Investment Opportunity Assessment for Timor-Leste

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Executive Summary

How can Timor-Leste create new and sustainable employment and reduce poverty? The young country has one of the highest poverty rates in the world—estimated at more than 40 percent. About 20 percent of the labor force is unemployed; and in urban areas, about 40 percent of young people are unemployed. Each year, another 15,000 people enter the labor force. About two-thirds of the employed work in the agricultural sector and mainly at a subsistence level. In urban areas, the Government of Timor-Leste is the major employer. Total foreign direct investment (FDI) in Timor-Leste is about $1.75 billion, nearly all in the capital-intensive oil and gas sector and creating few jobs onshore.

In addition, Timor-Leste's economy has been in transition since the country broke from Indonesia in 1999. GDP was $270.1 million that year, then rose steadily to peak at $380.7 million in 2002, largely because of a "dollar bubble" created by the presence of the United Nations and a large military contingent. With the drastic reduction of that presence, GDP for 2003 fell 3 percent from the 2002 peak. The national budget estimates a further decrease of 1 percent for 2004, though some believe the decrease to be as much as 3 percent. Timor-Leste is also an import economy with major trade imbalances. Trade data for 2003 show that the paltry $7 in export earnings barely covered 3 percent of that year's imports of $230 million. Oil and gas revenues are expected to correct the trade balance by 2006—and to boost GDP in 2004-2005. Imports will likely dominate non-petroleum trade for some time and non-petroleum contribution to GDP is likely to remain negative until 2006, when new laws are expected to stimulate domestic investment and attract foreign direct investment. Although the Sector Investment Program (SIP) estimates average economic growth of 1.7 percent between 2003–2007, performance so far suggests that non-oil real growth is likely to be negative.

The Government of Timor-Leste clearly faces major challenges in generating sustainable employment. But no government can create the number of jobs required to meet labor market demands without a vibrant private sector nourished by domestic and foreign investment. To stimulate investment as the source of growth, the government needs to create an enabling environment for the private sector. The government has already taken some pro-investment steps: passing investment laws with incentives linked to business inputs and job creation; building the capacity of investment promotion agencies; and adopting "one-stop-shop" investment licensing to simplify decision-making. Still, optimism regarding Timor-Leste's investment opportunities is guarded because of numerous constraints: poor economic infrastructure, low worker skills, low labor productivity, relatively high wages, small population, a small market, and stiff competition from neighboring countries that are aggressively improving their business environments.

To attract and retain more FDI, Timor-Leste must prepare itself to compete with its neighbors. Here, the country enjoys some advantages that will enable it to position itself favorably as an FDI destination: oil, gas, and mineral resources; arable land; natural beauty and rich cultural traditions; good investment incentives; and a simple, transparent investment regime superior to competing countries. Because of its small internal market, high production costs, and low labor productivity, Timor-Leste will have to produce for the export market. Competing in that market will be daunting. Timor-Leste must adopt a strategy that takes into account its limitations as well as its strengths. The country lacks sufficient comparative advantages to compete on price. Instead, a competitive advantage model based on strategic positioning of products in niche markets, a model successfully adopted for the country's organic coffee, is recommended.

Promoting, attracting, and realizing investment poses a broad agenda, especially for Timor-Leste, which needs to develop skills, policies, infrastructure, sector strategies, business associations, and skills. Campaigns to attract foreign investment should target high–potential markets in countries whose investors have already expressed strong interest in Timor-Leste: Australia, Malaysia, Singapore, Thailand, Macau, Hong Kong, and Portugal. Synergies between foreign and domestic investors will multiply the benefits of targeted investment promotion. Timor-Leste's potential for linkages and spillovers, especially in agribusiness and tourism, is substantial, and can be best realized through sector development strategies. Once sector strategies are underway the government can promote skill development. Institutions that combine business management and technical training are needed to supplement the Business Development Center program. Strong business associations and public-private dialogue will be crucial. The IEPA and ADE can foster a collaborative spirit to ensure that synergies between FDI and domestic investment occur. Branding strategies implemented with sector strategies and investments will have significant spillover effects on domestic businesses. The success of these efforts will depend on investments in economic infrastructure (public or private): power, communications, ICT.

In sum, we recommend that the Government of Timor-Leste, the IEPA, and private sector leaders undertake the following steps to promote, attract, and realize investment in Timor-Leste:

- Develop strategic business plans
- Create sector strategies and working groups
- Provide training in administrative procedures
- Pursue sector-driven private-sector training and capacity building, especially for tourism and agribusiness

- Improve the business environment
- Build transport and energy infrastructure
- Improve telecommunications infrastructure and reduce communication costs
- Reduce air transport costs.

Though only three years old, Timor-Leste has a considerable stock of FDI (US$ 1.75 billion), making it the envy of many similar countries, some of which have been promoting investment for decades. But this impressive stock is in non-renewable resources, a sector characterized by capital-intensive equipment and low employment. To achieve sustainable development, Timor-Leste must invest the income from its non-renewable resources in its people and infrastructure while promoting investment in other sectors.

1. Introduction

On May 20, 2002, Timor-Leste regained its independence after nearly a quarter-century under Indonesia occupation. During that time it was considered one of the poorest areas in Indonesia. In 1996, half of its population lived below the poverty line and infrastructure was lacking—paved roads serviced less than 16 percent of population centers and less than 15 percent had access to electricity.

Still one of the poorest countries in the world, Timor-Leste now has bright prospects. The Government of the Democratic Republic of Timor-Leste recognizes, however, that the lack of a solid legal and regulatory framework for business development and the lack of domestic capital, technology, managerial expertise, and general know-how in the private sector are hindering economic development. Thus, to create jobs and combat poverty it has made attracting foreign direct investment (FDI) a priority. In this regard, it considers developing and implementing a business-friendly regulatory environment essential. While the government has planned and taken many steps to support private sector development, legislation to regulate the business environment and each sector is still needed so private investors have a predictable environment in which to make investment decisions.

In addition to instituting measures to create a framework for private sector development, the government needs to better understand the country's general and sector-specific investment opportunities, as well what obscures these opportunities. This Investment Opportunity Assessment (IOA) examines investment opportunities and challenges facing Timor-Leste and provides guidance on how government, institutions, and the private sector can build on newly passed legislation to attract domestic and foreign investment into key economic sectors. It examines the country's investment climate, comparative and competitive advantages, and the prospects and constraints of key economic sectors. It draws on (1) the experience of Nathan Associates' Resident Investment Advisor (RIA) gained over the past 20 months in Timor-Leste, (2) a workshop and SWOT (strengths, weaknesses, opportunities, and threats) analysis, and (3) fieldwork involving the workshop and SWOT analysis. The few existing studies or recommendations on investment opportunities and challenges in Timor-Leste were also considered, though most of these focus on the functional business environment:

- Feasibility and market studies on a few niche agricultural products by IFC and others, as well as a more recent recommendations for IFC in Timor-Leste;
- A small and medium industry strategy that focuses on the investment framework (prepared for AUSAID);
- A detailed study by the World Tourism Organization on the potential of the tourism sector; and
- Sectoral investment programs (SIPs), including one for private sector development, that focus on public investment and reform needs (prepared by the government and donor organizations).

Other than what is available from individual entrepreneurs or projects, statistical and sector-level information is scant.[1] A team of three Nathan Associates experts and two Timorese staff from the Investment Division of the Ministry of Development and Environment (MDE) carried out fieldwork, including a workshop from April 4-22, 2005. The team gathered information from various sources, including existing literature and documentation, face-to-face interviews, observation of business operations and potential investment locations, and the workshop. The team interviewed domestic entrepreneurs, foreign investors, technical advisors, government officials, and many others. Their opinions are reflected in this report, but without attribution.

Sponsored by the MDE and financed with USAID resources under Nathan Associates' Investment Advisory Services Project, the one-day workshop was a core activity. More than 50 representatives from government, business, and local civil society and international organizations participated enthusiastically in the workshop and its working groups. The workshop was the first of its kind in Timor-Leste to address investment opportunities and constraints for the country as a whole. It also provided a means for gathering opinions on strengths, weaknesses, opportunities, and threats in six key sectors: fisheries and aquaculture, tourism, light manufacture, oil and gas upstream and downstream services, and financial and business support services.

Section 2 of this assessment provides information on the state of the private sector and investment in Timor-Leste, including investment trends and the business environment. Section 3 sets Timor-Leste in the context of global FDI trends and summarizes the motivations for foreign investment. Section 4 examines the country's comparative and competitive advantages; Section 5 the potential of key economic sectors and the implications of that potential by region. Section 6 examines the relationship between domestic investment and FDI in Timor-Leste; and Section 7 describes challenges for investment promotion—creating a favorable investment environment, competing in the region, and targeting investment sources. In Section 8 we offer recommendations and next steps for realizing Timor-Leste's investment opportunities. As a type of guide

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[1] Indeed, in due course, statistical capabilities and the tracking of investment-related information and benchmarking in Timor-Leste need to be improved. USAID and the Government of Timor Leste are expecting to collaborate on this issue as part of MCA Threshold activities.

for the IEPA, this assessment stresses the role desired for the new agency where appropriate. Terms of Reference for this assessment are provided in Appendix A, and persons interviewed are listed in Appendix B.

2. General and Economic Context

With a population of 924,600[2] and occupying 15,007 square kilometers at the tail end of Southeast Asia, between Indonesia and Australia, Timor-Leste is the region's newest and second smallest country.[3] It occupies more than half of the Timor Island, primarily the eastern half, with the exception of the enclave of Oecusse-Ambeno in Indonesia's southernmost province of West Timor. From the perspective of investment opportunity, Timor-Leste is well positioned. It stands to soon become a part of ASEAN[4] and its proximity to Australia provides ready access to a robust market.

Economic Structure

Timor-Leste has a very small economy; in 2003 GDP was $341 million and annual per capita income was $369—a national average of barely more than $1 per person per day on a 365 day basis! Logically, the estimated poverty rate is also one of the highest in the world, affecting more than 40 percent of the population.[5] In addition, Timor-Leste is principally an import economy: total imports in 2003 were $230 million and merchandise imports were about $143 million. Measured against a paltry $7 million in exports for the same year, [6] export receipts covered only 3 percent and 4 percent of total imports and merchandise imports, respectively, in 2003. Table 2-1 presents GDP distribution by sector.

Timor-Leste's economy has been in transition since 1999 and has fluctuated with political events. According to Ministry of Plan and Finance and IMF data, GDP was $270.1 million in 1999, the year Timor-Leste broke from Indonesia and the economy was plundered by social strife. GDP then rose steadily, peaking at $380.7 million in 2002, the year of the rebirth of the Democratic Republic of Timor-Leste. This four-year rise in GDP was due principally to the "dollar bubble" created by the presence of the UN and a military contingent. With the drastic reduction of that presence in 2003 and 2004, GDP decreased

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[2] 2004 National Census.
[3] Only Brunei is smaller, with a land area of about 5,200 sq. kilometers and a population of 372,000.
[4] The Timorese Minister of Foreign Affaires and Cooperation recently announced that Timor-Leste intends to join ASEAN.
[5] UN Human Development Report.
[6] Coffee was the principal export commodity in 2003 and the United States was its principal market where it is sold as organic coffee.

by 3 percent in 2003. The national budget estimates a further decrease of 1 percent in 2004, though some experts believe the actual decrease to be between 2–3 percent. This contraction is due principally to the exit of the UNMISET (May 2005). While gas and oil revenues will boost GDP beginning in 2004-2005, non-petroleum contribution to GDP is likely to remain negative until 2006, when domestic and external investment laws recently passed by Parliament are expected to stimulate domestic private investment and attract foreign direct investment. Although the SIP estimated average economic growth of 1.7 percent between 2003–2007, economic performance suggests that non-oil real growth is more likely to remain negative for the period.

Table 2-1
GDP by Economic Sector, 2003

Sector	Value (US$ million)	Percentage
Agriculture, forestry, and fishery	104.4	30
Public administration and defense	79.9	24
Construction	55.9	17
Trade, hotel and restaurant	29.9	9
Transport and communications	27.5	8
Finance, rent, and business services	23.8	7
Manufacturing	11.0	3
Mining and quarrying	3.8	1
Electricity, gas, water	3.2	.9
Private services	2.3	.7
TOTAL	341.2	100

SOURCE: *Ministry of Planning and Finance and IMF.*

As indicated by 2003 trade figures, Timor-Leste is an import economy with major trade imbalances. While oil and gas revenues are expected to reverse these imbalances in 2006, imports are likely to dominate non-petroleum trade for some time. In 2003, Indonesia accounted for more than 40 percent of import volume (Table 2-2). While Timor-Leste imports a wide range of products from Indonesia, petroleum products dwarf others (Table 2-3). Preliminary 2004 trade data indicate that Indonesia, Australia, and Singapore will remain in their trade positions, while Vietnam and Italy surpass Portugal, and Japan displaces India from the top ten in 2004. A large portion of petroleum products imported in 2003 were consumed by the Peace Keeping Force and UNTAET administration and program.

Table 2-2

Timor-Leste's Top 10 Countries of Import, 2003

Country	Value (US$ million)	Percentage
Indonesia	83	41
Australia	23	11
Singapore	13	6
Portugal	10	5
Thailand	.95	0.5
China	.92	0.5
Vietnam	.68	0.3
Italy	.61	0.3
India	.38	0.2
Denmark	.33	0.2

SOURCE: RDTL Department of Statistics.

Table 2-3

Imports by Product Category, 2003

Product Category	Value (US$ million)	Percentage
Petroleum products	64	32
Food and beverages	20	10
Capital goods	14	7
Construction materials	12	6
Vehicles and spares	12	6
Others	81	40
TOTAL	203	100

Source: RDTL Department of Statistics.

As shown in Table 2-4, Timor-Leste's exports in 2003 were very limited—earning barely $7 million. Coffee was the primary export and the United States was the principal market. Indonesia was the second-largest export market, but exports were valued at less than $1 million. Exports to Australia, the third-largest market, were valued at little more than half a million dollars. Exports to the remaining top four countries were negligible, when combined, accounting for less than the Australian market.

Timor-Leste's economy remains primarily rural, based largely on agricultural production. The main products are coffee and a few other cash and food crops, such as rice and maize. Under occupation, the main export crops were coffee, some spices (such as cloves), vanilla, and candlenut.

Table 2-4
Timor-Leste's Top Seven Export Markets, 2003

Country	Value (US$ million)	Percentage
United States	2.85	41
Indonesia	.91	13
Australia	.54	8
Singapore	.16	2
Germany	.14	2
Norway	.07	1
Portugal	.07	1

Source: RDTL Department of Statistics.

Investment Trends

The Sector Investment Program (SIP) presents GDP and investment figures from 2000-2003 by public and private sector shares (Table 2-5). While indicating a mixture of public and private economic activity, data also indicate that private-sector activities dominate and are increasing even though non-oil GDP has been declining: private-sector activity accounted for about two-thirds of GDP in 2003. Agriculture continues to contribute the most to GDP, about 30 percent. The agriculture sector employs more than three-quarters of the labor force but is characterized by low productivity because of the subsistence nature of the sector activity.

From the perspective of gross fixed investment, data in Table 2-5 indicate that investment in Timor-Leste fluctuated in a pattern similar to GDP fluctuation during 2000-2003. From a base of $118.8 million in 2000, gross investment peaked at $145.4 million in 2001 and then declined steadily to $105 million in 2003. As can be expected in a post-conflict period, public investment far outstripped private investment. Concomitantly, because of recent contraction in non-oil sectors, private investment share of the GDP in 2003 declined to 4.4 percent of GDP from a high of 9.5 percent in 2000 and 2001.

Why so much fluctuation? During the early period of transition, donor-funded expenditures on reconstruction and rehabilitation relied on private suppliers of goods and services. Private activity grew rapidly and helped restore the supply of goods and services. As reconstruction slowed in 2002, and UN staff began to leave, private-sector growth slowed. This slowing is expected to continue through 2005, as the UNMISET program concludes in May 2005 and the economy bottoms out in the second half of this calendar year. This negative trend may be countered in 2005 by higher-than-expected revenue from the petroleum sector and investment attracted by new domestic and external investment laws.

Table 2-5
Trends in Public and Private Value Added and Investment, 2000-2003

Indicator	Amount				Growth 2000-2003 (% p.a.)	
	2000	2001	2002	2003	Nominal	Real
Non-oil GDP						
Private sector						
Agriculture	81.5	84.7	91.2	97.4	6.1	4.7
Private non-farm	98.2	111.5	110.7	114.7	5.3	2.6
Subtotal	179.7	196.2	201.9	212.1	5.8	3.3
Public sector	136.5	171.7	141.4	123.6	(3.3)	(3.5)
Total	316.2	367.9	343.3	335.7	2.0	0.7
Oil and gas	77.5	44.3	41.5	52.7	(12.1)	(12.5)
Total GDP	393.7	412.2	384.8	388.4	(0.5)	(1.7)
Gross fixed investment	118.8	145.4	118.9	105.0		
% of GDP						
Private sector	9.5	9.1	5.7	4.4		
Public sector	20.7	26.2	25.2	22.6		
Total	30.2	35.3	30.9	27.0		
Memo item						
Private sector output	65.3	58.3	63.3	68.2		

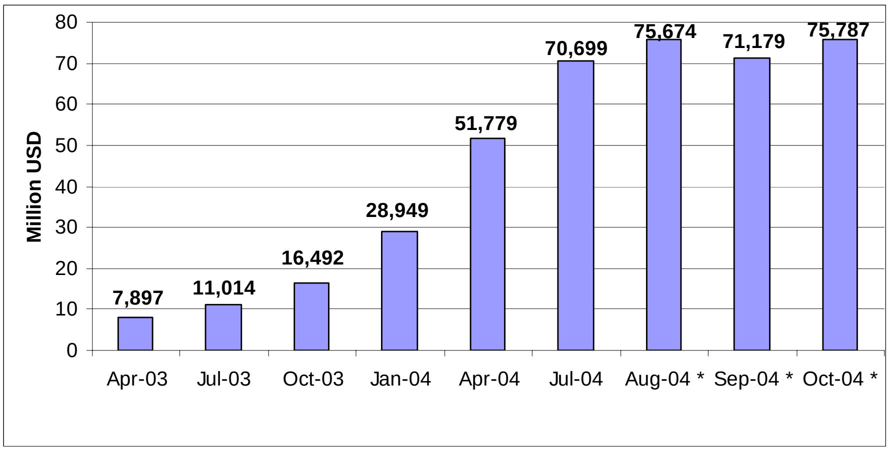
Note: Public and private investment are estimated independent of SIP data.

SOURCE: National Statistics Office, January 2005.

While the overall economy showed signs of contraction in the past year or two, the financial sector did not. As can be seen from Figure 2-1, the supply of domestic credit has expanded, with credit extended by commercial banks to private and enterprises increasing considerably since June of last year, mainly because of a change in credit policy and a lowering of interest rates by the largest commercial lender in Timor-Leste.[7] In January–October 2004, credit outstanding nearly trebled from $29 million to $76 million. According to BPA data, the main credit sectors as of June 2004 were construction; trade and finance; and industry, transport, and communication. This credit supply appears to be a response to credit demand caused by strong growth in domestic construction driven by government contracts and by the housing market. Some expansion has been associated with a reported increase in demand for working capital in the trade sector, given its importance to private business activity. A lowering of interest rates from 15+ percent to an average of 11–12 percent and premium customers taking out loans with rates as low as 8-9 percent contributed to the sharp rise in credit demand in the latter half of 2004.

[7] According to data published in local newspapers, Caixa Geral de Depositos, a wholly-owned Portuguese Government bank known locally as BNU, is the major lender in Timor-Leste,.

Figure 2-1
Outstanding Credit of Commercial Banks to Private Enterprises



SOURCE: *Bank and Payments Authority of Timor-Leste, Economic Bulletin.*

Another indicator of investment trends is the number of business registrations or "licenses" (Table 2-6). By the end of 2004, about 10,700 licenses had been issued—two-thirds to individually-owned businesses[8] and one-third to companies. Only 37 percent of licenses for individual business were legally valid, while 56 percent of licenses issued to companies were legally valid.[9] Licensing has declined because of lack of access to credit and because many licenses were obtained simply to bid on government contracts. The latter supposition was corroborated by a study conducted in mid-2003. Of the 200-plus licensed businesses examined, about 40 percent either no longer existed or had never opened.[10] In 2004, the number of new licenses issued grew considerably, suggesting a correlation with the sharp rise in credit supply from commercial banks during the second half of the year (Figure 2-1).

Foreign Investment

While no systematic means for collecting data on foreign direct investment in Timor-Leste yet exists (the soon-to-be established External Investment and Export Promotion Agency is to devise a means), total FDI is estimated to be slightly under $1.75 billion.[11] Most is concentrated in the gas and oil sector, with more than $1.65 billion already invested offshore. Onshore FDI is estimated to be close to $100 million.

[8] An individual business license costs $10 and a company license costs $100. Licenses issued in 2000 and 2001 were valid for two years, and since 2002 valid for one year.
[9] The number of legally licensed businesses in operation in 2004 was 4,572 (2,760 individual business and 1,812 companies). Although numbers represent a significant improvement over 2003, they indicate that approximately 6,200 individual businesses and companies had not renewed registration at end of 2004.
[10] ARD Report on Research Findings on Lease of Government Properties, October 18, 2003.
[11] Data based on informal survey conducted for this assessment.

Table 2-6
Number of Business Licenses Issued and Renewed

Indicator	2000	2001	2002	2003	2004
LICENSES ISSUED					
Self-owned	3,370	1,106	768	282	2,016
Company	376	337	696	926	894
Total	3,746	1,443	1,464	1,208	2,910
TOTAL LICENSES ISSUED					
Self-owned	3,370	4,476	5,244	5,526	7,542
Company	376	713	1,409	2,335	3,229
Total	3,746	5,189	6,653	7,861	10,771
LICENSES REQUIRING SELF-RENEWAL					
Self-owned	0	0	3,370	5,244	5,526
Company	0	0	376	1,409	2,335
Total	0	0	3,746	6,653	7,861
LICENSES RENEWED					
Self-owned	0	0	95	96	744
Company	0	0	162	586	918
Total	0	0	257	682	1,662
PERCENT OF LICENSES RENEWED					
Self-owned	0	0	2.8	1.8	13.5
Company	0	0	43.1	41.6	39.3
Total	0	0	6.9	10.3	21.1

SOURCE: Department of Trade, SSCI, January 2005.

The top 10 investor countries in all economic sectors are

1. United States
2. Japan
3. Italy
4. Australia
5. Portugal
6. Indonesia
7. Thailand
8. Singapore
9. Malaysia
10. China

The top four countries together have invested about $1.65 billion in the Bayu-Undan gas field in the Timor Sea. This gas field alone in the Joint Petroleum Development Area (JPDA), co-administered with Australia, is expected to net more than $4 billion in royalties, taxes, and profit revenues for Timor-Leste in the next 20 years. Depending on negotiations between Timor-Leste and Australia on an even larger gas field, the Greater Sunrise—whose estimated proceeds are expected to be net three to four times that of Bayu-Undan with revenue streams over a 30- to 40-year period—Timor-Leste's share may be at least equal to or substantially larger than that received from Bayu-Undan. The ranking of investor countries may change soon if the negotiations over the Greater Sunrise gas field are successfully concluded, as reported in the press.

Ensuring a prosperous future depends only in part in managing proceeds from hydrocarbon endowments. The greater challenge for sustainable development lies in promoting investment in the non-oil and mineral resource sectors. Timor-Leste must use income generated from non-renewable resources for capital investments in human resource and infrastructure.

Business Environment Framework

The Government of Timor-Leste is working to improve the enabling environment to build a strong foundation for sustained private-sector-led growth that stimulates domestic investment and attracts FDI. So far, the government has adopted a private investment policy and passed related laws and decrees. Legislation that supports private sector development includes the Land and Property Law, the Commercial Companies Law, the Domestic Investment Law, the External Investment Law, the notary decree-law, and the fisheries decree-law. Other laws, such as the insurance law and the private lease law, are now in Parliament; the registration decree-law, the decree regulating business registration procedures, and the bankruptcy decree-law are being drafted. Other legislation for a regulatory framework includes the association law, the chamber of commerce law, export promotion law, environment decree-laws, intellectual property law, competition law, accounting systems decree-law, social security law, and legislation required to regulate economic sectors (e.g., manufacturing, domestic and internal trade, tourism, environment). The creation of an effective private sector framework means that this legislation needs to be adopted and regulations passed to set up or strengthen implementing departments and services. This will be coupled with an investment promotion program

In recently passing investment laws, and with regulations expected to be adopted by the end of May 2005, the government has taken major steps to create the right legislative and regulatory framework for investment. The rights and guarantees of these laws contribute to a sound and predictable investment environment (Exhibit 2-1). In addition, domestic and foreign investment will be stimulated by robust investment incentives tied to job creation, and the work of the newly created investment promotion agencies. Effective promotion and expeditious investment licensing will be essential to fostering an environment that accelerates job creation and reduces poverty.

Exhibit 2-1

Laws and Incentives Creating a Favorable Investment Environment

On May 2, 2005, the National Parliament passed the Domestic Investment Law and the External Investment Law.[12] Domestic investors had expressed desire for a separate domestic law a little over one year ago. The foreign investment law had been in the works since 2000. The two laws are mirror images in their guarantees, incentives, and post-entry treatment. The External Investment Law, which imposes a higher minimum investment threshold, covers origin of invested capital, the right of foreign investors to repatriate profit and capital, and the right of foreign investors to pursue conflict resolution abroad under ICSID[13] rules. Otherwise, the two laws treat all investors equally. In creating a separate domestic law, the government demonstrated goodwill in listening to domestic investors, and domestic investors are very satisfied with their own role in the development of the country's private investment regime. The specific provisions of the domestic and external investment laws are provided in Appendix C. Timor-Leste's investment incentive program was based on analysis of competition in Southeast Asia, a region known for aggressive FDI promotion and success in attracting and retaining foreign investors. Appendix D presents the incentive package offered by competing countries and those offered by Timor-Leste. While Timor-Leste's package lacks aggressive incentives, such as corporate "tax holiday," it does offer a corporate profit tax credit system linked to the creation of direct full-time employment. The choice of this option is based on the country's desire to combat unemployment and ultimately reduce poverty.

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[12] Timor-Leste uses the concept of "external investment" to denote similar FDI treatment accorded its emigrant population abroad who invest under the same conditions as foreign citizens. Conflict resolution options available to foreign citizens are not naturally accorded to emigrant Timorese citizens. An emigrant is defined as someone who has lived continuously abroad or at least five years prior to submitting an external investment application.

[13] ICSID - International Center for Settlement of Investment Disputes. As Timor-Leste is a member of the World Bank it is automatically a party to the ICSID Convention.

3. Foreign Direct Investment Trends and Motives

Global inflows of FDI grew from $209 billion in 1990 to almost $1.4 trillion in 2000; inflows to developing countries rose from $26 billion in 1990 to $188 billion in 1999, an increase of nearly 630 percent (Figure 3-1). Though global flows have declined since 2000 to $560 billion in 2003, inflows to developing countries declined less. In fact, several low-income countries, including Timor-Leste and several Asian countries, enjoyed an increase. In 2003, developing country FDI inflow amounted to $146 billion, or roughly 26 percent of the global U.S. dollar value. China alone received $54 billion.[14]

Regionally, economic growth and an improved business environment are contributing to a 27 percent increase in FDI in Southeast Asia. The United Nations Conference on Trade and Development (UNCTAD) reports that inflows grew from $15 billion in 2002 to $19 billion in 2003. On the basis of surveys of multinational corporations and the economic rebound in most of the developed world, UNCTAD predicts that FDI inflow will increase in the mid-2000s.

Four Factors in FDI Surge of 1990s

1. Extensive investment in privatization of state-owned assets, particularly in Latin America and Eastern Europe.

2. Acquisitions of distressed banks after the 1997 Asian Financial Crisis.

3. A wave of international corporate cross-border mergers and acquisitions – many between developed and developing countries – outside the financial sector.

4. The growing attraction of China as an investment destination.

Rise of China

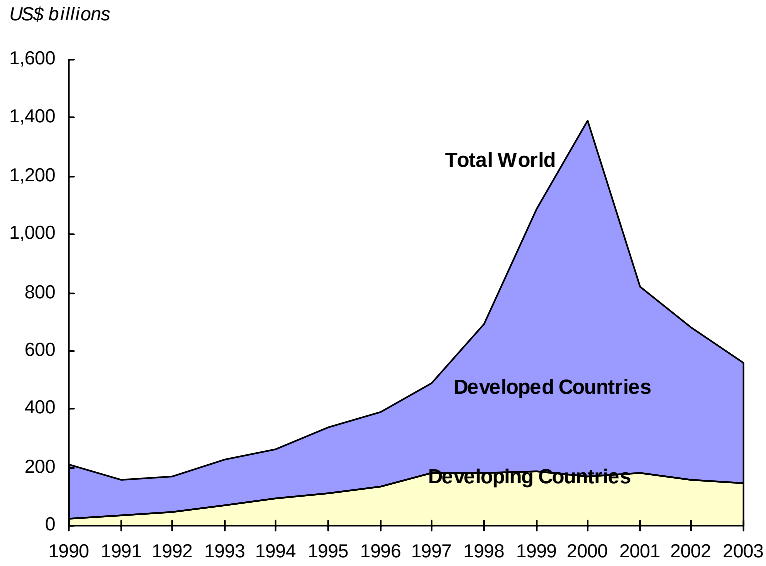
The rising popularity of China and, to a lesser extent, India, and the shift in FDI from manufacturing to services, are the two main trends in FDI of the last two decades. China is attractive because it has more than 1.3 billion consumers and highly productive labor. It has also embarked on a selective but wide range of business environment reforms and increased its integration into global commercial diplomacy by joining the WTO. India's inward FDI in

[14] China's figures are sometimes controversial because of "round tripping" : mainland firms recycle investment finance through Hong Kong as "new" investment to take advantage of incentives open only to foreign investors.

2003 was about $4.3 billion and its prominent companies, such as Tata Consulting and Infosys Tech Ltd., are active outward investors in Asia.

Figure 3-1

FDI Inflows, Developed and Developing Countries, 1990-2003



Note: Developed countries are high-income countries according to World Bank classification (2003 per capita GNI above US$ 9,385). Developing countries are low and middle-income countries according to World Bank classifications (2003 per capita GNI is US$ 9,385 or below). Regional groupings are according to World Bank definitions. Based on these criteria, certain countries considered "developing" by UNCTAD are considered high income by the World Bank, and are excluded from the definition of "developing countries" in these figures.

SOURCE: UNCTAD, World Investment Report 2004 *data on FDI inflows; World Bank,* World Development Report 2005 *for country classifications.*

Move to Services

FDI in services grew substantially in the second half of the 1990s, faster than investment in natural resources or manufacturing. Growth is in the "old" services—utilities, finance, insurance, and retail and wholesale distribution—and in the "new" services of business support and other services enabled by telecommunications and information technology. In developing countries as a whole, services represent more than half of inward FDI, with flows concentrated at the upper-middle income economies. But in China, the Pacific and in Africa, inward FDI stock[15] is still concentrated in manufacturing and the primary sector even though the share of total FDI stock increased in Asia from 43 percent in 1995 to 50 percent in 2002. Competition among Malaysia, Singapore, and Thailand for high value-added services has increased.

Global growth in service sector FDI is associated with

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[15] FDI Stock is the total value of all foreign owned assets in a country at a given point in time.

- Increased liberalization of regulation and loosening of foreign ownership in the services sector in many countries -- including signatories to the WTO GATS and TRIM;
- Privatizations in the former Soviet Union and Eastern bloc countries as well as in Latin America and Africa;
- IT sector development and growth, which itself has enabled services to be traded internationally; and
- Efficiency-driven contracting of business services that used to be performed in-house in corporations (e.g. call centers and financial service back office operations).

As Timor-Leste formalizes the legal and policy framework governing all forms of investment, including FDI, it must bear in mind the nature and recent trends in FDI

Sources of FDI

FDI originates from companies domiciled in the United States, France, the United Kingdom, Belgium, the Netherlands, and Japan. Other important sources of investment are Asia, Singapore, Taiwan, Hong Kong, and mainland China. And regional blocs, such as the EU and ASEAN, are emerging as sources of FDI among member countries.

Though developed countries will probably continue to provide most global FDI, companies in developing countries increased investment in other developing countries in the 1990s. This “South-South” FDI peaked in 2000, when it accounted for about one-third of flows to developing countries, up from 17 percent in 1995. Though these flows diminished in the early part of 2000s, as did global FDI, they remain important for Timor-Leste. Investors from Asia, particularly ASEAN countries, can complement investment from other regions and could be better equipped to tolerate the risks and challenges of investment in Timor-Leste. Malaysia, Thailand, and Singapore, are increasingly active in the region (e.g., Singaporean and Malaysian investors are active in telecommunications and leisure/hospitality). Malaysia’s state-owned oil and gas company, Petronas, has investments in Vietnam, Cambodia, and Lao People’s Democratic Republic.

In addition to ASEAN countries, whose investors have expressed interest in Timor-Leste, the country can count on investments from Australia and Portugal, which are already investing in Timor-Leste, even under adverse economic conditions and a less than ideal regulatory environment. Australian business interests first came to provide goods and services required by the Australian contingent in post-conflict Timor-Leste. Portuguese investors also came for similar reasons but have chosen to remain in strategic sectors, such as commercial banking, telecommunications, and power. As a former colonial power, Portugal’s investment interest in Timor-Leste will probably be long-term and is likely to continue and expand to other areas, such as the financial sector (i.e., insurance, risk capital) and infrastructure management.

Table 3-1 summarizes the FDI outflows from countries in the region that could be important to Timor-Leste. The amounts include the activity of smaller, less-capitalized investors, a group that could be particularly important for targeted investment promotion. Like domestic investors, these foreign investors would have concerns about the business environment, complex or unclear business regulations, incentives, and red tape.

Table 3-1
Outflows of FDI from Select Countries

Country	2002/2003 Value of FDI (US$ millions)
Australia	7576.04/15107.6
China (Hong Kong)	17463.19/3769.4
China (Macao)	61.6/24.1
Malaysia	1904/1369.5
Philippines	59/158
Portugal	3288.63/95.5
Singapore	3699.4/5536.2
Thailand	106/557.2

SOURCE: Nathan Associates based on UNCTAD data.

As with overall FDI flows and in the OECD countries in particular, outflows fell more dramatically in Portugal and Australia than in developing countries, such as Thailand where figures indicate a rebound. Portuguese outward FDI is concentrated in Brazil and Spain. In 2000, Brazil was host to 47 percent of Portuguese foreign investment. FDI from Portugal is concentrated in telecommunications, electricity, financial services, and retail. Investments are also mainly through holding companies. As the Government of Timor-Leste devises policies and determines regulatory priorities, investment opportunities of the "old" or conventional service sector should be remembered.

FDI Motivations and Implications for Timor-Leste

Competition for global FDI is stiff. As a new nation emerging from conflict, Timor-Leste gained FDI in the building and construction, trade and distribution, banking and finance, and telecommunications sectors. As they seek to attract more FDI to complement domestic investment and boost development, decision makers and other stakeholders in Timor-Leste need to appreciate the motives for global and regional foreign investment.

FDI is first and foremost a business transaction; investors seek the highest possible return on investments within calculated risk margins. While often calculated with sophisticated capital pay-off techniques that demonstrate how investments can be maximized, the basic concept is simple and predicated on a bottom-lines principle: the greater the risk the higher the return expected.

Investors have four basic reasons for undertaking foreign direct investment. They seek

- ***Resources***, such as mineral and petroleum resources, fisheries, forestry, agricultural and other natural assets, or cheap and highly productive labor; or
- ***Markets*** of new customers and clients that can be served best through local production rather than exporting, and to take advantage of access offered by trade agreements; or
- ***Efficiency*** that lowers the cost of production within global production networks; or
- ***Strategic assets*** or alliances that complement and promote corporate strategic objectives.

The decision to investigate a location and to eventually locate there is determined by the enterprise's corporate strategy, competitive structure of its industry, and host-country attributes (Table 3-2). Every investment tends to be unique and it is helpful to think in terms of FDI project types. Factors predicated on corporate structure are *push* factors; those based on host-country attributes are *pull* factors. Competitive pressures faced by enterprises in their existing locations push them to look overseas, and the way an investor perceives the attractiveness of a country pulls in the particular type of project.

In addition to considering profits and the reduction of unique operating costs, investors take into account incentives that governments confer on investors. The two most important in developing countries are financial and tax incentives and guarantees on investment provided by the state or by the state's status as a signatory to an internationally recognized agreement. Governments usually determine incentives by assessing the likely benefits of a particular type of FDI project. Timor-Leste is formalizing its policy and legal framework governing all kinds of investment, including foreign investment.

Multilateral and bilateral trade and investment agreements have provisions that address investors' concerns about non-commercial risks. The World Trade Organization and its rulings are widely known, but investors from countries targeted by Timor-Leste could be interested in bilateral investment treaties (BITs). Evidence of BITs' direct stimulation of FDI is inconclusive, but large investors in developed countries find them reassuring. The number of BITs globally has skyrocketed from 385 at the end of 1995 to about 2,000.

Table 3-2
Foreign Direct Investment Motives and Host-country Attributes

Motives for Investment	Host -country Attributes
Resources or assets	Raw materials/primary commodities
Markets	Market size and per capita income Market growth potential Access to regional and third-country markets Country-specific consumer preferences Proximity to strategic clients/customers Structure of markets (concentration, price structure)
Efficiency	Low-cost unskilled labor Skilled labor Other input costs (e.g., transport and communications to/from host economy) and costs of intermediate products Membership of a regional integration agreement conducive regional corporate networks
Strategic Assets	Created assets based on technology or innovation (e.g., brand names) including assets Created assets embodied in individuals, firms, industry clusters (e.g., R&D capabilities) Physical infrastructure (ports, roads, power, telecommunications)

SOURCE: Nathan Associates, based on UNCTAD, World Investment Report *2003.*

What do these motives imply for Timor-Leste?

Natural resource seeking FDI. Total FDI in Timor-Leste is estimated to be about $1.75 billion, with the Bayu-Undan gas field taking up $1.65 billion. Onshore investment is estimated to be $80 to $100 million, of which $22 million have been invested in the telecommunications sector. Success in attracting natural resource-seeking FDI, particularly in extractive industries, tends to bring about "Dutch disease"—the real appreciation of a country's currency due to a sudden inflow of capital usually caused by the export of natural resource. Capturing additional export value within Timor-Leste will entail attracting more investors into agro-processing. For these investors, concerns include profit margins and the price of the particular commodity in the world market; availability and cost of labor; quality certification; and adequate road and sea transportation. Timor-Leste can probably satisfy conditions for land availability and raw materials.

Market seeking FDI. Current and past export data indicates potential for market-seeking FDI in the agricultural/agribusiness sector (coffee, coconut, vanilla, palm oil, and candlenut) as well as in fisheries. Location attributes of market-seeking FDI include market size and access, and the near- and medium-term potential for economic growth. Timor-Leste's market is small and purchasing power is low. With the reduction and ultimate end of UNMISET activities in May 2005, purchasing power will be even lower.

In other parts of the world, small and regional investors, whether because mandated by the state or in pursuit of commercial success, have been motivated to undertake joint ventures with domestic firms on investment projects that initially focus on import substitution, then gradually increase export share over time. Should Timor-Leste join ASEAN, the potential for gaining market-seeking FDI could improve considerably. AFTA-CER[16] envisages closer trade and investment between ASEAN and Australia and New Zealand. Timor-Leste's potential for having a large market through membership in the Community of Portuguese Language Countries (CPLP) is constrained because the CPLP functions as a political organization[17] and is not geographically contiguous. Small economies, such as Timor-Leste haves served as trampoline for investors from quota-constrained countries and have exploited the privileged market access that attaches to being a developing country. But marketing a country as an export platform is no longer much of a comparative advantage. Doing so was most effective in the textiles and apparel industry but international agreements, WTO accession, and the end of global import quotas on textiles and apparel have eroded the value of such market access.

Efficiency seeking FDI. The shift in global FDI to from manufacturing to services has intensified efficiency-seeking FDI. Manufacturing processes are now disaggregated in complex networks. This efficiency-seeking FDI desires cheap labor and adequate productivity, with production carried out by foreign affiliates in an extensive network organized by the parent company.[18] Affiliates deliver the best cost-productivity characteristic for the intermediate product, which is then exported to its next location in the value chain for the next stage of processing. For smaller investors, such networks are less extensive, but the focus on reducing costs is still the primary motive. Frequently, the decision to produce overseas is driven by rising costs in a parent company's home country or current location. For Timor-Leste, implications and concerns center on the high unit cost of labor relative to neighbors—though the real wage may be comparable.[19]

Strategic asset seeking FDI. This type of investment grew in the 1990s with the wave of cross-border mergers and acquisitions and extensive privatizations in Eastern Europe and Central Asia. Investors seeking strategic assets want intangible as well tangible assets: technology, brands, or trademarks. Though this form of FDI is increasing in South-South investment, it is still largely an activity of developed countries. Timor-Leste is a very young with no widely known brands.

At present, Timor-Leste has only natural resources to offer potential foreign investors. The country has attracted FDI in the gas and oil sector, but investment in other resource-based sectors such as agribusiness and fisheries has yet to materialize. The only agribusiness commodity in which Timor-Leste seems to have a competitive advantage is coffee exported to the United States as organically certified. Experts believe that demand in the international niche market for organic coffee is still high; however much more needs to

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[16] AFTA-CER is ASEAN Free Trade Area-Closer Economic Relations

[17] In July 2003 Foreign Minister Jose Ramos Horta called for more focus for CPLP on economic, trade and business cooperation.

[18] Parent company is the multinational corporation based in the home country.

[19] See Background Document, Timor-Leste Development Partners Meeting, June 2003, pg 6.

done to renew and improve the coffee stock, and to expand production. Likewise, organic coffee branding needs to be strengthened and broadened.[20]

The government and private investors have signed several letters of intent with regard to palm oil production and processing, modified cassava starch processing, and fisheries catching and processing. Though promising to employ thousands, no investment has materialized, in part because a lack of a sea port in the southern part of the country. And according to some experts, the more productive variety of palm oil envisaged for the proposed venture requires a higher rainfall than Timor-Leste has, making high-quality cultivation difficult without irrigation. A recent study by the World Bank examining palm oil, shiitake mushroom, and vanilla production in Timor-Leste underscored the lack of local experience and expertise. The emergence of an industry based on these commodities will be impossible without strategic partnership or lead investment from experienced foreign producers.[21] Hence, to tap its natural resource potential, Timor-Leste must seek foreign expertise, capital, technology, and markets to launch and sustain investment.

[20] Starbucks recently launched a project to market Timor-Leste coffee in Washington D.C. and Australia under the country brand.
[21] World Bank financed niche market studies of palm oil, vanilla and shiitake mushroom under the ARP II Project.

4. Comparative and Competitive Advantages

The concept of comparative advantage is expressed by the dictum: “Nations should export goods and services that they can produce at lower costs then other nations, and import goods and services that they cannot produce at lower costs.“ Comparative advantage is based on a production model: lower production cost equals greater advantage. It also comprises resource endowments and natural conditions that form a basis for building comparative advantage and, eventually, *competitive* advantage. Competitive advantage is achieved on the basis of price or of product differentiation, which are usually mutually exclusive. Consumers are willing to pay a higher price for quality and unique products and services and unlikely to believe that lower priced products or services are of the same quality.

The Investment Opportunity Workshop held April 13, 2005 was the second workshop of USAID’s Resident Investment Advisor (RIA) program. The first built consensus on the value of private investment to Timor-Leste. In the intervening period, the government approved foreign and domestic investment laws and established the Investment and Export Promotion Agency (IEPA). The second workshop solicited the opinions of private and public sector representatives on the country’s comparative and competitive advantages by using strengths, weaknesses, opportunities, and threats (SWOT) analysis in a plenary session and in sector working groups (Exhibit 4-1). In articulating strengths and opportunities through public-private sector dialogue, the workshop helped counter the many studies that have focused exclusively on bad news and challenges for Timor-Leste, and built the enthusiasm necessary as the IEPA begins promoting investment in partnership with government and business.

Recall that comparative advantages are natural or consolidated characteristics that support private sector development and attract investment, while competitive advantages are attributes created for the same purpose. As shown in Exhibit 4-1, many perceived strengths may not be as well established or as accurate as workshop participants assume. Some opportunities, such as “heritage, tradition and diaspora” are also to be seen as comparative advantages. And some apparent contradictions exist; for example, climate was noted as a strength and a threat.

Exhibit 4-1

Summary of Workshop Opinions on Timor-Leste's Strengths, Weaknesses, Opportunities, and Threats

STRENGTHS

- Natural resources
- International goodwill from donors
- Strong leadership/vision in government
- Stable macro political-economy
- Public-private dialogue on development
- Sound national petroleum management plan
- Low labor costs
- Climate for specific agro-production
- Rich culture, political history, personalities

WEAKNESSES

- Inadequate infrastructure
- Enduring negative aspects or legacy
- Unavailable/unreliable economic data
- Small domestic market and income levels
- Centralization of government services
- High labor costs compared to competitors
- Unavailability of skilled labor
- Commercial legal framework unclear
- Multiple spoken languages
- High government taxes (excise etc)
- High transportation costs
- Wide trade imbalance
- Lack of recreation and social amenities for investors
- Weak financial sector (intermediation)
- High interest rates

OPPORTUNITIES

- Heritage, tradition and diaspora/CPLP
- New Nation -- Assimilate best practices
- New Nation -- branding opportunities/niche
- Trade agreements and market access
- Differentiating T-L from neighbors
- Converting weaknesses into opportunities
- Investment in infrastructure development
- Great potential in tourism
- New investment laws may open opportunities

THREATS

- Natural disasters and unfavorable climate
- Established regional brands (e.g., Bali)
- Lack of urgent attention to weaknesses
- Stiff economic competition from neighbors
- Cost of doing business
- Lack of attention to equitable growth
- Unfair competition from foreign investment
- Lack of consultation on future regulation
- High visa costs

SOURCE: *Investment Opportunity Workshop Plenary Session edited by Nathan Associates.*

Natural Resources. Timor-Leste's most significant strength or comparative advantage is its natural resources: offshore (and some onshore) oil and gas resources natural beauty that supports tourism, and fertile, underused land that can support the expansion of agro-industry. The country's climate and lack of pollution are also supportive of tourism and agriculture, including branding as an organic producer. Timor-Leste's economic growth will depend on careful management and exploitation of these resources (see Section 5).

Culture. Timor-Leste's "rich culture, political history and [charismatic, strong] personalities" are also a comparative advantage. A new, previously downtrodden nation, it boasts two Nobel Peace Prize winners and a rich culture dominated by Catholicism, unique in Southeast Asia. These advantages need to be developed and branded to achieve their full potential.

Labor Costs. Workshop participants saw low labor costs as a strength. Indeed, notional minimum wage levels are about $85 per month. But given the high-cost dollar economy—

largely the result of the extended presence of an international organization--wage levels are subject to upward pressure. And when adjusted for productivity, wage levels are far less attractive or viable for domestic or foreign businesses. One potential textile and garment investor from Thailand observed that Timor-Leste has extremely limited experience in light manufacturing sectors, and that productivity in greater Bangkok is probably three times higher. Because wages in Timor-Leste are unlikely to be lowered, boosting competitiveness will require improving skills, negotiating better (preferential) market access, and increasing logistical (infrastructure) and administrative efficiency.

Leadership and Vision. The government has shown strong leadership and vision, characterized by the personal involvement of the Prime Minister. It has passed investment legislation and established an investment agency. Even though these achievements have taken far longer than originally envisaged, the consultative process has created a shared vision and strong foundation for future investment promotion (e.g., witness the nearly unanimous approval of foreign and domestic investment laws in Parliament in April 2005). These achievements, however, merely signal that Timor-Leste is joining the competition for foreign investment. Vision and leadership must be sustained as the country engages and responds to foreign and domestic business henceforth. Leadership and vision is a competitive advantage.

Stability, Dialogue, and Petroleum Management. Workshop participants saw "stable macro political-economy," "public-private dialogue on development," and a "sound national petroleum management plan" as strengths. Though well founded, these strengths must not be taken for granted. Macroeconomic stability, for example, has been achieved with considerable foreign aid and budgetary support, and many potential investors will see the next elections as a test of stability. Public-private dialogue on development, especially investment, has been nurtured, but the real test lies in implementation. Regular dialogue, particularly in key sectors and on the business environment will be crucial, and potential investors will be watching how government reacts when disputes arise, as they inevitably will. And though strong, Timor-Leste's plan for managing royalties and revenues from oil and gas production will face many of the same challenges faced by other countries with similar plans.

Timor-Leste also has many opportunities or potential competitive advantages:

- Ability to leapfrog other nations or stages of development by assimilating best practices in administrative procedures or by introducing the latest technology. Timor-Leste already depends on mobile telephony rather than fixed-line communication, but now has the opportunity to exploit the potential of Internet communication. (Timor-Leste is in a position to invest in a simple but advanced Internet infrastructure whether through cables or wireless systems that has spillover effects for the entire economy, from agriculture to tourism and government.)
- Exploitation of natural resources to enhance competitiveness. The most direct example is the plan to install hydroelectric generation capacity that could meet Timor-Leste's needs three times over. With negligible marginal cost, this energy could help electrify

large areas of the country and provide uninterrupted and reasonably priced power to emerging industry. Typical charges of more than 20c/kwH constrain business growth and burden poor households that are on the power grid.

- Ability to build infrastructure, including hydropower plant, using financing options not open to many poor nations. Eventually, these options will include revenue and royalties from oil and gas operations, but in the interim concessional loans (e.g., IDA loans) and Millennium Challenge Corporation grants are possibilities. In a small country like Timor-Leste, such funding would have widespread benefits. Workshop participants saw private investment in infrastructure as a possibility but this demand is likely to be insufficient, whether in roads or electricity, to make this a near-term option.
- Ability to pursue niche market opportunities that would be inconsequential for large countries but would create jobs and have other good economic effects in a small country.
- Abundant and fertile agricultural land with potential for organic branding, a lead established by the coffee cooperative. Café Cooperativa Timor exports more than 60 percent of Timor-Leste's coffee—and coffee represents about 90 percent of non-service, non-oil/gas exports by value.
- Starting from an artificially low point in some agricultural and forestry products. Timor-Leste was once a major exporter of sandalwood and teak, principally to Indonesia, but many forests and plantations were exhausted before independence with no attempt at reforestation. Forestry could be restored given government attention and time.
- Poor country status and partner country goodwill that could lead to preferential trade arrangements.

Most of these are real or natural advantages. But advantages are also created. Consider positive investment incentives created through preferential tax treatment and more streamlined investment processing. Thus, Timor-Leste has inherited and created comparative advantages that will enable it to position itself more favorably as an FDI destination.

Because of its relatively small market, high production costs, and low labor productivity, Timor-Leste will have to produce for the export market. Competing with regional neighbors who have comparative advantages in cost and productivity will be difficult. Timor-Leste in fact lacks sufficient comparative advantage to compete on price, the most common approach, especially in Asia.[22] It must therefore compete on the basis of product differentiation and enter niche markets, as it has done successfully with organic coffee. To

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[22] Asian economies typically enter markets by producing low-price, low-quality products. Even Japan and South Korea used the price model to gain market entry. They then improve product quality in response to consumer demand, and by competing with countries that enter the market later and sell at lower prices. The automobile and electronic industries exemplify this pattern that drives innovation. Research on this model has focused on products and firms but the model true for countries as well.

the extent possible, differentiation should be the principal strategy of investment promotion.

To realize Timor-Leste's significant comparative and potential competitive advantages, the government must maintain economic and political stability, continue working with the private sector and civil society toward a common vision of economic development, and nurture vibrant businesses, whether domestic or foreign.

Some actions, such as improving infrastructure, will require significant financial resources or foregoing revenues (e.g., fiscal incentives to match regional competitors). Other actions are equally important but require fewer resources: raising skill levels, improving the efficiency and transparency of the business environment, and increasing public-private dialogue. Finally, the new IEPA will play a central role in mediating between government and the private sector, in listening to businesses and communicating their concerns to government, and in identifying new business areas and opportunities for government support through public policy and investment.

5. Potential of Economic Sectors

In Timor-Leste, identifying and promoting subsector investment opportunities must go hand in hand with improving the business environment, facilitating public-private dialogue, and devising a sector strategy. This is partly because of the concentrated pattern of activity in some sectors that have a record of competitive production, and the disparate pattern in other sectors, and partly because of investment decisions that must be made to boost basic skills and improve infrastructure. Consider, for example, the coffee subsector of agriculture. Coffee represented roughly $7million of Timor-Leste's $8 million of non-petroleum exports in 2004. Café Cooperativa Timor (CCT) was responsible for about 80 percent by value. CCT has 300 full-time and 3,000 seasonal employees. Almost 18,000 farming families are CCT affiliates. Even if non-CCT producers (40 percent of volume) have a proportional impact on full-time employment, the aggregate contribution of this major export industry on non-seasonal employment is limited. Thus, diversification and encouragement of derivative industries will be crucial.

Employment by Sector

Timor-Leste needs to create new employment in and beyond agriculture. About 15,000 individuals join the country's workforce each year, many with aspirations beyond agriculture now that Dili's 18 institutions of higher education institutions are beginning to produce graduates. Absorbing 15,000 new workers each year poses a modest challenge for most countries, but a major challenge for Timor-Leste.

Employment statistics in Timor-Leste are unreliable, and the treatment of part-time or seasonal agricultural workers is unclear. In a population of roughly 900,000 the workforce is estimated at 270,000, with about 220,000 in the farm sector and 50,000 in other sectors (manufacturing, agroprocessing, services, tourism). Government employs about 17,000. There is pressure to increase government employment, but major problems are lack of skills and underemployment, and the government intends to remain lean and efficient. Labor demographics and estimated employment figures by major sector groups are as follows:

- Farm sector—220,000 (2001 est. from PSD SIP)
- Non-farm sector—50,000 (2001 est. from PSD SIP)

— Tourism—1,300 (WTO investigations)
— Government—17,000 (GOTL, Draft Budget Paper, April 2005)
— Non-farm private sector (incl. NGOs)—33,000

Further breakdown of non-farm employment is difficult to come by, but these figures along with anecdotal evidence have several important implications:

- Employment in more efficient agriculture and expanded agribusiness niches will be crucial.
- Manufacturing employment, including from petroleum sector spillover, from a low base, especially with relatively low skill levels, cannot be relied on.
- Substantial net expansion of government employment should not be expected.
- Expansion of service sector employment, especially tourism, will be very important. Tourism can boost employment countrywide, especially for women, and services export receipts. Tourism resources are a major comparative advantage of Timor-Leste. Trading sector services employment will continue to be important, acting as a non-rural employment buffer for many, but the domestic consumption market will remain small (and probably shrink), and the sector adds little value.

GDP and Exports by Sector

A breakdown of economic activity by GDP contribution in 2003 (Table 2-1) confirms the importance of agriculture, forestry, and fisheries. The future contributions of other sectors will vary considerably. Construction, for example, contributed 24 percent to GDP in 2003, reflecting donor financing for reconstruction. The sector’s future contribution will depend on the government’s public investment decisions, which will be a function of the economic infrastructure development strategy and of emerging sector strategies.

The trade, hotel, and restaurant sector has been depending on and serving a large international community. When the UN presence declines substantially beginning in May 2005 this demand will need to be replaced by growth in a proper tourism and hospitality industry. Some pockets of activity and growth exist (e.g., diving) but the sector desperately needs a vision and strategy, and the government is working with the World Tourism Organization to devise one.

The contribution of the transport and communications sector is due in large part to the performance of Timor Telecom, which has a monopoly on fixed and mobile phone services until 2019. The performance of this sector notwithstanding, the braking effect of this monopoly and high service costs on the rest of the economy will soon be acute. Manufacturing contributes only 3 percent to GDP, and as the country moves out of reconstruction the sector’s future direction, other than possibly expanding to include agro- and fish processing, remains unclear. The government expects mining and quarrying (e.g., of precious metals) to contribute more to GDP; activity in this sector will pick up once the relevant legislation is in place.

Manufactured exports are heavily concentrated in processed green bean coffee, while tourism has some impact on services. According to the World Tourism Organization, tourism's contribution to GDP in 2003 was only about 0.5 percent or under $2 million, although it contributes to value-added in other sectors.

Sector Investment Opportunities

As expressed in the Private Sector Development SIP, the government believes that significant opportunities for private investment exist in construction, agribusiness, forestry and fisheries, petroleum and minerals, manufacturing and services, infrastructure, finance, and tourism. Each sector has its investment dynamics, but several represent derived demand or opportunities as already discussed. Private investment growth in Timor-Leste will be led by the agribusiness group and tourism in the near term (the petroleum sector in particular has its own dynamic), and by manufacturing and services to some degree.

Identifying specific opportunities in promising sectors has been limited and often contradictory in conclusions. The World Bank has conducted some feasibility and market studies for niche agricultural products such as vanilla, palm oil and shiitake mushrooms; and CCT has been investigating vanilla, candlenut oil, fast-growing teak, and other products. A detailed IFC report on coffee, candlenuts, coconut oil and vanilla, and tourism is forthcoming. Some feasibility studies for infrastructure projects, such as industrial zones and electric power generation, have also been prepared. The World Tourism Organization and SETAI have taken first steps for a master tourism plan. The nature of tourism development in Timor-Leste is evidenced by the 2004 tourism promotion budget of $10,000.

STRATEGIC PLANNING

Even with new investment laws and incentives in place, Timor-Leste will have to move carefully in promoting investment in sectors. Promotion needs to be treated holistically (e.g., improving the general business environment) and stress constructive engagement between public and private sectors and integrated approaches to development. Alongside traditional promotion, especially of sectors such as tourism or coffee, the IEPA will need to advise the government on workforce skills, domestic private-sector capacity, and public policy and public investment decisions (especially in infrastructure).

Because small-scale entrepreneurial initiatives can have a big impact in Timor-Leste, the government—through the new IEPA or domestic SME agency—needs to work with entrepreneurs to identify and develop niches on an ongoing basis. For example, even though prospects for coconut oil exports by one entrepreneur may not have been identified through an investment agency strategy, the agency and government still need to systematically support the growth of such niche products. For industries with clear potential but a limited record, the investment agencies need to facilitate dialogue between government and business to ensure that opportunities are identified and acted on, and that training, capacity building, and policy and infrastructure needs are met.

WORKSHOP OPINIONS AND INTERVIEWS

The Investment Opportunity Workshop articulated expectations for six sectors, and interviews provided additional suggestions on how to promote development in some sectors. Workshop participants produced SWOT matrices covering the following areas (matrices are included as Appendix E):

- Agriculture and agribusiness
- Oil and gas upstream/downstream
- Tourism
- Light industry/handicrafts
- Fisheries/aquaculture
- Finance/business services

Devising and implementing sector strategies and responding to entrepreneurial initiatives will require a systematic process. Addressing weaknesses and opportunities will likely require collaboration between government and private sector to build the foundations for growth (i.e., training, business environment improvement, policy, infrastructure) without which investment promotion will have little impact.

Agriculture and Agribusiness

Workshop participants saw the major strengths of this sector as being natural and eco-friendly cultivation, plentiful crop and animal varieties, and a reputation in coffee production. Weaknesses include inadequate transportation infrastructure, lack of management and marketing skills, low productivity, lack of awareness of quality, lack of modern equipment, lack of information about markets and strategic government policy, market access challenges, high utility costs, and lack of pest control systems. Significant opportunities are in organic branding, growing demand for organic products, preferential market access, previously underdeveloped agro-processing, and returns from strategic infrastructure investment. The main threats are climate, unfair overseas competition, and volatile commodity prices.

Rather than identifying opportunities for specific products, participants discussed the foundation that would allow opportunities to be realized. This implicit admission that investment will not materialize automatically signals the pressing need for systematic dialogue to prioritize investment in and policy for training, infrastructure, market access and information, and the pursuit of investment opportunities. Participants also understood that while the coffee sector has additional potential, diversification is critical.

Interviews suggested that opportunity for moving up the value chain beyond the green bean stage of coffee production is limited, and that better subsector performance would come from training more farmers to produce high-quality beans (i.e., increase volumes and yields). At the same time, the potential for small-scale derivative industries such as fuel briquettes, instant coffee from lower quality beans, and boutique final coffee production, is considerable. Such activities would require limited capital investment, and could be a focus of the national investment agency. As discussed later, better Internet access and infrastructure and market information training would help small businesses by improving their access to input and output markets.

Other agricultural niche products hold potential. Vanilla has possibilities, but worldwide attention to the value of vanilla, and periodic over-supply have caused a precipitous drop in prices. Thus, a rush into this commodity is not advisable. Shiitake mushrooms is another niche product investigated by IFC prompted by its potential use of coffee production by-products, but may only be attractive if potential buyers can be identified in advance. One entrepreneur, having identified a niche arbitrage market, has started exporting coconut oil. If market access negotiations are successful, these exports could expand and be followed eventually with value-added processing.

It is often difficult to identify agricultural niches in advance, but support for niche development through market access negotiations, broad agriculture-related infrastructure provision, and access to input and output market information will be critical. Furthermore, by reason of these products' arbitrage and niche nature, entrepreneurs may be unwilling to engage in planning and strategic efforts.

Fisheries and Aquaculture

Well-informed workshop participants were aware of the interest of several foreign investors in this sector, and the importance of understanding the scope of sustainable fishing resources before committing to licenses. The recently passed Fisheries Law attends to the interests of local fishermen by reserving coastal waters for them. The workshop demonstrated the potential value of sustained public-private dialogue and planning for this sector.

Sector strengths include the approved legislation and the interest of local and foreign businesses; weaknesses include lack of data on fish stocks, lack of infrastructure to support catching and processing, inconsistent quality, and lack of a credit program to support small-scale activities. Threats include the possibility of not properly managing the environmental dimensions and intensity of activity in the sector. Downstream fish processing also offers a variety of opportunities that could locate in industrial zones and, with quality improvement and foreign investment, enter high-quality export markets.

Tourism

The tourism sector employs only 1,300 people and contributes only 0.5 percent to GDP, but could add significant value-added to related industries and offers vast opportunities for more equitable growth across the country and across genders. Sector strengths include the natural range of tourism products, the country's status as a "new destination," its unspoiled facilities, and friendly people. Favorable location and multilingual population were also mentioned, but Timor-Leste's remoteness is also a disadvantage. Multilingualism is not necessarily an advantage, but English language skills could be made a part of hospitality training. Weaknesses include inadequate infrastructure; lack of skills, training, and government support; significant bureaucratic barriers to operators; lack of emergency medical care; health and hygiene concerns; and being unknown in the tourism industry.

Growth has been erratic, and the industry operates far below its potential. Dili has hotels of varying quality and about 400 rooms; the rest of the country has perhaps 100 rooms. Demand is mostly from donors and UN personnel and visitors. Tourism activity has focused on diving, as Timor-Leste is recognized as one of the world's top diving locations. Potential for other niches is vast: religious tourism; "surf and turf" activities, including horseback riding or mountain biking; historical or cultural group tours; and ecotourism. Entrepreneurial operators have begun considering new overseas markets, such as Japan.

The main challenges for the industry are high costs, poor service and skills, poor infrastructure, and the lack of strategy. Lack of training was the most commonly cited weakness. Given that the country's beauty is the sector's primary resource, the industry must grow in a sustainable manner that protects that beauty. Tourism could support numerous small-scale businesses and jobs, including ferry services, souvenir manufacturing, boutique and rural hotels, and after-diving activities.

The government is developing a comprehensive tourism strategy with the WTO, and such a strategy will be essential in dealing with these opportunities and challenges effectively and efficiently. The strategy should emphasize the country's strengths, such as those identified in the workshop; consider the type of tourism that Timor-Leste wants; aim to cultivate external marketing activities using existing operators as much as possible; develop the country's international image in a coordinated fashion; and include a tourism infrastructure strategy. It should also provide for

- An strong, inclusive tourism association as an effective counterpart to government, as well as a Tourism Steering Committee of government leaders and an IEPA representative. A proactive, high-level steering committee will ensure broad participation in the association.
- Regular public-private dialogue, with the IEPA or other body acting as secretariat.
- Development of small, replicable employment-generating projects.
- Training and skills through a dedicated institute (this may need to be subsidized).

Light Manufacturing and Handicrafts

Workshop participants offered few opinions on the light industry and handicraft subsectors, reflecting their lack of experience or awareness of possibilities or constraints in this area. The broader textile and garment niche, for example, beyond the local *tais* and its cultural status, were not mentioned even though potential investors have visited Timor-Leste.

Interviews raised the possibility of import substitution sectors in concrete and other building materials, furniture, and other products, some of which could lead to exports if skills, quality control, and market access were improved. Interviewees also provided anecdotal examples of entrepreneurs supplying furniture to a few local and foreign customers. Encouraging such activity will depend more on improving the general business and exporting climate for small business than devising an investment promotion strategy around the niche.

Feasibility studies for industrial zones have not gone beyond analyzing the potential of fish and other agro-processing. A second feasibility study may attempt to engage government and industry on what industry might locate in a zone and how to encourage it, rather than merely focusing on zone design for a certain industry.

Sector stakeholders need to institute dialogue to develop a vision and strategy. If current options are limited, a working group could decide that public policy should focus on training and small-scale cottage industries. At the same time, it may be possible to kick-start certain light-industry niches as the Investment Department and the new IEPA receive enquiries from potential investors. The government and the IEPA need to blend these approaches.

Financial and Business Services

Financial and business services will grow as the business environment improves and as entrepreneurial activity grows. In due course, demand for small business services such as accounting and marketing should grow. In the meantime, Timor-Leste could develop related skills through vocational training. Various microfinance initiatives and financial sector initiatives are being implemented, and the workshop did not focus on this sector.

Investment Impact by Location

In identifying locations suited to various types of investment, we assume balanced development in the country and consider geography, natural resource endowment, and existing or potential for infrastructure development. Identifying types of investment by sector has implications for infrastructure development (Table 5-1). Consider the cases of Oe-Cusse and Ataúro.

Table 5-1
Sectors and Possible Locations in Timor-Leste

Sectors with Investment Potential	Possible Locations
Agribusiness and forestry	South and Southeast
Fisheries	South and Northeast
Tourism	North and Northeast + Ataúro and Oe-Cusse
Light manufacture	Northeast and South
Financial and business services	City of Dili
Economic infrastructure	Throughout, but mainly in Dili District, Northeast and South
Oil and gas upstream and downstream	Dili District and South

By constitutional mandate, Oe-Cusse and Ataúro are accorded special administrative and economic treatment. Investment incentives under the domestic and external investment laws also accord longer periods of benefits for these two areas. But the lack of economic infrastructure, communication, and public utilities will likely deter investment for at least the next few years. While Ataúro's isolation and economic development are not difficult to overcome given its proximity to the Dili, the socioeconomic development of Oe-Cusse presents a challenge, especially because it as an enclave in West Timor. In fact, ensuring the economic viability of Oe-Cusse may require a radical departure from traditional FDI. Asian investors have asked informally about the possibility of regulated gambling. The prospect of regulated gambling in Timor is not new, and was entertained before 1975. Some assert that Stanley Ho, gambling tycoon born in Timor-Leste, built the Timor Hotel with gambling in mind. The possibility of gambling has been raised only informally for fear of offending the government. In addition, recent positions taken by the Catholic Church in Timor-Leste[23] make raising the subject of regulated gambling unwise.

Tourism and fishing are investment options for Ataúro and Oe-Cusse, including livestock raising in the latter, but a radical and rapid development track for these two areas must be devised. The development of Ataúro should be contemplated in the context of the greater Dili, with tourism, fishing, and gold mining as strong possibilities. Oe-Cusse could be made a free trade zone if doing so would stimulate rapid development and have a positive effect on general development.

Conclusion

Investment promotion and business environment improvement in Timor-Leste should focus on the agriculture, agribusiness, and tourism sectors, especially to enable equitable

[23] In an agreement recently signed between the two Bishops and the government in the aftermath of the three-week long Catholic Church-supported public demonstration against the government, the Church's position on religious education, abortion, and prostitution were made very clear,. The current that preceded the agreement was moralistic in tone and the Church vows to exercise its influence in shaping a morally conservative society.

growth and employment. In the short term, few non-farm industries outside of agro-processing and tourism are likely to generate the amount of employment Timor-Leste needs.

In these broader sectors, some larger investors may identify business opportunities, but many small businesses will emerge in response to an improved sector-level environment, including infrastructure provision and training. An improved environment will support employment generation over the medium and long term.

In addition to establishing public-private dialogue, improving business environments, and advising on public policy and investment, the IEPA will be responding to external investor interest. Here, traditional investment promotion becomes more than introducing new investment legislation and accompanying incentives. The IEPA will

- Help investors understand the laws and incentives;
- Gather information about suppliers for investors;
- Identify and work to improve skills and capability gaps with the government;
- Help advocate for infrastructure improvements;
- Encourage and facilitate public-private dialogue to identify and resolve problems and respond to opportunities.

The workshop highlighted strengths, weaknesses, opportunities, and threats in the broader business environment. Enduring needs include the need for infrastructure improvements and reliable utilities; the need for high-quality but practical private-sector training, especially in the hospitality sector, in light-industry, and in agro-processing and business; and the need to train government officials and raise the quality of the public-private administrative interface. At present, public-private dialogue that includes enthusiastic officials, business associations, and key individuals is lacking. Because such dialogue is not viewed as a strategic mechanism, industry representatives often do not participate in associations. Here, the IEPA can be helpful in setting a new tone.

6. Domestic and Foreign Direct Investment

Domestic and foreign business and investment need to be stimulated in tandem in Timor-Leste as part of integrated sector development strategies. In fact, Timor-Leste needs lots of investment—domestic and foreign. Recent growth in lending by the main bank consists largely of short-term loans for housing or trade financing, while anecdotal evidence suggests that clearer and enforceable land-titling would open the way for foreign joint-venture equity capital. Long-term domestic credit is still rare.

Long-term capital is a major benefit of FDI, but unique benefits lie in its package of management expertise, technology, and ready-made market access for export-related investments. These benefits can have significant spillover effects on the host economy, assuming a certain level of existing development. Timor-Leste, however, needs to develop its sectors from a very low base, almost from scratch. All sectors need policies, development strategies, and improved infrastructure and workforce skills. Thus, with the exception of some low-level trading and retail activities, foreign investment will not be competing with Timorese industry. The country's new investment legislation may help mitigate the perceived risk of detrimental competition, but vested interests should not be able to use that risk to drive away desirable foreign investment.

To avoid detrimental effects, the risks of FDI needs to be understood. New, large investments where policies are weak are immature carry risks such as environmental overload, over-fishing, enclave investments, and too-generous concession periods for natural monopolies. The potential benefits of FDI also need to be understood. For example, it is rarely effective to force linkages (e.g., through local content requirements or joint ventures), even if a country has compensating attractions. Links to the local economy need to be generated naturally, for example, by identifying infrastructure needs that serve the industry rather than particular companies, by designing training programs jointly, and raising the quality of local suppliers and service providers. If FDI's risks and benefits are not understood, FDI may be blamed rather than poor planning or supervision.

The full benefits of FDI also depend in part on the absorptive capacity of the host economy. Foreign investors seek locations that have an optimum "gap" between the technology or sophistication level of domestic industry, suppliers, and workforce and the investor. If the gap is small then the host economy may not need the investment; if it is too large the investment will either not materialize or become an enclave that does not embed or provide spillovers. Absorptive capacity increases over time, but it needs to increase faster than the technological sophistication of target investors. Host-country governments and industry can help raise capacity by developing the workforce. Timor-Leste can help optimize the gap by focusing on sector development strategies.

International Experience with Linkages and Spillovers

FDI offers attractive benefits to developing countries: technology transfer, market access, managerial expertise, investment capital, tax revenue, and new and better jobs.[24] These benefits may be limited to foreign affiliates or may spread to the general economy. Linkage effects boost the productivity and competitiveness of the domestic suppliers of a multinational affiliate, preparing those suppliers to compete outside the network of the multinational. But such direct effects are often not large or sustainable for many reasons:

- A foreign investor will eventually want to get more out of an investment than it puts in;
- Foreign investments provide only limited direct employment;
- Tax revenues are often foregone for long periods because of incentive packages;
- Trade surpluses from an investment are limited when inputs are imported, and the net benefits are even more limited if affiliates borrow within the multinational's network at relatively high rates, or pay substantial royalties; and
- Technology used by investors is often relatively old, especially when joint ventures are forced or local markets are serviced behind protectionist barriers that relieve investors from the need to competitive.

In contrast, spillover effects indirectly boost productivity and competitiveness in the broader economy. Spillovers have long been seen as the main benefit of FDI—and justification for large incentive packages.

GENERATING JOBS, REVENUE, AND INCOME IN THE BROADER ECONOMY

FDI can generate jobs, fiscal revenue, and individual income. These direct effects often produce a strong multiplier or indirect effect. For example, jobs, tax revenues, and income among suppliers, wholesalers, transporters, and retailers are many times the level that can be traced directly to the investment.[25] The World Tourism Organization, for example,

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[24] For a summary of the linkage effects see UNCTAD, *Foreign Direct Investment and Development*, (Geneva: United Nations, 1999), pp.18-27 & 33-42. For an overview of linkages and supplier development by multinationals, but with little analysis of their success, see UNCTAD, *World Investment Report* 2001 (UNCTAD: Geneva, 2001), esp. pp. 127-62 (pp.134-5 offer a brief impact assessment).

[25] Multiplier effects of foreign direct investment vary by industry and by country, and few studies of this effect have been undertaken, but sophisticated modeling of the indirect impact of FDI by The Coca-Cola Company in a variety of developing countries, ranging from Morocco to South Africa to Romania to

found the employment multiplier for tourism to be around 20 times in many cases. The beneficial effects of FDI are found across all sectors. In natural resource industries, FDI often creates foreign exchange revenues. In manufacturing, it can bring developing countries into the production chains of transnational enterprises and gradually promote them up the chain. Taiwan began by making computer peripherals such as hard disk drives then advanced to producing laptop computers. FDI also can bring superior management and efficiency to service sectors, stimulating the rest of the economy. In Zambia, a single international hotel investment near Victoria Falls has revitalized the region's tourism industry.

TRANSFERRING TECHNOLOGY AND MANAGERIAL SKILLS

FDI brings new technologies to developing countries. These technologies are diffused through "vertical" linkages between foreign investors and local suppliers. Foreign-owned enterprises also provide suppliers with technical assistance and training that improves product quality and production efficiency. In China, the Coca-Cola Company sources 98 percent of inputs used in its bottling plants locally. To raise the quality of those inputs, the company provided technical assistance to manufacturers of glass and plastic bottles, aluminum cans, and sugar. One supplier of plastic bottles followed the company to each new bottling line and now supplies Coca-Cola country-wide, growing from a single 20-person enterprise to a complex of three dozen factories employing 5,000 workers and exporting throughout Asia.[26]

STIMULATING LINKAGES AND SPILLOVERS

FDI can boost private sector development, but assuming that growth is automatic leads to disappointment and a backlash against investment. To avoid this, developing countries need to think carefully about the role of FDI and maintain a dialogue with the business community. Governments should have the answers to some critical questions as they embark on an FDI strategy:

- What is our national development strategy and which sectors are most important?
- How can FDI help develop those sectors?
- How do we attract FDI and use it to stimulate the domestic economy?

Such a systematic approach clarifies investment and sector policy and identifies where the economy can benefit the most from FDI, including small, low-profile activities. It also helps government decision makers understand the needs of local industries (e.g., information, production technologies, training).

China has found that employment multipliers range from 10 to nearly 30 indirect jobs for each direct job resulting from FDI; tax revenues and national income multipliers can be up to three times the value of the direct investment. See Woodward, Douglas, Lin Justin, and Ping, Xinqiao, "Economic Impact of the Coca-Cola System on China," August 2000.

[26] Op. Cit., pp. 58-60.

Governments have sometimes helped build local workforce skills, the absorptive capacity of local firms,[27] and industrial and export infrastructure. Such efforts have focused on particular sector entry points. They have also used zones to cultivate linkages between domestic and foreign companies, and to improve worker skills. Successful zones boast some combination of the following:

- ***Superior infrastructure***. This includes superior IT infrastructure, high-quality utilities, and sometimes leased production facilities, often focused on a particular sector (e.g., refrigerated warehousing facilities).
- ***Streamlined administration***. Business formalities are simplified in zones, especially if privately managed (publicly managed zones tend to be less successful).
- ***Financial and fiscal incentives, including duty exemptions***. Zones depend heavily on financial and fiscal incentives, including subsidized land rental costs.

Present and Potential Linkages and Spillovers in Timor-Leste

Few linkages between FDI and the domestic private sector exist in Timor-Leste. This is partly because of the limited amount of FDI, but also because strategies and plans have not tapped potential. The banking sector can help generate linkages by providing smaller loans to businesses that will supply larger and foreign companies; representatives should be consulted for sector development strategies.[28]

AGRIBUSINESS

The agribusiness sector has no foreign investment *per se*. CCT, the principal exporter, is supported by U.S. technical assistance that has driven Timor-Leste's coffee into export markets. The linkage effect of such activities is clear: CCT has 300 direct employees, 3,000 seasonal workers, and supports 18,000 farming families. Spillover effects on the development of derivative industries using byproducts have not been realized, whether through lack of entrepreneurial interest or financing, inappropriate skills, or limited awareness of opportunities.

Though much growth will come from local entrepreneurs or cooperatives with the help of technical assistance, foreign investment interest in palm oil and the fisheries sector exists, the latter promising downstream linkage as well as direct and indirect employment upstream. Other opportunities may emerge as Timor-Leste's reputation increases. In addition to fielding enquiries, the IEPA needs to learn about agribusiness skill levels and supplier capacity so it can advise the government on training or infrastructure needs, on

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[27] A key finding of Borenzstein *et al* is that linkages and technology transfer are dependent on a "threshold stock of human capital". See, Eduardo Borenzstein et al, "How does Foreign Direct Investment Affect Economic Growth?" *Journal of International Economics* 45 (1998), pp. 115-35.

[28] We do not examine petroleum upstream and downstream linkages as theyhave peculiar needs and dynamics that warrant separate examination in conjunction with existing investors.

trading arrangements needed to render agribusiness activities viable, and on marketing the Timor-Leste brand (e.g., niche organic opportunities).

The IEPA, in conjunction with the domestic investment agency, needs to scout for small investment opportunities related to existing agribusiness or tourism operations. For example, what existing foreign businesses might consider producing water in small bottles? The ubiquitous small bottles are all imported mostly from Portugal. CCT has pointed out the potential for niche, coffee-based derivative operations such as roasting and packaging, or instant coffee production. Such investments require little capital, and may be opportunities for small entrepreneurs with technical assistance, or for larger investors looking for business sidelines. Such ventures, with their linkages and spillovers, can have a substantial impact in a small country like Timor-Leste.

INFRASTRUCTURE

Infrastructure investment, whether publicly or privately funded, holds significant linkage and spillover potential beyond the construction phase and can lay a foundation for diverse entrepreneurial activity. Timor Telecom is the country's major infrastructure investment with private involvement. The company supports numerous telephone card hawkers as well as Internet cafés. But as the cornerstone of rapidly modernizing economies, IT infrastructure investment offers linkages and spillovers far beyond these.

Timor-Leste has an opportunity to leapfrog several stages of development and begin exploiting IT and Internet potential. Competition for providing Internet telephony and other services, and other mobile telecommunications, would reduce costs and produce village phone-provider entrepreneurs. This would open opportunities for rural farmers to obtain accurate price information and initiate trade with urban areas; it would allow more sophisticated entrepreneurs to obtain information on overseas input and output markets at reasonable cost; and it would spawn many more Internet cafes because of the expanded market. In addition, upgrading electricity generation and distribution would provide construction jobs, but more important, provide rural communities access to uninterrupted power, allowing new businesses to flourish, as well as social, educational, and business activities to occur at night. It would also reduce the barriers to business entry by reducing costs. The spillover effects of improved IT and electricity infrastructure are enormous.

Though more expensive and long term, improvements in road infrastructure could have huge social and economic benefits and spillover effects. Improved or new roads would open more of Timor-Leste to large-scale agribusiness and other opportunities; enable processing or other light manufacturing activities; and create opportunities for tourism. Improving maritime infrastructure could confer some immediate benefits. The World Tourism Organization's assessment suggests that coastal transportation is a cost-effective way to improve access to potential tourism sites. In any case, coastal transportation needs to be improved to better service the Oe-Cusse Enclave and Ataúro Island. Moreover, tourism needs to grow gradually and sustainably to avoid environmental overload and threats to natural beauty. Road construction from a tourism perspective would require very rapid growth to justify costs. Coastal transport allows better control of traffic volume, and easier, transparent collection of a tourism levy to support the spending necessary to make tourism sustainable in rural communities.

ZONES AND MANUFACTURING

Timor-Leste does not have a manufacturing base beyond production of handicrafts, furniture, and concrete building materials. Nor does it have commercial or industrial zones. Thus, future manufacturing will locate either close to production (if possible and with adequate utility provision) or commercial zones that have adequate and uninterrupted utilities and good physical communications infrastructure. Coffee bean processing occurs in central Dili— not ideal as the plant suffers from regular brownouts. Such processing naturally gravitates toward a commercial zone close to a port. In the future, such a zone might be located near Hera, while locations more distant from Dili would need careful justification (perhaps related to fish processing).

Timor-Leste is revisiting plans for a commercial zone strategy with the assistance of the World Bank. Timor-Leste should aim for zones that have superior infrastructure and streamlined administration, preferably privately managed. Zones in rural areas will need to be justified carefully on the basis of fishery-industry benefits or of agro-processing that cannot be done close to production or closer to Dili. Locations close to Dili would be desirable in the short term given that Dili Port will probably need to be relocated or expanded anyway. In addition, Timor-Leste should consider establishing an IT-ready park to attract services investment and to support manufacturing. There are clear advantages of having these two types of park close to each other, if not co-located. Linkage, spillover, and training considerations should all figure in zone design.

TOURISM

The tourism industry in Timor-Leste directly employs 1,300 people, including expatriates and overseas workers. Many more are employed in restaurants and other support establishments, but much demand has come from the rapidly declining UN presence. UN personnel and their visitors have easy access to transport so demand for overland tour operators is low. Timor-Leste's economy already benefits from some tourism linkages and spillovers to domestic business, but the impact is vastly below potential.

Small-scale diving is the main tourism activity in Timor-Leste. Do-it-yourself snorkeling or sophisticated dive-training both require trained overseas instructors to be brought in. The potential diversity of tourism activities in Timor-Leste is vast: small package tours for religion, cultural sightseeing, flora and fauna, ecotourism, and so on. These activities—from simple souvenir selling to sophisticated ecolodges—all have substantial spillover and linkage effects.

The sector's mixture of local and foreign investment is due partly to restrictions on foreign ownership of land. Nevertheless, investment from both sources could increase significantly with (1) a good sector strategy, and (2) clearer land ownership rules for key tourism areas (without clear ownership domestic as well as foreign investors will hesitate to invest in high-quality facilities). A healthy, sustainable tourism industry will produce substantial linkage and spillover benefits in many different parts of the country. Immediate steps for building the industry are as follows:

- Establish a strong and inclusive tourism association with an accompanying mechanism for public-private dialogue on strategy,
- Prepare a sector development strategy, and
- Step up tourism and hospitality training at new dedicated institutions or in conjunction with universities.

Conclusion

In addition to attracting FDI, Timor-Leste needs to develop linkages between larger and smaller domestic businesses. The country's two leading sectors, agribusiness and tourism, have naturally large linkages and spillovers. Sector development strategies need to tap the potential for linkages and spillovers, effects which are also to be had through (1) branding strategies implemented in conjunction with sector strategies and lead investments, and (2) public or private investments in economic infrastructure, such as electricity and IT. Local content requirements are unlikely to be effective in Timor-Leste given the low skill levels and low absorptive capacity of domestic industry—a capacity and skills building strategy is required instead.

Once strategies are underway the government can help by promoting training and skills development. For even the most basic skills, skill volume and quality need to be increased. Good combined business management and technical training institutions are needed alongside the Business Development Center program. During development and implementation of sector strategies, strong business associations and accompanying public-private dialogue will be crucial. Here, the IEPA, as well as the domestic investment agency, will be important.

7. Investment Challenges

Timor-Leste faces many challenges in stimulating private investment. It needs to create an environment conducive to investment—with sound regulations, physical infrastructure, trade policy, public-private dialogue, and a skilled workforce—while preparing to compete against neighboring countries in attracting investment. Indeed, after much planning and consultation Parliament has passed foreign and domestic investment laws, and the Investment and Export Promotion Agency (IEPA) is now established. The following also must now occur:

- Reform procedures governing starting, locating, and operating a business.
- Prioritize social and economic infrastructure needs, especially in relation to sector development strategies.
- Implement appropriate land use and commercial zone strategies.
- Cultivate public-private dialogue.
- Develop a trade policy that identifies preferential market access arrangements and strengthens links with trading partners.
- Promote foreign and domestic investment through the IEPA.
- Promote skill development and improvements in local industry performance, with priorities driven by sector strategies.

Regulatory Environment

A sound, easily navigated regulatory environment is fundamental to attracting investment. In Timor-Leste experience with administrative procedures varies widely, ranging from the smooth to tortuous. Many local investors or long-term residents are accustomed to obstacles, and so view poor infrastructure and the financial costs of doing business as more troublesome. But for investors that Timor-Leste has yet to attract, difficulties with administrative procedures need to be addressed. Bureaucrats seem unaware of regulations; regulations are frequently changed or reinterpreted without warning; and many procedures must followed in sequence rather than in parallel. Here, guidebooks on procedures can be helpful, along with “one-stop-shop” roles of the investment agencies. In addition, inconsistent and confusing implementation of laws is a source of complaint. Improving implementation will require raising the capacity and skills of civil servants in the long term and improving and automating core procedures (e.g., registration) in the short term. Contentious cases need to be dealt with expeditiously. For foreign investors the IEPA will play a crucial role in this regard.

VISAS AND THE LABOR MARKET

While short-term business visitors and tourists encounter few problems, several investors have been frustrated by problems with working visas and other immigration procedures. Few investors expressed frustration with hiring or firing procedures, and the labor market seems flexible. The relatively high cost of labor and low productivity, however, are major concerns.[29] One potential small-scale textile and garment investor holds that wages of $90 per month are comparable in Bangkok and Dili, but that productivity in Thailand is probably three times higher.

BUSINESS REGISTRATION AND INVESTMENT APPROVAL

Business registration and accompanying tax registration in Timor-Leste define whether businesses are in the formal sector, and constitute the first procedure that many new investors encounter. For some the procedure has been simple, for others extremely difficult. Improvements in registration are being planned. Simple automation could bridge the skills gap but this may be difficult to implement. Nevertheless, registration reform is a priority, along with other statistical functions of government, and is likely to be supported by preparatory monies from the Millennium Challenge Account (MCA). Approval of investment and incentives will soon become a function of the IEPA. The procedures are probably more complex than elsewhere, but the government promises that they will be smooth; investors will soon be able to judge firsthand.

Though not investigated for this assessment, procedures related to business operations—tax payment, customs, periodic licensing, inspections—seem distorted by arbitrary decisions, especially decisions relating to customs.

LAND AND CONSTRUCTION

As in many post-conflict countries, land issues in Timor-Leste are a problem, but wholesale improvement is a long-term agenda. Much foreign investment requiring real estate and significant capital will not come to Timor-Leste if clear title is not available. Though the many land-related disputes stuck in the courts suggest a chaotic state of affairs, some suggest that much land does have acceptably clear title.

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[29] The World Bank will be conducting a labor market study in mid-2005. This will provide additional detail, although the main challenges are already clear.

Because Timor-Leste is seeking to develop commercial zones and tourism areas, land registration in those areas must be clarified in parallel to clearing the backlog of court cases. Though not investigated for this assessment, construction procedures also pose problems. Construction procedures for target investment areas, such as commercial zones, need to be simplified, even if doing so means making exceptions.

Infrastructure, Utility Provision, and Zones

The inadequacy and high cost of infrastructure and utilities are barriers to investment in Timor-Leste. Expensive and inadequate electricity and communications infrastructure poses huge social and economic costs, while transportation costs erode business viability and raise the general price of goods. At this stage in the country's development, infrastructure investment is likely to be funded by government or donor institutions. In contrast to other small, young countries, Timor-Leste can turn to natural resource revenue and donor support mechanisms to improve social and economic infrastructure. Potential funding mechanisms include

- ***IDA Concessional Funding***. The government has so far chosen not to mobilize this funding even though Timor-Leste qualifies and even though the loan principal would become due conterminously with strong revenues from Timor Sea resources.
- ***Petroleum Fund***. It may be possible by parliamentary vote to use Petroleum Fund monies for projects that have substantial social and economic benefits (e.g., hydro-electric power generation and rural distribution).
- ***Millennium Challenge Corporation***. The government may well qualify for MCC funding in the next two years, acquiring access to funds that could have a substantial impact.

ELECTRIC POWER GENERATION AND DISTRIBUTION

Timor-Leste has major power generation and distribution problems. Power cuts are regular and many rural areas depend on generators. As a result of high oil prices and sub-optimal generation, electricity charges exceed 20 cents per kilowatt hour. This is a critical cost factor for many manufacturing and service industries, and makes power too expensive for rural users and entrepreneurs. A major hydropower project or several, smaller options could supply more than 250 percent of Timor-Leste's current demand, allowing for substantial commercial growth as well as exports. Such projects have enormous social as well as economic potential.

COMMUNICATIONS INFRASTRUCTURE

Timor-Leste needs to improve quality and reduce costs in the telecommunications sector to avoid falling further behind competitors and placing unsustainable burdens on business. Internet-related infrastructure is a strong candidate for public investment given its benefits to all economic sectors. Potential benefits of improved infrastructure and reduced costs include

- Access for small entrepreneurs to enter and download market information;
- More involvement in tourism, including by smaller service providers;
- Increased viability of business operations thanks to reduced costs;
- Increased demand and revenues; and
- “Natural” IT skills training of many individuals, and increase in Internet café’s and other small service sector businesses.

Although all landline and mobile phone services in Timor-Leste are provided under a 15-year contract with Timor Telecom, the government needs to bring competition to communications and reduce prices. Timor-Leste is in a position to exploit the latest advances, such as satellite broadband, internet telephony, and “hotspot” technology. The exclusive arrangement with Timor Telecom does not cover Internet services, but only Timor Telecom has been issued an Internet license. Timor-Leste needs to encourage and license multiple providers if existing contracts and laws allow it, and should develop a spectrum policy that permits diversification of wireless communication technology (e.g., Indonesia has different systems using different spectrum frequencies). Timor-Leste might consider setting up an IT-intensive zone or park, and using concessional funding to build this basic infrastructure.

ROADS, ZONES, AND PORTS

The extremely poor state of transportation infrastructure, especially roads and ports, in Timor-Leste is a great concern to businesses and investors. Sector as well as social priorities should guide the necessary master planning, which needs to take into account a number of factors. For example, road construction and maintenance is extremely expensive, especially if traffic volume grows slowly. The annual cost of maintaining Timor-Leste’s road system is an estimated $30 million, but current spending is only $8 million. Road quality is likely to continue deteriorating. A maintenance and expansion strategy should take into account rural and agricultural investment opportunities, and consider a coast-to-coast road and a better or straighter road from Dili to Baucau.

Many agricultural products are transported in smaller bags before being loaded into containers that require better roads and larger trucks at central locations (e.g., coffee is not containerized until it arrives in Dili). Containerization can happen at the exit port or at other road-serviced destinations such as the envisaged industrial zones. Roads typically represent a better social and economic investment than over-provision of port facilities.

Many tourists, however, are happy to travel poor roads if natural beauty at the destination is rewarding. In addition, much-improved roads may create surges in activity that the tourism location cannot absorb, but must absorb to recoup the costs of road improvement! Many coastal destinations can probably be reached efficiently by sea. For small groups of coastal and diving tourists, maritime transport may be a viable and lower-cost alternative, especially since passenger jetties are at coastal locations. Ferries make it easier to collect a visitor tax to destinations that would be used to maintain tourist assets. Ferries will in be required for goods and passenger transport to Oe-Cusse and Ataúro, as well as for tourism excursions to Jaco and other small islands.

Efficient port operations and deeper water ports will be important as Timor-Leste exports more agricultural and industrial goods, and the port in central Dili will become inadequate. Investors and exporters will expect better and larger facilities. Given the current small-scale of industrial activity in Timor-Leste, a port strategy should be considered in parallel with the expected development of commercial zones. Efficient port and maritime transport infrastructure will be crucial to Timor-Leste's productive and tourism industries.

Recognizing that many economically successful countries have used zones, Timor-Leste is commissioning its second zone feasibility study. All zones offer some combination of superior infrastructure, dependable utilities, incentives, and a simplified regulatory environment. The first feasibility study considered sites in Vemasse and Lautem, and Hera Port has also been considered.

Public–private Dialogue and Business Associations

Apart from discussions of legislation, systematic interaction between government and business has been limited to engagement of individual business people or loose business associations with government officials on the policy front. On the subject of business procedures government and business have little understanding of mutual concerns and problems. The Investment Opportunity Workshop contributed to constructive public-private engagement, as did the dialogue that characterized the preparation of investment legislation.

Now that the legislative framework for investment is in place, public-private dialogue needs to be systematized around sector strategies. Stakeholders will vary according by sector, but both the foreign and domestic investment agencies should help build linkages between domestic and foreign businesses. For sectors where FDI is involved, IEPA must play a central role. Tourism and agribusiness are strong candidates for systematic dialogue. Timor-Leste, however, lacks a strong tourism association. The loose grouping of operators does not include many key players, and domestic operators have their own group. In agribusiness, domestic entrepreneurs are most important, alongside the CCT and its technical advisers. An agribusiness public-private strategy dialogue needs to consider issues such as infrastructure, external trade opportunities and needs, as well as investment opportunities.

Timor-Leste has several loose national business groups that often gather to discuss issues of common concern, and sometimes interact with government officials. While this is unlikely to change, the IEPA should make seek to engage regularly with these groups to hear their concerns and scout for new investment opportunities. For foreign investors generally the IEPA must act as a channel of interaction between business and government, above all in ensuring the smooth operations of existing businesses.

Trade Policy

For a small country like Timor-Leste, where much foreign investment will focus on exports of goods or services, trade policy is an important dimension of investment promotion. It should address

- Export promotion and diversification,
- Border trade promotion and management (with Indonesia),
- Incentives for export-oriented investment, and
- Membership of regional and international trade groups as well as bilateral preferential arrangements for key export markets.

A study of trading arrangements and needs is underway, but a more systematic analysis and a capacity-building program will be necessary. Timor-Leste's ability to secure preferential trade arrangements will boost its attractiveness as an investment location. In some cases, this may be driven by niche market activity in Timor-Leste. For example, one local entrepreneur was able to ship virgin coconut oil to Australia duty free. A similar duty-free arrangement, with other countries—such as Thailand where customers are already identified—would increase production significantly. Given the close relationship between trade and investment in Timor-Leste, the IEPA is also responsible for trade promotion, and will need to engage in these issues.

Skill Development and Domestic Businesses

Upgrading the skills and absorptive capacity of the domestic workforce and business community is an urgent priority. Many education institutions have sprung up or been reenergized since independence, but training needs have not been prioritized; small business, IT or hospitality skills are in very short supply. The tourism industry has one training institution with 30 students per year on a three-year course and no training facilities before a three-month residency. Thus, most tourism training is conducted on the job by investors in the hotel subsector. This situation could be improved easily. Vocational training requires fewer financial resources than infrastructure investment, and the international community would probably be keen to support well-designed, pragmatic training. Training strategies should be designed alongside sector strategies and should complement them. Improving skills will help breed home-grown business and attract higher-quality foreign investment. As the domestic business community expands it will attract and benefit more from the presence of foreign investors. Government investment in economic infrastructure will also stimulate local business, especially if accompanied by targeted vocational training, especially in the IT sector.

Investment Promotion and the IEPA

Investment promotion in Timor-Leste will be a multifaceted task, and the IEPA will play a central role. Investment promotion includes traditional functions as well as approval of investments and incentives, and participation in public-private dialogue and sector strategy implementation.

- ***Public-private dialogue.*** IEPA will facilitate dialogue that will have as its aim improving the business environment, developing sector strategies, and solving investors' problems before start-up or during operations. The IEPA could host meetings on regulatory procedures, inviting government officials and business representatives.
- ***Sector strategies and working groups.*** The IEPA should either lead or take a leading role in sector working groups, especially tourism and agribusiness.
- ***Training, infrastructure, and other policy priorities***. The IEPA should base its advice on training, infrastructure, and other policy matters on interaction with existing investors and enquiries from new investors.
- ***Investment facilitation and servicing.*** One aspect of this is the one-stop-shop function described in the investment laws and awaiting implementing regulations. Facilitation and servicing entails knowing local supplier businesses and promoting linkages between domestic businesses and foreign investors. To keep abreast of policy or administrative problems, possibilities for expanding operations, and training needs, IEPA should build solid relationships with existing investors. It should also cultivate relationships with government officials to ease facilitation. Facilitation should include preparing reference guides to administrative procedures for officials and businesses.
- ***Investment generation.*** IEPA will respond to enquiries from potential investors, target new opportunities when sector strategies are in place, and help existing investors identify and realize expansion or diversification opportunities. The IEPA should be aware of potential small-scale import-substituting opportunities that could have spillovers for local business, and work closely with the domestic investment agency to identify possibilities for local business. An improved and reasonably priced Internet infrastructure would aid this kind of marketing.
- ***Image building.*** Early on, image building should not be the object of great effort or expenditure. A better business environment and investment successes will soon create the desired image, and Timor-Leste is fortunate to have many high-level and commercial visits from foreign countries.
- ***Investment and incentive approval.*** This should be made as automatic as possible and involve only a little of IEPA's time.

Timor-Leste will soon have new investment legislation in force, and two separate entities to promote domestic and external investments. This is just the beginning of the challenge of promoting investment and achieving sector-level growth. Many countries have made the mistake of introducing new legislation with generous incentive packages, along with an approval and screening process that becomes the primary activity of the investment agency, assuming that this is sufficient and effective as an investment promotion strategy. The government should keep this lesson in mind to ensure the success of its investment promotion.

Regional Competitors

Timor-Leste has many regional competitors for FDI (Table 7-1). It must contend with larger and more experienced countries that have been promoting investment for some time—Indonesia and the Philippines—as well as newcomers, such as Laos and Cambodia, and Vietnam. Direct competitors more similar to Timor-Leste are Fiji, Papua New Guinea, and Solomon Islands. Vanuatu and Samoa are disadvantaged by remote location and smaller size.

Table 7-1
Countries Competing for FDI in the Southeast Asia and Pacific Regions

Country	Population	GDP per capita (US$)	FDI Stock (US$ Millions)			
			1990	1995	2000	2002
Timor-Leste	924,600	341	n/a	n/a	n/a	Est. 1,750
DIRECT COMPETITORS						
Indonesia	217,600,000	680	38,883	50,601	60,638	55,836
Fiji	856,000	2,242	414	834	1,017	1,183
Papua New Guinea	5,390,000	519	1,582	1,667	2,007	2,119
Samoa	171,700	1,511	9	29	53	56
Solomon Islands	460,000	522	70	126	126	107
Vanuatu	210,000	1,095	110	249	366	399
EXTENDED COMPETITORS						
Cambodia	13,500,000	274	38	356	1,336	1,503
Laos	5,440,000	312	13	205	550	599
Myanmar	49,909,500	1,700	n/a	649	3,178	3,395
Philippines	87,857,500	5,000	3,268	6,086	9,081	11,579
Vietnam	83,535,600	2,700	260	5,760	14,624	17,124

SOURCE: *FDI data from UNCTAD* World Investment Report, *2003. Timor-Leste FDI data gathered from internal survey.*

Investment Targets

International evidence suggests that investment promotion that targets firms yields the best outcome. Such targeting usually occurs after broader dissemination at the level of industry or the country. Promotion usually starts at the country level, with messages pitched through media, trade associations, and specialized publications. It then concentrates at the firm level until the deal is closed. Hence, targeting will begin with countries and sectors that offer the greatest likelihood of successful tapping of potential investors. For Timor-Leste the most promising country-level targets are Australia, Malaysia, Singapore, Thailand, China (Macau & Hong Kong), and Portugal.

These countries are recommended as starting points for the following reasons. First, investors from these countries are already in Timor-Leste and know the country as an investment location. Second, potential investors from these countries have visited Timor-Leste to explore investment opportunities. Some may not be serious candidates or may have lost interest because the investment environment was not appropriate at the time of their visit. Nonetheless, their visits are significant and should be followed up on. Other high-potential investors have kept up with business and investment conditions in Timor-Leste; some have signed letters of intent with the government, while others are still waiting. Targeting this group of potential investors should be a top priority of the External Investment and Export Promotion Agency. By focusing on investors from these six countries, promotional campaigns can be focused and sustained at lower cost and with better results because already-expressed interest is most likely to develop into concrete investment ventures.

8. Recommendations and Next Steps

The Government of Timor-Leste faces a major challenge in creating sustainable employment. Meeting that challenge requires a vibrant private sector nourished by healthy investment flows, domestic and foreign. At present, Timor-Leste's private sector is weak, with limited capital, technology, and know-how, and FDI is concentrated in offshore gas and oil exploration and operation with little impact on onshore job creation. To stimulate private domestic and foreign investment as a source of growth, the Government of Timor-Leste needs to improve the general business environment and eliminate a number of constraints on investment.

The recent passage of domestic and external investment laws is a major step forward. The investment incentives offered by the laws, as well as the new investment promotion entities, will help attract investment. Investment promotion and expeditious licensing will simplify and speed decision making. Still, optimism regarding Timor-Leste's investment opportunities is guarded because of the country's poor economic infrastructure, low skills, low labor productivity, relatively high wages, small population, a small market, and stiff competition from neighboring countries that are aggressively improving their business environments.

To attract and retain more FDI, Timor-Leste must prepare itself to compete with its neighbors. Here, Timor-Leste has some advantages that will enable it to position itself favorably as an FDI destination: oil, gas, and mineral resources; arable land; natural beauty and rich cultural traditions; good investment incentives; and a simple, transparent investment regime superior to competing countries. Because of its small internal market, high production costs, and low labor productivity, Timor-Leste will have to produce for the export market. Competing in that market will be daunting. Timor-Leste must adopt a strategy that takes into account its limitations as well as its strengths. The country, for example, lacks sufficient comparative advantages to compete on price. Instead, a competitive advantage model based on strategic positioning of products in niche markets, a model adopted for the country's organic coffee, is recommended.

Investment promotion should target high-potential markets, countries whose investors have already expressed interest in Timor-Leste: Australia, Malaysia, Singapore, Thailand, Macau, Hong Kong, and Portugal. Non-oil investment promotion should focus on the agribusiness, fisheries, tourism and light manufacture sectors—sectors that hold the most promise for non-farm sustainable employment in the short and medium term. In these broader sectors, some larger investors may identify opportunities, but many small businesses will emerge in response to an improved sector-level environment, including infrastructure provision and training.

The IEPA is well positioned to respond to external investor and export-ready domestic investors through traditional promotion functions. But it must do more. It needs to

- Help investors understand investment laws and incentives;
- Gather information about suppliers for investors;
- Identify gaps in skills and capabilities and work with the government to bridge those gaps;
- Advocate for infrastructure improvements; and
- Encourage and facilitate public-private dialogue to identify and resolve problems, and respond to opportunities.

In addition, synergies between foreign and domestic investors can multiply the benefits of targeted investment. Timor-Leste's potential for developing investment-based linkages is substantial, and can be best realized through sector development strategies. Once sector strategies are underway the government can promote skill development. Institutions that combine business management and technical training are needed to supplement the Business Development Center program. Similarly, strong business associations and public-private dialogue will be crucial. The IEPA and ADE can foster a collaborative spirit to ensure that synergies between FDI and domestic investment occur. Branding strategies implemented with sector strategies and investments will have significant spillover effects on other domestic businesses. The success of these efforts will depend on investments in economic infrastructure (public or private): power, communications, ICT.

A few recommendations emerge naturally from this state of affairs. The country's investment promotion strategy and investment promotion program should consider the following detailed recommendations:

Develop Strategic Business Plans. The investment promotion agencies, IEPA and ADE, should devise realistic business plans focused on each institution's target audience. While technical assistance will probably be required to develop plans, institutional ownership must be ensured for effective implementation. Each agency should organize retreats led by a workgroup expert once the core team has been recruited and oriented. Retreats in a neutral location help generate ideas and strategies and build team spirit.

Create Sector Strategies and Working Groups. This activity should be a priority for the government and the IEPA in particular, with tourism and agribusiness receiving special attention. IEPA could lead while ADE builds the capacity of domestic investors. Such positive collaboration will lay a solid foundation for other activities.

Promote Training and Skills. Key government administrative procedures should be the focus of training supported by information technology. The IEPA and the administrative functions it is trying to facilitate could be a focus for such initiatives. Business registration is also a natural target given the various small-country models elsewhere.

Pursue Sector-driven Private Sector Training and Capacity Building. Here, tourism and agribusiness training should a top priority. IT training (only 2 of 18 higher education institutions in Dili have IT courses) would be very valuable, but young people will people will "naturally" acquire IT skills if Internet access and computers become cheaper.

Improve the Business Environment. Creating a business-friendly environment is essential to domestic and external investment. Improvements in immigration, labor, and business registration should be implemented to facilitate the issuing of visas and permits. Procedures should be simple, clear, and stable to avoid confusion among employers and workers. Training of public officials should be practical and possibly IT-driven. Clear guidebooks and manuals that explain what officials must do and what businesses can expect would be particularly helpful.

Target Infrastructure Development. Transportation investment should be planned carefully to make the most of limited resources. Given the importance of tourism and the cost of improving roads, the government should seek a balance between sea, air and land transport infrastructure. For example, agribusiness and fisheries investments cannot proceed until an adequate seaport is built in the southern part of the country. Inadequate power generation is a major hindrance to investment in general, but especially outside Dili. Efforts to implement the Ira Lalaro hydropower system should continue for the sake of rural electrification and to lower the costs of electricity. Given the potential benefit of developing hydropower in the western part of the country, the government should consider accelerating such projects and selling excess power to West Timor.

Improve Telecommunications Infrastructure and Reduce Communications Costs. Timor-Leste can boost competition and improve Internet-related infrastructure, thereby "connecting" the country, reducing costs, and facilitating Internet telephony. A spectrum plan should be drawn up as soon as possible, and an analysis conducted of how to issue more Internet licenses.

Reduce Transport Costs. It is expensive to travel to Timor-Leste. Daily flights from two separate routes—via Bali and via Darwin—exist, but Timor-Leste should consider moving toward more competition in the local and regional airline industry. Kakoak Air is a laudable initiative from Timorese private investors to provide low-cost air transport. Its routes need to be expanded to Bali and Darwin to compete with the established "de facto" monopolies that charge maximum fares. Air transport regulation should be accelerated to lower air transportation costs in and out of the country.

Build a Positive Image and Have Leaders Promote the Country as an FDI Destination. Given Timor-Leste's recent history, the country needs to build and promote an image conducive to attracting and retaining FDI. Timor-Leste is fortunate to have leaders of international standing, such as President Xanana Gusmao and Foreign Minister Ramos–Horta, who can a play pivotal role in promoting the county as an FDI destination.

Host an Investment Conference in Late 2005. Once it has met conditions necessary for investment, Timor-Leste needs to announce that it is serious about stimulating domestic and external investment. It is estimated that by late November 2005, the necessary conditions will be in place. The conference theme could be "Timor-Leste Open is for Business."

Create a Master Plan for Economic Infrastructure Development. FDI attraction depends greatly on a country's infrastructure, level of investor service, and responsiveness to investment requests. Timor-Leste needs to invest heavily in economic infrastructure such as seaports, airports, tunnels, roads and bridges, to meet the expectations of foreign investors.

Conduct Sector-specific Investment Assessments to Gauge Investment Opportunities. This assessment is a first attempt to understand and gauge opportunities and constraints country-wide and to a lesser extent in certain sectors. Sector-specific assessments will provide the understanding necessary for detailed promotional strategies.

Seek Donor Funds to Support a Domestic and External Investment Promotion Program for Five or More Years. Investment promotion is a medium- to long-term commitment. Creating, launching, and sustaining a positive image will require time and considerable resources. Timor-Leste needs to commit funds for the medium to long term, while considerable donor support will be required for the short and medium term.

9. Current Investment Opportunities

Though Timor-Leste's economic and business environment is highly constrained at this time, the country still offers domestic and foreign investors significant opportunities. This section presents some opportunities identified by prospective investors or those concerned with stimulating domestic investment and attracting FDI.

Agriculture, Agro-Industry, and Agribusiness

Agriculture-related activities offer prospects for both domestic and FDI investment. Plentiful land in the south not yet used for commercial agriculture is attractive to potential investors and holds opportunity for organic agribusiness in specialty crops. Potential investors have identified some investment opportunities and some are in an advanced stage of pre-implementation. Others opportunities need to be promoted among investors with resources, know-how, and markets.

CASSAVA STARCH

Prospective investors from Thailand and Germany have identified investment opportunities for native and modified cassava starch. The Government and two foreign investors have discussed a Letter of Intent (LOI) and reached preliminary agreement on a two-phase modified starch project. Given the urgency of beginning the project and the technology required to produce modified starch, the parties have agreed to postpone the project, estimated at about US $15 million, for the second phase of implementation where German investment and technology will be required.

In the meantime, the Thai investor and the government have signed an LOI for a native starch production operation to be implemented during the first phase in southern Timor-Leste. Initial investment is estimated at US $7.5 million and will require 30,000 hectares of land for full production of 400 tons of cassava roots per day to be processed into 100 tons of native starch daily. Depending on production methods and assuming small producers each have 3-hectare plots, 1,000 to 10,000 small independent producers may be involved in producing cassava roots. The processing plant will employ about 150 workers full time.

Such an investment will generate income for thousands of households in an area characterized by high poverty and subsistence farming. A major constraint on the project is the lack of a seaport to berth ships transporting equipment and inputs as well as native starch to major markets such as Thailand and China). (The plant is projected to produce one container per day of finished native starch). The LOI identifies this constraint and the Government is intent on finding a solution. The other constraint is a lack of electric power. The project is expected to consume about one Megawatt of electricity in high energy production processes. Specific equipment and fuel incentives provided for under the domestic and external investment can help mitigate the cost of generating electricity for operations until it can be supplied locally on a commercial basis.

Palm Oil

The Government and a Malaysian investor group have also signed an LOI to produce palm oil in the south, not far from the native cassava site, primarily for the export market. Initial investment is estimated at about US$20 million and will require about 30,000 hectares of land for full production. Up to 7,000 workers will be required to produce raw material for the plant, which will employ about 100 workers full time. This investment will also generate income benefiting thousands of households of unemployed or underemployed subsistence farmers. The lack of a seaport and electric power are also major constraints. Electric power usage at the plant is also projected to be about one Megawatt. Again, incentives provided for under the investment laws can help mitigate the cost of generating electricity for operations until power can be supplied locally.

Coconut Processing

A Thai investor and a Timorese investor are finalizing an MOU to invest in a coconut processing operation that will produce copra, coconut oil, fiber, charcoal, and other products, primarily for export. Initial investment is estimated to be US$3 million and more than 700 workers are projected for the operation, most likely in Eastern Viqueque.

Coffee

Timor-Leste's unique hybrid coffee is developed from arabica and robusta stocks. Certified as organic after about 10 years of effort, Timorese coffee is finally tapping into a niche market, mainly in the United States. Markets for this organic coffee are growing fast in Australia and Europe while the Asian market is likely to be able to absorb all the non-certified coffee Timor-Leste can produce. Recently, investors from Macau and Singapore have shown great interest in investing in the coffee sector. The latter have imported equipment and hope to set up production facilities to take advantage of this year's crop.

VANILLA

Because vanilla can be produced in similar conditions as coffee, interest is growing fast in its production. Production shortfalls in Madagascar have made world markets increasingly attractive; many other countries are rushing to produce vanilla to meet world demands, so a glut may be likely in the near future. Timor-Leste should focus on building on its reputation in organic coffee to ensure its standing in the niche market and to get much better prices than commodity producers.

ORGANIC AND SPECIALTY RICE

Rice consumption increased steadily in Timor-Leste during Indonesian occupation. The country produces rice but is unable to market it domestically or compete with imports from major Asian producers. The production of organic, brown, and wild rice for specialty markets that command much better prices may hold opportunity.

CANDLENUT AND OTHER SPICES

Timor-Leste used to produce and export (internally to Indonesia) candlenut, cloves, and other spices. Some investors from Hawaii are investigating candlenut production for the cosmetic market. The climate is also suitable for small-scale production of other spices. Again, as with other specialty crops, Timor-Leste's comparative advantage lies in the organic niche market rather than commodity-type large-scale production for the world market.

OTHER AGRICULTURAL PRODUCTS

Other agricultural products, such as tobacco and flowers, can be produced in Timor-Leste. Again, production should focus on niche markets as production capacity is limited and factor costs are higher in Timor-Leste than in neighboring countries.

Livestock

During Indonesian occupation, livestock was produced and shipped to other parts of Indonesia. But the market chain was broken in 1999 and has not been reestablished. There have been recent attempts at raising cattle for export, particularly out of Oe-Cusse. The government is also developing a cattle-fattening program to augment the income of subsistence farmers. The cooperative CTT is promoting an experimental cattle-fattening program among its members. Indeed, livestock raising is a potential investment opportunity, particularly in Oe-Cusse and the more temperate areas of the central highlands where conditions are amenable for the raising of dairy as well as beef cattle.

Even though chicken is widely consumed in Timor-Leste, it is imported from Brazil—and sells for half the price of the local free range chicken. Clearly, the growing domestic market presents an opportunity to develop a poultry business. One challenge may be producing chicken feed at lower cost than imported feed. Meeting this challenge may present another opportunity for developing an animal feed business.

Forestry

For centuries, Chinese, Malays, and the Portuguese were attracted to Timor-Leste because of its sandalwood. Though the country's sandalwood forests were virtually decimated just before and during the 1999 period of conflict, sandalwood forestry is an attractive long-term investment. Experts claim that Timor-Leste's climate is particularly suited to the production of higher quality sandalwood essence. By weight, the market price for sandalwood essence compares favorably with the price of gold—but sandalwood takes 30-40 years to mature and few private investors are likely to invest in such a long-term business. The government can invest in the forestry sector for possible later exploitation by the private sector.

Opportunities also exist in eucalyptus, bamboo, teak, and other wood products that can be grown in Timor-Leste for industrial applications, building, and the furniture industry.

Fisheries and Aquaculture

Fisheries and aquaculture represent resource-based investment potential that will attract domestic and external investment. Since reclaiming independence in 2002, Timor-Leste has not issued fishing licenses. Little is known about its fish stocks or maximum sustainable yield, but it is assumed that the fishing stock in its EEZ, particularly in the south, is sizable. The Government of Thailand recently sent a vessel to begin surveying Timor-Leste's fish stock. High expectations are placed on initial findings—soon to be announced—so licenses can be issued. In the meantime, a Japanese company of Korean investors signed an LOI with the government to set up a joint-venture company to catch, process, and can tuna and other pelagic species, primarily for the export market.

Timor-Leste's broad and shallow costal zones, particularly in the north, and abundant estuaries are suitable for aquaculture. Researchers from the University of Hawaii and potential investors are investigating developing aquaculture projects in Timor-Leste.

Tourism

Visitors to Timor-Leste readily acknowledge its potential for tourism due to climate, striking seascape and landscape, and rich and diverse culture. Tourism development in

Timor-Leste can be directed at various market segments, from high end tourism to backpackers and local home stay.

High End Tourism

To set a standard and launch its tourism program, Timor-Leste should aim to first attract a high-end operator such as the Oberoi Group, The Four Seasons, or operators of similar quality. Beautiful natural coves and white sand beaches are near the Baucau airport, which has Timor-Leste's longest runway. Timor-Leste could develop its status as an exclusive and exotic resort to distinguish itself from the region's biggest competitor, Bali. Unfortunately, potential investors rarely venture to high-potential, remote sites. Those promoting tourism and investment should make it a priority to identify and lead potential investors to such sites, which could very well put Timor-Leste on the world tourism map.

Pousada Tourism

Pousadas are usually white or pastel colored villas of traditional Portuguese architecture originating from the colonial period. Each of the 13 districts has a pousada and a few have been restored; the best known in use today is in Maubisse. They could be developed as a central building in a compound surrounded by Timorese housing serving as guest rooms. This would take full advantage of the country's colonial past as well as local cultures and traditions. Pousadas in Portugal are part of that country's high-quality regional tourism program and are integrated in a national network that draws on the uniqueness of each region's setting and traditions. A similar program could be developed in Timor-Leste, perhaps through some form of cooperation with the Portuguese program.

Ecotourism

Timor-Leste has considerable ecotourism potential given its setting, diversity of land and sea in a compact geographical space, and friendly people. The ecotourism resort in Atauro Island is at times fully booked with people from Dili and visitors from abroad. This form of low-impact tourism could be spread to other parts of Timor-Leste.

Backpackers and Local Home Stay

Not many backpackers are touring Timor-Leste yet, but this form of tourism has good potential because of the country's setting, friendly people, and numerous footpaths. It can be developed easily and at a low cost. Linked to backpacking is "home stay" in the local community whose villagers build accommodations and offer rooms to tourists. Several people in Com offer rooms for the night at a fraction of the cost of the local motel. If a program can be developed to support this form of tourism, local communities could benefit greatly.

DIVING

Several diving operations in Dili provide instruction and cater to divers at pristine dive sites. Experts claim that diving in Timor-Leste is unique because corals come to the shoreline in many places, especially in the north. This type of tourism has attracted modest investment near Dili and appears to have great potential for development.

CULTURAL AND RELIGIOUS TOURISM

Though Timor-Leste is a small country (15,007 km2 and a population of less than 1.0 million) some 32 languages and dialects are spoken there. This rich linguistic tradition evinces the country's diverse ethnic groups. A theme park, similar to the Polynesian Cultural Center in Hawaii, although on a much smaller scale, could be developed to draw on this unique feature. The park could be a microcosm of Timor-Leste in which cultures, housing, and traditional events are presented in a single location, possibly near Dili. With cruise ships from Australia increasingly calling at port, this type of tourism represents a potential investment when the time is right and conditions more favorable.

In addition, as the only predominantly Roman Catholic country in the region and filled with fervent believers, Timor-Leste holds potential as a religious tourism destination.

SUPPORT SERVICES

Tourism development will heighten the need for restaurants, bars, travel, transportation, tour guides, and entertainment. All offer small investment opportunities for supporting the core industry. Arts and crafts development, for example, is a support industry. Tourists seek mementos ranging from weaving, paintings, carvings, to souvenirs and trinkets from a destination.

Light Manufacturing

Light manufacturing opportunities exist in handicrafts, furniture, light assembly, and bottling. While Timor-Leste has a carving tradition, quality needs to be upgraded. Timorese women excel at weaving a colorful cloth known as "tais," used mainly as bed and table covers. If more uses can be devised for them (e.g., seat covers, purses) weavers and producers of raw textiles alike stand to earn more income. Women also produce high-quality needlework that can be put to more commercial use if the right products can be designed and marketed.

Locally made furniture is rudimentary. Quality can be improved and output increased. And with the right design, furniture can be produced for the local market and for export.

Wages and power costs may be higher in Timor Leste than in neighboring countries and industrial worker skills may be limited, but privileged access to major markets may stimulate investors. Indeed, an Indonesian investor owns motorcycle assembly plant in Dili; and a Malaysian investor is interested in starting a similar plant for the local and the export market. Garment assembly operations could draw on the talents of local weavers and needlecraft artisans who can adapt to assembly operations with little training.

Bottled water and soft drinks consumed in Timor-Leste come mainly from Indonesia as finished products. Because of the excise tax, soft drinks are very expensive and provide no local value. The opportunity is ripe for bottling water and soft drinks for the local market. Such investment would create jobs and lower prices.

Food Processing

Food processing may offer investment potential for the local and export markets. The local hot sauce is very good but is produced and sold in large bottles. Similarly, wild honey is harvested and sold unprocessed in the streets. If packaged properly for a niche market, these products—the honey, in particular—can be sold as organics in export markets.

Oil and Gas

The oil and gas industry is expected to generate considerable upstream and downstream business. Plants and refineries will be established, creating jobs and products for the local market and for exports. Offshore activities require considerable logistics support, services currently being supplied from abroad. Opportunities exist to set up logistics support locally to support the oil and gas industry. And rapidly developing oil and gas operations will increase the need for repairing equipment used in drilling and in downstream operations.

Timor-Leste has started to produce gas for export while it imports bottled gas for local consumption. While the local market is still quite small and probably cannot sustain even a small LPG bottling and distribution business, the government should support a program to move the population from cooking with firewood to cooking with propane or a similar gas. By reducing the number of trees cut for cooking such a program will benefit the environment in addition to creating jobs and providing for a healthier way of cooking.

Only Dili and the larger towns have fuel stations, while roadside metal drums and plastic containers abound to serve the increasing number of vehicles moving around the country. Remedying this health and safety hazard represents a business opportunity if properly regulated.

Financial and Business Services

Financial and business services support investment activities. This sector is still in its infancy in Timor-Leste, posing serious constraints on development. Investment opportunities in this sector could stimulate development in other areas.

COMMERCIAL BANKING AND INSURANCE

Commercial banking is limited to Dili, with the exception of the Portuguese bank subsidiary Caixa Geral de Depositos (BNU), which has been expanding outside the capital in partnership with Timor Telecom. While the local population no doubt needs banking services nearby, the economy of scale is lacking to justify opening more local branches. Nonetheless, this sector that will expand with other economic activities. While the three full-service banks in Timor-Leste are all branches of foreign banks, a group of Timorese investors is establishing a local bank with American investors. Similarly, the government and donors are trying to find a solution for the local Microcredit Institution of Timor-Leste, which has grown too big to remain a microlending organization but is too small to be a commercial bank. This turning point may present an opportunity for upgrading the institution into a full-service bank if the right option can be found.

Timor–Leste has no insurance companies, but this situation will soon change when the Insurance Law recently passed by Parliament enter into force.

OTHER FINANCIAL SERVICES

Local businesses complain that the banks are not extending credit and that interest rates are too high to support investment projects. Banks maintain that lending is too risky in a weakly regulated environment and that potential investors lack sufficient equity capital to initiate projects. While both parties are partly right, other forms of financial services and products need to appear to facilitate investment. Some of these could be venture capital or other forms of raising equity capital to complement liability capital.

Accounting and audit services in Timor-Leste are being provided by offshore companies. If the country were to adopt a regulatory measure such as an official accounting plan, local accounting and auditing services might emerge.

Business legal services are very rare in Timor-Leste. Only one firm in Dili advertises such services. But when the Commercial Companies Law is fully implemented as expected in early 2006, this type of business will be in heavy demand as companies seek to legally incorporate and new businesses are set up as a result of incentives provided under domestic and external investment laws.

Other Services

Other services include business consultancies, architecture and engineering, and general business support. Needs for business consultancies of various types, ranging from economic and market research, to marketing and advertisement, are increasing. At present, only one company in Dili advertises such consulting services. As business organizations develop, however, demand for consulting services will spur supply.

Much of the buildings in Dili and the rest of the larger towns that were burned in 1999 have yet to be rehabilitated. As economic activity increases demand for adequate buildings will increase—and new construction and building rehabilitation will require more sophisticated support, such as architecture and engineering services.

As the general business environment develops, various business services will be needed. These include services to support business start-ups, accounting and bookkeeping, business-related training, translation, and interpretation.

Economic Infrastructure

Inadequate economic infrastructure limits development of the Timorese economy. It also represents an important investment opportunity if the right projects can be conceived.

ELECTRICITY

Electricity supply needs to be reliable and less expensive. Power at US 20 cents per kW/hr is untenable for any investment project and is not competitive with the regional norm of 5-6 US cents kW/hr. A large-scale hydropower project is under study for the eastern part of the country and promises to deliver 28 MW of power, but Timor-Leste could produce up to 100 MW through hydropower—an amount well above foreseen needs (current installed capacity is 19 MG). Should hydropower prove commercially viable, Timor-Leste can look forward to producing enough electricity for its own use and for export to West Timor—all in the not too distant future.

In the meantime, some Thai investors are considering investing in power plants of up to 10 MW capacity that run on biomass at much lower cost than conventional fuel. Such an operation can be set up relatively quickly but the proposal is for government to purchase power output for distribution. While this may not be the preferred option of the government at this point, other creative solutions should be explored along the lines of privatizing power production and distribution.

WATER AND SEWERAGE

Water and sewerage in Dili is fast becoming a problem as the population is now well beyond the system's capacity. Water and sewerage problems are also a public health hazard that must be addressed if the country is going to take advantage of its tourism potential. Given the small size of water and power infrastructure in Dili, services could be combined in one utility company and privatized. Naturally, major infrastructure investments such as sewerage lines and plant, as well as power transmission lines, would need to be public investments although under private management.

SEAPORTS

As indicated earlier, lack of seaports is a major hindrance to investment projects now in the pipeline. Given the country's mountainous terrain, sea transport should be studied seriously as a complement to other modes of transport. A seaport is needed in the south, probably near Betano, to support agribusiness projects, as well as commercial fisheries and quite possibly oil and gas activities. A large seaport in Tibar near Dili is also being considered. A third seaport may be necessary in Com, at the northeastern tip of the country, to support fishing and industrial production. While considering three seaports in Timor Leste seems ambitious now, meeting the country's development needs for the next 10-15 years may depend on such major investments.

AIRPORTS

Timor-Leste's principal airport is Nicolau Lobato International Airport in Dili. The airport's runway is short and extending it to operate as a true international airport may be almost impossible given the lack of land. The other major landing strip is at Baucau airport. This could be upgraded into an international airport to support passengers and cargo. Some investors are examining this investment possibility. As mentioned earlier, Baucau airport is well located to support a high-end tourism.

TUNNELS

Considering the country's mountainous terrain and the difficulty of extending road transportation linking economic centers, it is not too early to start thinking about tunnels. Indeed, the only plausible way to significantly improve overland transport from Dili to Baucau is through a tunnel because Dili is encircled by mountains, with the exception of a small access south toward Tibar.

ROADS LINKING MARKETS

While economic roads—roads that can accommodate vehicles with large cargoes—are needed throughout the country, the need is acute in the coffee country and on roads leading to and from Dili/Baucau. In particular, a way of circumventing the infamous

Subao incline/decline must be found. An inland alternative from Metinaro to Manatuto would do much to make road transport more secure and halve the 2.5 hour journey between Dili and Baucau.

INDUSTRIAL AND EXPORT ZONES

Timor-Leste needs real estate infrastructure to support industrial and export activities. In the last 3-4 years, industrial and export processing zones have been much discussed. Vemasse, Baucau District, was studied as a possible industrial zone site, but may be unviable because it lacks infrastructure. It is hoped that a World Bank-financed study now underway will identify better locations and the infrastructure necessary to support zones.

BUSINESS PARK

A business park in Dili will energize business in the city and the country as a whole. Plans to study the feasibility of locating a park at the Old Market—Mercado Municipal—stopped when a new site was found in the center of town that could provide basic services under one roof. Services will be under private ownership and management. The two institutes for domestic and external investment promotion will also be located in the proposed park.

SHIPYARD AND HEAVY EQUIPMENT REPAIR

Currently, Timor-Leste has no heavy equipment repair and maintenance service. As the new coastal ferry will enter service next year local maintenance and repair facilities are needed. A German investor group is studying the feasibility of launching a small shipyard and heavy equipment maintenance facilities to support shipping, offshore oil and gas equipment, power plant, and other heavy equipment.

Appendix A. Terms of Reference

Appendix B. Persons Interviewed

Appendix C. Investment Law Provisions

Conditions and Guarantees

- Equal access to all sectors of the economy permitted under RDTL legislation
- Minimum investment required under the domestic investment law $5,000
- Minimum investment required under the external investment law $100,000
- Guarantees and protection of private property rights
- Legal guarantees against nationalization and expropriation
- Equal treatment of all investors, domestic and external
- Rights to repatriate profits and investment proceeds for external investors
- Right to hire management and skilled foreign workers
- Right to sell and transfer assets Access to foreign currency
- Conciliation and arbitration of investment disputes resolution for foreign citizens under according to ICSID rules

Fiscal Incentives

Tax deduction of $300 for each worker employed full-time according to location or type of investment:

- Urban areas during 5 years; rural areas during 7 years
- Oe-Cusse and Ataúro during 10 years

External Investment in Economic Infrastructure

- Urban areas during 10 years
- Rural areas during 12 years
- Oe-Cusse and Ataúro during 15 years

External Investment Principally Directed to the Export Market

- Urban areas during 7 years
- Rural areas during 9 years
- Oe-Cusse and Ataúro during 12 years

Customs Incentives

Exemption of duties and sales taxes on

- Capital goods and equipment
- Raw materials for manufacturing
- Semi-finished goods
- Components and spare parts for use in the incorporation or production of goods and services
- Fuels (except gasoline) used in the generation of electricity for the production unit where there is no provision of public power

Government Land and Property Lease Incentives

- For Government Land and Property in Rural Areas Exemption of lease payments for 7-12 years (10-15 years for investments in Oe-Cusse and Ataúro)

Appendix D. Investment Incentives in Selected Southeast Asian Countries

Tax or Incentive	Hong Kong	Singapore	Cambodia	Lao PDR	Vietnam	Thailand	Malaysia	Indonesia	Philippines	Timor-Leste[a]
Standard CIT rate.[b]	17%; non-corp. business pay 15%.	20%.	20%.	Greater of 35% or 1% of turnover.	32%.	30%.	28%.	Progressive rates: 10, 15, 30%.	32%.	Greater of 30% or 1% of turnover.
Dividend withholding taxes.	None.	None.	Taxed at relevant CIT rate; creditable against CIT.	10%; creditable against CIT.	3%, 5%, or 7% on dividends remitted abroad.	10% on dividends remitted abroad; domestic inter-company dividends are partly or wholly exempt.		15%: resident; 10-20%: nonresidents (50% reduction in favored sectors and zones).	10–25% on dividends remitted abroad.	15%; creditable against CIT.
Sectors qualifying for incentives (not exhaustive).	Int'l finance and insurance; int'l shipping (outside HK); patent, royalty, trademark; copyright, etc.	Hi-tech, SMEs, corp. HQ, int'l trading, oil trading, aircraft leasing, int'l consultancy, plant and machinery cos.	Hi-tech, export, tourism, infrastructure, energy, rural development, environmental protection.		Exporters, agricultural processors, certain locations.	Exporters, various other industries.	Corps. in mnfctrg., agriculture, tourism, and other activities may receive "pioneer" status.	Exports, hard crop plantations, mining, businesses in remote areas.	Exporters	All economic sectors qualify??? (Alternate exports, import substitution, economic infrastructure and tourism).
Tax holidays	None	None	Up to 8 years	Negotiable but rare	Up to 8 years.	3-8 year income tax holidays.	5 years tax holiday on 70-100% of statutory income (10 years for companies of national-strategic importance).	3- to 8-year income tax holidays for new enterprise in 22 sectors.	3- to 8-year income tax holidays.	None.

Tax or Incentive	Hong Kong	Singapore	Cambodia	Lao PDR	Vietnam	Thailand	Malaysia	Indonesia	Philippines	Timor-Leste[a]
Reduced CIT rates	8% int'l finance, re-insurance; life ins. 5%; patent, etc 1.6%; int'l shipping operating outside KH waters 0%.	10% int'l, oil trading, aircraft leasing, hi-tech SMEs, int'l consultancy 5 years; RandD, plant or machine leasing; 0% on int'l shipping outside Singapore.	9% after end of holiday for favored project	20%: foreign investor; 15%: companies in lowlands; 10%: companies in remote areas.	25%: foreign investors; 10, 15, and 20% for 10+ years under certain criteria.	Enterprises in investment promotion zones get 50% reduction of CIT for 5 years.	3%: offshore companies in Labuan. 10%: foreign fund management companies.			Tax credit of US $500 for each resident Timorese worker employed on full time basis. 5, 7 and 10 years, depending on regional location of investment.
Investment allowances and credits.	Various, i.e. property tax, capital gains, income tax paid abroad.	20%			If profits reinvested for 3 consecutive years, some or all of CIT refunded	Allowance of 25% for investment in infrastructure.	Investment allowance of 60–100% of qualifying capital expenditure.	Reduction of taxable income by up to 30% of investment in priority sectors.	Tax credits for purchase of domestic breeding stock and genetic material, as well as for incremental export revenue.	Petroleum up to 125% of investment.
Accelerated depreciation.	100% first year on manufacturing plant and capital equipment, comp equipment, 60% other plant and capital equipment, 20% construct. and 4% year thereafter.	20–33% per year for plant and capital equipment.	Immediate expensing of plant and equipment investment financed from reinvested.				Accelerated depreciation of computer, technology, and environmental protection investment.	Doubling of depreciation rates in favored zones and sectors.	Immediate expensing of major infrastructure investments by export enterprises in less developed areas.	Petroleum

Tax or Incentive	Hong Kong	Singapore	Cambodia	Lao PDR	Vietnam	Thailand	Malaysia	Indonesia	Philippines	Timor-Leste[a]
Import duty and VAT exemption			Import duty exemptions for promoted investments	Reduced import duties on inputs: 1%—foreign investor; 0%—exporters	Exemption from import duties and VAT in certain sectors	Exemption and reduced import duty and VAT rates on inputs in certain sectors, esp. exporters.	Exemptions and reduced import duty and VAT rates on inputs in certain sectors, especially exporters.	Exemptions and reduced import duty and VAT rates on inputs in certain sectors, especially exporters.	Exemptions and reduced import duty and VAT rates on input in certain sectors, especially exporters	Exemptions on import duties, sales and excise tax for capital goods, raw materials, spares diesel for power generation in rural areas
Export Processing Zones					Various additional incentives apply in these zones.				Flat 5% tax on gross income after tax holiday period for EPZ enterprises	Same as for other investments
Others		None		Investor can negotiate for special incentives on a case-by-case basis		Dividend distributions during holidays are tax exempt.	Double deduction of certain expenses (e.g., RandD, training).	Loss carry-forward extended to 10 years for companies in favored zones and sectors	Additional 50–100% deduction for labor expenses for exports above a certain capital/ labor ratio.	Exemption on reinvested dividend during reduction period

a. Tax incentives proposed in external and domestic investment laws.
b. Higher rates apply in some cases to industries engaged in natural resource extraction.

SOURCES: *Chalk (2001) and PriceWaterhouse Coopers (2001).*

Appendix E. SWOT Analysis of Timor-Leste

Country SWOT Analysis from Plenary Session

Strengths	Weaknesses
Natural resources	Inadequate infrastructure
International goodwill from donors	Negative legacy of recent history
Strong leadership/government vision	Small domestic market and limited purchasing power—high poverty rate
Stable macro political-economy	Centralized government services
Public-private dialogue on development	High labor costs compared to competing countries in region
Sound national petroleum management plan	Lack of skilled labor & small labor pool
Suitable climate for specific agro-production and tourism	Weak business legal and regulatory framework
Rich culture, political history, personalities	Incipient judicial and weak court system
	High taxes
	High transportation costs
	High communication and power costs
	Incipient financial sector with high interest rates
	Lack of business support services
	Wide trade imbalance dominated by imports
	Multitude of spoken languages in the country
	Limited recreation & social amenities
Opportunities	**Threats**
Heritage, tradition and Diaspora/CPLP	Natural disasters and unfavorable climate
New nation—assimilate best practices of others experience	Established regional brands (e.g., Bali)
New nation—branding and niche market development	Stiff competition from neighbors
Preferential access to major markets	Monetary and administrative costs of doing business
Differentiating Timor-Leste from neighboring countries	Red tape
Investment in economic infrastructure	Inattention to equitable growth and inability to address weaknesses
Tourism	FDI crowding out domestic investment
Virgin territory for agriculture and tourism	Social, political, and labor unrest

Sector SWOT Analysis from Working Groups

Agribusiness

Strengths	Weaknesses
Natural and eco-friendly cultivation	Inadequate roads and transport infrastructure
Plentiful animal, land, and crop varieties	Lack of marketing and management skills
Established reputation in organic coffee production	Low worker productivity
	High labor costs
	Lack of certification agency
	Lack of modern machinery and equipment
	Lack of pest control system
	Subsistence farming practices and mindset
	Lack of attention to quality production
	Lack of strategic sector policy
	Lack of market information
	Low soil fertility in some regions
	Not a member of ASEAN
	Lack of electricity and high costs
Opportunities	**Threats**
"Organic" branding	Climate and natural disasters
Growing world demand for organic products	Crop diseases
Opportunities in specific crops	Strong regional competition
Market access to major markets	Unfair overseas competition (subsidies)
Improve produce and product quality	Volatility in world commodity markets
Joint ventures	Donor fatigue
Infrastructure investment	Lack of attention to issues of land ownership
Good general potential	

Finance and Business Services

Strengths	Weaknesses
Support from financial/business sectors	Reduced capacity to implement services
Donor goodwill toward sector development	Lack of adequate legislation and regulation
Various IFIs	Lack of adequate information for entrepreneurs
Motivated investors	Low skills and human resources capacity
Strong informal/micro business sector	High interest rates
High demand for credit	Lack of support and monitoring of entrepreneurs
Government willingness to support sector development	Inadequate communication between private and public sectors
	Low organization of the private sector
	Poor infrastructure
	High cost of doing business
Opportunities	**Threats**
Organization of entrepreneurs and business community	Competition of funds and donors projects
Development of IFIs, especially in other financial services	Low interest of business community for financial services (rural areas)
HR development and training	Pressure from donors to support own projects and not what is best for Timor-Leste
Many opportunities for investors with money and know-how	Discrepancy in implementation of investment laws and regulations
Investment laws provide good incentives	Conflicts of interests and corruption
One stop shop support for investors facilitates and expedites investment processing	Lack of security for investors
	Creation of two separate investor support entities

Fisheries and Aquaculture

Strengths	Weaknesses
Fish stock in unfished waters	Lack of baseline data on fisheries in general and sustainable yield stock in Timor-Leste
Many estuaries for acquaculture development	Lack of infrastructure to support development of fishing industry and aquaculture
Legislation to regulate fishes and aquaculture in force	Weak capacity of financial resources and management of fishing business by Timorense
National entrepreneurs interested in developing fisheries and aquaculture	Dispersion of the fishing community makes communication difficult
Foreing investors very interested in fisheries and aquaculture	Low product quality, inadequate fishing boats, low processing capacity and capability, etc.
	Lack of professional and business organizations in fishing sector
	Lack of credit program to support small-scale fisheries and aquaculture development
	Fishing still largely at subsistence level
Opportunities	**Threats**
Commercial and industrial fishing	Lack of effective control of maritime border in fishing areas
International market for fisheries and aquaculture products from Timor-Leste	Illegal fishing by poachers in Timorese waters
Varied fish species of high economic value (tuna, groupers, red snapper, etc.)	Pollution risk from oil and gas activities
High interest among potential foreign investors in fisheries and aquaculture	Likely fishing with explosives and poisoning by fishermen
Investment legislation facilitates investment and provides incentives to domestic and external investors	Fish prices not regionally competitive
	Limited fishing area, mainly in south

Light Industry (Handicraft)

Strengths	Weaknesses
Availability of raw materials	Low level of technology
Local weaving tradition	Lack of attention to quality
Rich tradition of local patterns and design	Lack of quality control
	Lack of access to finance
Opportunities	**Threats**
Growing demand linked to tourism	Similar products from neighbors/competitors
Increased promotion, which will increase exposure and quality	Established products/brands in SE Asia
	Lower-cost regional competitors

Oil and Gas (Upstream)

Strengths	Weaknesses
Known world-class reserves	Low participation of domestic companies
Short exploration period	Low human resource and skill levels
Legal framework imminent and world-class	Lack of experience
Proximity to gas fields	Inadequate infrastructure (especially ports)
	Lack of domestic skills and experience
	Lack of downstream industry
	Lack of national oil company
Opportunities	**Threats**
Continued high demand in world markets	Gas market may be lost (e.g., Sakhalian)
Increase in oil prices	Volatile world prices
Upgrading skills	Dry holes
Possible new discoveries offshore	Contestations/border disputes and rulings
Onshore oil and gas seepages	Downstream activities end up in Australia
Possibility of more offshore fields	Oil and gas spills
Possible power plants to be built	
Acquisition of pipeline and LNG Plant	
Proper investor servicing brings investment	

Tourism

Strengths	Weaknesses
Diverse range of products and activities	Inadequate infrastructure
Diverse traditions and cultures	Lack of lodging, restaurants, amenities
Favorable location	Only a few operators
New country = new destination for tourists	Lack of trained labor and poor service
Unspoiled, clean environment	Lack of adequate vocational training
Scenic and diverse land and seascape	Lack of awareness of tourism in districts
Favorable climate with plenty of sunshine	High cost of travel and lodging
Friendly people with rich culture	Lack of government support for sector development (i.e., policy, legislation, programs)
	Red tape for operators
	Still relatively unknown as a destination
	Lack of emergency medical care and effective emergency response
	Low healthy and hygiene in population
Opportunities	**Threats**
Create novelty brand and launch new destination – adventure tourism	Natural disasters
Segment tourism market from high end to backpackers, diving, etc	Manmade disasters (environmental)
Investment laws provide incentives to domestic and external investors	Social, political, and labor unrest
Tourism development can employ, train, and develop capacity of many workers	Brain drain of trained personnel
	Anticompetitive behavior in major neighbor markets