

INCOME AND CONSUMPTION TAX REFORM FOR TIMOR-LESTE:

GENDER AND POVERTY IMPACT, POLICY OPTIONS AND RECOMMENDATIONS



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This brief is a summary based on the UN Women Report, *Income and Consumption Tax Reform for Timor-Leste: Gender and Poverty Impact, Policy Options, and Recommendations*.

Background

In August 2016, the Fiscal Reform Commission in Timor-Leste released draft legislation that will:

- increase the 10% corporate income tax (CIT) rate to 15%;
- keep the 10% personal income tax rate (PIT) for incomes between USD 6,000 and USD 40,000, but add a second rate of 15% for incomes over USD 40,000;
- increase excise tax rates, payable on items such as tobacco, alcohol, and luxury cars; and
- replace the sales, services, and duties taxes with a new 10% Value Added Tax (VAT).

The draft VAT law will exempt a wide range of processed and unprocessed foods as well as medical and education expenditures, which will protect many basic necessities. It also limits VAT registration in the non-oil sector to businesses with annual gross receipts over USD 100,000. Small businesses will thus not be required to register for VAT, which means that they will not have to take on the administrative burdens of VAT tax accounting, remittances and filing. They can, however, elect to become VAT-registered businesses in order to benefit from VAT refunds and take on those administrative responsibilities at that time. Exports are to be zero-rated, which lets exporters recover all input VAT payments they have collected at the point of departure.

The Fiscal Reform Commission was advised that a 10% VAT with no exemptions could provide a good start toward the objective of increasing non-oil domestic revenues from 8% to 15% of GDP by 2020. Issues concerning the distributional, development, poverty, gender equality and income inequality effects of a VAT were raised in public consultations and partially considered during the drafting process.

Key findings from the gender and poverty impact analysis:

1) Even with the exemptions in the VAT, most of the new revenues will burden the poorest

Estimated additional revenue from the new personal and corporate income tax, plus the new 10% VAT, is USD 66.6 million (2016 values).¹ About 83% of this new revenue will be from the new 10% VAT. A VAT is considered to be regressive in impact because the VAT tax will take a larger share of total income from low income people than it will from high income people. The lowest income households will pay an estimated 27% of total household income for the VAT on their consumption while the highest income households will only pay 9% of their total income on the VAT. The additional tax bracket in the Personal Income Tax (PIT) of 15% for those earning annual revenues above USD 40,000, will do very little to make the whole tax package more progressive in incidence, as it will apply to a very small proportion of people, and will only produce a small portion of the total new tax revenues (USD 7.9 million).

2) At least 60% to 65% of all Timorese will not have the ability to pay the VAT

The current proposed exemptions for unprepared foods, medical and education costs are essential provisions, but on their own, these exemptions do not sufficiently ensure that those living on low incomes will have the ability to pay the 10% VAT. In fact, even small amounts of VAT liability will reduce already-inadequate consumption budgets to lower levels than exist now. Using the basket of individual basic necessities valued at USD 41.22 (HIES 2011) and taking into account the proposed food/medical/education exemptions, only USD 21.47 of those basic needs costs will be VAT exempt in the proposed law (2011 values), leaving USD 19.75 where 10 % VAT will apply.² About 60% to 65% of people (2011 HIES) do not have enough income to pay for all their basic necessities. The VAT will make the package USD 1.98 more expensive, which will only further reduce their ability to pay for it. Women represent 66% of the people with the lowest income (from zero to USD 9.63) (see table 1). This means that, within the general population, women have much less ability to pay the 10% VAT than men, whose incomes average USD 1,000 to over USD 2,000 in their peak working years.

3) VAT will burden small businesses, particularly businesses owned by women

Small businesses that do not register as VAT collectors risk having lower profits from 'trapped' VAT that they pay their suppliers or contractors. In this very common situation, these small businesses will either have to absorb those VAT payments as new costs or pass their VAT cost on to their customers. Both of these effects will reduce business profits, perhaps encourage 'VAT free' sales competition and encourage informality of business operations rather than encourage openness. Businesses owned by women are disadvantaged because they are comparatively smaller, have fewer employees and lower profit margins than businesses owned by men. The VAT is likely to significantly further reduce the profitability of women's businesses and add to the ever-widening gap of inequality which continues to place women's economic security and family welfare below that of men's financial and political gain.

¹ All estimates in the analysis use 2011 Timor-Leste United States (US) dollars for all calculations, because these estimates are based on data from the 2011 *Household Income and Expenditure Survey* statistics on incomes and living costs, combined with data from the 2010 census on household structures. 2011 Timorese US dollar values can be converted to 2016 values by a factor of 24.49%.

² The analysis was based on the basket of individual basic necessities, as provided in the HIES 2011, and valued at USD 41.22. This figure is the national average cost of monthly individual consumption, which means that it represents an average figure that is close to minimum essential individual needs.

Table 1: Cost of new 10% VAT on non-exempt basic necessities as percentage of average monthly individual incomes, by decile and gender, 2011

Income deciles (individuals)	Average monthly incomes of individuals in decile	VAT on non-exempt basic needs (USD 1.98) as % of monthly income	Men in decile (%)	Women in decile (%)
1	—	(\$43.20)	34%	66%
2	\$9.63	20.6%	34%	66%
3	\$16.67	11.9%	41%	59%
4	\$23.33	8.5%	52%	48%
5	\$30.77	6.4%	59%	41%
6	\$40.00	5.0%	65%	35%
7	\$51.67	3.8%	74%	26%
8	\$65.00	3.0%	80%	20%
9	\$84.67	2.3%	74%	26%
10	\$131.67	1.5%	80%	20%
Median	\$40.00	5.0%	60%	40%

Sources: Average incomes by decile: HIES 2011, table 5.1.3, 23; gender in deciles: Census 2010; VAT on nonexempt median basic necessities per month: derived from HIES 2011, table 5.1.6, 24 (national average cost of total consumption, minus gift food: \$41.21, less VAT exempt consumption (food, \$19.47, and non-food immaterial consumption, \$2.00): \$19.75).

Proposed policy options:

Ensure ability to pay the VAT in the new tax laws with direct support for low incomes

- Focus the tax reforms on increasing personal and corporate income tax (PIT and CIT) rates that apply a progressively higher income tax as income increases over a certain threshold. For example, PIT rates that gradually increase from 5% to 30% combined with a 30% CIT rate and a low initial VAT rate of 1% (while keeping sales tax) or up to 5% (replacing the sales tax) could produce USD 50.4 million in new revenues (2016 USD). In this option, only 11% of this new revenue will come from the VAT and all the rest (15% CIT and 74% PIT) will come from those with higher than average incomes.

- Increase the number of essential goods exempted from VAT. Given the serious concerns with malnutrition in Timor-Leste, especially among children, it would be far better to exempt the whole range of basic household and food items, including all prepared foods, and to extend exempt status to an average budget for personal care items, transportation, footwear, children’s clothing and basic household implements, for example.

- Services essential to women’s equal access to paid work such as childcare and afterschool care and prepared foods, including meals purchased from dine-in or take-out establishments should also be VAT exempt. There is a significant risk that the new VAT will create new barriers to women’s paid work or create a tax incentives for women to increase the focus of their efforts in continuing to do unpaid work such as childcare, food preparation and work within family businesses.

Provide social protection allowances for households that do not have ability to pay VAT

- Create a cash safety cushion for the poorest households that already have difficulties paying for essential goods, as well as to prevent larger numbers of individuals from falling into poverty.
- This economic support can be given as VAT vouchers or as direct allowances alongside social protection payments to those living on low incomes.
- At the very least, those who do not have the ability to pay the VAT on items outside the proposed exemptions for unprepared foods, medical and education costs should be granted a basic needs VAT allowance, advance refund or waiver card for a new regional Basic Market Basket that can protect their ability to pay the VAT on basic food, personal clothing and household tools.

Zero-rate or tax credit small businesses and agricultural enterprises to protect profits

- Extend zero-rating to small business and agriculture operations to allow them to reclaim their VAT costs, as is done for agriculture and tourism in Indonesia and by other countries for domestic enterprises that can contribute to the growth of the national economy.
- Provide flat VAT allowances to all small businesses and agricultural enterprises that register and produce prescribed standards of accounting and bookkeeping, thus accelerating the formalization of business operations as they develop and improve administrative efficiencies.

Provide tax credits for businesses that employ Timorese women and men workers equally

- The draft changes to the Tax and Duties Act propose enhanced tax deductions for businesses that employ Timorese, letting them claim 150% and 200% of their wages. These deductions should be made conditional on hiring equal numbers of women and men at all wage levels, in all types of jobs, and on the same terms of job security and benefits, with proof of this employment filed as part of business tax returns.