PARPA II Review—The Tax System in Mozambique

Volume I

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Executive Summary

This study is part of a wider evaluation of government performance in achieving the objectives of PARPA II, which has the ultimate goal of promoting rapid, broad-based and sustainable growth to reduce poverty and improve standards of living for the people of Mozambique. The study examines the impact of the tax system on revenue mobilization, investment, savings, job creation, and private sector development, with special attention to small and medium enterprises, as well as the issue of tax equity. The study draws on a review of the tax laws and other documents relating to the tax system; an analysis of data on revenue performance, including international comparisons; and extensive field interviews conducted in July 2009. Based on the analysis, the study identifies 12 priority issues for the next PARPA and recommends corresponding measures for consideration by the government.

The Tax System

Since 1998, all of the main tax instruments have undergone deep reform. Principal features of the system are now well aligned with best practices for developing countries, including primary reliance on a broad-based value-added tax and a modern income tax, supplemented by excise duties on selected products and moderate import duties. The government has made notable progress, too, in improving tax administration since establishing the Revenue Authority (AT) in 2006. As a result, most of the PARPA II tax objectives have been realized, including the central aim of boosting revenue from 14.0 percent of GDP in 2005 to 16.2 percent by 2009. The actual figure for 2009 will fall short of this mark due to weak economic conditions, but AT data show that the ratio reached 16.4 percent in 2008. Other achievements include enacting a new General Tax Law clarifying rules for tax collection and taxpayer rights; rationalizing fiscal benefits, in particular ending the special regime for large projects; passing a new Municipal Finance Act; easing the burden on small businesses by increasing tax thresholds and enacting a Simplified Tax for Small Contributors (ISPC); and strengthening the tax regime for the mining and petroleum sectors. Several objectives, however, are still works in progress. These include integrating tax and customs information systems; tax collection via the banks; improving audit revenues relative to total revenue; modernizing tax administration; and implementing tax courts.

There is little scope for revenue gains through further tax policy measures, but great potential for increasing revenue by broadening the effective tax base, allocating AT resources more efficiently, and facilitating taxpayer compliance through further measures to modernize tax administration. These include functional integration of tax and customs operations; automation of procedures and systems; risk management; human resource management; and development of a service culture among tax officials. Most of the required measures are incorporated in the AT’s Strategic Plan for

2009–2010. To be effective, it is essential that the reforms be carefully planned, properly sequenced, adequately funded, and well managed.

The tax system in Mozambique is reasonably progressive. The poor bear very little of the tax burden as a result of high thresholds for entering the tax net (relative to per capita income), the low tax rate on small contributors via the ISPC, the progressive rate structure under the individual income tax, and the structure of zero ratings and exemptions for basic necessities under the VAT. However, import duties and excise taxes on goods consumed by the poor have regressive effects.

Taking into account the strong revenue growth since 2000, the likely effects of recent policy reforms, prospective reforms to tax administration, and the natural responsiveness of revenues to economic growth, it should be possible for the government to achieve a revenue ratio of 18.5 percent of GDP by 2015, including tax and non-tax revenues. International benchmarks suggest, however, that it is very difficult for low-income countries to boost revenue beyond 18 to 19 percent of GDP without special conditions such as oil wealth. In setting the medium-term revenue target, the government should strike a balance between public and private resource requirements for national development, job creation, and sustainable growth. This consideration suggests that a portion of the revenue gain from reforms and the underlying economic dynamics should be used to reduce tax rates, rather than aiming solely for a maximum revenue ratio.

Effects of the Tax System on Private Sector Development

Standard tax rates on businesses in Mozambique are now slightly above the regional and international averages, due to the global trend towards lower company taxes. Nonetheless, the prevailing tax rates should not be a deterrent to most investments, because other aspects of the business environment are far more important in determining the viability of most projects. Lower tax rates would, however, increase the capacity of existing firms to finance expansion and improve productivity by boosting net earnings and cash flow. One case where tax rates have a critical effect is on internationally mobile ("footloose") investments that could easily go to other countries; these investments, however, should be covered by the fiscal benefits applying to IFZ enterprises, which are highly competitive. In contrast, the effective tax rate is very burdensome for investments that lack special incentives and face double taxation of dividend distributions to individual shareholders. This feature of the tax code creates a disincentive for incorporation.

The tax system affects the efficiency of investment, as well as the level. Special tax breaks under the Code of Fiscal Benefits tend to have the greatest impact on investments with relatively low rates of return, since projects with an intrinsically high return would be undertaken anyway. The fiscal benefits also tilt the playing field in favor of new investors who qualify for tax breaks, relative to existing businesses and other investors—especially small businesses. Similarly, tax benefits that lower the cost of imported capital tend to encourage capital intensity and import dependence, which inhibits the extent of job creation and domestic linkages. Business linkages to small enterprises are also hindered, in less obvious ways, by the need for registered entities to obtain proper tax receipts from suppliers under the VAT and income tax, as well as provisions for 20 percent withholding tax on various transactions.

The quality of tax administration also has an important effect on investment and business operations. Indeed, concerns about arbitrary and punitive enforcement practices by tax officials, complexity of the tax system, lack of taxpayer services, and difficulties in recovering refunds are far more prevalent than complaints about the level of taxes. These problems particularly affect small and medium size enterprises: the primary engine of job creation for the economy.

Tax rates, compliance costs and complexity of the tax system also affect decisions by small businesses to formalize. The Simplified Tax (ISPC) passed in 2009 should go a long way towards reducing these tax-related barriers, if effectively implemented. The VAT, too, creates incentives for formalization, for any small enterprises that wish to do business with VAT-registered companies. Incentives to formalize are also influenced by the cost of non-compliance, which is determined by the AT's capacity to enforce registration requirements.

The effect of the tax system on saving is complex. Higher taxes could reduce business and household saving but increase government saving, leaving an ambiguous net effect in the short run. In the medium to long term, however, the most important consideration is how the tax system affects the growth of income, which is the primary determinant of saving.

Priority Tax Issues

From the analysis of the tax trends and features of the current tax system, 12 issues emerge as medium-term priorities for the next PARPA.

- ***Medium-term revenue target.*** As noted above, a revenue ratio of 18.5 percent of GDP should be achievable by 2015, with a strong commitment to further reform. Yet revenue maximization is not the sole aim of tax policy. Depending on the desired balance between revenue enhancement and tax relief for the private sector, the study suggests options ranging from 16.5 to 18.5 percent of GDP. In any case, the revenue target for each year's budget program should be determined from an analysis of prevailing conditions.
- ***Tax rates***. Moderate tax cuts would provide the private sector with additional financial resources for expansion, innovation, and job creation. Furthermore, Mozambique should not lag too far behind the global and regional trend towards lower tax rates on company income. The study therefore recommends planning for income tax reductions as revenue prospects improve. Also recommended are a reduction in the withholding tax and elimination of double taxation on dividends disbursed to individual shareholders.
- ***Capacity for tax analysis***. Decisions on tax policy should be informed by a careful analysis of the revenue effects and economic impacts. The study recommends establishing a Tax Policy Unit at the Ministry of Finance and training a group of specialists to conduct quantitative and qualitative analysis of tax policy issues.
- ***Functional integration within the AT.*** The Revenue Authority can greatly improve efficiency and effectiveness by further modernizing tax administration. One major requirement is functional integration of common operations between customs and tax services, including audit, risk management, debt management, and customer services, as well as human resource management and master data files for each taxpayer.
- ***E-taxation.*** The government and the AT recognize the importance of information technologies (*e-Tributação*) and have begun planning and implementing major reforms. Priorities include e-declarations, electronic payments through the banks, an automated

single window for border clearances, and automated debt management. These IT measures should also be a catalyst for re-engineering related business processes.

- ***Risk management.*** There is enormous room for improvement in collection efficiency through modern risk management—which will simultaneously reduce the compliance burden and facilitate tax transactions for most taxpayers. The concept is to use automated systems to distinguish cases with high versus low revenue risk, enabling the AT to focus resources on cases where the potential revenue gains are highest.
- ***Tax simplification.*** Despite genuine progress during the PARPA II period, tax simplification remains a major priority. Complexities in the tax code, in tax forms, and in administrative procedures—including those for obtaining tax refunds—continue to create serious problems, especially for small and medium size enterprises.
- ***Taxpayer services.*** The AT has been made impressive progress in improving taxpayer services, but the process is far from complete. Better provision of information is central to any solution, including increased capacity within the AT to provide clear and prompt answers to questions from taxpayers at all levels of sophistication. Another longstanding problem is the tendency of tax officers to employ unpredictable and punitive enforcement practices, where educational support would be more constructive.
- ***Tax culture***. Many of those interviewed for the study emphasized the weak “tax culture” as a primary obstacle to improving compliance and curbing tax fraud and tax evasion. Changing the tax culture requires a combination of carrots and sticks to strengthen incentives for compliance and increase the costs of cheating, while improving public understanding of their obligations. To hasten the cultural transformation, the AT can also pursue measures that would resonate with the public, such as cracking down on affluent taxpayers who have been escaping their tax obligations with impunity.
- ***Tax training.*** There is a great need for expanding and improving tax training for both AT cadres and tax professionals serving the private sector. A thorough training needs assessment is required as the basis for determining training priorities, taking into account the benefits in revenue yield and customer service, as well as requirements for implementing the modernization program. From a revenue perspective, training in advance audit skills for dealing with large taxpayers is especially important.
- ***EITI Implementation.*** The government’s formal application in May 2009 to join the Extractive Industries Transparency Initiative (EITI) is a landmark commitment to revenue mobilization from mineral resources, as well as fiscal transparency. Ensuring follow-through is one of the most important revenue issues for the medium term.
- ***Donor coordination***. Most of the priorities outlined here will require financial and technical support from international partner agencies. Several donors are channeling financial support through a Common Fund controlled by the AT. It appears that other donors will be assisting the AT through other channels. It is important for donors to deliver assistance in a manner that minimizes the burden on the AT of coping with a multiplicity of procedures and requirements.

1. Introduction

This study examines the impact of tax policy on sustainable revenue mobilization, broad-based economic growth, the development of small and medium enterprises, and other basic objectives of the government's second *Plano de Acção para a Redução da Pobreza Absoluta*, or PARPA II. The study forms one part of a wider evaluation of government performance in achieving the PARPA II objectives, with the ultimate goal of reducing poverty, promoting rapid, yet broad-based and sustainable growth, to improve the standards of living and welfare of the people of Mozambique.

Consistent with the terms of reference, the study provides an overview of the principal issues, the main reforms, and their impacts on PARPA II objectives, leading to recommendations on priorities for further improvement of the tax system in the next PARPA period. The study draws on three sources of information: a thorough review of documents and studies relating to the tax system, including the main tax laws; an analysis of data on revenue performance, including international comparisons; and extensive field interviews conducted in July 2009. The analysis focuses on developments during the PARPA II time frame of 2006 to 2009, but also examines a longer period of data to put recent trends in perspective.[1]

A number of general points that emerge from the study are worth highlighting at the outset. The first is that large strides have clearly been taken to improve the efficiency and capacity of the tax authorities since the establishment of the Mozambique Revenue Authority (AT) in 2006. This is widely acknowledged by all parties, and reflects very positively on the recent reforms.

A second basic observation, encountered in many of the field interviews, is the scale of the challenge in designing and administering tax laws that must deal effectively with firms ranging from large multinational firms with access to highly-skilled accounting services to very small enterprises and even family farmers, many of whom are illiterate and lack basic legal documents. Integrating all types of economic actors into a single tax system is no easy task for any tax administration. Many of the issues raised in this study relate to this aspect.

A third point meriting emphasis is the divergence of views on the performance of the AT, depending on the background of the interlocutor. Government officials generally emphasize the

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[1] Although the stated objective of the study is to analyze the "impact" of the tax system on PARPA II objectives, the analysis does not include formal modeling to quantify cause and effect in the complex relationship between tax variables and indicators representing PARPA objectives. This approach is necessitated by time and resource constraints, as well as the limited period of time-series data for Mozambique.

positives, focusing on recent and planned reforms to broaden the tax base and improve tax administration. In contrast, many business representatives, while acknowledging the progress, emphasize the lack of a service culture on the part of the tax authorities, and the corresponding absence of a tax-paying culture on the side of many firms and individuals. One widely cited grievance is that many tax officials continue to arbitrary and punitive enforcement actions in response to minor and unintentional infractions, in order to meet revenue targets, rather than encouraging compliance through education and support for the taxpayers. This approach creates obstacles and costs for businesses, undermines the PARPA objective of using the tax system to promote the national business community, and leads to an unhelpful perception of the AT as a predatory bureaucracy. These deep-seated problems will not be overcome quickly, but attention is urgently needed.

Alongside the divergent perceptions about AT performance are differing views on the role of the tax system. Government officials typically focus on the need for higher revenue yields, relative to GDP, to finance public services while reducing dependency on donor support. In contrast, many in the private sector argue that measures to broaden the tax base and improve collection efficiency should be used as an opportunity to reduce tax rates in order to stimulate private investment and foster more rapid growth. All parties recognize the importance of both objectives, but opinions differ widely on the appropriate balance.

Finally, it is clear from the research conducted for this study that few opportunities remain to achieve sizeable revenue gains through changes in tax policy. Yet there is huge potential for improving the revenue yield by strengthening and modernizing tax administration through measures that will broaden the effective tax base, allocate AT resources more productively, and facilitate taxpayer compliance.

The remainder of this study is organized as follows: Chapter 2 provides an overview of the tax system, covering its characteristics at the start of the PARPA II period, the major issues arising during that period, and recent reforms. Chapter 3 discusses in more detail the current tax system, including issues relating to tax administration. Chapter 4 provides an analysis of revenue performance over recent years, looking at revenue targets, revenue performance, and international comparisons. Chapter 5 assesses the impact of the tax system on broader outcomes for the economy in light of the goals set out in PARPA II. Chapter 6 then draws on the analysis from earlier chapters to highlight key issues that warrant attention as priorities for the next PARPA period, along with preliminary recommendations for addressing these concerns. In a separate volume, Appendix A presents basic data tables used in the revenue analysis; eight other appendices provide supplementary information on aspects of the report, as referenced in the text.

2. Background

As a prelude to the analysis of the current tax system, this chapter briefly reviews the system as it stood at the start of the PARPA II period. This is followed by a summary of PARPA II priorities and targets in the area of taxation, progress to date in achieving these goals, and major tax reforms adopted during the time frame for PARPA II.

THE TAX SYSTEM AT THE START OF PARPA II

Between 1998 and 2002, all of the main tax instruments were subject to deep reforms. Subsequent studies by the IMF and the World Bank's Foreign Investment Advisory Service (FIAS) concluded that the tax system in Mozambique conformed broadly to international best practices for developing countries.[2]

The value added tax (*Imposto sobre o Valor Acrescentado*, or *IVA*) was enacted in 1998 and introduced in 1999 at the rate of 17 percent for the normal regime. Exports and other designated goods were subject to zero tax (*isenção completa*) and qualified for a full refund of VAT paid on inputs. In addition, a long list of goods and services were exempt from VAT. The VAT code also offered a simplified regime (*regime simplificada*) to enterprises with a turnover less than 250 million MT per year (about $12,500), consisting of a 5 percent tax on gross sales. Enterprises with a turnover below 100 million MT per year (about $5,000) were exempt from VAT. Note that local currency figures in 2005 referred to the old metical (equal to .001 new MT).

In 2002, a new income tax system was introduced, with separate tax codes for corporations (*Imposto sobre o Rendimento das Collectivas*, or IRPC) and individuals (*Imposto sobre o Rendimento das Pessoas Singulares*, or IRPS). The standard IRPC tax rate was 32 percent, though income from agricultural activity was subject to a tax rate of 10 percent until 2010. The IRPS had progressive marginal tax rates ranging from of 10 to 32 percent applied to nearly all sources of personal income,[3] with an adjustment for marital status and deductions for dependents. Income under 24 million MT (about $1,200) per year was not taxable, while the top rate applied to incomes in excess of 1,008 million MT (about $50,000). The IRPC and IRPS also provided a simplified regime for small enterprises that lack organized accounts and have a turnover of no more than 1,500 million MT (about $75,000) per year. For these entities, taxable income could be

[2] See IMF (2005a); Versano et al. (2006); FIAS (2006).

[3] Technically, the IRPS defines five categories: income from employment ("dependent" income); professional and business income; capital income; income from buildings; and other incomes. Each category covers multiple types a variety of income.

determined by tax officials on the basis of “technical-scientific indicators” or deemed to be 20 percent of the value of sales of merchandise or products, or 30 percent for other income.

After several rounds of import duty reductions, standard duties in 2005 ranged from 0 to 25 percent, according to the import category:

- 25 percent of consumer goods (Class C)
- 7.5 percent for intermediate materials (Class I)
- 5 percent for capital goods (Class K) and fuel (Class N)
- 2.5 percent for raw materials (Class M)
- 0 percent for basic goods (Class E)

The simple average tariff was 12 percent, and the trade-weighted average was 9 percent. Both figures were among the lowest in the region. According to the *Diagnostic Trade Integration Study* (DTIS) for Mozambique, the tariff rate for Class C still provided a fairly high level of effective protection to most final goods produced in Mozambique.[4] Beyond the standard tariffs, Mozambique had begun by 2005 to reduce duty rates on imports from SADC member states, under the SADC trade protocol. Duty free imports of SADC origin covered over 1,500 tariff lines, all involving products that did not compete against local enterprises. Other duty exemptions were granted under the tax incentive regime for investors (*Código de Benefícios Fiscais*) and a special customs regime for selected manufacturing industries (*Regime Aduaneiro para a Indústria Transformadora*).

The Specific Consumption Tax (*Imposto sobre Consumos Éspecificos*, or ICE) was restructured in 1998 to complement the VAT. The ICE is an *ad valorem* excise tax on more than 140 products, at rates that ranged from 15 to 65 percent in 2005. Items subject to ICE included luxuries (such as cars, jewelry, perfume, and sporting goods) and health risks (particularly tobacco and alcohol). The tax is charged on both domestic products and imports. In addition, the Fuel Tax (*Taxa de Combustíveis*) was adopted as a specific nominal levy per liter of various types of fuel. The tax was restructured in 2003 with a formula for quarterly inflation adjustments to maintain the real value of the tax per unit.

Under Decree nº 6/2004 of 1 April, the tax stamp is imposed on a lengthy list of documents, contracts, papers, and economic activities. Many of the charges are fixed amounts per item, but others are *ad valorem* assessments at rates ranging from 10 percent on the fee for land use concessions, to 0.02 percent on certain collateral guarantees.

In 2002, the government adopted a major reform of the Code of Fiscal Benefits for investment (*Código de Benefícios Fiscais*, or CBF). The reform was designed to rationalize the incentives regime and improve its cost-effectiveness by concentrating on investment tax credits and accelerated depreciation, while scaling back tax holidays. Partial tax holidays were retained for agriculture and for enterprises in Industrial Free Zones (IFZs). The new code also retained exemptions from import duty on capital goods, and standard exemptions from indirect tax for exporters operating in an IFZ.

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[4] Nathan Associates (2004), p. 7-4.

By 2006 the government had therefore taken major strides to transform what had been an archaic and inefficient tax system into one that was largely in line with international best practices. Virtually every observer acknowledged great progress. Yet the post-reform system was still subject to sharp criticism, especially from the private sector.[5] As PARPA II was being prepared, the most prominent tax issues included:

- Low tax yield. In 2005, government revenues totaled 13.8 percent of GDP, and tax revenues amounted to 11.2 percent of GDP. An IMF analysis found the tax ratio to be well below the norm for sub-Saharan Africa, and far short of what could be achieved in Mozambique.[6] The government, too, was deeply concerned to improve the revenue yield in order to reduce dependency on donor funding. This was reflected in the PARPA goal of boosting revenue to 16.2 percent of GDP by 2009.
- High tax burden on companies. Two studies found that the tax rate on companies was broadly in line with regional averages, and that investors obtaining fiscal benefits faced a marginal effective tax rate (METR) that was very competitive compared with other countries in the region. For businesses without tax incentives, however, the METR was unusually high by regional and international standards, due to the combined effect of the company tax plus the tax on distributed dividends.
- Narrow tax base. The combination of high effective tax rates and low tax revenues underscored the problem of gaping holes in the tax base. Both the local private sector and the IMF recommended stronger efforts to broaden the tax base, improve tax compliance, and reduce the generosity of tax breaks for large scale projects.
- Tilted playing field and inequitable tax burden. The tax system gave a competitive advantage to companies enjoying tax incentives, and also to enterprises that escaped the tax net by virtue of informal operations, bribery, or tax fraud. The system tended especially to penalize tax-registered small and medium enterprises.
- Excessive complexity. Representatives of the private sector were especially critical of the complexity of the income tax and the value added tax. One commentator likened the tax code to a “Mercedes stuck in the sand” – modern, well engineered and powerful, but inappropriate for conditions in Mozambique.
- Lack of public information and taxpayer services. Even though the income tax and VAT services conducted seminars and public appearances to present the 2002 tax codes, the effort fell far short of the need. Equally important was the general absence of a service culture among tax officials.
- Arbitrary and punitive enforcement. Another major complaint by the private sector was arbitrary and punitive behavior by tax inspectors, especially outside of Maputo. Because the tax code was complex, many businesses (especially SMEs) could not comply fully

[5] See FIAS (2006); Bolnick (2004); Versano et al. (2006); Arndt, Tarp and Jones (2009); CTA (2006).

[6] Versano (2006); IMF (2005a). Jones (2009), however, conducted an econometric analysis showing that Mozambique’s tax ratio through 2003 was very close to the value predicted, based on the country’s structural characteristics.

with all of its technicalities. Consequently, many entrepreneurs faced arbitrary treatment and costly penalties, which created incentives for unofficial side payments to tax officials.

- VAT refund delays. The single most contentious issue in 2006 was the problem faced by many businesses, especially exporters and contractors, in obtaining timely payment of VAT refunds. Even large businesses had problems submitting acceptable refund petitions, due to the complex paperwork requirements.

Since 2006 the government has been addressing many of these issues. Even so, every point on the list remains today as a major concern.

TAX ISSUES IN PARPA II

Tax issues appear at various points in PARPA II. The Macroeconomic and Fiscal Scenario in Chapter V (paragraphs 130-131) targets an increase in total State revenues from 14.0 percent of GDP in 2005 to 16.2 percent in 2009. This is a primary target in the Matrix of Strategic Indicators, for the category of Public Finance Management. According to the fiscal scenario, the additional revenue "must be mobilized in a way that does not jeopardize growth of the private sector or undermine the incentives to pursue economic activities in the formal sector, by expanding the tax base curbing tax evasion, and reducing tax incentives."[7]

PARPA II addresses tax policy explicitly under the Economic Development Pillar, in the section on Macroeconomic Management (Chapter VIII, paragraph 489). The objective here is "to reform and increase the efficiency of the tax administration with a view to gradually increasing the mobilization of domestic funds as a percentage of GDP, with the idea of reducing external dependency." To this end, the PARPA lists eight priority actions:

- "Domestic revenues will gradually be increased;
- "The tax system will be simplified and refined, and the tax base broadened;
- "Reforms made in direct and indirect taxes will be consolidated;
- "Simplified taxation regimes will be reviewed, the effectiveness of tax and investment incentives will be evaluated, and the process of establishing tax courts will be continued;
- "Work on modernizing the tax administration will be continued, to make it an efficient tax-collection system and to curb fraud and tax evasion;
- "Legislation will be approved that simplifies the relationship between the tax administration and the taxpayers, making it easier for them to exercise their rights and receive the protection assured them;
- "Tax and customs courts will be effectively implemented; and

[7] The statements cited here from PARPA II are based on the English translation posted by the IMF as Country Report No. 07/37.

- "Legislation on local government finances will be refined and the conditions of the responsible for collection and control of local government taxes will be improved."

Revenue issues also appear in other parts of the PARPA. In the section on Promoting Priority Sectors, Broadening the Business Base, and Creating Jobs: Industry (Chapter VIII, paragraph 537) one key action is to "establish tax-free zones, on the condition that an evaluation be made, in advance, of the net contribution to the national economy and to tax revenues." The section on Mining (Chapter VIII, paragraph 551) covers several objectives, one of which is to strengthen the legal and fiscal framework "as a way of increasing investment, tax revenues, and exports by the mining sector." Finally, the section on Assistance from Cooperation Partners (Chapter IX paragraph 611) states that the government will, among other things, examine "the ideal balance between the weight of domestic funds (tax revenues) and external aid as regards State expenditures."

Table 2-1 lists the major PARPA II objectives, actions and strategic indicators relating to the tax system, along with notes on the status of implementation. Most targets have either been achieved or are now in process. In particular, the government succeeded in 2008 in meeting the target revenue ratio that was set for 2009; this year will see a shortfall in the revenue ratio, however, due to the adverse effects of the global economic crisis via slower growth of GDP and trade, and a sharp reduction in commodity prices. The government also succeeded in introducing a new simplified tax regime for small businesses, and revising the code of fiscal benefits.

In some respects, however, achievements fell well short of the PARPA II targets. The areas of deficiency or delay include the program for implementing new tax information systems, increasing the collection rate from tax audits, establishing tax courts, and curbing tax fraud and tax evasion.

MAJOR TAX REFORMS 2006-2009

A series of reforms to the tax code and measures to improve tax administration have been undertaken during the period 2006 to 2009. By and large, the reforms have aligned well with the PARPA II objectives and targets for tax policy.

The period began with a new law (Law 1/2006) establishing the Mozambique Tax Authority (Autoridade Tributária, or AT), combining formerly separate organizations for tax and customs. The purpose of this reform was to create a new organizational foundation for modernizing tax administration and professionalizing the tax service in order to strengthen enforcement, improve services, combat evasion, and expand the tax-base. Since the AT began operations, the number of registered taxpayers (individuals plus enterprises) has more than doubled from 374,181 in 2006 to 864,317 by July 2009. The AT expanded its staff by 18 percent and opened 14 new collection offices between 2007 and the first half of 2009; introduced new programs for public education and customer service; reduced delays in the approval of VAT refunds; increased the number of audits of large tax payers; introduced post-clearance audits for customs; simplified tax declaration forms; and reduced the average time to release imported goods at the border. In addition, the AT opened a new training institute in 2009 to intensify staff training.[8]

Table 2-1
Tax Objectives, Actions, and Strategic Indicators in PARPA II

PARPA II Element	Source in PARPA	Status: July 2009
1. Objective: Progressively increase domestic revenues and expand tax base. Goal for 2009: Total Revenues as % of GDP = 16.2%	Strategic Indicators Matrix, Management of Public Finances, Objective 5	AT (2009): Total Revenue = 16.4% of GDP for 2008 IMF (2009): Total Revenue = 16.0% of GDP for 2008 AT target of 17.3% for 2009 will not be met due to effects of the global economic crisis; IMF projects ratio declining to 15.7% this year.
2. Action: Rationalize the granting and improving the management of fiscal benefits. Goal: Systematize data on benefits; published statistics	As above	New Code of Fiscal Benefits approved in January 2009, ending the special negotiation regime for large projects. (For details see Appendix B of the present report.) According to CPI, procedures for approval of an investment remain largely unchanged, but the process of obtaining tax and duty relief has been streamlined since the AT was established. Survey of investors obtaining CPI approvals in 2005, 2006 and 2007 shows that 47 of 60 had no significant problem with the procedures, but 13 of 60 reported major problems in terms of costs or delays (Bolnick, 2009). AT reports data on tax expenditures in its Annual Reports since 2007; the data also appear in the Annual Report on the Conta Geral do Estado from the Tribunal Administrativo (without information on methodology).
3. Action: Integration of information systems management into the ATM within the context of the approved PDTI. Goal: By 2009 integrated systems in full operation, including banking collection management module	As above	Planning well advanced for e-taxation module of e-SISTAFE, including e-declarations, electronic collection via banks, and customs single window; pilot system for e-tax module procured and training begun via UTRAFE.
4. Action: Increase audits. Goal: To be defined. Baseline annual revenue recovered by audit = 0.2% of GDP.	As above	AT Annual Report for 2008 (Table 18) shows revenue collection from audits = 0.4% of total receipts in 2007, and 0.2% of total receipts in 2008.
5. Objective: Strengthen institutional capacity of local governments. Action: Development of municipal revenue collection capacity. Goal for 2009: Own revenues, % of annual budget: Capital cities 60% Other cities 55% Villages 45%	Strategic Indicators Matrix, Public Sector Reform, Objective 9	Municipality of Maputo (calculated from Orcamento Rectificativo 2009 do Municipio de Maputo): Own current revenue/current revenue 2008 = 71.5% Budget 2009 = 76.5% Own total revenue/total revenue = Own total revenue/budget 2008 = 36.8% Budget 2009 = 27.8%

[8] The data are from IMF (2008, 2008a, 2009b and 2009c), AT Annual Reports for 2007 and 2008, and information provided by the AT's Gabinete de Planeamento Estúdios e Cooperação Internacional.

PARPA II Element	Source in PARPA	Status: July 2009
6. Domestic revenues will gradually be increased	Economic Development pillar, Macroeconomic Management and Tax Policy - Paragraph 489	See item 1 above.
7. The tax system will be simplified and refined, and the tax base broadened	As above	AT Annual Report for 2007 (Table 15) and 2008 (Table 30) show new income tax registrations = 100227 in 2006; 190019 in 2007; 191140 in 2008. Various IMF reports show total number of taxpayers increasing from 295000 in 2005 to 587205 in 2007 (latest figure). New Simplified Tax (ISPC) approved 2009 (see item 9)
8. Reforms made in direct and indirect taxes will be consolidated	As above	New IRPC, IRPS, IVA codes approved in 2007 consolidating amendments and other statutory changes.
9. Simplified taxation regimes will be reviewed, the effectiveness of tax and investment incentives will be evaluated, and the process of establishing tax courts will be continued	As above	New Simplified Tax (ISPC) approved 2009 for small businesses with turnover up to 2,500,000 MT. ISPC replaces simplified regimes for income tax and VAT with single tax at 3% of turnover, up to a maximum liability of 75,000 MT.
10. Work on modernizing the tax administration will be continued, to make it an efficient tax-collection system and to curb fraud and tax evasion	As above	Mozambique Revenue Authority (AT) established by Law in 2006, with operations starting 2007. General agreement among stakeholders interviewed for this report (government, private sector, and donors) that AT has achieved major gains in professionalism and efficiency in tax collection – but also widespread view that tax fraud and tax evasion are still rampant.
11. Legislation will be approved that simplifies the relationship between the tax administration and the taxpayers, making it easier for them to exercise their rights and receive the protection assured them	As above	New General Tax Code approved in 2006 establishing clear rules and procedures for exercise and protection of taxpayer rights.
12. Tax and customs courts will be effectively implemented	As above	Customs courts in operation; few cases on the docket. Legal framework for tax courts in place; judges selected and trained; operations expected to start soon in Maputo followed by Beira and Nampula. Large backlog of tax disputes (contenciosos) requiring attention.
13. Legislation on local government finances will be refined and the conditions of the responsible for collection and control of local government taxes will be improved.	As above	New Local Government Finance Act passed in 2008, clarifying authority of local governments for expenditures and own revenue sources.
14. Establish tax-free zones, on the condition that an evaluation be made, in advance, of the net contribution to the national economy and to tax revenues.	Economic Development pillar, Promoting Priority Sectors, Broadening the Business Base, and Creating Jobs: Industry - Paragraph 537	New Fiscal Benefits Code includes incentives for Special Economic Zones (ZEEs); plans well advanced for establishment of ZEE in Nampula. Study conducted on revenue effects of the Nampula ZEE.
15. Strengthen the legal and fiscal framework for mining "as a way of increasing investment, tax revenues, and exports	Economic Development pillar, Promoting Priority Sectors, Broadening the Business Base, and Creating Jobs: Mining - Paragraph 551	New Mining and Petroleum Act approved in 2007, restructuring the regime of tax incentives applicable to investment in these sectors to increase revenues for the state while remaining attractive to investors.
16. Examine the ideal balance between the weight of domestic funds (tax revenues) and external aid as regards State expenditures.	Factors Determining Success, Assistance from Cooperation Partners (Chapter IX paragraph 611)	PARPA II target for increasing the ratio of domestic revenue to GDP by 0.5% percentage points each year largely achieved, except for shortfall in 2009 due to effects of the global economic crisis.

The administrative reforms have been accompanied by a raft of new tax legislation and accompanying regulations, which are summarized in Table 2-2.

Table 2-2
Major Changes in the Tax Law, 2006 – 2009

Legal Instrument	Title and Description
Law 1/2006 of 22 March and Decree 29/2006 of 30 April	Tax Authority of Mozambique – Organic statute for establishment of the AT.
Law 2/2006 of 22 March	General Law on Taxation – General principles and provisions regulating responsibilities and obligations of the tax authorities at all levels and taxpayer rights and responsibilities.
Law 3/2007 of 7 February	Customs Law – Reduces the duty rate on consumer goods from 25% to 20%.
Laws 11/2007, 12/2007, 13/2007 of 27 June and Decrees 4/2008 and 5/2008 of 9 April	Mining and Petroleum Laws – Reforms the tax regime and surface concessions for mining and oil production activities, and the incentives regime for investment projects falling under the Mining Law and the Petroleum Law.
Law 28/2007 of 4 December	Inheritance and Gift Tax Code
Law 32/2007 of 31 December and Decree 7/2008 of 16 April	Value Added Tax Code (IVA) – Consolidates amendments and other legal changes relating to the VAT code; raises the threshold for registration and expands the scope of the simplified tax scheme; revises the list of exempt goods and transactions.
Law 33/2007 of 31 December and Decree 8/2008 of 16 April	Personal Income Tax Code (IRPS) - Consolidates amendments and other legal changes relating to the VAT code, and adjusts tax bracket thresholds and family allowances; also introduces tax on income from traded securities and term deposits.
Law 34/2007 of 31 December and Decree 9/2008 of 16 April	Corporate Income Tax Code (IRPC) - Consolidates amendments and other legal changes relating to the VAT code, and raises the threshold for paying tax.
Law 1/2008 of 16 January and Decree 632008 of 30 December	Municipal Finance Law – Defines the financial, budgetary and asset regimes for local governments, and reforms the municipal tax system.
Law 4/2009 of 12 January	Code of Fiscal Benefits (CBF) – Reforms the available package of fiscal benefits for investments approved under the Investment Act, including both generic benefits and specific benefits for designated types of projects.
Law 5/2009 of 12 January and Decree 14/2009 of 14 April	Simplified Tax for Small Taxpayers (ISPC) – Introduces a new simplified tax system for small enterprises, replacing simplified tax regimes for both income tax and VAT.
EITI Board Approval of candidacy for Mozambique, 18 May 2009	This measure begins the formal process of qualifying Mozambique for participation in and adherence to the Extractive Industries Transparency Initiative.
Law ??/2009 [forthcoming]	Excise Tax Code (ICE) – Restructures the excise tax rates on certain goods including wines, tobacco products, jewelry, and vehicles; eliminates excise tax on some toys and sporting goods.

SOURCE: *Deloitte, GTZ APSP and ACIS (2009) and MozLegal, Mozambique Investor (2006-2009).*

In March 2006, a new General Law on Taxation redefined the basic framework governing the tax system, including the duties and responsibilities of the tax authorities, and the obligations and rights of the taxpayers. In 2007, the government adopted a new VAT code that altered the list of exempt products, and increased the turnover thresholds for VAT exemption and for coverage by the simplified VAT regime. At the same time, the government revised the tax codes for individual and corporate income taxes. Both tax codes were shortened considerably, as some provisions were shifted into the regulations, and others were covered by the new General Law on Taxation. In addition, the new IRPC code updated thresholds for coverage by the simplified regime, and the

IRPS code updated the threshold for non-taxable income and the various tax brackets. Tax rates, however, were unchanged, and the tax structure itself was not noticeably simplified.[9]

Perhaps the most important reform of 2007, in terms of future revenue potential, was the passage of new laws governing mining and petroleum concessions. Among other things, the legislation removed the authority of the Council of Ministers to negotiate special tax arrangements for mining and petroleum investments and reduced the fiscal benefits for such projects. More recently, in May 2009, the government followed this up by formally initiating procedures to qualify for the Extractive Industries Transparency Initiative. Once completed, the EITI process should institutionalize improvements in transparency and management of revenue from investments in extractive industries.

Other policy reforms in 2007 involved a reduction in the top rate of customs duty on consumer goods from 25 percent to 20 percent and a new code for inheritance and gift tax. In 2008 the government adopted a new Municipal Finance Law, including reforms to the municipal tax system in line with the PARPA objective of decentralization.

The SADC free trade area came into effect in January 2008, entailing duty-free treatment of most imports from other SADC member states, though the complex rules of origin have impaired access to duty-free trade in both directions (IMF 2009a). Additional tariff reductions will be introduced through the Interim Economic Partnership Agreement (EPA) between Mozambique, other participating SADC members, and the EU. Once the EPA is finalized and approved, participating SADC states will retain quota- and duty-free access to the EU and, on a reciprocal basis, will reduce customs tariffs on EU imports.

In response to civil unrest caused by a steep rise in fuel and food prices in early 2008 (of 27 and 15 percent respectively), the government suspended fuel price increases until June and then deferred fuel-related taxes until end-2008 (IMF 2008), though this measure was reversed in 2009 (IMF 2009a).

More recently, in 2009, the National Assembly revised the Fiscal Benefits Code, passed a new Simplified Tax for Small Taxpayers (ISPC) and revised the excise tax code, including adjustments in the tax rates on designated alcoholic beverages, tobacco products and luxury goods. These major reforms are discussed in more detail in the next chapter.

[9] Frei, A. The Mozambican Investor, Issues 81 (February 26, 2008) and 82 (March 04, 2008).

3. The Current Tax System

The main features of the tax code prevailing in 2009 are essentially the same as the baseline system in 2005, outlined in the previous chapter. The discussion here provides more details and updates the information to 2009. Particular attention is focused on the 2009 Simplified Tax for Small Taxpayers (ISPC) and the 2009 Code of Fiscal Benefits (CBF). The chapter also examines the standing of Mozambique's tax system in the World Bank's *Doing Business* ratings. The final section summarizes the Revenue Authority's plans for further reforms to modernize tax administration.

THE TAX SYSTEM IN 2009

The current tax system in Mozambique conforms broadly to international standards for good practice in developing countries, with the main sources of revenue coming from the value added tax (IVA) and modern corporate and individual income taxes (IRPC and IRPS, respectively), and taxes on trade declining in importance.[10]

Figure 3-1 shows the principal sources of domestic revenue (excluding grants) in 2008 compared to the baseline conditions in 2005.[11] In 2008, total revenue amounted to an estimated 16.0 percent of GDP, with tax revenue (*receitas fiscais*) at 13.5 percent of GDP. Both numbers represent an increase by more than two percentage points relative to GDP between 2005 and 2008, despite reductions in the top rate of customs duty, implementation of SADC trade preferences, higher thresholds for entering the tax net for the VAT and income tax, and temporary deferment of the fuel tax in 2008 to cushion the effects of soaring world prices for petroleum. These facts show that government efforts to improve tax administration and enlarge the tax base have indeed been bearing fruit.

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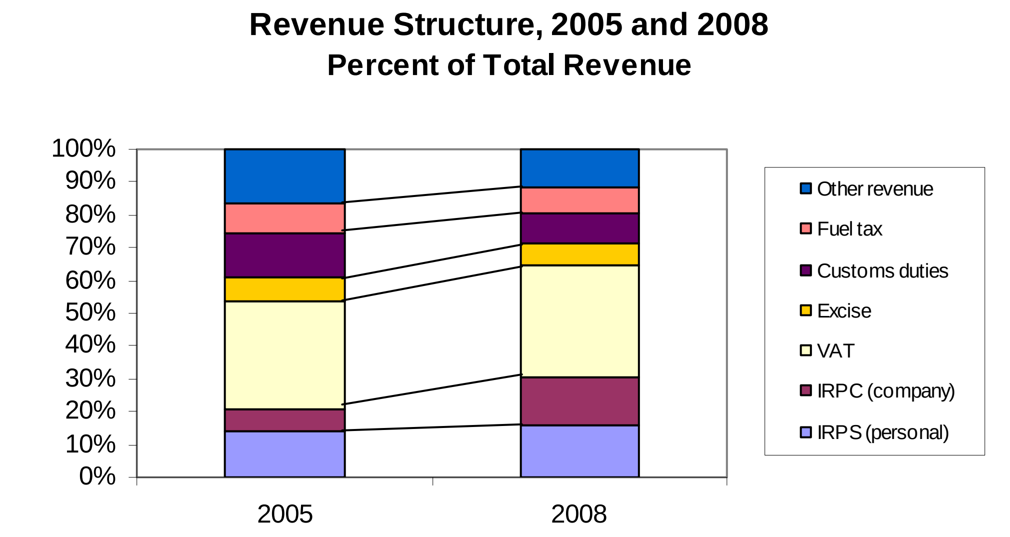
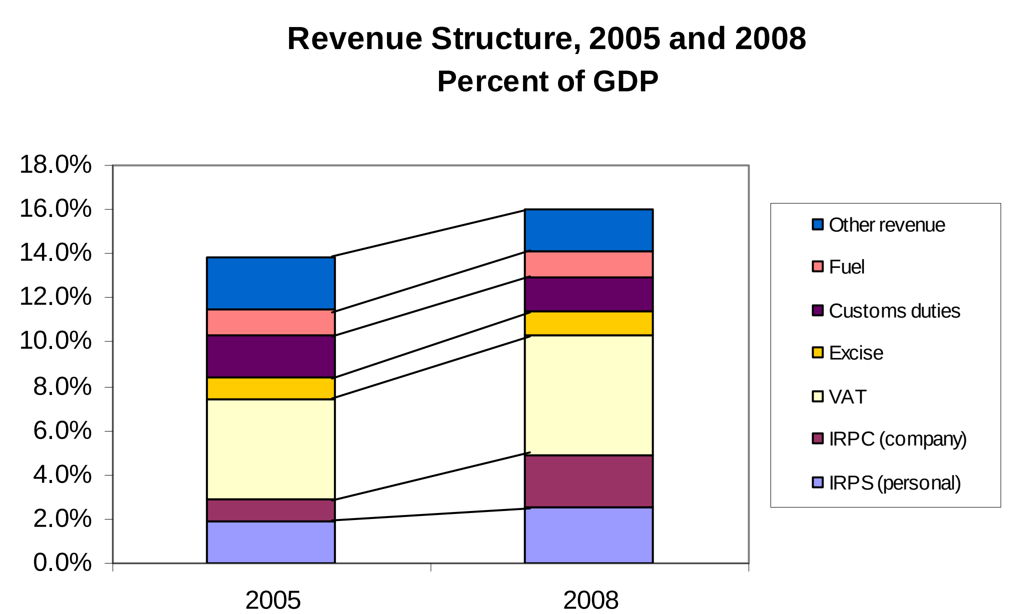
[10] The IMF (2008a, p.13) states that "The legal framework for the tax system is modern, comprehensive, and generally broadly disseminated."

[11] These figures are from the Medium-Term Fiscal Framework of the Ministry of Planning and Development (MPD), as of June 2009. Some figures differ from those in the IMF's Article IV Review from May 2009 (IMF, 2009b), and from data presented by the AT in their Annual Report for 2008 (AT, 2009). For example, for 2007 the three sources, respectively, show a ratio of total revenue to GDP of 16.2, 15.9, and 16.6 percent. For 2008 the corresponding figures are 16.0, 16.0 and 16.4 percent.

Figure 3-1
Principal Sources of Domestic Revenue, 2005 and 2008



Source: Calculated from data provided by DNEAP, Ministry of Planning and Development



Source: Calculated from data provided by DNEAP, Ministry of Planning and Development

Looking at the structure of tax receipts, the value added tax (including imports) in 2008 raised 5.4 percent of GDP, up from 4.5 percent in 2005. Income taxes amounted to 4.9 percent of GDP, split almost evenly between the IRPS (2.5 percent) and IRPC (2.4 percent). This is a huge improvement from 2005, when IRPC revenues amounted to just 1.0 percent of GDP, and IRPS revenues raised 1.9 percent of GDP. In contrast, revenue from customs duties has declined in relative importance to 1.5 percent of GDP in 2008, from 1.9 percent in 2005. In absolute terms, however, even customs revenue increased by 29 percent over the period, indicating that the rising volume and value of imports, and a higher nominal exchange rate have more than offset the effects of SADC trade liberalization.

Revenues from the excise tax (ICE) in 2008 totaled 1.1 percent of GDP, slightly higher in relative terms than the 1.0 percent yield in 2005. Hence, ICE receipts grew slightly faster than nominal GDP, though declining as a share of total revenue. Revenue from the fuel tax also declined in relative importance from 1.2 percent of GDP in 2005 to 1.0 percent in 2008, reflecting the temporary suspension of fuel taxes last year. The stamp tax generated just 0.1 percent of GDP in revenues in 2008. Finally, the government earned negligible revenue from royalties and surface taxes on mining and petroleum in 2008, amounting to just 0.2 percent of tax receipts–unchanged from 2005–and 0.0 percent of GDP.

The remainder of this section describes the main features of the current tax structure.[12]

Value Added Tax

The standard value added tax rate of 17 percent applies to imports and domestic supplies of goods and services from businesses with turnover greater than 2,500,00 MT per year (approximately $95,000 at the exchange rate in July 2009).[13] The 2007 revision of the VAT code retained the simplified regime (*regime simplificada*) consisting of a 5 percent tax on gross sales, applying to enterprises with an annual turnover below 2,500,000 MT, excluding exporters and importers. Enterprises with a turnover below 750,000 MT per year (about $28,000) qualify for VAT exemption (*isenção*). Firms registered under the simplified or exempt regimes cannot claim credit for VAT paid on inputs; they also do not need to maintain organized accounts conforming to established standards. Another provision of the 2007 code (Article 15, section l) reduces the VAT liability by 60% for enterprises contracted for construction of public roads, bridges and water supplies.

In line with international norms, exports are subject to zero tax (*isenção completa*) and qualify for a full refund of VAT paid on inputs. Zero rating also applies to certain basic foods, animal feed, and kerosene for lighting. In addition, the system continues to exempt a long list of goods and services from VAT, meaning that they do not charge VAT on sales, and do not recover VAT paid on inputs. Exempt items include medical services and drugs, financial services, basic inputs to agriculture, and products of agriculture, forestry, animal husbandry, and fishing. Clearly, these

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[12] This short review excludes the vehicle tax, municipal taxes, and other fees and levies.

[13] For a detailed explanation of the VAT Code, see Deloitte and ACIS, *Legal Framework for Taxation in Mozambique: Value Added Tax Manual*, Edition 1, October 2008, and separate manuals covering IRPC, IRPS, and VAT. The documents are available for downloads at: http://www.acisofala.com/ .

provisions are designed to minimize the burden of VAT on basic goods consumed heavily by the poor.

Taxpayers in a VAT credit position—which arises when a firm owes less VAT on its taxable sales than it the tax paid on its inputs—can claim a refund (*re-embolso*) after twelve months if the credit balance continues to exceed 50,000 MT (approximately $1,900). Exporters can claim a refund without a twelve month wait with a credit balance above 5,000 MT, as can firms with zero-rated supplies constituting at least 75 percent of total receipts. All parties interviewed for this study remarked that the VAT refund process has improved since 2005, but it is still a major source of grievance due to the extremely cumbersome procedures. This issue will be addressed further in Chapters 5 and 6.

Income Tax

The standard tax rate on corporate income (*Imposto sobre o Rendimento das Collectivas*, or IRPC) remains at 32 percent, with a special rate of 10 percent for agriculture and animal husbandry until December 2010. Withholding tax at a rate of 20 percent is due on a variety of payments such as rentals, services provided in Mozambican territory, and royalties for the use of intellectual property. On payments to nonresidents, withholding tax is a final payment; in other cases it is a pre-payment against tax due for the year. There is also a special tax rate of 35 percent applying to expenses that are not adequately documented, and therefore disallowed as deductions.[14]

As with the VAT, the IRPC code includes a simplified regime applying to companies with a turnover below 2,500,000 MT (about $95,000), which are not required to maintain organized accounts. Under the simplified regime, taxable income is deemed to equal 20 percent of revenues from the sale of produced goods or the supply of lodging, restaurant or beverage services, and 30 percent on gross revenue for other economic activities. In cases where the coefficient of 0.2 is applicable, the tax due would amount to 6.4 percent of gross receipts (=.20 x 32%). Tax authorities can also use “indirect methods” to assess income in cases where the taxpayer cannot provide appropriate or credible and timely accounts.

The income tax on individuals (*Imposto sobre o Rendimento das Pessoas Singulares*, or IRPS) retains progressive marginal tax rates of 10, 15, 20, 25, and 32 percent, assessed on total household income after allowance for personal and family deductions.[15] No tax is due on incomes below 36 times the maximum minimum wage in force at the end of the previous year. For 2008, the highest minimum wage was 2139.50 MT per year, giving an IRPS threshold of 77,022 MT (about $2,900). In turn, the top marginal tax rate of 32 percent applies to chargeable income exceeding 1,512,000 MT (about $57,000). Compared to the zero-tax threshold in 2005 of 24 million (old) MT, or just $1,200, the 2007 IRPS revision frees many more households with very

[14] For a detailed explanation of the IRPC Code, see Deloitte and ACIS, *Legal Framework for Taxation in Mozambique: Manual on Corporate Income Tax*, April 2009.

[15] As in 2005, the IRPS defines five categories: income from employment (“dependent” income); professional and business income; capital income; income from buildings; and other incomes. Each category covers multiple types of income, with restrictions on loss offsets across categories.

low incomes from tax liability. In addition, the zero-rate bracket is now implicitly indexed for inflation because it is defined relative to the national minimum wage. By the same token, this linkage in the tax law could create a problem with revenue loss if the government were ever to approve a hike in the minimum wage far above the inflation rate. For employees of registered businesses, the IRPS on wage income is withheld at source and remitted monthly to the AT. [16] Those earning employment income of up to MT 100,000 are not obliged to file returns.

Under both the IRPC and IRPS, taxpayers can claim refunds if the amount of tax withheld at source or pre-paid as provisional estimated payments, which are required for corporations and for individuals receiving professional or business income. The widely discussed problems with VAT refunds apply as well to the procedures for obtaining timely refunds of income tax.

Simplified Tax for Small Taxpayers

The National Assembly approved the new Simplified Tax for Small Taxpayers (*Imposto Simplificado para Pequenos Contribuintes*–ISPC) on 26 December 2008 and the law entered into force on 1 January 2009. The Council of Ministers published the first regulations in the *Boletim de República* on 14 April 2009. During the first half of 2009 the Revenue Authority and other agencies, including private sector organizations, engaged in a broad campaign of meetings and media coverage to inform the public about the ISPC and their obligations to contribute to national development. The underlying aim is to use this new tax tool to make formalization more attractive (or at least less daunting) for small enterprises, and thereby attract large numbers of new taxpayers into the system.

In June, the Revenue Authority began registering taxpayers under the ISPC, even though forms and procedures were still being developed. According to information provided by the AT, 1,800 new contributors registered under the ISPC in the first month, while 300 taxpayers elected to switch their status to coverage under the ISPC instead of the simplified regimes for VAT and income tax.

The main features of the ISPC are as follows:

- Enterprises with an annual turnover up to 2,500,000 MT (just under $100,000) may elect to register under the ISPC. This is the same threshold as provided in the 2007 codes for VAT and IRPC to qualify for the respective simplified regimes.
- For income covered by the ISPC, taxpayers have an exclusion from VAT, IRPC, and IRPS. Other income is subject to IRPS.
- Enterprises with a turnover of up to 36 times the highest minimum wage in force as of the previous year-end are exempt from tax. This provision of the ISPC matches the threshold for entering the IRPS, except that the former relates to turnover while the latter relates to income. Hence, the ISPC will be charging tax to individuals operating micro and small enterprises who would fall below the tax threshold under the individual income tax.

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[16] For a detailed explanation of the IRPS Code, see Deloitte and ACIS, *Legal Framework for Taxation in Mozambique: Manual on Individual Income Tax*, January 2009.

- The applicable tax rate is 75,000 MT per year (about $2800), or 3 percent of sales volume, at the option of the taxpayer.[17]
- For new businesses, the tax is reduced by half for the first year of operations, as a lure to register in the system.
- The tax is paid in four quarterly installments.

In essence, the ISPC is designed as a substitute for the simplified schemes under the VAT and income tax laws. Recall that the simplified VAT imposed a tax equaling 5 percent of turnover; in addition, income above the zero-bracket threshold is subject to a minimum 10 percent tax rate under the standard IRPS. Under the IRPC code, the income tax would amount to 2 percent of turnover for enterprises subject to the coefficient of 0.2 for presumed income. Hence, the ISPC represents not only a consolidation of what had been two separate simplified tax regimes, but also a reduction in the effective tax rate from approximately 7 percent of turnover to just 3 percent. In addition, the AT is developing simpler procedures for registration and simpler formats for official receipt books under the ISPC. They further plan to make it easier for small enterprises outside major cities by opening additional offices in new localities and launching mobile tax units. There is also discussion of possibly engaging local authorities as tax collection agents in more remote locations, with appropriate incentives to make it worth their participation in the system.

According to sources within the AT, the Ministry of Finance, and the Ministry of Planning and Development, the budget program does not anticipate a significant revenue contribution from the ISPC in the near term. The expectation is that the simplified tax, by drawing large numbers of new contributors into the formal tax system, will capture a growing stream of revenues over time from the natural growth of enterprises that enter the system due to the ISPC.

Import Duties

As of 2009, the standard duty rates range from 0 to 20 percent according to the import category:

- 20 percent for consumer goods (Class C)
- 7.5 percent for intermediate materials (Class I)
- 5 percent for capital goods (Class K) and fuel (Class N)
- 2.5 percent for raw materials (Class M)
- 0 percent for basic goods (Class E)

Under the SADC trade protocol most imports from member states enter Mozambique duty-free when accompanied by the required (and complicated) documents for compliance with SADC rules of origin. Customs duties will fall to zero by 2012 on all complying imports from member states other than South Africa, and for imports from South Africa by 2015. The SADC Interim Economic Partnership Agreement (EPA) with the European Union, which Mozambique signed in June of 2009, will also reduce the tax base for collecting customs duties as duties are gradually removed on imports from the EU. In addition, extensive duty exemptions are granted to qualified investors under the Code of Fiscal Benefits (*Código de Benefícios Fiscais*), which is discussed below.

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[17] The latter condition is clarified in the regulations.

Excise Tax and Fuel Levy

The National Assembly recently approved a revision to the tax code for the Specific Consumption Tax (*Imposto sobre Consumos Éspecificos*, or ICE). As of this writing, the new ICE code was not yet gazetted, but it should come into force at the beginning of 2010. The ICE continues to apply *ad valorem* tax rates to an extensive list of domestic products and imports, mainly alcoholic beverages, tobacco products, vehicles, and jewelry, and other luxury goods. In 2005 the ICE rates ranged from 5 to 65 percent. The 2009 ICE code increases the top rate to 75 percent, for tobacco products. It also increases the tax rate on jewelry and several vehicle categories, while reducing the ICE rate on some alcoholic beverages, sporting goods and art works, among other things. Another feature of the new ICE law is a minimum *specific* tax (per quantity) on most alcoholic beverages and tobacco products, as a safeguard against undervaluation.

The Fuel Levy (*Taxa de Combustíveis*) remains unchanged as a tax per liter of various types of fuel, subject to a formula for quarterly adjustments reflecting changes in the cost of petroleum products and the exchange rate. Because a large share of the levy is earmarked for use by the Road Fund, special provisions are in place to compensate non-road producers who use large amounts of fuel, particularly mechanized farmers, mines, and fishing boats. In mid-2008, the government suspended the fuel levy on kerosene until year-end, as well import duties and VAT on petroleum products, in order to cushion the impact of rising world fuel prices, which had sparked civil unrest.

Stamp Tax

The stamp tax has not changed since 2005 (see Chapter 2.) The study team understands that the AT is examining the implications of eliminating or narrowing the scope of the stamp tax. Many tax experts view this as an archaic “nuisance tax” with a low revenue yield relative to the cost of administration and compliance. Elimination of the stamp tax is often recommended in the interest of simplification. While the elimination of any tax reduces revenue, in this case the revenue effect is very small and could easily be offset by other measures as part of the overall tax reform program.

Other Elements of the National Tax System

In addition to the components discussed above, the national tax system also includes:

- Special tax on gambling income
- Inheritance and gift tax
- Property transfer tax
- Royalties on mineral and petroleum extraction and surface tax on resource concessions
- Vehicle tax
- National reconstruction tax

Municipal Taxes

Consistent with the government’s plans for decentralization and devolution, one of the strategic indicators in PARPA II is to increase the percentage of municipal and local government budgets financed by their own revenue sources. To support this objective, the Municipal Finance Act of 2008 establishes clear guidelines for the types of revenue falling within the jurisdiction of municipalities, and limits on the tax rates. Without going into detail here,[18] municipalities have the authority to impose the following taxes and charges:

- Municipal individual tax
- Municipal property tax
- Municipal property transfer tax
- Municipal tax on vehicles
- Contributions for infrastructure improvements
- Levies for issuing operating licenses
- Tariffs and charges for the provision of municipal services

Tax Incentives for Investment

Under the Investment Act of 1993, investments approved by the Center for Investment Promotion (CPI) qualify for specified fiscal benefits. Eligibility requires a minimum investment of $50,000 for foreign companies, and $5000 for domestic companies, as well as detailed business plans and evidence of financial and management capability. CPI approval is subject to a fee of 0.1% of the total investment, up to a maximum of $50,000 for large projects.

In January 2009, the government introduced a new Code of Fiscal Benefits (*Código de Benefícios Fiscais,* or CBF), to replace the 2002 Code. The stated aim of the 2009 Code is to “rationalize the fiscal benefits for investments and make them more effective as an instrument of the political economy.”[19] Appendix B provides a detailed point-by-point comparison of the 2009 and 2002 Codes. The new CBF provides “specific” benefits for ten categories of investments: basic public infrastructure projects; rural commerce and industry; manufacturing and assembly industries; agriculture and fisheries; hotels and tourism; science and technology parks; large-scale projects; rapid development zones; industrial free zones, and special economic zones. The specific benefits generally involve exemption from customs duty and VAT, partial tax holidays in the form of income tax reductions for defined periods of time, and additional provisions such as accelerated depreciation and deductions for professional training.

For the specific benefits, major changes in 2009 are as follows:

- Elimination of “exceptional incentives” for large-scale projects, which previously were negotiated with the Council of Ministers. Large projects now bear the standard company tax. The former regime usually applied a 1 percent tax on gross receipts in lieu of the income tax, in line with the precedent set for Mozal in the 1990s. Large projects still benefit from an exemption from customs duty—extended now to include VAT—on imported capital goods, plus accompanying spare parts and accessories.

- Elimination of a 25 percent tax reduction for eight years for investments in mining.

- Deep reductions in income tax rates for approved investments in basic public infrastructure projects, phased over 15 years; for agriculture and fisheries, phased through

[18] Deloitte and ACIS, *General Overview of the Tax System in Mozambique*, Edition 1, October 2008, pp. 30-35, provides a summary of the revenue provisions of Law 1/2008 of 16 January.

[19] CPI, *Code of Fiscal Benefits, Law 4.2009 of 12 January* (English version), p. 3.

2025; for science and technology parks, phased over 15 years; and for enterprises in Industrial Free Zones (ZFIs) and Special Economic Zones (ZEEs), phased over 15 years. ZFI and ZEE operators (as distinct from enterprises within a zone) are exempt from income tax for 10 and 5 years, respectively, followed by 5 years with a 50 percent reduction and then a 25 percent tax reduction without time limit. Investments in agriculture and IFZs already enjoyed tax rate reductions in the 2002 Code, but the time frames are now longer and the IFZ reduction more generous.

- Extension of the customs duty exemption to a broader range of goods in addition to capital goods in category "K." The specification varies by type of investment, and includes, for example: accompanying spare parts, accessories and raw materials for manufacturing and assembly industries; goods required for construction and "outfitting" of tourism and hotel investments; and "essential goods" for investments in rural commerce.
- Extension of the exemption from customs duty to include exemption from VAT for specified purchases by most investments that qualify for specific incentives (the exception being manufacturing and assembly industries).

The 2009 Code also offers "general" fiscal benefits for investments that do not fall into a category covered by "specific" incentives. These benefits cover import duty exemptions (but not VAT exemptions) on class "K" goods; investment tax credits; accelerated depreciation; deductions for modernization and new technology; deductions for professional training; and deductions for certain expenses on infrastructure that will benefit the public.[20] The 2009 Code introduced several changes to the general benefits provided in the previous Code, including:

- Scaling back accelerated depreciation from 200 percent to 150 percent of the normal rate.
- Scaling back tax deductions for investments in specialized equipment involving new technology, as well as expenditures on public infrastructure.
- No exemption from the stamp tax and real property transfer tax.

One bizarre "benefit" is the deduction for expenses on professional training of Mozambican locals, which is capped at 5 percent of taxable income (or 10 percent for training on advanced technology equipment). With the cap defined in this way, the benefit is worthless for an investment in a tax-loss condition, which is common for start-ups during early years of operation. More to the point, it makes no sense to limit the deduction for a legitimate business expense, especially one that creates positive externalities for the economy by upgrading labor force skills. Indeed, some countries in the region such as Botswana and Swaziland allow a super-deduction (more than 100 percent) for training expenses, to provide an effective subsidy for these desirable activities.

Both the 2002 and 2009 Codes state that fiscal benefits are to be considered as a form of government expenditure, requiring a declaration of benefits used each year. Table 3-1 summarizes government estimates of the "tax expenditures" for 2006 and 2007, with partial

[20] The 2009 Code specifies that general benefits may not be cumulated with specific benefits, except as stated in the designation of the latter.

estimates for 2008.[21] It is interesting to see that value of fiscal benefits in 2007 under the IRPC jumped to over 90 percent of actual company tax receipts. The *Tribunal Administrativo* (2008) points out that this large increase reflects high profits at Mozal, CFM, M-Cel and Banco Internacional de Moçambique.[22] These figures underscore the importance of the 2009 revision to the CBF, which closes off the special income tax benefit for large projects in the future, though it leaves the benefits unchanged for existing large projects.

Table 3-1

Approved Tax Exemptions, by Major Tax (10^6 MT)

	Import Duty	VAT	Excise	IRPC	IRPS	Sum
Tax exemptions						
2006	822.8	1534.3	271.8	517.4	0.2	3146.5
2007	923	1857.1	112.8	3967.2	0.9	6861
2008	710	1291.6	188.1	na	na	na
Tax receipts						
2006	3260.6	9385	1818.6	2535.5	3784.4	20784.1
2007	3803.8	11314	2076.2	4364.9	4859.1	26418
2008	3597.4	12969.6	2634.3	5425.9	5957.2	30584.4
Exemptions as % receipts						
2006	25.2%	16.3%	14.9%	20.4%	0.0%	15.1%
2007	24.3%	16.4%	5.4%	90.9%	0.0%	26.0%
2008	19.7%	10.0%	7.1%	na	na	na
Exemptions, by type of tax (%)						
2006	26.1%	48.8%	8.6%	16.4%	0.0%	100.0%
2007	13.5%	27.1%	1.6%	57.8%	0.0%	100.0%
2008	na	na	na	na	na	na

Notes: IRPC = Company Income Tax
IRPS = Individual Income Tax

Sources: 2006 and 2007 exemptions from Tribunal Administrativo, Relatório e Parecer sobre a Conta Geral do Estado de 2007, p. V.
2008 exemptions from Autoridade Tributária, Relatório de Actividades 2008, p. 50.
Receipts, by type of tax from Autoridade Tributária, Execução da Receita do Estado 2008

Appendix C provides an international perspective on tax rates and tax incentive regimes in the SADC member states and four other comparator countries in Africa (Ghana, Kenya, Senegal, and Uganda). It difficult to judge from this information the extent to which Mozambique's tax system is regionally competitive because the incentive regimes contain many technical details that defy simple comparison, and in any case the effects depend on characteristics of particular investments. The most useful comparisons come from several studies that are discussed in Chapter 5 (see Investment), showing that the 2002 Code of Fiscal Benefits in Mozambique was highly competitive within the region. No comparable studies have been conducted, however, on the 2009 Code.

It is also important to emphasize that the question of tax competition only arises in the context of internationally mobile investment projects. For investments that are motivated by access to particular natural resources, opportunities in the domestic market, or proximity to ports and

[21] The IMF (2008a) notes that government documents fail to explain the methodology behind these estimates.

[22] Using conservative assumptions, Versano and others (2006) estimate that the income tax benefit for Mozal, alone, in 2004 was worth approximately $37.5 million, compared to total company income tax receipts of approximately $45.6 million that year.

corridors – and are therefore anchored geographically – tax rates in other countries do not enter into consideration.[23]

DOING BUSINESS RANKINGS OF MOZAMBIQUE'S TAX SYSTEM

This section reviews Mozambique's performance on tax system rankings from the World Bank's annual Doing Business reports.[24] Although there are technical problems with the indicators (see Exhibit 3-1), the ratings have proven to be useful in highlighting constraints to the business environment, providing both an impetus and political leverage for reforms to improve market conditions, including reforms to establish a more efficient, transparent and effective tax system.

The Doing Business reports are designed to provide a set of "standard tools used across a broad range of jurisdictions to measure the impact of government rule-making on business activity…," particularly with reference to the effect of institutional conditions on opportunities for domestic small and medium-size enterprises.[25] In *Doing Business 2009*, Mozambique ranked 141 out of 182 countries for the overall ease of doing business. For the category "paying taxes," however, Mozambique fares much better, with ranking 88. This is ahead of all but two other SADC countries with comparable income levels, though Malawi (at 58) and Zambia (at 38) show that better rankings can be achieved even for low income countries. The overall SADC median rank is 58, with the best performers being Mauritius and South Africa, at 11 and 23, respectively.

The Doing Business score for paying taxes is calculated for a specific case involving a medium-sized limited liability company that started operations one year earlier, undertaking general commercial or industrial activities.[26] The score consists of three components, which have equal weight: the number of tax payments; the hours spent in preparation and payment of taxes; and a computation of the total tax rate as a percentage of profits for the representative business. The total tax rate itself has three components: the tax on profits; taxes and contributions on labor that are borne by the employer; and other taxes.

In Doing Business 2009, the World Bank team estimates that the standardized case-study business would require 230 hours of work to prepare and submit taxes in Mozambique (rank 89) involving 37 payments (rank 120), and face a total tax equaling 34.3 percent of the assumed profit margin (rank 52). Over the past three years these tax scores have not improved for Mozambique, while some other countries have leapfrogged ahead by implementing reforms affecting one or more of the indicators. Consequently, Mozambique's rank on paying taxes dropped from 77 to 88

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[23] Bolnick (2009) reports the results of a survey of 60 investments in Mozambique that were approved by CPI in 2005, 2006 and 2007. The most important and frequent motive for investment was opportunity in the domestic market; only 7 of 60 investors even considered alternative locations, and only 10 of 60 rated tax incentives as being critical to their investment decision.

[24] Appendix C provides a summary of tax indicators from the World Economic Forum's *African Competitiveness Report* for 2009, and executive survey results from the WEF's *Global Competitiveness Report* for 2007-2008.

[25] http://www.doingbusiness.org/documents/DB09_About.pdf. Accessed June 24, 2009.

[26] For the full set of assumptions see: http://www.doingbusiness.org/MethodologySurveys/PayingTaxes.aspx.

Exhibit 3-1
The Paying Taxes Indicator: How does it measure up?

The World Bank's Independent Evaluation Group (IEG) criticized this the indicator on two grounds in its recent report, *Doing Business: An Independent Evaluation.* First, whereas most Doing Business indicators gauge the burden of business regulation, the paying taxes indicator includes subjective judgments about fiscal efficiency and equity by including an estimate of the total tax rate (TTR) as a share of profits for an illustrative business case. This indicator implicitly equates low tax rates with a more efficient and equitable tax system. In reality the situation is more complex. For instance, in a country where revenue mobilization is a paramount concern, lower taxes are not necessarily advisable. Moreover, including the TTR, as calculated, within the score for paying taxes leads to the curious result that Mozambique ranks ahead of advanced countries like Finland, Austria and Japan in this category.

A second criticism raised by the IEG report is that Doing Business relies on a single source and an opaque methodology for calculating TTR. The analysis was developed by PricewaterhouseCoopers (PwC) and PwC is the sole informant for the paying tax scores in 142 countries. Collaborating with a single source is inconsistent with the overall approach used by Doing Business, and increases the likelihood of anomalous results, especially for a complex calculation like TTR.

As an example, Doing Business regularly accords Zambia a very strong ranking on paying taxes, largely because of the TTR estimate. *Doing Business 2009* shows a TTR for Zambia of 16.1 percent, 8th best in the world. Looking at the TTR elements, the estimated company tax equals 1.7 percent of profits for the standard business case (compared to 27.7 percent for Mozambique). Yet Zambia imposes a standard company tax rate of 35 percent, versus 32 percent in Mozambique. The extremely low TTR for Zambia appears to be an artifact of the particular cost structure assumed for the standard business case. (Note that the methodology is based on the standard tax system without reference to any special fiscal benefits.)

Another problem with the TTR calculation is that it does not take into account the tax on distributed dividends, which directly affects the net rate of return to shareholders.[a] Countries that have eliminated double taxation of dividends therefore get no advantage in the TTR score. Furthermore, the methodology adopts a restrictive assumption about how profit margins are set for the standardized business case, leading to the implausible result that the businesses bear a tax exceeding 200 percent of their profit in several countries, including Burundi and DRC.

Estimating the number of tax payments would appear to be straightforward, but there is an arbitrary element to the count for electronic payments. Suppose a country moves from a paper system of monthly VAT returns to a system allowing electronic payments. By assumption, Doing Business would reduce the tax payment count from 12 to 1, producing a big jump in the ranking for paying taxes. This jump is difficult to justify. If the case-study business has computerized accounts, then printing out and signing monthly forms is not that much more onerous than sending an electronic version. And if the case-study business lacks computerized accounts, it cannot take advantage of the option for electronic filing.

In short, Doing Business scores for paying taxes should be viewed with caution, though they may be useful in highlighting problems with the tax system that require attention.

[a] *World Bank, IFC and PwC (2008), Paying Taxes 2009: The Global Picture, Appendix 2 (Methodology).*

between 2008 and 2009.[27] Looking at the components, Mozambique's rank slipped from 112 to 120 on the number of payments; from 83 to 89 on the time required; and from 43 to 52 on the total tax rate.

These scores suggest that complexities affecting tax compliance in Mozambique are a more serious barrier to doing business than the tax rates–an observation corroborated in all of the interviews conducted for the present study. To ascend in the rankings and significantly improve its score for the ease of paying taxes–and the overall ease of doing business ranking as well – the focus of attention should be on reducing the time and number of payments involved in paying taxes. The most important action to jump in the rankings would be to introduce electronic declarations and payments for the VAT, the corporate income tax, and social insurance contributions for workers. Given the methodology used by the World Bank, automating these tax payments would reduce the number of payments for these three taxes from 31 to 3. In To calculate the impact of this measure on the Doing Business score, we assume that automation of the payments would also halve the estimated time to pay taxes. If other countries maintain their present policies, these reforms would improve Mozambique's rank on paying taxes from 88 to 14, and its overall ease of doing business rank from 141 to 130. Eliminating the stamp duty would further reduce the number of payments by one, and improve the ranking by one more place.

The same measures would boost Mozambique's rank from 10 to 3 in the SADC region in the category of paying taxes, trailing only Mauritius and South Africa (see Table 3-2). In addition, these measures would improve Mozambique's SADC ranking on the overall ease of doing business from 10 to 8. Of course, if other SADC countries are simultaneously pursuing tax reforms there will be less improvement in Mozambique's relative position. Nonetheless, these measures would still significantly improve the ease of paying taxes in absolute terms–which is the primary objective.

TAX ADMINISTRATION

Chapter 2 outlined an impressive number of reforms to tax administration during the PARPA II period. All of the available information—from documentary evidence, interview results, and data analysis—show that the reforms genuinely improved the quality of tax administration and significantly increased the revenue yield relative to GDP.

Nonetheless, the glass is still less than half full when it comes to modernization of tax administration in Mozambique. This section examines the current conditions, focusing on shortcomings relative to best practices for developing countries. The final section of the chapter summarizes the AT's plans for dealing with many of these challenges. It must be emphasized that instituting major reforms to tax administration is a complex and difficult task that requires detailed technical planning, careful sequencing, diligent attention to change management, adequate financial, technical and personnel resources, and coordination of administrative reforms

[27] In 2007, Mozambique ranked 80 on the ease of paying taxes. The jump to 72 in 2008 occurred despite the absence of improvement in any of the country's component scores. The 2007 rankings, however, are not directly comparable to those for 2008 and 2009. In fact, the time series data set on the World Bank's Doing Business website shows scores for 2007 and 2008 only in the category of paying taxes.

Table 3-2
Doing Business 2009, Paying Taxes Indicator Components

Economy	Paying Taxes				
	Rank	Payments (number)	Time (hours)	Profit tax (%)	Total tax rate (% profit)
Angola	130	31	272	24.6	53.2
Botswana	17	19	140	17	17.1
Congo, Dem. Rep.	153	32	308	0	229.8
Lesotho	54	21	324	14.5	18
Madagascar	92	25	238	19.6	42.8
Malawi	58	19	292	29.6	31.4
Mauritius	11	7	161	11.3	22.2
Mozambique	**88**	**37**	**230**	**27.7**	**34.3**
Namibia	96	37	375	16.7	25.3
Seychelles	40	16	76	23.6	46.6
South Africa	23	9	200	24.5	34.2
Swaziland	52	33	104	28.1	36.6
Tanzania	109	48	172	19.8	45.1
Zambia	38	37	132	1.7	16.1
Zimbabwe	157	52	256	0	63.7
SADC Median	58	31	230	19.6	34.3

SOURCE: *Doing Business, 2009*

with supporting legal and regulatory changes, all driven by strong champions of reform in leadership positions. Otherwise, deep administrative reforms can be highly disruptive to the AT's business processes, to the point of jeopardizing the revenue yield and prospects for success of the reforms themselves.

Organization

The establishment of the Revenue Authority was a giant step towards professionalizing tax service. Compared to the previous organizational arrangements under the civil service, the AT is endowed with a high degree of managerial autonomy, including flexibility in determining remuneration and decisions on hiring, promotion, and retention of staff. Creation of the AT also provides the basis for achieving major gains in efficiency through the integration of common operations. To date, however, the integration of customs and domestic tax services has been limited, largely involving back office functions. Greater efficiency can be achieved through the integration of revenue operations such as audit, debt management, risk management, and refund processing, as well as support functions such as human resource management, taxpayer database pooling, IT systems development, and customer services.

Procedures and Information Systems

Every department in the AT uses computer applications in the daily course of business. Yet many basic interactions with taxpayers still operate in a cumbersome pre-automation mode relying on paper documents, error-prone manual inputs of data into the IT systems, and physical movement of hard-copy files for processing and approvals. This description applies to tax declarations and payments, customs clearances, refund claims, and case management for appeals, among other business processes. The introduction of electronic systems will cut compliance costs for taxpayers and free AT personnel time from pushing paper to tasks that generate a higher revenue yield. The government and the AT are committed to implementing a modern system of e-taxation, including electronic declarations, electronic payments through commercial banks, and the introduction of an automated single window (ASW) for customs clearances.

Another serious source of administrative inefficiency and burdensome compliance costs for taxpayers arises from the continued use of out-dated approaches to risk management. Many developing countries have been adopting systems using automated statistical analysis of past tax records and other third-party data to select high-risk taxpayers as targets for the verification of returns, tax investigations, customs inspections, and integrated audits. This system supports broader application of “green channel” procedures to allow simple and rapid processing of most customs and tax transactions with minimal revenue risk.

Automated systems are also the hallmark of good practice in screening tax returns and other incoming documents to catch arithmetic errors or other inconsistencies, and for identifying and notifying non-filers, stop-filers, and late filers. Here, too, more effective use of computerized systems can free AT personnel from routine low-value tasks and allow a reallocation of human resources to activities that are more productive in generating revenue.

The VAT refund process is a prime case in point. Over the past few years the AT has reduced refund delays and improved its support to taxpayers who have difficulty dealing with the procedures and documentation requirements. But the system is still paper based, with detailed manual verification of every refund petition, and approvals centralized in Maputo. A more efficient system would be based on electronic refund petitions, automated error-checking in real time, prompt electronic transmission to a centralized approval center, without requiring the shipment of paper files, selective risk-based verification based on the taxpayers overall compliance record, and prompt payment of low-risk claims.

The VAT refund system also illustrates the critical importance of thoroughly re-engineering workflows in conjunction with IT modernization. To realize the potential benefits of electronic tax systems, it is essential to restructure basic business practices rather than simply putting current practices onto a computer. This applies to virtually every area of operation.

Accompanying procedural reforms, the AT also needs to expand the management information system (MIS) to include more indicators of operational efficiency (*indicadores de desempenho*). The Annual Reports (ARs) of the AT are filled with tables and figures providing important information on issues such as revenue results relative to targets; the number of registrations, audits, inspections, refunds, and other proceedings; the size and composition of AT staff; and the budget for tax administration. But management also needs regular reports on operational efficiency, such as data on added revenue per audit and per auditor; the ratio of late-filers and non-filers to registered (non-exempt) taxpayers; the time distribution of refund payments; the percentage of customs clearances or VAT refunds benefiting from Green Channel treatment; and surveys of taxpayer knowledge and customer satisfaction.[28]

Another major challenge is that the software systems currently in use by customs (DGA) and the domestic tax department (DGI) do not share data..[29] The software platforms need to be changed so that all of data for each taxpayer can be integrated into a single master file, based on his or her unique taxpayer identification number (NUIT). Integration of the data systems is a basic requirement for efficient risk management and case management.

Human Resources

The AT has made notable progress in increasing the complement of staff, upgrading educational credentials, and expanding training programs. However, the AT still needs to embed these developments in a strategic approach for integrated human resource management to ensure that personnel are deployed across the organization to maximum advantage in generating revenue and improving taxpayer compliance. As noted above, the introduction of e-taxation systems and modern approaches to risk management will open new avenues for reallocating staff and increasing operational efficiency.

The on-going process of administrative reform also creates new training needs. For example, the establishment of a large taxpayers unit to handle all aspects of tax administration for large corporations with sophisticated financial planning capabilities, accentuates the need for training in advanced audit techniques and comprehensive taxpayer services involving even arcane technicalities in the tax code.

The Culture of Taxation

Comments on the tax culture in Mozambique were among the most frequent observations arising in field interviews. Three related elements stand out. First, nearly every interlocutor from the private sector offered vivid anecdotal examples illustrating the lack of a customer service culture among many tax officials, especially outside of Maputo. The incidents generally involve encounters where tax officials pursue a punitive approach to enforcement, such as levying heavy penalties for inadvertent and inconsequential mistakes, or errors stemming from inadequate information about tax system, rather than taking these opportunities to educate taxpayers and help them avoid errors. The interviews and the documentary evidence suggest that the AT is improving taxpayer services and tax education programs. Yet there are still many complexities or procedural requirements that can trip up even well meaning taxpayers. Also, the incentive

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[28] Appendix E contrasts the type of data contained in the Annual Reports with the type of data recommended for monitoring operational efficiency, as suggested in IMF(2009c). The Appendix also tabulates data showing trends in selected indicators of tax administration performance, drawn from the AT's Annual Reports.

[29] The customs data system has other significant technical limitations which will not be discussed here. These limitations have been identified in restricted reports to the AT from the IMF and a Quality Assurance Group (QAG) of tax experts representing donors contributing to a Common Fund in support of tax reforms.

structure within the AT encourages harsh enforcement practices whenever a local tax office is falling short of an assigned revenue target. Revenue targets that are overly ambitious relative to economic conditions and institutional capacity tend to create costly problems for small and medium businesses at the local level.

Many interviewees emphasized equally the lack of a “taxpaying culture” in Mozambique. The AT has been working to address this problem through public information highlighting the role of taxation in financing public services, and the obligation of citizens to contribute to national development. The AT is also in the final stages of developing its website to provide ready access to any businesses or citizens with Internet connections. This information campaign is an important step in the right direction, though it will take time to alter deeply ingrained attitudes and habits. Changing the culture of taxpaying is particularly difficult if tax officials are often perceived as being predatory rather than supportive, and if the public does not see corresponding benefits from government expenditures.

A related observation on the tax culture, also widely encountered, is that tax evasion and smuggling are still rampant and blatant, along with bribery and corruption. Here, too, the AT has made progress in adopting and publicizing a code of conduct for tax and customs officials, and promoting greater integrity and professionalism throughout the organization. By all accounts, however, the revenue loss from unethical practices on the part of taxpayers and tax officials is still very large.

PLANS FOR MODERNIZING TAX ADMINISTRATION

The discussion of tax system would be incomplete without including a summary of plans for further modernization of tax administration. The Autoridade Tributária (AT) recently developed and adopted a Strategic Plan for reform in 2009 and 2010, along with a Tactical Plan for 2009 setting deadlines and responsibilities for each activity. The Strategic Plan includes an overall statement of vision, mission, and values for the AT:[30]

- <u>Vision</u>: To establish premier quality services in collecting revenues and promoting and protecting the economy and society.
- <u>Mission</u>: To collect revenues for financing public sector activities by applying the tax and customs laws effectively, efficiently and equitably, with greater convenience for taxpayers in complying with their obligations, as well as protecting the economy and society.
- <u>Values</u>: Confidence and mutual respect, fairness, integrity, transparency, courtesy, dedication and excellence.

The Plan defines three strategic objectives and actions:

- <u>Strategic objective 1</u>: To increase tax collection in a sustainable manner.

[30] Translation by the authors of the present report.

- Strategy 1.1: Help taxpayers understand and comply with the tax laws. Actions include promoting tax education; providing taxpayer assistance; and simplifying procedures for paying taxes.
- Strategy 1.2: Strengthen measures to improve compliance with tax obligations. Actions include the formulation of legislation to combat tax evasion; simplification and improvement in processes for inspection, investigation and audit; more effective systems for collection and control of tax debts; and strengthening regional and international cooperation.
- Strategy 1.3: Create an integrated central management for large taxpayers and mega-projects. Actions include development and implementation of a new organizational unit to provide more professional treatment of large taxpayers; and strengthening the specialized capabilities needed by tax auditors dealing with mega-projects.

• Strategic objective 2: To modernize and strengthen tax administration.

- Strategy 2.1: Develop the human resource management system and improve the quality of life for tax officials. Actions include recruiting, training and promoting AT functionaries based on qualifications, experience and performance; establishing a unified career framework for AT personnel; and providing social and professional assistance to AT staff.
- Strategy 2.2: Improve the organizational structure and management system to guarantee well planned and well managed operations. Actions include developing a new organizational structure; implementing an effective system of change management; and extending geographical coverage of tax services throughout the national territory.
- Strategy 2.3: Improve the infrastructure to support effective functioning of Tax Authority. Actions include new and rehabilitated buildings; new equipment and furnishings, including vehicles; and effective management in providing essential gods and services.
- Strategy 2.4: Strengthen the organizational culture of the Tax Authority. Actions include programs to promote integrity and combat corruption; and development of a culture of controls in accounting, legal procedures and systematic risk management.

• Strategic objective 3: To develop information technology that permits the improvement of management of tax processes

- Strategy 3.1: Modernise businesses processes of tax administration through the application of information technology and maintenance of the functioning of the current system. Actions include designing modern software applications for e-NUITs, e-Taxation, and the automated Single Window for customs; provision of modern hardware, integration of software systems, and implementation of an efficient communication environment; effective education and training for AT personnel; and systems maintenance to guarantee smooth functioning of operations and administration while new integrated systems are developed.

Finally, the Strategy establishes four quantitative and qualitative indicators for measuring performance against the objectives:

- Annual increase in revenues of 0.5 percentage points of GDP.
- Minimum annual increase in collections of 2 percent over the previous year.
- Survey results on taxpayer satisfaction.
- Survey results on AT personnel satisfaction

The Strategy acknowledges major issues facing the AT in order to improve efficiency, effectiveness and fairness in tax administration. Particularly important are the need for taxpayer education and taxpayer support services; stronger enforcement and collection, especially relating to large taxpayers; the introduction of modern and integrated IT systems; better training for tax officials; and creation of a culture of integrity and control within the organization. The difficulty, of course, comes in translating the strategy into effective action.

4. Revenue Performance

This chapter reviews revenue performance over the PARPA II period and preceding years. The chapter begins with a discussion of revenue targets in the PARPA and the government's medium-term fiscal framework (MTFF), and follows this with a descriptive overview of the revenue trends. For insight into what might be an appropriate revenue target for Mozambique the chapter also examines international benchmarks for the ratio of revenue to GDP, and presents a regression analysis based on cross-section data for developing countries.

While tax revenues for 2009 are projected to fall short of the PARPA II target, the chapter concludes that overall revenue growth has been strong over the PARPA II period, reflecting positively on AT efficiency and the policy reforms carried out over the last ten years. In conjunction with evidence presented elsewhere in this study, the analysis of revenue buoyancy and appropriate international comparisons indicate that there is still scope for increasing the revenue ratio in the coming years.

REVENUE TARGETS

As shown in Chapter 2, PARPA II set a target for total domestic revenue target to reach 16.2 percent of GDP in 2009, up from 14.0 percent in 2005. For the longer term, the indicative target in PARPA II is to increase revenues to 16.6 percent of GDP in 2014 (p.39, Table 11). The PARPA also states that these targets are to be achieved without placing an undue burden on the formal sector, by broadening the tax-base and reducing tax exemptions and evasion.

The long-term need to increase revenues is highlighted by the persistently large fiscal gap – the difference between total expenditures and total revenues, excluding grants and loans.

Figure 4-1 illustrates the scale of the issue, [31] showing that external grants and loans financed 49 percent of expenditures in 2006 and 43 percent in 2008. While a reliance on external finance is acknowledged as a necessity for the foreseeable future in PARPA II, the long-term goal is to reduce this dependency by increasing government revenues.

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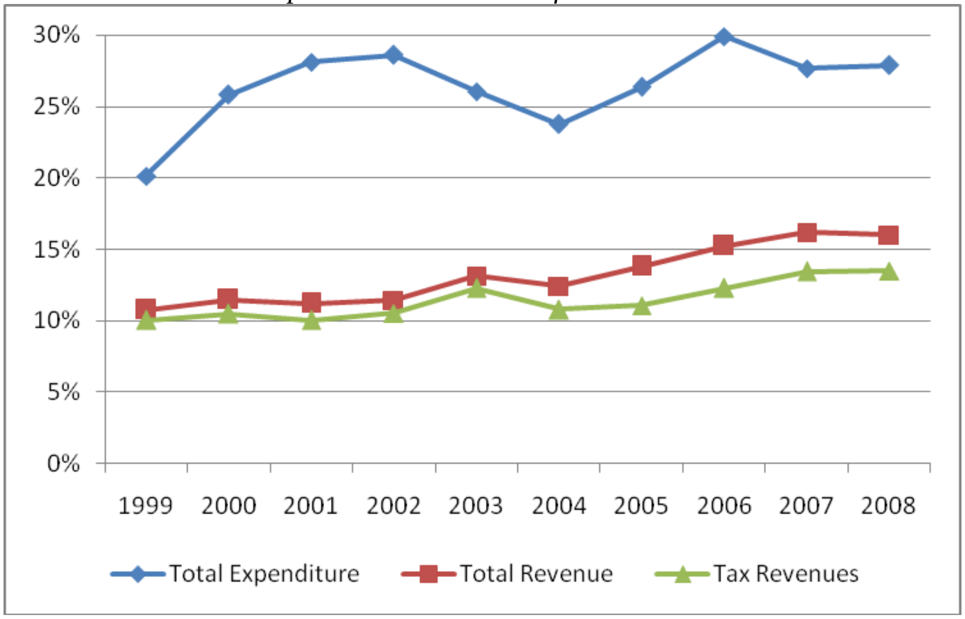
[31] As the latest wave of major tax reforms in Mozambique goes back to the introduction of VAT in 1999, this is taken as the starting point for analyzing revenue performance, permitting a longer time horizon for analysis of trends and patterns although the focus will remain on the PARPA II period 2006 to 2008.

Figure 4-1

Domestic Revenue & Expenditure as a Share of GDP



SOURCE: MPD, "Quadromacro Revisto CFMP Proposta", received June 2009.

This long-run goal is reflected in government annual budget programs which, in agreement with the IMF, have targeted an increase in revenues of 0.5 percent of GDP per year since 2005 (IMF reports from 2005 to 2009a). In fact, the latest Medium Term Fiscal Framework (*Cenário Fiscal de Médio Prazo- CFMP*) projections target average growth of nearer 0.6 percent of GDP from 2005 to reach 17.4 percent of GDP in 2011, reflecting more ambitious targets than those expressed in PARPA II.[32] Further, a recent IMF Debt Sustainability Analysis assumes that tax revenue will reach 21 percent of GDP in 2028, with total revenues reaching 23.5 percent of GDP (IMF 2009a).

This optimistic long-term view is based at least to some degree on two IMF studies.[33] An internal study in 2004 used a combination of macroeconomic data, household surveys and foreign trade statistics to estimate the potential tax base for VAT, income tax and import duties, and then applies the respective tax rules and rates to the estimated tax base to arrive at an estimate of potential revenue. Comparing potential revenue with actual collection, Schenone estimates that the maximum revenue potential for these three taxes was roughly double the realized revenue of 11 percent of GDP in 2001 and 2002, illustrating a large degree of foregone revenue due to exemptions, evasion, and weak administration as of the reference dates. The second IMF study applied an econometric “tax frontier” model to estimate the potential tax revenue from cross-country panel data for the period 1995 to 2005. This study also estimated the tax capacity for Mozambique at around 22 percent of GDP. The authors note that this would be on a par with Kenya’s performance.

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[32] From MPD, DNEAP's "Quadromacro Revisto CFMP Proposta", received June 2009.

[33] Both studies are discussed in Varsano et al. (2006).

Notwithstanding these conclusions and ambitious revenue targets, growth and revenue forecasts have recently been revised downwards, reflecting effects of the world economic downturn. The most recent IMF report from June 2009 projects total revenue on the order of 15.7 percent of GDP in 2009, rising to 16.5 percent in 2011 (IMF 2009b).

The following section discusses revenue performance and the observed trends for the main contributing taxes in light of the PARPA II and other targets mentioned above.

REVENUE GROWTH

Recent revenue growth has been strong. After a dip in the ratio of revenue to GDP in 2004, growth in the ratio resumed in 2005 and continued for the first two years of PARPA II, coinciding with the introduction of the AT. This helped to narrow the gap between domestic revenues and expenditures (illustrated in Figure 4-1). In fact, domestic revenues reached the 2009 PARPA II target of 16.2 percent of GDP in 2007, and narrowly missing this mark in 2008, with 16.0 percent of GDP, as shown in Table 4-1.

Table 4-1

Principal Revenues as Share of GDP (%)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total revenues	10.8	11.5	11.2	11.4	13.1	12.4	13.8	15.2	16.2	16.0
Tax revenues	10.0	10.5	10.0	10.5	12.3	10.8	11.1	12.3	13.4	13.5
Income taxes	1.5	1.6	1.8	2.1	2.9	2.7	2.9	3.5	4.5	4.9
Personal income tax	0.8	1.0	1.1	1.4	2.0	1.9	1.9	2.1	2.3	2.5
Corporate income tax	0.7	0.6	0.6	0.7	0.8	0.8	1.0	1.4	2.1	2.4
Expenditure taxes	6.6	7.3	6.9	7.2	7.9	7.2	7.4	8.0	8.3	8.0
Value-added tax (VAT)	3.9	4.4	4.2	4.4	4.9	4.5	4.5	5.2	5.4	5.4
VAT on domestic transactions	1.0	1.8	1.9	2.0	2.1	1.9	1.8	2.1	3.2	2.4
VAT on imports	1.4	2.6	2.4	2.6	2.7	2.6	2.7	3.2	2.2	3.0
Spec. consumption tax (SCT) dom.	0.6	0.6	0.6	0.6	0.7	0.6	0.6	0.6	0.6	0.7
SCT Beer and soft-drinks	0.0	0.5	0.4	0.5	0.5	0.4	0.5	0.5	0.5	0.5
SCT – tobacco	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
SCT – Other products	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Specific consumption tax imports	0.4	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Customs duties and sugar surtax	1.7	1.9	1.8	1.9	2.0	1.7	1.9	1.8	1.8	1.5
Other tax revenues	1.9	1.6	1.3	1.2	2.2	0.9	0.8	0.7	0.7	0.6
Other revenues	0.7	1.0	1.2	0.9	0.9	1.8	2.9	3.0	2.7	2.5
Mem: Imposto s/ Combustivel	1.3	1.2	1.0	0.9	1.2	1.3	1.2	1.0	1.1	1.0

Notes: Years 1999 to 2007 from Conta Geral do Estado, 2008 from Relatorio de Execucao. Data MPD

"Quadromacro Revisto CFMP Proposta", received June 2009. Note that here Imposto de Combustivel is presented separately as but is otherwise included partly in "Non-tax revenues" and partly in "Consigned revenues".

Within total revenues, tax receipts also increased as a share of GDP from 10.8 percent in 2004 to13.5 percent in 2008. The difference between total revenue growth and tax revenue growth is due to “other revenues”, comprising non-tax revenues, pre-assigned revenues and capital revenues, with assigned fuel tax and capital revenues mostly responsible for growth in this category.

Despite missing the PARPA II goal for 2008 and 2009, overall revenue performance suggests significant gains from the introduction of the AT, reforms to tax administration, and efforts to broaden the tax base. This is particularly impressive given that several tax policy measures were carried out that were likely to reduce revenues, namely lowering the top import tariff rate, implementation of the SADC trade protocol, raising the VAT threshold, and the temporary suspension of fuel tax. Part of the increase in revenues is also due to the natural elasticity of the tax system.

Revenue Elasticity and Buoyancy

In discussing revenue performance, it is important to understand the concepts of revenue elasticity and buoyancy. Revenue elasticity refers to the increase in revenues which occurs naturally as a result of economic growth, excluding the revenue effects of changes in tax policy or administrative reforms. Economic growth itself moves individuals into higher tax brackets, increases the number of households and businesses above the exemption threshold, pulls more workers and firms into the formal sector, increases the incomes of successful firms, and expands expenditure on taxable goods and services relative to GDP. These basic factors suggest that both the corporate and individual income tax, as well as the VAT are inherently elastic sources of revenue. That is to say that they tend to generate higher revenues relative to GDP as the economy grows, aside from any measures to broaden the tax base, improve collection efficiency, or improve tax compliance. To a lesser extent the same is true of the excise tax, because sumptuary spending tends to increase relative to total consumption expenditure as incomes rise. Customs duties, on the other hand, may be less elastic, depending on trends in the ratio of trade to GDP and changes in the composition of imports.

Revenue elasticity is hard to quantify due to the difficulty of separating the effect of policy measures from the underlying dynamics due to growth. Revenue buoyancy is an alternative measure that is easier to calculate because it simply looks at the overall change in revenues relative to income and expenditure, without trying to distinguish the effects of policy or administrative measures. Table 4-2 presents revenue buoyancy measures by type of tax, averaged over two periods: 2000 to 2008, and the PARPA II period of 2006 to 2008. The average buoyancy of total revenues over the period 2000-2008 is 1.38, implying that revenues increased by 1.38 percent for each 1 percent increase in GDP. Over the shorter PARPA II period, total revenue buoyancy has been nearly the same, at 1.34. For both periods the buoyancy rate has been higher than one, showing that revenues grew considerably faster than nominal GDP.

Tax revenues were less buoyant than total revenues over the full period 2000 to 2008, but the relationship reversed in the PARPA II period, with a strong buoyancy factor of 1.48 for tax receipts. Income tax revenues have been especially buoyant over this period, particularly the corporate income tax (IRPC) for which revenues increased by 3.5 percent for every 1 percent rise in GDP. VAT revenues have also been highly buoyant over the past three years, with domestic rising by 2 percent and the VAT on imports rising by 1.58 percent for every 1 percent rise in GDP.

Table 4-2
Revenue Buoyancy with Respect to Nominal GDP

	Ave. 00-08	Ave. 06-08
Total revenue	1.38	1.34
Tax revenue	1.32	1.48
Income taxes	2.08	2.35
Personal income tax	2.13	1.62
Corporate income tax	2.10	3.49
Expenditure taxes	1.22	1.18
VAT on domestic transactions	2.16	2.00
VAT on imports	2.00	1.58
Specific consumption tax - domestic	1.15	1.15
Specific consumption tax - imports	1.17	1.28
Customs duties and sugar surtax	0.97	0.52
Fuel tax	1.06	0.78
Other revenues	2.37	0.64

SOURCE: Authors' calculations using data from MPD, "Quadromacro Revisto CFMP Proposta", received June 2009.

This is important to keep in mind in discussing the prospects for further revenue increases as a share of GDP. The buoyancy evidence suggests that administrative and tax policy measures, combined with the inherent effects of rapid GDP growth, have produced strong growth in tax revenue relative to GDP over the PARPA II period. There is no reason to expect the favorable dynamics to dissipate over the medium term given the prospective revenue effects of recent changes in tax policy relating to future large projects, including mineral and petroleum ventures, the rapid expansion in tax registrations, and the scope for substantial revenue gains through further administrative reforms, as discussed in Chapter 3.

Revenue Sources

Figure 4-2 disaggregates total revenues into the main components: income taxes; VAT; customs duties (plus the surcharge on sugar imports); fuel tax; "other taxes;" and "other revenues."[34] This clearly shows that the largest contributors to revenue are income taxes and VAT and that these have been increasing as a share of GDP at least since 2005, although VAT revenue growth tails off in 2008. The next largest contributor to revenues is customs duties and the sugar surtax, followed by "other revenues" which have seen a leap in their share of GDP since 2004. These are discussed in more detail below.

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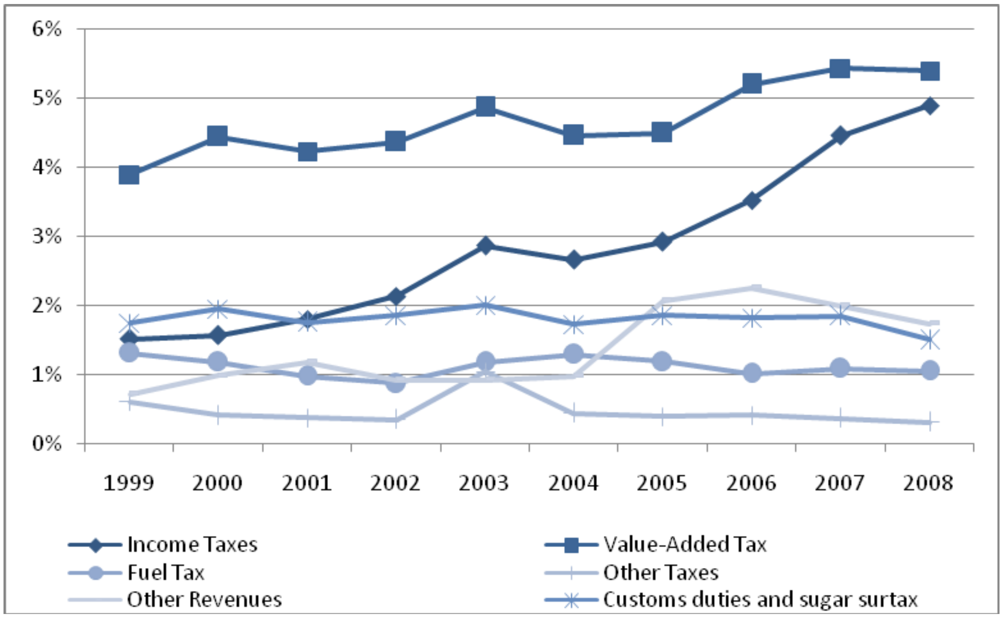
[34] Revenues from the specific consumption tax (excise tax) on domestic goods and imports are left out to avoid clutter, and given their relatively low share of GDP through time. More detailed data are presented above in Table 4-1.

Figure 4-2

Principal Tax Revenues as a Share of GDP



SOURCE: MPD, "Quadromacro Revisto CFMP Proposta", received June 2009.

Expenditure Taxes

Expenditure taxes are the primary source of domestic revenue, representing 9.0 percent of GDP in 2008, with 60 percent of this sum coming from VAT. [35] VAT revenues have increased as a share of GDP from 3.9 percent of GDP in 1999 to 5.2 percent in 2006 and 5.4 percent in 2007 and 2008, making VAT by far the most important tax, providing approximately one third of total revenues and 40 percent of overall tax receipts in 2008.

Given the importance of VAT revenues, it is useful to examine revenues from domestic transactions and imports separately. As can be seen in Table 4-1 above, VAT collections on imports fell from 3.2 percent of GDP in 2006 to 2.2 percent of GDP in 2007 before rebounding in 2008 to 3.0 percent of GDP. At the same time, revenues from import duties and the sugar surtax declined in 2008 from 1.8 percent of GDP to 1.5 percent. While this decline in duty revenues makes sense following the reduction in the tariff rate on imports of consumer goods and the phasing in of SADC trade preferences, the accompanying VAT surge should reflect the broader trend in imports. In fact, the local currency value of imports increased by just 8.6 percent in 2007 – below the growth rate for nominal GDP. Imports by value then jumped by 24.7 percent in 2008, reflecting in part the surge in world commodity prices.[36]

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[35] Note for 2005 that the breakdown of VAT between domestic and imported goods, and the breakdown of the ICE on national products between beverages, tobacco and other goods is imputed as an average of the breakdown in 2004 and in 2006 due to the absence of the relevant data.

[36] Figures from the DNEAP Quadromacro from June 2008.

In contrast to VAT on imports, domestic VAT receipts increased markedly in 2007 and then fell in 2008 as a share of total revenue. This may be a consequence of the revised VAT code which introduced a 60 percent reduction in VAT on supplies of services to the state for public works such as roads, bridges and water supply infrastructures. The increase in the turnover threshold for VAT exemption may also have had an effect on revenues beginning in 2008. Even though a large number of firms may have been affected (no figures are available), this is not likely to have been a major factor given that affected firms would be very small, and the exemption only eliminates VAT on a firm's final sales margin, without providing relief from VAT paid on inputs. Further analysis would be needed to explain more fully the recent behavior of VAT receipts. Analysis of this sort should be a routine function of the studies office (GEST) in the Ministry of Finance.

Overall VAT performance can also be examined in terms of a standard indicator called VAT productivity. This is defined as the ratio of VAT receipts to GDP, divided by the VAT rate, which in this case is 17 percent. The resulting value lies between zero and one, where an estimate close to one implies that actual VAT collections are high relative to the theoretical maximum, or high VAT productivity, while a value close to zero implies low productivity due to a combination of exemptions, zero-rating, tax evasion, and weak tax administration. Table 4-3 shows that VAT productivity in Mozambique has broadly been rising since 2000, the first full year of implementation, with minor declines in productivity 2005 and 2006 only.

Table 4-3
Mozambique VAT Productivity

	2000	2001	2002	2003	2004	2005	2006	2007	2008
VAT Productivity	0.23	0.26	0.25	0.26	0.29	0.26	0.26	0.31	0.32

SOURCE: Authors' calculations using data from MPD, "Quadromacro Revisto CFMP Proposta", received June 2009.

The Mozambican average for the period 2006 to 2008 is 0.30 which, as shown in Table 4-4, is above the average of 0.25 for sub-Saharan Africa, and the average of 0.24 for low-income economies worldwide. Although this still puts Mozambique below the levels attained in the low-middle-income economies group of 0.47, it should be noted that VAT productivity is 0.37 for Western Europe, and 0.32 for the United States and Canada.

In relation to other expenditure taxes, the revenue yield from the domestic excise tax and the excise tax on imports has remained roughly constant at around 0.6 percent of GDP and 0.4 percent of GDP, respectively. Revenues from fuel tax have also been relatively stable, ranging between 1.0 and 1.3 percent of GDP, despite the foregoing of fuel tax receipts as of June 2008 mentioned above.

Table 4-4
VAT Productivity for Mozambique and Comparator Country Groups

Country/Group	VAT Productivity
Low-income economies group	0.24
Sub-Saharan Africa	0.25
South Asia	0.28
Mozambique	0.30
United States and Canada	0.32
Western Europe	0.37
High-income economies group	0.39
Upper-middle-income economies group	0.43
Latin America and the Caribbean	0.44
East Asia and Pacific	0.45
Central Europe and Central Asia	0.45
Middle East and North Africa	0.47
Low-middle-income economies group	0.47

Note: Fiscal Reform data does not refer to one particular year, but employs the most recently available data as of December 2007, the most part coming from 2005, 2006 and 2007 (Fiscal Reform, 2009, accessed at http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132).

SOURCE: *Fiscal Reform (2009).*

Income Tax

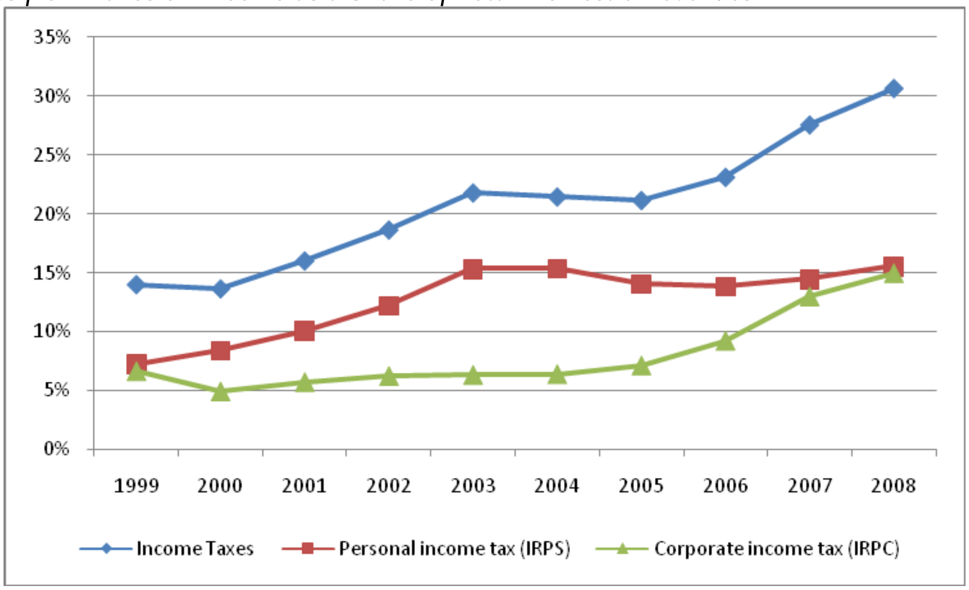
Income tax revenues increased markedly from 1.5 percent of GDP in 1999 to 3.5 percent in 2006 and then to 4.9 percent in 2008. This overall growth stemmed from implementation of the revised income tax code (the IRPS and IRPC) in 2003 which, from 2004, led to a higher growth path for revenues, and from more efficient tax enforcement following establishment of the AT.

Figure 4-3 shows that income tax revenues climbed from under 15 percent of total revenues in 1999 to over 30 percent in 2008. The graph shows that much of the growth has been due to the corporate income tax revenues (IRPC). These revenues increased from five percent of the total in 2003 to 15 percent in 2008. In addition to the effects of the new tax regime and improvements in administration, this rapid growth in company tax revenue is likely related to strong growth in the financial sector, which doubled its share in GDP from 1.6 percent in 1999, to 3.3 percent in 2003 and continued rising to 5.6 percent of GDP in 2008. Expansion of the financial sector was particularly strong in 2004 and 2005, with growth rates of 25.2 and 49.2 percent, respectively (see the data on GDP in Appendix A).[37] The transport and communication sector is also likely to have been instrument here, given its high average growth rate of 13.1 percent over the period 2006 to 2008 and share of around ten percent in GDP.

[37] The manufacturing sector also displayed a higher accumulated growth than most other sectors over the period 1999 to 2008, but this is mainly due to megaprojects, and Mozal in particular, which contributes disproportionately little to government revenue due to the special negotiated tax regime for this project.

In contrast, personal income tax receipts received a one-off increase in revenues with the introduction of IRPS in 2003 and the inclusion of public sector salaries into the tax-net, but have since remained around 15 percent level of total revenue, even declining as a share of total revenues in 2005 and 2006.

Figure 4-2
Revenues from Taxes on Income as a Share of Total Domestic Revenues



SOURCE: MPD, "Quadromacro Revisto CFMP Proposta", received June 2009.

As a result, income tax revenue in 2008 was almost equally shared between companies and individuals (15.0 percent and 15.6 percent of total revenues, respectively). While the current growth slowdown may dampen company profits in the short run, the overall trend suggests that company tax revenues should overtake personal income tax revenues in coming years. This trend suggests that efforts to strengthen tax administration have had a disproportionate impact on company tax collects, as would be expected given that the individual income tax is largely paid through monthly withholding by employers in the formal sector. The trend is likely to be further helped by the new fiscal benefits code, discussed above, which reduces the level of benefits to future mega-projects and mining and petroleum investments, bringing these under the IRPC (though the revenue potential from large projects is generally very low in the initial years of operation due to deductions for capital expenditures and loss carry-forward provisions of the tax code).

Other Revenue Sources

An important consideration is the distinction between total domestic revenues and tax revenues. As illustrated in Figure 4.1 the gap between the two revenue figures has increased since 2004, with total revenues broadly in line with the PARPA II target even though tax revenues are below target. A part of the increase in this gap is due to the reclassification of a portion of fuel tax from “Other Taxes” to non-tax “Consigned Revenue” as of 2004. This statistical artifact increased “Other Revenues” by 0.8 percent of GDP. Even excluding this reclassification effect, however, the gap between total revenues and tax revenues has still increased due to growth in “Own

Revenues” (*Receitas Proprias*) of central and district government agencies, from zero percent of GDP in 2004 to 0.5 percent since 2005, and also an increase in capital revenues from 0 percent of GDP in 2004 to 0.7 percent in 2005, declining to 0.4 percent of GDP in 2008. As privatization revenues are now mostly exhausted, capital revenues are mainly derived from dividends earned on government investments state-owned corporations and government shares in private ventures. These might be expected to rise further as government stakes in Mozal and other mega-projects bear more fruit.

Finally, some commentators contend that tax cuts may increase revenue by stimulating higher compliance and faster growth. There is no empirical evidence, however, to support the proposition that a moderate reduction in the tax rates would have a large enough impact on investment, productivity, or compliance to avert a revenue loss. One possible exception, mentioned in Chapter 4, is the extremely high tax on certain products like vehicles from the combined effect of import duties, VAT, and excise tax. Experience in other countries suggests that lowering the excise tax or the import duty in such cases can actually boost revenue. This option warrants study.

INTERNATIONAL COMPARISONS

To gain perspective, it is instructive to compare the revenue performance in Mozambique with that of other countries. In fact, international comparisons were frequently mentioned in interviews conducted for this report, particularly in connection with discussions of an appropriate revenue target. Mozambique currently has a revenue ratio that is one of the lowest of the 15 SADC member states, and well below the SADC median of 23.3 percent of GDP (averaged over the period 2006 to 2008). Closer examination, however, shows that this is not an appropriate comparison. Several member states benefit from having abundant natural resources (Angola, Botswana, Namibia, South Africa), while some have access to extraordinary revenues through allocations from the SACU common revenue pool (Botswana, Lesotho, Namibia, Swaziland), and five are irrelevant to Mozambique due to very different economic and political conditions (Mauritius, Seychelles and South Africa as much wealthier countries, and DRC and Zimbabwe as highly disrupted economies). This leaves only Malawi, Zambia, Tanzania, and Madagascar as relevant comparators within the SADC region.

Table 4-5 presents fiscal indicators for SADC countries and some additional comparators. Malawi and Zambia have revenue ratios that are higher than in Mozambique, at 18.7 percent and 18.2 percent of GDP, respectively, while Madagascar and Tanzania have revenue shares considerably lower than in Mozambique, at 12.1 and 13.2 percent of GDP, respectively. Notably, Malawi and Zambia also score better than Mozambique in the World Bank’s Doing Business ranking for “ease of paying taxes” (as discussed in Chapter 3). Although not in SADC, another strong reformer in the region is Uganda, which also has a revenue ratio well below that of Mozambique at 12.7 percent of GDP. This basic comparison might lead to the conclusion that that Mozambique is well placed, given its level of development and economic structure, and in particular given the continuing level of administrative reforms underway.

According to World Development Indicators (WDI) data from the World Bank for 2008, only three low-income countries managed to generate revenue ratios above 19 percent of GDP in 2006. These are Ghana (21.9 percent), Kenya (21.1 percent) and Vietnam (27.9 percent). For

2007, this group also includes Senegal at 21.1 percent of GDP. However, all of these countries differ considerably from Mozambique in economic conditions. All four have much higher levels of per capita income. Measured in terms of purchasing power parity, the respective income levels in 2007 were $2,602 for Vietnam, $1,424 for Ghana, $1,672 for Kenya, and $1,698 for Senegal, compared to $842 for Mozambique (IMF, 2009b). These figures are only illustrative, but Mozambique clearly lags far behind the high-revenue countries of the low income group in terms of overall development. In addition, Vietnam benefits from having substantial amounts of oil revenue.

Table 4-5

Fiscal Indicators, Three-year Averages, 2006-2008 (% GDP)

	Overall Fiscal Balance		Government Revenue (excluding grants)	GDP per capita (current USD)
	Including grants	Excluding grants		
SADC Mean	2.5	-1.7	28.0	3,106
SADC Median	0.6	-4.85	23.3	1876
SADC COUNTRIES				
Angola	12.9	12.9	46.9	3,813
Botswana	4.6	3.9	35.7	7,011
Congo, Dem Rep	-0.7	-5.8	15.4	165
Lesotho	11.8	10.3	59.8	666
Madagascar	10.6	-8.3	12.1	373
Malawi	-2.4	-5.2	18.7	273
Mauritius	-4.3	-4.5	20	5,803
Mozambique	-3.7	-13.5	15.8	408
Namibia	1	0.8	30.3	4,146
Seychelles	-4.4	-6.2	37.8	10,943
South Africa	0.2	0.2	26.6	5,686
Swaziland	5.8	5.3	41	2,750
Tanzania	-2.8	-8.1	13.2	442
Zambia	5.7	-5.8	18.2	1,002
COMPARATOR COUNTRIES				
Ghana	-9.7	-15	22.5	665
Kenya	-3.1	-4.3	21.8	766
Senegal	-4.6	-6.7	20.1	925
Uganda	-1	-5.2	12.7	391
Vietnam	n/a	-0.9	27.3	866

Note: Data on Zimbabwe as a SADC country is excluded as unreliable.

SOURCE: *Sub-Saharan Africa Regional Economic Outlook, April 2009; World Economic Outlook April 2009*

In discussing a suitable revenue target for Mozambique, Varsano et al. (2006) draw attention to the structure of the Mozambican economy. In particular, they highlight the importance of the commerce, transport and communications sectors which were responsible for 36.9 percent of GDP in 2004, higher than in Tanzania, Kenya, Uganda and Malawi. As they point out, these sectors should provide relatively good sources of VAT revenue. They also point out that that Mozambique and Kenya have a similar share of manufacturing in GDP (13.7 and 13.0 percent of GDP, respectively) and conclude that their revenue capacity should also be similar, at around 22 percent of GDP. This comparison ignores the fact that the Mozambique is considerably poorer and less developed than Kenya. Overall, these international benchmark comparisons suggest that a revenue target above 19 percent of GDP would be highly ambitious for Mozambique.

Nonetheless, simply comparing revenue ratios across countries ignores a wide range of factors relating to taxable capacity and demand for tax revenue. The following section presents further analysis relating to the appropriate target which takes economic characteristics more systematically into account.

REVENUE EFFORT

Revenue performance can be analyzed in terms of tax effort or revenue effort by comparing a country’s revenue yield with a predicted value of the revenue ratio as estimated from a cross-country regression analysis relating revenue ratios to economic and other characteristics. This statistical form of benchmarking takes into account differences in economic characteristics likely to influence potential revenues.

Jones (2009) carried out this exercise for Mozambique by comparing tax ratios across low and middle-income countries for the period 1990 to 2003 in a panel analysis. He controls statistically for differences in economic structure and institutional factors, the implication being that remaining differences in the observed tax ratios relate to differences in policy preferences and the quality of tax administration.[38] His econometric results suggest that 13 percent of GDP was a realistic tax ratio for Mozambique, circa 2003. He also shows that the actual tax ratio over this period closely followed predicted values, given the prevailing economic and institutional conditions.

For the present paper, a similar analysis was conducted using more recent data, and with the ratio of total revenues to GDP as the dependent variable. To capture basic characteristics of the country that affect revenue performance, the independent variables in the regression analysis include GDP per capita, measured in constant US$2,000; the annual consumer inflation rate; the trade share of GDP (defined as exports plus imports divided by GDP); the nonagricultural share of GDP; and three widely cited measures from the World Bank on institutional quality, covering government

[38] Economic structure variables include GDP per capita, imports as a share of GDP, industry as a share of GDP, whether or not the country is resource-rich; while institutions are controlled for indirectly by introducing the share of the country found in the tropics, whether or not the country is landlocked, and who the colonial power, all variables variously associated with institutions in the cross-country empirical literature on growth.

effectiveness, regulatory control and control of corruption, all of which are indices ranging between -2.5 to 2.5.[39]

The regression equation is estimated for low and middle-income countries. To verify robustness of the estimates, the regression is run for three periods: 1999-2007, 2003-2006, and 2005-2007. Table 4-6 presents the results. In particular, it shows the actual ratio of revenues to GDP and the predicted ratio, as estimated from the regression equations. Assuming that the predicted revenue share indicates the expected revenue yield for a country with Mozambique's level of development and structural characteristics, the revenue effort can be defined as the ratio of the actual to predicted revenue ratios. This is reported in the final column of the Table 4-6.

Table 4-6
Mozambique Actual & Predicted Revenue-Ratio & Revenue-Effort

Period	Actual R/Y	Predicted R/Y	S.E.	Normal Range		Revenue-Effort
99-07	14.28	15.17	1.30	14.30	16.05	0.94
03-06	13.85	16.49	1.45	15.51	17.47	0.84
05-07	15.03	17.04	1.67	15.91	18.16	0.88

*Note: Normal range is defined as the (predicted T/Y)+/-0.67*S.E., which provides the 50 percentile range around the predicted value. The S.E. is the standard error of the predicted tax ratio.*

SOURCE: *Authors' estimation using WDI and WEO data as described in the text.*

Table 4-6 also shows the standard error of estimate for the predicted value of the revenue ratio, and a corresponding "normal range" around the predicted value, taking into account the fact that the expected value is estimate with a margin of error. Specifically, the "normal range" is defined here such that 50 percent of the observations should fall inside this interval, with 25 percent above and 25 percent below.[40]

The most important point to note in Table 4-6 is that the actual ratio of revenue to GDP is below the predicted value, implying that Mozambique is consistently collecting less revenue than would be expected given its economic structure and other characteristics, based on evidence from other countries. This is reflected in the revenue-effort measures, which are all below one (where a revenue effort of one would imply that Mozambique was achieving its predicted ratio). For the most recent period, the revenue ratio is even outside the normal range on the low side. This result adds weight to the view that there is considerable scope for improvements in the revenue effort, and that a target ratio of slightly more than 18 percent should be achievable.

In contrast to earlier econometric studies which provided evidence for a very low revenue target of around 13 percent of GDP (Jones 2009) or a very high tax ratio of around 22 percent of GDP (Varsano et al., 2006), the message to emerge from the present analysis is that an appropriate

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[39] See Appendix F for a complete discussion of the methodology and other studies of this sort.

[40] The "Normal Range" is calculated as Y+/-(0.67428*S.E.), where Y is the predicted tax ratio, 0.67428 is the Z-score from the normal distribution associated with the middle 50 percentiles, and S.E. is the standard error of the predicted tax ratio.

revenue ratio for Mozambique lies between those extremes, most likely between 16 and 18 percent of GDP.

5. Impact of the Tax System

Previous chapters presented an overview of the structure and recent performance of the tax system. This chapter provides a more detailed analysis of the impact the tax system on major objectives of PARPA II. The chapter assesses in broad terms the impact of the tax system on investment, saving and employment, on private sector development, and on fairness and equity. This analysis leads into to a discussion of major tax issues for consideration in the preparation of PARPA III, which is the subject of Chapter 6.

The discussion of tax impacts on the PARPA objectives parallels in many ways a review of basic principles of taxation. The fundamental purpose of taxation, of course, is to raise revenue to finance the provision of public goods and services. The first principle is therefore that the tax system should be effective in mobilizing and sustaining revenue. But taxes have a pervasive influence on economic decisions of individuals and businesses, and on social equity. In view of these effects, the tax system should achieve the appropriate level of revenue as efficiently and fairly as possible. Hence, a well designed tax system should also conform to three other principles:

- ***Economic efficiency.*** An *efficient* tax system minimizes tax-driven distortions of economic behavior in order to foster productivity and economic growth. Economic efficiency considerations are especially important for low-income countries, which can least afford the cost of avoidable resource misallocation. Efficiency effects are also related to *predictability*. A tax regime that is subject to unexpected changes or arbitrary enforcement is a major risk factor for investors.
- ***Equity.*** A fair tax system is characterized by vertical equity (collecting proportionately more from those with higher incomes) and horizontal equity (provides relatively uniform and non-discriminatory treatment of taxpayers with similar economic circumstances). It also minimizes the tax burden on the poor, and avoids excessive tax burdens or arbitrary impositions all around. Fairness is a fundamental objective in its own right. In addition, perceptions of unfairness can erode compliance and undermine the sustainability of the tax system.
- ***Administrative efficiency.*** The tax system should also be administered efficiently, with due regard to both the direct costs of collecting taxes and compliance costs imposed on taxpayers. Even the best tax code produces poor results when it is not well administered. In countries with limited institutional capacity and weak capacity on the part of taxpayers to deal with complexities of financial management, simplicity is a virtue.

These principles are implicitly related to the PARPA II objective of raising government revenues without increasing the tax burden on the formal sector, by expanding the tax base, curbing tax evasion, and reducing tax incentives.

INVESTMENT

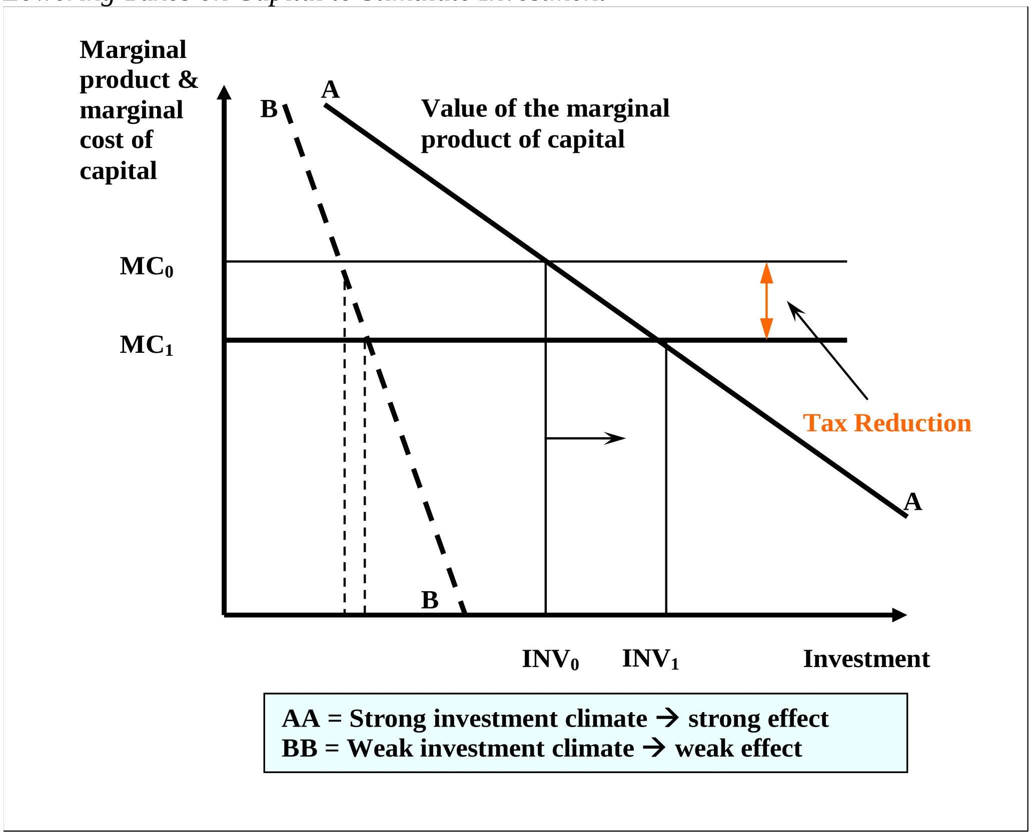
This section examines the effects of the tax system on two central building blocks for sustainable growth: the level and quality of investment.

How Taxes Affect Investment: The Basics

Figure 5-1 illustrates the general relationship between taxes and investment decisions. Line AA represents the returns to capital. The downward slope shows that there is a continuum of investments ranging from high to low returns. Line MC_0 represents the "user cost of capital" (UCC), which includes cost of funds, the effective tax rate on income from capital, and the impact of indirect taxes on the acquisition cost of capital goods. A reduction in any of the tax components shifts the UCC downward from MC_0 to MC_1, and stimulates an increase in investment from INV_0 to INV_1.

Figure 5-1

Lowering Taxes on Capital to Stimulate Investment



This picture illustrates two important points. First, tax cuts have little effect on investment projects with inherently high rates of return (along the upper segment of AA) or inherently low rates of return (along the lower segment of AA). Tax considerations mainly affect projects that are marginally viable (in the mid-range of AA). This selective impact matters because economic growth depends on quality of investment as well as the quantity.[41]

Second, attracting investment with fundamentally high rates of return requires policies to improve the business environment and hence shift the entire line AA to the right. The investment climate also has a strong effect on the amount of new investment that will occur as a result of lowering the cost of capital through tax breaks. With favorable business conditions a reduction in the cost of capital may induce a large investment response (as along AA), but the same tax incentives may induce very little new investment if business conditions are poor (as along BB). Overall, non-tax considerations are likely to be of paramount importance for most investment decisions.

Various tax tools can be used to stimulate investment by reducing the cost of capital: cutting the standard company tax rate; reducing the double taxation of dividend income; offering special tax incentives to selected investments; providing more generous investment deductions or credits in the calculation of taxable income; or reducing indirect taxes on the acquisition of capital goods. Many tax experts regard the latter two approaches as most cost-effective in terms of balancing the impact on investment against the revenue loss from special incentives.[42] The government's decision in 2002 to reform the Code of Fiscal Benefits was consistent with this view, as it eliminated most tax holidays in favor of investment allowances, accelerated depreciation, and investment tax credits, on top of the exemption from import duty on capital goods.

Taxes and Investment in Mozambique

During the PARPA II period, Gross Domestic Investment ranged between 18 and 19 percent of GDP, according to figures reported by the IMF. The latest actual data point (as distinct from estimates) is 18.0 percent for 2007, of which two-thirds comes from government investment and just one-third, or 6 percent, from non-government investment. Private investment has fluctuated between 6 and 13 percent of GDP since 2004, with variations driven by the timing of mega-projects. These investment rates are exceedingly low, to the point of being seriously inconsistent with the objective of sustaining rapid economic growth.[43]

Is the low level of investment a sign that tax rates in Mozambique are too high? Several studies undertaken prior to PARPA II found that company tax rates in Mozambique have been broadly in line with regional and international norms (see Bolnick 2004a; FIAS 2006; and IMF 2006).[44] As seen in Chapter 3, Mozambique also scores well on the World Bank's Doing Business estimate of

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[41] A 10 percent increase in productivity delivers the same boost to growth as a 10 percent increase in the amount invested Hence, a policy that adds 10 percent to the amount invested while reducing investment efficiency by 10 percent adds nothing to the growth rate.

[42] See Zee, Stotsky and Ley (2002) and Bolnick (2004, chapter 5)

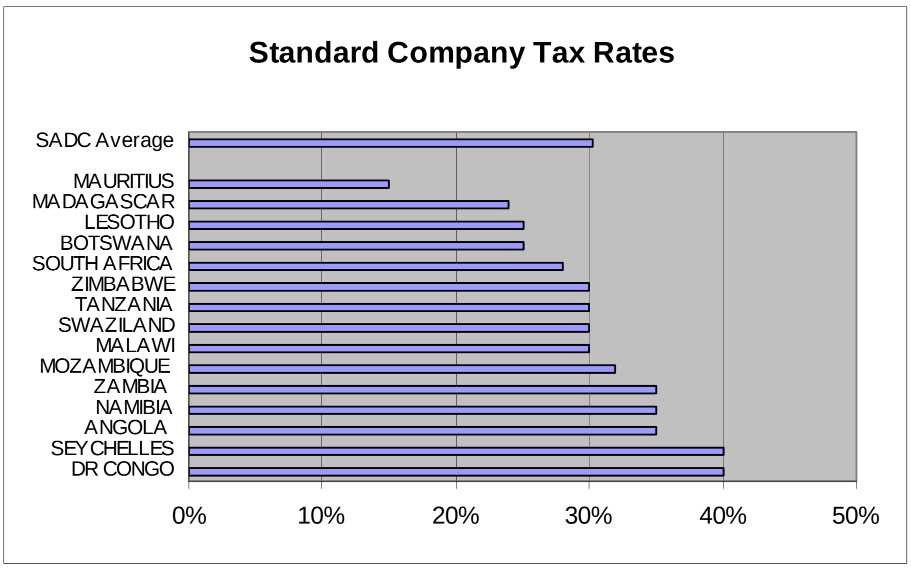
[43] The National Statistics Institute (INE) may systematically underestimate investment in farm works, rural buildings, and machinery and equipment used by small enterprises, though it does obtain reasonably good data on public sector capital expenditures, FDI inflows, imported machinery and equipment, and major construction projects.

[44] Mozambique also scores well on the World Bank's Doing Business estimate for the Total Tax Rate on company profits, but the methodology behind this measure is seriously flawed, as seen in Chapter 3.

the Total Tax Rate on company profits (though the methodology behind this measure is seriously flawed, as discussed earlier).

Figure 5-2 compares company tax rates in the SADC region, based on the latest available information for each country. The SADC average of 30.3 percent is now slightly lower than the 32 percent rate in Mozambique. Five years ago, the regional average was slightly higher than the rate in Mozambique, at 32.5 percent (Bolnick 2004). In the interim, the SADC average declined due to the entry of Madagascar, with a 24 percent tax rate, as well as company tax reductions in South Africa (from 30 to 28 percent), Lesotho (from 35 to 25 percent) and Mauritius (from 25 to 15 percent). In Mauritius, the reduction in tax rates was part of a move to a "flat tax," which also eliminated special tax incentives and discretionary tax breaks.[45] These tax cuts reflect a global trend towards lower taxes on capital. With the advent of the SADC free trade area, tax differentials among member states will become more prominent in affecting location decisions, as more investments will be driven by a regional perspective.

Figure 5-2
Company Tax Rates in the SADC Region, 2009



SOURCE: Internet information accessed between July 27 and August 6, 2009 from 2009 Tax Highlights produced by Deloitte offices in most SADC countries, plus: for Lesotho, Southern Africa Regional Poverty Network and US Embassy; for Mauritius, PKF International Ltd. Mauritius Tax guide 2009; for Seychelles, Revenue Commission.

The studies cited above by Bolnick and by FIAS also showed that investments subject to the standard tax regime faced an extremely high marginal effective tax rate (METR) in both absolute terms and relative to regional norms, to the point of being a severe impediment to investment. The principal cause of the elevated METR was the double taxation of dividends paid to individual shareholders. (Investments within a corporate group would not face this high METR, since dividend payments in this case are exempt from double taxation, subject to conditions of the

[45] Bolnick (2009) explains the flat tax concept. He concludes that while Mozambique can benefit from measures to broaden the tax base and reduce tax rates, the flat tax as such is but one possible means to this end.

IRPC.) Figure 5-3 shows, for SADC member states, the combined effect of the company income tax and withholding tax on dividend payments to individual shareholders.[46] For both residents and non-residents as shareholders, the combined tax in Mozambique is far higher than the regional average. Reducing the double taxation of dividend income earned by individual shareholders would therefore remove a significant barrier to investments that do not enjoy fiscal incentives and are not part of a larger corporate group. As a by-product, this measure would also eliminate a serious disincentive for domestic enterprises to incorporate.

For investment covered by the Code of Fiscal Benefits (CFB), the same METR studies showed that the effective tax rates in Mozambique were very competitive under the 2002 Code. The 2009 Code has not been subject to detailed analysis, but it clearly offers even more attractive tax benefits for investments in agriculture and fisheries, public infrastructure, and science and technology parks, as well as projects in Industry Free Zones (IFZs) and the Special Economic Zone (SEE) planned for Nacala. As discussed in Chapter 3, the 2009 Code also curtails benefits for large projects. This change is warranted because the tax breaks for large projects proved to be very costly, and in any case internationally mobile investments, for which tax competition would be a major factor, can still qualify for special treatment under the 2009 CFB provisions for Industrial Free Zones or the planned Special Economic Zone in Nacala.[47]

In conclusion, the tax burden is very high for investments subject to double taxation. For other investments the level of tax rates should not be a serious problem – though it a concern to see that the standard tax rate in Mozambique is now above the regional average. Unfortunately, there is no empirical basis for estimating the extent to which lower tax rates would stimulate additional investment in a country like Mozambique. Given the prominence of other barriers to investment, one would not expect a large impact from a moderate tax reduction. Lower tax rates would, however, increase the capacity of existing firms to finance expansion plans or investments to improve productivity, by boosting net earnings and cash flow. Empirical studies for other countries show that lower taxes do have a positive overall effect on investment (Klemm 2009).

The quality of tax administration, too, has an important effect on the investment climate, independent of the level of tax rates. In the interviews for this study, grievances about arbitrary and punitive enforcement practices by tax officials were far more prevalent than complaints about the level of taxes. These complaints undoubtedly reach the ears of many potential investors. Hence, problems with tax administration take precedence over concerns about the level of tax rates. Besides, improvements in tax administration can provide the revenue leverage needed to support reductions in the tax rates.

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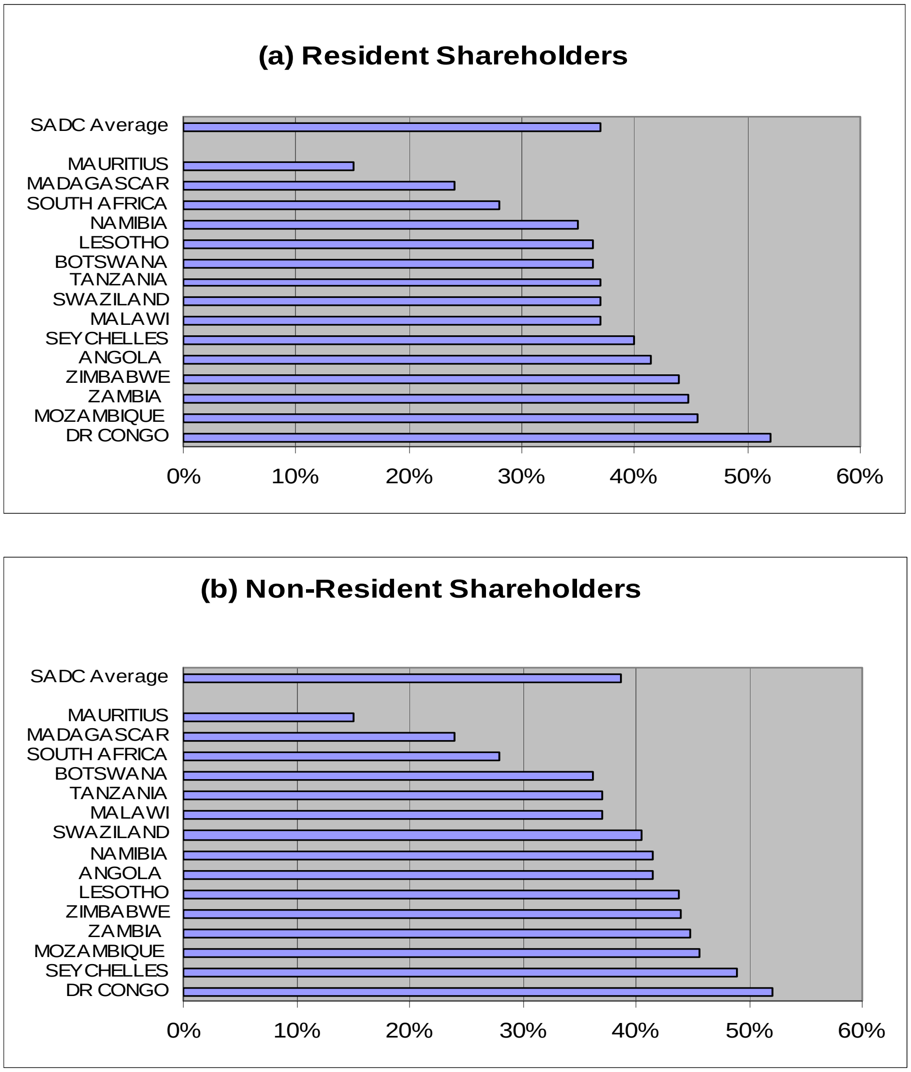
[46] The calculations here assume that after-tax earnings at the company level are distributed in full to shareholders. Using some other illustrative assumption would alter the absolute values of the combined tax, but would not change the relative comparisons.

[47] Klemm (2009) finds that international tax competition is the most prominent reason for countries to offer tax incentives. Appendix 7 summarizes the on-going debate about tax incentives as a tool for investment promotion.

Figure 5-3

Company Tax + Dividend Withholding Tax in the SADC Region, 2009



SOURCE: See note to Figure 5.2.

The tax system also affects investment efficiency. While virtually all taxes create efficiency losses by distorting economic behavior, sharp differences in the METR by sector or by type of investment, as found by FIAS (2006), accentuate the misallocation of resources, to the detriment of economic growth. To illustrate, an investment in agriculture that has a 15 percent pre-tax rate of return produces a better after-tax yield under the current tax system than an alternative investment in manufacturing that would generate a 20 percent pre-tax rate of return. Yet the latter investment is more productive and contributes more to growth. The greater the tax differentials, the greater the efficiency loss for the economy through distortions of this kind.

Another source of inefficiency arises when the provision of special fiscal benefits creates a revenue loss that necessitates higher tax rates on other business activities.[48] Also, tax concessions that reduce the price of imported goods, such as the exemption from import duty and VAT on category "K" imports for investments approved by CPI, create a strong incentive favoring the use of imports rather than the establishment of linkages to domestic suppliers. For these reason, and also on grounds of equity, most economists favor more uniform application of broad-based taxes at moderate rates, rather than offering special tax breaks to some investors while imposing higher tax rates on others.

EMPLOYMENT

The tax system affects both the supply and demand side of the labor market, as well as the development of labor force skills. Starting on the supply side, taxes on labor income – both the personal income tax and payroll tax for social insurance (INSS) – create a "tax wedge" between the cost of labor to employers and the income received by the workers, at least in the formal sector. Economic models indicate that market interactions tend to shift the effective burden of these taxes onto the workers, in the form of lower take-home pay. In Mozambique, the tax wedge is very low for most unskilled workers, but may be high enough to affect labor supply decisions for some workers at the higher end of the income scale.

One method for comparing the tax wedge across countries is to examine tax thresholds in relation to per capita GDP. Since 2007 a worker in Mozambique enters the ISPC tax net at an income of 36 times the highest minimum wage, which was approximately 7.6 times per capita GDP in 2009. Hence, most unskilled workers in Mozambique suffer no ISPC liability. By comparison, the median value for this ratio among low-income countries globally is 1.3, and for sub-Saharan Africa, 0.9.[49] Lower numbers indicate a lower threshold for entering the tax net, relative to average income levels in each country.

The INSS imposition in Mozambique, at 7 percent (with 3 percent paid by the employee and 4 percent by the employer) is also on the low side, compared to the median of 10 percent for low income countries, and 10.3 percent for sub-Saharan Africa. Both the high tax threshold and low social insurance charge in Mozambique produce a low tax wedge for most workers. Given the abundance of job seekers for any unskilled labor position in the formal sector, it is safe to say that the tax system has no serious effect on the labor supply at this level. High income workers, however, face a 32 percent marginal tax rate plus INSS charges. This tax wedge is large enough to impair incentives to work in the formal sector. While there is no empirical evidence to estimate the size of this effect, stories of rampant income tax evasion and resistance to formalization suggest that the tax system probably does affecting labor market decisions for some members of the economically active population.

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[48] A basic proposition in tax analysis is that the efficiency loss from taxation rises with the square of the tax rate. Hence, if tax breaks for A necessitate higher tax rates on B and C, the result is a net loss of economic efficiency.

[49] Calculations by the study team, using the "Collecting Taxes" data base from the USAID Fiscal Reform website, at www.fiscalreform.net, accessed on July 2, 2009.

Turning to the demand side of the labor market, the impact of the tax system is determined by three elements: the effect on investment; on enterprise development and formalization; and on the capital intensity of business operations. The analysis presented in the Investment section suggests that the present tax system is not a significant deterrent to most types of investment. Nonetheless, lower tax rates would likely stimulate additional investment demand for labor by enhancing returns and increasing the flow of earnings as a source of financing for business expansion. At the same time, other deficiencies in the business environment are much more important than taxes as barriers to investment and job growth.

A more serious concern is the impact of the tax system on business development, and in particular the growth of small and medium sized enterprises, which are the main engine of employment creation in most countries. As discussed below (see Private Sector Development), the complexity of the tax system, the lack of clear information on the tax code, and punitive enforcement practices by tax officials serve to deter formalization. Furthermore, several tax technicalities of the tax system, such as withholding requirements and the denial of expenses due to minor errors in documentation have inhibited the development of linkages between large and small enterprises, to the detriment of both. In addition, the difficult procedures and long lags involved in obtaining VAT refunds greatly diminish the scope for small business entry into export markets. The implication is that tax simplification, improved customer services by the AT, and better tax information can, in principle, help to spur job growth.

A less obvious factor is that the tax system also effects decisions about the capital intensity or labor intensity of investment, and hence job creation. As an example, a survey of 60 recent investors in Mozambique found that projects depending critically on fiscal benefits were far more capital intensive than project that were viable in their own right without tax breaks (Bolnick 2009a). Business plans for latter group envisioned five times as much job creation, even though total planned investment was far higher in the former group. More generally, tax breaks such as exemption from import duty and VAT on capital goods, investment tax credits, and accelerated depreciation favor capital-intensive projects. These tools may have some positive influence on the volume of investment, but they have less pronounced effects on expanding employment opportunities for Mozambican workers.

A final aspect of the employment issue is the effect of the tax system on workforce development. In most countries, legitimate training expenses are recognized as a cost of doing business. Indeed, some countries in the region, such as Botswana and Swaziland, allow a super-deduction of more than 100 percent for training expenses, to provide an effective subsidy for these activities. In Mozambique, Article 18 of the Code of Fiscal Benefits allows a deduction in calculating taxable income for “investments in professional training” only during the first five years of operation, only for qualifying investment projects, and only up to a maximum of 5 percent of taxable income (10 percent for new technology). Consequently, many businesses are not allowed to deduct training expenses, or can do so only to a limited extent. The effect is to discourage greater investment in training, even though training activities generate positive externalities for the economy through employee turnover, worker interactions. This provision of the tax system requires reconsideration in the interest of upgrading worker skills and improving labor productivity. Higher productivity, in turn, contributes to an increase in the demand for labor, and higher incomes for the workers.

SAVING

There are three components of Gross Domestic Saving (GDS): saving by households (Sh); by businesses (Sb); and by the government (Sg). The gap between gross domestic investment and gross domestic saving is filled by net foreign saving (Sf), which includes foreign aid and net inflows private capital. In Mozambique, the IMF estimates that GDS has been extremely low over the PARPA II period, at around 3 percent of GDP.[50] Most of the meager supply of domestic saving originates in the private sector, as Sg has been under 1 percent of GDP. Foreign saving has therefore financed virtually all of the capital formation in the government sector, and most private investment as well.

Household Saving

The main determinant of household saving is the level of personal income. Since lower taxes would boost personal income, they would encourage more saving. Over the long term, however, the critical consideration is whether the tax system fosters rapid and sustainable growth, to boost household income and, with it, household saving.

Household saving is also strongly affected by the distribution of income, which in turn is heavily influenced by the tax system. A progressive tax system, as in Mozambique (see Fairness), taxes high-income families more heavily, and minimizes the tax burden on the poor. This tax structure is justified on equity grounds, and is fully consistent with the central PARPA goal of poverty reduction. But it does tend to reduce household saving because affluent families tend to have a higher propensity to save.

Taxes also reduce the rate of return on assets, and hence the incentive to save. Concern has been expressed that the decision in 2007 to tax income from tradable securities will have an adverse effect on saving. For developing countries, however, there is little evidence of a strong effect on total saving from moderate changes in the yield, as long as the returns to saving are significantly positive in real terms. The main effect of this measure is likely to be a more level playing field for allocating saving across different financial assets. Hence the 2007 measure was justified not only on grounds of equity, but also to eliminate a tax distortion that increased the cost of credit to the private sector by making (tax-free) government securities more attractive to the banks.

Several tax measures could improve the incentive to saving. In theory, the best approach would be to eliminate the tax on income from capital, but this would be extremely regressive. More practical measures include a reduction in the double taxation of dividend income earned by individual shareholders, as discussed earlier;[51] implementation of the monetary adjustment for the calculating capital gains, as called for in the tax laws (and long overdue); and eliminating the Stamp Tax on financial transactions. No estimates are available on the likely impact of these

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[50] See the Selected Economic Indicators tables in IMF (2007) and IMF (2009b).

[51] Hassan (2009) shows that the tax system in Mozambique strongly favors debt financing over equity financing, due to the deductibility of interest expenses and the double taxation of dividend income.

measures on domestic saving, but they all have the basic advantage of being consistent with good tax practices.[52]

Business Saving

Gross saving by the business sector consists of retained earnings plus the accumulation of depreciation allowances (capital amortization). These internal sources of saving are a major form of finance for private investment everywhere in the world, and especially in countries like Mozambique where credit access is limited and borrowing costs are high. A reduction in the company tax rate would clearly enhance net earnings, and some portion of the extra cash flow will be retained to finance business expansion. This is one of the strongest arguments in favor of using base-broadening measures to reduce the tax rate on business income, rather than channeling the benefits fully into boosting government revenue. The extent to which additional earnings are channeled to investment depends, however, on the availability of profit opportunities, which in turn depend on the quality of the business environment and growth prospects for the economy.

Another important tax factor affecting business saving is the familiar problem of delays and denials in obtaining refunds of VAT and income tax. These refund problems impair business cash flow and reduce the availability of internal earnings that could be used for business expansion.

Government Saving

Government saving is the difference between current revenues and current expenditures – in other words, the funds available for capital formation from current government income. (Government borrowing is a claim on the saving of some other sector, rather than a source of saving by government.) An increase in Sg can be achieved by reducing current expenditures or increasing current revenue – or any combination of the two that would provide more resources for capital formation.

Sum of the Parts

The tax effect on any one component of GDS is less important than the sum of the parts. For example, a tax cut might reduce Sg while increasing Sh and Sb. The net impact on GDS could be positive or negative, depending on the conditions. In addition, the short run effects on saving from a change in the tax yield could be very different from the effects in the medium to long run, depending on how the government spends the revenue. A more concrete conclusion is that tax policy should avoid creating undue disincentives to saving or unnecessary distortions favoring certain forms of saving over others. This principal lends support to the measures noted above in the sections on household and business saving.

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[52] Versano et al. (2006) recommended retaining the stamp tax on financial transactions on the argument that income from financial assets was not taxed. This condition changed in 2007.

PRIVATE SECTOR DEVELOPMENT

This section examines how the tax system affects private sector development. Given the small size of most businesses in Mozambique, this objective is inseparable from the promotion of small and medium sized enterprises (SMEs), and efforts to increase formalization. Thus, PARPA II prioritizes (on page 1) “greater integration of the national economy and an increase in productivity” via “measures to help small and medium-size companies to flourish in the formal sector.” To this end, the Council of Ministers in 2007 adopted an “SME Development Strategy,” which identified an excessive tax burden and the high cost of paying taxes as a major obstacle to SME development. Tax considerations also significantly affect a second issue highlighted in the strategy document: the lack of vertical and horizontal linkages between firms.[53]

Tax Policy and Enterprise Performance

The most direct (and obvious) impact of the tax system on enterprise performance results from the fact that income tax payments reduce net earnings, which, in a credit-constrained economy, are a primary source of finance for investment and expansion. Import duties and export taxes similarly affect business conditions by increasing the cost of competing imports and thus prices in the domestic market; the benefits are greatest for firms that are otherwise uncompetitive.

Inefficient processing of tax refunds, for both VAT and income tax, further constrain working capital and funds for expansion. Ebrill et al. (2002, p.6) highlight the “tension between the importance of assuring prompt refunds—without which the VAT loses many of its economic merits—and the desire of governments to guard their revenues against fraud and the temptation they face to strengthen revenues by simply delaying refund payments.”[54] The adoption of modern information technology and risk-based procedures for verifying and approving refund requests can go a long way towards reducing this tension (see Chapter 3: Tax Administration).

The tax code and the Code of Fiscal Benefits also affect investment efficiency (see Investment) and business decisions on labor intensity and job creation (see Employment). Furthermore, the provision of fiscal benefits tilts the playing field in favor of new investors who qualify for CPI approval, relative to existing businesses and investors who do not enjoy the same tax advantages.

Enterprise development is also strongly affected by the quality of tax administration. High compliance costs, particularly for SMEs, stem from the complexity of the tax code, the use of outdated procedures by the AT for many tax operations, and inadequate public information and taxpayer services (see Chapter 3: Tax Administration).[55] Faced with these complexities, even

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[53] Other major obstacles identified in the SME Development Strategy are excessive regulatory barriers; high finance costs and limited access to finance; poorly qualified labor; poor market access; and a lack of entrepreneurial spirit.

[54] Given the apparently widespread under-declaration of sales (discussed below), some firms may be reporting a credit position with regards to VAT only because they are fully declaring VAT paid on inputs while under-declaring that collected through sales.

[55] According to private sector tax specialists, many technical details of the tax code have not yet been clarified through supporting regulations or formal interpretations from the AT. Faced with ambiguities of this sort, even companies who try to comply fully with the tax law using professional accounting services can be vulnerable to costly penalties.

well intentioned firms are vulnerable to arbitrary and unpredictable decisions by AT officials regarding interpretation of the law, and costly penalties for even inconsequential infractions (such as misspelling a name on a receipt). Cases of this sort were mentioned by nearly every private sector interlocutor interviewed for this study, with particular reference to situations in which local tax offices need additional revenue quickly to meet revenue targets.

As discussed in Chapter 3, plans by the AT to modernize tax administration will eventually address many of these issues. In the meantime, administrative problems impose extra costs for many firms and create unequal competitive conditions in the market place, as some firms bear disproportionate tax costs while others benefit from generous tax breaks or elude the tax net altogether.

Taxes and Formalization

Encouraging formalization of micro and small enterprises is an important objective of government policy. Informal sector activity is undoubtedly a large part of the economy. Widespread informality deprives the government of revenue, and limits the scope for business expansion and thus growth potential for the economy. Informal business activities even also impair the growth potential of firms in the formal sector. This can be seen in the World Bank's most recent Business Climate Assessment for Mozambique, which found that informal sector competition ranked first on the list of "major or severe" obstacles to business operations, in a survey of almost 600 firms in 2008 (World Bank 2009). In the World Bank study, "formality" was synonymous with tax registration. An earlier Informal Sector Survey (INFOR) by INE in 2005 defined "informality" more broadly to include firms that are not fully registered taxes or other purposes as obliged by law. From this survey INE estimated that 75 percent of the economically active population earns their livelihoods in the informal sector (GoM 2006b).

The extent of informality in any economy depends on the benefits and costs of formalizing, which are strongly influenced by the tax system. In particular, the costs include both tax payments and expenses related to tax compliance, as well as direct and indirect expenses for registration and licensing, and identity cards. Even travel costs to government offices can be a significant barrier for very poor household enterprises. Informality avoids these costs, though it often requires the payment of bribes, and restricts the scope for business expansion. On the other side of the formula, the benefits of formalization include access to the banking sector, access to the legal system for contract enforcement, greater flexibility to expand operations, and protection from exposure to penalties or various forms of official harassment. If the costs of formalization outweigh the benefits, as perceived by each firm, or if the benefits are not sufficiently clear to allow an informed judgment, then informality is the default option for micro and small enterprises.

Tax evasion is widely considered to be one of the primary motives for informality in Mozambique. Data from INE's most recent survey of the informal sector (INFOR), conducted in 2004, cast doubt on this hypothesis (INE 2006). Table 5-1 summarizes the INFOR findings for self-employed non-agricultural informal operators.

Table 5-1
Reasons for Being Informal

	Frequency	Percent
Too complex	113	11.7
Too expensive	144	14.9
In process	71	7.3
Not obligatory	198	20.5
Don't know if need	398	41.2
Anti-state	8	0.8
Other	35	3.6
Total	967	100

SOURCE: Sub-sample of self-employed, nonagricultural informal firms from INE's 2004 INFOR Survey (INE 2006).

These results indicate that a lack of information is far more important as a reason for informality than the cost of formalization or complexity of the process. Yet better information would not necessarily lead to a surge in formalization; it could instead convince many informal firms that the costs of formalization indeed outweigh the benefits.

In particular, tax rates, tax compliance costs and the complexity of the tax system, as applied to very small businesses, strongly influence firm-level decisions on formalization. The new Simplified Tax (ISPC) passed in 2009 should go a long way to reduce these tax-related costs, and therefore shift the balance towards formalization for many more enterprises. For some small businesses, however, even the ISPC will be too heavy a tax to bear because the 3 percent rate applies to sales volume rather than income or profit. For many small enterprises, the tax liability under the ISPC will exceed the standard IRPC tax rate as well as the maximum effective tax on high-income households under the IRPS. Take the case of an enterprise operating with a narrow profit margin of 5 percent, for example: the 3 tax on sales represents a 60 percent tax on income. Finally, registered entities start paying tax at a much lower level of income under the ISPC than under the income tax, because the exemption threshold–equal to 36 times the minimum wage in each case – relates to sales rather than income. The risk is that many informal enterprises, especially those with highly variable income from one year to the next, will still have an incentive to avoid registration under the ISPC.

In practice, the outcome from introduction of the ISPC will depend on how the program is administered. Prospects will be favorable if the AT succeeds according to plan in establishing simple procedures, simple forms and receipt documents, and extensive geographic coverage of tax services. Early evidence is very positive: the AT reported that 1800 new taxpayers registered under the ISPC in June, 2009, the first month of operation for this new tax. In addition, 350 small enterprises converted their registration from the simplified VAT and income tax regimes, to take advantage of the lower tax rate under the ISPC (as discussed in Chapter 3).

The VAT, too, is designed to create incentives for formalization. Registered firms are allowed to deduct the VAT component of input costs only if the supplier is VAT-registered and provides a proper VAT receipt. This feature of the tax encourages all participants in the value-chain to register, for any product or service that passes through a formal sector entity on its way to the final consumer. The same incentive does not arise for value chains operating entirely within the informal sector, or among VAT-exempt registered businesses. Hence, the incentive for formalization due to VAT depends in part on the extent to which the economy is already formalized.

Another important feature of the VAT, highlighted by Keen (2008), is that this tax effectively generates revenue from informal activities, to the extent that unregistered enterprises purchase inputs or supplies though channels that have been subject to VAT, including either registered domestic enterprises or imports (other than smuggled goods). Since the unregistered enterprise cannot claim credit for VAT paid on these inputs, the tax (to this extent) is incorporated into the cost of doing business.

The incentives for formalization are also influenced by the capacity of the AT to monitor tax compliance. Effective enforcement of registration, filing, and payment requirements, along with broader geographical coverage of tax inspections, increase the likelihood of detection and the cost of noncompliance. This can shift the benefit-cost balance in the direction of encouraging registration (and also paying an appropriate amount of tax). The danger here is that punitive and arbitrary enforcement practices applied to registered enterprises could undermine the advantages of compliance, and foster bribery and corrupt practices rather than formalization. Improvements in taxpayer services must therefore go hand in hand with efforts to strengthen enforcement.

As noted above, one problem with informality is that it deprives the government of revenue. Many people interviewed for this study expressed the view that getting large numbers of informal sector enterprises to register will significantly enhance revenue, and provide fiscal space that could be used to reduce the tax burden on firms that are already complying with the tax laws. This is probably a false hope, for two related reasons. First, the amount of revenue that can be obtained from very small businesses is likely to be very small, even in the aggregate. International experience suggests that large taxpayers account for 70 to 80 percent of total revenues, and small taxpayers just 5 to 10 percent.[56] The potential revenue yield from registering small, informal enterprises is further reduced by virtue (and it is indeed a virtue) of the relatively high exemption threshold under the income tax and the ISPC, and the low tax rate that now applies to firms registered under the ISPC. Neither the Ministry of Finance nor the AT are expecting substantial revenue gains in the near term from the ISPC.

The second reason not to expect a large revenue gain from the ISPC is that the AT should not devote substantial resources to chasing large numbers of very small enterprises. It is important, of course, to enforce the tax law and promote tax compliance across the board. But resources for tax administration are limited, and there is a high opportunity cost from trying to cover very small enterprises thoroughly, in the form of revenue foregone from allocating AT personnel and budget resources to other operations with a higher yield.

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[56] IMF (May, 2009c), , pp. 26-27.

These remarks about the limited revenue potential from bringing informal enterprises into the tax net do not apply to informal or unreported operations of larger enterprises or high-income individuals. In the interest of both revenue generation and tax equity, this set of “informal” activities should be a primary target for tax investigations and audits, using all available legal tools.

Differential Tax Effects by Firm Size

What is the differential effect of the tax system on small, medium, and large firms? Byiers (2009) examined this question using data from a 2006 enterprise survey. Although the survey involved a relatively small sample, and limited information on financial issues, the analysis suggests that the effective tax burden does vary considerably by firm size, across firms in similar sectors and locations. The results show an inverted-U relationship: small firms tend to bear a low tax burden through evasion or exemption, and large firms tend to minimize taxes through sophisticated tax planning and exemptions provided under the Code of Fiscal Benefits. Middle-size, in contrast, cannot easily escape the tax net or afford professional services to engage in sophisticated tax planning. These findings provide only a crude indication of inequities, because the observed tax differentials could reflect legitimate and systematic differences in firm structure, such as deductions due to capital costs, interest expenses, and loss carry forward among large firms, and the policy of exempting very small incomes from tax through the threshold level. Nonetheless, the evidence suggests that the tax system tends to be a greater hindrance to business operations as firms reach a certain “visible” size.

Table 5-2 provides some insight on access to fiscal benefits, by size of firm, using CPI data for 2006 and 2007. Out of 192 investments approved in 2007, more than half were fully foreign direct investments (FDI), rising to 79 percent including joint ventures with a majority foreign equity share. Just 17 percent were fully national enterprises, with 3 percent being joint ventures having a national majority and 3 percent with equal shares. The story is the same for 2006.

Table 5-2

Fiscal Benefit Code Investments as a Share of Total Approved Investments

Category	2006	2007
Total approved investments	157	192
FDI only	46%	51%
Joint ventures	36%	33%
FDI majority share	31%	28%
National majority share	2%	3%
Equal shares	3%	3%
National only	18%	17%
Equity < $50,000	6%	5%
$50,001 to $100,000	2%	2%
$100,001 to $250,000	3%	4%
> $250,000	8%	6%

SOURCE: Calculations based on data provided by CPI.

National enterprises can qualify for CPI approval and fiscal benefits with an investment as low as $5,000. Yet only 10 national projects were approved in 2007 with equity capital less than $50,000, and only 13 with equity capital under $100,000. The fact that very few small investments by national companies qualify for fiscal benefits suggests that the procedural costs exceed the prospective benefits. Moreover, anecdotal evidence from the interviews suggests that even with project approval, the stipulated fiscal benefits are not always obtained due to procedural complications at the implementation stage.

The World Bank's recent Investment Climate Assessment (ICA) provides further information on the relationship between taxation and firm size, based on a survey of business managers covering the main economic sectors and cities, as summarized in Table 5-3 (World Bank 2009).[57]

Table 5-3
Number of Firms by Size, Industry, and City

	Firm Size				Total
	Micro (1-4)	Small (5-19)	Medium (20-99)	Large (100+)	
INDUSTRY					
Food	7	37	42	10	96
Garments	5	41	8	3	57
Other manufacturing	5	56	15	0	76
Retail	86	74	26	6	192
Other services	17	100	51	10	178
CITY					
Maputo	71	239	97	18	425
Matola	15	19	25	3	62
Beira	24	17	12	2	55
Nampula	9	33	8	6	56
Unknown	1	0	0	0	1
Total	120	308	142	29	599

SOURCE: *Authors' calculation using World Bank (2009).*

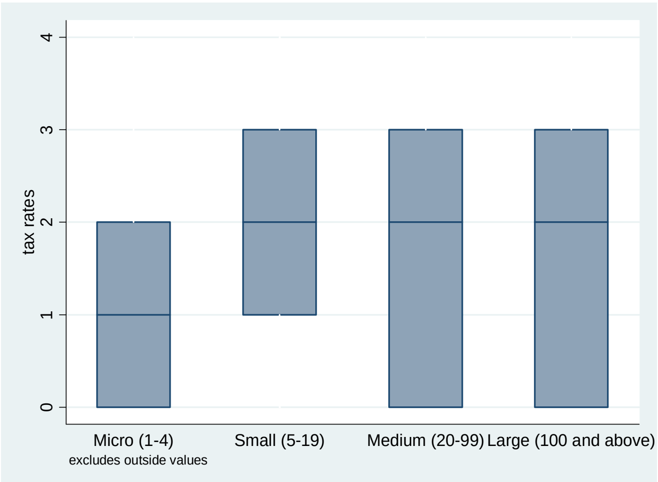
Figure 5-4 shows survey responses on the extent to which tax rates are an obstacle to firm operations, on a scale from 0 (no obstacle) to 4 (serious obstacle). For micro-enterprises the median response is 1 (minor obstacle) while small, medium and large firms all have median responses of 2 (moderate obstacle). Also, the spread of responses is more concentrated around the median for micro and small firms than for medium and large firms. (The shaded box represents the middle fifty percent of firms, those in the 25^{th} to 75^{th} percentiles). This evidence suggests that

[57] The World Bank survey data discussed here is from the Investment Climate Survey carried out in 2007, which surveyed approximately 600 manufacturing and service industry firms in Maputo, Matola (Maputo province), Beira and Nampula, stratified by location and firm size.

micro-firms are not much affected by tax rates, but as firms increase in size, tax rates become a more significant burden. The higher variation among medium to large size firms may indicate inconsistent implementation of the tax laws. Nonetheless, very few of the firms in the survey regarded tax rates as a serious hindrance, and fully 160 of the 599 firms interviewed did not regard tax rates as an obstacle at all.

Figure 5-4

Tax Rates as a Constraint to Business, by Firm size



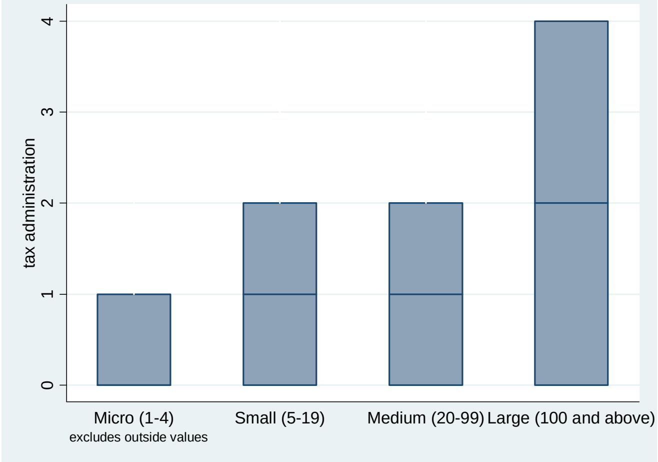
Note: This graph displays the distribution of responses. The middle line is the median response, and the shaded box shows the range between the 25th and 75th percentiles. Source: Authors' calculations using data from World Bank (2009).

The number of zero-obstacle scores rises to 276 for tax administration, suggesting (surprisingly) that administrative issues are viewed as an obstacle less frequently than tax rates. Here, too, the responses differed by firm size, as shown in Figure 5-5. For micro-firms the median score was actually zero (no obstacle), while for large firms the median was 2 (moderate obstacle). This may be due to a greater concentration by the AT on large firms, to ensure greatest revenue gains, along with the fact that many micro-firms are outside the tax net through avoidance or exemption.

Finally, Figure 5-6 shows the response by firm managers when asked to estimate the share of sales declared for tax purposes by firms similar to theirs. This question is a proxy for the extent of tax evasion. The results indicate that large firms are, on average, perceived as declaring a very high share of sales for tax purposes, with small firms reporting the lowest share.

Figure 5-5

Tax Administration as a Constraint to Business, by Firm Size

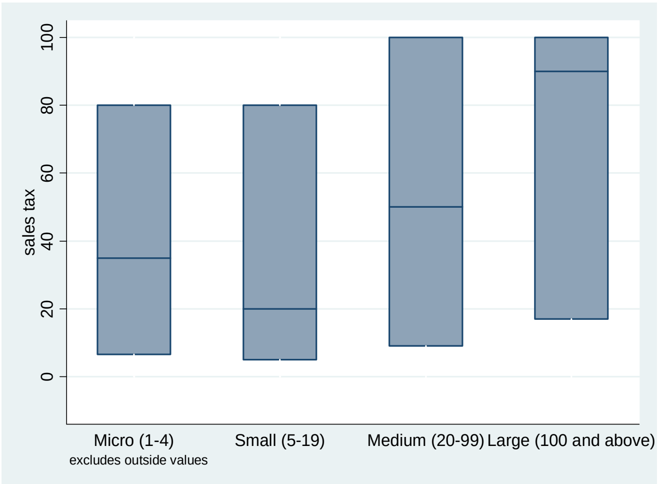


Note: This graph displays the distribution of responses. The middle line is the median, and the shaded box shows the range between the 25th and 75th percentiles. For micro-firms, the median score coincides with the bottom of the shaded box.

SOURCE: Authors' calculations using data from World Bank (2009).

Figure 5-6

Responses on Sales Declared for Tax Purposes, by Firm Size



Note: This displays the distribution of responses as follows: the middle line is the median, the surrounding shaded box the middle 50 percentiles (between the 25th and 75th percentiles).

SOURCE: Authors' calculations using data from World Bank (2009).

To highlight an important detail from this question, Table 5-4 reports the share of respondents, by firm size, who estimate that firms declare either zero or 100 percent of sales. Among large firms in the survey, 45 percent estimated that a typical firm reports 100 percent of sales for tax purposes, compared to just 22 percent for small firms and 20 percent for micro firms. And in all size categories, the percentage of zero estimates is very small, with the highest fraction (just 4.2 percent) coming from micro-firms. While highly subjective, these results suggest that tax evasion varies substantially by firm size, most likely due to the varying ability of firms at different scales to avoid the scrutiny of the tax authorities. The results also support the contention, mentioned in many interviews, that the tax system creates unfair competition for firms that are compliant, to the degree that other firms evade taxes or hide sales.

Table 5-4
Shares of Firms Reporting 0% and 100% Sales Declared

Firm Size	0% Declared	100% Declared	N
Micro (1-4)	4.2	20.0	120
Small (5-19)	3.2	22.1	308
Medium (20-99)	2.8	32.4	142
Large (100 and above)	3.4	44.8	29
Total	3.3	25.2	599

SOURCE: Authors' calculations using data from World Bank (2009).

The World Bank survey results indicating that under-reporting is greatest among small and micro firms does not invalidate the point made earlier (see Formalization) that the AT should not devote substantial resources to pursuing small taxpayers. The argument is that the revenue yield from dealing with a large number of small payments will be low relative to the opportunity costs of deploying personnel to other uses. Information on this point can be seen in INE's most recent Annual Enterprise Survey of over 24,000 firms (INE, 2009) that are registered in one form or another. Table 5-5 presents the distribution of number of firms and sales turnover, by size of firm. Micro-enterprises constitute 82.4 percent of the firms, which account for 36.2 percent of the aggregate sales turnover. In contrast, the top 9.3 percent of firms account for 50 percent of sales turnover, and more than half of the total sales come from the largest 1.1 percent of firms. By comparing turnover shares with the number of firms in each size category, one can see that the average large firm in this sample generates more than 50 times as much business volume as the average micro firm on INE's list of enterprises. These figures imply that the tax authorities need to deal with more than 50 times as many micro firms to cover the same volume of business as would be covered, on average, with one large firm.[58] If anything, the data appear to underestimate the sales share of large firms. This could be the case if very small firms registered with INE tend to be those with higher revenues, such as professional service providers.

[58] A similar calculation from Enterprise Survey can be made using data by sector, rather than firm size. This calculation shows that the volume of business per firm is greatest by far in the electricity, water and gas sector. Other sectors with relatively high sales per firm are, in descending order: transport, storage and communication; extractive industries; construction; and manufacturing.

Table 5-5
Distribution of Sales Turnover by Firm Size

Workers	Share of firms	Share of Sales Turnover	Ratio: sales share to firms share
<5	82.4	36.2	0.4
5-9	8.3	14.1	1.7
10-29	6.0	12.8	2.1
30-49	1.2	5.6	4.7
50-99	1.0	5.7	5.6
>=100	1.1	25.5	24.1
Total	100.0	100.0	

SOURCE: INE (2009) and authors' calculations.

The problems arising from VAT and income tax refunds also have a differential effect by firm size, because large firms are much more capable of dealing with filing and documentation requirements. They are also more able to cope with working capital costs of long delays in obtaining a refund, by having a stronger financial position and better access to credit. VAT refund problems are especially pernicious for small businesses that may have an eye on export markets. Exports are zero-rated under the VAT to ensure that Mozambican products do not bear the burden of home-country indirect taxes when competing in external markets. If small businesses are effectively blocked from obtaining VAT refunds due to complex procedures and long delays, then they are also largely blocked from penetrating export markets. See Bolnick (2007) for more details.

Taxes and Business Linkages

As stated above, one of the PARPA priorities is to strengthen linkages within the domestic economy. The tax system actually discourages the achievement of this objective in several unintended ways. Import duties have an obvious influence on business decisions to use imported versus domestic inputs, and thus the development of linkages within the domestic economy. In particular, the full remission of duty and tax on imported capital goods and other inputs for certain types of investments under the Code of Fiscal Benefits creates an incentive favoring the procurement of imported inputs. An example is the purchase of imported versus locally produced furniture by a new tourism facility.

In less obvious ways, the VAT and income tax also affect the development of business linkages. Looking first at the VAT, the same feature that encourages formalization–namely, the need for suppliers to registered businesses to provide VAT receipt–serves to impede linkages between formal businesses and small suppliers who are not registered for VAT and have reasons to maintain this status (see Formalization). In an economy with a large informal sector, small businesses may decide against registering if they purchase their own supplies of goods and services from unregistered enterprises, and would face substantially higher costs in dealing with registered vendors. The complexity of the VAT refund process is another factor hindering the development of linkages. This occurs in cases where a small domestic supplier would be eligible to claim a refund of VAT paid on inputs to goods or services that are sold to potentially important clients operating in IFZs, such as Mozal. Without timely refunds, small suppliers may be unable to sustain these transactions, even if they would otherwise be a very favorable business opportunity.

The income tax, too, creates unintended barriers to the development of linkages between large and small businesses. Under the income tax code, “expenses not duly documented” are disallowed as business deductions and subject to a tax of 35 percent. This provision may be invoked by tax officials wherever a tax-registered firm has purchased goods or services from a small-scale supplier who could not issue a receipt complying with legal requirements in every detail, including proper spelling and abbreviations that match tax registration records. In theory, this provision creates incentives for formalization on the part of small-scale suppliers, but in practice it raises serious problems similar to those noted for VAT. Examples encountered during interviews for this study include large food processors purchasing crops from large numbers of small family farmers in outgrower schemes; tourist facilities in remote locations purchasing foods or crafts from local households; and two instances of medium sized firms (one in manufacturing and one in services) being constrained from procuring transportation services from small business partners.

Under the income tax code, larger enterprises can avoid disallowance of a deduction and the penalty tax rate on improperly documented expenses by withholding 20 percent at source on payments to suppliers who cannot issue formal and accurate tax receipts. Even with this course of action, the tax system still impedes linkages, because 20 percent withholding on gross receipts creates an onerous burden on small suppliers. If, for example, the small supplier operates on a 20 percent gross margin, then withholding tax would absorb 100 percent of the income – from a business that ought to be paying a very low effective tax rate, or even no tax at all if net income falls below the tax threshold. In theory, prompt payment of income tax refunds could mitigate the problem, but, as discussed earlier, the AT is very inefficient in paying such claims, and in any case small businesses are least able to deal with the required forms and procedures. Of course, the small supplier could mark up its invoice by 25 percent in order to obtain full payment after the client withholds 20 percent on the transaction,[59] but this alternative makes the small supplier much less price-competitive.

The new ISPC should go a long way towards mitigating tax impediments to the development of business linkages. But it is unlikely to overcome the problems altogether, given the practical difficulties of registering every family farmer, local trader, and handicraft producer – many of whom are illiterate, and often lack even a proper identity card. Also, as noted above, the actual impact of the ISPC remains to be seen.

On balance, these features of the tax system work at cross purposes to the stated PARPA objectives of increasing the integration of the national economy and promoting SME development. The fundamental problem is the difficulty of designing a tax system suitable for the full range of economic actors in Mozambique. Nonetheless, the discussion above points to several

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[59] To see this, suppose the small supplier seeks a payment of $100. This can be obtained by invoicing for $125, from which 20 percent of the gross amount (in this case $25) will be withhold at source as tax.

measures that can reduce the disconnect. In addition to effective implementation of the ISPC, these include streamlining the payment of refunds (with risk-based management of the revenue effects), reducing the withholding tax rate, allowing business to deduct legitimate expenses even when there are minor and inconsequential mistakes on receipts or invoices, and reducing the incentive under the CFB for using imported inputs rather than domestic products.

FAIRNESS AND EQUITY

The Enterprise section above discussed effects of the tax system on equity and fairness across enterprises, particularly in connection with wide variances in tax compliance. This section focuses equity across households, through tax effects on incomes and prices, as well as tax differentials resulting from tax evasion and corruption.

Income Taxes

As noted earlier, the IRPS has a progressive structure. Annual incomes below 36 times the minimum monthly wage are free of tax,[60] and marginal tax rates above that threshold range from 10 to 32 percent (Table 5-6). This structure conforms to the principle of vertical equity, by eliminating the tax on very poor households, and subjecting households with higher incomes to higher marginal and effective tax rates. The IRPS code also broadly satisfies the principle of horizontal equity, because the tax applies to nearly all sources of personal income,[61] adjusted for marital status and deductions for dependents.

Table 5-6
IRPS Rates

Taxable Annual Income (MT)		Rate (%)	Deducted (MT)
Up to 42000	(US$1.570)	10	0
From 42.001 to 168.000	(US$1.570-6.279)	15	2,100
From 168.001 to 504.000	(US$6.279-18.839)	20	10,500
From 504.001 to 1.512.000	(US$18.839-56.519)	25	35,700
More than 1.512.000	(US$56.519)	32	141,540

SOURCE: *IRPS Law 33/2007.*

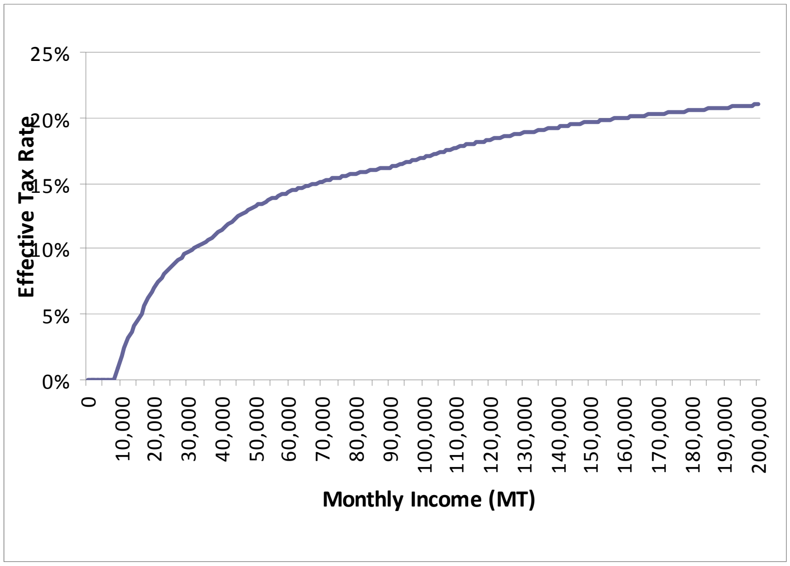
To illustrate the progressivity of IRPS, Figure 5-7 shows the effective tax rate in 2009 at different levels monthly income, for the case of a married couple, assuming for simplicity no other dependents or deductions. The tax structure results in an effective tax rate that gradually increases from zero percent at the exemption threshold of MT 8,235 per month ($308), rising to 8.1 percent for a monthly income of MT23.000 ($860), 13.2 percent for monthly income of MT50.000

[60] There are nine minimum wages, by sector, for agriculture, fisheries, mining, manufacturing, electricity, construction, non-financial activities, financial activities, and public service: http://allafrica.com/stories/200904280769.html .

[61] The IRPS defines five categories: income from employment ("dependent" income); professional and business income; capital income; income from buildings; and other incomes. Each category covers multiple types a variety of income.

($1,869), 17.0 percent at an income of MT 100,000 ($3,738) and so on up to 32 percent as an asymptotic ceiling. Detailed data on the distribution of income in 2009 would be needed to determine the population share subject to each tax rate, but it is clear enough that the effective tax rate is very low for most households, and that very few are facing an effective tax rate above 20 percent.

Figure 5-7
Applied Tax Rates



SOURCE: Authors' calculations based on IRPS Law33/2007.

Even though the statutory structure of the individual income tax is suitably progressive, many interviewees suggested that there are major problems of horizontal equity due to widespread tax evasion. While formal sector employees cannot easily avoid paying IRPS on wage income, due to withholding by employers, it is easy for evaders to under-report incomes from professional services, housing rentals, and business activities lacking modern accounts. It is difficult and costly in such cases for the AT to assess directly the unreported incomes. For individuals with high unreported incomes, however, the benefits of tougher enforcement–in terms of both revenue and equity–greatly outweigh the administrative costs. The AT has the authority to use third party data to determine gross under-declarations of income and to use "indirect methods" to assess tax in cases there is clear evidence of improper declarations. In combination with tougher enforcement, efforts by the AT to provide better information to the public about tax responsibilities and obligations, and to instill pride in contributing to national development, may also have a positive effect in improving compliance and reducing inequities from tax evasion.

Another equity aspect of the personal income tax involves administrative problems similar to those discussed above regarding VAT refunds. Under the IRPS, taxpayers should be reimbursed by the AT when the amount of tax withheld at source plus estimated payments during the tax year exceeds the final amount payable on reconciled total income at the end of the tax year. In reality, the AT handles refund very slowly and inefficiently, resulting in long delays in payment or no payment at all. This problem creates serious inequities, and contributes to a perception of unfairness that undermines incentives for tax compliance. Apart from devoting more personnel and resources to handling claims for income tax refunds, the AT could facilitate these payments through two measures that are warranted in their own right (for reasons discussed elsewhere in this report): reducing the withholding tax rate; and developing risk-based management of refund claims with immediate settlement of low-risk declarations, subject to selective audit. Another measure that might be considered, though it would entail minor inequities of its own, would be to simplify the system by disallowing refund claims below a certain threshold (as done in the case of VAT refunds). This would probably require an amendment to the law.

Consumption Taxes

Turning to taxes on consumption, the most important equity effects of the tax system involve the VAT, because it is the largest source of revenue for the government. There is a widespread view that the VAT, as a broad-based tax on consumption, is inherently regressive. This view is not supported by the data on household consumption patterns.

Table 5-7 presents a breakdown of rural and urban expenditure patterns for rural and urban households by income quintile, based on 2002/03 data. For rural households, between 52 and 61 percent of total expenditure is auto-consumption across all quintiles, and therefore not subject to tax. In addition, there is little or no VAT on important items like farm products, wheat flour, health and education expenditures, and kerosene for lighting. Thus, for the bottom two rural quintiles, only about 12 percent of household expenditures are potentially subject to VAT, rising to 23 percent for the top rural quintile. This implies a maximum VAT burden of around 2 percent of income for the poorest quintiles. Even this figure is too high to the extent that poor households purchase taxable goods from small enterprises that qualify for VAT exemption. Figure 5-8 converts the data to visual form, showing the share of expenditures potentially subject to VAT for both rural and urban households, by income quintile. The graph demonstrates that the VAT structure in Mozambique is progressive, because higher shares of expenditures are subject to VAT for households in the top quintiles.

A similar analysis applies to the equity effects of trade taxes on consumer goods. While import duties affect the prices and availability of many basic goods, the link is very weak for rural households, which devote a large share of expenditure to auto-consumption or the purchase of locally produced goods. The effect of trade taxes on household welfare is stronger in urban areas, where market purchases of imported goods are far more important.[62]

Sonne-Schmidt (2009) provides further information on the equity effects of indirect taxes. This study estimates for selected goods the combined effect of import duties, VAT and excise taxes on households at different income levels, using household expenditure data. Sonne-Schmidt finds that the import duty on flour and tomatoes is highly regressive, despite a VAT exemption, and that taxes on kerosene, sugar, and tobacco have a significant adverse impact on the poor, due to

[62] This issue is discussed in detail in Chapter 2 of Nathan Associates (2004), Diagnostic Trade Integration Study for Mozambique.

the relative importance of these items in their consumption basket.[63] In contrast, he finds that taxes on automobile fuel, bottled gas, wine and beer have a progressive effect, due to the low share of spending on these products by poor household.[64] More studies of this sort are needed to provide better information on the poverty impact of the tax system.

Table 5-7

Rural and Urban Expenditure Share by Quintile

Product Group	Rural					Urban				
	QI	**QII**	**QIII**	**QIV**	**QV**	**QI**	**QII**	**QIII**	**QIV**	**QV**
Food: Auto-consumption	46.0	52.1	52.8	54.0	47.4	11.7	16.6	16.2	12.4	4.6
Food: purchased	15.8	15.2	14.9	13.2	15.5	39.1	36.3	35.2	31.9	24.3
Housing & fuel: Auto-consumption	11.4	8.3	6.8	6.8	4.8	7.1	4.3	3.5	1.7	0.5
Housing and fuel: Purchased	14.1	11.1	10.2	8.5	8.4	24.6	23.3	21.7	25.1	28.4
Beverages	0.8	1.0	1.0	1.7	1.7	0.6	1.0	1.1	1.8	2.5
Clothing	2.3	3.7	4.6	6.3	7.8	2.8	3.7	6.0	6.5	8.7
Furniture and decoration	6.1	5.1	5.4	5.5	7.3	6.6	6.7	7.5	9.7	14.6
Health	0.9	0.7	0.6	0.7	0.7	1.0	1.1	1.2	1.5	1.5
Transport	1.0	1.3	1.8	1.7	3.8	2.7	3.1	3.1	4.0	6.1
Communication	0.0	0.0	0.0	0.1	0.1	0.1	0.3	0.5	0.8	2.0
Recreation and leisure	0.5	0.3	0.5	0.3	0.4	0.8	0.7	0.6	0.9	1.8
Education	0.3	0.1	0.1	0.1	0.1	0.8	0.7	0.6	0.6	1.1
Restaurants, hotels	0.4	0.6	0.7	0.7	0.9	0.9	0.7	1.0	1.8	1.6
Other goods and services	0.3	0.5	0.4	0.5	1.1	1.1	1.3	1.8	1.5	2.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

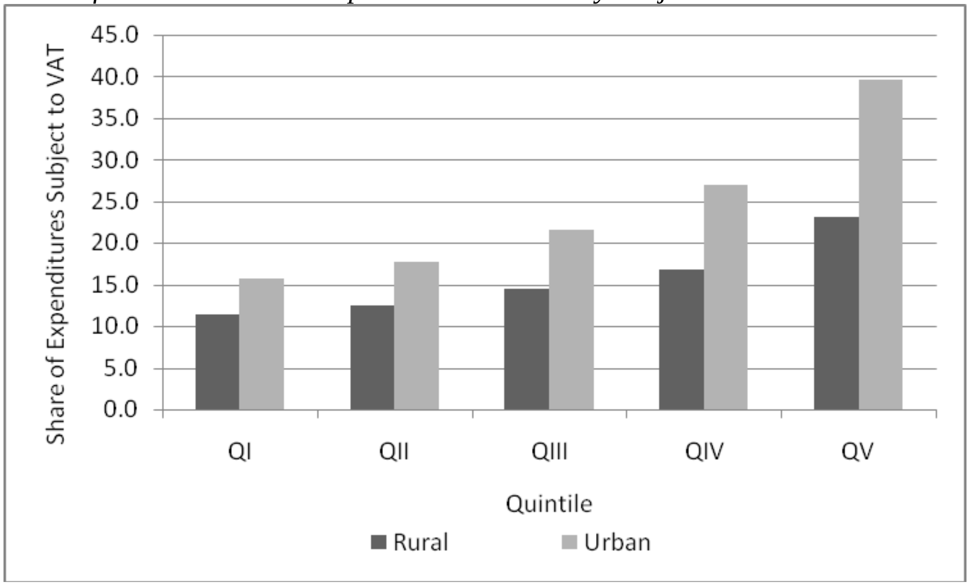
Note: Quintile breakdowns computed by MPF differ from those reported by INE because the former use regional deflators to normalize expenditure levels.

SOURCE: *MPF calculations based on IAF 2002/03 household survey data.*

[63] Sugar is subject to import duties of 7.5 percent (putting it in the category of intermediate good), VAT and a sugar surtax ranging from 90 percent to 100 percent in order to provide protection to domestic sugar producers.

[64] This is in broad agreement with the Fuel Tax Poverty and Social Impact Analysis (PSIA) carried out in 2003 which found that "the aggregate short-term impact of a rise in fuel tax on poverty is modest" (Nicholson et al., 2003), while there was some qualitative evidence of pockets of longer-term impact on "vulnerable activities" such as rural transport and marketing, grain milling, and fishing.

Figure 5-8
Share of Rural and Urban Expenditures Potentially Subject to VAT



SOURCE: Authors' calculations based on IAF 2002/03 household survey data.

6. Priority Issues

This chapter identifies twelve issues that emerge from the analysis in previous chapters as medium-term priorities for the next PARPA period, and offers recommendations for addressing each.[65] The priorities include the overall revenue target, several policy and process issues, and a set of inter-related requirements for modernizing tax administration, which overlap in many respects with the AT's agenda for reform.

MEDIUM-TERM REVENUE TARGET

The strategic objective in PARPA II for tax policy is "to reform and increase the efficiency of tax administration with a view to gradually increasing the mobilization of domestic funds as a percentage of GDP, with the idea of reducing external dependency" (paragraph 489). More specifically, PARPA II targeted a revenue ratio of 16.2 percent of GDP by 2009. Looking ahead to the next PARPA period, determination of a medium-term revenue target is again a central strategic issue for tax policy. This is inherently a political decision, but one that should be informed by an analysis of economic conditions and the trade-offs involved in levying taxes. In interviews for this study, some government officials contended that the government should continue aiming at an increase in revenue by 0.5 percentage points of GDP per year up to the SADC average, now 23 percent (using the median). This target is consistent with estimates of the maximum potential revenue yield from two IMF technical studies in 2004 and 2006. Other officials, however, expressed concerns about the economic effects of squeezing the private sector to achieve such a large increase in the revenue ratio.

As discussed in Chapter 4, the SADC average is largely irrelevant for Mozambique due to structural differences in the economies of member states. International benchmarks suggest that a medium-term target in the range of 18 to 19 percent of GDP is the maximum that should be expected. This target should be attainable in view of recent reforms to broaden the tax base, continuing efforts to modernize tax administration, and the underlying elasticity of the tax system in response to economic growth. And yet one must also recognize that the optimal tax ratio may be lower than the maximum potential ratio (which was the object of the IMF studies). Just as government borrowing crowds out financing for the private sector, boosting the revenue ratio also draws resources away from both enterprises and households. The objective of tax policy should be to balance public and private requirements in the interest of national development, job creation, and sustainable growth. The government should therefore use a portion of the

[65] This report is not intended to provide a comprehensive analysis of the agenda for tax reforms. According to several sources, there are plans for a comprehensive review of the tax system in 2010 through technical assistance from the IMF and the World Bank.

prospective gains in revenue capacity to reduce tax rates, rather than focusing exclusively on increasing the revenue ratio.

The extent and timing of gains in revenue capacity will depend on the implementation of tax reforms, the pace of global economic recovery, and the flow of new investment to Mozambique. Considering the effects of the depressed global economy, the latest IMF estimates (from May 2009) project that the revenue ratio will not increase significantly for the next few years.

Recommendation. Modify the strategic objective for tax policy from PARPA II as follows: "to reform and increase the efficiency of the tax administration with a view to gradually increasing domestic revenue as a percentage of GDP to reduce external dependency, while also reducing tax rates affecting private sector development."

Recommendation. Consider three options for the medium-term revenue target, depending on political decisions on the balance between higher revenues and lower tax rates:

- If the central objective is to increase revenue, an ambitious upper-bound target for 2015 would be approximately 18.5 percent of GDP. This option continues the recent practice of targeting a revenue increase of around 0.5 percentage points of GDP per year.
- If the objective is to balance revenue gains with tax relief for the private sector, a plausible mid-range target for 2015 would be 17.5 percent of GDP.[66]
- If the objective is to use base-broadening measures and revenue enhancements to lower tax rates, a reasonable lower-bound target would be to stabilize the revenue ratio at 16.5 percent of GDP.

Recommendation. Medium-term targets are valuable guidelines, but revenue targets for each budget year should be determined from an analysis of prevailing economic conditions and the revenue effects of concurrent and recent measures to reform tax policy and tax administration.

TAX RATES

The call for tax cuts is a common theme of policy discussions with the private sector, who view the prospect of lower tax rates as a major objective of measures to broaden the tax base and strengthen tax administration. As the headline issue, the private sector would like to see a reduction in the standard rates for income tax. Empirical evidence on the effect of a lower tax rate is actually inconclusive. The World Bank's ICA survey in 2008 found that the majority of respondents did not view tax rates as a major or severe problem. International benchmarks show that the tax on company income is not especially high. In contrast, studies of the marginal effective tax rate (METR) on investment show it is very high for investors who do not enjoy special tax breaks under the code of fiscal benefits (though very competitive for those who do qualify). In any case, the quality of the business environment is far more important than tax rates as a determinant of most investment decisions. Consequently, moderate tax cuts are unlikely to spur a wave of new investment. And yet a lower income tax rate would directly improve net

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[66] This option is consistent with the revenue assumption used by the IMF in their most recent Debt Sustainability Analysis for Mozambique. See IMF (2009b), p. 60

earnings for most enterprises and provide an important resource for expansion, innovation and job creation. Furthermore, to compete for mobile capital, Mozambique should not lag too far behind the global and regional trend towards lower taxes.

The analysis in Chapter 5 (Private Sector Development) suggests that two technical tax cuts take priority over general reductions in the tax rate: reducing the withholding tax rate, to facilitate the development of linkages between large and small enterprises; and reducing or eliminating the double taxation of dividend payments to individual shareholders, to lower the METR on new investments subject to the standard tax regime. These two measures target significant problems for the private sector, at a relatively low revenue cost.

Because the VAT is the primary source of domestic revenue, the cost of reducing this tax rate would be high. Furthermore, the VAT (as structured) falls primarily on non-poor households, not on businesses.

Recommendation. To avoid revenue risks, package any tax cuts with measures to enhance revenues, or calibrate the tax cuts so that the revenue costs are covered by expected gains from earlier reforms.[67]

Recommendation. Reduce or eliminate the double taxation of dividend income paid to individual shareholders, taking into account the effects on revenue.

Recommendation. Reduce the withholding tax rate to 10 percent on all transactions currently subject to a 20 percent rate, taking into account the effects on revenue.

Recommendation. Target a reduction in the company income tax (IRPC) and the individual income tax (IRPS) as revenue prospects permit, to improve the earnings and growth prospects for both corporate and non-corporate enterprises.

TAX POLICY ANALYSIS

All decisions on tax policy should be informed by a careful quantitative analysis of the revenue effects and at least a qualitative analysis of the economic impacts. This includes the decisions on revenue targets for the budget program each year. The MOF therefore requires the capability to undertake serious tax policy analysis. The standard approach is to establish a Tax Policy Unit (under various names and organizational arrangements) staffed by a small group of economists and tax administration specialists. The mandate for the TPU can include: producing revenue forecasts for the annual budget cycle and revenue projections for the medium-term fiscal framework; analyzing the fiscal, economic and distributional effects of tax policy issues under consideration; reviewing and analyzing the current tax system to make recommendations for improving its effectiveness in generating revenues and facilitating an improved business climate;

[67] Tax reform packages are often designed to be revenue neutral, in which case the gains from revenue enhancement measures are fully passed along to the private sector in the form of tax cuts. One common method for financing tax cuts is by eliminating or reducing the scope of special tax incentives or tax preferences. Given that Mozambique recently adopted a new Code of Fiscal Benefits, however, major changes in the near term are best avoided in the interest of stability and predictability in the tax system.

and serving as the government's focal point for dialogue with the public on tax policy issues, including the dissemination of data reports and policy briefs. The TPU should collaborate closely with the *Gabinete de Planeamento e Estúdos* at the AT, with the latter focusing on monitoring and assessing revenue performance, maintaining and developing the tax data base, and providing analytical support to AT management.

Recommendation. Establish a Tax Policy Unit (TPU) at the Ministry of Finance, possibly within the *Gabinete de Estudos*, and train a group of specialists to conduct quantitative and qualitative analysis of tax policy issues. The TPU should have primary responsibility for revenue forecasting, technical analysis of tax policy issues, and dialogue with the public on tax policy issues.

FUNCTIONAL INTEGRATION OF TAX OPERATIONS

The modernization of tax administration is a work in progress. The AT has achieved major improvements in tax administration, with highly favorable effects on revenue mobilization. Yet large additional gains in efficiency and effectiveness can be obtained through further steps to modernize tax administration, improve compliance, and reduce the scope for tax evasion and unethical practices. These administrative reforms will also facilitate private sector development and improve the business environment for small and medium enterprises by simplifying procedures, lowering compliance costs, and reducing glaring inequities caused by uneven and arbitrary enforcement of the tax laws.

One major requirement – the first of five to be cited here – is the functional integration of common operations between customs and domestic tax services, including (in rough order of priority) audit, risk management, debt management, and customer services, as well as support functions such as human resource management and an master files for each taxpayer covering all tax and customs transactions. The purpose of consolidating services is to reduce duplication of effort within the AT, strengthen synergies across different tax lines, and provide more seamless services to taxpayers. As discussed in chapter 4, progress on functional integration has been limited to date. Further action in this direction is part of the AT's strategic plan.

Recommendation. Formulate and implement specific plans for integrating basic operational functions of the customs and tax departments of the AT, focusing first on audit, risk management and debt management, and customer services.

Recommendation. Formulate and implement specific plans for further integration of support operations in the AT, including compatible IT systems, a unified master data base for each taxpayer, and comprehensive systems for human resource management.

E-TAXATION

The government and the AT recognize the importance of introducing modern information technologies into the tax system (*e-Tributação*), and have already begun the process of planning and implementing these reforms. The main focal points include integration of revenue accounts into the government's automated public finance management system (e-SISTAFE), introduction of electronic tax declarations and electronic payments through the banking system, and implementation of electronic single window systems to facilitate border clearances.

Compared to existing processes, IT-based systems offer enormous potential for enhancing revenue by improving the efficiency of AT operations, while reducing compliance costs for the private sector. But caution is very much in order. The reforms must be carefully planned and sequenced, well managed, properly funded, and effectively coordinated with technical support, to avoid potentially serious pitfalls that could impede ongoing revenue operations, or lock in systems that will not meet future needs (as in the case of the TIMS system now being used by Customs). It is extremely important, too, for the AT to use e-taxation as a catalyst for fundamental re-engineering of basic business and work-flow processes, instead of just automating existing systems. Finally, the transition to e-taxation may require supportive legal or regulatory changes.[68]

Recommendation. Proceed expeditiously with the introduction of e-taxation systems, but with diligent attention to the design, planning, sequencing, and management of the change process. To improve efficiency and effectiveness of the AT's revenue operations, priorities include e-declarations, e-payments through the banks, the automated single window for customs, as well as automating the systems for dealing with stop-filers and late-filers, and systems for risk management.

Recommendation. Use the introduction of e-taxation as a catalyst for fundamental re-engineering of business and work-flow processes in each of the areas covered.

Recommendation. Carefully review the legal and regulatory environment to ensure that all required revisions are in to support e-taxation, including not only tax laws but also laws relating to electronic information and transactions.

RISK MANAGEMENT

In conjunction with the integration of tax and customs operations and the introduction of e-tax systems, there is also enormous room for improvement in collection efficiency through the introduction of modern risk management practices – which will simultaneously reduce the compliance burden and facilitate tax transactions for most taxpayers. The concept is to use computerized data records and automated statistical systems to screen for cases with high revenue risk, as well as those with low revenue risk, enabling the AT to focus its resources more productively on cases where the potential revenue gains are highest. For cases with low revenue risk, most tax and customs procedures can and should be handled quickly and at minimum cost, effectively supporting broader application of automatic "green channel" approvals and "gold card" treatment of taxpayers with excellent compliance records—in the interest of collection efficiency. By comparison, existing risk management systems are rudimentary, subjective, and

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[68] See, for example, Nathan Associates (2008), ASEAN Single Window: The Intersection of Law & Technology, for a detailed discussion of legal technicalities associates with the introduction of Automated Single Window processes. The issues include not only enabling legislation for electronic transactions, but also laws relating to the protection and storage of personal data, cross-border authentication of electronic signatures, and electronic transfer of rights in goods.

highly inefficient. Even low-risk cases must face the chance of audit, and serious penalties if major infractions are detected; but the audit rate for this group should be low.

Recommendation. Once taxpayer data systems are in a condition to support statistical risk analysis, seek technical assistance for the development of automated risk-management systems. Priorities for modern risk management include customs clearances, audit selection, and the payment of VAT and income tax refunds.

Recommendation. Expand the application of “green channel” and “gold card” treatment for clearances and approvals with low revenue risk as identified by the risk management systems

SIMPLIFICATION

Two of eight “priority actions” for tax policy in PARPA II dealt with simplification. One called for a review and evaluation of the simplified tax regimes under the income tax and VAT, while the second called for approval of legislation “that simplifies the relationship between the tax administration and the taxpayers, making it easier for them to exercise their rights and receive the protection assured them” (paragraph 489). These aims have been realized on paper at least through adoption of the 2009 ISPC code for small taxpayers and the 2006 General Law on Taxation – though the implementation of both laws is still work in progress. In addition, the AT has simplified tax forms and greatly improved public information campaigns. The Authority is also investing heavily in expansion of the physical infrastructure in order to make it easier for taxpayers outside major cities to comply with tax obligations and seek assistance.

Despite this genuine progress, simplification remains high on the agenda of key issues for tax reform. Complexities in the tax code, in tax forms, and in administrative procedures continue to create serious problems, especially for small and medium size enterprises with weak financial management and lack of access to professional assistance. Taxpayers who, as a result, make inadvertent errors are vulnerable to arbitrary reassessments and burdensome penalties – a recurrent theme in interviews for this study. Complicated documentation requirements and approval procedures also continue to bog down the process of obtaining VAT refunds, despite improvements in recent years. The refund process also functions poorly for the IRPC and IRPS. Similar problems arise from the complex rules and cumbersome procedures involved in obtaining certification for preferential tariff treatment under the SADC trade protocol and the emerging SADC free trade area. These problems affect both importers and exporters.

The introduction of e-taxation and modern risk management systems should simplify tax compliance and reduce payment problems for many taxpayers. Additional measures can also be considered to simplify the system, such as eliminating end-year reconciliations under the IRPS for households whose sole source of income is from formal sector employment, even if more than one member of the family is working.

Recommendation. Ensure effective implementation of the simplified tax for small contributors (ISPC) and taxpayer protection provisions of the General Law on Taxation.

Recommendation. Seek and pursue further opportunities to simplify tax forms and tax procedures, with special attention to the refund process for both VAT and the income tax, through the application of information technology and efficient risk management procedures. A review of the legal and regulatory environment may also be needed to support simplification reforms.

Recommendation. Simplify the procedures for certifying rules of origin (ROO) on exports to other SADC states. For example, ROO documents should be available in the provinces, not only in Maputo. The government should also negotiate with SADC partners to simplify ROO certification on exports to Mozambique, so that importers in this country can benefit from the preferential tariff rates.

TAXPAYER SERVICES

The AT has been made impressive progress in improving taxpayer services through innovative public information and education programs, new tax service and call centers, geographical expansion of facilities, greater delegation of authority to regional offices (such as in checking VAT refund documents for accuracy before transmission to Maputo), development of the website, and upgrading human resources to provide taxpayers with better support and more objective treatment. These are important steps in the direction of facilitating compliance, helping taxpayers avoid costly errors, and improving taxpayer attitudes about the AT and their tax obligations.

But the process of improving taxpayer services is far from complete. Better provision of information is a central part of the problem. This includes not only continued media coverage of basic facts about the tax system, but also increased capacity within the AT to provide clear, consistent and correct answers to questions from taxpayers at all levels of sophistication about the tax code or procedural requirements. Many technical ambiguities in the tax code have not yet been clarified through subsidiary regulation, and several tax specialists told the study team that it is very difficult (or impossible) to obtain written rulings or interpretations from the AT.

Another continuing problem is the long-standing concern of the private sector about unpredictable and punitive enforcement practices by tax officers, especially in reaction to insignificant errors or unintended infractions caused by lack of information about details of the tax code. This behavior creates an adversarial relationship, incentives for corrupt practices, and sources of dispute, where educational support from tax officials would be more productive all around.

Recommendation. Develop and disseminate specific plans for improving taxpayer services in the medium term, applying computer technology where possible to improve efficiency. The plan must include implementation benchmarks and results targets. It should cover public information programs as well as direct services to taxpayers who require support.

Recommendation. Maintain an active file of frequently asked questions, with authoritative answers presented in language that can readily be understood by most taxpayers. Where necessary, formulate and issue supporting regulations. These information products should be made available to taxpayers through the Internet, through easily operated computer kiosks in tax service centers nationwide, and through cooperating non-government organizations.

Recommendation. Expand training on taxpayer services for all tax officials who deal with the public, not just those assigned specifically to taxpayer service functions.

Recommendation. Conduct regular surveys of taxpayer knowledge and satisfaction with AT operations, to provide management information for monitoring the results of the taxpayer service initiatives.

TAX CULTURE

Many of those interviewed for the study emphasized the deep-seated weakness in the "tax culture" as a primary obstacle to improving compliance and curbing fraud and evasion. Aside from the inherent tendency for individuals and businesses to favor "free-riding" behavior if they can get away with it, the weak tax culture also reflects a widespread lack of understanding of how taxes contribute to national development. It is also influenced by the complexity of the tax system, and the limited geographical coverage of revenue services, which makes it hard to pay taxes in many regions of the country. Further fueling popular resistance to paying taxes is a perception of blatant tax evasion due to bribery and political favoritism.

Strengthening the tax culture requires a combination of carrots and sticks to strengthen incentives for voluntary compliance and increase the costs (or reduce the benefits) of cheating. Actions addressing the priority issues discussed above will shift the balance of considerations in the direction of compliance. But a more focused effort can hasten the cultural transformation. This can be done most effectively through measures that resonate with the public and underscore the importance of paying taxes, such as the two that follow. To be sure, these approaches are easier said than done, and require high-level political backing.

Recommendation. Crack down on affluent taxpayers who have been escaping their tax obligations with impunity. The AT has legal authority to pursue and catch blatant tax evaders through indirect assessments based on external signs of wealth and third party data such as automobile registrations. Where possible, consistent with tax privacy laws, make an example of penalizing or prosecuting these cases.

Recommendation. Require senior members of the government and members of the national assembly to submit income and wealth declarations to an independent audit authority and to the AT.

TAX TRAINING

There is an enormous need for expanding and improving tax training for both AT cadres and tax professionals serving the private sector. The AT has already embarked on an ambitious program to strengthen staff training, including the establishment in 2009 of a new Training Institute in Matola. The training program should be developed on the basis of a thorough assessment of training needs and a clear plan for prioritizing and sequencing training activities, taking into account the benefits in revenue collection and customer services, as well as skill requirements for implementation of the modernization program (as discussed above). From a revenue perspective, training in advance audit skills for dealing with large taxpayers is especially important.

The private sector likewise suffers from an acute shortage of well trained tax professionals. Large companies, of course, have few problems in this respect. In addition, the new ISPC should allow very small enterprises to manage their tax affairs without engaging accountants or trained bookkeepers. For many other SMEs, especially outside of Maputo, professional services for tax support and advice are either unavailable or unaffordable. In large parts of the country, it is literally impossible for a medium-sized business to submit properly certified accounts for tax purposes, due to the absence of accounting services. This situation increases the costs and risks of doing business, because enterprises without properly signed accountant are vulnerable to heavy penalties. The problem involves the quality of tax training as well as the quantity.

Recommendation. Conduct a thorough training needs assessment for the AT. On that basis establish a training plan with priorities and targets for the short term and medium term, including formal training courses, structured on-the-job training – and training of trainers. Priorities are likely to include advanced audit for dealing with large taxpayers; taxpayer services; integrity in tax administration; internal investigation; and new skills requirements relating to the modernization of systems and procedures.

Recommendation. Devote far more attention and resources to expanding and improving the quality of training for accountants, including specialized courses on tax accounting.

EITI IMPLEMENTATION

Along with the adoption in 2007 of a new legal framework for investments in the mining and petroleum sectors, and elimination of special negotiations on the tax treatment of future mega-projects in the 2009 Code of Fiscal Benefits, the government's formal application in May 2009 to join the Extractive Industries Transparency Initiative (EITI) is a landmark commitment to revenue mobilization from the exploitation of mineral resources, as well as fiscal transparency. In brief, the EITI is a mechanism requiring, first, that companies involved in oil, gas and mineral production disclose their tax and royalty payments to a participating government; second, that the government discloses the receipt of these payments; and third, that these payments are subject to independent verification.

The formal application is one step in a multi-year validation process for full compliance with the EITI (see http://eitransparency.org). Ensuring follow-through over the next few years is one of the most important revenue issues for the medium term. As an objective, it also has the advantage of being well defined and easy to monitor.

Recommendation. Adhere to the required schedule for full compliance with the EITI.

DONOR COORDINATION

Most of the priority reforms outlined above require financial and technical support from international partner agencies. Several donors are now channeling financial support through a Common Fund that is controlled by the AT but monitored periodically by a Quality Assurance Group of international tax and customs experts, who have been working with specialists from the IMF and the U.S. Treasury. The Common Fund streamlines the relationship between the AT and the donors by establishing a single set of procedures and controls. It also helps to strengthen the AT's capacity for planning and managing reforms. Another coordination mechanism is the Tax

Working Group, which brings donors together to exchange information and discuss common concerns relating to tax and customs reforms. Recently, however, this group has not been very active.

Looking ahead, it appears that other donors will be providing assistance to the AT through channels outside the Common Fund framework. It is important for these donors to develop and deliver assistance in a manner that minimizes the burden on senior managers of the AT of coping with a multiplicity of donor agency procedures and requirements.

Recommendation. Revitalize the Tax Working Group as a primary mechanism for coordinating donor support on tax and customs issues, with particular attention to ensuring liaison between Common Fund activities and other support programs. As far as possible, donors who chose to operate outside the Common Fund should seek to develop mechanisms that minimize the administrative burden placed on the AT.

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