Commentary by Tim Anderson, University of Sydney

On RDTL Tax and Duties Bill 2008

March 2008 and March 2007 (below)

Here is a brief summary of and some observations on the DRTL "Tax and Duties Bill 2008.

The Bill:

1. The Bill presents mainly as enabling legislation, the substantial tax rate decisions are in the schedules to the bill.

2. Several categories of tax have been defined at a very low level excise tax and import duty (tariffs), sales tax and income tax. There are special provisions for oil and gas taxation.

3. Excise and import taxes have been set in Schedule II and Schedule IV. There are special rates for tobacco, alcohol and arms (Sch. II) (which may be waived for “raw materials”, s.14) while the general import duty / tariff rate has been set at 2.5% (Sch. IV).

4. Sales tax on imports is also set at 2.5%, while sales tax on local goods and services is to be set at a “rate to be determined by Parliament” (Sch. III).

5. Income tax has been set at four broad levels: (i) wages exempt from tax, for foreign public servants and others on “official duties”; (ii) taxable income for persons set at 10% for those on $500 per month or more, and zero for those below $500 (Sch. V); (iii) business tax, set at effectively the same rate 10% for those on $6,000 per year or more and zero for those below that (Sch. VI); (iv) corporate tax (at 30%) and other taxes (e.g. services tax at 12%) applying to the oil sector.

6. There is a sales tax exemption process (s.16-17) and a deduction and depreciation process for income tax (Chapter VII).

7. A different tax regime is provided for Timor Sea oil and gas, presumably because of rates set under contracts that fall under the Timor Sea agreements. I presume there is no change in this regime, because that would require breaking those contracts. However I have not been able to compare this bill to the oil and gas contracts.

Comments:

8. Limits on excise and the very low (2.5%: almost non-existent) import duty rate means that this already very small source of revenue will nearly disappear. As a consequence, the relative effort involved in collecting tariffs will increase; this may encourage neglect. Tariff abolition is certainly a course encouraged by Australia, which dispensed with all its tariffs on Timor Leste goods back in (I think) 2005. The problem is, Timor Leste exports hardly anything to Australia, while Australia exports quite a bit to Timor Leste. This asymmetry means that virtual tariff abolition (on both sides) benefits Australian companies but provides no real benefit to Timor Leste businesses. Though there has been great pressure for tariff reduction at the WTO, most developing countries have maintained a greater on tariffs as: a source of

revenue, a means of sustaining a more equitable progressive taxation system (since it is usually luxury imports that are targeted by tariffs) and some forms of protection of local industries. Unilateral tariff abolition by a poor country may reduce the cost of luxury goods, but removes an important revenue source and policy instrument.

9. The sales tax exemption process is not well explained in the Bill. It looks like exemption may be granted to those who just fill out a form (s. 16.2). Sales tax relates to the sale of both goods and services. Of particular concern here is that the provision seems to apply to tourism services, a potentially major future industry for the country, when the troubles subside and infrastructure and public health are improved. A minimal services tax (2.5%) means that a potentially major source of government revenue will be denied, as tourism grows. With low services tax and business income tax, almost all the benefits of increased tourism would be privatised.

12. There are a range of allowable income tax deductions, even though the general rate has been set flat (the same for all) and very low (10%). Often the argument for very low or flat rates are justified by a claim that this will "simplify" a complex system and require at least a basic rate be paid by those who best manipulate deduction regimes. Companies (particularly international companies which can "price transfer") typically take best advantage of deduction regimes and pay little or no income tax, even in countries with relatively high tax rates. In this case there is, unusually, a very low rate AND a wide deduction regime. The likelihood is that this will lead to many businesses paying NO income tax. Most other people in TL, of course, will pay no tax, as most earn less than $500 per month. A very small number of higher income wage earners will pay 10% tax. The likely overall result is that there will be very little income tax revenue in TL, and little capacity to build this revenue as the economy grows.

13. Drastic reductions in import, sales and income taxes (instead of, say, a carefully targeted regime which focused on luxury goods, tourism services and business taxes) will certainly make the "tax base" in RDTL more narrow. However it is well accepted (even in neoliberal countries) that it is wise to broaden the "tax base" that is, broaden the range of possible tax sources, so that state revenue is steady, not vulnerable to sectoral changes and grows with the economy. A narrower tax base will increase reliance on petroleum revenues, but also make escape from this reliance far more difficult, even when the general economy recovers.

14. Tax base narrowing is one key part of "resource curse" arguments. Other elements are that over-reliance on natural resource "rents" encourages a culture of complacence and corruption in a "rent seeking" society.

15. This Bill is similar to the proposals made by Jose Ramos Horta when he was Prime Minister in 2007. I made some comments on those proposals and some other related policy matters, at that time. This note is reproduced below.

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Discussion of Jose Ramos Horta's tax proposals
By Tim Anderson, 19 March 2007

In March 2007 East Timorese Prime Minister Jose Ramos Horta announced a general proposal for tax reform in Timor Leste. It amounts to a brief discussion paper, because, as JRH says, as an interim PM and with elections looming, he does not have the time to see any of these proposals implemented. Here is a summary of the proposals, along with some observations.

The framework of the proposals attempts to combine "pro-poor" and "pro-business development" notions, a common theme of the World Bank. It is also said to be aimed at making Timor Leste a "free trade state", though what JRH seems to mean by this is a combination of cutting tariffs, sales tax and income tax.

The fiscal idea of the proposal is to reject the costly administration required to recoup small tax revenues (which, although small, are said to be a disincentive to investment) and to rely even more heavily on revenue from oil and gas. Non oil government revenues are said to be 5% of oil revenues. This proposal would make them an even smaller proportion.

In particular, JRH proposes:
(1) To cut tariffs, sales tax and excise, except for those goods which "are damaging to the environment or to the health of the people" this might mean maintaining excise on such imports as cigarettes and alcohol. However in recognition of the damage to some (unspecified) local producers from cheaper imports, he suggests compensation be paid to them. This is an uncosted proposal, presumably to be paid with oil revenues.

(2) To abolish tax on persons and businesses with incomes of less than $1000 per month. He says there is "no reason for poor Timorese to be paying any tax". However it seems unlikely that East Timorese people earning, say, $800 or $900 per month could be considered "poor", nor is it clear what tax they pay at the moment.

(3) To set a flat income tax of 5-10% on all persons and companies earning more than $1000 per month. JRH says this could even go to 0%, and compares his proposal favourably to the IMF's suggested 15-20%. The rationale is presumably to encourage business investment. A flat tax rate of 5-10% is a major concession and benefit to high income people in Timor Leste, but from experience elsewhere (e.g. Nicaragua), it is not clear that this would attract more foreign investment. However investors would certainly accept the privilege, if offered.

(4) To remove the 1% tax on business turnover. There is no suggested rationale here (except to say collection of the tax is a burden and it does not raise much revenue) but, again, it is presumably to encourage investment. However a low turnover tax is simple in principle and the revenue raised would increase as the economy grew.

(5) To "simplify the incentives offered to foreign investors". This aim is said to be met by lowering income tax.

(6) To minimise the use of indirect and temporary measures. JRH says "permanent and direct" policies (such as low tax rates rather than "tax holidays") are preferable to "temporary and indirect measures" (such as subsidised utilities, presumably including electricity and water). The former are advocated as fostering stability and avoiding corruption and waste. The latter

is a standard neoliberal policy, (as in World Bank SAPs) calling for up-front payments rather than “price distorting” policies.

JRH suggests that both Xanana Gusmão and Mari Alkatiri broadly agree with his proposals. This seems unlikely, as they are wide ranging and lack detail. It is hard to agree or disagree with some aspects of the proposals.

The proposals have some useful elements. The idea of stable policies (fixed tax rather than tax holidays) could establish more transparent relations with foreign investors, and also raise revenue. Abolishing income taxes for the poor is also valuable, both for their well-being and to stimulate the economy (because poor people spend all their income). However (i) it is not clear that poor East Timorese currently pay any tax, and (ii) the $1000 a month definition of “poor” would seem to need some serious revision. The average *annual* income in Timor Leste is currently less than $1,000.

The idea of abolishing tax on the poor, however, might be thought to give greater legitimacy to the proposal to abolish most income tax for high income earners. “Flat taxes” like this are regressive, in that people with greater capacity to contribute to public revenues are exempted. This “flat tax” proposal is extremely low. When combined with the abolition of a turnover tax, it amounts to an extraordinary concession to wealthy people in Timor Leste. The principal rationale would seem to be to encourage investment but (i) it is not clear that it would do so and (ii) as a regressive tax it is inequitable. If high income earners and companies are to be exempted from contributing to government revenues, either (i) state capacity will shrink or (ii) the burden will be passed onto poor people (e.g. through consumption taxes) or (iii) public assets (e.g. oil an gas revenues) will be pilfered.

The abolition of all tariffs (except for those on harmful goods though presumably some of these should not be allowed into the country) misses the opportunity to tax luxuries. While Timor Leste may not currently gain much revenue from tariffs and excise, many developing countries (as opposed to wealthy countries) do indeed get significant revenue from tariffs and excise. JRH says that tariffs and excise currently amount to only 1.78% of oil revenues at the moment. But this is the largest category of non-oil revenue, and would increase with economic growth, including growth in tourism.

Overall, the proposal would increase state dependence on oil revenues, which seems undesirable. This would most likely undermine one of the main objectives of RDTL’s Petroleum Fund, that is: “to save a significant share of the revenue so that future generations will benefit from .. [the] natural endowments.” Demands on these funds would increase.

Tax proposals which broaden (rather than narrow) a government’s revenue base are regarded favourably in most countries. In wealthy countries neoliberal policies have pushed for greater reliance on consumption taxes to “broaden” this revenue base. In developing countries tariffs and excise, as well as corporate and resource taxes, usually play important roles. In general, cutting taxes alone has not been found to stimulate much new investment. However it is certainly true that stable rules (including at times high tax regimes), when an investor becomes convinced of an opportunity (e.g. in a tourist hotel), will encourage investment.