

SUPPORTING ECONOMIC GROWTH IN EAST TIMOR



East Timor's achievement of full statehood in May 2002 has placed the responsibilities of government completely in the hands of the East Timorese for the first time in many generations. The violent disruptions following the 1999 referendum on independence triggered an exodus of capital and business acumen, both indigenous and foreign, and left behind a fractured economy with destroyed infrastructure, poorly functioning markets, and a collapsed financial sector. The new government faces daunting challenges in improving the living conditions of its population and charting a new path for economic growth. Forty percent of the population lives below the national poverty line of \$1.50/day, and human development indicators are among the lowest in Asia.

Given the country's small economy and limited human resource capacity, engagement with the international economy will not only be an advantage but a necessity for sustainable poverty reduction. With over 90 percent of the population engaged in subsistence agriculture or barter, East Timor needs to attract investment and expand trade to generate new off-farm employment opportunities. This cannot happen without the creation of an enabling policy and regulatory environment for commerce and investment. The Asia Foundation is working with the private sector of East Timor to identify the determinants of and impediments to economic growth, and is providing technical assistance to the government as it formulates a new legislative framework for investment activities.

ECONOMIC GROWTH THROUGH TRADE

In 2002, The Asia Foundation undertook an investigation of the patterns of trade between East Timor and Indonesia and the barriers that restrict

this commerce. The research findings will help inform government officials as they formulate new policies to facilitate greater economic engagement with East Timor's largest trading partners, and will strengthen the ability of the private sector to work with the government on policies that shape the local business environment.

A survey of 120 small and medium enterprise (SME) owners in Dili and Maliana in East Timor provided data on important trade indicators such as commodities traded, transportation costs, price levels, tax structure, and the regulatory framework. Survey results showed that in the last two years, trade in East Timor has been dominated by food-stuffs, construction materials, electronics, and clothing. Around 97 percent of manufactured goods are imported, with coffee constituting the sole significant export.

Several factors were found to constrain trade flows. Formal and informal controls on cross-border trade have produced price distortions and, in turn, smuggling, while poor port management has raised handling costs at Port Dili. Moreover, weak judicial authority undermines law enforcement, and the absence of commercial and investment regulations raises uncertainty in the business environment. The survey further isolated specific factors that are raising the prices of goods exported from East Timor, namely high sea transportation costs and relatively high wages for the region, and these factors effectively undermine the competitiveness of nascent local businesses.

To increase trade flows, policymakers need to improve the efficiency of holds and inspections at the Dili port and to lengthen port operation



EAST TIMOR

The Asia Foundation has been programming in East Timor since 1991.

The Foundation provided technical assistance on the draft Investment Law.

The Foundation conducted the first study on patterns and impediments to trade and investment in East Timor.

hours. Another issue that needs to be tackled is the normalization of the land border with West Timor, where goods smuggling is active. Policymakers should also look into ways to reduce transport costs, to strengthen judicial authority as it relates to commerce, and to ensure a flexible labor market that generates private job opportunities.

ECONOMIC GROWTH THROUGH INVESTMENT

The Foundation also conducted a comparative study of manufacturing costs between East Timor and Kupang, Indonesia, to identify impediments to investment and to provide information regarding the impact of future policy initiatives on investment and economic growth in East Timor. The survey gathered production cost data from furniture and food processing manufacturers in Indonesia and East Timor.

Survey findings had several implications for investment and job growth for East Timor. Investment potential in East Timor is constrained by high labor costs, which were twice as high as in Kupang, Indonesia, and by worker productivity, which was significantly lower than in Kupang. On the other hand, it was found that regulatory fees are much lower in East Timor, and that transport costs account for a much smaller share of total costs in East Timor than in Indonesia. The current system of business registration in East Timor is also more straightforward compared to Indonesia.

As East Timor formulates new policies to encourage international investment, policymakers need to enhance the flexibility of the local labor market and to raise labor productivity levels through training and education. The new legal framework for commerce will also need to address concerns about the physical security of doing business, the level of taxes (and regional comparisons), and the regularity of utility charges to ensure that East Timor presents a competitive business environment.

The findings of the two studies were subsequently disseminated and discussed through two conferences in Dili that were attended by East Timorese officials, donors, private sector representatives, and the local press.

BUILDING A SUSTAINABLE INVESTMENT STRUCTURE

A critical challenge faced by the new administration is to articulate a coherent and sustainable development strategy through new economic legislation, replacing the current admixture of directives promulgated by the United Nations Transitional Administration in East Timor and old Indonesian and Portuguese laws.

East Timorese policymakers are currently considering a range of laws, but often with insufficient support from experts in relevant fields. In the rush to legislate, it is feared that decisionmakers will be unable to adequately consult either external technical expertise or broader public opinion in the consideration of draft legislation.

The Asia Foundation undertook a project to support the East Timorese government in the drafting of the a new Investment Law. The Foundation provided an international specialist on investment law to offer direct technical assistance in the consideration and drafting of the investment law. This involved strengthening the relevance of the law to local conditions, as well as considering its impact on the business environment. Additional assistance was provided in translating the technical document to the relevant languages spoken in East Timor.

These steps taken helped to strengthen the draft Investment Law. By incorporating the views of the local private sector and foreign business already invested in East Timor, the draft Investment Law reflected a legal environment that would encourage investment and create an enabling environment for private sector-led growth.

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