

The Nation Builders' Blind Spot

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Multinational efforts to rebuild a nation following a conflict often fail. After the foreign peacekeeping troops go home, the old disputes reignite. Why does peace so often dissolve? I suggest that the breakdown reflects a lack of attention to the economy. As important as security is the creation of jobs.

While a civil conflict is usually about ethnic or regional grievances, it would be less likely to gain traction if jobs were plentiful. There will always be agitators trying to stir up resentments, but leaders need followers. Whether the agitators succeed in enlisting foot soldiers depends on the people's alternative opportunities. You tend not to riot if you have something to lose—an obvious enough point, you might think, but strangely ignored by those charged with rebuilding nations.

In what follows I use one small country, East Timor, as a case study. The point, though, is general: job creation is key to peace, and the current approach to nation building pays far too little attention to job creation.

The Sad Case of East Timor

The chaos in East Timor of 2006, when foreign troops were called in to control rioting factions of the police and the army, is a sad letdown from the euphoria of 2002, when the bloody fight for independence from Indonesia came to an end.

Small and remote as East Timor is, the missteps there hold a vital lesson for the world at large. From Rwanda to Somalia to Haiti to Iraq, of all the rebuilding of postconflict nations being attempted around the globe, East Timor should have had the best chance of success. As a David against the Indonesian Goliath, it became a *cause*

célèbre for global activists. Its people are longing to do well after the horrors of the independence struggle. Money has been flowing in from foreign aid and is starting to flow in from oil. An army of skilled technocrats from the World Bank, the United Nations (UN), and other international agencies has been proffering advice. East Timor's development strategy, in emphasizing the building of institutions, has followed the most up-to-date academic thinking.

Where did things go wrong? Why did gangs of youths armed with machetes start rampaging through the streets of Dili looting and killing? What does East Timor tell us about how to undertake nation building anywhere?

East Timor came into being after a ferocious 24-year war against the Indonesian army from which, out of a population of less than a million, some 100,000 to 250,000 Timorese died. The last thing the people need is more bloodshed. Although the conflict that broke out in April 2006 divides along regional lines—those from the east of the country against those from the west—the underlying problem is economic.

The armed gangs causing havoc are a symptom of economic underperformance. The economy could have and should have done better. The reason it did not, I suggest, is that the development strategy laid out by the international agencies had a blind spot.

Living standards in East Timor are desperately poor. Per-capita income in 2005, according to the World Bank, was just US\$750. Most people live off subsistence agriculture. Many are hungry. The official poverty line is 55 US cents a day: beneath this very low benchmark falls a full 40 percent of the population. The only feasible solution to such deep poverty is economic growth, but East Timor has failed to grow. Since 2001, the non-oil component of per-capita income has fallen by 20 percent.

Jobs are scarce. The unemployment rate among urban youth is 40 percent. If jobs had been created, the violence might have been averted.

The private sector is undersized. In 2004, 4,600 registered firms were in operation. This means there is about one registered firm for every hundred adults. (For comparison, another small country in the region, New Zealand, has one firm for every ten adults.) The Timorese seem reluctant to start businesses.

The firms that exist are small, most having less than ten employees. Most registered businesses are in the service sector: retail shops and kiosks, hotels, and restaurants. Others are engaged in construction and in small-scale production.

There is also a shadow economy of unregistered businesses: street vendors, market stallholders, minibus drivers, bicycle repairers, hairdressers, makers of cheap cookware and clothing, and so on. The size of the shadow economy is unknown, but the government believes the unregistered firms to outnumber the registered firms.

Job creation is a pressing need. The urban private sector employs about 44,000 people. With East Timor's young and rapidly growing population, over the foreseeable future an estimated 15,000 people will enter the labor force each year: a large addition compared with the number currently employed.

The hope that the private sector might absorb the new job seekers is dashed by its unwillingness or inability to invest. In 2005, gross fixed investment by the private sector was just 2.1 percent of non-oil GDP, one-ninth the investment by the public sector.¹

Why are so few Timorese setting up businesses? Why is the formal private sector smaller than the shadow economy? Why is the private sector investing so little and creating so few jobs?

Setting up a new firm or expanding an existing one in East Timor is an ordeal, for the wrong reasons. The state places obstacles in the way of entrepreneurs. According to the World Bank's excellent *Doing Business* dataset (at www.doingbusiness.org), East Timor is the world's 174th worst country, out of 175 surveyed, for regulatory difficulties of doing business. The rules on budding firms are particularly cumbersome. To register a new firm takes three months. The applicant must visit six different government agencies, deposit in a bank a sum of seven times per-capita income, and pay fees that add up to US\$625, or 83 percent of per-capita income.

The rules on business registration were initially written in 2000-02 by the United Nations Transitional Administration for East Timor. Signed by Sergio Vieira de Mello, the UN administrator, Regulation No. 2002/4 specifies a US\$100 fee to be paid annually.

¹ Government of Timor-Leste, "Combating Poverty as a National Cause," March 2006 (data from pp. 3-6, 8, 22, 28), http://siteresources.worldbank.org/INTTIMORLESTE/Resources/TLDPM_promoting_balanced_dev_22Mar2006.pdf; Government of Timor-Leste, "Private Sector Development," April 2005 (data from pp. 3-6, 12), http://www.mopf.gov.tl/dp/RTL%20Planning%20Documents%20and%20Publications/SIP%202005/SIP%20REPORTS/English%20version/PRIVATE%20SECTOR%20DEVELOPMENT_Eng.pdf.

The penalties for failing to register a business are a US\$500 fine and closure.² For most Timorese, the US\$100 fee the UN prescribed is a very hefty sum to pay for the right to run a firm. A question crying out for an answer is why the UN officials thought it a good idea to impose a punitive tax on job creation.

Still further charges were since added. The rules acquired extra convolutions in implementation. According to *Doing Business*, there is now, in addition, a US\$15 fee to verify the uniqueness of the company name, a US\$10 fee for a company seal, a US\$200 fee for approval from the health ministry and a US\$300 fee for a business license. In 2005, the World Bank said the business-registration process “remains complex and unclear.”

Analysis of cross-country data finds that, in countries with high regulatory barriers to entry, the shadow economy is large and the rate of formation of new firms is slow. High entry barriers are also correlated with corruption.³ East Timor seems to be following this pattern. In 2003, the World Bank’s East Timor country manager, Elisabeth Huybens, reported anecdotal evidence of “low-level corruption that is making it difficult for businesses to do business,” including “civil servants demanding bribes for permits” and “influence peddling by midlevel bureaucrats.” In 2005, the World Bank said that businesses increasingly “complain of harassment and corruption.” In 2006, José Ramos-Horta, who won the Nobel Peace Prize for his work on East Timor’s independence, warned of “allegations of low-level corruption in key government agencies.”

Discouraged by the costs of registering a firm, entrepreneurs may just not make the effort. Either they maneuver through the red tape by bribing bureaucrats; or they neglect to register their firm, staying instead in the shadow economy; or they completely give up the idea of creating a firm. Each of these responses is socially harmful. Bribes are corrosive to a professional public service and unduly raise the cost of doing business. Firms in the shadow economy must stay small and operate surreptitiously because, operating illegally, they are vulnerable to predatory bureaucrats and policemen. Most

² UNTAET, “Regulation No. 2002/4,” http://www.un.org/peace/etimor/untaetR/2002_04.pdf.

³ Cross-country evidence: S. Djankov, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, “The Regulation of Entry,” *Quarterly Journal of Economics* 117, 2002, 1-37; L. Klapper, L. Laeven, and R. Rajan, “Business Environment and Firm Entry,” NBER paper no. 10380, March 2004. Quotes from *Newsweek International*, May 12, 2003, *Wall Street Journal*, June 9, 2006, and World Bank, “Country Assistance Strategy for Timor-Leste FY 06-08,” Aug. 18, 2005, p.14, http://siteresources.worldbank.org/INTTIMORLESTE/Resources/Final_Timor-Leste_CAS_English_website.pdf.

important, the would-be entrepreneurs who give up are not generating the jobs they otherwise would.

Every country in the world requires its firms to be registered for valid reasons like taxation, intellectual property, worker safety, and pollution control, but to make the registration process as expensive and time consuming as it is in East Timor is unjustified. The high cost of entry excludes the poor, in particular, from starting their own businesses. Why is registration deliberately made so expensive? One reason is the ideology that sees small businesspeople, the bourgeoisie, as the enemy of progress—an ideology that has long been discredited. The other reason is that some people benefit from the rules. The low-level bureaucrats who hand out the licenses, and their bosses, profit from the bribes they take. Also, the incumbent firms—the crony capitalists—profit from any incipient competition being choked off. In countries with a large shadow economy like Egypt and Peru, the political power of the crony capitalists and the bureaucrats is probably why the counterproductive registration rules persist. East Timor, however, had a clean slate. At the outset there was a window for keeping the barriers low.

To be sure, East Timor’s foreign advisors are aware of the entry regulations. In 2006, the World Bank said that “significant action is needed to free up cumbersome business registration processes.”⁴ But the Bank should have been pushing this recommendation earlier and harder. Four years after the start of the rebuilding is too late to begin worrying about the entry rules. Politically, it is difficult to cut the red tape after the vested interests have become entrenched. Moreover, and this is my main point, delaying cutting the red tape has meant missing out on the single best opportunity to create jobs.

The Spark of Small Business

In March 2006, a long four years into East Timor’s rebuilding effort, the International Monetary Fund (IMF) summarized the priorities as seen by the international agencies. In “the near term, well-targeted public investment (in infrastructure and human capital) should be stepped up,” the IMF said. “Over the longer-term, growth and job

⁴ World Bank, “Background Paper for the Timor-Leste and Development Partners Meeting,” 3-4 April 2006, p.2, http://siteresources.worldbank.org/INTTIMORLESTE/Resources/WB_Background_Paper_cleared_final.pdf.

creation will need to come from the private sector.”⁵ To assign public investment as the immediate task and to wait for private-sector job creation to come “in the longer term,” I contend, gets things backwards. The urgent priority, from day one, ought to have been smoothing the progress of the private sector.

Since the fall of communism and the rise of the Asian economies, hardly anyone would deny that the key to successful development is a thriving private sector. Nevertheless, there is one sense in which the private sector is more robust than generally recognized. Markets are able to operate, up to a point, even in the absence of market-supporting institutions. (This is not an argument for a libertarian economy. Eventually, the whole array of state-set rules and regulations, as well as public investments, will be needed. Rather, this is about timing and what works.)

Why do the IMF experts see building the private sector as a task for “the longer term”? Their rationale, presumably, is that there exist prerequisites to a market economy. The development of East Timor’s private sector has been discouraged, the IMF says, by “the incomplete legal and regulatory framework, an ineffective administration and a weak judiciary.”⁶ Without laws, courts, regulatory agencies, and financial institutions, in this view, markets cannot function.

East Timor lacks these market-supporting institutions. When the Indonesians departed, for example, the new country reportedly was left with not one practicing lawyer. It is via institutional development that the foreign advisors have worked to foster the private sector: writing laws to protect contracting and property rights, setting up courts and the rest of the machinery to administer those laws, offering training programs for businesspeople, and starting microcredit organizations. Importantly, a petroleum fund has been set up in an attempt to prevent East Timor, with its oil riches, from falling victim to the resource curse. (At around US\$200 million per year, over 50 percent of non-oil GDP, the oil revenues will promote development if they are managed wisely, or they will push the country deeply into corruption if not.) All of these initiatives are

⁵ IMF, “Statement by IMF Staff at the Conclusion of the 2006 Article IV Consultation Discussions with the Democratic Republic of Timor-Leste,” March 15, 2006, <http://www.imf.org/external/np/sec/pr/2006/pr0655.htm>.

⁶ IMF, “Staff Report for the 2005 Article IV Consultation,” July 25, 2005, p.12, <http://www.imf.org/external/pubs/ft/scr/2005/cr05245.pdf>.

essential if the private sector is to become sustainable. But institution building takes many years. Jobs are needed now.

The growth of the private sector did not have to be put on hold while waiting for market-supporting institutions to be built. The institutions are needed to take the private sector to a sophisticated level. They are not needed to get it started.

By now there is plenty of evidence contradicting the view that markets cannot operate in the absence of supporting institutions. In fact, small businesses can get by, up to a point, without any support from the state, if only they are not impeded by corrupt bureaucrats or misguided regulations. When the level of development is low, small-scale entrepreneurs are able to work under economic anarchy. Given the chance, entrepreneurs are ingenious at devising ad hoc ways to do business.

In poor countries, small business is a job-creation engine. In Sierra Leone, for example, 90 percent of manufacturing employment is in firms with nine or fewer employees. In Ghana it is 84 percent; in Indonesia, 77 percent; in Honduras 68 percent; and in the Philippines, 66 percent. Across countries, small-business employment tends to be higher where per-capita income is lower.

Evidence on entrepreneurs' adaptability comes from the post-communist transition. Rebuilding from the ruins of communism is not unlike rebuilding from the ruins of war. Surveys of start-up firms in Vietnam, China, and the countries of the former Soviet bloc have shown them operating before financial markets became accessible and before the courts became available to enforce contracts.⁷ When the environment is unsupportive, firms make do by self-help.

Unable to rely on laws of contract to support their deal-making, businesspeople use ongoing relationships, dealing with people whom they know or who come recommended by a trusted third party. If a trading partner cheats them, they cease dealing with him, so the sanction against dealing in bad faith is a loss of future business. This sanction is strengthened if the loss of business is still wider: if word about the cheating spreads. Gossip is crucial to these firms. People in the same line of business meet each other

⁷ On Vietnam: J. McMillan and C. Woodruff, "Interfirm Relationships and Informal Credit in Vietnam," *Quarterly Journal of Economics* 114, 1999, 1285-1320. On China: K. S. Tsai, *Back-Alley Banking*, Ithaca, Cornell University Press, 2002. On Poland, Romania, Slovakia, Russia, and Ukraine: S. Johnson, J. McMillan, and C. Woodruff, "Property Rights and Finance," *American Economic Review* 92, 2002, 1335-56.

socially to talk about who is reliable, who is not. Sometimes this process is formalized by trade associations, which keep records for their members' use of customers who have reneged on payments owed. Ongoing relationships, underpinned by the exchange of information, thus substitute for the missing laws of contract.

Unable to get finance from banks or outside investors, firms cope in a variety of ways: receiving loans from family and friends and trade credit from suppliers; joining rotating credit associations and informal credit cooperatives. Moreover, these firms may need no external finance. In a disrupted economy, consumers' basic needs are left unmet and there are unfilled market niches. Early entrants make healthy profits, so they can grow their firms by reinvesting.

How quickly can the private sector grow from scratch? While new firms were created in every transition country, the speed varied. In Vietnam, after the government simply ceased prohibiting private-sector activity while doing nothing to encourage it, entrepreneurship boomed: between 1988 and 1992, private-sector employment rose from under 4 million to over 10 million. In Russia in the 1990s, where businesses were preyed on by out-of-control bureaucrats demanding bribes and the mafia demanding protection payments, entry was slow; whereas in Poland in the 1990s, where businesses were less subject to these unofficial charges, entry was rapid.⁸ Why did the speed of entry vary by country? It was not that some countries had a more supportive business climate, for early in the transition market-supporting institutions were absent everywhere. Rather, entry was slow or fast depending on whether or not entrepreneurship was actively held back.

The private sector can be workable even if impeded by the government. In *The Other Path*, Hernando de Soto depicts Peru's shadow economy as a democratic system, run by the people themselves quite independently of the state.⁹ Driven underground by Peru's business-registration rules, entrepreneurs developed an informal passenger transportation system, set up their own marketplaces selling food and clothing and even consumer durables, and created small factories making garments and the like. De Soto tells a good-news-bad-news story. On the one hand, using their own set of norms and customs, the underground businesses are able to run a productive sub-economy. On the

⁸ J. McMillan and C. Woodruff, "The Central Role of Entrepreneurs in Transition Economies," *Journal of Economic Perspectives* 16, 2002, 153-170.

⁹ H. de Soto, *The Other Path*, New York, Harper and Row, 1989 (quote from p.152).

other hand, operating outside the law “involves tremendous costs,” de Soto notes; “the apparent chaos, waste of resources, invasions, and everyday courage are the informals’ desperate and enterprising attempts to build an alternative system to the one that has denied them its protection.”

The shadow economy in East Timor exhibits the same limitations as de Soto observed in Peru. Forced to operate under the radar, the unregistered firms stay tiny. About a half of them, according to a survey, have an annual turnover of less than US\$1,000. About a half have a single worker, and almost none have more than ten workers. Employees are usually family members paid not in wages but in kind.¹⁰ East Timor’s registered firms are also small, but unlike the unregistered firms they do pay wages in cash and they do have an opportunity to grow: 30 percent have more than ten workers. The shadow economy offers limited scope for generating jobs and incomes.

The costs of registering a business in East Timor are among the highest in the world. If registration were made easier, not only would firms move themselves out of the shadow economy but also extra new firms would be set up. The evidence from other countries suggests that, even if no other changes were made—if contract enforcement remained uncertain and financial markets inaccessible—lowering the barriers to running a business would unleash entrepreneurship and give a boost to job creation.

The firms that are currently engaged in production in East Timor, though relatively few in number, have a wide range of activities, including making furniture, weaving the traditional *tais* textiles, tailoring, baking, ironworking, salt making, coffee grinding, and rice milling. These firms are run in uncomplicated ways. Operating on a small scale, without expensive machinery, they do not need bank loans or equity finance to get started. Buying their supplies and selling their outputs mostly within their own neighborhoods, they deal with people they know and trust and so can get by without laws of contract. Their dealings are straightforward enough that their managers, while they need innate talent, do not need to be trained in advanced business methods.

The standard market-supporting institutions will be needed before these firms are able to upgrade into more capital-intensive activities or to begin exporting. The

¹⁰ J. Conroy, “Timor-Leste: Access to Finance for Investment and Working Capital,” World Bank, 2005 (data from pp.18-20), http://siteresources.worldbank.org/INTTIMORLESTE/Resources/Financial_Services_Sector_final.pdf.

institutions will also be needed to attract foreign investment. However, the low standard of living means there is a domestic need for rudimentary consumer goods, from household utensils to pottery to shoes to textiles. Can the local people afford to buy such goods? They could if they had jobs. Once some new firms start producing, a virtuous circle could go from jobs to demand for consumer goods to further jobs.

East Timor's geographic remoteness could actually help to bring domestic industry into being. Because it would not pay to ship in imports whose value is low relative to transport costs, like cheap wooden furniture, remoteness provides a natural form of infant-industry protection.

Building the full set of market-supporting institutions will take many years. In the meantime, East Timor could kick-start its private sector simply by lowering its abnormally high costs of doing business.

Top-Down Rebuilding

Foreigners bringing nation-building advice and aid funds have been conspicuous in East Timor. Over its first five years, the new nation received official development assistance totaling almost a billion dollars. Each year's aid amounted to around a half of GDP. Much of the aid money, according to the government, went in salaries and consultant fees for the foreign advisors. The weak performance of the economy and the 2006 riots are a disappointing return on this investment of money and expertise.

A sentence in the World Bank's 2005 East Timor country-assistance report is indicative of what I am calling the blind spot in the foreign advisors' view of nation building. "*A whole-of-Government approach around a results matrix, as embodied in the TSP/CSP, is critical to nation building in a post-conflict environment.*"¹¹ (The italics are in the original.) The meaning of this piece of bureaucratese doesn't become much clearer if you read it in context. The report does explain, though, that the TSP is the Transition Support Program and the CSP is the Consolidation Support Program, and that the "whole-of-Government approach" refers to "active engagement" between the East Timor

¹¹ World Bank, "Country Assistance Strategy for Timor-Leste FY 06-08," Aug. 18, 2005 (quotes from pp. 22, 12), http://siteresources.worldbank.org/INTTIMORLESTE/Resources/Final_Timor-Leste_CAS_English_website.pdf.

government and the donor countries, the European Commission, the UN agencies, the Asian Development Bank, and the World Bank.

The “whole-of-Government approach” is to build the private sector from the top down. “In the coming years, the main source of non-oil growth is likely to be the public sector,” the World Bank said in the same report, proposing a public-works program spending US\$20 million annually on construction. “*The most effective way* to increase non-petroleum GDP and to create jobs in the short term,” the report continued (italics added), “is through improved execution of the Government’s budget, with an emphasis on labor-intensive programs.” No. The foreign advisors’ blind spot is in not seeing the private sector’s immediate value. Public works are indeed warranted to create jobs and to supply much-needed roads and other infrastructure, but the most effective way to create jobs now would be to rewrite the rules that stand in the way of business.

In rebuilding an economy, there is unquestionably a need for top-down policies to supply infrastructure and institutions. Also needed, however, is spontaneous evolution. For all the talk of the importance of the private sector, the World Bank and the other international agencies do not seem to recognize the private sector’s potential for growth early in a nation’s reconstruction. The top-down approach focuses on what the government should do—and not on what ordinary Timorese could do for themselves if only they were given the chance.

Job Creation and Peace

The big lesson from East Timor for the rest of the world, I suggest, is that small-scale entrepreneurs should not be obstructed from doing their part of economy building. Talent goes to waste when entry barriers are high, for all but the affluent are excluded from growing their own businesses.

The following table shows that countries in internal conflict or emerging from it often have high regulatory costs of starting a business. The data, taken from the *Doing Business* website, show, for various countries emerging from or still in conflict, the number of days it takes to obtain a license to start a new business if all prescribed procedures are followed, the cost of obtaining the license as a percentage of the country’s per-capita national income, and the World Bank’s ranking of the country (out of 175

countries surveyed) in terms of difficulty of obtaining a business license (the world's worst country being ranked 1).

Regulatory costs of starting a business

	Time (days)	Cost (% of per-capita income)	Rank
Angola	124	487	6
Bosnia-Herzegovina	54	37	35
Burundi	43	222	67
Cambodia	86	236	17
Cote d'Ivoire	45	134	22
Democratic Republic of Congo	155	481	4
East Timor	92	83	16
Haiti	203	128	9
Iraq	77	68	16
Rwanda	16	188	118
Sierra Leone	26	1,195	96
Sri Lanka	50	9	132
West Bank-Gaza	93	325	3

By the World Bank's ranking, for example, Haiti is the world's ninth most unfriendly country to entrepreneurs, Angola is the sixth worst, the Democratic Republic of Congo the fourth worst, and West Bank-Gaza the third worst. In most of the countries listed, to start a firm costs more than the average annual income. (There are exceptions, notably Sri Lanka.)

Why would countries that are caught up in conflict also have high regulatory barriers? Perhaps it is simply that countries that are badly run in the political sphere are also badly run in the economic sphere. Or perhaps there is an underlying cause: the exclusionary business rules may be part of a broader pattern of the elite holding back the rest of the population that can, in the extreme, lead to civil war.

Whatever the reason, East Timor is not unique. In any postconflict country, the urgent priority—and an essential aspect of the prevention of future conflict—is removing the barriers to job creation.

Some of the problems of building a nation are going to be solved not by officials in the finance ministry, the UN, or the World Bank, but by people whose livelihoods are on the line.