PRIVATE SECTOR ASSESSMENT (SUMMARY)¹

A. Overview

1. Timor-Leste’s private sector is at an early stage of development and is focused on serving the direct and indirect demand created by rapid increases in government spending and public investment. The non-oil business sector is based primarily in Dili and is dominated by construction and retail. Of the 58,200 people estimated to be formally employed in non-oil businesses in 2010, 80% were based in Dili and approximately 54% were employed in either construction (18,000) or retail and wholesale (13,600) (footnote 1). These two sectors accounted for an even larger share of non-oil business income (almost 69%), and businesses operating in these sectors made the majority of non-oil private capital investment (footnote 1).

2. As of June 2014, there were approximately 10,000 registered business entities in Timor-Leste. The majority of registrants are small, locally owned one- and two-person shareholder companies. The value of production from agriculture, forestry, and fisheries showed virtually no growth in real terms during 2007–2013. Manufacturing output started from a low base and declined during this period. Coffee exports and net travel receipts, the country’s primary source of non-oil foreign exchange, together amounted to just $59 million in 2013. It will be important for the government to facilitate a shift in private sector focus and activity towards productive sectors, particularly ones that are export oriented, in order to diversify the economy, create new formal sector jobs, and improve rural livelihoods.

B. Key Issues

3. Limited human capital. Skills shortages constrain public sector service delivery and private sector development. The foundations of a productive workforce have yet to be firmly established, as 40% of the population aged over 15 years has not had any education at all and only 58% of the population is able to read and write. Net enrollment rates for basic education have increased substantially since independence in 2002, but the dropout rate is still a significant problem. The government has introduced a workforce development strategy and established a National Qualifications Framework, but it faces the challenge of moving from strategy to implementation. There is a need to improve coordination among stakeholders, generate better information on the demand for skills (particularly the needs of employers and investors), and improve the quality and appropriateness of training to bring it into line with market needs.

4. Local labor costs are high relative to productivity and skills. Average wages represented 95% of gross domestic product per employed person in 2010, suggesting that workers’ efforts in aggregate generate little surplus. High labor costs reduce the competitiveness of the economy and lead to the substitution of capital for labor in a context where capital is scarce and labor abundant. It also keeps the majority of the workforce in the informal sector. Access to foreign workers is also problematic. The visa and work permit system is opaque, overly bureaucratic, and time-consuming, and it treats all foreign workers, including investors, the same. Women are underrepresented in the formal economy and in 2012, only 26% of persons employed in the non-oil private sector were women (footnote 1).

¹ This summary is based on Asian Development Bank (ADB). 2015. Growing the Non-Oil Economy: A Private Sector Assessment for Timor-Leste. Manila.
5. **Poor public investments.** Public investment has focused on establishing core infrastructure services, including power, transportation, and water and sanitation. While there is a real need for these services, limited public investment management capacity has constrained delivery of quality infrastructure projects with positive economic returns. While the public investment management system was reformed in 2011, the new processes have so far failed to (i) prevent selection of large projects with low economic rates of return, (ii) stop single source procurement, and (iii) protect maintenance budgets. More effort is also needed to address systemic weaknesses in procurement and internal controls to avoid corruption. The new government, established in February 2015, includes a Ministry for Planning and Strategic Investment whose primary mandate is to ensure publicly funded projects are well planned and implemented. Centralizing and elevating the public investment management function is a good step but significant effort is needed to improve the quality and efficiency of public investment.

6. Most infrastructure services are delivered by government agencies that lack meaningful financial or managerial autonomy, including Electricity of Timor-Leste; the National Directorate of Roads, Bridges and Flood Control; Timor-Leste Port Authority; National Aviation Authority; and the National Directorate of Water Supply. These agencies lack the management and technical capacity to efficiently and sustainably manage operations. The government is exploring options for public–private partnerships (PPPs) or introducing corporatized structures for this purpose. A PPP policy and associated legislation were introduced in 2012, and work is underway to introduce a PPP for a new seaport near Dili. It will be important to ensure PPP projects have viable commercial structures and are regulated appropriately.

7. **Fundamental gaps in the commercial regulatory environment.** Property rights for land and buildings remain ill-defined due to slow progress in resolving land ownership and developing capacity within the Ministry of Justice. Some land laws have been introduced, but there is no law to determine property rights. Only a small portion of the total land base has ever been formally registered, with very little of it in rural areas. Once the land law is in place, there will be a need for an efficient land registry to record land titles and property transactions.

8. While a security interest can be registered in many types of movable property, its operation as a means of collateral is limited. A legal diagnostic that was commissioned by ADB confirms the need for new legislation to (i) establish a registry; (ii) address existing gaps in what types of property may serve as collateral; and (iii) set rules governing the operation of the registry, including effective enforcement. While significant reforms were made in 2013 to streamline business registration, there continues to be no effective means for reorganizing or winding up a company. This is due to a lack of national insolvency and bankruptcy legislation. The rules currently in effect are found in Indonesian legislation, and fail to specifically mention the types of claims of creditors and the order in the distribution of assets. There is also no official translation of the Indonesian law into one of the country’s official languages.

9. A Civil Code that came into force in March 2012 provides a legal basis for establishing and enforcing commercial contracts. However, there is still limited use of formal contracts in many sectors of the economy, particularly in rural areas. The justice system is improving but is still characterized by inadequate infrastructure, staff shortages, and very limited specialist training on commercial law. As a result, enforcing a contract through the court system is time-consuming and relatively expensive. There is no arbitration law or commercial arbitration facility in place. The country also lacks other important elements that are needed to create an attractive enabling environment for private sector investors and ensure that investment benefits society.

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These include a competition policy and law, a policy on the role and governance of state-owned enterprises, and development planning legislation including a building code.

10. **Limited coverage of financial services.** Access to finance in Timor-Leste is limited due to (i) a high-risk lending environment that stems from constraints in using immovable and moveable property as collateral; (ii) a lack of credit information; (iii) difficulty enforcing contracts; and (iv) limited capacity on the part of businesses to develop quality, bankable proposals. The financial system comprises a number of micro institutions providing deposit and credit services to micro-scale borrowers, along with a small commercial banking sector comprising three branches of large international banks and a fledgling government-owned bank. While lending in general is limited, there is also an absence of long-term risk capital for small- and medium-sized enterprises. A new national development bank has been proposed to increase access to finance, although without reforms that reduce the constraints referred to above, this is unlikely to address the fundamental problem of lack of access to credit. A real-time gross settlement payment system is being launched by the Central Bank of Timor-Leste to improve the efficiency and stability of the banking system. Currently there is no mechanism to enable financial institutions to interconnect as a system, and the majority of transactions are still conducted in cash. Insurance is available, but the sector is underdeveloped.

11. **Lack of foreign investment.** Given its limited human capacity and ability to generate domestic capital, Timor-Leste needs foreign investment to provide much-needed skills and finance. Despite a liberal trade policy, preferential market access to many countries, an open foreign investment regime, and a low corporate tax rate and generous tax incentives, foreign investment into the country to date has been minimal. Uncertainty about Timor-Leste’s recent emergence from a post-conflict situation following the departure of international peacekeepers in 2012, its relatively small domestic market, and constraints in the enabling environment (e.g., difficulty in accessing land) have likely contributed to low levels of foreign investment. Other important factors include:

(i) **Bureaucratic administrative processes.** Many licensing and permitting processes lack coordination and transparency; the process of obtaining work visas for foreign investors and highly skilled workers is particularly challenging.

(ii) **Weak investment facilitation.** Investment promotion and facilitation has been focused on processing investment certificates rather than providing basic facilitation services. From 2014 to 2015 the Specialized Investment Agency was the mandated government agency for promoting foreign investment and assisting investors. In December 2015 the Specialized Investment Agency was disbanded and replaced by TradeInvest Timor-Leste which will provide a one-stop shop for investment and export promotion.

(iii) **Relatively high average and minimum wages.** The cost of labor in Timor-Leste is high relative to its productivity and in comparison to neighboring countries.

(iv) **Rising real effective exchange rate.** Timor-Leste uses the United States dollar as its currency. Despite data limitations constraining quantitative evaluation of the real effective exchange rate, estimates are that it has significantly appreciated since 2010, undermining the country’s export competitiveness.

12. Greater effort is required to make the overall investment approvals process more transparent, certain, and responsive to investors. In addition, there is a need to proactively assist investors to secure land and mediate disputes when they arise. It will also be important for the government, particularly in respect of its target priority sectors, to consult with foreign investors to better understand their concerns and develop practical strategies to address them.
13. **Untapped agriculture potential and nascent tourism sector.** The government has emphasized the role of agriculture and tourism in developing the non-oil economy. From 70% to 80% of Timor-Leste’s population depends on agriculture for their livelihood. The sector, however, is characterized by subsistence farming, high levels of seasonal household food insecurity, and low agricultural productivity. Increasing productivity will require integrated, locally based strategies to develop agricultural markets, supported by land reform, infrastructure improvements, access to tailored financial services, and supportive government policy. The tourism sector, while regarded as critical for the country’s future economic growth, is currently undeveloped and faces a number of constraints, including expensive access to Timor-Leste relative to competitive destinations, poor domestic road networks and transportation services, limited accommodation and tourism activities outside of Dili, and lack of hospitality training.

C. Government Strategy and ADB Support

14. **Government sector development strategy.** The Strategic Development Plan, 2011–2030 outlines the government’s economic growth priorities. It includes a strategic vision to transition from a low-income to upper-middle-income country by focusing on human capacity and infrastructure development, and encouraging private sector led growth within the agriculture, tourism, and petroleum sectors. The Central Bank of Timor-Leste has launched a Financial Sector Master Plan, which outlines objectives and targets for the development of the financial sector. The government continues to manage its Petroleum Fund in a transparent and responsible way, which is viewed positively by the business community. It also continues to pursue membership of the Association of Southeast Asian Nations (ASEAN). ASEAN accession could provide greater certainty with respect to future policy direction and have a positive impact on foreign investment interest in the country. However, maximizing the benefits of ASEAN accession will require supporting actions to improve Timor-Leste’s competitiveness.

15. **ADB’s support for private sector development.** This has focused primarily on working with the government to upgrade infrastructure services (particularly roads and water supply) and improve technical education. ADB has also supported development of a policy and legislative framework for PPPs, assisted in the development of the financial sector with support to the government-owned Banco Nacional de Comercio de Timor-Leste, and provided support to Central Bank of Timor-Leste on financial sector regulation. Ongoing support is being provided for development of a secured transaction framework for moveable property, a legislative framework for bankruptcy and insolvency, modernizing of the company law, and a policy framework for the promotion of competition.

16. It will be important for ADB to continue to address the fundamental constraints to private sector development. This will require continued support for improvements in infrastructure services, education, and the business enabling environment. It will be important to ensure that ongoing reforms are implemented effectively, as they are important for improving the country’s investment climate. ADB should consider providing additional assistance to encourage government engagement with the private sector through the development of a policy on state-owned enterprises and advisory input on the role of government in developing the financial sector. Other areas where ADB could be of practical assistance include streamlining the work visa process, helping the government build effective investment facilitation capacity, and helping the government align its preparations for ASEAN accession with a broader reform agenda to improve Timor-Leste’s competitiveness.

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