Private Sector-driven Development in an Infant Economy

Setor Privadu nia Kontrbuisaun ba Dezenvolvimentu iha Ekonomia Foin Moris

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Summary

This report explores economic aspects of the business and private sector environment in Timor-Leste. The study builds on case studies and economic development theory to assess where Timor-Leste sits in the transformation from a traditional, subsistence economy into a modern economy with a thriving business sector. In doing this, the study identifies a number of themes which will be pivotal in nurturing and strengthening the emerging private sector.

The main ideas and themes the study explores are as follows:

(1) Timor-Leste can currently be described as being in the early stages of transformation from a traditional, subsistence economy into a modern economy. Some writers refer to this as the 'infant economy" stage. At this stage the transformation is usually led by increases in productivity of labour. Labour becomes more productive as capital investments are made that modernise production methods, and markets established that allow specialisation in production. In the agricultural sector for example, transformation will come from resourcing farmers with basic tools, infrastructure and knowledge, and access to markets to sell and buy their produce.

(2) The key to an emerging private sector is knowledge. Wealth is created as labour becomes more productive, and productivity grows as the best means of production are learned and adopted, and as pioneers lead the way in creating new and productive entrepreneurial activities.

(3) The future of the private sector in Timor-Leste is to develop and nurture the entrepreneurial pioneers. In some models of development it is assumed that entrepreneurial potential is present and ready to emerge, and just needs the right environment in which to thrive – once the right laws and institutions are in place, business will thrive because entrepreneurs are there ready to take up the opportunities. In an infant economy, however, the level of entrepreneurial activity is also still in its infancy, and budding entrepreneurial pioneers need to be developed and nurtured.

(4) The study begins to explore how learning and knowledge are best promoted and transferred, and how entrepreneurs are best developed and nurtured. This provides guidance for many activities, from investments in education and training through to extension work in agriculture. It also suggests emphasis on creating a learning environment for business through stronger dissemination of information, opportunities for networking, and so on.

(5) Doing business in Timor-Leste poses many challenges, common to being first movers in an infant economy. The study identifies the characteristics of businesses that are likely to successfully emerge as first movers in this setting.

(6) Foreign Direct Investment (FDI) is critical, bringing knowledge through transfer of expertise. Some FDI brings with it a much greater contribution to knowledge transfer (spillovers) than others. Understanding these dynamics is critical to getting the best value out of FDI activities in Timor-Leste.

(7) The role of the government is critical in a supporting the emergence of the private sector. The study will explore different roles government can play, centring around the question of how government action is helping firms to be more productive and to acquire and best use knowledge.

The aim is that this study will provide greater understanding of the current realities, and directions for future priorities in promoting private sector development, for the good of all the people of Timor-Leste.

1 Introduction

Fourteen years after becoming an independent nation, Timor-Leste sits on the edge of a significant economic transformation. The public rhetoric of recent years has increasingly been around the need to move to being a 'post-oil economy'. In the first decade of independence, growth and development has been reliant heavily on the revenues generated from oil and gas activities in the Timor Sea. This revenue has provided substantial funds to support the activities of government and to invest in reducing poverty and in long term sustainable development. This reliance on the oil and gas revenues is, however, not sustainable. The reserves are rapidly depleting, the world price for crude oil is at an all-time low, and as a result, the economy will need to move away from reliance on petroleum fund reserves as the primary driver of economic activity and source of government revenue.

The public discourse around economic development is now focused heavily on building a diversified post-oil economy (Asian Development Bank, 2015), alongside a number of initiatives aimed at broadening the government revenue base.

In this context, attention is being paid to the need to develop the 'private sector'. It is understood that the private sector will provide much of the drive behind this new, diversified economy. That said, it must be recognised that currently there is a relatively small and nascent private sector, much of which is heavily reliant on project funding from public programs - which are in turn funded from oil and gas revenues.

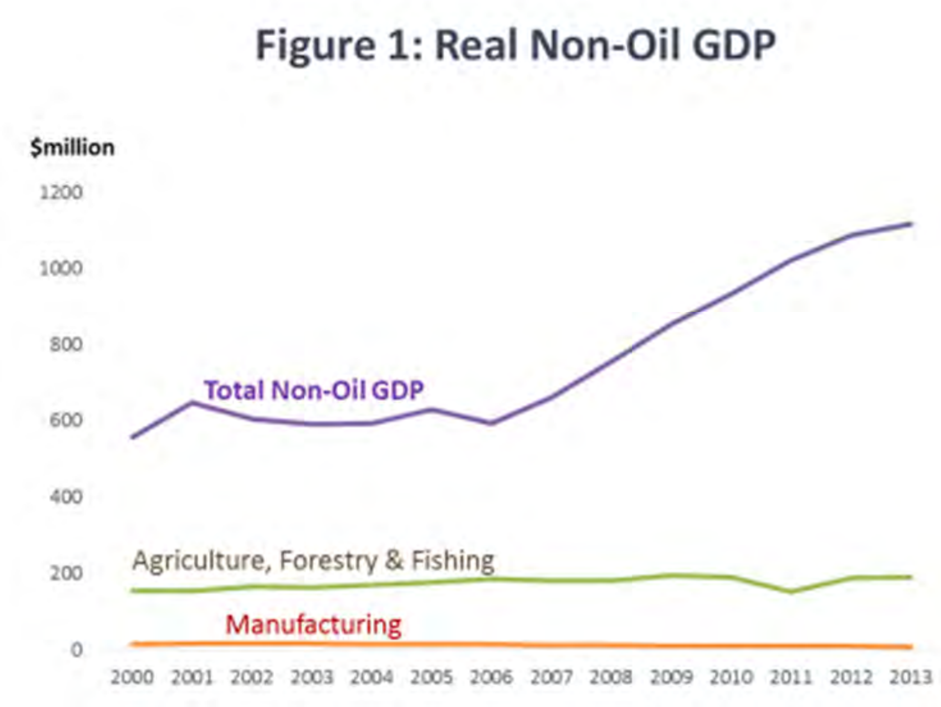
With this background, this report will look at the private sector in Timor-Leste. The report reflects lessons and thoughts acquired over several years of observation and research into the economic conditions that prevail in Timor-Leste, along with more intensive study of the private sector in 2015 and 2016. It will explore the current reality, and what key steps can be taken to develop the kind of private sector the people of Timor-Leste need and want to see emerge. The report does not offer all of the answers. It is a humble attempt to provide some insight into the issues and challenges, along with suggestions and priorities for future directions.

2 Context for Developing the Private Sector

There are two important points to emphasise as a context for discussion of building the private sector in Timor-Leste. First, it is useful to consider the current realities of economic activity in Timor-Leste, and the extent of dependence on oil and gas revenues.

To give substance to this point, we have sought to put some realistic parameters around the current composition of the Timor-Leste macroeconomy. This provides the basis for realistic projections into the future of economic growth. Here is a brief summary of the analysis, illustrated in the Figures below. Further details of the underlying assumptions and parameters are available from the authors.

- Real non-oil Gross Domestic product (GDP) has increased strongly in the past 10 years, but not in agriculture or manufacturing.
- Most of the growth in GDP has been driven by government spending of funds generated from the Petroleum Fund.

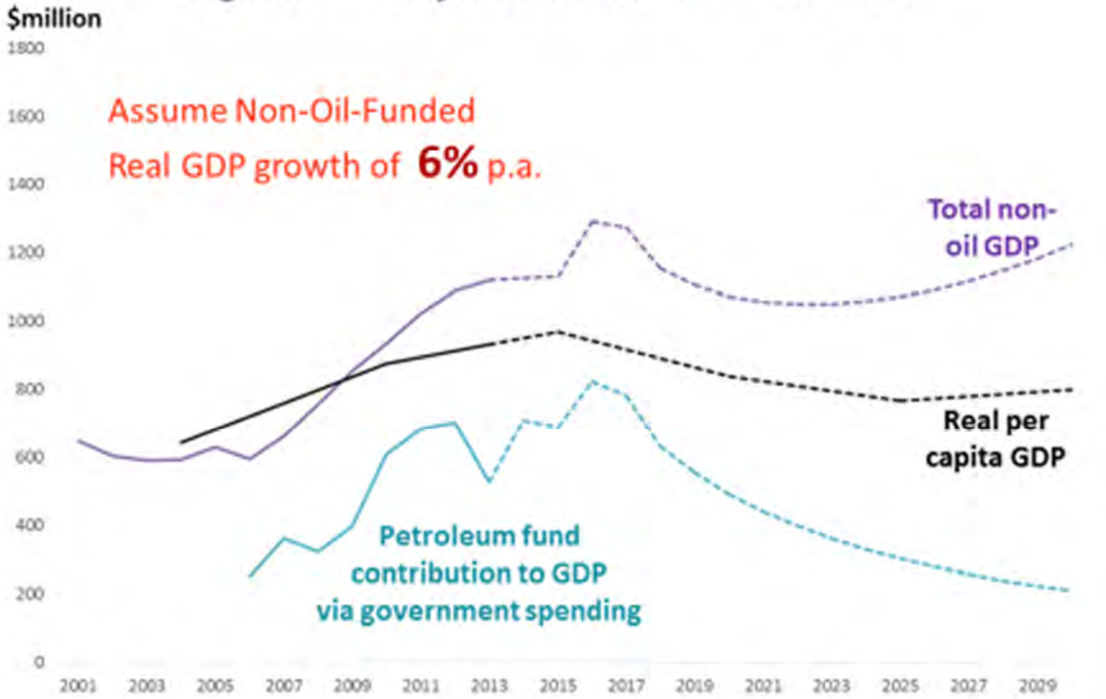


Data Source: Timor-Leste National Accounts 2013

- In the future the Petroleum Fund will decline (based on the Government's projections), and hence the contribution to non-Oil GDP which is based on the Fund will also decline.

- The portion of non-Oil GDP that is not reliant on Petroleum Fund revenue is the true “non-Oil GDP”. It will need to grow rapidly to make up for the decline in the petroleum-funded component.
- Our projections are that growth in this component of 6% per year (real, after adjusting for inflation) will be needed for the next 15 years just to see overall non-Oil GDP eventually recover to its current / 2014 level. Even with this relatively strong 6% growth over a long period, this represents a decline in GDP per person, making the average person in Timor-Leste worse off economically in 2030 than they were in 2014.

Figure 2: Projections of Non-Oil GDP



Data Source: Timor-Leste National Accounts 2013, plus author calculations

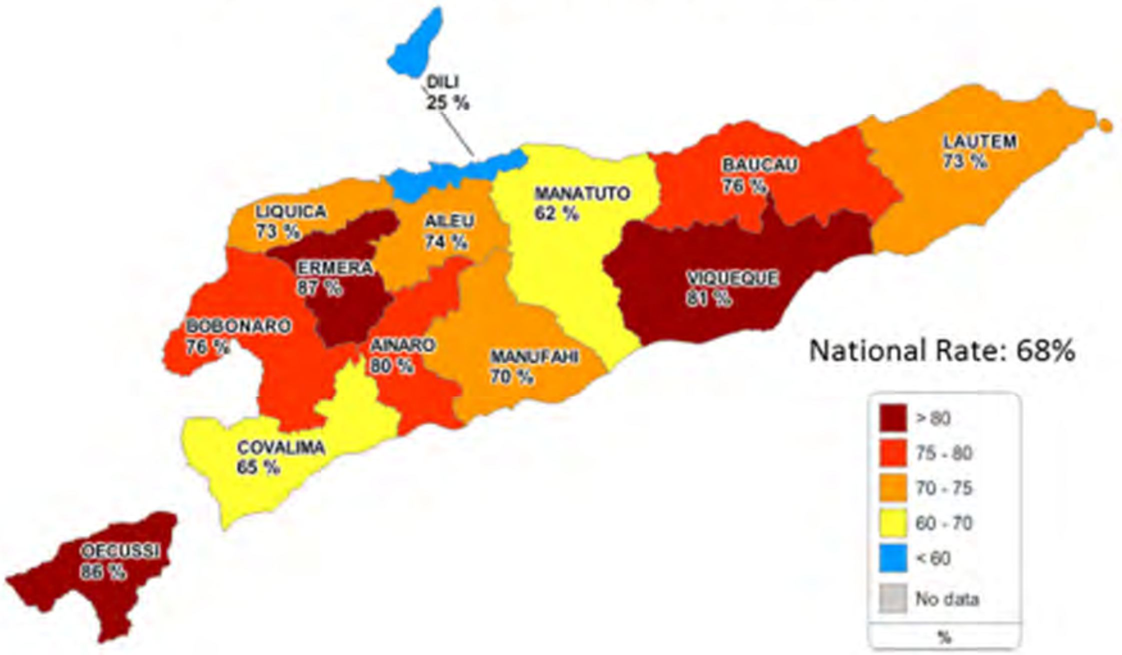
In other words, there is an imperative to diversify the economy because in the future Timor-Leste will be unable to rely on the revenues from oil and gas; it is an unsustainable source of revenue into the future. Furthermore, there is an urgency about this, because sustained high rates of growth of the non-petroleum-funded economy will be needed to replace the anticipated decline in oil revenues. The issues we discuss in this report are therefore of vital importance.

The second main context for this work is that Timor-Leste is a country with high levels of poverty. Poverty is the reality faced by a large percentage of the population, and it affects many aspects of their lives. Poverty shows itself in families not having enough of the right kinds of food to eat, so the children do not develop in the ways that they should and adults do not have the energy they need in order to function well in work and daily life. Poverty is also clear in the quality of housing and other living conditions, as well as health and educational outcomes.

Based on the 2010 Demographic and Health Survey, the Multidimensional Poverty Index (MPI) shows a National rate of poverty of 68%.

The MPI defines poverty more broadly than the way the poverty line is normally used. The poverty line is normally about income or consumption poverty and the last reliable measure for that measure was from 2007; it showed a poverty rate of 49.9%, virtually half the population (at the time of writing, the poverty rate based on the most recent survey, 2014, had not been released). The multidimensional poverty index is based on the view that poverty is represented not just by the food you eat, but also the living conditions, the health, the educational achievement of people. When you factor in these dimensions the poverty rates are very high, particularly in certain districts, as shown in Figure 3. The highest rates are in Oecussi and Ermera, with rates of 86% and 87% respectively.

Figure 3: Multidimensional Poverty (MPI)
Poverty Rates by District (DHS 2010)



Source: Cornwell, Inder and Datt (2015)

There are signs of improvements in poverty rates: previous work on poverty (Cornwell, Inder and Datt, 2015) showed when the MPI is compared between 2007 and 2010, there was a reduction of around 7 percentage points, a good outcome over only three years. As of June 2016, there are no officially available data sets from which more recent estimates of poverty rates can be calculated, but preliminary analysis suggests some modest improvement is likely to have taken place over the past few years as well. But this does not hide the reality of very widespread poverty.

It is this reality that provides the context in which we consider the role of the private sector. We do not look at the private sector because there is a broad-based ambition among the people of Timor-Leste to see Dili emerging as the next Singapore. We study this issue because we believe that the private sector provides the drivers of economic activity that is able to address these great human needs associated with poverty and other deprivations – ekonomia ba communidade.

3 Economic Activity and how it Progresses

In this section we will take a step back and explore the basic concepts relating to economic activity, with a particular focus on how wealth is created and how poverty can be reduced. In doing so, we will explain why the private sector is key to this process. The simple example below will also introduce a number of the key terms that are used in analysing economic activity.

Consider a community of poor, rural households who each grow a small amount of crops. How will the people in this community improve their **material wellbeing**? How will they **create wealth**?

Put simply, wealth is created when economic activities are carried out in ways that are more productive or more efficient than they were previously. A common way this increase in productivity occurs is by **investment** in a new means of production such as a piece of equipment, otherwise known as **capital.**

Assume that the community we mentioned above currently prepares the land for planting crops by turning over the soil with basic tools, which is very slow. If the farmers get access to a tractor, they could do their work much more efficiently. With a tractor, the community can now plant more crops and harvest more food. In economic terms, they have increased productivity and created wealth in the form of food.

Specialisation

But who would buy this tractor? A tractor is costly and one household with only a small piece of land could not justify the expense. The increase in harvest that a single farmer would experience would not be enough to cover the tractor's cost. What may happen instead is **specialisation**. One person finds the money to buy a tractor and starts up a tractor-leasing business. Individuals then pay that person to come and plough their fields whenever needed. That way the tractor is busy most of the year, serving many farmers and the capital expense of the tractor is well and truly justified.

Essentially, because of the benefit that equipment, or capital, has in improving productivity, we inevitably end up with one party specialising in a particular product or service in order to produce greater degrees of productive efficiency in the whole.

Markets

The tractor owner has a service to sell to buyers, that is, individual farmers. Farmers need to know that the service is available and how to access it. This is the function of a **market**: an information gathering point between buyers and sellers of a good or service.

Note that in this example everybody is potentially better off than before the tractor owner came along: every farmer is getting more crops, and even after paying for the tractor, every farmer is potentially better off financially. The tractor owner is also earning plenty of money from leasing out the tractor to cover its cost. In other words, wealth has been created!

Inequality

Now let's introduce a problem into the example: suppose there is only one tractor owner in the district. They can charge a very high price for leasing the tractor, and farmers will pay it if they see sufficient benefits in improved yield. However, while the farmers are a bit better off, a lot of their gains in production are being used to pay for the tractor, so they are not much better off. On the other hand, the tractor owner is doing very well financially, making plenty of profit. The existence of the tractor business has created wealth and everybody does benefit, BUT inequality has also increased.

It could get worse. Suppose one farmer cannot afford to pay for the tractor lease. The owner of the tractor agrees to lend the farmer the money for the lease on the condition that the loan is repaid at harvest time (with interest!). This is manageable until one year there is a drought, and the harvest is poor. The farmer can barely feed their family, let alone sell any surplus crops to pay back the loan. Now they are in debt! In the worst situation, the tractor owner may demand that that loan be repaid in land – insisting ownership of the farmer's land is transferred to them and the farmer is reduced to being a tenant. In the end the farmer is in fact worse off, and potentially in a spiral of decline into greater poverty.

This scenario illustrates that it may not always be the case that everyone is better off as wealth is created. A society must be mindful of those who lose out through misfortune or other means.

Competition

Reducing the risk of increasing inequality can be done through competition. Suppose we modify the above example to include a local business person who notices that the tractor owner is making a lot of money. They see an opportunity and also buy a tractor to be available for lease by farmers. We now have two suppliers of tractors, and given that they have to compete for business, the price of the service is likely to come down. This helps reduce the risk of growing inequality.

Why the Private Sector?

At this point one may ask why the government could not just provide the tractor? Why a private business person?

This is where we must introduce the importance of **Incentives**.

Human beings respond to incentives. If we are strongly motivated about something, we are likely to work hard, smart, efficiently and effectively. On the other hand, if our main motivation is some external pressure, like the demands of a boss for example, the task will still be done, but with minimum effort, and potentially not very effectively.

So what is the ultimate motivation that drives economic behaviour? The evidence in the economics literature suggests that in most situations, personal / family success and financial gain is the strongest motivation. For example, in a recent, carefully designed study of health workers in Zambia, Ashraf, Bandiera and Lee (2016) found that workers motivated by career progression and personal reward performed far better in their jobs than those motivated out of care for their community and social responsibility.

So how do incentives affect our example? If the tractor owner is a private business person they will receive no money if they do not provide the service. The tractor owner therefore has an incentive to optimise their activities so that they maximise their profit. In contrast, if the tractor is owned by the government, and a government employee is paid to manage it, that employee is paid the same even if the tractor sits idle all year!

The private business that leases the tractor has an incentive to continually improve their operations. For example, if they can order their visits to farmers to spend less time traveling between households then they will; this means they can then reach more farms, help more people, and earn greater profit. The private business is always looking to operate more efficiently.

Furthermore, the private business has an incentive to prevent the loss of money, because it is their own money they are losing. If there are not enough households who need the tractor in a particular area, they will take immediate steps to attract more business: they may go in search of new farms, or move to other areas, or reduce the lease cost of their tractor.

In other words, the incentives created by private investment mean that the service is delivered efficiently. Furthermore, when competition is strong, the service is provided at the best possible price, offering potential benefits to the farmers.

Risk and Incentives

A final perspective on the importance of the private sector relates to the concept of risk.

Transformation towards a modern economy requires entities that are able to take risks and to venture into new initiatives. If an economy does not undergo reform or transformation, it will grow slowly at best, and slow growth will ultimately be insufficient. What is needed is people and businesses, like the owner of the tractor in our example, who are prepared to do new things and take new initiative.

However, innovation inevitably involves taking risks. Undertaking a new initiative may be a great success, or it may produce no benefit at all. Different entities, from individuals to governments to businesses, have different attitudes towards risk. Some are very reluctant to take risks because it might put their livelihoods or reputations in jeopardy, while others are more willing to take risks because there are legal or other protections against the worst possible outcomes. The key factor in encouraging innovation is the incentives that are in place for people who takes risks.

This is where the private sector comes in. Anyone who takes a risk has to have the incentive to do so, usually in the form of a greater benefit or at least a return on effort. The private sector is designed around rewarding those who take risks, particularly those who succeed and gain extra rewards or profit. The innate incentives of the private sector make it well suited to meet the need for innovation and risk taking.

For these reasons, the private sector is a high priority in the Timor-Leste's strategy for diversifying the economy and reducing poverty.

Governments can take one of two positions in relation to risk. Both pose problems. Sometimes Governments are very risk averse. They will not support ventures which pose too much risk of failure, because of the likely criticism they would experience from the public about a failed government project. This means governments will choose to support activities that are low risk, and often not the best investments. They may offer protection for investors, and support non-competitive business ventures. At the other extreme, Government can be too inclined towards taking risks. They can undertake ventures without proper assessments of the risks and likely returns, because they are putting at risk public money, not the personal wealth of the decision makers. Often large scale infrastructure projects can fall into these categories. It is a good rule of thumb to ask a decision maker: "if this was your own wealth being invested in the project, would you still go ahead?"

In summary:

- To help improve wellbeing and reduce poverty, a society needs to create wealth.
- Wealth is created as private entities invest in means of producing goods and services that are delivered to consumers at lower cost than has previously been done.
- Markets are critical to this system, as markets are the key process by which suppliers and consumers meet.
- The Government can play an important role in facilitating the private sector, but typically the incentives created by private sector involvement in modernising the economy are critical.

4 Approaches to Development

There are a number of countries which, at certain stages of their development, have been in similar situations to Timor-Leste, and who have sought to build a private sector culture in their countries. The task of forming an approach to developing the private sector in Timor-Leste is to a large extent about learning from the experiences of other countries and from the theories that have evolved out of those experiences. This frames a way of thinking about the best way forward for Timor-Leste.

The most important lesson to be taken from the broader economic development literature is that process matters: how you go about development is absolutely critical to determining outcomes. There may be broad agreement with the development objective - the goal - for Timor-Leste to become an upper/middle income country with vastly improved material quality of life for their citizens. However, how we go about achieving that goal is extremely important. We see in history many occasions where noble goals have achieved little, or more seriously, have been harmful because of the approaches that have been taken.

We need to constantly ask the question: 'are we taking the best approach that we could take, suited to Timor-Leste at this stage of our development?' Healthy scepticism is an important part of forming an approach to development. Economic development is a difficult process, and nobody knows all the answers for how it is best facilitated. It is an ongoing process of seeking the best advice, learning from the things that do and do not work and seeking to improve them.

The economy will grow and poverty will be reduced as economic activity is made more efficient and more productive.

In simple terms, economic development is about modernising the activities of the economy. The organising idea that this report will work from is the argument that the economy will grow and poverty will be reduced as economic activity is made more efficient and more productive. With the context of international experience and broader literature, this research has involved extensive listening and learning from those who are actively in the private sector and in government and in academia. The report presents just some of the key themes that have emerged, and seek to give a roadmap for priorities in seeing the private sector built into the future.

Before focusing on the nature and importance of efficiency and productivity, it is important to note that the link from growth to poverty reduction is not obvious or inevitable. There is an extensive literature on the relationship of growth, poverty and inequality (e.g. Dollar and Kraay, 2004, and related papers by the same authors), that generally concludes that growth does tend to reduce poverty. However, not all economic growth is the same: depending on the sectors of the economy that provide the primary source of the growth, there can be very different impacts on poverty (see Inder *et al.,* 2015, for some analysis of this for Timor-Leste). So if there is a concern for reducing poverty through economic growth, attention has to be paid to the types of economic activities that are supported, and the ways in which growing wealth is distributed.

It is clearly a priority for the citizens of Timor-Leste that the poor benefit from economic growth, particularly those in the rural areas of Timor-Leste.

5 Timor-Leste Development: Infant Economy

There are a number of models for economic development. A model is a basic set of views about the process by which the goals of development are achieved. There is usually little debate about the goals of development – the debate is more about the process by which progress towards those goals takes place.

Distinguishing between the aim and the process of development is important. When a particular economic initiative takes place, it may have critics. The critics are normally focused on the process by which the development goal is being pursued. It is important that the debate focus on that. Sometimes those responsible for the initiative defend what they are doing on the basis that it is focused on achieving a particular goal, and that goal is well accepted. But this misses the point. Mostly the criticism is not about the goal, it is more questioning the process.

There is a great deal written about different models for development. The models emerge as a result of observing the process of development in different countries across history, and identifying patterns about the way development takes place, as well as times when the development process fails.

One very important factor determining the relevance of a particular model for development is the country's history and their current situation – in economic terms, it is important to understand the current stage of development that an economy has reached. The process of development will differ markedly depending on how an economy is currently functioning (Rodrik, 2007).

For example, consider an economy with strong institutions, a diverse commercial and industrial sector, and rapid growth in new businesses run by local people. Their recent history has been one of rapid migration from rural areas to urban areas. As the agricultural sector becomes more productive, a surplus of labour emerges in rural areas, while opportunities for employment in urban areas appear attractive. The problem is that the growth in the industrial sector is not fast enough to absorb all the additional potential workers. The growth in businesses is constrained by lack of infrastructure – roads are congested, ports are slow in importing and exporting goods and electricity supply is unreliable.

What can the government best do in addressing these problems? From this simple description, it is obvious that they need to invest in infrastructure. This creates additional capacity and addresses the constraints to the growth of private sector activity. The potential for expansion of the private sector is there, waiting only for these blockages and constraints to be removed.

Now take another economy, just emerging from long history of conflict and colonial occupation. The society is dominated by small landholder subsistence farmers. Because of conflict and other problems the vast majority of adult citizens have had little exposure to quality formal education or employment. Many of the best educated have fled the country because of the conflict. The country begins to build itself with a foundation of little infrastructure, few formal institutions, and a very small formal or modern economy. It is unlikely that the same strategies that are obvious in the first country are going to be as effective here. Simply improving institutions and infrastructure will provide the environment in which entrepreneurship and innovation can flourish, but with little history of these kinds of activities, there is not likely to be some spontaneous response of rapid expansion of business activities. The culture of business and entrepreneurship is being established for the first time, and this takes time and deliberate intentional intervention. So the best approach to development in this case is likely to be based around a very different set of priorities.

The latter type of economy is referred to in the economics literature as an ***infant economy,*** and provides an apt description of the realities of Timor-Leste in these early years since independence.

The Nobel Prize winner Joe Stiglitz has developed a stream of research around Infant Economies which can provide very helpful guidance to development priorities for Timor-Leste. His recent book, titled *Creating a Learning Society* (Stiglitz and Greenwald, 2015) provides a good introduction to Infant economies and the implications for development policy. Based on Stiglitz' work, we argue the Infant Economy has two main and defining features.

1. **An Economy comprising of Infant Industries**

   In an Infant Economy, almost all sectors are what could be described as infant industries. An infant industry is one that is in its early stages, operates at a relatively small scale, and is unable to compete with established competitors internationally. This provides an agenda for policy makers wishing to see the emergence of that industry, knowing that without support, they will not be able to compete (Melitz, 2005).

   There are a number of challenges facing first movers in an infant industry, but these are amplified even more when the economy as a whole is comprised of mainly infant industries. The main reason for these additional challenges is the reality that economic activity relies heavily on the need for **co-ordination** between many businesses across industries. For example, a food processing business needs to rely on a number of other businesses in other sectors – transport, communications, IT, financial services, manufacturing and equipment experts, utilities, and so on. If there are weaknesses or high costs across several industries, then investing in building one industry may not be sufficient. The challenge is to develop several industries in parallel, because the success of each depends on the others.

2. **Little or no history of modern economic activity or institutions**

   An economy can comprise of mainly infant industries for one of two reasons: either they are emerging for the first time from a long history of reliance on subsistence agriculture and few formal institutions outside the local village level, or they previously had strong modern sector economy but it has been lost because of a major crisis such as a civil war. The infant economy is characterised by the first of these.

   The economy recovering from a civil war will have a collective memory from which the supporting institutions of the economy can be rebuilt, and experienced entrepreneurs who can quickly create momentum in growing the level of economic activity. They know what to do and how to do it, because they have done it before.

   The challenge of being an economy with minimal history of modern sector activities is that the institutional memory and the stock of experience are not present in society.

   There will be a long list of institutions to be built, laws to create, infrastructure to be built. There will be many opportunities for new businesses to start and industries to emerge. Alongside these limitless needs and opportunities is a population with little background in these kinds of activities, and most likely big gaps in their basic education system, both past and present. The shortfall in **human capacity** to deliver these institutions and to kick-start modern-economy economic activity will be the biggest constraint to development, the biggest challenge to overcome.

Facing up to this reality is a key step in developing an agenda for developing an Infant Economy. It influences the ways institutions are formed, and the approaches to supporting the emergence of the private sector.

According to the Timor-Leste 2010 Census:

- 49.7% of the population aged 25 and above have never attended school

- 55% of the population aged 15 and above have not completed primary school

- 40.2% of the population classify as illiterate in any of the main languages

School attendance rates have been improving rapidly, so these statistics will improve with time, but improvements in population levels of education are typically slow.

Source: National Directorate of Statistics (2013)

6 Infant Economy: Obstacles & Challenges

Given the focus of this Report is on developing the Private Sector, it is useful to describe the particular challenges and obstacles commonly encountered in an Infant Economy from the point of view of the private sector.

The two main challenges businesses face are:

1. **Costs of Production** are high
2. **Risks of doing business** are high

Key reasons for the high costs of production

- Farm gate prices of primary produce (or other inputs) are high because labour is comparatively unproductive. The question of productivity will be discussed further in Section 7.
- Transportation costs are high due to poor infrastructure and high fuel costs
- In many areas there is a lack of specialised business support services, such as transport companies or IT services, to provide low cost options for various aspects of business operations.
- The gaps in complementary businesses and business services mean that most firms have to be vertically integrated – the one business undertakes virtually all aspects of their business through the whole supply chain and across the whole range of business activities. For example, a producer or importer of packaged foods organises their own vehicles for distribution to retailers across the country. This limits the capacity of the business to specialise and is less cost effective.
- Many businesses and farms are small, and in most cases, small firms are less efficient and have higher costs per unit of production.
- Costs of compliance with labour laws and other regulatory requirements can be high.

Key reasons for the high level of risk in doing business

- Lack of diversification of economic activity within the small firm or household. This leaves a risk of significant loss when something goes wrong. For example, a household for whom coffee is their only cash income, is vulnerable to fluctuations in world coffee price or a drop in demand, or a particular disease that affects their trees.
- Markets with low volume. Businesses rely heavily on there being a market for the goods or services they provide. In an infant and small economy, the market can often

be quite small and unpredictable. For example, a vegetable grower in Aileu who produces premium quality vegetables for supermarkets in Dili has to rely on a small customer base. They are vulnerable because if the demand is not there when their crop is harvested, their only alternative is to sell in the local market at a heavy loss.

- Lack of institutions and infrastructure. This can range from an unreliable electricity supply or uncertainty about land tenure, or ambiguity about labour laws or contract enforcement, among many others. Businesses feel this lack heavily because it can increase both costs and risks.

The Vicious Circle of Poverty

Kaushik Basu, World Bank Chief Economist, opens his book *Analytical Development Economics*, with the sentence ‘Poverty has a tendency to persist’ (p.21). His book explores the puzzling reality that poor countries experience incredible difficulty in overcoming their poverty.

One might think that overcoming poverty should not be difficult. Theoretically, the world should move towards economic convergence. Poorer countries have cheaper labour and other costs, and can replicate the new technology emerging in other countries relatively cheaply. So in theory, poorer countries ought to grow faster than rich countries and closing the economic gap should be relatively swift.

Unfortunately, this convergence often does not happen because poor countries can often be trapped in a vicious circle of poverty.

Consider the following hypothetical example. Timor-Leste grows mangoes, but they are not always available when consumers need them. So a proposal is put forward to establish a large mango processing facility that pulps mangoes and freezes the pulp. The pulp can then be available for restaurants in Dili and elsewhere for making juices. This initiative would provide more income for rural mango farmers, as well as jobs for workers in the factory, transport sector, and so on.

In practice, however, a number of difficulties arise. The first problem economists highlight is that in a low-income economy, there is little ***demand*** for manufactured products. Establishing a factory is expensive, so the factory must be large in order to make all this expense worthwhile. A large factory will produce a significant amount of frozen mango, much more than the restaurants of Dili will require. More people may have extra income because of the work the factory generates, but all this extra money is unlikely to be spent just on mangoes. There simply will not be enough demand for the product within Timor-Leste. This is called the problem of **unbalanced growth**: one sector grows rapidly and most others do not, and the extra income produced from that growth sector does not produce sufficient demand for the product of that sector. There is too little demand to justify the supply.

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The Vicious Circle of Poverty Continued…

The unbalanced growth problem can be addressed in a number of ways. Demand could be found outside of Timor-Leste and the product could be exported. If a low-tech processing solution is available, then an emerging business could begin by producing low volumes economically until demand for the product increases in Timor-Leste. Alternatively, focus can be placed on producing a product locally that is currently being imported. That way, demand is already assured.

A second problem that is likely to be encountered in our example is to do with co-ordination. Starting a mango processing factory and selling the product is not easy. It requires co-ordination across many sectors and people with a wide range of skills. Establishing a factory would require electricians, fitters and plumbers to install, maintain and repair the machines. Access to replacement parts is also required, as is transport to deliver the fresh produce, facilities to freeze and store the product on site and at the port and reliable electricity supply to ensure the frozen product is not spoiled. More people would be required to oversee export quality processing facilities, accountants and lawyers would be needed to manage the contracts, computer experts to maintain IT systems and international marketing experts to generate and manage clients. The way modern production works, failure in virtually any one of these many linkages can halt the entire process. This is referred to as the O-ring theory in economics, based on the experience of the Space Shuttle Challenger that crashed because of one small faulty part – an O-ring. Similarly, if one link in the chain is weak or low in productivity, the productivity of all others involved in the process is reduced.

This problem of co-ordination is a significant challenge in Timor-Leste. There are no simple answers, but acknowledging the difficulties this creates is an important first step in identifying achievable progress. Timor-Leste need not be trapped in the vicious circle of poverty forever.

7 Development Priorities in an Infant Economy: Productivity

Productividade, Productividade, Productividade

In an infant economy the most obvious weakness is with the productivity of labour. In almost all areas of life a great deal of effort is expended to yield relatively little output. This is the fundamental symptom of widespread poverty. However, we would argue that this is also the primary point to focus on in establishing a strategy for developing the economy. Productivity is the benchmark that needs to be used to measure whether a program or reform initiative is effective.

In economic analysis, the emphasis on productivity has a long history, dating back to the pioneers of research into economic growth. For example, Solow (1956 and 1957) demonstrated that 'most economic growth is related not to increases in the factors of production – like labor and capital – but rather to increases in productivity' (Stiglitz and Greenwald, p.2).

Let us consider locally produced rice as an example. It is often noted that locally produced rice cannot compete with imported rice, and the cause of this is attributed to a range of government subsidies of imported rice. However, analysis by Young (2013) suggests that while subsidies are a factor, the real issue is that domestically produced rice is just much more expensive to produce. Strangely, this sits alongside the reality that rice farmers receive a very poor return on their efforts – they work many hours throughout the season to produce their harvest, and in the end, receive a very small amount. How can these two facts sit next to each other: locally produced rice is too expensive, and rice farmers earn too little for their efforts? The answer is productivity. With very basic farming techniques, local rice farmers have to spend excessive hours producing relatively small quantities of rice. Essentially their productivity is low.

Improving productivity is about taking what we do and changing the way we do it so that we produce more with the same amount of input. The same amount of time or effort, or the same amount of land is used, but as a result of changing the way one does things, more is produced afterward.

Productivity can be improved in a number of ways.

- It can be achieved by improving the skills of labour. If you give a task to two different people, one person is often able to do that task quicker than the other because they have greater skills - they know how to find things on the computer faster or know a quicker route to take to get to the destination. Arrow's influential work in 1962 describes the process of improving productivity via this means as **learning by doing.** This insight is the foundational concept of modern day theories of economic growth known as **endogenous growth theory.**

- Sometimes productivity improvements can be achieved by investing in capital. A machine can do some things that previously human beings had to do much slower by hand.

- Productivity can also be achieved by specialisation in production. By specialising in a narrow band of activity, we become highly proficient at it and can do it faster and to a higher quality. Those simple things change the way we act and make us more productive.

So why is improving productivity the starting place for development in an infant economy? Let us consider an example.

The photos above are taken from a flat piece of land where rice is grown in Viqueque. Suppose the owner of the land in the first picture puts in 100 hours of effort and produces 100 kilograms of rice.[1] Then suppose that farmer is given some equipment that means that they can double their productivity. Now they can they can do twice as much with every hour of work that they do - they can work for 50 hours and still produce 100 kilograms of output. Is that what they will do? Will that farmer say, "I now no longer have to work 100 hours, I only have to work half as much and produce the same amount of rice"?

Observation and theories of human behaviour suggest that the answer to this question is no. The farmer is more likely to continue to work for 100 hours, or possibly more, because the return on their effort has increased. In economic terms, the labour-leisure trade-off has

[1] These numbers are for illustration purposes only. This is not actually the rice production of these particular communities.

just moved in the direction of better relative return on labour, so labour supply will not decrease, in fact it will increase. This means the farmer is likely to continue working 100 hours or more, only now they will be producing 200 kilograms of output. They have just doubled production. They have just made more food available for their family and taken one step towards reducing poverty. What this example shows is that the point is not to concentrate on increasing production but to concentrate on increasing productivity. Increased production will then follow.

Now consider an example with coffee. The Table below presents some data on the productivity of coffee activities based on a Ministry of Agriculture report of 2009. The study asked farmers to document how many days they spend working on coffee activities across the year. Farmers were then asked how many kilograms of coffee they sold and whether they were green beans or parchment. This can be used to calculate the productivity per day worked. For Timor-Leste on average, each day of work produces four kilograms of coffee.

Table 1

Average Coffee Productivity: Comparing across countries

Country	Kgs Produced per day worked	Kgs Produced per Hectare
Timor-Leste	4 kg / Day	250 kg / Ha
Costa Rica	20kg / Day	1,400 kg / Ha

Sources: Ministry of Agriculture and Fisheries (2009), Lyngbaek et al. (2001)

Compare this to Costa Rica, where every day of work produces 20 kilograms of coffee. Costa Rica does not have sophisticated equipment or mechanisation in its coffee sector. It is a smallholder, middle income country and yet your average coffee farmer in Costa Rica can produce five times as much coffee per day as your average coffee farmer in Timor-Leste. Similarly, the land that is used is almost six times more productive in Costa Rica per hectare than it is in Timor-Leste. This should not be taken as a criticism of Timor-Leste, but rather as a simple answer to the question of how we can help reduce poverty among coffee farmers in Timor-Leste.

Consider the huge benefit that would flow from increasing the return on effort for those farmers. We need not be too ambitious and seek to achieve the Costa Rica rate, but if return was just doubled from four kilograms per day to eight kilograms per day that will double the income of those coffee farmers without any additional work. Some of them will no longer be in poverty and others would certainly be taking steps towards reducing poverty. Simply focusing on improving productivity can make a huge difference to the well-being of those farmers.

If productivity is the starting place for development, how does this relate to the private sector? There are a range of theoretical arguments that support the claim that focusing on labour productivity will not only improve livelihoods but will also improve the environment for business. Here we provide a simple description of the theoretical argument.

Private sector businesses must produce a profit in order to survive. Unprofitable businesses die. Profit is driven by one basic thing: being able to achieve a market for your product or service. Finding a market is relatively simple in an infant economy. Most businesses at first will focus on producing new versions of goods and services already on the market (imitation), and a small number will develop new and unique products (innovation). For businesses in the 'imitation' category, the critical factors to successfully claiming market share (sales) are two things: quality and price. If the locally produced product or service is similar or better quality to those already on the market and offered at a competitive price, consumers will purchase it.

What does this have to do with productivity of labour? To be able to set a competitive price and still be profitable, a business needs to have production costs that are low enough. In most businesses labour comprises a very high proportion of total costs, and is also the cost that is most easily changed. If cost of labour is held low, profit is greater, and this generates growth in business. The business expands, or other new businesses start up. In other words, we see growth in the private sector.

Herein lies a problem: What happens if an employer seeks to reduce costs by simply paying lower wages to their employees (or, in a more common equivalent situation, by reducing the price they pay for raw ingredients from local farmers)? This might lower business costs, but at the same time makes low income workers or farmers worse off! The poor become poorer. On the one hand, costs have to be lower in order to be competitive, and on the other hand, the poor deserve a fair return for their effort. There is only one solution to this dilemma: improved productivity of labour. If workers can, for example, double output with the same amount of time, the gains can be shared: the employee can be paid a higher rate, AND the employer can reduce costs. Everybody is better off.

It is not just reducing the cost of labour that benefits business. Increasing the quality of labour also has a major role to play. Prioritising labour quality is based on recognising the major role **people** play in the success of a business. As successful employer will consider not just how to keep labour costs low, but also how they can get the best contribution from their employees. Labour productivity is not just about costs, it is about energy and creativity. A successful business will achieve a good return on their labour costs if their workers can produce more goods at lower effort, but they also rely on motivated and well-informed employees to generate the ideas and energy for future opportunities and growth – for doing business better.

Efficiency Wages

In economics, a theory has emerged that tries to make sense of a puzzle: often employers pay their staff more than the minimum salary they are required to by law or market forces. Why do they do this when it imposes extra costs on the business with no obvious benefit? The theory of **Efficiency Wages** explains this (Katz, 1986). Evidence suggests that productivity increases with the salary an employee is paid. An employee who is being paid more than the minimum has been given a vote of confidence by their employer, and in return many will work with greater **effort.** They will seek to improve the way they work, for the benefit of the business, because they know they are experiencing some of the benefits of this successful business.

The main point of relevance here is that the efficiency wage theory demonstrates the absolute high value successful businesses place on labour productivity – they know it is critical to their success and are prepared to sacrifice short term profit to achieve it.

To summarise, the one most important and first step in developing the private sector in an infant economy:

Productividade, Productividade, Productividade

Why is productivity so low?

This is the key question that frames the remainder of this report. If the first and most important place to start is improving productivity, we need to understand what causes low productivity; this sets the agenda for improving productivity.

1. **Lack of Specialisation.** The greatest leaps forward in productivity come as firms and labour are able to specialise in a relatively narrow set of activities so they can improve skills, and can also acquire capital that makes them more productive. There are several obstacles to specialisation, but one most relevant to infant economies is the absence of markets. The next section will discuss the role of markets and highlight some ways forward for developing markets in Timor-Leste.

2. **Lack of human capacity to learn how to improve productivity.** Section 9 will argue that improvement in labour productivity come almost exclusively from learning. Learning how to do things better is key to improving people's capacity to be productive. The infant economy will often start from a comparatively low base in human capital – knowledge, skills and capacity to function in a productive modern economy setting are all relatively low. Developing these capabilities and a culture of learning and improving will be a top priority for building the economy into the future and developing the private sector.

3. **Lack of human capacity to deliver institutions and infrastructure that support improved productivity.** As noted, the Infant Economy will have many gaps in institutions of society and infrastructure that affect the productivity of the private sector. The agenda is daunting. What makes these gaps even more challenging to address is that the biggest constraint is the most difficult to fix. The critical constraint is rarely to do with access to funds to invest in building government institutions and public infrastructure: it is the **human capacity** to set priorities, to develop and manage well-functioning institutions, to make plans and execute them. The implications of this for a government's reform agenda are explored further in Sections 13 and 14.

8 Markets: Facilitating Specialisation

Markets are the means of breaking the requirement to align production to consumption. Producers and consumers can exchange goods and services so that there is realignment. Production finds its way to those who want to consume.

In the absence of markets, production is largely at the subsistence level, characterised by:

- **Inefficient production:** For example, agricultural households will choose what they produce with their consumption needs in mind, rather than production that maximises their return. They may produce crops that do not suit the climate well, or may produce a diverse range of crops with none of the efficiency benefits of specialisation.
- **Inferior Consumption:** Households will eat mainly the crops they and their local community produce or can access easily, which often leads to consumption of a mix of foods that do not offer the greatest nutritional benefit.

In the context of improving productivity, a market allows producers to specialise in the products that they can produce most efficiently. They can invest in capital and in developing skills that improve productivity and reduce costs of production so they can be competitive in the marketplace.

In an infant economy, it is common for important markets to be missing or barely functioning. This is true for Timor-Leste.

Consider the following example. There is a young man in Viqueque who had been working in Australia for a few months as part of a farm employment program. He has saved money while in Australia, and after returning to Viqueque he built a huge chicken coop. He has plans to have nearly 10,000 chickens safely kept in this huge chicken cage. As a result he will produce eggs and chickens for sale in massive quantities. Unfortunately the young man is a long distance away from Viqueque town. When asked, "How are you going to sell these eggs and these chickens when they are ready to be sold?" He said, "I hope that some NGO will come along and buy them from me." This critical step in the success of this venture is the creation of access to a market. If the market is missing it will be very difficult for economic activity to flourish.

What is a market?

Markets are more than just physical places. They are fundamentally places where information is exchanged. A market has two key features:

- **A means of exchanging information,** in particular information about who has what to sell and who wants to buy; and

- **A physical mechanism for exchange,** a place where buyers and sellers can meet.

What markets are needed?

As noted, in an economy transitioning out of largely subsistence agriculture, there are likely to be a number of gaps in the economy where markets do not exist, or are incomplete. An incomplete market is one where the **transactions costs** of exchange are high – it takes a lot of time and effort for a seller to sell their product, or a buyer to purchase, usually because of the large amount of effort required to access information and to reach the place of exchange.

We cannot stress highly enough how important markets are to the private sector flourishing – almost every activity of the private sector relies on markets that functioning well. Transactions costs for poorly functioning or absent markets can be orders of magnitude higher, and can make the difference to businesses being viable or not.

In Timor-Leste, there are a number of places where markets are still in their infancy. A focus on building these markets would provide a very significant boost to private sector activity. A few examples of areas that have been noted include (there are many others as well):

- **Real Estate / Land markets:** in many cases there is limited information about the "market price" for land to lease or buy, leading to widely varying and unrealistic pricing. These market features result in far fewer transactions than could take place – in other words, businesses and others are unable to secure the land they require. While there are many regulatory issues with land title which are being addressed in the midst of the reform program, the argument here is that many of the immediate obstacles to linking supply and demand for land for business can be overcome with a substantially improved flow of information.

- **Sale of primary agricultural produce.** These clearly exist in many areas, but there are many cases of inability to access markets. In addition, the direction of the future is likely to require centralising markets further on District and Sub-District towns, so volume is higher. Higher volume leads to more consistent supply and quality, along with lower prices to consumers.

- **Markets for finance.** These are incomplete and often the information and security requirements do not match with the current realities of the economic environment, again leading to an under-use of available capital for investment. It is well documented that domestic savings are vastly higher than domestic investment – a weak market is part of the explanation for this.
- **Labour markets**. Improvements are needed to the way employers are matched with the pool of potential job candidates. Likewise, there is a need for improvements in learning about skills shortages.

9 Learning: Developing Human Capacity

> "Most of the increases in standards of living are … a result of increases in productivity – learning how to do things better. And if it is true that productivity is the result of learning …, then a focal point of policy ought to be increasing learning within the economy; that is, increasing the ability and the incentives to learn, and learning how to learn, then closing the knowledge gaps that exist between the most productive firms in the economy and the rest."
>
> Stiglitz and Greenwald (2015), p.6-7.

Learning is crucial for developing an infant economy. Most businesses in any economy, but especially in an economy that is in its early decades of existence, operate well below what is described as their **production possibility frontier**. This frontier is the potential level of production that could be achieved for a given set of inputs, if the business processes were operating as efficiently as possible. Businesses are typically not producing at the efficiency that they could achieve if they were to follow the best examples of others. In part this is because of the broader economic environment - issues with infrastructure, communications, transportation, financial institutions or legal arrangements that don't support their activities. Invariably, however, it is also because they simply have not learnt the better ways in which they can operate.

Consider the pictures of two families in a rice farming area of Timor-Leste (Section 7). These two families are actually operating on exactly the same piece of land. There is a huge field and each household has a square of land which is for their use. So literally 200 metres from each other are two households which are operating their rice farming activities in very different ways and yielding markedly different results. The first farmer uses very basic tools and subsequently their productivity is very low. The second farmer is able to produce at a far quicker rate, with the help of better equipment. The first household does not have to do very much in order to improve their productivity. They simply need to learn from the second one. They may also need financial assistance to rent or borrow the machine from their neighbour, but the growth in productivity that the first household will achieve will come simply as a result of learning from their neighbour.

Why is one business more successful than another? Why is it that you see some businesses flourish and others not? The widely accepted answer to this question is that the level of knowledge and information that a business has is key to them being able to flourish. Two firms can have the same amount of start-up funds, access to land and number of employees. But the firm that uses these inputs in the smartest way will be much more successful. Using those inputs in the best way depends almost entirely on knowledge.

The implication if this emphasis on learning is that the first steps to improved productivity do not require major changes in the ways in which businesses operate, or in provision of infrastructure. Those operating within all levels of the economy simply need to develop the mindset to learn, and be given the opportunity to learn from others.

How does Learning take place?

This is a big question, and has many dimensions. This report will only touch briefly on the topic.

A society and an economy that has learning as a central theme will see that infiltrate all aspects of society, from formal education systems through to private sector employers, public service and the NGO / Development Agencies. It will involve a broad range of activities and infrastructure, from professional development of employees, formal and informal networks of businesses with common interests, to IT and communications infrastructure. Here we will touch on just a few of these aspects.

- **Formal Education:** A culture of learning and improvement in the private sector is built upon the mindset of key people within this sector. The basic building blocks of learning and the mindset of learning are established through the primary and secondary education system. The National priority of improving the quality of education at all levels is reinforced here, because a well-educated society that creates a learning mindset is critical to the private sector. But note the importance of an approach to education that helps people to have lifelong learning skills, not education that teaches a stock of knowledge.

  Alongside continued improvement in primary and secondary education, a particular focus on business and economics in tertiary education provides another vital place for developing a learning culture among key participants in the private sector. There is a case for providing substantial support for the Tertiary Sector, to provide high quality education and training of those who will be future hold important positions in the government and private sector.

- **Business networks:** Most learning in business takes place through informal networks, not through formal training. Businesses learn by gathering information from each other. We learn and acquire information in many ways, but most knowledge that businesses have is referred to as tacit knowledge: it is primarily learning by doing and by learning from others. Businesses often exchange information with each other when they interact. They learn about markets and obstacles. They learn about best practice. One simple conversation about a particular problem could save a business literally days of effort. Interaction between businesses also facilitates coordination of activities so that efficiency can be improved.

  As an example, consider two coffee exporters where each independently import the sacks which they use to bag their coffee. Each of them is importing those sacks at a very expensive cost as the transportation costs are high. Suppose the coffee exporters talk to each other and realise that they are both separately paying these import costs. The next year one coffee company imports all of the sacks for both companies. They save a sizeable amount on the cost of those sacks simply because of their exchange of information.

  Business networks can be key for businesses, enabling them to acquire knowledge about how to do what they currently do better and smarter, and learn about new opportunities.

- **Business Development Support:** It is already apparent that private sector initiatives in an infant economy encounter many challenges. A new entrant into the sector will have much to learn about navigating these challenges. Specialised business development support can play a critical role here. Business Development specialists have a good understanding of the basic principles of business, but can also build a good knowledge base of what current private sector businesses are doing, how they are addressing obstacles, and so on. The Business Development specialist serves as a mediator of this vital learning between businesses.

10 Entrepreneurs: Developing Human Capacity for New Things

As noted, in an infant economy, human capacity is the main constraint to developing the private sector and improving productivity. An important aspect of developing this human capacity is in developing entrepreneurs.

Entrepreneurs are those who take the opportunities to establish and build businesses. In an infant economy they do not just spontaneously emerge. Entrepreneurs must be nurtured. They must be developed.

This is not as much the case in an economy that is recovering from a crisis but has in the past been thriving and modern, such as Europe after the Second World War. The main priority in such an economy is to rebuild some infrastructure and create opportunities for business to flourish; those who were entrepreneurs before would re-emerge and rebuild businesses.

In Timor-Leste, as with most infant economies, that history is not there. There is history of economic activity, but little knowledge or experience of the modern economic activities we are moving towards in the 21st century. This means it is a high priority to create a first generation of entrepreneurs and help build new businesses.

> "At the time of independence, … countries typically can be characterized as lacking a class or private sector to become entrepreneurs in "modern" activities".
>
> Noman (2012)

As an example, let us consider a number of shops that are operating in a town in one of the Districts. Each shop has to purchase stock to sell. One shop owner takes their motorbike, goes down to a central warehouse where they buy their goods, returns and stocks the shop. The neighbour does exactly the same thing and so do the other four or five neighbours along the row of shops. Now let us introduce an entrepreneur into the equation. The entrepreneur notices that each shop owner is duplicating the effort of the others and makes the following suggestion: "Why don't we all work together? For a small fee, I will take orders from all of you and go and get the stock on all of our behalf." We have just saved four motorbike trips to the warehouse. We've just saved the time and the effort and the fuel that those trips expend. People have become more productive, more efficient and ultimately have increased their incomes. That's the entrepreneurial mindset that must be nurtured and developed.

How does entrepreneurship develop?

This is also a big topic, and one we will touch on only briefly here.

Entrepreneurship comes firstly from a mindset of learning, as discussed in the previous section. An entrepreneur is always asking "Why do we do things this way? What can be done differently? What new things can we do?"

With that learning attitude, entrepreneurial activity comes largely as a result of exposure to new ideas and to the broader business environment. Most ideas, even entrepreneurial ideas, do not come in a vacuum. They are not created out of nothing. Most entrepreneurial innovation is actually copying what somebody else is doing. The best way for us to see that kind of innovation flourish is to provide the opportunity for business people to interact with others and to observe those who do things differently.

This is why foreign investment into Timor-Leste is important. Foreign investment provides an opportunity for Timorese entrepreneurs to observe the skills and practices of foreigners and to work in firms that operate according to the approach to business taken in Australia, Singapore or elsewhere. Entrepreneurs can then take that experience and skill and translate it to their activities in Timor-Leste.

The entrepreneur also needs a particular attitude to risk. The safest form of business is one that imitates exactly what other businesses are doing. The entrepreneurial business tries something new and untested. It may succeed or it may fail. The regulatory and business support environment can facilitate this kind of (sensible) risk-taking attitude by providing venture capital for new activities, as well as a sound regulatory environment around bankruptcy laws. That said, any interventions designed to support entrepreneurial activities must ensure that substantial risk remains with the private sector entrepreneur. It is this very risk that ensures that they make careful decisions and work hard to pursue success, knowing that their own wealth is at stake.

11 Foreign Direct Investment: Facilitating Learning

Foreign Direct Investment (FDI) typically plays an important role in an infant economy. A foreign investor can make use of its international base to address some of the challenges and difficulties of operating in an infant economy environment. For example, the foreign investor can often access capital at more affordable rates than that available in a relatively young financial sector. They bring extensive experience in business and entrepreneurial skills that are often lacking in an infant economy. They can undertake projects with larger scale, which allows the benefits of **economies of scale**, where cost per unit typically is lower for larger companies than small. They can also often overcome the issues with **unbalanced demand** (lack of domestic demand for production) by bringing established export markets to the business initiative.

In the long run FDI can generate wider benefits to the economy, particularly in the areas we have discussed in previous sections. A foreign investor who places high priority on developing local staff can help with developing the required entrepreneurial and business skills that allow domestic investment to thrive.

A counter view to this is that foreign investment can **crowd out** domestic entrepreneurial activities (see Spencer, 2008, for a useful discussion of these issues). There is no evidence in Timor-Leste at all of financial crowding out in terms of increasing the cost of capital, as the constraint to domestic investment is not the availability of funds. Banks report that currently around 75% of domestic savings are not invested in projects within Timor-Leste, due to a lack of sound investment or lending opportunities. The crowding out, however is an issue with the use of scarce human resources. In the short term, foreign investors (this applies equally to NGOs and international development organisations) create a demand for the scarce skilled labour, resulting in increased wages for appropriately skilled locals, making it difficult for domestic firms to compete.

While this crowding out is a potential issue in the short term, there are long run benefits for the supply of skilled labour that this critique neglects. First, if experience working in a foreign-owned company or international development agency is able to significantly improve the skills of the local staff, then the short run loss of skilled labour can be seen as an investment in the future. This depends critically on the priority placed by the foreign investor on professional development of their local staff. Secondly, the higher wages paid to these skilled workers has further benefits: it increase demand for education and other relevant skills, as locals see the benefits of being able to access this kind of employment; this in turn produces a bigger supply of skilled labour.

How does a country like Timor-Leste attract FDI?

This is another big topic which this report can only briefly touch on. Issues such as sovereign risk and major infrastructure gaps are obvious and important considerations. Likewise, investment is more likely to succeed in certain sectors of comparative advantage, so the discussion on Section 12 is relevant to FDI as much as domestic investment.

Noting these factors, the key issue, we would argue, is something different. There is a critical stage of attracting FDI which is the 'make or break' point. There is a relatively high level of interest in investment in Timor-Leste, but conversion to actual activity on the ground is much more difficult to achieve. For example, the 2005 World Bank report on Investment opportunities documents at least 6 potential foreign investors with discussions that had reached the stage of formal agreement (such as memoranda of understanding). It appears that 11 years on, none of these came to fruition.

What is the key obstacle? Our argument is that is largely centres around knowledge. Foreign Investors will find the biggest obstacle will be in knowing 'how things work'. In an Infant economy with gaps in markets and few examples to follow, a new arrival will have a very steep learning curve. Services which help accelerate the learning for foreign investors are extremely important. It is therefore a top priority to establish institutions that bridge the knowledge gap.

These might include:

1. **Investment Promotion Agencies (IPA):** these are common throughout the world. Timor-Leste has recently reformed the Investment Agency, with renewed leadership, focus and energy. International research suggests these agencies can work and they serve useful roles. See Morisset and Andrews-Johnson (2004) for an overview.

2. **Business Development Support:** An Investment promotion agency is best complemented by a more business-oriented, private sector body that can broker business partnerships. A foreign investor with few contacts in Timor-Leste will have great difficulty managing relationships with government and bureaucracy, as well as with establishing linkages with other essential business partners and activities (suppliers, business support, services, meeting labour requirements, and so on). Private sector business development partners provide a good model for sharing this essential knowledge and information.

12 Priority Sectors

A proactive approach to developing the private sector by necessity involves selecting industries to prioritise. How does a government decide what industries it provides support to? What types of businesses are more likely to succeed?

Comparative Advantage?

Let us first reflect on current wisdom in the economics literature about the appropriate approaches to supporting industry development.

The theory of **comparative advantage** is the basic building block for determining what types of economic activities a country ought to pursue. Under one version of this theory, the country ought to invest in an industry where they have greater endowments of the inputs required for that industry. For example, if a country has land and climate well suited to growing rice, they may benefit from increasing the coverage and productivity of rice farms as a strategy for growth.

Reflection on the growth experiences of many East Asian countries has led to a modification of this theory, referred to as **dynamic comparative advantage** (see Redding, 1999). Under this theory a country invests in an industry where they may not currently have a comparative advantage, but with appropriate investment in physical and human resources, a comparative advantage can be developed in the future. Under the principles of development of an infant economy, this would include investing in the human resources required to build a modern sector, even though in the present, there may not be a strong human resource base for that sector.

The key message of dynamic comparative advantage is that a country ought not just to look at current endowments and capabilities but also look forward to the capabilities that they wish to develop in order to grow in the direction they see most fruitful in the future. Simply imitating neighbouring nations' economic sectors but doing it cheaper is not likely to lead to strong and sustainable economic growth.

The reality is that in an infant economy, with a forward-looking approach of dynamic comparative advantage, initial ventures into a new industry or sector are rarely likely to be profitable. Under dynamic comparative advantage, there may not be a standard comparative advantage in the short term, so a case is there for subsidies or other assistance to establish new industries or develop those in their infancy.

Factors that are important in determining fruitful directions for the future

- **Do no harm**: Arrival of new industry has the potential for harmful impacts, particularly to the vulnerable in society, such as environmental damage, loss of traditional land or introduction of harmful businesses and products. Beware of pursuing economic gain at high social cost.

- **Competitiveness:** Demonstrate that the industry can be competitive in the near future via realistic improvements in productivity. It may not be competitive in the short term, but a business case needs to be put for how productivity can be improved to the point of being internationally competitive.

- **Private sector interest:** Look for industries where there is private sector interest, where investors are prepared to commit their own capital and take risks. If there is little interest from private sector investors, this suggests they perceive the risk to be too high or the achievable returns too low.

- **Spillover:** Will the industry facilitate learning of broader benefit? Looking through the prism of learning as a key to improvements in productivity, priority needs to be given to industries that develop skills and knowledge that can "spill over" into other areas of a growing economy.

- **Current Capabilities:** Atkinson & Stigliz (1969) point out that learning is localised. New activities that use production processes similar to existing processes are easier to learn. For example a good coffee roaster will quickly learn the skills of roasting peanuts. It thus makes sense where possible to pursue initiatives that build on current capabilities, but stretch in new directions.

- **Firm size:** This can be critical to productivity. There needs to be a realistic view of how firms in the industry can operate efficiently, and firm size is a key determinant of this. In some capital intensive industries, it only makes sense for the firms to be larger. But in many industries, it is possible for small and medium size firms to be competitive. Research by Tybout (2000) shows that in a developing country setting, there are plenty of small and medium sized firms that can be as productive as large firms. This includes small scale farming activities in certain contexts. The benefit of small and medium firms is that they tend to be more labour intensive, thus generating broader economic benefit in society. But small firms do not suit every industry: "small firms …tend not to locate in those industries where they would be at a substantial cost disadvantage relative to larger incumbents" (Tybout , 2000, p.19).

- **Industry Strategy:** Develop a strategy that will address as a top priority the means of increasing labour productivity, and consequently return on labour. Scale and volume will follow. The strategy needs also to address the potential final demand, market gaps, all links from producer to consumer, and quality assurance.

13 Institutions and Infrastructure: foundations for improving productivity

The government plays a very important role in the emergence of the private sector. However, the role of government is not to do the work of growing the economy but rather to provide an environment and a context in which the private sector can build the economy.

There are specific challenges for Government in operating in an Infant Economy setting. These include:

- The institutions and infrastructure required for a well-functioning modern economy are often quite under-developed, so a great deal of work is needed to develop these to maturity.
- The public sector, government and public service operate with relatively limited experience and capacity.

These two obstacles combine to make for a very challenging situation – there is much to be done, and limited capacity to do it!

The risk here is that a government confronted with a vast agenda of development will seek to take on too much, and end up not doing well in any of the tasks. In some cases government decision making can fluctuate between paralysis (inability to make any decisions for fear of making a mistake) to hyperactivity (rash decisions in a push for decisive action and progress).

Experience and expert analysis offer four suggestions for the best ways to deal with this dilemma:

1. **Apply the best minds to simplifying the role of government where possible.**

   Focus government activity on the core business of developing the framework for the economy and delivery of services. In the context of economic development, this fits well with an agenda for developing the private sector, where the energy for growth and development comes from outside the direct initiative of government.

2. **Do not be too preoccupied with setting up all the "right" institutions and legal frameworks to imitate modern economies internationally.**

A key role for government is to develop the physical infrastructure required for a modern economy, as well as the legal frameworks and institutions that oversee the various government functions and establishing strong service delivery processes. However, it is important to recognise that particularly in an infant economy setting, these structures alone will not create the engine room of private sector development within Timor-Leste. They are the shell within which the opportunities can flourish. There is a danger that they will become big 'white elephants' if all they do is create the infrastructure or the support structures and do not fill those with entrepreneurs who know how to take the opportunities that are created.

Put another way, entrepreneurs have an amazing ability to find ways to function in an environment with weak infrastructure and institutions. It is true that these extra efforts to manage the challenges result in higher costs and risks, so businesses would flourish much more in an environment of greater certainty and more efficient infrastructure. But the key point here is that the starting point for developing effective institutions must be to support further development of these entrepreneurial activities, and from these activities will emerge the push for institutional reform and infrastructure.

3. **Seek where possible to build institutions and infrastructure from the ground up.**

Work by Nobel prize winning economist Avinash Dixit (2009) and others, like William Easterley (2008), have challenged the standard approaches to building the institutions of government. Easterly (2008) framed the different approaches to building institutions as either 'top down' or 'bottom up'. A top down approach assumes there is a well-established and internationally accepted 'best practice' set of institutions that can be put in place, usually relying heavily on external advice and expertise. The research demonstrates that in the medium term at least, building institutions this way does not translate to strong and sustainable economic growth.

In contrast, a Bottom-up approach is built on the assumption that informal or private (non-government) institutions governing an orderly functioning of society already exist, and these are well embedded in the culture. They are not perfect, and often do not fit well with a functioning modern economy, so they need reform. But it is a more effective approach to build on and formalise these informal institutions, rather than importing a set of institutions from other countries that may be a poor fit for the local context.

Dixit's (2009) analysis has a slightly different emphasis: he points out that private arrangements for overseeing economic transactions can often do quite well in covering for gaps in the formal, Government-led institutions. In fact, even in a society with world class public institutions, private arrangements and institutions have an important role to play.

Formal institutions that do not pay sufficient attention to existing informal and private structures may not lead to an improved business environment or greater justice. For example, private firms in many settings can tend to have very few difficulties with contract enforcement, despite limited formal frameworks in laws and a legal system. The relational and other informal links between firms provide sufficient assurance of reliable contract performance.

> "The advisers from Western countries, international organisations, and even academia who prescribe institutional and policy reforms to less-developed countries … need to remember one very important general principle. You should first achieve a good understanding of the structure and properties of the existing institutional equilibrium. This understanding is important even if (especially if?) your aim is to undermine and replace the institutions. But there is more. Before recommending any change you should determine whether existing institutions and organisations are there for a good reason, and how your reforms would interact with them in the short run and the long run."
>
> Dixit (2008), p.21

As a specific example, foreign advisers have long advocated that developing countries adopt a comprehensive program of formalising land title, giving security under law to the occupiers of land. This is seen as critical for providing landowners the incentive to invest – for farmers to improve their land, industrialists to build factories and so on. Land ownership provides a clear access to title that can be used as security for a loan. The program of land reform is typically designed to supersede traditional tribal arrangements (see for example: World Bank, 2003).

However, analysis of the impacts of such reform suggest that in many cases, they have little impact on agricultural yields or on broader incentives to invest (Easterly, 2008, Deininger and Feder, 2009). Uncertainty can actually increase, as new formal arrangements run in conflict with traditional relationships. Security for loans has proven to be no more easily provided in this environment. Experts react to this situation in one of two ways: some say the reforms have to be more comprehensive, others say the whole reform agenda is misguided. The new institutional economics approach of Dixit would suggest that reform is appropriate to pursue, but must take a bottom up approach of modifying or formalizing existing informal / traditional and private arrangements rather than replacing them. This is a slower and more painstaking process, which requires deep understanding of the local context, not something a foreign adviser can deliver easily in a short term assignment.

We want to stress that this report is not the place to undertake a thorough analysis of the current reforms under way in Timor-Leste in relation to land laws. That would require much more detailed analysis and bringing in greater specialist expertise. The point here is to illustrate that there are strong arguments and empirical evidence to suggest that moving in the direction of formalising land titles through a government-controlled system, with little regard to existing informal and private arrangements, provides no guarantee of an improvement on the status quo. This would apply equally in other areas of institutional reform.

4. **Where possible, design processes for facilitating investment that are realistic in light of the constraints of infrastructure and governance in an infant economy.**

We will consider one specific example here: Special Economic Zones. These zones provide a model for government support of investment and development of the private sector that responds to these limitations. In a special economic zone there is a concentration of investments in infrastructure and services in a small (usually) geographic area that allows private sector to invest without encountering as many constraints as exist in the wider economy.

In Timor-Leste, Special Economic Zones form an important part of the Strategy for developing the economy, with the ZEESM project in Oecusse being the first of these initiatives.

Based on international experience and the model propagated through the ZEESM project, there some key potential lessons for producing positive economic outcomes from a special economic zone project.

- It is valuable to build social impact and poverty alleviation into any zone either by its intrinsic design or by a social development fund that sits alongside. This helps ensure economic development also achieves broader social objectives. However, there is a risk with this approach: the social impact aspects need to be designed in such a way that they do not unduly inflate costs to the private investor. They already face significant investment risk and costs relative to more developed neighbouring nations, and some requirement of significant commitment to social programs may make the investment unattractive. Specific social objectives may be better funded by mostly public money.

- A Special Economic Zone with key and influential local leader(s) as the champion of the project can help overcome many obstacles and blockages.

- Private investment in businesses and industry that are part of the zone can potentially provide a catalyst to infrastructure development that supports the investor's objectives, but also benefits the wider (local) community. This might, for example, involve a new road or improved water supply.

- The Zone will only be as effective and viable as the private sector activity that makes up the Zone. If unviable businesses are enticed to invest through unsustainable subsidies, then it is only a matter of time before their investments fail, and the special zone can develop into an industrial / commercial ghost town.

- The best gauge of viability of proposed business activity is willingness of the private sector to actually invest. A government must be wary of over-relying on public investment in business. Government money rarely takes full account of the risks – this is where private sector investors specialise. So the Zone must be built in response to private sector-led interest. A government might have visions of, for example, a high-tech hub within the zone, but if no businesses are interested in investing in that sector, this suggests the vision is not going to produce viable and sustainable business activity.

14 Implications for Timor-Leste's Development Agenda

This Section will bring together the various issues addressed throughout the report, and seek to draw implication for the development Agenda in Timor-Leste. This will include implications for the Government's priorities and strategic direction in diversifying the economy.

The implications are not presented with detail and specific recommendations; they are more general than that. It is not our place as outsiders to recommend very specific courses of action: those inside government and civil society understand these things better than we do, and hence must drive the specifics. Our aim here is to provide some guiding principles and areas that are worthy of focused attention. We hope to contribute to a conversation about how the nation will develop that involves all stakeholders in Timor-Leste.

Lesson 1: Productividade, Productividade, Productividade

Actions:

1.1 Business Support that Prioritises Productivity

Strategic business support will have as its top priority to help businesses and individuals to be more productive with the activities that they undertake. Productivity first, then production and quality will follow. So a guiding question to always be asking ourselves in private sector and government or in NGOs: are we helping these businesses to get a better return on their effort? By businesses we mean the farmer in a rural area who produces crops on their small area of family land, through to the larger businesses in Dili. If business support in Timor-Leste is not focused on that, it will produce unsustainable businesses. Improving productivity ought to be the primary instrument to evaluate any initiative that is aiming to improve livelihoods or support emerging businesses.

1.2 Productivity as the criterion for Government priority-setting

Government faces many challenges and competing priorities. The demands for improved infrastructure and growth-enhancing institutions are well beyond the capacity of any new government to establish in a short time frame. This means tough decisions have to be made and priorities set. A good deal of money can be spent on a project that may produce only a small return in building a diversified economy or reducing poverty.

Priority needs to be given to initiatives that give the best improvements in productivity relative to the amount of time and money invested.

This is a challenge in the context of Timor-Leste. It is difficult to make decisions that set priorities in this way when there are other competing interests that demand other priorities. These competing interests might include political or social pressures. These interests are not able to be ignored, but if they dominate the priorities, they will lead to wasteful spending that produces little long term benefit. More importantly, money spent on an unproductive project means less money available to invest in activities that have more direct and obvious productive benefits.

One challenge with taking the productivity-first approach to setting priorities is that in many areas the productivity benefits are difficult to measure. Who can measure the economic payoffs to a national electricity network? While it might be feasible to measure the productivity benefits of a program improving yields of coffee farmers, the benefits of these larger scale projects are less easily measured.

Two things can guide decisions in the cases where benefits are difficult to measure. Both reflect the benefits of an incremental / step-by-step approach to progress rather than a "grand vision" approach.

1. Consider existing businesses and assess the infrastructure and institutional constraints and costs that have greatest impact on their ability to be internationally competitive. When asked, businesses can easily list many problems they face when doing business in Timor-Leste. The challenge is to dig further and assess which are the most pressing. This will vary with the type of business, but a set of clearer priorities can emerge from this.

In the course of this research the most common and pressing constraint businesses encounter is human capacity: having the people with skills and capacity to do the job well. This refers to those they employ, but also those they deal with in business-to-business activities and in government institutions. The question of human capacity has to be the number one priority in improving productivity.

2. Pursue improvements in infrastructure and institutions in parallel and incrementally.

There are two reasons for this:

- As noted already, modern economic activity requires a high level of **co-ordination**. As a specific example, there is no benefit to having a world class port facility with massively increased capacity if there are problems with the electricity supply, or the roads leading to the port, or with the systems of processing import and export permits, or with the communications systems the port relies on.

- The **Law of Diminishing Returns**. The greatest productivity benefits come early in the process of improving a core service or institution. Further benefits come with subsequent improvements, but these typically require more effort and investment to give the same level of benefits.

It thus makes sense to design a reform and development agenda that addresses constraints progressively, and spans the full range of areas where reform is needed. This is also consistent with an emphasis on a bottom-up approach to developing institutions, where careful respect is paid to the existing informal and private institutions, and the Government's agenda is kept simple and bedded in current realities as much as possible. It is likely this will mean simple and incomplete infrastructure and institutions and laws in the first instance. These will need further refinement in future, but having some simple structures in place will be more important than having the "right" structures.

1.3 Pursue an Industry Strategy based on potential international competitiveness

A productivity mindset will affect Industry strategy in many ways, but we reflect on just a few key points here:

- It is wiser for a government strategy to focus where possible on sub-industry / sub-sector level support of an industry, rather than individual businesses in isolation. This acknowledges that developing a sustainable industry in a particular sub-sector requires several market players. For example, a firm-based investment might be to subsidise capital investment of one particular company. A sector-based approach will spend those funds on removing key constraints that affect all businesses in that sector (eg supporting improved transportation infrastructure in a particular area).

- Consider what can be competitive with imports, not necessarily now but in the foreseeable future? What is the plan for making this competitive over next period, say 5 years?

- For agricultural production, we argue there needs to be a greater focus on crop selection that produces maximum economic benefit to the household, and less on nutrition. Ultimately food security and nutritional requirements will be addressed by dealing with missing markets and improving households' income, not by seeking to align production to consumption at the local or household level.

Lesson 2: Human Capacity and Learning are the Biggest Constraints

2.1 Action: Build the institutions that encourage learning

2.1.1 Pursuing a top class formal education system at all levels from pre-primary to tertiary.

Education is not just an important factor in human and social development, it is the primary driver of economic growth and improvements in livelihoods, because productivity improvements come with greater learning. There is no shortcut to building the required human capacity that can contribute to the formal economy or entrepreneurial activity or public service provision. A high quality education system will prepare the next generation of adults to be able to provide leadership in society and the economy.

> Sustainable, broad-based growth in livelihoods in Timor-Leste will only occur as there is a sustainable, broad-based growth in human capacity – a well-educated population with strong capacity for ongoing learning.

In section 2 we highlighted the extent of reliance on petroleum fund revenues for much of the productive economy, and the risks this poses as these revenues decline rapidly over the next few years. One risk in this narrative is that it creates a sense of urgency in developing the diversified economy, and tempts policy makers to pursue short term avenues to rapid growth – large scale foreign investment and "megaprojects". The reality is that sustainable, broad-based growth in livelihoods in Timor-Leste will only occur as there is a sustainable, broad-based growth in human capacity – a well-educated population with strong capacity for ongoing learning. This takes time, and there are no shortcuts. But it will take even longer if priority is not given to substantial investment in building a strong formal education system.

2.1.2 Prioritise skills development within the public service and development partners

Government and Development Partners provide an excellent environment for developing workplace and other skills among the next generation of Timorese. Seeing this as an explicit function of these work environments will affect the dynamics of these workplaces, the nature of interactions with foreign advisers, as well as the priority of professional development activities.

2.1.3 Expand business development services

There is potential for a significant expansion of services provided by Business Development and support specialists, but importantly led by people with a business mindset and experience. The challenge of accessing information in Timor-Leste is great, both for domestic and foreign investors. A business development and support role is critical to facilitating this information flow.

International experience suggest that the best source of business development expertise comes from those who specialise in these skills, often led by those with business experience themselves. Business support from organisations that operate within government and international agencies can sometimes work well, but often not. The issues can be a mismatch of experience (private sector business people receiving support from people with primarily government or development expertise), and a confusion of objectives (tension between business success and social development goals).

There is a need for substantial upscaling of business development activity that walks alongside investors and entrepreneurs in all phases of activity: conceiving, establishing and building a sustainable business.

This support lays the platform for both domestic and foreign investment from small, medium and large businesses.

2.1.4 Support institutions that help businesses learn from each other

The report has emphasised the importance of businesses learning from businesses. This learning can be facilitated with a greater emphasis on organisations that facilitate this learning. Setting up industry associations may sound like a small contribution to developing the private sector but it could actually be one of the most critical and crucial. Industry associations that are targeted to specific sectors will maximises the chances of mutual learning.

2.1.5 Agricultural Extension work models that reflect best practice

Given the prominence of agriculture in Timorese society, it is worth commenting on the implications for agricultural extension work of the emphasis in this report on productivity and learning.

A learning approach to agriculture in small-farmer communities tends to work best when there is a focus on **localized learning** and productivity. We ask questions like:

- Who is doing the best in this crop / location?
- How can others learn from them?
- Where do the 'best' go to continue learning from others?
- How do we build co-operation among farmers, to allow learning, and possibly build a base for capital investment?
- How do we help farmers become learners, ***NOT*** just teach them skills?

2.1.6 Work on building an entrepreneurial culture & mindset

Building an entrepreneurial culture and mindset needs to be a very high priority for business development. What is needed are innovators who see what is currently happening and look for opportunities to "do things better", not just imitators.

While there are a number of initiatives taking place to build greater entrepreneurial presence in Timor-Leste, there would be value in a thorough review of what is happening in the business development and entrepreneurship areas, asking questions like:

- What is currently happening?
- What is international best practice?
- How can cultural obstacles to entrepreneurship be overcome, and self-belief built?
- How can business development services be expanded in a sustainable way that offer tangible and ongoing support to businesses?
- What are the best ways of investing resources?
- What additional resources are needed?

2.1.7 Pursue an Industry Strategy based on human capacity development

As discussed in this report, the guiding principle of an industry strategy is Dynamic Comparative Advantage - focus on industries that over a medium term horizon can be internationally competitive. Dynamic comparative advantage also applies to human capabilities: choose industries where the investment in human resources associated with that industry produces priority skills – industries where developing this industry will utilise current human skills and develop human skills that will be applicable in a number of related industries.

For example, a business in food processing that uses locally produced ingredients relies on a range of human skills that are already present in part in Timor-Leste (sourcing from suppliers, managing supply chain, light manufacturing, branding and marketing, etc), but that can be developed further to produce a food processing industry that is at export standard at competitive prices. The same skills would be easily adaptable to other related processing activities. In contrast, an industry that relies on highly complex imported technology may not be as relevant for existing skills, and potentially is less transferrable to other industries.

Lesson 3: Markets are crucial to Improving Productivity

3.1 Action: Focus targeted support on businesses that strengthen markets or support other businesses

When considering interventions to support emergence of the Private sector, government is faced with many options. In light of the importance of markets, our argument is that investing in businesses that strengthen markets themselves will bring the broadest benefit and stimulus to emergence of private sector activity. Many businesses will benefit from stronger markets, where information can be more easily shared, and buyers and sellers meet.

What are the markets that are missing or weak that result in significant gaps in information and coordination of activities? Those are the areas where there is potential for some targeted interventions to help parts of the private sector to fill those gaps.

Consider a specific example in relation to land. While it is true that the land laws are sometimes difficult to manage in Timor-Leste, it is also well acknowledged that most businesses are able to overcome the problems with some persistence, usually by relying on informal networks of relationships and information. This approach is far from perfect, because those who do not know the relevant people and processes are left out of this market. However, potential gains can be achieved very quickly by simply improving the information flow around the access to land, whether it's an office to rent in Dili, or a piece of land on which to build a factory. A real estate agent company would fill an invaluable role in strengthening the operation of this market.

We stress in terms of creating markets that the role of government interventions is not to try and create markets directly. Government can contribute best by removing the constraints to markets evolving (eg introduce regulations to control trade, roads that improve access, setting up information / IT infrastructure, access to credit), and sometimes where necessary to support businesses to fill those gaps.

Alongside businesses that facilitate markets, strategic interventions can get good return by supporting businesses that facilitate other businesses to operate well. What are the business to business activities where there are real limitations? Interventions to support these can have flow-on benefits for many other businesses that rely on these services.

15 Concluding Remarks

This report has explored economic aspects of the business and private sector environment in Timor-Leste. The lessons are many and the challenges are great. But the people of Timor-Leste have shown great determination in the past, through many difficult circumstances. Building a strong society with a thriving economy that benefits all citizens will be a slow process, but it is not beyond reach. It will take patience and a willingness to invest in the most valuable asset the nation possesses - the people of Timor-Leste. It is this investment which will produce the capacity to deliver ongoing, sustainable economic and social development that makes a difference to people's lives.

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