-Leste Petroleum Fund.* London: Overseas Development Institute. http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8337.pdf

Table 1: Central Government Non-Oil Fiscal Balance Funded by the Petroleum Fund, 2010–2014 ($ million)

Item	2010	2011	2012	2013[a]	2014[b]
Government Expenditure[c]					
Recurrent	506.1	502.3	708.8	730.9	903.1
Capital	254.3	603.0	538.2	350.5	448.2
Total	760.4	1,105.3	1,247.0	1,081.4	1,351.3
Non-oil Revenue					
Total	96.6	105.3	142.2	151.1	184.3
Non-oil Fiscal Balance	(663.8)	(1,000.0)	(1,104.8)	(930.3)	(1,167.0)
% of expenditure	87	90	89	86	86

( ) = negative balance.

[a] Beginning in 2013, a small amount of government borrowing also was used to finance the non-oil fiscal balance.

[b] Estimated.

[c] Excludes expenditures and revenues associated with donor projects.

Source: Democratic Government of Timor-Leste. Timor-Leste Budget Transparency Portal. http://budgettransparency.gov.tl/public/index?&lang=en

PUBLIC SPENDING LEVELS ABOVE THE GOVERNMENT'S YELLOW ROAD FRAMEWORK

Unfortunately, the large non-oil deficits funded by withdrawals from the Petroleum Fund (the Fund) are well in excess of the estimated sustainable income (ESI). Over 2010–2014, they averaged $300 million per year (Table 2). Continuing this trend is unsustainable under current assumptions, and will lead to the Fund's steady depletion. If this issue is not addressed, the country will eventually require significant cutbacks in future public spending that could destabilize the economy.[17]

Recognizing the unsustainable nature of continued large withdrawals from the Fund in excess of the ESI, the government adopted a plan in 2013 (the "Yellow Road" process) to scale back future spending plans. Under the Yellow Road framework, the total expenditure envelope over 2014–2018 would average $1.3 billion annually, and then grow at around 3% annually (footnote 17). Yet, the approved budgeted expenditure envelope over 2014–2018 averages $1.8 billion annually—well above the Yellow Road expenditure ceiling.[18]

Transferring amounts from the Fund in excess of the ESI has been justified by the need to scale up investment to promote development. In a low-income country such as Timor-Leste, with significant deficiencies in human capital and infrastructure, the rate of return on marginal investments in these areas is likely to be higher than the returns from investing the Fund's resources in low-risk instruments abroad. A case can, therefore, be made for adopting a withdrawal rate higher than the Fund's rate of 3% in the short-term (a rate based on Norway's experience, which is a mature economy) to fund capital investments. This assumes that these investments result in infrastructure improvements that increase productivity and spur private sector investment.[19]

However, the government faces a major challenge in ensuring that such a front-loading

Table 2: Annual Withdrawals from the Petroleum Fund in Excess of Estimated Sustainable Income, 2010–2014 ($ million)

Item	2010	2011	2012	2013	2014
Estimated Sustainable Income (ESI)	502	734	665	787	632
Actual withdrawal from the Petroleum Fund	811	1,055	1,495	730	732
Withdrawal in excess of ESI	**309**	**321**	**830**	**(57)**	**100**

( ) = figure does not exceed ESI.

Sources: Democratic Republic of Timor-Leste, Ministry of Finance, Petroleum Fund Administration Unit. 2014. *Petroleum Fund Annual Report—Financial Year 2013.* Dili. https://www.mof.gov.tl/wp-content/uploads/2014/08/2013_Complete_Petroleum_Fund_Annual_Report_2013-eng.pdf; and La'o Hamutuk. 2014. Timor-Leste Petroleum Fund: 2014. http://www.laohamutuk.org/Oil/PetFund/05PFIndex.htm#2014

17 Footnote 12. The IMF analysis assumes that no new oil fields will be developed. However, only about 50% of the country's offshore, and nearly all its onshore, areas remain to be explored. While the exploration outcome is uncertain, there appear to be reasonable prospects for further economically viable discoveries.

18 The approved budget for 2014 was $1.50 billion, although public spending for the year is estimated to be $1.35 billion. Over 2015–2018, the budgeted expenditures are: $1.57 billion in 2015, $2.089 billion in 2016, $2.033 billion in 2017, and $1.84 billion in 2018. Source: Democratic Republic of Timor-Leste, Ministry of Finance. 2014. *State Budget 2015: Budget Overview, Book 1*. Dili.

19 See P. Collier et al. 2009. Managing Resource Revenues in Developing Economies. Revised 18 May 2009. *OxCarre Research Paper 15*. Oxford: Oxford Centre for the Analysis of Resource Rich Economies (OxCarre), University of Oxford.

strategy actually delivers capital investments with high economic returns. Ensuring that overall public spending does not lead to inflation and undermine export potential is also important. Unfortunately, public spending in Timor-Leste has been inflationary over several years and, in many cases, capital spending has not delivered quality infrastructure with positive economic returns.

PROBLEMS OF PUBLIC INVESTMENT IN INFRASTRUCTURE

The Timor-Leste Strategic Development Plan 2011–2030 (SDP) places public investment in asset creation at its center. A particularly high priority is placed on basic infrastructure investment.

There are significant gaps in the availability and quality of core infrastructure services

Good quality infrastructure is essential to an economy that encourages investment, entrepreneurship, and growth. A reliable, low-cost electricity supply keeps operational costs down, and removes the need for both businesses and individuals to have back-up generators, thereby freeing up capital for more productive uses. A safe and efficient water supply keeps the population healthy and reduces work absences due to illness.

Widespread availability of telecommunication services brings small countries closer to the rest of the world, and remote areas within their borders closer to the rest of the country. Road networks provide an efficient and cost-effective means of moving people and goods between rural areas and population centers, and to and from ports and airports. Efficient seaport and airport facilities enable open, export-driven economies to move goods and people in and out of the country easily and cheaply.

A brief overview of Timor-Leste's core infrastructure services is provided in Appendix 2. Key points:

- The availability and quality of infrastructure services remain poor, particularly for roads, water and sanitation, seaports, and airports.
- Major investment in the power sector has led to improved service, but at a very high cost and requiring ongoing subsidies.
- The telecommunications sector has been successfully liberalized; yet, it lacks an effective regulator and depends on satellite technology for international connectivity.

Effective public investment management is critical in building cost-effective infrastructure

Despite infrastructure improvements in areas such as electricity, there is a tremendous need for the government to continue strengthening the country's core infrastructure.

An effective public investment management (PIM) system is critical for making wise infrastructure investment decisions. A poor system will result in low economic rates of return on capital projects, making it difficult for an economy to grow in a sustained and diversified way. Critical policy aspects of a PIM system concern (i) the efficiency with which it allocates available resources, and (ii) the operational proficiency with which it implements projects.

The first addresses questions such as the amount of infrastructure investment necessary to achieve economic growth targets, and the sectors on which to focus. The second ensures that, once these choices are made, the right projects are selected, prepared, implemented, and cost-effectively maintained. A public expenditure review published in 2015 identified concerns—both with the public expenditure choices being made, and how infrastructure projects are implemented.[20]

Strategic Development Plan infrastructure targets appear overly ambitious

The SDP aims to achieve upper middle-income status by 2030, and assumes that improved infrastructure will boost economic growth and domestic revenue.[21] This is based on the assumption that Timor-Leste's infrastructure is worse than that of the average middle-income country; and that infrastructure construction, as outlined in the SDP, will not lead to infrastructure oversupply.

Evidence suggests that, while necessary, infrastructure improvement targets in some areas may be overly ambitious. For example, Timor-Leste has a much lower density of "good condition," paved roads than the average middle or low-income country. This suggests some road rehabilitation is required. Rehabilitating the six SDP priority roads would result in Timor-Leste achieving a good condition paved road network similar to that of the average lower middle-income country. However, rehabilitating all roads—as defined in the SDP—would result in Timor-Leste achieving a much denser good condition paved road network than most upper-middle income countries.[22] Moreover, increasing the country's good condition stock of paved roads will require larger recurrent spending to maintain. Spending funds on road asset stock beyond what the country needs is likely wasteful; and reduces spending in other sectors, such as education and health, where long-term investment returns may be higher.

Planned infrastructure investment does not appear targeted at building a more diversified and inclusive economy

Capital spending on infrastructure over 2008–2014 was focused predominantly on electricity, roads, and district development. In the 2015 State Budget, the government plans to spend in excess of $3 billion capital investments over the period 2015–2019; the four largest areas of infrastructures spending are South Coast development, airports, roads, and public buildings.[23]

The South Coast development refers to the Tasi Mane Project, which includes development of the Suai logistics base (including new seaport and airport); and construction of roads and bridges (Suai–Betano–Beacu highway). The 2013 State Budget earmarked $1.3 billion for the Tasi Mane

[20] Much of the analysis in the following sections is based on a joint public expenditure review conducted by the Ministry of Finance and the World Bank. Unless otherwise specified, financial data is sourced from this report. Source: Democratic Republic of Timor-Leste, Ministry of Finance; and World Bank. 2015. *Timor-Leste Public Expenditure Review: Infrastructure.* Dili.

[21] The SDP sets targets for improving the country's road network; improving the population's access to safe water and sewerage systems; introducing reliable 24-hour, 7-day electricity throughout the country, with generation from increasingly renewable sources; establishing new efficient and expanded port facilities (seaport and airport); and ensuring the population has access to reliable and affordable telecommunication services.

[22] Timor-Leste's paved road density by gross domestic product per capita is estimated to be less than 0.010. Rehabilitating the six priority roads identified in the SDP would increase the road density ratio to 0.015, while rehabilitating all roads would push the ratio to 0.048. The average paved road density for lower middle-income and upper middle-income countries is 0.016 and 0.025, respectively. Democratic Republic of Timor-Leste, Ministry of Finance; and World Bank. 2015. *Timor-Leste Public Expenditure Review: Infrastructure.* Dili.

[23] Democratic Republic of Timor-Leste, Ministry of Finance. 2014. *State Budget 2015: Budget Overview, Book 1.* Dili.

Project, of which $780 million was to support development of the Suai logistics base.[24] Budget execution for the project is proceeding slowly.

In 2015, the State Budget reduced the allocated spending on the project to $433.1 million over 2015–2019. Despite the reduction, capital spending on the Tasi Mane Project is expected to consume approximately 14% of total capital spending over the 5 years to 2019. As the project is focused almost exclusively on the petroleum industry, it is unhelpful in addressing the challenge of diversifying the economy, away from oil dependency. The industry's capital-intensive nature also means that few domestic jobs will likely be created.

Moreover, because a comprehensive project cost–benefit analysis has not been prepared, it is unclear what net benefits will actually be realized.[25]

Some past capital spending is generating low economic returns

There has been a problem of excessive spending on projects with low-to-negative economic returns (Box 2). The first example is an irrigation

Box 2: Poor Economic Returns of Past Infrastructure Investments

Irrigation Rehabilitation

Timor-Leste's irrigation strategy is based on rehabilitating irrigation schemes developed during the period of Indonesian government. The Bebui irrigation rehabilitation project was completed in 2012: it rehabilitated irrigation covering 1,300 hectares of land, and cost $8.6 million. The Ministry of Finance ex-post evaluation found that the project is generating a negative internal rate of return. This was due to the project's high cost per beneficiary or farmer, and because it was producing only moderate yield increases. The increase was attributed to a failure to provide adequate support services to farmers, and a lack of financial incentives for them to produce crops in surplus to the family's needs.

Electricity Grid Development

Timor-Leste has made significant progress in improving access to reliable electricity. However, this achievement has come at a high financial cost. It spent approximately $1.6 million per megawatt (MW) of electricity generation capacity in constructing the Betano and Hera power plants. The two plants' total generation capacity (256 MW) is far in excess of demand (53 MW). Moreover, the cost of generating electricity using the new diesel-based system is expensive; in 2012, it was estimated to be $0.42 per kilowatt-hour (kWh). Yet, Electricidade de Timor-Leste (Timor-Leste Electricity) is only managing to recover about 15% of this cost through its operations. This is a function of the below-cost average tariff rate ($0.19 per kWh), and a lack of comprehensive metering. As a result, the government is forced to significantly subsidize electricity consumption through its annual recurrent budget.

In 2012, the subsidy amounted to approximately $90 million. Alternative choice, and sequencing of capital investments, could have delivered lower cost electricity and avoided overcapacity. Choosing to build the Ira Laharo hydropower plant to complement diesel-fired plants, for example, could have reduced the 2012 subsidy and fuel import bill by nearly 50%. Phasing in the Betano plant, starting in 2017, would have reduced the overall capital cost for the project in 2013 prices by 20%. Ultimately, the project's ability to generate a positive rate of return will depend on significant increases in demand from industry and households over the medium term.

continued on next page

[24] Democratic Republic of Timor-Leste, Ministry of Finance. 2012. *State Budget 2013: Budget Overview, Book 1*. Dili.

[25] Also see an analysis by La'o Hamutuk for a discussion about the Tasi Mane Project. Source: La'o Hamutuk. South Coast Petroleum Infrastructure Project. http://www.laohamutuk.org/Oil/TasiMane/11TasiMane.htm

Box 2 *continued*

Investors have shown interest in exploring the establishment of energy-intensive investments in brewing and cement-making. This is a good sign. However, these potential investments may be unattractive at an electricity tariff level that fully covers the cost of generation. There is, therefore, an urgent need to improve the existing power sector's performance by reducing the cost of generating electricity, improving metering and collection, and reducing the subsidy.

Source: Democratic Republic of Timor-Leste, Ministry of Finance; and World Bank. 2015. *Timor-Leste Public Expenditure Review: Infrastructure.* Dili.

rehabilitation project; the second relates to the development of the national electrical grid. Both projects were driven by their inclusion in the SDP. Neither project underwent a detailed cost–benefit analysis demonstrating positive economic rates of return nor, as for electricity generation, showed the ability to operate without a significant government subsidy. A better planned capital investment in the power sector, for example, would cut approximately 10% of the State's 2015 recurrent budget.[26] Given the ongoing electricity subsidy, there is an urgent need to improve the power sector's performance.

New public investment management institutions were introduced in 2011, but implementation remains a challenge

Recognizing past problems, the government has introduced a number of institutional reforms since 2011 to strengthen its public investment management system. An Infrastructure Development Fund, chaired by the Prime Minister, was established in 2011 to manage all large projects over $1 million. It accounts for approximately 80% of allocated capital spending. Other smaller capital expenditures are managed through line ministry budgets or the district development program.

Three new central agencies were established to support the Infrastructure Development Fund—the Major Project Secretariat (MPS), the National Procurement Commission (NPC), and the Agência de Desenvolvimento Nacional (National Development Agency, or ADN). The MPS focuses on conducting ex-ante analysis of project proposals; NPC on procurement; and ADN on upstream project appraisal, with an emphasis on costings, downstream project supervision, and management of district infrastructure programs. The Ministry of Finance also audits the procurement processes.

Prior to 2011, all capital spending was decentralized to line ministries. While line ministries continue to be responsible for proposing and justifying large projects, project proposals undergo a greater degree of scrutiny under the new system than previously. Despite the reforms, a number of implementation problems remain:

- **Continued selection of large projects with low economic returns.** Large irrigation and road projects continue to be funded, despite very low to negative economic rates of return. This issue continues, despite MPS' important role. The economic and planning function is missing, which would assess the economic returns of sector strategies, and ensure individual infrastructure projects form part of an integrated development package. In agriculture, for example, this would involve

[26] Footnote 23. The total 2015 recurrent budget is $1.1 million, of which $115.0 million is allocated to supporting electricity generation.

carefully assessing the economic returns from the irrigation strategy aimed at achieving rice self-sufficiency.

- **Insufficient maintenance budgets to preserve physical assets.** Timor-Leste's climate and topography create problems for infrastructure maintenance. The quality of the road network, for example, has significantly deteriorated since independence in 2002. The country's poor record in maintaining road infrastructure can be partly explained by inadequate planning and limited capacity. Insufficient maintenance budgets are also a likely factor. The roads maintenance budget has previously been estimated at a quarter of optimal levels.[27]

  There has also been a tendency to spend this less-than-optimal maintenance budget on emergency road rehabilitation work. Successful implementation of all road projects outlined in the Infrastructure Development Fund between 2014 and 2018 would require a substantial increase in maintenance spending over what is planned.[28]

- **Weaknesses in the procurement process remain.** Internal audits in 2009–2011 highlighted serious systemic weaknesses in internal controls and procurement systems across line ministries. The government appears committed to addressing the audit findings and reporting on progress. Ensuring procurement processes are competitive is one simple way of reducing rent-seeking opportunities.

  Unfortunately, the new processes appear unable to halt the growth of single-sourced procurement. For example, in 2013, the procurement portal indicated that nearly 75% of the value of all contracts under $1 million was single-sourced. In the same year, 60% of the value of all contracts over $1 million was also single-sourced.

  Excessive use of noncompetitive procurement methods is neither beneficial for government, nor the private sector. Government is unlikely to get value for money, and this habit creates an incentive for bribery by businesses. A 2014 survey of businesses identified corruption as one of the most problematic factors for doing business in Timor-Leste. Corruption ranked third, behind "lack of access to finance" and "poor work ethic in national labor force."[29]

  The lack of competitive procurement processes also tends to provide those businesses awarded government contracts with excessive profit margins. This has a knock-on effect, undermining competitive pressures in other parts of the economy that provide goods and services to these favored businesses. In response, the government introduced a cap on the use of single-source procurement (10% of each line ministry's budget) in 2014.

[27] The funding needed to maintain the core road network in 2009 (1,600 kilometers) was estimated at between $20 million and $30 million. Yet, annual expenditures averaged less than $2 million a year from 2004–2010. In 2013, $4.4 million was allocated for routine road maintenance. Sources: ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Asian Development Fund Grant to the Democratic Republic of Timor-Leste for the Road Network Development Sector Project*. Manila; ADB. 2010. *Performance Evaluation Report: Timor-Leste Emergency Infrastructure Rehabilitation Project (Phases 1 and 2)*. Manila; and ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Democratic Republic of Timor-Leste for the Road Network Upgrading Sector Project—Economic and Financial Analysis*. Manila.

[28] The Government of Timor-Leste's 2014–2018 5-year roads plan allocates $234 million for routine and periodic maintenance, or 14% of the overall $1.7 billion plan. Other countries with substandard roads, such as India, allocated approximately 45% of its total road expenditures to maintenance. Source: Democratic Republic of Timor-Leste, Ministry of Finance; and World Bank. 2015. *Timor-Leste Public Expenditure Review: Infrastructure*. Dili.

[29] World Economic Forum. 2014. *The Global Competitiveness Report 2014–2015*. Geneva.

Further changes are planned in an ongoing effort to address these issues. In February 2015, the government announced the establishment of a new Ministry for Planning and Strategic Investment, with the country's former Prime Minister and President as its minister.[30] Part (or all) of MPS, NPC, and ADN is expected to fall under this new ministry.

There is interest in encouraging public–private partnerships to deliver infrastructure services

Many of the country's infrastructure services are delivered by government agencies. The Directorate of Roads, Bridges, and Flood Control manages roads; Electricidade de Timor-Leste (Timor-Leste Electricity, or EDTL) is responsible for electricity delivery; the Direcção Nacional dos Serviços de Água (National Directorate for Water Services, or DNSA) and the Direcção Nacional de Saneamento Básico (National Directorate for Basic Sanitation, or DNSB) manage water and sanitation; the Dili Port Authority overseas the seaport; and the Civil Aviation Authority manages the airport. It is essential to provide these services reliably and efficiently.

Using the electricity sector as an example, previous investment decisions have saddled the country with a financially and operationally unsustainable system. The government, not EDTL, made the decision to use diesel-fired generation.

In early 2015, EDTL did not have financial autonomy over its operational and investment decisions. Corporatizing the agency, giving it greater financial and operational autonomy, can increase the incentive to improve sector performance. This option may also suit other agencies and sectors. However, this strategy's success relies on highly experienced and capable management. Unfortunately, these agencies have limited capacity and experience to effectively plan and implement investments, or to manage service delivery.

Another option to strengthen infrastructure provision is through greater private sector participation. The government has recognized this potential, and is actively pursuing public–private partnerships (PPPs) in building and delivering infrastructure services.[31] A PPP policy was prepared in 2012, followed by the introduction of a legal framework for implementing PPPs.[32] A small PPP Unit (PPPU) has also been established in the Ministry of Finance. It is in the early stages of building its capacity, supported with technical assistance from the Asian Development Bank (ADB), International Finance Corporation (IFC), and World Bank.

Successful PPP procurement requires a highly iterative and analytical process that is markedly different from traditional public procurement. Involving institutions responsible for traditional

[30] Democratic Republic of Timor-Leste. 2015. Media Release: Members of the incoming Sixth Constitutional Government meet. 12 February. http://timor-leste.gov.tl/?p=11219&lang=en

[31] A PPP is a procurement (contractual) process to provide services or deliver assets through public and private sector cooperation, for periods ranging from 5 to 30 years. PPPs can take a number of forms; the most common include (i) service contracts, (ii) management contracts, (iii) concessions, and (iv) build-own-lease (BOL) or build-operate-transfer (BOT) contracts. Under a service contract, the private sector provides a service (such as road maintenance or transport) for a fee. Under a management contract, the private sector manages but does not own public assets. Concessions involve the private sector modernizing public assets to deliver a specific output. Under BOL and BOT contracts, the private sector builds a new asset (such as a hospital or power generation unit), and then leases the asset back to the public sector (e.g. hospital) or sells its output (e.g., power) to the public sector, or directly to consumers.

[32] Democratic Republic of Timor-Leste. 2012. Decree Law No. 42/2012—Regime Jurídico das Parcerias Público Privada (Legal Regime of Public Private Partnerships); and Democratic Republic of Timor-Leste. 2013. Media Releases. Diploma Regulating the Legal Regime of Public Private Partnerships. 22 November. http://timor-leste.gov.tl/?p=9394&lang=en&lang=en. A further revision to the 2012 decree law was introduced in 2014 (Decree Law No. 08/2014).

public procurement in the PPP procurement process could hamper the government's ability to effectively conclude PPP arrangements. The first projects to move through the procurement phase should provide an opportunity to adjust the PPP legislation to improve the procurement process.

There is one major PPP project underway in 2015, to develop a new seaport at Tibar Bay. Due to their complexity, PPP projects must be well prepared to attract quality international bidders. Given the PPPU's limited capacity, the World Bank is providing support to manage the procurement process for the Tibar Bay project. Four companies prequalified to bid on the project in February 2014, and a contract is expected to be awarded in 2015.

Power and water are additional infrastructure sectors that warrant increased private sector involvement. Both are managed by government agencies (EDTL for power and DNSA for water) with weak capacity. The government is exploring the potential of engaging the private sector to manage the Dili water system through a PPP arrangement. Similar exploratory work should be undertaken for power generation and distribution.

Once established, PPP contracts need to be managed to ensure that services are efficiently and effectively delivered. In Timor-Leste, it is unclear how PPP contracts will be managed, and by whom. The separate issue of how infrastructure services will be regulated is discussed in the competition policy section (Chapter 5).

INCREASED GOVERNMENT RECURRENT SPENDING NEGATIVELY AFFECTS PRICES AND EXPORT COMPETITIVENESS

Timor-Leste uses the United States dollar as its currency and, as such, the government is unable to use monetary policy to control inflation. Managing public spending (fiscal management) is the main policy tool at its disposal.

Over the period January 2010 to December 2014, Timor-Leste's consumer price index (CPI) increased by 21%, from 100.0 to 121.3.[33] Much of the increase occurred during 2011 and 2012, when average annual percentage change in the CPI exceeded 10% (footnote 12). This is well above the annual target inflation range of 4%–6% set out in the SDP, and much higher than inflation registered in other dollarized economies.[34]

A 2011 analysis conducted by the Ministry of Finance identified sharp increases in government recurrent spending as the main cause behind the trend.[35] Inflation began to fall during the second half

[33] Democratic Republic of Timor-Leste, Central Bank of Timor-Leste (Banco Central de Timor-Leste). CPI, NEER, and REER Timor Leste with Trading Partner. http://www.bancocentral.tl/en/ReerIndex.asp?Groups=CPIIndex&FromMonth=1%2F1&FromYear=2010&UntilMonth=3%2F1&UntilYear=2015&submit=Submit (accessed 27 March 2015).

[34] For example, the average annual percentage change in consumer prices for Ecuador, El Salvador, the Marshall Islands, the Federated States of Micronesia, and Palau (all of which use the United States dollar as their currency) for the years 2011 and 2012 was approximately 4.4%. Source: IMF. World Economic Outlook Database. http://www.imf.org/external/pubs/ft/weo/2014/01/weodata/weorept.aspx?sy=2011&ey=2012&scsm=1&ssd=1&sort=country&ds=.&br=1&pr1.x=59&pr1.y=11&c=867%2C868%2C565%2C248%2C253&s=PCPIPCH&grp=0&a= (accessed 27 March 2015).

[35] The analysis found that increases in international food, beverage, and commodity prices—together with the dollar's depreciation—were contributing factors to the rise in inflation. However, it also found evidence that greater recurrent expenditures by government, financed by oil revenues, increased inflation. Because international prices and the value of the dollar are not under government control as is recurrent expenditure, the pressure for stabilizing inflation lies with fiscal policy. The report recommended prudent fiscal management as important for curtailing inflation. Source: Democratic Republic of Timor-Leste, Ministry of Finance. 2011. *Analysis of Inflation in Timor-Leste*. Dili.

of 2013, and has been well below the 4%–6% target range since the beginning of 2014.[36]

The period of increased domestic prices helped drive increases in the country's real effective exchange rate (REER).[37] The REER provides information on the degree of competitiveness of one country versus others. It measures both exchange rate changes, and inflation differentials between trading partners. A rising REER means that the cost of purchasing goods and services in a country is increasing, relative to its major trading partners.

Despite data limitations, Timor-Leste's REER appears to have steadily appreciated since 2010. Data produced by the Banco Central de Timor-Leste (Central Bank of Timor-Leste, or BCTL) indicates that the REER increased by just over 43% between January 2010 and December 2014.[38] This implies that Timor-Leste's economic competitiveness has declined versus that of its trading partners. This negatively impacts on the potential for businesses to develop domestic manufacturing and exports.

Much of the REER appreciation in recent years, however, can likely be attributed to a strengthening dollar compared with other currencies, rather than relative increases in inflation. For example, the dollar appreciated approximately 34% versus the Indonesian rupiah (Timor-Leste's major trading partner) between January 2010 and December 2014, with the majority of the appreciation occurring since the beginning of 2013.

In the longer term, the SDP raises the possibility of Timor-Leste introducing its own national currency. This could help deal with inflation pressures and improve domestic competition, but any move to create a national currency would need to be carefully assessed. It would also need an institutional and operational capacity (that does not exist) within BCTL to effectively manage the currency's introduction, and more flexible exchange rate arrangements. Moreover, an independent monetary policy and nominal exchange rate flexibility would likely provide little immediate benefits, given the economy's structure. This is also likely to increase the risks facing prospective foreign investors.

In the absence of a flexible national currency, prudent fiscal management will be critical to keep inflation under control and prevent further appreciations in the REER. The government should, therefore, consider reducing the inflation target from its current 4%–6% range, to 2%–4%.

36 Year-on-year inflation between September 2013 and 2014 was 0.5%. Source: Democratic Republic of Timor-Leste, National Directorate for Economic Policy. 2014. *Quarterly Inflation Review: July–September 2014*. Dili.

37 REER is a weighted average of the nominal exchange rates of trading partners. Weights are based on the trade shares. REER adjusts for inflation differentials with countries whose currencies are in the basket. As the inflation rate in each country is expected to indicate the trends in domestic cost of production, the REER is expected to reflect foreign competitiveness of domestic products. A trend appreciation in the REER is considered unfavorable for the growth of exports, as it favors imports from competing countries.

38 The eight trading partners covered by Timor-Leste's REER include Indonesia (45%), Australia (17%), Singapore (17%), Japan (7%), Viet Nam (5%), Thailand (4%), Malaysia (3%), and Portugal (2%). The REER index was 68.8 in January 2010 and had increased to 98.6 in December 2014. Source: Banco Central de Timor-Leste (Central Bank of Timor Leste). CPI, NEER, and REER Timor Leste with Trading Partner. http://www.bancocentral.tl/en/ReerIndex.asp?Page=6&Groups=REERIndex&FromMonth=1/1&FromYear=2010&UntilMonth=12/1&UntilYear=2014 (accessed 27 March 2015).

4 HUMAN RESOURCES AND RELATED ISSUES

Recommendations:

- Reduce student repetition and dropout rates in the primary school system (particularly the first 3 years), and increase student learning achievements in foundational skills such as literacy and numeracy. This requires
  - improving early childhood nutrition to maximize children's learning potential, and
  - improving teacher qualifications and increasing opportunities for them to upgrade skills.
- Strengthen implementation of the existing workforce strategy by
  - improving coordination among ministries and agencies with skills training responsibilities;
  - enhancing the quality and relevance of the secondary school system;
  - expanding the National Qualification Framework to cover all vocational training providers (both informal providers and technical secondary schools);
  - developing (with private sector assistance) regular, credible assessments of the demand for skills within the country; and
  - improving the quality of training providers' offerings, in line with market demands.
- Review the existing policy and legislation surrounding visas and permits for foreign investors and workers, to enhance the system's transparency and efficiency and make it more welcoming to foreign investors and employers. Explore consolidating the entire process within one agency, and introduce a more strategic approach that provides employers with streamlined access to highly skilled workers
- Review the legislated minimum wage to bring it more in line with competitor countries and local circumstances
- Reduce the total size of the public sector over time, and limit increases to public sector wages
- Continue efforts to mainstream gender concerns into government policies and programs
- Effectively implement the National Strategy and Action Plan for Gender and Private Sector 2014–2017

Human resources development has multiple dimensions, including educational attainment, workforce skills, and population health. It also includes employment policies that connect workers to business enterprises, and which enable them to adapt quickly to changing circumstances. Each is important to creating a favorable environment for private sector investment.

Approximately 40% of Timor-Leste's population aged 15 years and older has not had any education, and 25% has not advanced beyond primary education.[39] This low level of education presents significant challenges for the country as it attempts to develop a vibrant, competitive business sector, alongside competent institutions capable of providing quality, cost-effective public goods and services.

BASIC EDUCATION LEVELS AND LEARNING OUTCOME QUALITY

Access to basic education for girls and boys is a recognized human right, and educational attainment at the primary level is a minimum condition for development. It provides young people with skills such as literacy, numeracy, and problem solving, along with work habits that provide the foundation for further learning. International research also suggests that spending on early childhood development has the highest benefit–cost ratios compared to other types of education investment.[40]

Basic education in Timor-Leste is compulsory. It includes the first 9 years of schooling, and is provided free by the government (covering fees associated with enrollment, attendance, and certification). Significant progress has been achieved in increasing primary school enrollments, although disparities continue to exist between urban and rural areas. Net primary enrollment increased from 71% in 2008 to 91% in 2011, and girls' enrollment rate exceeds that of boys in both primary and secondary schools.[41]

Despite this, improvements continue to lag in the quality of instruction and learning outcomes. Many children who enter the primary school system are forced to repeat years. This occurs across all grades, but is highest in the first 3 years of school—creating overcrowding in grade 1 to 3 classes, and making teaching and learning at these levels more challenging.

Unsurprisingly, many children leave before reaching secondary school. In 2011, only 38% of secondary school aged children were enrolled in secondary school (footnote 41). Even that low figure was an improvement on the 2008 level of just 32%.

Teaching quality also continues to be problematic; the majority of teachers remain underqualified, with limited opportunities to develop and upgrade their skills.[42] Learning

39 Democratic Republic of Timor-Leste, Ministry of Finance, National Statistics Directorate; and United Nations Population Fund. 2012. *Timor-Leste Population and Housing Census 2010: Analytical Report on Education, Volume 9*. Dili.

40 G. Psacharopoulos. 2014. Benefits and Costs of the Education Targets for the Post-2015 Development Agenda. *Working Paper as of July 17th, 2014*. Lowell, Massachusetts: Copenhagen Consensus Center.

41 World Bank. World Development Indicators. http://databank.worldbank.org/data/views/variableselection/selectvariables.aspx?source=world-development-indicators#s_s (accessed 30 March 2015).

42 The Basic Education Act 2008 requires a minimum *bacharelado* (a bachelor, or undergraduate degree) qualification to teach at the primary level. Yet, few primary school teachers have achieved this minimum qualification. A new curriculum for grades 1 to 6 was also introduced after independence. While teacher training was conducted in the use of the new curriculum, it appears that still further training is necessary. One problem is that many teachers are weak in the language of instruction. The curriculum includes the country's two official languages (Tetum and Portuguese), with English as the first foreign language. Another challenge is a lack of capacity in learner-centric methodologies, with teachers lecturing (one-way communication) for more than 90% of class time. The high levels of absenteeism and violence in schools also indicate a problem with professionalism. Source: Democratic Republic of Timor-Leste, Ministry of Education. 2011. *National Education Strategic Plan 2011–2030*. Dili.

outcomes are also an issue, as many primary students show poor literacy and numeracy skills.[43]

Children's ability to be successful at school is also undermined by poor nutrition, particularly in the early years of life. Undernourished children are at a high risk of impaired cognitive development, which negatively affects their ability to learn.

Timor-Leste has one of the highest rates of "stunting" in the world. Stunting refers to having a low height for one's age, reflecting chronic undernourishment of a child between conception and 2 years. Preliminary analysis of a 2014 nutritional survey administered by the United Nations Children's Fund and the government indicates that 52% of children in Timor-Leste under 5 years of age are moderately or severely stunted.[44] Poor childcare and feeding, and limited access to nutritious foods, are the primary causes of undernourishment.

The government has developed national strategies to improve nutrition and education. However, the government needs to focus more attention and investment on addressing the stunting problem, and on improving the quality and outcomes of the basic education system. Failing to do this will significantly and adversely affect the country's long-term productivity and growth.

IMMEDIATE LABOR FORCE CHALLENGES

Businesses identify access to skilled labor as a major challenge in Timor-Leste. A survey published in 2014 by the World Economic Forum indicated that labor issues represented two of the five most problematic factors for doing business in the country.[45]

Workforce strategy is in place but implementation needs to be improved

Secondary and tertiary education is essential for equipping young people with the workforce skills that business needs. A shortage of trained workers is a serious obstacle to expanding business activity and investment.

The Government of Timor-Leste rightly views workforce development as a commitment priority. The SDP recognizes that that an effective technical and vocational education and training (TVET) sector is an important precondition to growing the private sector. Some notable related developments have occurred, including a TVET National Qualifications Framework (NQF) introduced in 2010, and the development of a TVET plan in 2012.[46] An NQF is a particularly useful reform, because it allows a country to integrate all its qualifications (by content and complexity) to enable equivalency across training providers.

[43] An assessment of early grade reading acquisition conducted in 2009 found that more than 70% of students at the end of Grade 1 could not read one word of a simple text passage; the same test applied at the end of Grade 2 resulted in 40%, and about 20% at the end of Grade 3. This failure to acquire a basic reading skill is a major contributor to the high rates of grade repetition and dropouts in Timor-Leste's primary schools. Source: A. Amorim, J. Stevens, and L. Gacougnolle. 2010. *Timor-Leste: An Analysis of Early Grade Reading Acquisition*. Washington, DC: World Bank.

[44] United Nations Children's Fund (UNICEF). Summary Results Matrix: Government of Timor-Leste UNICEF Country Programme, 2015–2019. http://www.unicef.org/about/execboard/files/Timor_Leste_CPD-SRM-2015-2019.pdf

[45] A "poor work ethic in the national labor force" was identified as the second most problematic factor for doing business in the country, and an "inadequately educated workforce" was the fifth most problematic factor. Source: World Economic Forum. 2014. *The Global Competitiveness Report 2014–2015*. Geneva.

[46] Democratic Republic of Timor-Leste, Secretariat of State for Vocational Training Policy and Employment; International Labour Organization; and SMYL Community Services. 2012. *Timor-Leste Technical and Vocational Education and Training Plan 2011–2030*. Dili.

Timor-Leste's workforce training system is organized into three groups: (i) secondary schools that include general and technical schools, (ii) post-secondary TVET with a wide range of training providers, and (iii) higher education institutions that provide mostly technical education (Table 3). The Ministry of Education is responsible for secondary schools, while the Secretária de Estado para a Política de Formação Profissional e Emprego (Secretariat of State for Vocational Training Policy and Employment, or SEPFOPE) oversees post-secondary TVET. Private institutions regulated by the Agência Nacional para a Avaliação e Acreditação Academica (National Agency for Academic Assessment and Accreditation) deliver higher education.

A review of Timor-Leste's workforce system published in 2014 indicates that, while workforce development is a high political priority, the system's

Table 3: Overview of Workforce Training Provision in Timor-Leste

Category	Description
Secondary schools	• Administered by the Ministry of Education • Includes – **general secondary**—total of 74 schools (43 publicly managed), and total number of students enrolled approximately 35,000 in 2010; and – **technical secondary**—total of 31 schools (12 publicly managed), and total number of students enrolled approximately 6,000 in 2010.
Postsecondary Technical and Vocational Education and Training	• Administered by the Secretariat of State for Vocational Training Policy and Employment (SEPFOPE) • Includes about 100 training providers. Two are public institutions: Centro Nacional de Emprego e Formação Profissional (CNEFP Tibar) and Centro Nacional de Formação Profissional–Becora (CNFP SENAI). The remainder comprises nongovernment organizations, churches, and donor-funded organizations. Thirty-nine are registered with SEPFOPE and eligible to receive funding support, while 21 are accredited. The total number of students enrolled in accredited institutions was approximately 2,000 in 2012. • Accredited training providers must meet quality assurance standards set in the National Qualifications Framework (NQF). The Instituto Nacional de Desenvolvimento de Mão-de-Obra (National Labor Force Development Institute) acts as the regulatory body for implementing the NQF.
Higher education	• Includes 11 private institutions offering higher education degrees and programs. Most offer technical education. Total number of students was approximately 8,000 in 2011. The government plans to create three new publicly funded polytechnic institutes focusing on tourism and hospitality; engineering; and services, tourism, and administration. • Training providers must meet quality assurance standards set by the Agência Nacional para a Avaliação e Acreditação Academica (National Agency for Academic Assessment and Accreditation).

Source: World Bank. 2014. *Timor-Leste Workforce Development Systems Approach for Better Education Results (SABER) Country Report 2013: Timor-Leste*. Washington, DC. http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/08/25/000470435_20140825124050/Rendered/PDF/901090WP0Box030rLeste0CR0Final02013.pdf capacity to deliver results remains weak.[47] The review's findings identify the key challenge as moving from strategy to implementation. There are a number of specific problems to address.

- **Insufficient attention to secondary schools.** This is the largest component of the system for student numbers. Yet, the national curriculum is outdated and lacks quality and relevance. There is insufficient attention paid to practical skills training in technical secondary schools. Coupled with poor infrastructure and equipment, this produces students who lack work-ready skills.

  This component of the system also lacks an appropriate quality assurance framework. Moreover, these schools are financed from the state budget (largely based on enrollment), and suffer from a severe lack of funds. For example, technical secondary schools receive only $1 per student every 3 months for recurrent expenditures.

- **Insufficient business input into the national training system.** Training institutions need reliable information on existing and emerging skills demands, to ensure their program offerings are relevant to the marketplace. This is typically achieved through partnerships with employers and industry associations, and ongoing assessments of national economic prospects and future skills requirements.

  The Instituto Nacional de Desenvolvimento de Mão-de-Obra (National Labor Force Development Institute, or INDMO) has established a number of sector-specific consultative commissions to provide industry input into the postsecondary TVET system,[48] and ad hoc labor force assessments are conducted. Yet, greater business input is needed to define strategic workforce development priorities, along with regular, credible assessments of businesses' skills demands. There are no links between the secondary school system and industry.

- **A National Qualifications Framework with limited reach.** While the NQF's introduction was a positive step, it covers less than 25% of total postsecondary TVET training providers. Moreover, technical secondary schools operate completely independent from the NQF. The system's capacity needs expanding to include all postsecondary TVET training institutions, and determine how general technical schools can benefit from reforms.

- **Limited capacity and coordination to effectively implement workforce strategies.** Translating strategic plans into actionable measures, and coherently involving and coordinating different stakeholders in implementation efforts, are critical. Unfortunately, there is limited technical and planning capacity within the Ministry of Education and SEPFOPE to translate policies and strategies into actionable measures. Coordination is also a major issue. While different ministries and agencies have well defined roles, coordination is haphazard. The

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47 World Bank. 2014. *Timor-Leste Workforce Development Systems Approach for Better Education Results (SABER). SABER Workforce Development Country Report 2013: Timor-Leste*. Washington, DC. Unless otherwise stated, information presented is sourced from this report.

48 For example, INDMO has established industry subcommissions to enable industry participation in the vocational training system: construction, administration, finance and information and communication technology, education, training and assessment, tourism, agriculture, automotive, and oil and gas. Each subcommission has majority membership from industry. Source: Democratic Republic of Timor-Leste, Secretariat of State for Vocational Training Policy and Employment. 2013. *INDMO: The First Five Years 2008–2013*. Dili.

government plans to establish a structured interministerial working group on skills and training. This working group could also help solve coordination issues.

Agencies responsible for different aspects of the education and training system need to work collaboratively to develop a plan for addressing these issues and ensuring that the workforce strategy can be effectively implemented.

Access to foreign workers is problematic

Information on specific skills gaps in Timor-Leste's labor market is limited; the overall low levels of education and business owners' concerns suggest significant gaps, occurring across the economy in all types of occupations. An enterprise and skills survey conducted in 2013 noted that, due to these skills gaps, the number of foreign workers was increasing in most sectors of the economy.[49]

This is understandable. To be competitive and profitable, businesses need the ability to hire competent and experienced staff. If businesses are unable to find staff in the local labor market, they will look to hire from abroad. This approach applies for all job positions, and is especially critical for management and technical areas. The ability to readily access foreign workers is particularly important for foreign investments, which often require experienced staff to deploy from more established parts of the organization to ensure that new facilities and local implementation of best practice corporate operations are smoothly implemented.

Immigration policy is a politically sensitive issue in most countries, and involves finding an acceptable balance between encouraging investment with a liberal foreign worker regime on one side, and protecting the local labor market and national security on the other. In countries with limited labor pools such as Timor-Leste, it is good practice to establish a strategic approach that provides investors with confidence they can access foreign workers, particularly highly skilled ones, quickly and transparently. Unfortunately, Timor-Leste's system is overly bureaucratic, time-consuming, and treats all foreign workers equally.

In Timor-Leste, access to foreign workers is regulated under the Immigration and Asylum Act (Law No. 9/2003). There are three different types of visas and permits.[50]

(i) **Tourism or business visa.** It is valid for up to 90 days. It allows foreign citizens to visit the country for tourism and business activities.

(ii) **Work visa.** It is valid for 1 year and can be renewed for a total of 3 years. It allows foreign citizens to temporarily perform a remunerated professional or independent activity, as specified in the visa.

(iii) **Residence permit.** It includes a temporary resident permit (valid for 2 years), or a permanent resident permit (no time limit, but must be renewed every 5 years). To be considered for a permanent resident permit, a foreign worker must have been a legal resident in Timor-Leste for at least 12 consecutive years.

[49] Democratic Republic of Timor-Leste, Secretariat of State for Vocational Training Policy and Employment. 2014. *Enterprise and Skills Survey 2013*. Dili.

[50] Summarized from information provided in T. Santos and C.A. Florindo. 2013. New Country, New Needs, New Responses: Irregular Labour Migration to Timor-Leste. *Research Report ACPOBS/2013/PUB14*. Brussels: African, Caribbean, and Pacific Observatory on Migration.

There is no readily available written information that clearly explains how the visa and permit system works. This makes it difficult for businesses to know what to do to comply with the legislated requirements.

More problematic is the lack of a mechanism for businesses to access new foreign workers for a period beyond 1 year. Identifying, hiring, and relocating a foreign worker into a country is expensive. To recoup this cost, employers typically expect to keep these workers for several years. In Timor-Leste, annual work visas must be obtained for 3 years before a 2-year residence permit can be applied for. The application process for a work visa involves interacting with three agencies—Ministry of Foreign Affairs, SEPFOPE, and Serviço de Migração de Timor-Leste (Immigration Service of Timor-Leste). Each plays a role in the final decision.

The Ministry of Foreign Affairs issues the work visa but requires mandatory reports from the other two agencies before doing so. SEPFOPE's role is intended to address the labor market question (i.e, "Could the position be filled by a citizen worker?"), while the Immigration Service's role is to ensure the proposed worker does not pose a health or security threat. Neither the law nor regulations specify time lines within which these consultations should occur. Anecdotal feedback from the business community suggests it is not uncommon for the overall process to take 6 months or more.

SEPFOPE's opaque decision-making process, along with its one-size-fits-all approach, is equally problematic. The Immigration and Asylum Act 2003, for example, does not specify the requirements to be complied with, nor how decisions about work visas should be made. SEPFOPE typically requires a site visit to the business to ascertain the position's legitimacy. It then requires the employer to demonstrate they have advertised the position and their inability to find a suitable local candidate, and interviews the candidate. These requirements apply regardless of the type of position.

Timor-Leste, like other countries, needs skilled workers. Moreover, because of their age, qualifications, and experience, these types of workers are unlikely to take jobs away from citizen workers. A more transparent, strategic approach that differentiates between highly and less skilled workers seems warranted.

The Immigration and Asylum Law 2003 also does not include a specific visa classification for investors. However, the Private Investment Law No. 14/2011 allows foreign investors to access temporary resident permits and permanent resident permits, if residing in the country for more than 3 consecutive years. The Private Investment Law 2011 also establishes a mechanism to allow foreign workers, who are part of investment agreements, to access work visas. However, it is unclear how these elements are implemented in practice.

Labor costs are relatively high compared to competitor countries and productivity

Governments can play an important role in private sector wage formation, both directly (interventions such as the use of minimum wages), and indirectly (through their civil service wage policies). In countries characterized by large public sectors and a limited skilled labor pool, businesses are forced to align their wages with those in the civil service to attract skilled workers.

A review of wages in Timor-Leste (footnote 4) identified several issues.

- **High average wages, relative to productivity and skills.** Using data generated by the Timor-Leste Labour Force Survey Report 2010, it determined that average wages represented 95% of gross domestic product (GDP) per employed person (footnote 5). Including nonwage benefits would likely increase this to 100% or more, suggesting that workers' efforts in aggregate are not generating any surplus—the entire value of what they produce is only sufficient to compensate them.
- **The number of people employed in public sector, and the civil service wage bill, is high compared to other countries.** Timor-Leste's public sector employment to population ratio was 3.6%. Of its neighbors, only Malaysia's ratio was higher. Its civil service wage bill as a percentage of GDP was 25%–50% higher than in Fiji, Tonga, and Vanuatu; and two to four times higher than in Cambodia, the Lao People's Democratic Republic, and Solomon Islands.

  The informal minimum wage set in 2009 by the United Nations Transitional Administration in East Timor of $85 per month served as the initial benchmark for wages in the formal sector, particularly the civil service. A country's minimum wage policy is typically set at close to the estimated poverty line. In Timor-Leste, the rate was set more than two and a half times the estimated basic needs poverty line of $32 per month.
- **High minimum wage relative to other comparison countries.** The minimum wage policy was reviewed in 2012; and a new national minimum wage was set at $115 per month, to be paid 13 times a year. Timor-Leste's minimum wage was estimated to be 207% of GDP per capita, compared to ratios between 18% and 37% of countries such as Brazil, Cambodia, the Dominican Republic, Indonesia, Malaysia, Thailand, and Viet Nam.

High public sector wages, and the minimum wage, force businesses to pay more for labor than would normally be warranted. It also encourages the substitution of capital for labor in a country where capital is scarce and labor, abundant. This is particularly problematic in Timor-Leste, where the available workers' productivity and skills are low. The relatively high wages for unskilled labor, and the need to train those workers, are likely to negatively affect business expansion and job creation. Notably, the formal sector's relatively high wages are limited to just 12% of the working age population. The majority of people, many of whom fall below the poverty line, do not benefit.

Research from Indonesia has found that minimum wage increases, as was introduced in Timor-Leste in 2012, had significant and negative employment effects in small firms and among less educated workers.[51] It also found that negative employment impact was more severe for nonproduction or service sector workers, and that women were disproportionally affected within this group. A high minimum wage policy also increases rates of noncompliance, and pushes people into the informal sector. Future adjustments to Timor-Leste's national minimum wage will need to be carefully considered. Ideally, it should be set at a level close to the revised estimated poverty line.

[51] X. Del Carpio, H. Nguyen, and L.C. Wang. 2012. Does the Minimum Wage Affect Employment? Evidence from the Manufacturing Sector in Indonesia. *Policy Research Working Paper Series.* No. 6147. Washington, DC: World Bank.

The public sector wage bill steadily increased between 2010 and 2014, growing on average 18% per year.[52] Much of the growth appears due to increased staff numbers, rather than wage increases. This is despite the civil service review findings that recommended a freeze in staff recruitment, because the civil service was growing too quickly and unsustainably. Because wages have not kept pace with inflation, government agencies have been encouraged to recruit people outside of the normal service structures. As such, the real government wage bill has likely grown by more than 18% annually.

The civil service is undertaking a civil service remuneration review. Because of the civil service's size, its wages are influential in setting wages throughout the economy. The country will need restraint to ensure that its already relatively high wage structure is not made even more uncompetitive.

CONSTRAINTS TO INCREASING WOMEN'S CONTRIBUTION TO THE FORMAL ECONOMY

A country significantly benefits when it ensures that men and women have equal access to and control over resources, along with equal opportunities to participate in the formal economy. Discriminatory policies and practices generate significant economic and social costs.[53]

The government is committed to ensuring women are able to participate equally in all aspects of life. It acceded to the United Nations Convention on the Elimination of All Forms of Discrimination against Women in 2003, a year after independence. The government also established the Secretaria de Estado da Promoção da Igualdade (Secretariat of State for the Promotion of Equality, or SEPI) in 2008 to plan, implement, coordinate, and evaluate policies to support gender equality. In February 2015, SEPI became the Secretaria de Estado para o Apoio e Promoção Sócio-Económica da Mulher (Secretariat of State for the Support and Socio-Economical Promotion of Women, or SEAPSEM).

Despite significant achievements in areas such as improving girls' primary school enrollment rates and achieving high rates of female representation in Parliament, the country still faces significant challenges in economically empowering its female population.

Women remain underrepresented in the formal economy. While wage-earning jobs have tripled since 2001, the gains have gone largely to men: 31% of employed men in 2010 were in wage-earning jobs, compared with only 19% of employed women.[54] There is also a gender gap in business ownership and employment. Women are estimated to own around 24% of formalized businesses.[55]

Between 2011 and 2012, the percentage of male employment grew by 13%, while women's employment grew by 8.6%.[56] In terms of employment within the non-oil private sector, only 26% of the total persons employed in 2012 were

52 Timor-Leste's recurrent salaries and wage bill grew from $91.5 million in 2010 to $176.8 million in the 2014 budget. Source: Democratic Republic of Timor-Leste, Ministry of Finance. 2013a. *State Budget 2014: Budget Overview, Book 1*. Dili.

53 The United Nations Economic and Social Commission for Asia and the Pacific, for example, estimated that economies in the Asia-Pacific region are losing between $58 billion and $77 billion per year just by restricting women's access to employment and education. Source: Economic and Social Commission for Asia and the Pacific. 2007. *Economic and Social Survey of Asia and the Pacific 2007: Surging Ahead in Uncertain Times*. New York: United Nations.

54 ADB. 2014d. *Timor-Leste Country Gender Assessment*. Manila.

55 C. Parois and S. McCord. 2009. *Business Community in Timor-Leste Part One: Overview*. Dili: Peace Dividend Trust.

56 Democratic Republic of Timor-Leste, Ministry of Finance, General Directorate of Statistics. 2014a. *Business Activity Survey of Timor-Leste 2012*. Dili.

women. Moreover, the gap has continued to widen. Between 2010 and 2012, the number of women employed by non-oil businesses increased by 16%, whereas men's employment numbers increased by 45% over this same period (footnote 7).

To increase women's participation in the formal economy, a range of challenges need to be addressed (footnote 54).

- **High fertility rates.** Traditional social norms encourage women to marry and begin childbearing at a relatively young age. As a result, women's household responsibilities, especially childcare, limit their engagement in the labor market.
- **Persistent and pervasive gender-based violence, including domestic violence.** A survey conducted in 2009 and 2010 revealed that 38% of women over the age of 15 years had experienced physical or sexual violence (footnote 54). The government has responded by introducing a legislative framework to address the issue, including passing the Law Against Domestic Violence (Law No. 7/2010) and developing a National Action Plan on Gender-Based Violence.[57] While this is very positive, women face barriers in accessing justice due to limited police outreach; low number of, and long distances to, courts; coexisting customary and formal justice systems; and language and literacy challenges.
- **Educational disadvantages preventing women from building their productive capacities.** About 58% of women aged 25 years and above have never been to school (versus 43% of men), and only 52% of women aged 15 years and older are literate (versus 63% of men). Women comprise slightly more than half the trainees in accredited post-secondary TVET programs, but most are concentrated in traditionally "female" skill areas (administration, finance, and hospitality) rather than nontraditional technical areas where more high-paying employment opportunities exist.
- **Unresolved land tenure situation disadvantaging women.** Much of the land is community-owned with usage rights allocated to individuals; these rights are then passed on, through inheritance, to family members.[58] These rights are usually given to men (except in certain matrilineal communities) and passed through the male line. Women only acquire the use of land through marriage, and do not hold rights to the land. Proposed land legislation has been drafted to ensure that women and men are treated equally in matters of land ownership and inheritance rights.
- **Access to finance a major obstacle for starting and improving a business.** Microfinance is estimated to reach around 5% of the population, although the uptake varies considerably by district (footnote 54). Several microfinance institutions specifically target women entrepreneurs and, overall, more women than men benefit from microfinance loans. However, there is still a huge unfulfilled gap in the supply of microfinance. Filling that gap requires new products and business development training, and further research to determine how best to reach borrowers.

[57] Democratic Republic of Timor-Leste, Office of the Secretary of State for the Promotion of Equality. 2012. *National Action Plan on Gender-Based Violence*. Dili.

[58] The land tenure situation is discussed in Chapter 5.

Addressing these challenges requires actions to redefine social norms and institutions, to ensure they are gender-sensitive and that resources are provided equally to women and men. The government is implementing a number of related initiatives. For example, SEPFOPE has developed a draft Gender Mainstreaming Strategy 2010–2013,[59] and is implementing training projects that encourage greater female participation in nontraditional occupations,[60] and in rural areas.[61] In addition, the Secretaria de Estado de Apoio e Promoção do Sector Privado (State Secretariat for the Support and Promotion of the Private Sector, or SEAPRI) has developed the National Strategy and Action Plan for Gender and the Private Sector 2014–2017 in conjunction with the International Labour Organization.[62] The strategy strives to enhance stakeholder collaboration, and ensure that all policies and programs to develop the private sector are gender sensitive. It will be important for SEAPSEM to work closely with its counterpart government agencies to continue to mainstream gender concerns into government policies and programs. This particularly requires effective implementation of the National Strategy and Action Plan for Gender and Private Sector 2014–2017, along with other gender mainstreaming strategies.

59 Democratic Republic of Timor-Leste, Secretariat of State for Vocational Training Policy and Employment. Gender Mainstreaming Strategy 2010–2013 (Draft). Unpublished.

60 The Mid-Level Skills Training Project is being implemented with financial support from ADB, and focuses on accredited training in construction and automechanics. Under the project SEPFOPE aims to enroll at least 20% women among its trainees. ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Grant to the Democratic Republic of Timor-Leste for the Mid-Level Skills Training Project.* Manila.

61 The Business Opportunities and Support Services Project is being implemented with support from the International Labour Organization. It is aimed at boosting local economic development, enhancing government service delivery, and creating quality employment in rural areas.

62 Democratic Republic of Timor-Leste, State Secretary for the Support and Promotion of the Private Sector. 2013. *National Strategy and Action Plan for Gender and the Private Sector 2014–2017*. Dili.

5 LEGAL AND REGULATORY FRAMEWORK

Recommendations:

- Strengthen the legal framework and institutional capacity for land administration by
  - introducing land legislation that provides a way to settle land disputes and determine original title. Legislation should (i) recognize customary land tenure and provide state-managed negotiation frameworks, including voluntary registration, that facilitate access to customary land for economic development while minimizing the risk of land conflict; (ii) provide a legal foundation for developing a comprehensive land register of land titles and dealings; and (iii) establish clear procedures for expropriating land for a public purpose;
  - introducing an active monitoring process alongside the new land laws, enabling their amendment and further development as issues arise; and
  - continuing to build capacity within the Direcção Nacional de Terras, Propriedades e Serviços Cadastrais (National Directorate of Land, Property and Cadastral Services) to implement its land administration responsibilities, particularly in expanding the land claim process, efficiently processing land transactions, and working with rural communities to register their land for economic development purposes.
- Strengthen capacity for resolving and enforcing commercial contracts by
  - increasing public awareness on the use of contracts in commercial transactions;
  - continuing to build capacity within the justice system to credibly and more efficiently deal with commercial cases; and
  - introducing alternative dispute resolution legislation, and developing a local pool of mediators and arbitrators to settle disputes.
- Review the Commercial Companies Law No. 4/2004 to bring it in line with good international practice, and establish an online electronic business registry system
- Review business licenses and permits—particularly in key sectors such as agriculture, tourism, manufacturing, and trade—to ensure that they are efficiently administered using simple and transparent implementing regulations
- Develop a state-owned enterprise (SOE) policy. It should include
  - guidelines to ensure that proposals for establishing new SOEs are carefully assessed against private sector alternatives;
  - clear expectations for SOE financial performance, along with a transparent corporate governance framework to help prevent political pressure from distorting SOE priorities and managerial decisions; and

continued on next page

Recommendations *continued*

  - a clear framework for dealing with community service obligations, including allowing for private sector participation, where possible.
- Develop a framework for effectively regulating infrastructure services and promoting competition within the economy
- Introduce legislation and build capacity to enable development of land use plans, and develop clear implementing guidelines for conducting environmental impact assessments

A country's commercial legal and regulatory framework establishes a system of rules that govern business enterprises' behavior and activity. This framework establishes property rights, lays the foundation for reliable contracting, and determines how businesses operate and compete in the marketplace.

The Government of Timor-Leste has progressed in developing its commercial laws. Yet, significant gaps remain, particularly related to property rights in fixed and movable property. Fixed property refers to land and buildings, while movable property includes movable assets such as machinery, inventory, accounts receivable, harvests, and livestock. Property rights are the foundation of a modern economy. Effectively functioning laws establish ownership and property records, and enforcement mechanisms to protect property rights.

Institutional capacity to implement existing laws and regulations also remains weak in Timor-Leste. This continues to be a significant challenge, particularly in contract enforcement and business licensing.

INCOMPLETE LAND LEGISLATION AND REGISTRY

A well-defined, secure land title system delivers many economic benefits. It provides incentives for land maintenance, and reduces the probability of long-term land degradation.

A primary challenge for land governance in Timor-Leste is agreeing on a clear national land tenure policy. The country's tumultuous history is characterized by various waves of population displacement. This has created several layers of overlapping land claims based on different sources of legitimacy: (i) Portuguese land titles, (ii) Indonesian land titles, (iii) customary claims of authority over land, and (iv) long-term occupation. Since independence in mid-2002, some land-related legislation has been approved. However, this legislation has yet to establish a clear legal framework that separates the layers of land claims and determines "original" land rights.

The lack of land records prior to 1999 further complicates the issue. These records were destroyed in the violence following the independence referendum, making it impossible—in most cases—to independently verify claims. Consequently, a considerable number of land parcels remain under dispute. Moreover, claimants of other land areas not under dispute do not have a mechanism to safeguard their rights. This uncertainty makes it difficult for land to be as effective as it could be in the country's economic development.

The largest part of Timor-Leste's total land area of 14,870 square kilometers is governed by local customary tenure systems. A 2005 study estimated the amount to be as high as 97% of all land.[63] In Timor-Leste's customary systems, community leaders allocate the use of land; selling land to "outsiders" is generally not permitted. However, the systems vary across the country; and, in some areas, community members retain highly individuated rights to land that function like inheritable usage rights.[64]

During their occupation, the Portuguese issued approximately 3,000 land titles, of which half were in Dili. A large proportion of these did not have full ownership rights, but a form of limited-term lease with an option to buy. The Indonesian administration issued approximately 45,000 titles, evenly split between full ownership titles and a range of usage rights. The latter included several types of leases for state land. Most titles were located in urban and peri-urban areas. Dispossession of customary lands was a feature of both the Portuguese and Indonesian administrations, as neither gave much recognition to customary rights to land.[65]

The Secretary of State for Land and Property, under the Ministry of Justice, is responsible for overseeing land-related responsibilities on behalf of the Minister for Justice. The Direcção Nacional de Terras, Propriedades e Serviços Cadastrais (National Directorate of Land, Property and Cadastral Services, or DNTPSC) reports to the Secretary of State for Land and Property, and is responsible for land administration, including registration of land titles and dealings in land. These agencies are also charged with developing the national land policy. As with other government ministries, these institutions' ability to plan, develop, and implement policy is weak. This is compounded by complex and political land policy and land reform.

Under the Constitution, only national citizens can possess ownership rights over land in Timor-Leste. Other than the Constitution, the only laws regarding land tenure approved by Parliament were three components of a suite of laws proposed by the country's first postindependence government, between 2003 and 2005. These laws (i) define state property, (ii) open a process for registering land claims based on prior ownership, and (iii) establish a leasing system for state and private property. State property is defined as all land that belonged to the Portuguese and Indonesian administrations, and makes no reference to customary land rights.

Despite the overwhelming majority of land being under customary land tenure systems, they receive almost no recognition in Timorese legislation.[66] The Civil Code, introduced

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[63] R. Nixon. 2005. *Non-Customary Primary Industry Land Survey: Landholdings and Management*. Dili: United States Agency for International Development.

[64] While customary authority is recognized throughout rural areas of the country, it appears to be less influential in Portuguese-instituted sites of agricultural settlement programs (continued under Indonesian occupation) and peri-urban areas. Agricultural settlements refer primarily to irrigated rice field areas. Customary rights were weaker in many of these areas, because these lands were previously forested and used primarily for hunting. In Timor-Leste's peri-urban areas, the *chefe de suco* (village or community chief) may play a major role by witnessing documents and otherwise lending credibility to land transactions. Source: United States Agency for International Development (USAID). 2012. *USAID Country Profile—Property Rights and Resource Governance, Timor-Leste*. Washington, DC.

[65] International Crisis Group. 2010. Managing Land Conflict in Timor-Leste. *Policy Briefing: Crisis Group Asia Briefing No. 110*. 9 September. Dili/Brussels.

[66] The Civil Code has the only reference to communal lands. It establishes that land communally used within a community is that community's property.

through Law No. 10/2011 in September 2011, has provisions governing day-to-day decisions pertaining to land, including the sale and lease of land.[67]

DNTPSC, with the support of the United States Agency for International Development, initiated a 5-year project in 2007 (called *Ita Nia Rai*, or "Our Land" in Tetum) to strengthen land administration. The project's aim was to pass a land law and implementing regulations, begin to register land claims, and then convert these to legal titles in accordance with the land law. The goal was to register at least 50,000 property titles by the end of the project, building sufficient capacity within DNTPSC to operate independently. Following considerable effort, a package of land-related legislation was developed in 2009 and approved by Parliament in 2012. However, the President vetoed the legislation.

Still, the project made significant progress in collecting land claims in the district capitals' urban areas. As a stopgap, Decree Law No. 27/2011 and regulations were introduced in mid-2011 to provide a legal framework for the cadastral procedure, and begin registering ownership rights. A number of undisputed land parcels were subsequently issued registration certificates under this procedure; parcels in dispute were left pending. The project was handed over to DNTPSC in late 2011, but little progress has been made since. The Ministry of Justice contracted a private company (a Timorese and Portuguese joint venture) to recommence cadastral work in 2014.

Registration of a property right through Decree Law No. 27/2011 gives a legal presumption of ownership to the beneficiaries, allowing them to sell, lease, or mortgage the parcel. While the presumption can be contested in court, it requires the claimant to prove they hold a preexisting conflicting land right over the parcel. Further, the Decree Law does not provide mechanisms to resolve disputed land claims in urban areas, nor to register customary land claims in rural areas.

A nascent land registry has been established within DNTPSC, and is limited to the relatively few uncontested urban parcels of land registered through the Ita Nia Rai project. While existing decree laws enable leasing of state and private land, there is no mechanism to register either type of lease. This has resulted in no reliable records regarding the amount of leased land, or its occupants.

The government also lacks the legality to acquire land for public purposes, such as road building and other types of infrastructure. Government agencies, including DNTPSC, have limited experience in this area. The process typically relies on negotiation with affected persons, and varies according to who is undertaking the initiative.

The package of land-related legislation vetoed by the President in 2012 was subsequently revised and approved by the Council of Ministers in July 2013. They include a land law (titled the Special Regime for the Determination of Property and Immovable Property), an expropriation law, and a real estate financial fund law. The package of laws is with Parliament.

[67] While the Civil Code established a new bundle of land-related rights, it is unclear whether they are actually applied, or whether the property rights regulated by the Indonesian Basic Agrarian Law No. 5/1960 remain effective. These were incorporated into the Timorese legal system after 1999. Some reports suggest that application of the Civil Code's land-related rights are awaiting resolution of the outstanding land titles issue. Source: B. Almeida. Scoping Land Tenure and Land Governance: Draft Country Report Timor Leste—Land Tenure Initiative in the Asia Pacific. Unpublished.

UNCERTAIN SECURED TRANSACTION FRAMEWORK FOR MOVABLE PROPERTY

Insufficient collateral is often the reason that businesses face difficulties in obtaining finance. Collateral refers to property a borrower pledges to the lender to secure payment. If a loan is not repaid, the lender can take ownership of the property that the borrower pledged to guarantee the loan. Collateral can either be immovable property (such as land and buildings), or movable property (such as machinery and equipment).

In the developing world, approximately 75% of business enterprises' capital stock is in the form of movable property.[68] Unfortunately, businesses in Timor-Leste have difficulty using either type of property as loan collateral. While property rights regarding land in Timor-Leste remains uncertain (as discussed in the previous section), the legal framework for pledging movable property as loan security is also problematic.

An effective secured lending framework for movable property has a number of common features. Such a framework

- allows creation of security interests over all economically important movable property, transactions, and agents at a low cost relative to the transaction's value;
- provides unambiguous priority rules, and protects the secured party from hidden claims by third parties; and
- allows potential lenders to establish a ranking of priority in the collateral by filing notice of security interest in a publicly available registry.

The registry must be readily and easily searchable by potential lenders, to determine whether other claims exist against a borrower's property. Finally, if the debtor defaults, it allows the creditor to seize and sell the collateral quickly and inexpensively, usually outside the judicial system.

A 2014 analysis of Timor-Leste's secured lending framework identified several shortcomings, including the following:[69]

- **Problems with creating security interests.** Timor-Leste's legal system allows most types of movable property to serve as collateral. Yet, it does not allow the creation of security interests over floating charges. These charges represent an asset (or group of assets) that is subject to changes in quantity or value, such as a business inventory or accounts receivable. In Timor-Leste, a security over inventory and/or over future claims and receivables is permitted only if each item is identified in the security title.
- **Problems with prioritizing security interests.** There are some credit privileges that do not need to be registered, giving some creditors priority over other agreed security interests.
- **Problems with publicity.** Existing law, except for certain assets and rights that can be mortgaged, does not require security interests

[68] International Finance Corporation. 2010. *Secured Transactions Systems and Collateral Registries*. Washington, DC.

[69] ADB's Pacific Private Sector Development Initiative is working with the government (formerly with SEAPRI) on secured transactions reform. A discussion paper was circulated in late 2014 and outlines the technical issues to be addressed by the reform. Source: Miranda Correia Amendoeria and Associates. Secured Transactions Reform in Timor-Leste—Legal Diagnostic Report for the Asian Development Bank Pacific Private Sector Development Initiative. Unpublished.

to be registered. As a result, Timor-Leste lacks a central registry of security interests over movable property.

- **Problems with enforcement.** Security interests, with respect to mortgages, must be enforced through the courts. Importantly, parties should be allowed to agree that the sale of mortgages, like other types of pledges, may be made through private sale.

Reform is underway to address these shortcomings, and develop an effective legal framework and associated registry to support secured transactions using movable property. Secured lending by collateral is discussed further in Chapter 6 of this private sector assessment.

PROBLEMS WITH ENFORCING CONTRACTS

The ability to make and enforce contracts, and resolve disputes, is fundamental for markets to function properly. Numerous studies link efficient contract enforcement to decreased informality, improved access to credit, and increased trade.[70]

A contract is a type of promise or agreement that is enforceable by law. Contracts empower businesses to plan for the future, and effectively create their own legal rights to certain future outcomes. They significantly reduce the risk of broken promises by assigning penalties to those who break their promises. The courts support the process by requiring contracting parties to fulfill their promises to each other. If the courts did not enforce contracts, contracts would not have any value. The value of contracts is that they are legally guaranteed.

The Timor-Leste Civil Code, introduced in 2011, establishes laws for making valid contracts, doing what was promised in the contract, and enforcement. Yet, because contract law was introduced very recently in Timor-Leste, it is not surprising that the use of formal written contracts is limited in many sectors of the economy, particularly in rural areas. Cash transactions continue to be the primary means of exchange. Contracts are also not often used to obtain credit (common in other markets); contracts with government are the exception. Some work has been done to raise awareness of the importance of contracts to economic development, and explain the country's new contract laws.[71] Continued efforts in awareness-raising and education are needed to encourage greater use of contracting throughout Timor-Leste's economy.

The country has a small judiciary consisting of a Court of Appeals in Dili; and four district courts located in Baucau, Dili, Oecussi, and Suai. Another is the Audit Court, which is empowered to examine the legality of public income and expenditure, evaluate financial management, and impose penalties. However, the entire justice system (police, prosecutors, and courts) is still evolving. It suffers from inadequate infrastructure and staff

[70] See M. Safavian and S. Sharma. 2007. When Do Creditor Rights Work? *Policy Research Working Paper 4296*. Washington, DC: World Bank; E. Dabla-Norris and G. Inchauste. 2008. Informality and Regulations: What Drives the Growth of Firms? *International Monetary Fund (IMF) Staff Papers*. Vol. 55, No. 1. Washington, DC: IMF; and Y. Duval and C. Utoktham. 2010. Beyond Trade Facilitation: Impact of the Domestic Business Environment on Export Competitiveness in Asia and the Pacific. In M. Mikic and M. Wermelinger, eds. *Rising Non-Tariff Protectionism and Crisis Recovery: A study by the Asia-Pacific Research and Training Network on Trade*. Bangkok: United Nations Economic and Social Commission for Asia and the Pacific.

[71] For example, see K. Withen et al. 2014. *An Introduction to Contract Law in Timor-Leste*. Dili: United States Agency for International Development, The Asia Foundation, and Stanford Law School.

shortages, and has few people with specialist training in commercial law. The government is working to strengthen the system, and the justice budget, and number of court actors, have increased. Mobile courts have also been introduced in four districts, and there are plans to expand their reach.[72]

The court system remains primarily focused on criminal matters. Of approximately 1,600 cases tried during 2012, 86% were criminal in nature. The remaining 14% dealt with civil matters, of which a small portion likely involved commercial cases (footnote 72). The business community does not seem to attempt to enforce major commercial contracts through Timor-Leste's court system.[73] For example, commercial banks typically look to settle contract disputes in overseas courts, but this process is very costly.

The judiciary's weak capacity to enforce commercial contracts is evidenced by its poor results in the World Bank annual Doing Business survey. In 2014, the survey found that it took 1,285 days from filing a commercial lawsuit in the Dili District court, until actual payment (200 days for filing and service, 995 for trial and judgment, and 90 days for enforcement of the judgment). Moreover, it found that the cost associated with using the courts to enforce the contract would amount to 163% of the claim amount received. These results were considerably worse than other similar small developing countries. The same case moving through the Fijian judicial system would take 30% of the time (a total of 397 days), and cost about 39% of the claim amount.[74]

Until 2014, Timor-Leste's judicial system included international judges and prosecutors. However, in October 2014, the National Parliament passed resolutions that immediately terminated the existing contracts of all international staff within its judicial system. This action has undermined the good work done to build the system's credibility and capacity. Despite the Constitution guaranteeing the independence of the courts, the resolutions demonstrate the government's willingness to interfere in the judicial system. This raises questions about the judiciary's future ability to decide matters independently and impartially, which is critical to a good investment climate.

In the short term, these actions also negatively affect the functioning of the courts. Many cases have been adjourned and require retrial, either because international judges were hearing the cases, or because these were being prosecuted by international prosecutors. These actions also remove significant resources from the judicial system, further reducing its efficiency until the gaps can be filled. This is likely to hinder efforts to improve court performance related to commercial contract enforcement, because commercial cases of any complexity have predominately been managed

[72] The justice sector budget increased from $19 million in 2012 to $28 million in 2013. The number of court actors also increased. For example, the number of judges increased from 31 in 2012 to 36 in 2013, while the number of court clerks increased from 78 to 115 over the same period. Source: Timor-Leste Judicial System Monitoring Programme. 2014. *Report Overview of the Justice Sector 2013*. Dili.

[73] For example, the United States Embassy in Dili has indicated that it is unaware of "any major court case testing the sanctity of contracts or enforcement of contracts that have been processed to conclusion." Source: United States Department of State. 2014. *Investment Climate Statement 2014: Timor-Leste*. Dili.

[74] The World Bank Doing Business Enforcing Contracts Methodology states that "[…] data are built by following the step-by-step evolution of a commercial sale dispute before local courts. The data are collected through study of the codes of civil procedure and other court regulations as well as questionnaires completed by local litigation lawyers and judges […]." Source: World Bank. Enforcing Contracts Methodology. http://www.doingbusiness.org/methodology/enforcing-contracts

by international staff.[75] The removal of international judges is also worrying to foreign investors, who view this kind of interference as an indication of political risk and uncertainty.

There is also limited use of alternative methods of dispute resolution processes to complement the formal justice system. These processes can include negotiation, mediation, and arbitration; and are typically used prior to court proceedings because of their lower cost and shorter time frames.[76] While there is some informal mediation in Timor-Leste, the country lacks legislation establishing alternative dispute resolution processes. It also does not have a formally recognized commercial mediation or arbitration facility.[77] The Ministry of Justice is working on drafting alternative dispute resolution legislation.[78]

OTHER GAPS

Business start-up and licensing processes need review

A well-functioning regulatory system is an essential component of modern society. Where regulations work well, they enhance governance and promote stability, progress, and prosperity. Two important regulatory areas within an economy are business start-up and licensing. Business start-up involves the process of business owners registering their enterprise in a public registry, and registering the entity with the tax authority. Licenses regulate a business enterprise's entry and conduct within markets. Licenses, which sometime include the use of permits and certifications, require enterprises to obtain a certificate of compliance prior to commencing their business activity. They typically impose a range of conditions, obligations, and rights.

Their prescriptive nature means that licenses can generate significant costs for businesses, raise prices for consumers, and increase potential for corruption. Good practice limits their use to addressing instances of market failure and achieving public interest objectives. These include preventing damage to health, safety, security, or the environment.

With the creation of Services for Registration and Verification of Entrepreneurs (SERVE) in 2013, the government implemented reforms that significantly streamline the business start-up process. Prior to this, businesses had to register their business entity at the Ministry of Justice; obtain a tax identification number from the Ministry of Finance; and apply for a business license from the Ministry of Commerce, Industry, and Environment. The process took 90 days to complete. SERVE has brought these functions together and reduced the overall processing time to less than 10 days.

Despite the improvements, the business registration process still includes problematic elements. For example, the Commercial Companies

[75] In 2013, there were 24 judges (of whom 7 were foreign citizens) and 28 prosecutors (of whom 4 were foreign citizens). Sources: ADB. 2014d. *Timor-Leste Country Gender Assessment*. Manila; and East Timor Law and Justice Bulletin. 2015. Dismissal of international officials and advisors in the Timor-Leste judicial sector. 1 January. http://www.easttimorlawandjusticebulletin.com/2015/01/dismissal-of-international-officials.html

[76] In negotiation, parties attempt to resolve disputes on their own. Mediation is a flexible, nonbinding dispute resolution process where a neutral third party assists the parties to reach a voluntarily negotiated settlement. Arbitration is similar to mediation, but delivers binding agreements.

[77] DNTPSC regularly mediates land disputes at the request of interested parties. It successfully mediated 10 disputes in 2013. Source: B. Almeida. Scoping Land Tenure and Land Governance: Draft Country Report Timor Leste—Land Tenure Initiative in the Asia Pacific. Unpublished.

[78] The Ministry of Justice, with Japan International Cooperation Agency assistance, completed drafting a mediation law in early 2014. The ministry then shifted its focus, commencing work on developing an overarching law covering a range of alternative dispute resolution processes. Progress on mediation law has been suspended until the overarching alternative dispute resolution law has been developed.

Law No. 4/2004 still includes paid-in minimum capital requirements. For foreign investments, the law also requires at least one director to be employed by a registered company in Timor-Leste. This means at least one foreign director needs to establish residency in Timor-Leste to register a company, or a local director needs to be hired specifically for the registration process. The registry is also not internet-based, making it not as accessible to users as it could be.

The SERVE reform also reduced the licensing burden on businesses. When registering, a business must identify the activities in which it intends to operate; and, previously, a license was required to participate in any business activity. Due to the reform, enterprises operating in activities identified as "low risk" no longer need to obtain a business license. Over half of the business activities are included in this category. Businesses intending to operate activities defined as "middle to high risk" must still obtain a license. There are approximately 200 activities in this category.

There is no central repository of information describing requirements to obtain a license for these different activities, nor who within government is responsible for issuing them. Moreover, the process for issuing licenses is not based on a set of simple, transparent implementing regulations. The lack of clear rules creates uncertainty and unnecessary frustration for businesses.

The problem is also compounded by the lack of staff trained in customer service. For example, feedback from tourism sector businesses suggests that it can take months to renew an existing hotel license, let alone obtain one for the first time.

Reorganizing or winding up a company uses outdated, foreign legislation

Insolvency laws play an important role in a modern economy. They allow honest, but unfortunate debtors to obtain a fresh start by relieving them of their debts. They also allow resources to be quickly returned to productive use by enabling viable, but financially troubled companies to restructure without filing for bankruptcy.

Timor-Leste does not have its own bankruptcy law, and follows the statutes found in Indonesia's old bankruptcy legislation (comprising the Bankruptcy Ordinance 1906 and Law on the Amendment of the Bankruptcy Ordinance [4/1998]). This is the law that was effective when the United Nations assumed transitional administration of the country in 1999. Indonesia subsequently revised its bankruptcy regime, with the Law on Bankruptcy and Suspension of Payments (37/2004) enacted in October 2004.

The old Indonesian statutes, however, have not been officially translated into one of Timor-Leste's official languages. Moreover, they fail to specify the type of claims covered, or the order by which assets are to be distributed to creditors in the event of bankruptcy. These problems create uncertainty for how bankruptcy rules are applied in Timor-Leste.

State-owned enterprises operate without a clear policy framework

Timor-Leste has several state-owned enterprises (SOEs), but lacks a clear policy framework to effectively manage them.[79] It is possible that more SOEs will be created in the future, through

[79] These include TIMOR GAP, Radio Televisão Timor-Leste (Radio Television Timor-Leste), and Banco Nacional de Comércio de Timor-Leste (National Commercial Bank of Timor-Leste, or BNCTL).

corporatizing the government departments that provide infrastructure services such as electricity, water, and ports; and through the establishment of a new national development bank.

SOEs' defining characteristic is that they are government-owned. This can expose them to political pressures that privately owned companies do not face, and insulate them from competitive pressures and market discipline. SOEs typically underperform against comparable privately owned companies, when assessed using standard measures of commercial performance. This poorer performance often burdens public finances, and results in low quality or inefficient services.

International experience demonstrates that the best way to improve SOE performance is to make them operate like private, commercially driven companies.[80] This requires a clearly defined corporate governance framework to help prevent politics from distorting SOE priorities and managerial decisions. A best practice framework includes merit-based and nonpolitical appointments to SOE boards, clear structures for managing the relationship between the shareholder and the company, and transparent information disclosure on corporate performance. It also requires that SOE managers are given clear and consistent objectives to implement.

When they operate as corporate entities, SOEs have more independence, stronger performance incentives, and greater transparency than government departments. This can be a very positive step toward improving public service delivery. In the long run, however, SOEs will always be at risk of political interference, which will deter them from operating commercially. This is the reason that the SOE model was never intended to be a long-term ownership structure, rather a transitional arrangement from government departments to private services provision.

A government, therefore, needs to carefully consider whether SOEs are the best mechanism for achieving its objectives. Public–private partnerships (PPPs) can be a mechanism to introduce competition, access private expertise, and increase service providers' accountability. For utilities such as power and water, PPPs are often best to deliver high quality, cost-effective services and reduce the need for government involvement.

SOEs are often directed to provide services to communities—on noncommercial terms—to address basic or essential needs. Such services, also known as community service obligations (CSOs), are sometimes only partially compensated through government subsidy. This undermines SOE profitability and reduces accountability. SOEs can also use CSOs to request excessive budget support to compensate for operational inefficiencies.

Introducing CSO contracting frameworks addresses this issue by requiring all CSOs to be clearly identified, costed, contracted, and funded. This allows CSOs to be commercially contracted, reinforcing SOEs' commercial mandates and introducing efficiency incentives. A contracting framework also gives the government the option of seeking third party CSO providers, where they can be more cost-effective than SOEs.

Given the Timor-Leste private sector's limited development, policymakers understandably need to consider SOEs' role in supporting diversification and job creation. However, SOEs are usually

80 ADB. 2014b. *Finding Balance 2014: Benchmarking the Performance of State-Owned Enterprises in Island Countries.* Manila.

poorly positioned to lead the development of "strategic sectors." SOEs have a generally poor record, especially those operating in competitive sectors. Establishing new SOEs would, possibly, pull scarce capacity from other parts of government, and reduce attention to more general business environment improvements that are crucial for developing the private sector.

Importantly, the Government of Timor-Leste should carefully assess any proposals to establish new SOEs against private sector alternatives. Once established, SOEs then require a governance and legislative framework that provides government with the means to

- effectively assess their performance;
- achieve long-term improvements in the productivity of the underlying assets; and
- enable efficient delivery of CSOs, including allowing private sector participation (where possible).

Develop a clear competition policy

Effective competition strongly encourages using efficient production methods. It also channels an economy's resources toward producing goods and services that society values most highly. Competition creates incentives for innovation that increase productivity. As a result, consumers benefit from lower prices, and better quality and greater variety of goods and services.

Timor-Leste has an open trade and investment regime that is conducive to encouraging competition. It has also reduced barriers to entry by eliminating the general licensing requirements in many sectors of the economy. However, there are areas where the government needs to be more active, including introducing a clear and effective framework for regulating the delivery of core infrastructure services (power, water and sanitation, seaports and airports, and telecommunications). In liberalizing its telecommunications market, the government established Autoridade Nacional de Comunicações (the National Telecommunications Authority of Timor-Leste, or ANC) in 2012 to regulate competition within the sector. ANC, however, has yet to fully establish itself and effectively assume its responsibilities.

In other sectors, the regulatory role is played by the same government agencies involved in service delivery. Good practice separates the regulatory function from the service delivery function. In the future, using PPPs to deliver infrastructure services will help address this issue. However, the government needs to consider how best to regulate these sectors. Given low human capacity levels and the poor experience in establishing ANC, one option is to establish a multisector regulator for these services. As the economy develops, there will also be a need to develop a capacity to deter and sanction anticompetitive practices. The starting point is for Timor-Leste to develop a clear competition policy.

Site development approvals are not governed by legal guidelines

Site development involves transforming land and foreshore areas, including constructing buildings and other structures. Regulations are typically prescribed to ensure that developments are scrutinized before they are implemented to avoid environmental, social, and cultural damage; and public health and safety concerns.

Timor-Leste lacks any legislation regarding land use planning or land development. While it is theoretically possible to use Indonesian legislation that was in force in 1999, it is not applied in practice. The Ministry of Public Works, Transport, and Communications issues construction permits, but the process lacks a clear legal backing. The Environmental Licensing Decree Law No. 05/2011 requires a developer to undertake an environmental impact assessment if there is a risk that their project may negatively affect the environment. The environmental licensing process is administered by the Ministry of Commerce, Industry, and Environment. However, there are significant gaps in the process, including a lack of clear implementing guidelines.

6 ISSUES RELATED TO THE FINANCIAL SECTOR

Recommendations:

- Introduce a secured transactions framework to support the effective use of movable assets as collateral for loans, and work with lenders to design new financial products
- Introduce an effective insolvency and bankruptcy regime
- Review the credit registry information system to increase functionality and coverage
- Subject to licensing criteria, be open to licensing additional financial institutions—particularly nonbank financial institutions—to encourage financial sector competition
- Assess the role of a national development bank within a wider, competitive banking system
- Convert manual social welfare payments to bank accounts, where feasible
- Introduce a national payment system law and effectively implement the real-time gross settlement system, and encourage interbank interoperability
- Gradually develop the financial sector regulatory regime in response to innovations and emerging risks
- Prepare a national antimoney laundering and countering the financing of terrorism strategy, and national risk assessment, to comply with international standards

An effective, well-developed financial system is an important driver of private sector development and inclusive economic growth. A large body of research documents this relationship.[81] A well-functioning financial system has the following features:

- Financial institutions act as financial intermediaries, ensuring that savings are efficiently allocated to investments that boost productivity, increase output, and create jobs.
- Risks associated with saving, lending, and transacting are minimized and appropriately managed, to reduce overall costs and improve the efficiency of financial intermediation.
- Payment systems enable quick and efficient financial transactions.
- Individuals and businesses of all sizes are able to access basic financial tools to effectively participate in the economy.
- Responsive prudential regulation and consumer protection frameworks bolster confidence and support financial sector stability.

The Banco Central de Timor-Leste (Central Bank of Timor-Leste, or BCTL) has developed a master plan outlining a strategy and specific objectives for

[81] See for example: J. Zhuang et al. 2009. Financial Sector Development, Economic Growth, and Poverty Reduction: A Literature Review. *ADB Economics Working Paper Series*. No. 173. Manila: Asian Development Bank.

developing a financial sector that facilitates, rather than constrains, private sector development.[82] However, Timor-Leste's financial sector is at an early stage of development. The number and range of financial service providers, products, and services are small. The legal frameworks for securing loans and enforcing agreements are incomplete. Financial intermediation is undeveloped,[83] credit to the private sector is limited, and the long-term finance needed for investment is lacking.

Existing services are concentrated primarily in Dili, and financial sector outreach and participation are low. The payment system is in early stages of development, and most transactions are conducted in cash. As a result, households and businesses have limited access to finance and financial services. Those on low incomes cannot save securely to invest, pay bills, or raise their standard of living to more than subsistence. Entrepreneurs and firms cannot finance investment and productivity improvements, and opportunities to grow non-oil gross domestic product (GDP) and create jobs are missed.

FINANCIAL SECTOR OVERVIEW

Commercial banks dominate the financial sector

They include the Australia and New Zealand Banking Group (ANZ), PT Bank Mandiri, Caixa Geral de Depósitos (or CGD, operating under the trading name Banco Nacional Ultramarino, or BNU Timor), and the government-owned Banco Nacional de Comércio de Timor-Leste (National Commercial Bank of Timor-Leste, or BNCTL).[84] ANZ, CGD, and PT Bank Mandiri are the Timor-Leste branches of well-established foreign banks, subject to supervision in their home jurisdictions. Yet, their Timor-Leste operations contribute less than 0.3% of total group assets (footnote 82). The foreign bank branches primarily serve international organizations and their staff, and businesses and nationals from their respective home countries.[85]

BNCTL, formerly the Instituição Microfinanças de Timor-Leste (Microfinance Institution of Timor-Leste, or IMFTL), was granted an unrestricted banking license in 2011. Its commercial transformation is ongoing. Civil servants and social benefit recipients comprise approximately 70% of BNCTL's clients.[86] Historically, BNCTL has mainly provided loans secured by public sector salaries; but its portfolio is diversifying with loans to small and medium-sized businesses, seasonal crop loans, and a small volume of microfinance group loans.

Nonbank financial institutions are also important to a financial system's development

They provide additional competition for credit, and offer tailored savings products and financial services that meet specific clients' needs.

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82 Central Bank of Timor-Leste. 2014. *Spurring Growth: Master Plan for Financial Sector Development in Timor-Leste, 2014–2025*. Dili.

83 Financial intermediation describes financial institutions' role in searching out and evaluating available lending and investment opportunities, and then mobilizing savings to finance them.

84 Footnote 81. Commercial bank assets contributed 98% of the total combined assets of commercial banks and microfinance institutions at the end of September 2013.

85 Of the three foreign banks with branches in Timor-Leste, CGD plays the most important role in the domestic economy. It has the largest loan portfolio and branch network, and plans to further expand through an agent network. Further, tax and excise payments to the Timor-Leste Revenue Service can only be paid domestically at CGD branches.

86 Banco Nacional de Comércio de Timor-Leste. Operation Overview: Current Operations and Key Highlights. http://bnctl.com/operation-overview/

Timor-Leste's nonbank financial sector is undeveloped, and lacks diversity in financial products and providers. In 2010, BCTL (then known as the Timor-Leste Banking and Payments Authority)[87] issued a public instruction to bring other deposit-taking institutions (ODTIs) under its authority.[88] Two microfinance institutions (Moris Rasik and Tuba Rai Metin) are undergoing transformation to fulfil ODTI licensing requirements.

There are two general insurance companies (National Insurance Timor-Leste and Sinar Mas Insurance), nine money transfer operators that only offer international remittances, and at least 27 credit unions.[89] There are no equity or bond markets, and no government bonds are issued.

UNDEVELOPED FINANCIAL INTERMEDIATION

Commercial bank lending is limited

The ratio of private sector bank credit to non-oil GDP averaged 11.9% over 2010–2013, and was estimated to be 11.4% at end-2014 (Table 4). This is significantly below the average for lower middle-income countries at 36.6%.[90]

Table 4: Selected Banking Sector Indicators, 2010–2014

Indicator	2010	2011	2012	2013	2014
Assets ($ million)	338.3	403.3	555.2	665.3	805.1
Deposits ($ million)	303.9	322.1	414.6	506.3	583.3
Credit to private sector ($ million)	110.9	131.4	155.8	176.9	176.7
Credit to businesses ($ million)[a]	38.2	76.2	90.9	103.3	95.2
Credit to individuals and others ($ million)	72.6	55.2	64.9	73.5	81.4
Loan-to-deposit ratio (%)	36.5	40.8	37.6	34.9	30.3
Nonperforming loan ratio (%)	41.8	36.3	30.8	28.0	26.8
Net interest rate spread (%)	10.6	11.6	11.7	11.9	12.6
Credit to private sector/non-oil GDP (%)	11.9	11.7	12.1	12.0	11.4[b]

GDP = gross domestic product.

[a] Credit to businesses is calculated by taking total private sector bank credit and subtracting the category "individuals and others".

[b] Ratio for 2014 was calculated using forecast nominal non-oil GDP figure from Democratic Republic of Timor-Leste, Ministry of Finance. 2014. *State Budget 2015: Budget Overview, Book 1*. Dili. https://www.mof.gov.tl/wp-content/uploads/2014/10/2PRINTER-FINALDRAFT-BB1_2015_English_08.10-20141013-Revised.pdf

Sources: Central Bank of Timor-Leste. Banking Indicators for 2010–2012 and Banking Indicators for 2013. http://www.bancocentral.tl/en/b_indicator.asp (accessed 2 March 2015); Central Bank of Timor-Leste. Table 10: Commercial Bank Interest Rate. http://www.bancocentral.tl/Download/MonetaryStatistics/PDF/Commercial%20bank%20Interest%20rate(10).pdf (accessed 2 March 2015); and Democratic Republic of Timor-Leste, Ministry of Finance. 2014. *State Budget 2015: Budget Overview, Book 1*. Dili.

87 BCTL became the Central Bank of Timor-Leste on 13 September 2011.

88 Democratic Republic of Timor-Leste, Banking and Payments Authority of Timor-Leste. 2010. *Governing Board Resolution No. 11/2010: Concerning the Approval of Public Instruction No. 06/2010 on the Licensing and Supervision of Other Deposit Taking Institutions (ODTIs)*. Dili.

89 These 27 credit unions are affiliated with a federation, while others may operate independently. Credit unions are not under BCTL oversight, as member funds are not considered deposits.

90 M. Čihák et al. 2013. Financial Development in 205 Economies, 1960 to 2010. *National Bureau of Economic Research (NBER) Working Paper Series*. No. 18946. Cambridge, MA: NBER.

While private sector bank credit grew by an average of 12.6% annually over 2010–2013, it contracted by 0.1% in 2014.[91] The stagnation of credit growth is due to a fall in lending to businesses of 7.8% in 2014, although there are diverging trends in the sectoral allocation of credit.[92]

Credit to individuals and others increased by 10.7% in 2014.[93] The nonperforming loan (NPL) ratio has fallen, but remained high at 26.8% at end-2014.[94] Excluding NPLs, the ratio of private sector credit to non-oil GDP was only 8.3% at end-2014.

Lending rates have risen gradually since 2011, and the net interest spread was 12.6% at end-2014 (Table 4). Meanwhile, liquidity is high—the loan-to-deposit ratio was 30.3% at end-2014. Foreign banks routinely place excess deposits offshore rather than channel them into additional loans in Timor-Leste,[95] and the banking system is a net exporter of capital (footnote 82). This means that deposits from Timor-Leste are financing investments abroad, rather than much-needed investment in the domestic non-oil economy.

Several factors have raised lending risks, broadly related to difficulties with collateral and recovery, and in assessing risk. This results in a small minority of businesses able to access finance, despite ample liquidity and a comparatively low ratio of private sector credit to GDP.[96] Discussions with banks indicate that, where available, business finance is concentrated in large and well-established businesses; and in sectors that rely on government contracts and public investment, such as construction.

Lending secured by collateral is inhibited by institutional weaknesses

As described in Chapter 5, using both immovable and movable assets as collateral for loans is problematic. For land, there continues to be significant uncertainty of title and, as only citizens can own land, about foreign banks' ability to hold security interests in land. There is a lack of clarity in the legal system around creating and enforcing security interests in movable assets. Further, an outdated bankruptcy framework and weak contract enforcement systems add uncertainty about lenders' rights. Financial institutions, therefore, rely heavily on personal guarantees and standing orders for loan repayments from accounts where borrowers receive government contract payments, pensions, or government salaries.

To unlock the collateral value of movable assets, the government has commenced secured

91 Democratic Republic of Timor-Leste, Central Bank of Timor-Leste. 2014c. Economic Bulletin. *A Quarterly Publication of the Central Bank of Timor-Leste*. Vol. 24. December 2014. Dili.

92 Lending to businesses is calculated by subtracting the "individuals and others" category from total private sector bank credit. In 2014, sectoral growth rates in lending to businesses were: trade and finance (–63.6%); transportation (–18.0%); construction (15.1%); tourism and service (44.8%); industry and manufacturing (64.5%); and agriculture, water, and forestry (1,397.3%, albeit from a very low base). Source: BCTL staff.

93 At least part of lending to individuals is likely used, for business purposes, by the borrower or his or her extended family.

94 The ratio of NPLs to new loans written since 2010 appears significantly lower, reflecting the banks' more conservative approach to lending. The overall ratio remains high because a stock of NPLs from 2004–2010 has not been written off.

95 The International Monetary Fund (IMF) has reported that around 60% of commercial bank assets were placed overseas with parent banks at end-2012, noting that this raises country, counterparty, and concentration risks. The use of the United States dollar has increased opportunities for foreign placement. Source: IMF. 2013. Democratic Republic of Timor-Leste: 2013 Article IV Consultation. *IMF Country Report No. 13/338*. Washington, DC.

96 A survey found that 150 firms in Timor-Leste financed 98.6% of their investments internally, compared with 74.7% of investments in East Asia and Pacific. Source: World Bank Group Enterprise Surveys. http://www.enterprisesurveys.org/data/exploreeconomies/2009/timor-leste#finance (accessed 12 January 2015).

transactions reform, supported by the Asian Development Bank (ADB) Pacific Private Sector Development Initiative (PSDI). The reform will establish a clear legal framework for movable assets as collateral, a public registry of security interests, and provide clarity around enforcement. When completed, it will enable lenders to develop new asset-based products, as well as lend funds based on businesses' cash flow. The reform's successful completion should lower credit risk and, over time, increase access to finance for business.[97] The government has also requested ADB assistance to review the existing bankruptcy laws.

Lenders have difficulty assessing borrower risk

Lenders are more confident in their credit assessments when businesses have accurate financial records of past performance and well-developed plans for the future. Lenders also like business credit history details.

In Timor-Leste, business recordkeeping and accounting are generally poor, making it more difficult for lenders to evaluate risk. Limited credit information is available through the BCTL-managed credit registry information system, launched in 2009. Anecdotal feedback suggests that there are gaps in system functionality. BCTL plans to review the system, which should also consider extending coverage to nonbank creditors.

Financial products and providers are insufficiently diversified

Timor-Leste lacks long-term finance for investment, finance for small and medium-sized businesses, and finance for sectors such as agriculture and manufacturing.[98] Business loans typically have a term of 2 years or less, which discourages new investment. Risk factors are worsened by financial institutions' lack of diversity. For example, Timor-Leste does not have providers specializing in asset finance; these can be found in nearly all other countries in the region.

The government is encouraged to promote further competition in the financial sector by being open to licensing additional financial institutions, subject to licensing criteria. The newly established Agência Especializada de Investimento (Specialized Investment Agency, or AEI) could promote investment opportunities in the financial sector, particularly for nonbank financial service providers.

The government plans to establish a national development bank—Banco de Desenvolvimento Nacional de Timor-Leste (National Development Bank of Timor-Leste, or BNTL)—in response to the lack of long-term finance for investment.[99] This decision has been factored into the Timor-Leste Strategic Development Plan 2011–2030 and the Master Plan for Financial Sector Development in Timor-Leste, 2014–2025.[100] BNTL will be majority state-owned and, encouragingly, the government

[97] Since 2006, PSDI has supported the adoption of secured transactions frameworks in eight Pacific countries. See ADB. 2014e. *Unlocking Finance for Growth: Secured Transactions Reform in Pacific Island Economies*. Manila.

[98] At end-2014, total private sector bank credit to "agriculture, water, and forestry" and "industry and manufacturing" was $11.8 million, or 6.7% of total private sector bank credit, compared to $2.7 million, or 1.5% of total private sector bank credit at the end of 2013. It is unclear what drove a large increase in credit to the "agriculture, water, and forestry" sector in June–September 2014 and October–December 2014, and whether the increase will be sustained. Source: Democratic Republic of Timor-Leste, Central Bank of Timor-Leste. 2014b. *Economic Bulletin*. Vol. 23. Dili.

[99] Democratic Republic of Timor-Leste. 2010. Resolução do Governo No. 28/2010: Plano de Acção para a Criação do Banco de Desenvolvimento Nacional de Timor-Leste (Government Resolution No. 28/2010: Action Plan for Building the National Development Bank of Timor Leste). *Official Gazette*. Dili. http://www.jornal.gov.tl/?q=node/1743

[100] Democratic Repuibic of Timor-Leste. 2011. *Timor-Leste Strategic Development Plan 2011–2030*. Dili; and Central Bank of Timor-Leste. 2014d. *Spurring Growth: Master Plan for Financial Sector Development in Timor-Leste, 2014–2025*. Dili.

policy allows for up to 49% equity from both national and foreign private investors. The policy also acknowledges the importance of not displacing lending that could be undertaken by commercial banks, and good governance structures to prevent noncommercial lending decisions.

Yet, it is unclear whether establishing a development bank, which would have to be licensed by BCTL and conform to its regulatory and supervisory framework, is the best solution to address the long-term finance issue. International experience with state-owned development finance institutions is mixed, and applying this experience to Timor-Leste needs to be assessed. The government could consider other options, such as a development credit facility.

It is also unclear whether Timor-Leste has the capacity to operate another financial institution. The impact of any development finance facility on BNCTL's commercial transformation also needs careful consideration.

OTHER GAPS

There is low financial sector outreach and participation

Increasing access to financial services for the general population is a policy priority for the government. It recognizes the relationship between improved access to financial services and poverty reduction. Improving access to financial services is also important for private sector development, as it promotes efficient value chains and transactions between urban and rural areas, and enables businesses of all sizes to engage in an increasingly global economy.

Yet, an estimated less than one in six economically active adult Timorese actively use financial services (footnote 82). Financial literacy is very low, although BCTL is developing a financial literacy strategy and has launched a financial awareness campaign, including National Savings Day. The small number of microfinance and cooperative institutions, their severe capacity constraints, and their limited product offering are further hindering financial inclusion efforts.[101]

The government has started to make social welfare payments to bank accounts. The payments were previously manual, and in cash. This change can lower cost, reduce the risk of fraud, and introduce people to the formal financial system. Converting manual payments to bank accounts should continue, where feasible, as it is the most efficient disbursement method available.[102]

Commercial banks plan to introduce and expand branchless banking initiatives, including mobile money and agent banking services.[103] This can increase access to, and the use of, financial services. It can also reduce the distance traveled to make or receive payments, thereby lowering costs. However, the number of rural businesses that can be agents is limited. Their cash liquidity is also an issue.

Due to the challenges of extending access to financial services in Timor-Leste, BCTL should—

[101] Footnote 88. For example, a licensed ODTI is restricted from holding deposits above $1 million.

[102] ADB. 2013a. *Assessment of the Potential for G2P Disbursement, Cash Management, Field Agents and Mobile Banking Payment Service Provision in Timor-Leste*. Consultant's report. Manila (TA 7430-REG).

[103] CGD launched a mobile money pilot in 2014, in partnership with Timor Telecom, and with BCTL approval. The mobile money product allows unbanked customers to receive person-to-person payments for the first time, which will help formalize and grow the flow of domestic remittances.

where commercially viable—continue to encourage innovation and new technologies, and respond with proportionate regulation as the market develops.

The payment system is inefficient

The ability to transact quickly, efficiently, and across distances is a fundamental characteristic of a well-functioning financial sector. However, Timor-Leste's lack of a real-time system for interbank clearing and settlement of electronic payments, and lack of interbank interoperability across payment infrastructure, impede transactional efficiency.

For example, it is not possible for one bank's client to use a card in another bank's automated teller machine (ATM). The majority of transactions are conducted in cash, which is insecure and expensive. This particularly applies to payments involving government and businesses. Improving the availability of electronic payment channels—ATMs, point-of-sale devices, and internet or telephone banking—would facilitate efficient transactions and lower the cost of doing business.

BCTL has launched a strategy for developing the national payment system, which includes interoperability. It has developed a real-time gross settlement system infrastructure, called R-TiMOR (Rede Transferénsia iha Momentu Reál, or Real Time Transfer Network). R-TiMOR was launched at end-April 2015. BCTL also plans to introduce a national payment system decree law, which will provide the legal foundation for payment system development and financial innovation. These ongoing and planned measures will

- help to build confidence in the payment system,
- increase the volume of electronic payments,
- decrease reliance on cash, and
- reduce risks.

Developing the financial sector's regulatory foundation is necessary

As Timor-Leste's financial sector develops, its regulatory foundations will need further strengthening. BCTL continues to build its capacity to enable it to effectively identify, monitor, and respond to new and emerging risks. This is important to help ensure financial sector stability, and individual institutions' soundness.

Steps to bring the microfinance institutions under BCTL's scope, as ODTIs, are appropriate. While these institutions are unlikely to have systemic influence, protecting depositors and suppliers of capital from losses is important.

Sector innovations, such as branchless banking initiatives, warrant further gradual and risk-based regulatory regime strengthening. BCTL has responded to commercial banks' plans to establish agent networks through developing a circular on agent management. This work was supported by ADB, through PSDI.

BCTL is working to comply with international standards, including antimoney laundering and countering the financing of terrorism (AML/CFT), as developed by the Financial Action Task Force. Importantly, this protects financial sector integrity and linkages with the international financial system. Actual (or perceived) weaknesses in compliance with international standards can reduce the availability of financial services, such as money remittance services.

After the passage in 2011 of the Legal Regime Covering the Prevention of and Combat Against

Money Laundering and Financing of Terrorism (Law No. 17/2011), a financial intelligence unit was established in 2014. The unit is housed in BCTL and under the oversight of the Comissão Nacional para a Implementação das medidas de Combate ao Branqueamento de Capitais e ao Financiamento do Terrorismo (National Commission for the Implementation of Measures on the Fight Against Money Laundering and Terrorism Financing, or CNCBC). The commission will prepare a national AML/CFT strategy and national risk assessment with support from ADB, through PSDI.

7 OTHER ISSUES

Recommendations:

- Review existing fiscal incentives with aim of reducing and redefining them. If incentives are to be offered, they should be aimed at achieving clear objectives, performance-based, and issued automatically through the tax code
- Focus the newly established Agência Especializada de Investimento (Specialized Investment Agency) solely on providing effective investment promotion services, complemented by professional staff with private sector experience
- Develop integrated, locally-based rural development programs as a strategy for building agricultural markets. This requires
  - close coordination between government ministries, districts, and *sucos* (or villages); as well as donors, nongovernment, and private sector organizations;
  - developing community buy-in to encourage subsistence farmers to adapt their production practices;
  - focusing programs on improving crop quality, productivity, and supply consistency (for crops with obvious market demand and where production surpluses can be generated); and on establishing the entire supply chain linking producers to consumers;
  - ensuring price incentives and land tenure arrangements support farm investment and increased production; and
  - ongoing research to better understand constraints to markets expansion within the country and develop appropriate solutions.
- Agree on practical steps to grow tourism:
  - Improve tourism data collection, including market perceptions of Timor-Leste as a tourism destination, visitor numbers, and in-country experience.
  - Develop a concise policy and associated strategy for developing the sector, in close consultation with tourism stakeholders. Due to expected ongoing capacity constraints within the Ministry of Tourism, Arts, and Culture and the Associação de Empresas de Turismo de Timor-Leste (Association of Tourism Companies of Timor-Leste), ensure that agreed actions can be realistically implemented. Where feasible, contract activities to the private sector using a transparent tendering process.
- Establish a high-level interministry working group to discuss investment climate issues, and ensure that policy reforms are coordinated and mutually supportive
- Create opportunities for dialogue with private sector representatives
- Solicit assistance from the donor community to facilitate and support the dialogue process, and strengthen capacity within the Câmara de Comércio e Indústria de Timor-Leste (Chamber of Commerce and Industry of Timor-Leste) to engage on investment climate issues

LIMITED FOREIGN INVESTMENT

Foreign investment is an important driver of economic growth, and a source of long-term investment capital. It creates jobs, transfers technology, and fosters competition. Foreign investment also stimulates knowledge transfer by training local workers, developing their skills, and introducing new management practices and organization arrangements. Despite some potential drawbacks to foreign investment, most research has found that foreign investment helps foster development in recipient countries,[104] particularly in more open economies.[105]

The Government of Timor-Leste recognizes the contribution foreign investment can make to the country's economic development, and is interested in encouraging greater inflows. In 2005, it established an investment promotion agency, TradeInvest Timor-Leste, to promote foreign investment into the country. It made the Secretaria de Estado de Apoio e Promoção do Sector Privado (State Secretariat for the Support and Promotion of the Private Sector, or SEAPRI) responsible for creating an attractive foreign investment climate.

Yet, both these institutions were abolished in early 2015, and their responsibilities were assigned to new agencies. TradeInvest Timor-Leste was replaced by the Specialized Investment Agency (AEI) effective 1 January 2015; and SEAPRI's mandate will fall primarily to the new Minister of State and Coordinator for Economic Affairs, created under the government sworn in on 16 February 2015.

Few restrictions are placed on foreign investment. Apart from areas prohibited to all businesses, such as criminal and immoral activities, foreign investment is welcomed in most sectors. Exceptions include postal services, public communications, and weapons production and distribution; these are reserved solely for the state.

The majority of foreign investment has been in Timor-Leste's oil sector. ConocoPhillips is the country's largest investor. Along with several other foreign joint venture partners, it is involved in the Bayu-Undan gas field in the Timor Sea Joint Petroleum Development Area (JPDA). Eni, another foreign-owned energy company, leads a separate consortium operating the JPDA's Kitan field.

The remaining foreign investment is spread across the retail, tourism, construction, transport and logistics, and telecommunications sectors. While information is scarce on the total number and amount of foreign investment since independence, details are available on the number of investment certificates issued to foreign investors.

Investment certificates provide foreign investors (and citizen investors) with a range of incentives. As a result, they are typically obtained by larger foreign investments, particularly those requiring access to land. In Timor-Leste's Private Investment Law No. 14/2011, a foreign investment is defined as that owned by an entity with 25% (or more) of its shareholding with voting rights held by foreign citizens or foreign legal entities.[106]

[104] Potential drawbacks include deteriorating balance of payments as profits are repatriated (albeit often offset by incoming foreign direct investment [FDI]); lack of positive linkages with local communities; potentially harmful environmental impact of FDI, especially in the extractive and heavy industries; social disruptions of accelerated commercialization in less-developed countries; and effects on competition in national markets. Policymakers must understand these issues as they develop policies and strategies. See Organisation for Economic Co-operation and Development. 2002. *Foreign Direct Investment for Development—Maximizing Benefits, Minimizing Costs*. Paris.

[105] See U. Nair-Reichert and D. Weinhold. 2000. Causality Tests for Cross-Country Panels: New Look at FDI and Economic Growth in Developing Countries. *Working Paper No. 99/00-012*. Atlanta, GA: Center for International Business Education and Research, Georgia Institute of Technology.

[106] Foreign investment in the oil and gas, and mining sectors fall outside of the scope of the Private Investment Law 2011.

Since 2006, investment certificates have been issued to 97 foreign investments. Over the 5 years between January 2010 and March 2015, 36 were issued (Table 5). Rekindling foreign investor interest in Timor-Leste is needed, particularly considering the country's human resources constraints and limited domestic availability of long-term risk capital. AEI is expected to achieve this objective.

The disinterest that foreign investors have shown in Timor-Leste as a potential investment location can be attributed to many issues already discussed in this private sector assessment. The lack of a sound legal framework (particularly for land), contract enforcement, and operational matters such as licensing are key constraints. The situation has been exacerbated by a misplaced emphasis on fiscal incentives, at the expense of providing effective investment promotion services.

Table 5: Investment Certificates Issued to Foreign Investments, January 2010–March 2015

Category	Number of Certificates Issued
New foreign investments	• 36
Implemented as of March 2015	• 32
Key sectors where foreign investment is occurring	• Hotel, restaurant, and apartments (9) • Logistics and transportation (6) • Retail (5) • Property development (4)
Main source countries for foreign investment	• Indonesia (10) • Australia (7) • Singapore (3) • People's Republic of China (2) • Fiji (2) • Republic of Korea (2)

Source: Agência Especializada de Investimento (Specialized Investment Agency).

The emphasis on tax incentives is misplaced

Timor-Leste's tax regime poses a smaller burden on business than in many other countries. Its corporate tax, customs duty rates, and indirect taxes are considerably lower than in many other comparable countries in the Asia-Pacific region (Table 6).

Despite these already relatively low rates, the government has introduced a set of fiscal incentives that can further reduce business tax burdens. These incentives are specified in the Private Investment Law 2011. They include income tax holidays, as well as sales tax and customs duty exemptions, for up to 100% of the value in relation to all capital goods and equipment used in construction or management of an investment. These exemptions are for periods between 5 and 10 years. To be eligible, a foreign investor must invest or reinvest at least $1.5 million, of which at least 50% must be in cash. The minimum investment level is reduced to $750,000, where Timorese citizens control at least 75% of the voting shares in the investment.[107]

The primary role of TradeInvest Timor-Leste was supporting the Comissão de Avaliação do Investimento Privado (Private Investment Commission) to evaluate and make recommendations regarding applications for incentives. Applications are assessed to ensure that they are complete and consistent with application procedures; the applicant possesses the necessary managerial, technical, and financial capacity to successfully implement the investment; and

107 The same incentives are offered to citizen investments that make a minimum investment of $50,000, of which at least 10% of the total value is in cash.

Table 6: Comparison of Tax Rates for Selected Asia-Pacific Countries (%)

Type of Tax	Timor-Leste	Cambodia	Fiji	Lao People's Democratic Republic	Philippines	Viet Nam
Corporate tax rate[a]	10.0	20.0	20.0	24.0	30.0	22.0
Customs duty[b]	2.5	10.9	10.1	9.7	6.2	9.4
Sales tax/VAT[c]	2.5	10.0	15.0	10.0	12.0	10.0

[a] Sources: Cambodia, Lao People's Democratic Republic (Lao PDR), Philippines, and Viet Nam: KPMG International Cooperative. 2013. *ASEAN Tax Guide*. Singapore. http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/asean-tax-guide-v2.pdf; and Fiji Revenue and Customs Authority. 2014. *2014 Fiji Tax and Customs Incentives*. Suva. http://www.frca.org.fj/mypdf/2014-INCENTIVE-BROCHURE.pdf

[b] Timor-Leste uses a uniform ad valorem tax rate of 2.5% (except for selective items, to which an excise tax is applied) that has been in force since 2008. Ad valorem describes a tax based on property or real estate value, usually paid either annually, or at the time of transaction. Customs duty rates for all other countries represent the most recent available information reflecting the simple mean of the "most favored nation" approved tariff rate for all goods. In the case of Fiji and Viet Nam, the rates are for 2013. The rates for Cambodia and the Philippines are for 2012. The rate for Lao PDR is for 2008. Sources: World Bank. World Development Indicators. http://data.worldbank.org/indicator/TM.TAX.MRCH.SM.FN.ZS?page=1 (accessed 15 April 2015); and World Trade Organization, International Trade Centre, and United Nations Conference on Trade and Development. 2013. *World Tariff Profiles 2013*. Geneva. https://www.wto.org/english/res_e/booksp_e/tariff_profiles13_e.pdf

[c] Timor-Leste has a sales tax that is charged on all imports, but which is not collected on sales of domestically produced goods. All other countries use a value added tax (VAT) that is charged on the sale of all goods consumed in the country (imported and domestically produced). Timor-Leste has plans to eventually replace its sales tax with a VAT, like other countries in the region. Sources: Cambodia, Lao PDR, Philippines, and Viet Nam: KPMG International Cooperative. 2013. *ASEAN Tax Guide*. Singapore; and Fiji Revenue and Customs Authority. 2014. *2014 Fiji Tax and Customs Incentives*. Suva. http://www.frca.org.fj/mypdf/2014-INCENTIVE-BROCHURE.pdf

the development will not result in detrimental impacts on the environment, infrastructure, or communities.

The minister responsible for the Private Investment Law 2011 (previously the State Secretary for SEAPRI) makes final decisions about issuing investment certificates if the proposal is valued below $20 million; or if it does not require use of state land equal to, or greater than, 5 hectares (ha) for tourism operations, or 100 ha for agricultural, fishery, or forestry projects. The Council of Ministers makes decisions on applications above these amounts.

Available research suggests that foreign investment is affected by tax rates; higher levels of foreign investment are linked to lower effective tax rates. Timor-Leste already has comparatively low tax rates, with little to gain from further reductions in taxes. In many developing countries, low taxes and fiscal incentives ineffectively counterbalance unattractive climate conditions such as poor infrastructure, macroeconomic instability, and weak governance and markets.

Incentives have been shown internationally to be ineffective as a means to attract long-term investment.[108] In particular, this applies to investments oriented toward winning government construction contracts, serving domestic markets; and based on a country's unique natural resources, such as mining, fisheries, and tourism. Timor-Leste's low levels of foreign investment confirm that low tax

[108] For an overview of research concerning the impact of tax rates and fiscal incentives on investment see S. James. 2009. *Incentives and Investments: Evidence and Policy Implications*. Washington, DC: World Bank Group.

rates are not a significant factor in foreign investors' decision-making processes.

Besides reducing government revenues, the incentive process also means that Timor-Leste's government has been using its limited capacity unproductively. Rather than focusing on improving the investment climate, TradeInvest Timor-Leste and SEAPRI had devoted resources to administering a time-consuming, largely discretionary incentive process. If incentives are used, good practice is to grant them automatically through the tax code based on clear criteria, not through special permission or certification by investment promotion agencies (footnote 108).

The incentives offered under the Private Investment Law 2011 are under review. Emphasis appears to be placed on reorienting the available incentives to specific sectors and rural areas that will help diversify the economy. While this is positive, eliminating incentives should be considered. If they are to be maintained, they should be redesigned to achieve a few specific objectives (such as employment creation), using a transparent, rules-based system through tax legislation.

Effective investment promotion is lacking

Investment promotion's primary purpose is to reduce transaction costs facing foreign investors by providing information on business opportunities, prevailing laws and regulations, and the cost of doing business in the country; and by helping investors to deal with bureaucratic procedures. Investment promotion activities are usually grouped into four areas:

(i) **National image-building.** Activities involve building a perception of the country as an attractive location for foreign investment.

(ii) **Investment facilitation.** This involves assisting investors to understand and analyze the investment environment, establish a business in the country, and reinvest.

(iii) **Investor generation.** This involves identifying potential investors who may be interested in establishing an in-country presence, developing a strategy to contact them, and starting a dialogue with the purpose of having them commit to an investment project.

(iv) **Policy advocacy.** This encompasses initiatives aiming to improve the quality of the investment climate, and identifying the private sector's views in this area.

Evidence suggests that investment promotion can be a potent tool for countries wishing to attract foreign investment. A 2012 study showed that investment promotion led to higher foreign investment inflows to developing countries by decreasing information asymmetries.[109] These efforts were also found to be reasonably cost

[109] The study covered 124 countries and analyzed whether those sectors specifically pursued by investment promotion agencies attracted higher levels of investment after selection, compared with before the selection period and with nonselected sectors. The analysis also investigated whether an investment promotion agency's positive performance was due to providing better information to potential investors, or whether the positive performance reflected and capitalized on existing incentives. The study did not find proof to support the idea that incentives increased targeted sectors' inflows. It did find, however, that those sectors targeted by investment promotion agencies received greater foreign investment. The study's outcome was that providing information led to increased investment inflows, rather than providing fiscal incentives. Source: T. Harding and B.S. Javorcik. 2010. Roll out the Red Carpet and They Will Come: Investment Promotion and FDI Inflows. *Working Paper 221*. San Rafael, CA: Forum for Research in Empirical International Trade.

effective, with $1 spent on investment increasing foreign investment inflows by $189.

TradeInvest Timor-Leste had very little investment promotion capacity. Basic investment facilitation services were not addressed; and there was a lack of clear written information about investing in the country, such as an investor guide or a national investment policy statement. The agency also had only three professional staff, none of whom were fluent in English or had private sector experience. They were also responsible for covering both trade and investment. With investment, their efforts focused on supporting the process of issuing investment certificates. Unsurprisingly, investor inquiries and follow-up support received minimal attention.

To be effective, AEI will need to limit its focus on the investment promotion function, rather than on investment incentives or trade promotion. It will also need to hire competent staff with private sector experience and who understand how government works. An investment promotion strategy should then be developed in line with the country's comparative advantages and sector plans.

UNTAPPED AGRICULTURE POTENTIAL

Between 70% and 80% of Timor-Leste's population depends on agriculture for their livelihood, and 75% of the poor live in rural areas. Most rural dwellers are involved in subsistence farming where the marginal and average productivity of labor is low, and food security issues are ongoing. The high birth rate—and the formal private sector's early stage of development—means that it will be difficult to shift people away from agriculture in the short to medium term. Living standards will remain low for the rural population, unless farm production substantially improves.[110]

Timor-Leste has agricultural and food security potential. Its land base covers six agroclimatic zones, allowing it to grow a wide range of agricultural commodities. Food crops include rice, maize, cassava, legumes, and horticulture goods. Industrial crops include coffee, coconut, candlenut; and other products such as vanilla, cloves, black pepper, and cocoa.[111] Yet climatic, terrain, and soil conditions negatively affect the land's fertility and suitability for agriculture.[112] Only 8%–13% of the total land base is considered arable, of which approximately 5% is in permanent cropland.[113] Despite these limitations,

110 M. Lundahl and F. Sjöholm. 2013. Improving the Lot of the Farmer: Development Challenges in Timor-Leste during the Second Decade of Independence. *Asian Economic Papers Vol. 12 (2)*. pp. 71–96. The Earth Institute at Columbia University and the Massachusetts Institute of Technology.

111 United States Agency for International Development. 2013. *Accelerating Inclusive Economic Growth in Timor-Leste: Assessment of Opportunities for Inclusive Economic Growth in Timor-Leste—Final Report*. Dili.

112 Timor-Leste, like other parts of the eastern Indonesian archipelago, is characterized by too little or irregular rainfall, and land with steep slopes and low fertility. The country has regular droughts, which occur around every 4 years. During these periods, rainfall can be reduced by up to 50%, and the wet season can be delayed by several months. In 2012, Lopes and Nesbitt wrote that "44% of the land has a slope of 40% or greater, and the vast majority has only a thin covering of productive soil. Soils, particularly on the slopes, are generally shallow and impoverished and are becoming less fertile over time through increased nutrient depletion from leaching and erosion after torrential rainfall, deforestation, free grazing of livestock and overcropping [...] slash and burn agriculture [...] and fire wood collection." Sources: Footnote 109; M. Lopes and H. Nesbitt. 2012. Improving food security in Timor-Leste with higher yield crop varieties. Contributed paper prepared for presentation at the 56th Australian Agricultural and Resource Economics Society Annual Conference. Fremantle, Western Australia. 7–10 February; and J. Barnett, S. Dessai, and R.N. Jones. 2005. Vulnerability to climate variability and change in East Timor. *Melbourne University Private Working Paper Series*. No. 05/05. Melbourne: Melbourne University Private, School of International Development.

113 Food and Agriculture Organization of the United Nations (FAO) and World Food Programme (WFP). 2007. *Special Report: FAO/WFP Crop and Food Supply Assessment Mission to Timor-Leste*. Rome.

Timor-Leste has potential to commercially develop a range of agricultural products for the domestic and export markets.[114]

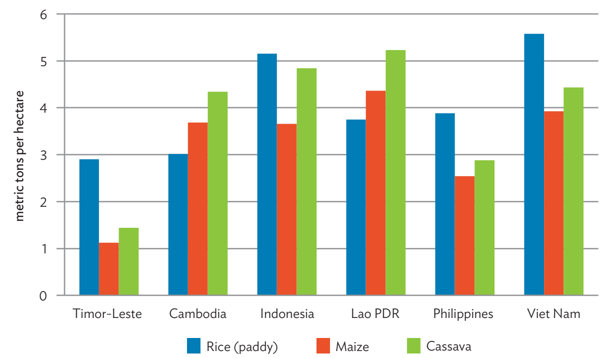
Seasonal household food insecurity levels are high, and there is low agricultural productivity

Hunger has been an issue in Timor-Leste for decades. The country has rarely been self-sufficient in food production since independence in 2002. Food shortages in rural areas typically occur in two phases. The first occurs when maize and rice household stocks are almost depleted, and households are forced to rely on root crops (cassava, sweet potato, and taro). The second phase is when all staple foods are in short supply. During this time, farmers rely heavily on harvesting wild food from the forest, and purchasing or borrowing food from off-farm sources.

Maize is the most important crop in Timor-Leste, although farmers grow a wide range to mitigate the risk of failure in one or more crop. The most frequent combination of crops is maize, cassava, and sweet potato. Annual surveys show that about a third of households harvest insufficient maize, and do not have enough of this staple crop to last the year. However, surveys over the period 2007–2012 suggest that food security is improving.[115]

Poverty within the farming population is caused by low agricultural productivity. Yields per ha for key crops grown in Timor-Leste, for example, are lower than they are in other countries within Southeast Asia (Figure 6). Rice production per ha

Figure 6: Agricultural Productivity of Key Food Crops in Timor-Leste versus Selected Southeast Asian Countries, 2013 (metric tons per hectare)



Lao PDR = Lao People's Democratic Republic.

Source: Food and Agriculture Organization of the United Nations, Statistics Division. Production—Crops. http://faostat3.fao.org/compare/ (accessed 24 April 2015).

is approximately the same as Cambodia, but substantially lower than Indonesia or Viet Nam. Productivity in maize and cassava is substantially lower than other countries in the region.

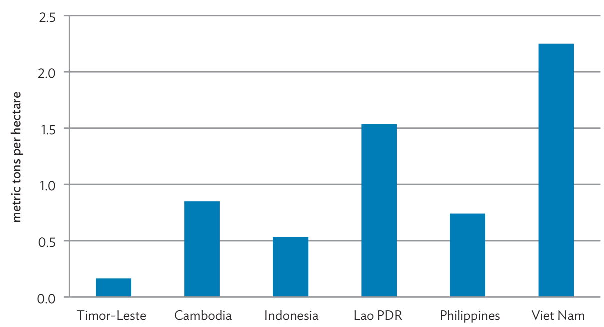
Coffee productivity, Timor-Leste's main agricultural export, is similarly low compared to other countries in the region. In 2012, the latest year for which comparable data are available, yields per ha were between 3 and 13 times lower (Figure 7).

As described in the Timor-Leste Strategic Development Plan 2011–2030 (SDP), the government intends to improve food security and raise income by increasing production levels of its basic crops such as rice and maize, and the yields of cash crops such as coffee. The strategy focuses on rehabilitating and extending irrigation systems;

114 World Bank. 2010b. *Expanding Timor-Leste's Near-Term Non-Oil Exports: Diagnostic Trade Integration Study (DTIS) Prepared for the Integrated Framework*. Washington, DC; and footnote 110.

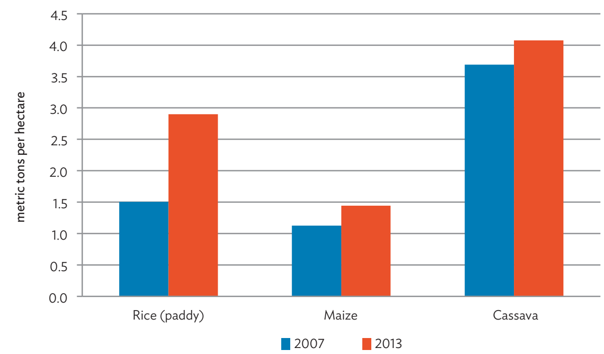
115 Annual surveys are conducted by the Seeds of Life Program, which is managed by the Ministry of Agriculture and Fisheries. The surveys indicate a significant decline of 5.4% each year of "at risk" households. Source: M.dJ. da Costa et al. 2013. Household food insecurity in Timor-Leste. *Food Security: The Science, Sociology and Economics of Food Production and Access to Food*. 5 (1). pp. 83–94. Dordrecht: Springer Science+Business Media and St. Paul, MN: International Society for Plant Pathology.

Figure 7: Coffee Productivity in Timor-Leste versus Selected Southeast Asian Countries, 2012
(metric tons per hectare)



Lao PDR = Lao People's Democratic Republic.
Source: Food and Agriculture Organization of the United Nations, Statistics Division. Production—Crops. http://faostat3.fao.org/compare/ (accessed 24 April 2015).

Figure 8: Productivity of Key Food Crops in Timor-Leste, 2007 and 2013
(metric tons per hectare)



Source: Food and Agriculture Organization of the United Nations, Statistics Division. Production—Crops. http://faostat3.fao.org/compare/ (accessed 24 April 2015).

and providing subsidies, training, and expert advice. Unfortunately, efforts do not yet appear to be generating significant results in increased yields.

There has been limited success in increasing food and cash crop production

While official data suggests that yields per ha of Timor-Leste's three key crops have increased between 2007 and 2013, the increases were minimal for maize and cassava (Figure 8).

Rice productivity appears to have increased, although it appears that the improvement has come at the expense of a reduction in the area under cultivation.[116] Rice is grown mostly in lowland areas. The total area under cultivation fell by an estimated 25% between 2007 and 2013 (from 40,000 ha to 30,000 ha). As a result, gains in rice production also appear minimal.

A 2013 review of rice production in Timor-Leste found that, despite significant government investment to rehabilitate irrigation systems—resulting in increased supplies of free irrigated water to farmers—overall rice production levels have not substantially improved (footnote 116). This is due to several factors:

- **Farmers' risk aversion.** They prefer growing a wide range of food crops and raising livestock, rather than limiting themselves to specialized production of rice.
- **Limited access to services and diverse inputs.** Increased access to water has not been accompanied by better extension

[116] A 2013 study on the impact of rice imports on rice production in Timor-Leste suggested that production data (and, by extension, the productivity estimates) may be considerably overstated. The study used data from 2011, and estimated total rice production in Timor-Leste during that year at approximately 50,000 metric tons. Yet, official government data for that year estimated total rice production at 98,000 metric tons. The study was unable to reconcile the difference. It noted, however, that the quantities of rice imported and consumed are known with reasonable accuracy—suggesting that the official rice production figures were too high. Source: P. Young. 2013. *Impact of Rice Imports on Rice Production in Timor-Leste: Commissioned Study for the Seeds of Life Program*. Dili: Ministry of Agriculture and Fisheries.

services, or access to production inputs other than seeds.

- **Other income sources.** The introduction of pensions and cash-for-work programs has provided some households with other sources of income.
- **Cheap, subsidized imports.** The domestic market is flooded each year with large amounts of imported rice, a significant portion of which is sold at a government-subsidized price. Due to the ready availability of cheap rice, farmers feel that there are minimal gains to producing rice beyond their subsistence needs. They will also need to compete against subsidized imports when selling their surplus.

Moreover, the 2013 study found that rice production costs, based on large government investments in river diversion irrigation systems, would compete with imported rice. It suggested a cheaper, potentially competitive system might be feasible through investments in tube wells and small pumps, more intensive use of production inputs, and improved market support. For success, the system would need to restore price incentives for farmers to produce more rice. It would also need close community consultation to understand local decision-making processes and cultural values. The consultations would also need to increase the chance of farmers responding to government proposals positively, by improving agricultural productivity through better practices.

Coffee is Timor-Leste's main cash crop, and also the country's main exported product. Production is concentrated in highland areas. While Timorese coffee is good quality or has high potential, coffee productivity has not improved. Coffee yields in 2012, for example, were about 25% less than in 2007 (0.16 versus 0.22 metric tons per ha).[117]

Poor productivity is mainly due to little on-farm investment. Existing coffee plantations are characterized by old and unproductive trees, with coffee canopies that have grown too tall to be harvested; and shade trees that are either unpruned and block too much sunlight, or infected with rust disease and no longer provide shade.

Production also lacks industrial crop cultivation, including weeding, pruning, planting, and managing pests and disease. Achieving productivity gains requires overcoming growers' reluctance to prune and replant coffee and shade trees; developing coffee growing, harvesting, and processing expertise; improving local infrastructure; and establishing certification programs and quality standards as part of a coffee marketing program.

One reason growers are likely reluctant to rehabilitate trees is due to a lack of clear title to the underlying land. Pruning increases production, but only after several years of reduced yields. Much of the country's stock of coffee trees is older than 30 years, after which yields significantly decline. Substantially increasing yields requires farmers to replant, rather than simply prune existing trees. Because replanting eliminates yields entirely for 3 to 5 years farmers, who are uncertain of their right to crops in the future, avoid pruning and replanting.

A 2013 review of Timor-Leste's coffee sector found that—despite considerable efforts by government and nongovernment organizations—training in pruning, replanting, mulching, and

117 Food and Agriculture Organization of the United Nations, Statistics Division. Production—Crops. http://faostat3.fao.org/compare/ (accessed 24 April 2015).

weeding is having little reach and impact.[118] It suggested that new approaches are needed to engage coffee producers to improve yields—including exploring the use of grower cooperatives to build sufficient trust and community social capital to encourage poor, risk-averse rural households to make substantive changes in their farming activities.

The review also suggested using a cash transfer scheme to improve the economic incentive for coffee farmers to increase their yields. This was deemed necessary because the very low price that coffee growers receive for their crops is inadequate incentive to increase their output. The review also proposed expanding the provision of simple and affordable financial services products among rural households, and using this as the institutional vehicle through which the cash transfer scheme is implemented. This should be done through existing microfinance institutions with a track record of operating in rural areas.

There are a lack of integrated, locally based strategies to develop agricultural markets

Well-functioning agricultural markets are critical for translating agricultural growth and increased productivity into improved rural household incomes. When markets function well, they enable efficient distribution of inputs (fertilizers and seeds) and outputs (crops) across time and space, the transfer of raw commodities into value-added products, and information and risk to be transmitted. This allows land, labor, and capital to be used to best advantage. It also enables specialization to occur, leading to further productivity improvements.

Economies dominated by subsistence agriculture—such as Timor-Leste—lack well-functioning markets. Obstacles in Timor-Leste are varied and complex, and include

- poor quality, minimal infrastructure (such as roads, clean water, and electricity),
- limited availability and access to productive inputs,
- uncertain land tenure,
- limited financial literacy and access to credit among farming households,
- lack of local storage facilities,
- an absence of traders and wholesalers to bring together farmers and buyers, and
- cultural constraints favoring social investment over economic investment.

A 2014 analysis of poverty and agricultural households in Timor-Leste confirmed that formal markets within the country are absent for most food crops.[119] It found that, while only a small proportion of food production is sold in markets, considerable quantities are shared informally across households. Postharvest losses are a major problem; this could be addressed with well-functioning markets, in which surplus production could be sold in a timely way.

The analysis emphasized the need to create better functioning domestic agricultural markets, based on a realistic understanding of local circumstances—and recognize that constraints and obstacles are often community and region-specific.

118 B. Inder et al. 2013. *Coffee, Poverty & Economic Development in Timor-Leste: Research Report 2013*. Melbourne: Monash University and Lismore: Southern Cross University.

119 B. Inder, A. Brown, and G. Datt. 2014. Poverty and the Agricultural Household in Timor-Leste: Some Patterns and Puzzles. *MONASH Centre for Development Economics and Sustainability Research Paper Series on Timor-Leste*. RP-TL1. Melbourne: Monash University. The analysis was done in 2014, and used data from Timor-Leste Survey of Living Standards 2007 because it was the best available; and because it is generally accepted that rural, agricultural life had not changed significantly for the majority of the population.

This view is supported by the research on rice and coffee discussed earlier. The analysis also stressed the need to establish the whole supply chain to support market growth.

Numerous initiatives are assisting rural farmers to connect with formal markets. However, much of this work suffers from insufficient coordination among supporting organizations. The agriculture sector has many players, each with different roles. The Ministry of Agriculture and Fisheries leads technology and extension efforts. Other government ministries play roles in infrastructure, education, entrepreneurship, land, and dispute resolution. District and *suco* (or village) councils are important local-level actors.

A large number of donors, nongovernment organizations, and private businesses assist the agriculture sector in different capacities. Given the problems' localized and complex nature, these players need to work together and closely with communities to develop the trust necessary to effectively address market constraints.

NASCENT TOURISM SECTOR

Globally, tourism enjoys continued growth, and is increasingly diversified and becoming one of the world's fastest growing economic sectors. Yet, tourism has never been an important component of Timor-Leste's economy. The first "modern" tourists arrived in the early 1960s. By the early 1970s, the country was attracting several thousand international tourists, mostly Australian backpackers stopping over on their way to Europe. Visitor numbers have begun to grow fairly recently. Over 2007–2013, annual inbound visitor numbers more than doubled from 22,000 to 58,000.[120]

However, a large proportion of these visitors are likely expatriates working for United Nations and donor agencies, international nongovernment agencies, and businesses. In 2010, the latest year for which data is readily available, 28,824 tourism visas were issued; that number likely includes international staff, their families and friends, and business visitors.[121] The total, therefore, likely significantly overstates the true number of people visiting Timor-Leste solely for tourism purposes.

The government regards growth in the tourism sector as critical to future economic development. According to the SDP, the sector expects to attract a large number of visitors, contributing substantially to incomes and jobs throughout the country by 2030. This goal is to be achieved by taking advantage of the country's natural beauty, culture, and heritage; and focusing on boutique, adventure, and ecotourism experiences, rather than mass market tourism.

Initial development is to occur in three areas:

(i) **Eastern zone**—Tutuala to Com and Baucau, and along the coastal road to Hera;

(ii) **Central zone**—Dili, Atauro, and Maubisse; and

(iii) **Western zone**—a loop from Dili along the Great Northern Coast Road to Balibo, then Maliana and the mountain areas of Bobonaro; and back through the coffee plantations of Ermera to Dili, via Tibar.

To achieve this ambitious goal, a wide range of constraints will need to be addressed (Table 7).

[120] United Nations Economic and Social Commission for Asia and the Pacific. Online Statistical Database. http://www.unescap.org/stat/data/statdb/DataExplorer.aspx (accessed 29 June 2015).

[121] C. Wollnik. 2011. *Sustainable Destination Management in Timor-Leste*. Philipps–University of Marburg Faculty of Geography.

Table 7: Constraints to Tourism Sector Development in Timor-Leste

Constraint	Details
Destination has limited access, and is expensive relative to competitive Southeast Asian destinations.	• Accessing Timor-Leste from other countries is predominantly by air. • All travelers receive a 30-day visa on arrival that can be extended up to 90 days. • Air connections are limited to three entry points: Singapore (three flights per week); Bali, Indonesia (daily flights); and Darwin, Australia (10 flights per week). Entry points and frequency have not increased since 2011. • Daily flights from Bali were only re-established in October 2014, following Merpati Nusantara Airlines suspending services in February 2014 under threat of bankruptcy. The Bali–Dili route is now serviced by Air Timor, in partnership with Garuda Indonesia. • Limited competition and small airplane size flying into Timor-Leste mean that flight prices are high, relative to closeby Southeast Asian destinations. A return flight between Bangkok and Bali (4.5 hours) is available from $385, but a return flight between Singapore and Dili (3 hours) is $500 or more.[a] • Accommodation is more expensive than in other tourism destinations within the region, such as Bali.
Road network and transportation services are poor.	• Once in Timor-Leste, tourists' movements are largely limited to travel by road. • The poor quality road network makes it difficult to visit sites outside Dili. • The situation is exacerbated by a lack of quality road transportation services.[b]
Accommodation and tourism activities outside Dili are limited.	• International-standard accommodation facilities outside Dili are limited. • Accommodation is found in few locations (Baucau, Com, Maliana, and Suai). • Tourism activities, except diving, are limited and largely "do-it-yourself."
Sector has a lack of tourism and hospitality skills.	• Training and education in tourism and hospitality are limited. • Some institutions provide courses in hospitality and tourism, but there are few people with industry experience to educate and train students.

[a] Price of a flight ticket in November 2014 based on quotes accessed from Air Timor (www.air-timor.com) and a flight comparison search engine, Fare Compare. http://www.farecompare.com (accessed 30 November 2014).

[b] Almost half the respondents in a 2014 visitor survey believed that transport costs did not offer value-for-money. This was compounded by only a third of respondents describing the country's infrastructure as either "good" or "very good" for their ability to travel within the country. Source: G. Rajalingam. 2014. *2014 Survey of Travelers to Timor-Leste*. Dili: The Asia Foundation. http://asiafoundation.org/resources/pdfs/VisitorSurvey2014English.pdf

The Ministry of Tourism, Arts, and Culture is responsible for tourism policy and planning.[122] The former Ministry of Tourism was established in late 2012; only about 5% of the current ministry's estimated 200 staff members have any practical tourism experience. Tourism operators have also organized themselves into an association, the Associação de Empresas de Turismo de Timor-Leste (the Association of Tourism Companies of Timor-Leste, or the Tourism Association). However, it only re-established itself in late 2013 after an absence of several years. The Tourism Association is in the early stages of developing a working relationship with the Ministry of Tourism, Arts, and Culture; and is determining what activities it can actively support.

The government's key challenge is translating the ideas in the SDP into a realistic plan for developing the tourism sector. The plan needs to assess existing strengths and weaknesses, and capture what visitors from target overseas markets want from their tourism experiences. Timor-Leste lacks a tourism sector development master plan that defines the type of tourism the country seeks to develop, and sets out clear actions for moving the sector forward.

The ministry has limited capacity to address this gap. A more viable short-term option may be a policy, and an associated strategy, to guide both local stakeholders and potential foreign investors in developing the sector. Without a common vision among tourism stakeholders and a realistic implementation strategy, the sector is unlikely to substantively and sustainably contribute jobs and income to the country.

Limited information on tourist numbers and their in-country experiences compound matters. Tourism statistics are not readily available, and the first visitor survey was only completed and published in 2014.[123] Work has yet to be undertaken to understand what tourists and inbound operators from potential source markets would find appealing in Timor-Leste. Such data are essential for developing an appropriate, realistic path for developing the tourism sector.

INSUFFICIENT DIALOGUE ON INVESTMENT CLIMATE ISSUES

Communication is vital for private sector development. A government is more likely to design credible and workable reforms when its ministries work together in a coordinated way, and when it listens to the private sector. Entrepreneurs, who understand the government's reform aims, are more likely to accept and support those reforms. Dialogue helps identify potential foundations for growth, creating a sense of local ownership that makes policies more likely to succeed in practice.

While various coordination mechanisms exist, the Government of Timor-Leste has lacked an interministry coordinating body focused on private sector development. However, the Sixth Constitutional Government, formed in February 2015, has established coordinating ministries for each of the four sectors outlined in the SDP: social issues (including education), infrastructure, governance (including justice), and the economy (agriculture, tourism, and investment).

[122] The Ministry of Tourism, Arts, and Culture was formed in February 2015, when the Sixth Constitutional Government was sworn in.

[123] The Asia Foundation, with support from the former Ministry of Tourism, conducted a survey of 700 travelers to Timor-Leste during May to July 2014. The majority of travelers arrived from Australia, Indonesia, and Portugal; and the primary reason for travel was for work and business purposes. The survey also found that travel planning was hampered by a lack of available information both outside Timor-Leste, and after arrival in the country. Source: G. Rajalingam. 2014. *2014 Survey of Travelers to Timor-Leste*. Dili: The Asia Foundation.

SEAPRI and the Ministry of Commerce, Industry, and Environment have both had responsibilities in coordinating private sector development efforts. Yet, neither appears to have played an effective role, and several ministries have established memoranda of understanding with each other in an effort to establish better coordination.

However, there is no whole-of-government approach to addressing the coordination issue. This increases the potential for conflict between ministries protecting their own interests, unnecessary duplication, and costly mistakes. There is, therefore, a sound opportunity for the Ministry for Economic Affairs, in its coordinating capacity, to promote communication within government to holistically discuss the full range of private sector issues. An organized government is also better placed to engage constructively with the private sector.

A formal public–private sector dialogue mechanism is also lacking. There had been a structured dialogue process; the Better Business Initiative, supported by the International Finance Corporation, brought together representatives from government and the business community to discuss investment climate issues. However, when external support for the initiative ended, neither the government nor another donor stepped in to continue the program.

The Câmara de Comércio e Indústria de Timor-Leste (Chamber of Commerce and Industry of Timor- Leste, or CCI-TL) is Timor-Leste's peak private sector umbrella group. The CCI-TL executive was elected into office in August 2014 and, like other institutions in the country, is relatively new. Therefore, it needs support to better understand its role and constructively engage with government.

Appendix 1
POLICY FRAMEWORK FOR PRIVATE SECTOR INVESTMENT

The following table is an overview of important policy issues that governments should consider if they wish to create an attractive environment for private sector investment. While the table is not exhaustive in its coverage, it identifies many of the key policy areas that need to be addressed. It also describes the types of policies that support steady economic growth and sustainable development.

Policy Framework for Private Sector Investment

Policy Area	Description of Supportive Policies
Fiscal and monetary	• **Macroeconomic stability.** Policies encourage low and stable inflation, the maintenance of debt at levels that can be sustainably met, an exchange rate policy that does not distort trade or inhibit growth, and an adequate level of net international reserves.
Investment	• **Private sector investment, including foreign investment is encouraged.** Areas prohibited to private investment are kept to a minimum; and, if foreign investment is restricted, it is done using a transparent and fast registration system. • **Effective investment promotion.** This involves a cost-effective strategy to promote the country as an investment destination, facilitate investment, and advocate for policy reform. • **Efficient business entry and exit.** The process for starting a business is simple, transparent, and fast; and clear and efficient procedures are in place to enable businesses to reorganize or wind-up if they become insolvent.
Trade	• **Competitive tariff regime and border procedures.** The policy regime allows competitive industries to develop and flourish, rather than try to develop competitiveness behind policies that seek to favor some industries over others; and the time and cost associated with importing and exporting goods is internationally competitive. • **International market access.** Efforts are made to expand market access through international trade agreements.
Tax	• **Simple tax system that is supportive of exporting, and is efficiently administered.** The direct tax system is characterized by relatively low marginal tax rates. If incentives are offered, they are limited in number, automatic, and performance-based; and used to achieve specific objectives. The indirect tax system avoids cascading effects on inputs for export-oriented businesses. Ongoing effort is made to reduce the compliance cost to business of tax processes and procedures.
Land and environment	• **Secure access to land.** Land ownership is clearly identified and registered; and mechanisms are in place to facilitate dealings in land, and resolve associated disputes, in an efficient and fair way.

continued on next page

Appendix 1 table *continued*

Policy Area	Description of Supportive Policies
	• **Effective mechanisms for managing impacts on the environment and local communities.** Integrated planning and development control regimes ensure that development activities are assessed for their potential adverse effects on communities, public health and safety, and environmental resources; and associated risks are effectively mitigated.
Contract enforcement	• **Effective mechanisms for enforcing contracts and resolving disputes.** A legal framework and institutions are in place that ensure timely and effective enforcement of contracts, protection of property rights, and resolution of disputes. Alternative systems of dispute resolution are also available to provide widest possible scope of protection, at a reasonable cost.
Human resources	• **Coherent and comprehensive human resource development strategy supported by effective labor market regulations.** The human resource development strategy is aligned with broad development and investment policies, and capable of responding to new skills needs created by changing technologies and economic structures. Core international labor standards are promoted and enforced, and labor market regulations effectively balance achievement of social objectives with the need for market efficiency. • **Equal economic opportunities available for men and women.** There is gender equality in policy and laws, supported by gender-balanced government institutions with an understanding, and capacity, to effectively integrate gender concerns in their work.
Physical infrastructure	• **Quality, accessible, and cost-effective infrastructure services.** There is a process in place to evaluate needs with respect to core infrastructure services, and prioritize development expenditures to meet demand. Regulatory authorities and infrastructure agencies have operational independence and capacity to deliver services, and are held accountable for their performance.
State-owned enterprises	• **Limited use of state-owned enterprises.** Government's commercial involvement in the economy is restricted to areas where true market failure exists. Robust state-owned enterprise (SOE) legislation is in place that promotes corporatization, privatization, and public–private partnerships. Legislation ensures that SOEs are governed in a transparent and accountable way. SOEs are centrally monitored and hard budget constraints are imposed on commercialized SOEs, similar to what firms in the private sector face.
Competition	• **Effective competition framework.** Competition laws and policies are transparent and predictably implemented. A competition authority is in place with adequate resources, political support, and independence to effectively prevent, correct, and sanction anticompetitive practices.
Financial sector	• **Financial sector that efficiently provides payment services, mobilizes savings, and allocates financing to firms wishing to invest.** A regulatory framework encourages financial deepening and inclusion, competition in financial services, efficient financial intermediation and movement of funds; and ensures prudential oversight of risk taking. Property rights are well-defined, and supported by an efficient secured transactions framework that enables investors to pledge land and movable property as collateral. There is also a supportive environment for credit information collection that allows sharing of information, while protecting consumer rights.

Source: Adapted from the Organisation for Economic Co-operation and Development. 2006. *Policy Framework for Investment*. Paris. http://www.oecd.org/investment/investment-policy/36671400.pdf

Appendix 2
OVERVIEW OF CORE INFRASTRUCTURE SERVICES

Roads

Timor-Leste has an extensive road[1] network of about 5,500 kilometers (km); just over 50% is undeveloped rural tracks. The core network comprises 1,400 km of national roads connecting Dili and the 13 districts, along with 900 km of district roads linking major population centers to the national roads. Almost the entire core road network needs to be rehabilitated or upgraded.[2] Rural roads are also in generally poor condition. Yet, the road network is the primary mode of transport within the country, and a 2013 public survey identified improving roads as local communities' biggest priority.[3]

The Timor-Leste Strategic Development Plan 2011–2030 (SDP) established the following targets to be achieved by 2015:

(i) Rehabilitating or fully upgrading and widening to international standard key national and district roads;

(ii) Rehabilitating all local roads using locally based contractors; and

(iii) Conducting annual monitoring surveys on all improved roads to determine maintenance needs.

The dates for achieving these targets were pushed back until the end of 2017 in the 5-year action plan for SDP implementation. The road network is managed by the Directorate of Roads, Bridges, and Flood Control within the Ministry of Public Works, Transport, and Communications.

Electricity

In 2008, approximately one third of the population had access to electricity. The system had 28 megawatt (MW) of generation capacity, based on a network of isolated diesel generators. Central parts of Dili and Baucau had 24-hour access to power, but were subject to regular outages. In other areas, service was limited to just 6 hours per day.

The SDP set a goal of 100% access to 24-hour electricity by 2015, and sufficient generation capacity to meet Timor-Leste's economic growth and social welfare. The government has spent $800 million on electricity infrastructure since 2008 to address these goals. By 2014, it had increased generating capacity to 264 MW of diesel generation at two sites; and had built 700 km of transmission lines, along with a distribution network. This increased the country's household electrification rate to around 58%.

1 Sources for Appendix 2: Democratic Republic of Timor-Leste. 2011. *Timor-Leste Strategic Development Plan 2011–2030*. Dili; Asian Development Bank (ADB). Forthcoming. *Country Partnership Strategy Timor-Leste 2016-2020: Sector Assessments*. Manila; BuddeComm. East Timor (Timor Leste)—Telecoms, Mobile and Internet. http://www.budde.com.au/Research/East-Timor-Timor-Leste-Telecoms-Mobile-and-Internet.html

2 A 2008 ADB road survey found that only 8% of core roads were in fair condition, with the remainder in poor (22%) or very poor condition (70%). Source: ADB. 2008. *Technical Assistance to the Democratic Republic of Timor-Leste for Preparing the Road Network Development Project*. Manila.

3 When choosing between education, health care, agriculture, access to water, and roads, 42% of the public surveyed in 2013 said improving roads was the biggest priority in their area. Source: The Asia Foundation. 2013. *Timor-Leste Public Opinion Poll—September 2013*. Dili.

Electricidade de Timor-Leste (Timor-Leste Electricity, or EDTL), within the Ministry of Public Works, Transport, and Communications, oversees the country's power grid. It interfaces with consumers, manages the system's distribution assets, and liaises with the private sector firms who operate the generation and transmission assets. The SDP also committed to introducing a new management model for the sector by 2012, although this has yet to occur.

Water and Sanitation

In 2010, just over 66% of people in Timor-Leste had access to an improved drinking source, such as piped water, protected well or hand pump, tanker, or bottled water. The main source of drinking water in urban areas is from household taps. In rural areas, the main source is from a well or spring. There are no centralized sewerage systems, and only 39% of people have access to improved sanitation facilities (such as pit latrine, pour or flush septic tank, or pit).

Only around 25% of urban households use a septic tank—the majority of those with access to improved sanitation use leach pits. Commercial premises use septic systems, although most lack effluent disposal systems to further treat or satisfactorily dispose of effluent. Illegal dumping and burning of solid waste are widespread. Nearly 35% of Dili's population disposes of waste this way. Unsegregated solid waste in Dili is taken to the unfenced and uncovered Tibar dumpsite, which lacks other engineered environmental protection systems.

The SDP commits to providing universal access to clean water and improved sanitation by 2030. National access targets for 2020 are 87% for water supply, and 76% for sanitation services.

The Direcção Nacional dos Serviços de Água (National Directorate for Water Services, DNSA) and the Direcção Nacional de Saneamento Básico (National Directorate for Basic Sanitation, DNSB)—both under the Ministry of Public Works, Transport, and Communications—are responsible for managing water supply and sanitation service delivery in Dili and district towns. Responsibility for solid waste management is shared between DNSB and district administrations under the Ministry of State Administration. In some urban centers, including Dili, district administrations have contracted private sector operators to collect solid waste.

Telecommunications

In 2011, Timor-Leste adopted a new policy to liberalize its telecommunications market. The government negotiated a settlement with Timor Telecom (the monopoly provider) in 2012, and awarded additional licenses to two foreign companies (Telekomunikasi Indonesia International [TL] S.A., trading in Timor-Leste as Telecomcel; and Viettel Timor-Leste, trading as Telemor). Both began operation in 2013.

Telecommunication services are mostly voice and largely mobile. Approximately 58% of the population had mobile telephones in 2011, most of which were prepaid. Wireless coverage extends to most areas, although there are regional disparities. Fixed line service is small, accounting for less than 1% of the population in 2013. Internet is also in its infancy, with fixed internet subscriber penetration just 0.6% of households in 2013.

The SDP commits, by 2015, to reliable and affordable mobile telephone coverage for the entire population and high-speed internet access for all district capitals, along with a regulatory framework to manage a competitive telecommunications market.

International connectivity is only provided through satellite links. Access to undersea cable infrastructure will be important to reduce costs and increase internet service speed in the future. The closest potential undersea fiber optic cable connection point is at Kupang in West Timor, connecting to the Mataram–Kupang cable system. There are also plans to connect Kupang to Atambua, Indonesia, by fiber optic land cable, bringing access to the undersea cable even closer to Timor-Leste—Atambua is less than 100 km from Dili. Other options are to connect to Darwin, Australia, through Suai, or to Singapore.

The telecommunications sector is regulated by Autoridade Nacional de Comunicações (National Telecommunications Authority of Timor-Leste), which was established in 2012 and has yet to become fully operational.

Seaports

Timor-Leste depends on a single national port in Dili for all general cargo and exports. Yet, the harbor faces several problems that limit its capacity and function. Harbor limitations, particularly draught restrictions, mean that only small ships can access the port. There is also a lack of surrounding land, preventing extension of the port's working area and storage facilities; and road access around the port is congested. In 2001, the Port of Dili received 21,000 tons of imports—this is expected to grow to 190,000 tons annually by 2040. The Dili Port Authority, within the Ministry of Public Works, Transport, and Communications, manages the Dili port.

The SDP set a goal of establishing a new port at Tibar by 2020. It also sought to establish a logistics base at Suai, including a new port, along with developing a number of regional ports by 2015. The Suai Port is part of the Tasi Mane Project, an ambitious plan to build a plant to process gas from the Greater Sunrise gas field, and a refinery and associated petrochemical industry on the South coast. The Suai development is expected to provide the logistics base for the petroleum sector and other supporting industries. Besides the port, the Suai base will include a storage yard, warehouses and offices, and an airport.

Front end engineering and planning have started on both the Tibar Port and the Suai development. Tibar is being implemented as a public–private partnership (PPP) project with International Finance Corporation (IFC) assistance.

Airports

The country also depends on one airport, the Presidente Nicolau Lobato International Airport in Dili. It provides the only international link, is in poor condition, and is unable to accommodate larger aircraft and expanded passenger numbers. It handles about 100,000 passengers each year, with expectations that numbers will triple by 2025 as the economy expands.

There are eight serviceable airstrips (Atauro, Baucau, Dili, Lospalos, Maliana, Oecusse, Same, and Suai), and a pending airstrip in Viqueque. A nongovernment organization, Mission Aviation Fellowship, operates charter flight services and a medical evacuation service for the Ministry of Health. A commercial helicopter operator began services in 2015, providing charter flights.

A new international airport will be constructed in Oecusse to support plans for a special economic zone. The government tendered construction of the new airport in 2014; an Indonesian firm, Wijaya Karya, won the tender in February 2015.[4]

The SDP set a goal of upgrading the Dili airport and establishing a commercially oriented airport authority to manage it by 2015. It also set a similar target for completing a district aviation plan and rehabilitating several district airports. As with the Tibar Port development, the Dili airport redevelopment was initially envisaged to occur through a PPP, with IFC assistance. However, the government decided not to pursue this option, and is exploring alternatives.

The Civil Aviation Authority, within the Ministry of Public Works, Transport, and Communications, manages civil aviation matters.

[4] Indonesian Business Daily. 2015. WIJAYA KARYA To Start IDR1,2 Trillion-worth Airport Development: Timor Leste. 20 February. http://business.bisnis.com/read/20150220/95/41282/wijaya-karya-to-start-idr12-trillion-worth-airport-development-in-timor-leste

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Growing the Non-Oil Economy
A Private Sector Assessment for Timor-Leste

This report investigates Timor-Leste's potential to develop a vibrant, stable, and diversified economy that is not dependent on oil revenues. Implementing challenging reforms across the private sector, banking and finance, agriculture, infrastructure, and judiciary requires sound policies and effective legislation. The Government of Timor-Leste shows promising reform appetite and willingness to engage the private sector in developing alternate investment options to attract business to the country. Yet, significant challenges remain to ensure that rebuilding efforts and institutions are managed effectively to benefit all Timor-Leste's citizens.

This report was produced by the Pacific Private Sector Development Initiative, a regional technical assistance facility cofinanced by the Asian Development Bank (ADB), the Government of Australia, and the New Zealand Government.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to the majority of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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