

# **Entrepreneurship in Timor-Leste**

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## **Introduction to Timor-Leste**

Timor-Leste – one of the poorest countries in Asia, with a GDP per capita of US\$ 366 in 2004 (UNDP, 2006, 10) – became a sovereign nation in 2002, after the end of almost 25 years of Indonesian occupation in 1999. During the first four years of independence growth rates were barely sufficient to keep pace with a population that increases with 3 percent per annum (Lundahl and Sjöholm, 2006, 16), in a country with 40 percent of the population living in poverty (Lundahl and Sjöholm, 2005, 13). During 2004, however, it became clear that Timor-Leste was on the threshold of substantial revenues from large oil deposits in the Timor Sea. The future looked reasonably bright in a medium-term perspective.

This would soon change. Dissatisfaction had spread in certain army circles. In February 2006, a cycle of violence was begun. This culminated with the fall of the government of Mari Alkatiri and the establishment of a potential guerrilla force near Dili under the leadership of Major Alfredo Reinado. Some 133,000 people had to leave their homes, and refugee camps grew up everywhere (Lundahl and Sjöholm, 2007, 29). In 2007, the Timorese went to the urns for presidential and parliamentary elections. President Xanana Gusmão and Prime Minister José Ramos Horta swapped jobs and the country got a new government, based on a potentially fragile four-party coalition.

Reinado was killed when he led an attempt to kill the president in February 2008, but the refugee problem remains unsolved. It was hoped that Timor-Leste would develop quickly with a committed leadership and strong foreign assistance. These expectations have not been met and the road to prosperity may be both long and rocky. Timor-Leste suffers from a structural weakness. Employment rests heavily on subsistence agriculture and the oil sector only serves to bring in revenue. The modern sector consists of trade-related activities serving the international community in the capital and the public administration. Productivity is so low in the non-service sector is that that it cannot compete with services or imports.

### **Government policy on enterprises and entrepreneurship in Timor-Leste**

The Timor-Leste constitution envisages a leading role for the private sector within a market economy (Ministry of Development and Environment et al., 2004, vii). Overall, however, Timor-Leste ranked as 168 out of 178 countries on the Ease of Doing Business Index computed by the World Bank (World Bank and IFC, 2007, 2). The country has a long way to go. The state cannot create employment alone (*Semanário*, 2008). What has the government of Timor-Leste done then to promote entrepreneurship?

In 1999, a multi-agency Joint Assessment Mission addressed issues like ‘restarting the flow of goods and services, transportation, payments system, procurement, currency exchange, claims on deposits in Indonesian banks, micro-credit, taxes and customs’ (Ministry of Development and Environment et al., 2004, 1). Foreign banks were allowed to operate, interim leasing systems were introduced, business registration was regulated, a system for taxation of personal corporate income was introduced and the US dollar was adopted as the currency of Timor-Leste. 2001 saw ‘inertia in the production of laws and regulations relating to issues such as bankruptcy, leasing, contracts, land, non-bank financial institutions, cooperatives, NGOs, collateral, loan foreclosure and insurance, and others did not allow much progress to be made in the private sector regulatory framework.’ In 2003-04, a petroleum tax law and a petroleum mining code were drafted. The corporate tax was reduced from 40 to 30 percent (Ministry of Development and Environment et al., 2004, 1-2).

In 2005 one domestic and one foreign investment law were passed. These make for tax deductions for employment of Timorese nationals and for tax and duty exemptions for inputs of various kinds. The minimum investment required is twenty times higher for foreign than for domestic firms. This discriminates against foreign investment. The tax deduction for employment discriminates against firms with few workers. Regulations are overly complex. The two laws should be merged into a single, simplified, one (IFC and ADB, 2007, 48). Two supporting agencies have been created: Trade Invest Timor-Leste (TITL), to attract foreign investment and promote exports, and a domestic Instituto Apoio Desenvolvimento (IADE) (World Bank, 2006, 10-12).

Implementation of existing laws also leaves a lot to be desired (World Bank, 2006, 2):

... laws and regulations ... are not being adequately administered. ... the court system ... has devoted hardly any time at all since 1999 to commercial dispute resolution, debt collection or other civil cases. [...] Getting approvals from Government departments ... is a problem, capacity in the civil service is very thin, there are bottlenecks caused by the centralization of decision making at higher levels, and there have been anecdotal reports of corruption ...

As new laws and regulations come into force, the strain on the government institutions increases, in a situation where trained and experienced personnel capable of exercising sound judgment is lacking.

### **The Environment for Entrepreneurship and the State of Small Business in Timor-Leste**

Entrepreneurship may be defined in different ways (Hébert and Link, 1989, Wennekers and Thurik, 1999). According to the more ambitious definitions (e.g. Schumpeter, 1961), entrepreneurship means discovery or creation of novel combinations of production factors. At the opposite end of the spectrum (e.g. Kirzner, 1973) it simply amounts to taking advantage of unused profit opportunities in the market, without making any innovative contributions. In the case of Timor-Leste any reasonable definition must be close to the latter end of the scale: engaging in routine business activities, setting up an enterprise. This is the definition used throughout our discussion.

In 2004, the vast majority of urban enterprises were very small: more than half of the informal establishments were one-man ventures, and only 0.4 percent had more than 10 workers. Among the formal enterprises over 72 percent had less than 10 workers, and only 0.4 percent had more than 50 (Das and O'Keefe, 2007). Around 45 percent of the formal and some 90 percent of the informal urban enterprises had a turnover of less than US\$ 5,000 (IFC and ADB, 2007, 49). The urban establishments were concentrated mainly in trade, construction and services. Manufacturing accounted for only 2.5 percent of the formal enterprises. Trade dominated all size categories. Timorese enterprises are mainly home operations (Das and O'Keefe, 2007).

#### *Institutional Obstacles*

Anyone doing formal business in Timor-Leste faces a number of institutional obstacles. The country ranks low on most indices computed in the Doing Business project of the World Bank

(World Bank and IFC, 2007). Setting up a business is costly. The average number of days required is 82, which puts the country at rank 140 of 178. Recently, however, the time for issuing business activities registration and licensing certificates has been cut from 30 days to between three and five (Gusmão, 2007, 6).

Enforcing a contract in court takes on average 1,800 days, involves 51 procedures and costs more than 163 percent of the value of the claim. Timor ranks at the very bottom: 178 (World Bank and IFC, 2007). The country lacks a civil code and a supreme court, and, until recently, also a cadre of domestic judges. All of them failed the examination in Portuguese and had to be remitted to a two-and-a-half year course. Private investors 'regard the court system as practically non-functional and since legal certainty is one of the major criteria upon which investment decisions are made, this weakness is a major deterrent to private investment in the country' (World Bank, 2006, 18).

The recent violence has not improved the situation. In January 2007, the prosecution caseload amounted to 1,658, significantly more than at the end of 2005, 985, but still not as much as the 2,700 in January 2005. The judicial system rested on international personnel until the first Timorese who had completed their course work were reappointed in mid-2006 (World Bank, 2007, 3).

Weaknesses are not found only in the courts. No alternative dispute resolution mechanisms that could act as substitutes for court decisions exist. The few lawyers who were active in 2005 also had to undergo Portuguese training before they were allowed to continue their work. Timor-Leste furthermore lacks an approved accounting system and there is no certification of accountants and auditors (World Bank, 2006, 9).

Investor protection against insiders is weak under Timorese law (rank 122). The protection index covers issues related to the approval and disclosure of proposed transactions to the shareholders and the public at large, the ability of investors to hold directors and board members liable for damage etc. Overall, Timor-Leste receives a score of 4 on a scale ranging from 0 (worst) to 10.

Property rights are chaotic. The land and property laws do not address the basic weakness: the absence of reliable land titles. Hence land cannot be used as collateral. Also, Timor-Leste

ranks at the very bottom when it comes to the Registering Property indicator (number of procedures, duration in number of days and cost in percent of the property value) (World Bank and IFC, 2007). The ‘complexity and incompleteness of the legal and regulatory framework and the lack of capacity in the Land and Property Department’ makes it futile to attempt registration (World Bank, 2006, 15).

Unfortunately, this situation can be expected to continue (World Bank, 2006, 15):

Although preparatory work on a land titling system has been underway ... for several years, the requirements are still complex and full implementation will depend on the resolution of conflicts over titles ... These include traditional land ownership structures dating back centuries, changes effected during the Portuguese and Indonesian occupations, the enforced uprooting of large sections of the population in 1999 [and 2006-07], and decisions taken during the UN transitional administration and under the rule of the present independent government. These uncertainties can be expected to continue until a new land titling system is fully designed and implemented. This will depend in turn on the completion of a cadastre, but progress on this so far has been very limited.

Foreign trade is cumbersome, especially the preparation of six and seven different documents for exports and imports, which requires 16 days. Customs clearance, controls, handling, etc. brings the total time to 25 and 26 days, respectively, at a total cost of close to US\$ 1,000 in both cases. Altogether this places the country at rank 78, worldwide, on the Doing Business index (World Bank and IFC, 2007).

Dealing with taxes is easier. Timor-Leste is in position 62, with no more than 15 payments per year, 640 hours to complete the various tax statements and a total tax rate of 28.3 percent on profits (World Bank and IFC, 2007). In the near future, the profit tax rate will be lowered to 10 percent.

#### *Wages and labor*

Wages are high in Dili (Das and O’Keefe, 2007, 25). The minimum wage is comparable to that of Uruguay in the 1990s, a country with a per capita income of US\$ 6,600 against 472 for Timor-Leste and 7.6 years of schooling on average, against 4.6 for Timor. The monthly

minimum wage in West Nusa Tenggara in Indonesia in 2003 was less than half the figure for Timor-Leste (US\$ 85).

More important, however, is the actual wage level. Around one-fourth of the urban workers earn less than the minimum wage (Das, 2004, 5), so the latter is not binding – what presumably goes for most potential competitor countries as well. On the other hand, in 2001 the monthly *average* wage in urban areas was US\$ 150. In 2004, it was US\$ 158. Given the 4-10 percent inflation rate 2001-04, the real wage hence seems to have declined (Das and O’Keefe, 2007, pp. 23, 25). The wage level is closely related to the demand emanating from the expatriate community in Dili. The 1999-2002 period saw a quadrupling of wages, driven by 15,000 foreign experts and by the relatively high wage level in the public sector (considerably higher than in Indonesia) (World Bank, 2002, 18). The subsequent withdrawal of foreign personnel should thus have resulted in downward pressure on the wage level. In which direction the future lies will very much depend on the extent of continued international presence.

Wages have to be related to employee skills. In 2004, formal employers reported various kinds of deficiencies among their personnel. When asked which skills they considered would become important during the next two years, they listed customer handling, driving, problem solving as well as advanced computer skills, technical and practical skills, literacy, numeracy, communication and foreign languages. Some 40 percent of the enterprises provide some training, possibly because they do not value the formal training institutions highly (Das and O’Keefe, 2007, pp. 27-29).

Still, at least at present, the workforce does not appear to be a serious constraint to enterprise growth in Timor-Leste. Less than 15 percent of the formal and less than 2.5 percent of the informal employers reported problems finding appropriate workers (Das and O’Keefe, 2007, 21). This statement, however, has to be interpreted with care, since it does not reveal what prospective entrepreneurs think.

Timor-Leste is in the middle range when it comes to hiring and firing: number 73 of 178, with a rigidity of employment index of 34 (maximum 100) (difficulty of hiring and firing and rigidity of work hours), zero non-wage labor costs and a firing wage cost of 17 weeks (World Bank and IFC, 2007).

### *Infrastructure*

The infrastructure in Timor-Leste is deficient. Destruction was extreme in 1999. Thus, 85 percent of the telecommunications structures, the airfield in Dili and much of the electricity producing capacity were destroyed (Lundahl and Sjöholm, 2005, 6). All has not been replaced.

The lack of roads makes transports costly and segments an already small market into even smaller parts. The existing road network is about 1,400 kilometers (IFC and ADB, 2007, 64). Country people have to walk for an average of two hours to reach the nearest market (UNDP, 2006, 29). Only 30 percent of the major roads are decent; most secondary roads are in dismal shape (Ministry of Agriculture, Forestry and Fisheries, 2004, 2). During the rainy season many roads become useless.

Timor-Leste has only one international airport, Dili, with a single daily flight to Indonesia and one to Australia. No regular domestic airline exists. The capacity of the port in Dili, which handles most international transports, is low and the goods-clearing process slow. The domestic ferry network is rudimentary (UNDP, 2006, 18).

Only 20 percent of all households (more than half in Dili) have access to electricity. The cost is very high mainly because power generation to a large extent depends on imported fuel. However, the government subsidizes electricity. Lack of maintenance and spare parts means that the existing power plants cannot use all of their capacity. Extensive bypassing of meters encourages waste and causes peak hour shortfalls. Since 2007, however, the Comoro Power Station has increased the supply capacity significantly (IFC and ADB, 2007, 43-45).

Telecommunications and IT services are in short and expensive supply. Only about 5 percent of the population have access to telecommunications in the form of fixed telephone lines, mobile service or internet, and computer access is almost non-existent. A major reason seems to be the monopoly of Timor Telecom (IFC and ADB, 2007, 59-60).

### *Credit*

Access to finance is a major problem for Timorese enterprises. The country ranks as low as 170 out of 178 on the Doing Business index (World Bank and IFC, 2007) and there is strong excess demand for credit (Conroy, 2006, 6):

... bank credit ... reach[ed] almost 22% of non-oil GDP early in 2005. This was only half the proportion for all 'low-income' countries ... The system was intermediating 87% of the deposits to domestic lending. Together with evidence of excess demand, this suggests the need for expanded savings mobilization to bring Timor-Leste up to a more appropriate level of financial depth.

[...] the great majority of the population remains untouched by formal financial services.

The activities of the country's three commercial banks are limited (Conroy, 2006). The Australia and New Zealand Banking Group (ANZ) is basically a non-lending institution. The Caixa Geral de Depósitos (CGD) (Portuguese) is more active, with over 85 percent of all bank credit in Timor-Leste. It has offices in several provincial towns. It is the main provider of commercial bank credits to small-scale and micro enterprises, mainly for construction – households rebuilding homes (40 percent of the total) – and to the 'trade and finance' sector (less than 20 percent). The state-owned Indonesian Bank Mandiri, finally, (10-12 percent of total bank credit), concentrates mainly on trade with Indonesia and on Indonesian interests in Timor-Leste, but it has also extended credit to the largest Timorese microlending institute. The remaining 2 percent or so comes from the Instituição de Microfinanças de Timor-Leste (IMfTL), a quasi-bank with a limited license. '... overall the banking system provides negligible finance for agriculture, industry or tourism' (Conroy, 2006, 33).

The commercial banks reach very few entrepreneurs, and hardly any small businesses at all. These have to turn to the microlending institutions. The latter have formed the Association of Microfinance Institutions in Timor-Leste (AMFITIL). The activities of its largest member, IMfTL, include weekly group loans mainly to women, daily repayment loans to market vendors, some seasonal crop lending and somewhat larger 'business' loans. Delinquency rates (30 days or more overdue) have been high, possibly as high as 25 percent on average. 80

percent of the IMfTL activities, however, consist of loans secured by borrower salaries, many of whom presumably have used the funds for micro enterprises (Conroy, 2006, 38-44).

The most important pure microfinance institution is Moris Rasik, with some 7,000 borrowers in late 2004 and a low 3.6 percent portfolio at risk. It also provides credits of up to \$ 1,000 to borrowers who have successfully serviced at least four progressively larger loans. Altogether, the AMFITIL lenders for which data are available (some three-fourths) served 19,200 borrowers in 2004. No microfinance institution is yet financially sustainable. The sector depends on support from international NGOs (Conroy, 2006, 42, 28).

Overall, in Timor-Leste, enterprises on all levels, except perhaps the few largest ones which may use cross-border arrangements, experience problems obtaining investment and working capital. The 2004 enterprise survey identified access to capital as the most important constraint to entrepreneurial development (Das and O'Keefe, 2007, pp. 19-20). Around 85 percent of all formal and informal enterprises had relied on personal funds for start-up capital and less than 7 percent had obtained bank loans. More than 60 percent of the formal and 81 percent of the informal enterprises also reported financial constraints as the most important barrier to expansion.

### **Internationalization**

The internationalization of entrepreneurship in Timor-Leste has been slow, and inward instead of outward. The main achievements have been the production sharing contract with Australia for the Bayu Undan oil field and two agreements, also with Australia, which will make possible the development of the Greater Sunrise oil field, the Timor Telecom venture, and the three commercial banks. Trade Invest Timor-Leste has signed a few letters of intent with potential overseas investors, a fisheries project and an oil refinery, among others, and more projects may be underway (World Bank, 2006, 11), but in practice little has happened. The oil sector will not contribute with employment or spillover effects into the rest of the Timorese economy, since it is located outside the country's *terra firma*.

The fact that the country's two different investment laws favor domestic companies does not help. Nor do the awkward export/import procedures, and the same argument may be advanced for all the other factors dealt with here, with the possible exception of credit, where foreign companies may have a competitive edge not being dependent on Timorese facilities.

In one sense, the main internationalization effects stem from the presence of the international community, but such ventures are often footloose. Hotels and restaurants easily close. Whenever political and social conditions get to the point where international presence is no longer required, demand will contract, and unless other business opportunities have by then been developed, the urban economy risks to find itself at the end of a temporary bubble. The sustainable internationalization of entrepreneurship in Timor-Leste lies in the probably not so near future.

### **Conclusions**

The business environment in Timor-Leste ranks low in an international perspective. The economy suffered severe destruction as the Indonesians withdrew in 1999 and reconstruction had to begin almost from scratch. The vast majority of the population depends on subsistence agriculture, and the modern sector consists of little else than the state bureaucracy and service establishments catering to the international community in Dili. Businesses are usually very small. Most are informal.

The business environment of Timor-Leste is not conducive to entrepreneurship. The political and social situation has recently been turbulent. Business legislation is incomplete and implementation is deficient. The courts are overburdened with criminal cases and bureaucrats lack experience. Setting up a business, enforcing contracts and exporting or importing are expensive and time-consuming. Investor protection is weak and property rights are chaotic. Urban wages are high, transportation is bad, power is expensive and telecommunications are deficient. The main problem for prospective entrepreneurs, however, is credit. Setting up a business requires personal funds. The country has only three commercial banks. One does no lending. The microfinance movement is not yet viable. Overall, the credit market is characterized by excess demand. The development of a sustainable modern sector will require both time and effort. Meanwhile, agriculture will have to continue to absorb the additions to the labor force, as it has done in the past.

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