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Submission to

**Commission C, National Parliament
Democratic Republic of Timor-Leste**

from

**La'o Hamutuk
Timor-Leste Institute for Development Monitoring and Analysis**

Regarding the

Proposed Tax Reform Law

25 March 2008

Introduction

La'ó Hamutuk appreciates this important opportunity for civil society to participate in this consultation process.

First, we would like to remind you that the National Parliament are the people's representatives, and therefore the Members have the obligation to listen to and understand the needs of the poor people, the rural people, and everyone who puts their trust in you. Members of Parliament are primarily responsible to the people who elected you, and therefore you should not listen only to advice from some Ministers and International Financial Institutions like the IMF, ADB, IFC and World Bank, but need to do what is best for the people of this country.

La'ó Hamutuk is a Timor-Leste organization which monitors, analyzes and reports on the activities of international institutions involved in the social, economic and infrastructural development of this country. We believe that the people of Timor-Leste should be the decision-makers, through democratic processes.

This submission will discuss some implications which affect our nation, especially our poorer citizens, if Parliament passes this draft law as presented. We hope that the Members of Parliament will make some changes to this law, to better protect all our citizens and to increase social and economic justice, which is important to the stability of our nation.

This law makes Timor-Leste more dependent on petroleum revenues.

We all know that today 97% of State revenues come from petroleum; this will increase to 99% if this law is passed. This law pushes Timor-Leste even more into petroleum dependency for many years. In 20-50 years, when our petroleum is all used up, Timor-Leste's oil income will be reduced. But our State will need more money, because our population continues to grow while the Estimated Sustainable Income (ESI) from the Petroleum Fund will stay the same. At that time, Government will try to reinstitute tax increases, which will be very difficult for our people to pay. This could cause economic disruption, leading to social unrest. For example, the Indonesian government used to subsidize oil for its people, but now, when oil prices are rising and unstable, the government stopped the subsidy, putting pressure on the people and creating many problems.

Government will give a two billion dollar present to oil companies by cutting business taxes to 10%.

Timor-Leste's Government is currently working hard to bring the pipeline from Greater Sunrise to Timor-Leste. It's not yet clear if this proposed law will apply to this LNG project, or if the Government is planning to create another new law for this project. If another law is passed which applies a 30% tax rate to this specific project while other businesses pay only 10%, the companies operating the LNG project may feel that it is unfair. But under this proposed tax reform law, the project would be taxed at only 10%, which will reduce tax revenues to Timor-Leste over the life of the project from \$3,600,000,000 (\$3.6 billion) to \$1.1 billion. (See La'ó Hamutuk's report "Sunrise LNG in Timor-Leste: Dreams, Realities and Challenges," Box 11.) Timor-Leste thus will give a present of around \$2 billion dollars to the companies operating the downstream Sunrise project.

This law increases the gap between poor and rich people, creating instability.

Since this law will reduce import taxes, poor people could pay less for imported goods. However, some importers may not reduce prices, so that poor people don't see the full benefit, while the importers' profit margins increase. This will increase the gap between rich and poor. Without economic justice for the people, rich people will become even richer, but poor people's lives will not change. This can create "social jealousy" in the community, because the Government gives more benefits to rich people and companies, leading to instability inside our nation.

Another concern is that when tax rates are very low, Timor-Leste can become a place for hiding money or other illicit activities of international actors. For example, we can become a place for laundering dirty money, or a conduit to funnel money to other countries. This problem arises because Timor-Leste uses the U.S. dollar, the currency used by international criminals.

Reducing taxes is not the only way to bring investors to Timor-Leste.

The IFIs and the Government officials who propose cutting taxes claim that it will help Timor-Leste attract investors, but this will not happen automatically. In reality, other factors are more important: stability, the justice system, the legal system, infrastructure, land titles, and government efficiency. Timor-Leste does not yet have the conditions which will provide confidence for investors to come here. Timor-Leste's judicial and legal systems are very weak, which creates much instability in our country.

According to studies, the current 30% business tax rate is not too high to prevent international investment; businesses invest in many other nations with comparable rates.

This law will hurt local products and companies.

Most of our citizens live from agriculture, although their products are not yet well developed. They live as subsistence farmers, producing for daily consumption and selling small additional amounts when available. If import taxes are reduced, this will hurt their agriculture, because more goods and food will be imported into Timor-Leste, which will reduce Government's responsibility to support local farmers and to protect and promote their products, as well as reducing farmers' motivation to increase their production, because many people won't buy it. We were saddened when our Prime Minister Xanana Gusmão explained to Parliament that with this Tax Law: "Farmers will receive some negative impacts from cheaper imports resulting from the 7% reduction in import taxes and wage tax cuts. But our agriculture is mostly subsistence, so only a few producers will suffer strong impacts, which will be limited to farmers who sell rice..."

If Government really wants to improve poor people's lives, there are better ways, such as giving subsidies to the people. Government could buy rice from our farmers, or other basic necessities that we produce today, and resell to people at low prices. Last year, when Government decided to give rice subsidies to public servants, they promised that this would support farmers to increase production because Government would buy from local farmers. But this has not happened, as they still import rice from Vietnam and other places. Instead, Government proposes this law which we know will reduce the prices of local products. If this

happens, it will increase profits for importing companies, but not for Timor's poor people or those in rural areas.

As a result, it will be even harder for local businesses to compete, because we know that the capacity of local companies is not yet strong enough to compete in a "free market."

Women and children will be affected.

Women and children will be victims of this law. Women and children are the poorest people in Timor-Leste society. When many investors come to Timor-Leste, this can increase violence against women, domestic violence, human trafficking and prostitution. Many children will drop out of school to look for work with these companies. Because of this, Government must have a good mechanism to manage and oversee international businesses here, and to prevent violations against women and children, smuggling, environmental destruction, human rights violations, etc.

Smuggling may increase.

If we reduce taxes, Government will assign lower priority and fewer personnel to our border control and customs departments, as they will not bring in as much revenue. If customs isn't well-run, this can enable drug-smuggling, gun-running and other illegal activities. Timor-Leste's Customs Department needs to protect our people and our country from this kind of illegal traffic.

The Government will be less accountable to the people.

When all people with salaries less than \$500 don't pay taxes, this can reduce Government's accountability to our citizens. But when everyone pays taxes, this can teach all our citizens that they share responsibility to contribute to development, and remind the Government of its responsibility to our citizens. If not, the Government may begin to provide services only for certain people. Also, people who pay taxes feel that the state should respond to their needs. Since they believe that public property belongs to them, they may take better care of it.

Nevertheless, we don't see a big problem with people making under \$500 not paying taxes, but the biggest problem is that people who make a lot of money will have their taxes reduced from 30% to 10%.

Supporters of this law say that a 10% "flat tax" system will be easier for the Government and companies to administer. We don't think this is correct, because they will still need to know each person's salary in order to calculate and collect the tax due. A company which is large and rich enough to pay someone more than \$500 each month has the resources to calculate the tax, and a progressive tax rate can help reduce class differences.

This law should not be retroactive.

We think that this law should not be applied retroactively, because that would benefit the companies twice over, and is not fair to consumers. It will give benefits to people and businesses who pay taxes directly, such as those paying wage taxes, but ordinary people, most of whom are unemployed, will be jealous. Even worse, when companies receive tax refunds on things they sold, they will not return the taxes which had been passed on to their customers.

If we want to be fair to everyone, especially consumers, we should pay the tax back to those who paid it indirectly, but this is very difficult.

If some parts of this law are to be retroactive, it would be fairer and easier to choose a future date, such as 1 June 2008 or 1 January 2009, for this law to come into effect. This also gives time to change procedures and forms, teach taxpayers, train public officials and do other things necessary for the tax collection system to work better. There is no urgency to bring this law into effect immediately.

As we analyze the implications of this law for our nation and people, we have a few questions that we hope Commission C will ask the proponents of this law to clarify:

1. With these lower taxes, how will the Government ensure that the benefits go to rural areas and poor people? Or will they only benefit businessmen and people living in the city, because mainly rich people buy food in the formal market?
2. If Governments wants to reduce taxes to attract investors, shouldn't they quickly enact the Environmental Impact Assessment law, and laws and systems to manage pollution and garbage, and to create an efficient system and develop mechanisms to provide security in land tenure?
3. How will the Government diversify its revenues in a few years, when our population has grown and our petroleum is used up?