



Commentary from La'o Hamutuk
to the
Fiscal Reform Commission
on the
Draft Value Added Tax (VAT) Law for Timor-Leste
15 August 2016

Firstly, La'o Hamutuk would like to appreciate that the Fiscal Reform Commission has provided this opportunity for public comment on the draft laws on taxes and duties. Nevertheless, we feel that this consultation process has not given enough space for the public to provide in-depth perspectives about the draft tax laws, because of the very limited time which has been allowed.

This effort to revise the tax laws is an opportunity which can help Timor-Leste become a more equitable society. In addition, it will bring in money to contribute to state finances. Therefore, the tax system should collect the most from the richest people in our society, to improve state revenues and strengthen social justice. Unfortunately, we haven't observed that this draft law takes advantage of this opportunity, and we wish that the law would really promote a more equal society.

Because of the limited time, this commentary focuses mainly on the draft Value Added Tax (VAT) Law. Our initial thoughts follow below.

Contents

Timor-Leste needs to invest before we can collect.	2
This VAT Law does not advance economic justice.....	2
The law should help local products compete against imported goods.....	3
The VAT shouldn't make it harder for poor people to improve their lives.....	3
Comments on specific articles.....	4

Timor-Leste needs to invest before we can collect.

Since the restoration of our independence, Timor-Leste's experience is that domestic revenues have always paid for a small part of the annual State Budget, much less than contributions from donors or revenues from oil and gas. Therefore, the Government hopes that this fiscal reform plan will help Timor-Leste increase domestic revenues through more effective tax collection, through the creation of a Value Added Tax (VAT).

We strongly agree that Timor-Leste's economy needs to move away from petroleum dependency. However, this requires our Government to begin to create economic activity in the country through public investment in the food processing industry, agriculture sector, education and health care which will open many job opportunities for our people, before we try to collect taxes from these people.

Unfortunately, the Government gives little attention to economic sectors which could create jobs or benefits for significant numbers of people. Every year, our State Budget prioritizes huge infrastructure projects whose future economic return is questionable, and which benefit only a few individuals and those who get contract awards. Timor-Leste needs to quickly change our direction, because we believe that when many people receive benefits, many people will be able to pay taxes to the state, which will greatly improve state income.

In addition, we think that one underlying objective of fiscal reform should be to balance the revenues of the state with state expenditures. Timor-Leste's 2016 Rectification Budget is about 31% larger than our 2015 state budget. Therefore, we suggest that the Government should reform its spending to adapt to the principle of sustainability, as well as the capacity of our local economy. If the Government doesn't want to reduce its annual expenditure, especially by re-evaluating the megaprojects which bleed our money, it will be impossible to achieve the objective of fiscal reform.

This VAT Law does not advance economic justice.

This law's principal objective of collecting taxes for state revenue often overlooks the people's economic reality, especially those who are poor, vulnerable and haven't yet found work.

Article 14.1 of this draft law states that a 10% tax will be imposed for selling or importing goods and services within the territory of Timor-Leste. We think that this law should apply different percentages for goods or services produced in the country, compared with those imported from abroad. Luxury goods, especially, which are used primarily by affluent people – such as cars and electronic appliances – should have higher taxes than goods which are necessary for ordinary people's daily lives. This can be done with targeted excise taxes -- the list in Annex II of the proposed Taxes and Duties Act is a good start, but does not go far enough.

When everything is taxed at the same percentage rate, poor people have to pay more compared with those whose incomes are higher. We think that everyone should pay taxes according to their economic capability, and the law cannot require poor people to pay taxes which should, more appropriately, be the responsibility of those with more money.

In addition, we are concerned about Article 40.1 which exempts businesses with turnover of less than \$100,000/year. We think that this is a policy which does not promote economic justice between Timorese and foreign businesses. Large companies already have a lot of experience, and often use their experience to exploit opportunities to avoid taxes.

With this provision in this draft, large companies can create many subsidiaries to sell or produce goods as their parent company does. However, because each has a different legal identity, when the value of the business is divided among all the subsidiaries, each individual company could qualify for an exemption.

This situation will harm Timorese businesses, because they will face challenges to promote their own economy, and weaken their capacity to compete with businesses from other countries.

The law should help local products compete against imported goods.

In principle, La’o Hamutuk totally agrees with the tax exemption for goods related to basic needs, such as food, especially so that poor people can access good nutrition for their entire families.

Annex II of this draft law list food items which will be exempt, but we think that it should also categorize food produced domestically and food which is imported. Article 15.1(a) of this draft law only mentions exemptions for “operações internas”, not for production inside the country.

Although most Timorese people live by the agriculture sector, we continue to import rice and other foods from overseas. During 2015, we spent nearly \$100 million to import food and drink, including \$26 million for rice and other cereals and \$30 million for beverages.

With this high level of imports, very few products produced by local farmers can compete with items from abroad. This weakens Timor-Leste’s economy, as a lot of money runs away and does not circulate in the local economy.

In 2014, Timor-Leste had a trade deficit totaling \$2,080 million, including goods and services. For goods alone in 2015, our deficit was \$562 million, while our exports (not including oil and gas) were only \$16 million, 95% of which was coffee.

Many factors influence this import dependency, and this law alone is not strong enough to protect locally-produced products; our money will continue to fly out of the country. Therefore, La’o Hamutuk would like to suggest to apply the VAT to imported food, so that local products will be able to compete in the domestic market.

In addition, applying a lower tax rate to products made in the country could create employment for Timorese people. When high taxes are charged on local production, business owners have to reduce their operational costs, which means fewer jobs.

The VAT shouldn’t make it harder for poor people to improve their lives.

VAT is a tax collection methodology which makes all consumers pay taxes on the supply chain from raw materials to the end user. Therefore, in countries like Timor-Leste, where many people live in poverty, without regular employment, without enough money to provide education and health care services, and which depend on imports, the VAT can become an obstacle to people escaping from poverty and vulnerability.

Few domestic products and dependency on imports from other countries adds the cost of bringing goods to Timor-Leste. Long-distance shipping takes many steps, each of which will incur its own VAT, but in the end the local consumer, especially the poor, will be required to pay the accumulated tax.

Government should understand that when goods become more expensive, this reduces the ability of poor people to buy them, or to access health care and education. We all know that when taxes rise, this makes prices higher for the people.

Unfortunately, the 2014 *Living Standards Survey* has not yet been made public, so La'o Hamutuk cannot analyze how many people in Timor-Leste still live below the poverty line. However, we have tried to use the 2014 *Business Activities Survey*¹ to approximate the potential VAT revenues – but there is no information on how much of its survey sample is small enough to be exempt from VAT. According to the BAS, the 2,684 businesses it surveyed had a total Industry Value Added of \$577 million. Since many of these will be exempt, the potential revenues from a 10% VAT are probably less than \$50 million, and could be even lower. The total income (“turnover”) of these businesses was \$2,043 million, but many are below the \$100,000 threshold. If the Fiscal Reform Commission has analyzed how much tax will be collected by company size and sector, we ask you to share that information with the public so that we can all better understand the implications of the new tax law on the people of Timor-Leste.

In addition, we have questions about the administrative overhead which businesses will have to perform to comply with this tax law, including companies whose turnover is less than \$100/day. Has the Fiscal Reform Commission estimated how much time it will take a typical company to prepare its tax records and forms? Do you know how many businesses are capable electronic filing? Using data in the World Bank’s *Paying Taxes 2016* report,² La'o Hamutuk calculated a “Taxpaying Inefficiency Index (TII)” equal to the number of person-hours a business spends preparing its tax returns for each one percent of its revenues paid in taxes. The world average is 6.4, and the Asia-Pacific average is 6.2. Our two neighbors, Indonesia and Australia, have TIIs of 7.9 and 2.2 respectively. Timor-Leste’s TII is 24.6 – four times larger than the world average, three times more than Indonesia and eleven times Australia. We should not continue in that sorry tradition.

Comments on specific articles

Article 2. Timor-Leste does not use the continental shelf definition of maritime territory. This article should refer to the Exclusive Economic Zone as defined in Law No. 7/2002 on the *Fronteiras Marítimas do Território da República Democrática de Timor-Leste*,³ as modified by subsequent treaties. The same correction should be made in **Article 4.2.**

Article 3.1(a) lists certain sectors but omits major parts of our economy, including retail, import and construction. These should all be included.

Does **Article 3.1(c)** refer only to entities of the **RDTL government**, or also of other governments, international agencies, etc.? These should all be taxable except when a case-specific exemption has been granted by mutual agreement.

Do **Article 4.1(a)** and **5.1** refer to goods or services exchanged by barter for other goods or services, or only to those sold for money? “For consideration/*a título oneroso*” is unclear, although **Article 12.3** implies that barter transactions are taxable. In such cases, how will the value of the transaction be determined? Similarly, how with the “market value/*valor de mercado*” be determined in **Article 12.5**? The discretion involved in this process seems vulnerable to collusion or corruption.

¹ <http://www.laohamutuk.org/DVD/DGS/BAS2014en.pdf>

² <http://www.laohamutuk.org/DVD/2015/paying-taxes-2016.pdf>

³ <http://www.laohamutuk.org/Oil/Boundary/RDTLBoundariesLaw2002en.htm>

Why does **Article 4.2** exclude offshore petroleum, the largest component of Timor-Leste's economy? There is no similar exclusion for onshore petroleum activities, or for mining. All companies, including subcontractors, who conduct taxable activities in the territory should be taxed, although there may need to be an exemption for the value of the specific petroleum products extracted, since these are subject to a Production-Sharing Contract. However, drilling test wells, building and importing infrastructure, conducting seismic surveys, construction, decommissioning, etc. should be subject to VAT. For areas in the Joint Petroleum Development Area (JPDA), these two articles, as well as **Article 7.2**, will have to be made consistent with the Tax Agreements in the Timor Sea Treaty and its Annexes.⁴ The exemption for offshore petroleum activities in **Article 14a.1(b)** should similarly be revisited and clarified.

Does **Article 5.2(a)** include sale of immovable property (land)? How about rentals and leases?

Article 9.3(e) is unclear, given that a lot of airplane travel is from round-trip tickets. For example, if someone buys a ticket in Bali (or over the internet) for a Denpasar-Dili-Denpasar round trip, is none of it taxable? If they bought a Dili-Denpasar-Dili ticket in Dili, is it entirely taxable? If they bought two one way tickets, is only one of them taxable? Can someone avoid VAT by using an overseas travel agency?

Article 15 does not provide exemptions for domestically-produced products, but only mentions "internal transactions/*operações internas*" which does not mean "domestic products."

Because **Articles 15.1(b)** and **15.1(c)** only discuss provision of education and health services, we suggest that Annex II be expanded to include a list of school supplies, such as workbooks, books, pens and school uniforms, as well as medical equipment and medicines.

Article 15.1(b) only discusses provision of education services by public entities, but we suggest that it should also include not-for-profit, private educational institutions which can attract quality professionals to help Timorese children learn better. In reality, UNTL alone can barely accommodate the 16,000 young people who finish secondary school every year, most of whom will turn to private higher education. Furthermore, this suggestion should also apply to **Article 15.1(c)**, exempting non-profit, private hospitals and clinics from tax.

Article 15.1(c) exempts insurance, while **Article 15.1(h)** exempts the leasing of commercial property. We hope that these activities will be taxed through other tax laws – it would be inconsistent for the government not to receive revenue from these activities, which primarily benefit large, often international, companies.

Article 17.1(a) about exemption of imports from taxes is unclear. We hope that this provision will not further reduce import taxes, as applied under Law No. 8/2008 and subsequent revisions.

Does **Article 17.2(a)** refer to Free Trade Agreements? Such agreements will come when Timor-Leste becomes a full member of ASEAN, and could significantly reduce the ability to collect VAT. Please consider carefully if these provisions will cause Timor-Leste's revenues to drop when we join ASEAN, WTO, or sign similar agreements.

Regarding **Article 22a**, Timor-Leste has already signed and ratified many international treaties, we have made diplomatic agreements with many nations, and we are involved in several international associations and organizations. Therefore, there should be a deeper explanation about the Special

⁴ <http://www.laohamutuk.org/Oil/Boundary/TST%20text.htm>

Refund Regime applied under international agreements to which we are a party, and also how it will affect our diplomatic relations.

In **Article 32.1(a)**, does “peripatetic sellers/*vendedores ambulantes*” refer only those who sell from carts or off their shoulders? We think that this provision should also include neighborhood market stalls, and kiosks, so that they don’t have to waste time proving that their turnover is less than \$30,000.

Article 40.1 should create different classifications for local and international businesses. Because when a local businessperson cannot benefit from the same exemption as an international, often our local businesses will not be able to compete with people from overseas who have more experience. This exemption should only apply to Timorese businesspeople, not to those come from abroad.

Article 40.1, exempting businesses with turnover of less than \$100,000 per year, is well-intentioned but needs more care to protect against corruption abuse. If one person or company owns several stores or restaurants, can they treat them as separate “legal persons” to avoid tax? If one consultant has contracts with several clients, can they create separate “persons” for each client?

The time for appeal in **Article 48.2** is too short – 15 days may not be long enough to analyze what the tax department has done.

In **Article 51**, legislative changes to the tax rate or the exemption threshold should not be buried in the Annual State Budget, which receives rushed consideration in a closed-door committee and is primarily concerned with other matters. Rather, they should be done through a separate Parliamentary Law on this specific issue (i.e. revising the Tax Law). Although it is probably legal to do this as part of the State Budget Law (as creating the autonomous Infrastructure Fund was done in the 2016 State Budget), La’o Hamutuk considers that it is not good practice and should not be encouraged.

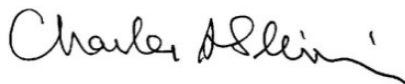
This concludes our comments, and we hope that the fiscal reform policy will reflect the issues we have raised, so that the enacted laws embody a perspective to advance development which is truly sustainable. Please keep us informed about any consultations or revisions of the draft laws, so that we can participate in future processes. We think that it would be better if there were more explicit notice and more time, rather than simply publishing draft documents on the Ministry of Finance website with an invitation “for comment and feedback from the private sector” alone.

Thank you very much for considering our ideas, and we are always ready to provide additional information about the above issues.

Sincerely,



Juvinal Dias



Charles Scheiner



Adilson da Costa Junior



Marta da Silva



Celestino Gusmão



Niall Almond

Researchers at La’o Hamutuk