

TECHNICAL REPORT

Tax Reform and the Business Environment in Mozambique

A Review of Private-Sector Concerns



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SUBMITTED TO
USAID/Mozambique

SUBMITTED BY
Nathan Associates

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Executive Summary

The Mozambique government has been pursuing a comprehensive tax reform program to modernize and strengthen the tax system. Yet many business leaders express deep concern about adverse effects of the reforms on private sector development. This paper examines the tax system in light of these concerns, with a focus on the income tax and the value added tax. The analysis endorses the overall direction of the tax reform program, but also finds that the concerns of the private sector merit serious attention. The paper recommends measures to address these problems, so that the tax system can raise the necessary revenue while better facilitating private sector development, efficient investment, and job creation.

Starting Point: Principles of Taxation for Developing Countries

The purpose of taxation is to mobilize the revenue required to finance public goods and services. Since taxes have a pervasive influence on economic decisions of individuals and businesses, and on social equity, the tax system should achieve the appropriate level of revenue as efficiently and fairly as possible. Pulling these elements together, a well designed tax system should be

- *Effective* in raising revenue,
- *Efficient* in its effects on economic decisions of households and businesses, and
- *Equitable* in its impact on different groups in society.

Main Elements of the Tax System in Mozambique

The principal sources of domestic revenue, as estimated in the 2004 budget, are the value added tax (39 percent of revenue), income taxes (22 percent), and other taxes on international trade (14 percent). Excise and petroleum taxes, combined, account for another 18 percent of domestic revenue. All of these revenue sources have been the object of reforms since 1998. Over the past five years, the ratio of tax revenue to GDP has gradually increased from 11.1 percent in 1999 to 13.7 percent (projected) in 2004.

In 1999, the government replaced a highly distortionary turnover tax with a 17 percent value added tax (VAT). It also restructured the excise tax (*Imposto sobre Consumos Específicos*, or ICE), which currently applies to over 140 specific products at rates that range from 15 to 65 percent. The reform of indirect tax was followed in 2002 by the introduction of two new income tax codes: a company tax (*Imposto sobre o Rendimento das Collectivas*, or IRPC), with a basic rate of 32 percent; and an individual tax (*Imposto sobre o Rendimento das Pessoas Singulares*, or IRPS), with marginal tax rates ranging from 10 to 32 percent. Under the IRPS, incomes below MT 2,400 million (about \$1,200) per year are exempt from tax. Both the VAT code and the income tax codes include simplified regimes for small enterprises without organized accounts.

The government has also been gradually reducing import duties. The standard tariff rates currently range from 0 percent on designated basic goods, to 25 percent on consumer goods. The standard tariff is 7.5 percent on intermediate goods; 5 percent on capital goods and fuel; and 2.5 percent on raw materials. The simple average tariff of 12 percent, and the trade-weighted average is 9 percent, are among the lowest in the region. The government plans to reduce the top tariff rate to 20 percent in 2006.

Other important reforms have been adopted for the fuel tax, the stamp tax, and municipal levies. On the administrative side, the government has introduced Unique Taxpayer Identification Numbers, enacted a new decree on tax penalties, restructured the tax department, and established a legal framework for establishing a central revenue authority (*Autoridade Tributária de Moçambique*). It is also in the process of strengthening training programs, information technology, and public information systems.

In short, the tax reform program has been bold in scope and substance. The question is whether the system is benefiting or harming private sector development.

Private Sector Concerns

The government's economic development program highlights the importance of private investment as the engine of growth and poverty reduction. Yet studies by the World Bank show that companies in Mozambique face heavy impediments to doing business. The Bank's ratings focus on the institutional and regulatory environment, but taxes also play a major role in determining the quality of the investment climate. On tax issues, business leaders in Mozambique contend that the recent tax reform program is impeding development of the private sector. Their main concerns are that:

- The new tax laws are too complex for local conditions;
- Tax rates are too high;
- The tax base is too narrow;
- Tax administration is inefficient, arbitrary, and prone to corruption;
- The tax system unduly impairs business cash flow and raises financing costs;

- Various tax provisions tilt the playing field against many domestic producers; and
- Public information on the tax system is highly inadequate, and public-private dialogue has been insufficient.

Complexity. Many business leaders claim that the tax codes are too complex for conditions in Mozambique, like a Rolls Royce that is stuck in the sand. In fact, the VAT in Mozambique is very similar to the system in many other developing countries, including 10 SADC states. Over 120 countries have adopted VAT in the last 40 years due to its advantages in revenue mobilization and economic efficiency, compared to traditional indirect taxes. VAT works reasonably well, and is a major source of revenue, in many low income countries, including Tanzania, Zambia, and Malawi (where it is called “surtax”). In poor countries, administrative problems invariably arise, and the efficiency benefits are attenuated by limited coverage. The tax also imposes a significant compliance burden on taxpayers. Nonetheless, tax experts generally conclude that the benefits outweigh the costs. With a view to simplification, the most important VAT problem in Mozambique is that the registration thresholds are too low, drawing into the tax net many small taxpayers who should be excluded by design.

The new income tax codes are also basically sound and consistent with best practices. Some apparent complications involve provisions for broadening the tax base by eliminating opportunities for tax evasion. For large businesses with highly skilled accountants, compliance costs for the new IRPC and IRPS codes are significant, but not unreasonable. Still, there are two major problems. First, most tax payers are *not* large businesses with highly skilled accountants. Other companies will face difficulties in completing the forms accurately and maintaining the necessary documentation. The second problem is that certain elements of the tax code could have been omitted in the interests of simplicity. Examples include the provision to tax worldwide income (which is very hard to implement), and the provision for a “special advance payment” (which is unnecessary, and hard for anyone to understand).

The analysis of tax complexity leads to the following main recommendations:

- Raise the registration threshold for the *normal* VAT regime, the *simplified* VAT regime, and the *normal company tax*, in order to eliminate the tax obligation for very small enterprises; adjust the thresholds annually to compensate for inflation.
- Accelerate implementation of the indirect tax regime under IRPC by conducting necessary studies to determine the appropriate indicators.
- Establish a joint public/private task force to identify provisions of the IRPC and IRPS codes that can be simplified without a significant loss of revenue.
- Introduce a simple unified tax for very small and micro enterprises, in lieu of the simplified VAT and IRPS; exempt entities with an estimated income below the normal threshold for income tax liability.

- Revoke the stamp tax (while applying minimal fees as necessary to cover the cost of essential administrative services).

Tax Rates. Are tax rates still too high? One must first ask: High relative to what? A common approach is to compare tax rates against those in other countries. This is pertinent for assessing the country's attractiveness to "footloose" investors. For other businesses, international comparisons are not particularly relevant. The issue is whether tax rates are too high to allow investors to earn an adequate return. A third criterion is to ask whether rates are too high in the sense that they actually reduce revenues (the famous "Laffer curve" issue). An argument often heard in Mozambique is that the tax base is narrow precisely *because* tax rates are too high.

The VAT rate of 17 percent is slightly above the regional average, but not by a large margin. The charge of high tax rates is more compelling when one looks at the combined effect of VAT plus import duties and excise taxes. For imported consumer goods, VAT plus duty works out to an effective tax rate of 46.25 percent. For goods subject to excise tax, the overall tax burden is as high as 141 percent. This is so high as to suggest that the government may be able to raise revenue by lowering the tax rates.

The picture is similar for the corporate tax. The basic rate of 32 percent equals the SADC average. But the combined burden of company tax plus tax on dividends works out to be *the highest in the SADC region*. Looking more deeply, the Marginal Effective Tax Rate (METR)—a measure of the extent to which the tax system overall reduces returns on investment—ranges from 48 to 56 percent for illustrative investment projects. This large "tax wedge" would certainly deter investors. In contrast, investors who qualify for fiscal incentives face a low to moderate METR. The problem is that incentives for new investors come at the expense of old ones.

For the individual income tax, the top rate of 32 percent is in line with international norms. However, the jump in this rate from 20 to 32 percent in 2002 was extraordinary increase in size and timing, giving the private sector good reason to squawk. Finally, some withholding tax rates appear to be excessive.

Mozambique would be in a better position to foster private sector development if the government would offer more attractive *standard* tax rates—starting with some relief from the double tax on dividends—and fewer special tax breaks. The following rate reductions would be desirable as a *medium-term* objective, contingent on the need for prudent fiscal management:

- Reduce the standard VAT rate from 17 percent to 14 percent.
- Reduce the maximum import duty to 20 percent, and then to 15 percent, to reduce the combined rate of VAT plus duty to 35 percent (which is still high in terms incentives for tax compliance).

- Reduce the IRPC rate and the maximum IRPS rate from 32 percent to 25 percent, as fiscal conditions allow.
- As a priority, reduce the double taxation of dividend income by adopting provisions to integrate the company tax and the individual tax on dividends, at least partially.

Tax Base. The business community contends that the taxes falls disproportionately on a few formal enterprises, while large sums remain outside the tax system due to evasion, corruption, ineffective tax administration, and tax laws that discourage registration. Discussion has focused on bringing the informal sector into the tax net. The analysis here suggests, on the contrary, that it does not make sense to tax multitudes of poor people, because the administrative costs are high and the revenue yield is low. One recent study (Ernst & Young 2004b) found that over 13,000 enterprises were registered for the normal VAT regime, and over 10,000 for the simplified regime, yet those in the simplified regime contributed just 0.4 percent of the revenue. This does not mean that efforts to bring informal entities into the tax net are important. The question is targeting. As Terkper (2003) points out, tax evasion among small and medium taxpayers “can adversely affect revenue and compliance among all taxpayers.” But he distinguishes between different “hard-to-tax” groups, and argues that efforts should be directed towards higher-income tax evaders.

The value added tax is itself a device for taxing the informal sector. This is so because VAT is levied at each stage in the supply chain. While an unregistered trader or producer may escape VAT on its sales, tax is still collected on any inputs that are purchased from a registered supplier. In addition, VAT has built-in incentives for voluntary registration. The new income tax codes also have provisions to capture some income of unregistered enterprises, through a relatively broad requirement for withholding at source.

Three other avenues for broadening the tax base are to strengthen tax administration, to eliminate special incentives that are not cost effective; and to introduce new tax instruments. A final consideration is that tax compliance is intimately linked to the quality of government expenditure. Programs to improve public expenditure management and increase efficiency in public services go hand in hand with tax reform. This analysis suggests the following main recommendations:

- Avoid the false expectation that large amounts of revenue can be raised by taxing micro and small enterprises.
- Target higher-income tax evaders, possibly through a presumptive tax based on objective outward signs of lifestyle.
- Mobilize special teams to inspect and audit target groups that are especially prone to evasion, and (in customs) to perform random checks on import clearances.
- Pursue ongoing programs to strengthen and modernize tax administration, intensify staff training, and fight corruption in the tax service.

- Build capacity for careful economic and fiscal analysis of instruments for stimulating investment, to eliminate incentives that are not cost effective.
- Enhance fiscal transparency by adopting tax expenditure budgeting, with regular public reports on the fiscal cost of tax incentives.
- Maximize domestic retention of resource rents from the exploitation of mineral resources and renewable natural resources. This is a top priority.
- Consider the adoption of a corporate Alternative Minimum Tax.
- Enhance tax compliance by pursuing ongoing programs to reform public expenditure management and improve public service delivery.

Tax Administration. Tax administration is a constant grievance of the private sector. The problem of controlling tax evasion was discussed above. Other major problems are delays in VAT refunds; discretionary assessments and penalties; and corruption.

VAT systems everywhere are vulnerable to fraudulent refund claims. Thus, the VAT service is on firm ground in examining claims carefully. Moreover, officials contend that the processing time is within the mandated period of 45 days; that times are improving; and that long delays, when they occur are caused by improper documentation. From this sharp divergence between private sector claims about long delays, and statements by the government, it is clear that the refund process suffers from a lack of transparency. A second conclusion is that the authorities must provide better information on procedures and requirements for obtaining refunds. A related problem is that every claim is subject to scrutiny. The system can be streamlined by adopting risk-based selective inspections. In addition, certain provisions of the VAT code may be overloading the system. Structural reforms to reduce the volume of claims and improve service.

The business community is also highly critical about the degree of discretion exercised by tax officials in determining assessments and penalties, leading to unpredictable tax bills, arbitrary fines, and corrupt practices. Discretion stems from structural and administrative features of the system. For example, the simplified regimes create an invitation to discretion and negotiation by the need to estimate turnover for small businesses without adequate accounts. Also, the new code of tax penalties provides an extraordinary range of fines for many infractions. In addition, tax inspectors personally share in fines and penalties. These issues feed the problem of corruption in tax administration.

This analysis suggests several recommendations:

- Enhance the transparency of VAT refund administration by publishing monthly reports on claims and approvals; provide clear information to the public about procedures and requirements.
- Adopt risk-based selective audits for inspecting VAT refund claims, including “gold card” treatment of regular exporters with a track record of accurate claims.

- Conduct a system audit of VAT refund procedures to ensure that valid claims can be paid without the separate step of approval from the Treasury.
- Reduce the volume of refund claims by increasing the threshold for claiming immediate payments, and eliminating “complete exemptions” (zero-ratings) for manufactured products that are not exported.
- Activate the public-private Task Force on VAT refunds.
- Amend the new regime on tax infractions to reduce the range of discretion and establish more transparent rules for determining the magnitude of tax penalties.
- End the sharing of tax penalties with officers involved in the decisions.
- Adopt a tough anti-corruption program including heavy sanctions for errant tax officials; undertake and publish periodic corruption surveys.
- Implement the planned Revenue Authority, ensuring that it is adequately funded and professionally managed, without political interference.

Cash-flow Costs. The tax system can also impede private sector development by imposing unnecessary cash-flow costs, especially for businesses with weak balance sheets, low profit margins, and limited access to working capital. The most prominent example is the cost of financing delays in obtaining VAT refunds. Illustrative calculations (using an interest rate of 27 percent) show that long delays sharply diminish net profits for companies that cannot pass the cost along to consumers, as is the case for exporters and firms selling domestically at an import parity price. A related problem is the handling of VAT credits arising from outlays on capital goods. When capital outlays are large relative to taxable sales, a refund is normally required. Long delays then increase the effective cost of capital goods and reduce the return on investment.

These cash-flow problems can be mitigated if the government would honor its statutory commitment to pay interest on overdue refunds. The widespread failure to do so is a scandalous breach on the part of the government. In addition, the interest rate on overdue refund payments is too low to compensate businesses for the excess financing costs caused by delays.

Some business leaders object to the very idea of paying VAT up-front on purchases and then recovering these payments out of tax due on sales, as well as the imposition of VAT on top of import duties. Another complaint is the introduction of quarterly advance payments under the new corporate tax code. All of these provisions, however, are standard and well justified elements of an effective tax system.

The main recommendations relating to cash-flow costs are to

- Take urgent steps to expedite VAT refunds, as discussed earlier;
- Re-assess provisions of the VAT code involving refunds for large capital outlays; and

- Enforce statutory provisions for the government to pay interest on overdue refund payments, and consider raising the stipulated interest payment rate to reflect the actual cost of funds to the business community

The Tilted Playing Field. Like most tax systems, the regime in Mozambique has many provisions that distort incentives and favor certain producers over others. Some tax incentives are justifiable, and in some countries they have been highly successful, when accompanied by supportive policies and institutions. But in many other contexts, incentives adopted in response to political pressure or weak policy analysis have been ineffective or even counterproductive—in that they complicate tax administration and open loopholes, without stimulating much new investment. In Mozambique, the package of fiscal benefits grants new investors a strong competitive advantage over other producers. It also favors transient investments. For these reasons, the starting point for stimulating efficient private sector development should be to establish an attractive standard tax system with moderate tax rates that apply even-handedly to broad tax base.

The tariff structure creates another tilt in the playing field. Though duty rates in Mozambique are among the lowest in the region, yet they are still distortionary. Even with a relatively moderate maximum tariff of 25 percent, the Effective Rate of Protection (ERP) can still exceed 100 percent for industries with low domestic content. This means that the tariff shields producers from import competition even if their operations cost more than twice as much as in other countries—a very high degree of inefficiency. The tariff code also discourages backward linkages, and creates a bias against exports. On balance, lower and more uniform tariffs can enhance productivity, stimulate exports, and improve prospects for long-run growth, while still providing moderate protection for domestic producers. The special customs regime for manufacturers (*indústria transformadora*) works in the opposite direction, by increasing tariff differentials. It also creates a huge advantage for larger enterprises, to the detriment of smaller firms that tend to be more labor intensive. Other tax provisions that favor capital-intensity are built into the Code of Fiscal Benefits, which also has a surprising limitation on the deductibility of training expenses.

Prospects for efficient private sector development and poverty reduction would be enhanced by improving the neutrality of the tax system. The main recommendations are as follows:

- Limit the scope of special tax incentives, and use the revenue so gained to reduce general tax rates.
- Continue phased tariff reductions to achieve lower and more uniform tariffs, to reduce distortions that foster inefficiency and impair backward linkages.
- Replace the special customs regime for manufacturing with a low uniform tariff on business inputs (classes K, M and I).
- Review the deductibility of training expenses in the tax code to provide stronger incentives for upgrading labor skills.

- Enhance capacity for tax policy analysis, to ensure that incentive programs are cost effective, with a minimum of distortionary side effects – especially those that discourage job creation.

Public Information and Dialogue. Many of the problems discussed above could have been resolved with better communications between the tax authorities and the private sector. Instead, the availability of tax information to the public is poor, and business leaders constantly criticize the public-private dialogue on tax policy (though consultations with customs have improved). Since there is no lack of contact, as such, the issue is the quality of the discussions. Government officials should view consultations as an important mechanism for learning about problems faced by taxpayers, educating a major constituency about tax issues, and strengthening the coalition in favor of good tax policy. Consultations may also improve tax compliance by creating a more cooperative, less adversarial relationship. In the process, officials still need to be cautious about filtering out special pleading that is not in the best public interest. Thus, the government should consider the following major measures:

- Allocate staff and financial resources to producing and distributing public information on the tax system.
- Develop a multi-media public information campaign including radio and television spots on tax issues (as done for traffic violations) and posting of all major tax documents (including authorized English translations) to a well-publicized website.
- Train tax officers, including tax inspectors, to integrate education functions into every contact with the public.
- Assist other institutions and organizations to establish affordable education programs for the public on taxation.

Conclusion

Business leaders contend that the new tax system is impeding private sector development because the new tax codes are too complex for local conditions; tax rates remain too high; the tax base is too narrow; tax administration is inefficient, arbitrary, and prone to corruption; the tax system makes undue demands on cash flow; the system tilts the playing field against many domestic producers; and both public information and public-private dialogue on tax issues have been inadequate. This paper finds that the tax reform program in Mozambique is solidly in line with best practices for low income developing countries; even so, concerns of the business community warrant serious attention. Based on this analysis, the paper offers more than forty recommendations for consideration by business leaders and the government. Some recommendations support reforms that are already underway, such as the establishment of an autonomous revenue authority, better public information, and further reductions in the maximum tariff rates. Most of them, however, point to measures that do not appear to be on the current agenda. Perhaps the most fundamental recommendations are that

the government needs to develop stronger capacity for tax policy analysis, and more effective dialogue with stakeholders such as private sector organizations. These steps can be instrumental in helping the government achieve its revenue targets more efficiently and equitably, while improving the climate for efficient private investment.

1. Introduction

Since 1998 the government of the Republic of Mozambique (GRM) has been phasing in a comprehensive tax reform program to modernize and strengthen the tax system. Key measures include replacing a cascading turnover tax with a value added tax (VAT) and a new system of excise taxes; a major revision of investment tax incentives; a new income tax code; sequenced reductions in import duties; and a revision of the fuel tax and other minor taxes. The government has also taken steps to strengthen tax and customs administration, simplify customs procedures, and establish plans for a central revenue authority. These reforms have been designed with the objective of raising revenue more effectively, fairly, and efficiently. Yet many business leaders express deep concern about adverse effects of the new system on private sector development. Among other things, they contend that the system is overly complex, that tax rates are too high and the tax base too narrow; that tax administration is arbitrary and corrupt.

In light of these concerns, the Confederation of Business Associations in Mozambique (CTA) requested technical assistance from USAID to conduct an independent review of the new tax system, drawing on experience elsewhere in the region, and best practices for developing countries.¹ This paper presents the results of that review. In particular, the paper examines the tax system from the point of view of the business community, giving special attention to the income tax and the value added tax. The analysis broadly affirms the overall positive direction of the tax reform program, but also finds that many of the issues raised by the private sector merit serious attention. Based on this analysis, the paper recommends nearly forty measures to address these problems, so that the tax system can raise the necessary revenue² while better facilitating private sector development, efficient investment, and job creation.

¹ See Keen and Simone (2004), Zee, Stotsky and Ley (2002); Ebrill, Bodin and Summers (2001); Tanzi and Zee (2000); Thirsk (1997). Earlier classic references include Hussey and Lubick (1996); Shome (1995); Burgess and Stern (1993); Bird (1992); World Bank (1991); Bird and Oldman (1990).

² Time and data constraints preclude any detailed revenue estimates. The analysis is therefore based on principles of tax reform for developing countries, lessons from tax reform in other low-income African countries, and information from local interviews and documents.

The analysis begins in Section 2 with a brief review of basic principles of taxation for developing countries. Section 3 outlines the current tax system in Mozambique. Section 4 explains the concerns of the business community, and provides a detailed assessment of the major issues as well as recommendations for improving the system. Section 5 summarizes the main conclusions.

2. Starting Point: Principles of Taxation for Developing Countries

The fundamental purpose of taxation is to mobilize the revenue required to finance public goods and services.³ Therefore, *the core principle of taxation is that the system should be an effective instrument for raising revenue.* In addition to raising revenue, 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. Pulling these elements together, a well designed tax system should be

- *Effective* in raising revenue,
- *Efficient* in its effects on economic decisions of households and businesses, and
- *Equitable* in its impact on different groups in society.

An Effective Tax System

An effective tax system is one that satisfies revenue requirements as defined by political decisions on the desired scope and size of government (including infrastructure and support services that are needed to improve the investment climate), and the availability of non-tax revenue and foreign aid. In dynamic terms, an effective tax system should be “elastic,” which means that revenues rise naturally with GDP growth, without requiring frequent ad hoc measures. An effective tax system must be consistent with a country’s administrative capacity. Even the best tax code produces poor results when it is not well administered.⁴ In countries with weak tax administration and limited capacity for taxpayer compliance, simplicity is a high virtue.

Net aid flows are likely to be declining relative to GDP. Hence, Mozambique faces a need to enhance revenue performance in order to satisfy demand for public services that are critical to economic growth and social welfare—such as education, health, public security, legal and

³ This section draws heavily on Bolnick (2004).

⁴ As famously stated by Casanegra de Jantscher (1990, 179): “Tax administration *is* tax policy.” Note that effective tax administration can damage the economy if the tax code itself is poorly designed.

judicial systems, and economic infrastructure—while maintaining macroeconomic stability. Over the past five years, domestic revenue has increased from a low level of 11 percent of GDP in 1999 to a projected 14.6 percent in 2004. The medium-term fiscal program calls for revenue to reach 17 percent of GDP by 2010. For present purposes, these revenue targets are taken as given.

An Efficient Tax System

Virtually all forms of taxation distort the market incentives that guide private decisions on investment, production, consumption and saving, work effort, and even the legality of activities. An *efficient* tax system is one that minimizes such distortions in order to minimize the tax-induced drag on efficiency, productivity, and growth. Efficiency considerations are especially pertinent for low-income countries, which least can afford the cost of foregone gains due to avoidable resource misallocation.

To minimize adverse effects on efficiency, well designed tax reform programs for developing countries aim to establish a regime of moderate tax rates applied to a broad tax base. In contrast, a tax system with high tax rates alongside special fiscal incentives for the few will tend to magnify distortions and inefficiencies.⁵ For example, special capital allowances and import duty exemptions on capital goods or intermediate goods draw resources into capital-intensive and import-dependent activities, and discourage investments that create more jobs and upstream linkages. These efficiency issues are presented in more detail in the discussion of tax provisions in Section 4 of this paper.

The efficiency effect of the tax system is also related to its *predictability*. A tax regime that is subject to unexpected changes or arbitrary enforcement is a major risk factor for investors. The risks associated with erratic tax policy and poor tax administration deter investment by increasing the rate of return required for a commitment of resources. The high value of predictability underscores the importance of pursuing a clear and consistent strategy for tax reforms, and minimizing discretion in implementing the tax laws.

A Fair Tax System

There is widespread agreement that a fair tax system

⁵ To be sure, the purpose of a tax incentive is precisely to alter market incentives. Ideally, incentives do so in a way that enhances growth and welfare. In very many cases, however, incentives do not have the intended effects, while causing costly unintended side-effects. See Bolnick (2004). The efficiency cost of distortionary tax policies can be astonishingly high. For example the World Bank (1988) reported one careful study in the Philippines which found that a 25 percent import tariff cost the economy two pesos (at the margin) for every one peso collected.

- Collects proportionately more from those with higher incomes (vertical equity);
- Provides relatively uniform and non-discriminatory treatment of taxpayers with similar economic circumstances in terms of ability to pay (horizontal equity);
- Minimizes the tax burden on the poor; and
- Avoids excessive tax rates and arbitrary impositions all around.

Fairness is a fundamental policy objective in its own right. In addition, perceptions of unfairness can erode compliance and undermine the sustainability of the tax system. In some cases, unfairness arises from good intentions, as tax cuts intended to benefit certain groups necessitate higher tax rates for others. One of the basic problems discussed in Section 4 is how the government might compensate for further reductions in current tax rates, as called for by the business community.

3. Main Elements of the Tax System

Table 3-1 shows the principal sources of domestic revenue as estimated in the 2004 budget. Value added tax (including the tax on imports) was budgeted to generate 39 percent of revenue, with income taxes yielding 22 percent, and other taxes on international trade 14 percent. Excise and petroleum taxes, combined, account for another 18 percent of domestic revenue. Each of these major revenue sources has been the object of deep reforms since 1998. The reforms have broadly conformed to international best practices for developing countries.

Table 3-1 also indicates that the ratio of tax revenue to GDP has gradually increased over the past five years, rising from 11.1 percent in 1999 to 13.7 percent (projected) in 2004. This has occurred despite lower import duties, a reduction in the corporate tax rate, and a stable VAT rate. These figures suggest that the government has succeeded to some extent in widening the tax base through a combination of structural changes and administrative reforms.

The reform program is still underway. Current efforts focus on further improvements in tax administration. Important reforms in progress include the introduction of a central revenue authority (*Autoridade Tributária de Moçambique*), computerization of tax information systems, further development of the appeals process, and improved systems for providing public information. The remainder of this section briefly describes major features of the new tax system.⁶

Value Added Tax

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. The VAT replaced a relatively ineffective and distortionary turnover tax (*Imposto de Circulação*), which imposed a tax of 10 percent at the retail level, on top of a 5 percent tax on imports and intermediate

⁶ This review is very brief because the primary audience for this study is familiar with the tax system. The information is based on recent tax legislation, as well as summaries given in Byiers (2004); LaFleur (2004); Ernst & Young (2004a); IMF (2001); CPI (no date); and PriceWaterhouseCoopers (2003a and 2003b), and interviews in the field (see the Appendix).

Table 3-1*Government Revenue, 1999-2004 (projected)*

	1999	2000	2001	2002	2003p	2004b
R E V E N U E A N D G R A N T S (% O F G D P)						
Total revenue	12.0	13.2	13.3	14.2	14.3	14.4
Tax revenue	11.1	12.0	11.8	12.5	13.2	13.7
Taxes on income and profit	1.7	1.8	2.1	2.5	3.1	3.2
Taxes on goods and services	7.0	7.6	7.3	7.5	7.6	8.1
Turnover tax	1.8	--	--	--	--	--
Value added tax—on domestic supplies	1.1	2.1	2.1	2.3	na	2.5
Value added tax—on imports	1.6	3.0	2.9	3.1	na	3.1
Consumption taxes (excises)	1.1	1.1	1.1	1.1	na	1.2
Tax on petroleum products	1.5	1.3	1.2	1.0	1.3	1.3
Taxes on international trade	2.0	2.2	2.1	2.2	2.2	2.0
Other taxes	0.4	0.4	0.3	0.3	0.4	0.5
Nontax revenue	0.9	1.2	1.5	1.7	1.1	0.7
Grants	11.7	8.0	14.8	11.8	10.6	9.6
Total revenue and grants	23.7	21.2	28.1	26.0	24.9	24.0
C O M P O S I T I O N O F R E V E N U E (% O F R E V E N U E)						
Tax revenue	92.4	91.1	88.7	88.2	92.6	95.6
Taxes on income and profit	14.0	13.7	16.0	17.5	22.0	22.1
Taxes on goods and services	58.6	57.3	54.6	53.1	53.0	56.3
Turnover tax	14.8	--	--	--	--	--
Value added tax—domestic goods and services	9.2	16.0	16.0	16.3	na	17.2
Value added tax—imports	13.3	22.6	21.7	21.7	na	21.6
Consumption taxes (excises)	9.1	8.5	8.2	7.9	na	8.4
Tax on petroleum products	12.2	10.2	8.7	7.2	8.9	9.1
Taxes on international trade	16.8	16.9	15.6	15.4	15.1	13.9
Other taxes	2.9	3.1	2.5	2.1	2.5	3.2
Nontax revenue	7.6	8.9	11.3	11.8	7.4	4.4
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0

NOTE: *p* = preliminary; *b* = budgeted

SOURCE: IMF, Ministry of Planning and Finance, and study calculations.

transactions. Overall, the effective turnover tax rate ranged from 10 percent on direct sales by producers, to more than 20 percent for goods passing through multiple transactions in the supply chain (hence the term “cascading” tax). Goods that were simply imported for retail sale faced an effective tax rate of 15.5 percent. VAT is collected from suppliers, who generally pass the extra cost on to customers. Thus, by design, the VAT is effectively a tax on domestic consumption. With this objective in mind, exports are subject to a zero tax (*isenção completa*),

and qualify for a full refund of VAT paid on inputs. In Mozambique, zero rating also applies to selected goods such as maize meal, wheat flour, rice, and bread, and kerosene for lighting.⁷ A long list of goods and services are exempt from VAT,⁸ which means that they are not liable for VAT on sales, but also not eligible for a refund of VAT paid on inputs. Exempt items include medical services and drugs, financial services, basic inputs for agriculture, and direct products of agriculture, forestry, animal husbandry, and fishing activities. Clearly, the policy was structured to minimize the tax burden on basic goods consumed by the poor.

The VAT code includes a simplified regime (*regime simplificado*) consisting of a 5 percent tax on gross sales, for enterprises with a turnover of less than 250 million meticais per year (about \$12,500). Enterprises with a turnover below 100 million meticais per year (about \$5,000) are exempt from VAT.

VAT returns are filed monthly. As with most VAT systems, the amount due is the difference between the tax on sales—which is zero for “zero-rated” goods—and the tax previously paid on inputs, including capital goods. In this way, VAT is collected on the value added at each stage of the supply chain, as long as transactions involve registered enterprises. In cases where the amount due is negative, the taxpayer is in a credit position and may claim a refund (*reembolso*) from the government if the balance exceeds 10 million MT, or after six months of credit balances. As discussed below, the VAT refund process has provoked bitter complaints from the private sector.

Corporate and Individual Income Tax

The income tax system prior to July, 2002, had three components: first, a 35 percent tax on profit; second, a tax on labor income, with a top marginal rate of 20 percent; and third, a “complementary tax” on other incomes, with a top marginal rate of 40 percent (20 percent for self-employment income) (IMF 2001).⁹ Under the profit tax, there were special provisions for companies that did not keep regular accounts (Group B), and a provision for provinces to collect specific taxes on small businesses.

The new system has two integrated components, one tax code for corporations (*Imposto sobre o Rendimento das Collectivas*, or IRPC), and for individuals (*Imposto sobre o Rendimento das Pessoas Singulares*, or IRPS), respectively. The standard corporate tax rate and the maximum marginal tax rate for individuals are equalized at 32 percent. Income from agricultural activity is taxed at 10 percent until 2010.

⁷ Código do IVA, Article 18.1.b.v, with reference to Article 9.29, as amended in April, 1999.

⁸ An amendment in April, 1999, included a table listing more than 120 items that are exempt from IVA.

⁹ See the Statistical Appendix table, Mozambique: Summary of Major Taxes, November 2000, in the IMF's country report.

More specifically, the IRPS is a progressive tax with marginal rates of 10, 15, 20, 25, and 32 percent. In place of the awkward complementary tax, the IRPS covers not only labor income but also professional fees, pensions, rents, interest, capital gains, and distributed profits, among other things.¹⁰ The tax applies to income from all sources, with an adjustment for marital status and deductions for up to three dependents. Income under MT 24 million (about \$1,200) per year is not taxable, while the top rate applies to incomes in excess of MT1,008 million (about \$50,000).

The IRPC and IRPS retain the tradition of applying a simplified regime to small commercial, industrial or agricultural enterprises—those which lack organized accounts and have a turnover of no more than MT 1,500 million (about \$75,000) per year. For these entities, taxable income may be determined on the basis of “technical-scientific indicators,” which have yet be established by the Minister of Finance; alternatively, taxable income is deemed to be 20 percent of the value of sales of merchandise or products, or 30 percent for other income.

Other notable features of the 2002 income tax codes include the introduction of a self-assessment system (*auto-declaração*), with quarterly estimated payments, broad applications of withholding at source on many forms of income, including wage income, and modern provisions to limit the scope for abusive tax avoidance through mechanisms such as transfer pricing or financial engineering. The new tax code also establishes a broaden definition of income, including non-wage remuneration such as income in kind or low-income loans from employers.

Import Duties

The government has been gradually reducing import duties both for the purpose of trade liberalization and tax reform. Currently, standard tariff rates range from 0 to 25 percent, by class of imports:

- 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 is 12 percent, and the trade-weighted average is 9 percent. Both figures are among the lowest in the region. Furthermore, the government plans to reduce the top tariff rate to 20 percent in 2006. According to the recent *Diagnostic Trade Integration Study* (DTIS) for Mozambique, despite the low average tariffs, the rate for Class C continues to

¹⁰ 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.

provide fairly high levels of protection to most final goods produced in Mozambique, including processed agricultural products, and even meat, dairy, fruit and vegetable products (see discussion of tax provisions in Section 4) (Nathan Associates 2004).

Beyond the standard tariffs, Mozambique has begun the process of reducing duty rates on imports from SADC member states, under the SADC trade protocol. To date, the government has eliminated duty on imports of SADC origin for more than 1,500 tariff lines, all involving products that do not compete against local enterprises. Indeed, the protocol grants Mozambique special status by which duties on “sensitive products” need not be eliminated until 2015.

Other duty exemptions are granted under the tax incentive regime for investors and a special customs regime for selected manufacturing industries (*Regime Aduaneiro para a Indústria Transformadora*). Both of these regimes are discussed in other sections.

Excise Tax and Fuel Tax

There are two major categories of taxes on designated products: the Specific Consumption Tax (*Imposto sobre Consumos Específicos*, or ICE); and the Fuel Tax (*Taxa de Combustíveis*). The ICE, which was restructured in 1998 to complement the VAT, is an *ad valorem* excise tax on more than 140 products, at rates ranging from 15 to 65 percent.¹¹ Most items subject to ICE are deemed to be luxuries (such as cars, jewelry, perfume, and sporting goods) or health risks (particularly tobacco and alcohol). The tax is charged on both domestic products and imports.

The fuel tax is a specific nominal levy per liter of various types of fuel. The tax was restructured in 2003, resulting in a 63 percent increase in the tax (which had not been adjusted for several years), and introduction of a formula for quarterly inflation adjustments, to maintain the real value of the tax per unit. With these measures, the tax accounted for approximately 30% of the retail price for regular gasoline, and a slightly lower percentage for diesel and lead-free petrol. In view of the social sensitivity of fuel prices, the measures were adopted after completion of an independent poverty and social impact analysis, funded by DFID, which concluded that “the aggregate short-term impact of a rise in fuel tax on poverty is modest,” and that the indirect benefits for poverty reduction from the extra revenue would likely outweigh the adverse effects (Nicholson 2003, vii).

¹¹ The item count and tax rates are taken from the official import tariff schedule (*Pauta*) for 2004.

Other Recent Tax Reforms

Another major tax reform was a revision of the code of investment tax incentives (*Código de Benefícios Fiscais*) in 2002. Drawing on an IMF study, which found that the previous system was not cost-effective, the new code unified incentives that were previously scattered across several different laws. It also reduced the generosity of tax holidays, and placed greater emphasis on capital allowances such as investment tax credits and accelerated depreciation. The new code retained an exemption from import duty on capital goods, and as well as the normal exemption from indirect taxes for inputs purchased by exporters operating in an Industrial Free Zone. Details are readily available from the website for the Center for Investment Promotion (www.cpi.co.mz).

Other significant reforms include the stamp tax (*Imposto do Selo*) in 2004, and various municipal taxes (*Impostos Autárquicos*). On the administrative side, the government has adopted legal provisions to implement Unique Taxpayer Identification Numbers (*Número Único de Identificação Tributária*, or NUIT), a new decree on tax penalties (*Regime Geral de Infracções Tributárias*), a new organizational structure for the tax departments (*Direcção Geral da Administração Tributária dos Impostos*), and a legal framework for establishing a central revenue authority (*Autoridade Tributária de Moçambique*).

This short overview shows the government's tax reform program has been bold in scope and substance. The question raised by many entrepreneurs, however, is whether the new system is benefiting or harming private sector development.

4. Private-Sector Concerns About the Tax System

The government's overall economic development program, as expressed in the PARPA and other official documents, depends on private investment and private initiative as the main engine of growth and poverty reduction. Yet, widely cited studies by the World Bank indicate that companies in Mozambique face unusually heavy impediments to doing business.¹² The Bank's ratings focus on the institutional and regulatory environment, but taxes also play a major role in determining the quality of the investment climate.¹³ It is no surprise that regulatory and tax issues share the agenda in the ongoing dialogue in Mozambique about reforms that are needed to stimulate more rapid private sector development.

On tax issues, representatives of the business community in Mozambique¹⁴ contend that the recent tax reform program is raising revenue in a manner that is detrimental to the private sector. Their main concerns are that:

- The new tax laws are too complex for local conditions;
- Tax rates are too high;
- The tax base is too narrow;
- Tax administration is inefficient, arbitrary, and prone to corruption;
- The tax system unduly impairs business cash flow and raises financing costs;
- Various tax provisions tilt the playing field against many domestic producers;
- Public information on the tax system is highly inadequate, and public-private dialogue has been insufficient.

¹² World Bank (2004). A summary of ratings for Mozambique can be obtained on line from <http://rru.worldbank.org/DoingBusiness>. For a summary and analysis, see Nathan Associates (2004) and Radelet (2004).

¹³ The Bank's *World Development Report 2005* recognizes the joint importance of regulations and taxes as determinants of the investment climate.

¹⁴ The concerns have been raised by officers and members of the Confederation of Business Associations in Mozambique (CTA). CTA is a confederation that includes many business organizations. Nonetheless, CTA does not represent the entire business community. Even within CTA there is not necessarily a consensus on the problems or possible solutions.

These inter-related issues will be discussed in turn, leading to recommendations on measures to redress the problems. The focus here is on the VAT and the income tax, though some attention is given to other revenue instruments.¹⁵

Complexity of the Tax System

Many business leaders consider the value added tax and the new income tax codes to be elegant tax instruments that are too complicated for Mozambique. A common analogy is that the country has a Rolls Royce tax system that is stuck in the sand. The sand consists of weak tax administration and deep structural constraints in the private sector, such as inadequate accounting standards, an acute lack of skilled accountants, and high rates of illiteracy or innumeracy among micro and small scale entrepreneurs. The tax authorities seem to endorse this point when they respond to complaints about tax administration by claiming that the problems are due to taxpayers' inability to file forms correctly, submit proper documentation, or otherwise comply with the tax laws. If taxpayers are unable to deal with the forms and procedures, then there is indeed a problem.

IS THE VAT TOO COMPLEX?

Since the late 1960s, the value added tax has been adopted in over 120 countries, including 10 of the 13 member states in SADC.¹⁶ The basis for this global wave of tax innovation is the relative advantage of VAT in terms of revenue mobilization and economic efficiency, compared to traditional instruments such as the turnover tax, sales tax, and import duties. Furthermore, a carefully designed VAT need not be regressive.¹⁷ VAT is operating reasonably well and has become a major source of revenue in many low income countries, including neighboring Tanzania, Zambia, and Malawi (where it is called "surtax"). To be sure, the introduction of VAT imposes a compliance burden on taxpayers, who must file regular self-assessment forms and keep accurate records of the tax paid on purchases as well as that collected on sales. In poor countries, especially, problems with VAT administration invariably arise, and the efficiency benefits are attenuated where VAT has limited coverage. Nonetheless, experts on taxation in developing countries generally conclude that the benefits of VAT outweigh the costs.

¹⁵ This paper does not address municipal taxes (*Tributarios Autárquicos*).

¹⁶ See Glenday (2004) for a thorough review of VAT systems in the SADC region, and Ebrill *et al.* (2001) for a more general review of VAT systems.

¹⁷ Keen and Simone (2004, 318) cite two careful studies on VAT in Africa, which found the tax to be moderately progressive. This is achieved—as in Mozambique—by exempting basic commodities that are heavily consumed by the poor, and setting the threshold for registration to exclude micro enterprises that cater mainly to the poor.

Thus, the government's decision in 1998 to replace the circulation tax with VAT was fully warranted in terms of principles of taxation for developing countries and best practices for countries like Mozambique. The basic structure of the VAT in Mozambique is comparable to that in many other low-income countries. Also, the standard monthly form for filing VAT (*Declaração Periódica, Modelo A*) appears to be simple enough for any enterprise with a capable part-time bookkeeper to deal with, after learning the basics. Notably, the VAT code in Mozambique includes a simplified regime for small enterprises. As outlined in Section 3, this regime is essentially a 5 percent tax on turnover, with no allowance for tax paid on inputs.

One important aspect of the VAT code bears consideration with a view to simplifying the system. That is that registration thresholds should be high enough to eliminate the obligation of very small enterprises to enter the system. As shown in the accompanying sidebar, the thresholds for VAT registration are very low even by regional standards. The normal regime now applies to enterprises with a turnover of MT 250 million—about \$12,500 per year, which amounts to about \$40 per day of gross sales. Assuming an average net profit rate of 20 percent,¹⁸ this means that enterprises earning (net) \$8 per day are in the normal system. Entities this small may genuinely lack the capability to comply with VAT procedures.

The simplified regime applies starting at a turnover of MT 100 million, which amounts to about \$16 per day, and net earnings of about \$3 per day. These people should simply not be in the system. Relative to income, enterprises of this size face onerous compliance costs, and the constant risk of penalties or demands for illicit payments if they make mistakes or fail to keep proper books—which may be the normal condition for most of them. The system should not assume that such enterprises can maintain an accurate sales register, which is required for even the simplified VAT regime. These enterprises also create a large amount of paperwork for the VAT service, while generating hardly any revenue.

IS THE INCOME TAX CODE TOO COMPLEX?

The new income tax system introduced in 2002 is basically sound, and consistent with best practices. Some of the apparent complications involve important provisions for broadening the tax base by eliminating opportunities to disguise income in forms that could otherwise

VAT Registration Thresholds

Mozambique

<i>Normal regime</i>	MT 250 million = approximately \$12,500
<i>Simplified regime</i>	MT 100 million = approximately \$5,000

Regional comparisons

Tanzania	\$18,000
Zambia	\$20,200
Malawi	\$20,800
South Africa	\$39,500
Uganda	\$50,000
Cameroon	\$60,000
Lesotho	\$66,000
Burkina Faso	\$80,000

SOURCES: Ebrill et al. (2001) and Glenday (2004)

¹⁸ Detailed national accounts tables from INE for 2001 show that the average ratio of profit margin to sales for the commercial sector was just 12 percent.

escape taxation (such as providing employees with vehicles or low income loans). Other complications, such as certain disallowed deductions, are tools that tax administrators need to combat well known forms of tax evasion. For a large business with highly skilled accountants, compliance costs for the new IRPC and IRPS codes are significant (particularly during the transition period), but not unreasonable.

Still, there are two major problems. First, most tax payers are *not* large businesses with highly skilled accountants. Indeed, there are few such accountants in the country, especially outside Maputo. Consequently, many medium-size companies and most small companies will undoubtedly have difficulty in completing the IRPC and IRPS self-assessment forms accurately, and maintaining the necessary documentation. One hears this complaint repeatedly, with good reason. As with the VAT, the income tax code does include a simplified regime to prevent these problems. Here, too, the threshold for entering the normal regime appears to be too low. Currently, the threshold is a turnover of MT 1,500 million, or about \$75,000 per year. Assuming a ratio of net profit to sales of 20 percent,¹⁹ enterprises earning \$15,000 per year are subject to the normal tax regime. Few enterprises in this size range can afford to engage highly qualified accountants. Thus, it is hard to escape the conclusion that the income tax code is too complicated for a large set of taxpayers, because of the low registration threshold. The direct solution is to increase the threshold to a level that more effectively excludes taxpayers who are incapable of complying with the full scope of the tax code. This measure should be accompanied by a thorough and sustained program to train taxpayers, accountants, and lawyers in the intricacies of implementing the new system, along with an effective campaign of public information on problems commonly encountered by taxpayers.²⁰ (This last point is a recurrent theme below.)

Even the simplified regime entails specific bookkeeping requirements²¹ that may be too complicated for many small entities. To avert these problems, the IRPC code includes special provisions for "indirect" assessments based on simple standard indicators for various types of business, as promulgated by ministerial diplomas. But no such diplomas have yet been issued. Hence, the indirect tax regime is not operational. This means that every small business is exposed to requirements of the "simplified" regime. It is a good idea, intrinsically, for the tax system to provide incentives for small businesses to adopt proper bookkeeping systems. Nonetheless, this is more of a hope than a reality in the short to medium run. The tax system should be structured accordingly. To create jobs and income opportunities for the growing labor force, it is essential to let micro and very small enterprises flourish. (Other problems with the simplified regime are discussed in the following subsection on tax rates).

¹⁹ National accounts tables from INE for 2001 show that the actual ratio of profit margin to sales for the enterprise sector (excluding agriculture) was 14 percent.

²⁰ Training seminars were delivered around the country when the new income tax code was introduced. This was an important step towards informing the public about the new tax system, but it was woefully inadequate as training for practitioners.

²¹ See articles 109 and 110 of the Código do IRPC.

The second major problem is that there certain elements of the tax code could well have been omitted in the interests of simplicity. A few examples will make the point:

- The income tax code applies to worldwide income. Very few developing countries use this system, because it is nearly impossible to implement.
- Employers are required each month to obtain personal income tax numbers for all employees and fill out IRPS forms (in triplicate, filled out manually), even if the vast majority of the workers earn incomes below the basic tax threshold of MT 2 million per month. This is an enormous waste of effort for everyone. There is no need for monthly IRPS returns to show anything more than the total payroll, payroll subject to tax, and the amount of tax remitted—subject to detailed annual reconciliation forms, and selective audit.
- The application of family allowances is a popular idea, but it requires a large amount of paperwork on the part of employers and employees, and raises cultural difficulties relating to traditional family structures. Most employees are likely to claim the maximum of three dependents anyway. Thus, the equity gains are likely to be tiny in comparison with the administrative costs.
- The provision for “special advance payment” (Article 92 of the IRPC code) is confusing and hard to justify.
- Withholding provisions on rent payments through third parties are so complicated that even lawyers have been subject to large penalties for good-faith efforts to follow the rules.

Local tax consultants have presented a proposal for a new kind of simplified income tax, called the *Sistema de Imposto Mínimo*, or SIM. The SIM would establish a fixed tax liability for qualifying entities based on indirect indicators (Ernst & Young 2004a). The proposal aims not only to streamline the tax system for small and microenterprises, but also to encourage informal entities to register. The main incentive is that the system would provide a simple method for establishing tax compliance, thereby eliminating demands for illicit payments. The SIM proposal has several flaws. First, the proposal would require collecting tax from every operating entity, however tiny. Yet the income tax is designed to exclude taxpayers with incomes below MT 2 million per month. A simpler way to regularize the tax obligation for very small enterprises is to issue an official certificate of exemption. Second, the SIM proposal would leave intact the VAT regime. Hence it would not eliminate intrusions by the tax authorities. Far better would be to introduce a single simplified tax to replace both the IRPS and the VAT, with a full exemption for enterprises that fall below a threshold that can be assessed (as in the proposed SIM) by indirect indicators.²²

²² The model here is Brazil's *Imposto Único*.

RECOMMENDATIONS ON TAX COMPLEXITY

This analysis leads to the following recommendations on steps to reduce undue complexity of the tax system in Mozambique.

- Raise the registration threshold for the *normal* VAT regime to perhaps \$50,000 per year of turnover.
- Raise the registration threshold for the *simplified* VAT regime to perhaps \$25,000 per year of turnover, to eliminate tax obligation for very small and micro enterprises.
- Raise the threshold for the *normal company tax* to perhaps \$200,000 per year of turnover (implying a net income level of about \$40,000 per year).
- Adjust these thresholds annually to compensate for inflation, to avoid dragging smaller entities into systems that exceed their capabilities.
- Accelerate implementation of the indirect tax regime under IRPC by conducting necessary studies and issuing ministerial diplomas to determine the appropriate indicators.
- Establish a joint public/private task force to identify detailed provisions of the IRPC and IRPS codes that can be simplified without a significant loss of revenue or administrative control.
- Introduce a simple unified tax for very small and micro enterprises, in lieu of the simplified VAT and simplified IRPS; exempt entities with an estimated income (based on indirect indicators) below the regular threshold for income tax liability.
- Work with nongovernmental institutions and organizations to establish comprehensive and sustainable training programs for taxpayers and accountants.
- Establish a sustained public information campaign highlighting problems that taxpayers commonly encounter.
- Adopt a public education approach in handling first-time errors in complying with the new tax code, in place of the current penalty approach.

Although the discussion here has focused on VAT and the income tax many business leaders also raise questions about the stamp tax. This tax adds unnecessary costs to vital business transactions, while raising little revenue (an estimated 0.2 percent of GDP in the 2004 budget). These facts suggest one additional recommendation for simplifying the tax system:

- Revoke the stamp tax (while applying minimal fees as necessary to cover the cost of essential administrative services).

High Tax Rates

There is a nearly universal preference for low tax rates. Businesses are no exception, because lower taxes reduce costs, boost demand, improve cash flow, and raise the effective return on investment. If this were the whole story, then taxes would simply be set at zero. Obviously, the cost of taxation has to be balanced (through the political arena) against the need for financing public goods and services—including those which benefit the business community, directly or indirectly.

The government's domestic revenue target of 17 percent of GDP by 2010 is in line with the standard for sub-Saharan Africa (19.7 percent), and for low income countries worldwide (18 percent).²³ Thus, for present purposes, the revenue targets are taken as given, and we focus on the widespread contention that they are being achieved with tax rates that are too high, and a tax base that is too narrow.

The starting point for assessing whether tax rates are “too high” is to ask: high relative to what? The most common approach is to compare tax rates against those in other countries. This criterion is pertinent for understanding how the tax system influences Mozambique’s attractiveness to “footloose” investors who are choosing among competing venues.

While footloose industries are an important target for investment promotion, most businesses do not fall in that category. Many investors are interested in opportunities to exploit local resources, as in agro-processing, tourism, wood products, or mining. Others are oriented towards the domestic market. Still others make multiple investments as long as they can make a profit in each country. For any of these categories of investment, international comparisons are not particularly relevant. The important issue is whether tax rates are “too high” to allow enterprises to earn an adequate return on investment.

The tax regime, of course, is just one of many determinants of an investment decision. Indeed, low tax rates may defeat the purpose of attracting investment if they cause a loss of revenue that cripples efforts to develop the economic infrastructure and improve market-supporting institutions.²⁴ Likewise, if tax cuts undermine macroeconomic stability, the net effect can be highly detrimental to private sector development.²⁵ Careful revenue analysis is thus a central requirement for any plan to cut tax rates.

²³ Figures from Keen and Simone (2004).

²⁴ Thus, the argument that taxes have to be low to compensate for other problems with the investment climate is not compelling, if low taxes cause the other problems to fester. For long run economic development, it is more important to strengthen the underlying foundations of the investment climate than to offer quick fixes through the tax system. The role of taxation in the investment climate is discussed in chapter 5 of the World Bank's *World Development Report 2005*. For a review of how taxation affects investment decisions in developing countries, see Bolnick (2004), chapters 2 and 3.

²⁵ Ireland and Egypt are cases where radical tax cuts were adopted to stimulate investment. However, both countries enjoyed high ratios of revenue to GDP, so the tax cuts did not undermine their ability to maintain

A third criterion is to ask whether tax rates are too high in the sense that they actually reduce revenues. The famous “Laffer curve” shows that as tax rates increase, revenue collections initially rise, then reach a peak, and then decline. An argument often heard in Mozambique is that the tax base is narrow precisely *because* tax rates are high, creating a strong incentive for potential taxpayers to remain informal, hide income and transactions from the authorities, or bribe authorities to look the other way. To apply this criterion, one requires technical studies to determine the “revenue-maximizing” tax rates as a function of estimated price elasticities. The formal analysis is beyond the scope of this paper,²⁶ but it is important to bear the issue in mind below.

ARE INDIRECT TAX RATES TOO HIGH?

Mozambique’s VAT rate of 17 percent is only slightly higher than the regional average of 16 percent (Figure 4-1).²⁷ In any case, businesses catering to the domestic market generally pass along the tax to consumers, while exporters are largely insulated from its effects (if refunds are well administered; see discussion of tax administration problems below). Hence, international differences in the VAT rate should not have much affect on investment decisions.

Various arguments have been raised in connection with a proposal from CTA to reduce the VAT rate to 14 percent. One is that with the expansion of regional trade, it would useful to harmonize Mozambique’s VAT rate with that of South Africa. This is a sensible medium-term objective, but there is no compelling reason to view the current rate differential as a serious policy problem, either for trade flows or for tourism.²⁸ Another claim is that lowering the VAT rate, by reducing prices, would stimulate demand in the domestic market. Lowering taxes obviously leaves more money in consumers’ pockets, but if a VAT rate reduction is matched by offsetting tax increases to maintain revenue neutrality, there is no net effect on incomes. In any case, where real incomes are rising rapidly a once-off boost to consumption from cutting the VAT rate to 14 percent is unlikely to have a significant impact on prospects for private sector development.

Another source of claims that the VAT rate is too high is a simple historical comparison with the previous circulation tax (CT). Under the CT, the tax rate on retail sales was just 10 percent. But this is a false comparison, since the 10 percent tax was charged on top of 5 percent taxes

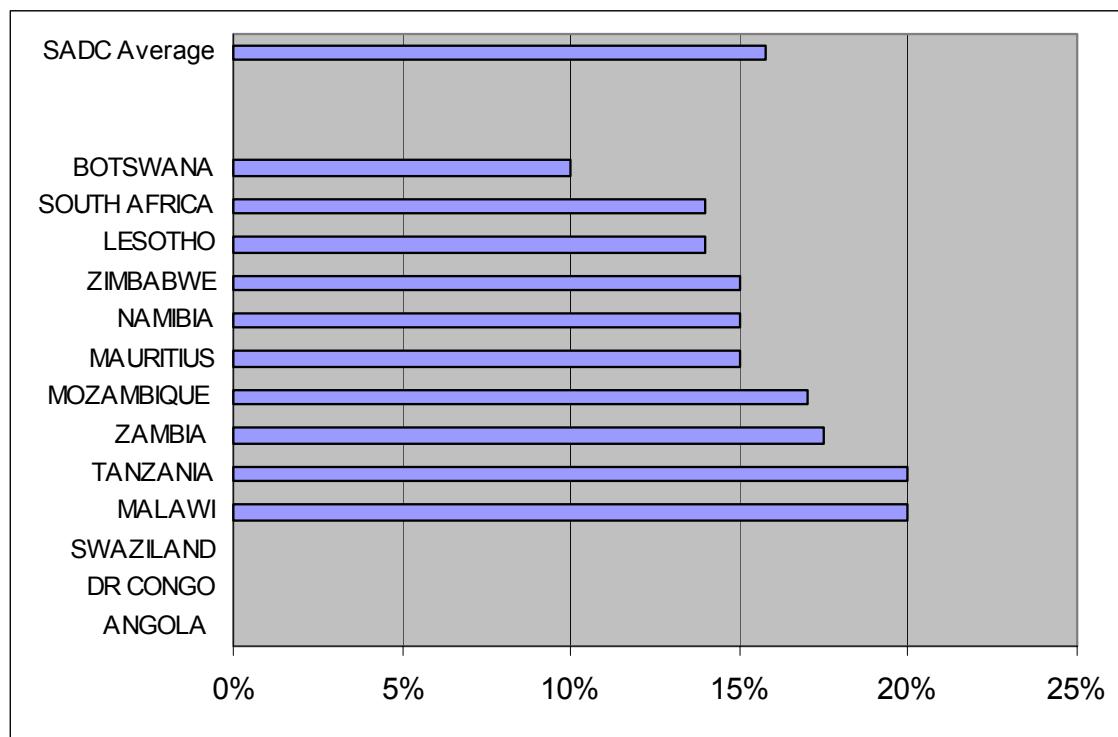
macroeconomic stability or deliver essential public services. In contrast, Tanzania in the early 1990s adopted a bold program of tax cuts, only to face a fiscal crisis that took years to reverse.

²⁶ To apply this criterion, one requires technical studies to determine the “revenue-maximizing” tax rates as a function of estimated behavioral elasticities.

²⁷ If one excludes Botswana from the calculation, on grounds that the enormous mineral revenues in that country provide a unique cushion to support rates for other taxes, then Mozambique’s VAT rate is exactly the same as the regional average.

²⁸ Glenday (2004) discusses cross-border VAT issues in detail.

Figure 4-1
VAT Rates in the SADC Region, 2003



on imports and on intermediate sales along the whole supply chain. For a simple import-to-retail transaction, the combined tax was 15.5 percent ($=1.05 \times 1.10 - 1$). For goods passing through one extra transaction on the way to the consumer, the effective tax rate was 21.2 percent. Additional supply-chain steps added further to the effective tax rate. Although final retail sales, as such, were subject to just 10 percent tax, it is incorrect to claim that tax rates were lower with the CT. The fact that the introduction of VAT increased revenue does not negate this logic; rather, it reveals that the VAT has been an effective tool for widening the tax base (see next section).

The charge that tax rates are too high is more compelling when one looks beyond VAT to import duties and excise taxes. For imported consumer goods (class C), the combined effect of 17 percent VAT and 25 percent import duty is an effective tax rate of 46.25 percent ($=1.25 \times 1.17 - 1$). This may well be over the peak of the Laffer curve—meaning that lower tax rates would expand legal imports enough to generate more revenue. The happy possibility of lowering tax rates to get higher revenue requires careful analysis by the Ministry of Planning and Finance. Note, however, that this is not an argument for reducing the VAT rate. For reasons discussed in the subsection on tax provisions below, the problem is solved more efficiently by reducing import duties.

Many goods are also subject to excise tax (*Imposto sobre Consumos Específicos*, or ICE). For these items the overall burden on imports ranges from 68 to 141 percent. (The highest rate applies

to products such as liquor, tobacco, sport aircraft, and artwork. The fact that revenue from excise tax on imports is less than 30 percent of total ICE revenue in the 2004 budget is strong evidence that ICE rates are “too high,” in that they push the tax past the peak of the Laffer curve. Lower excise duty rates may well enhance revenue.

ARE INCOME TAX RATES TOO HIGH?

Figure 4-2a shows that the 32 percent company income tax rate in Mozambique²⁹ is equal to the SADC average. Only two countries in the region have tax rates below 30 percent—Botswana and Mauritius, both at 25 percent. Mozambique’s tax rate is actually below the global average for low income countries (34.6 percent) (Keen and Simone, 2004). In terms of these comparisons, income tax rates in Mozambique are not noticeably “too high.”

A different picture emerges, however, when one examines the tax burden from the point of view of an investor who is concerned about the combined effect of the corporate tax and the tax on dividends or distributed profits.³⁰ This is called the “double taxation” of dividend income. Shareholders who reside in Mozambique face a tax of up to 53.8 percent on their investment earnings—consisting of 32 percent tax on the payout of dividends, on top of 32 percent tax on corporate profits. *This is the highest combined tax rate in the SADC region* (Figure 4-2b). Foreign shareholders face a 20 percent withholding tax on dividends, giving a combined rate of 45.6 percent—exceeded in the region only by Zambia. These combined rates impose a heavy burden on investors who are honest taxpayers—unless they plan to pull up stakes at the end of their eligibility for special tax incentives (discussed below). The high tax rates also send a distinctly negative signal about the environment for doing business in Mozambique. Since the dividend tax is difficult to collect in the hands of the recipient, it may be possible to reduce the double taxation without much loss of revenue. This should be a top priority for careful evaluation by the fiscal authorities.

Looking more deeply, the statutory tax burden is determined not just by the basic tax rates, but also by other provisions of the tax code such as depreciation allowances, investment allowances, loss carry forward, the deductibility of interest expenses, and the tax treatment of capital gains, as well as the import duty on capital goods. One way to evaluate the overall effect of the tax system on investment decisions is to calculate the extent to which taxation reduces the rate of return earned by investors, taking into account all of these features. The result of this calculation is called the Marginal Effective Tax Rate, or METR.

²⁹ 10 percent for agricultural activities.

³⁰ The analysis here focuses on profit distributions to shareholders, who are the ultimate investors. The IRPC code does allow for an offset of double taxation on profits distributed between corporate entities. Also Tax Treaties with Mauritius and Portugal eliminate withholding tax on dividend payments to shareholders in those countries. (Thanks to Dr. Ibraimo Ibraimo for this information.) Note that Mauritius exempts dividends from income tax, so investors from that island state fully escape double taxation of corporate income.

Figure 4-2a
Standard Company Income Tax Rates in the SADC Region, 2003

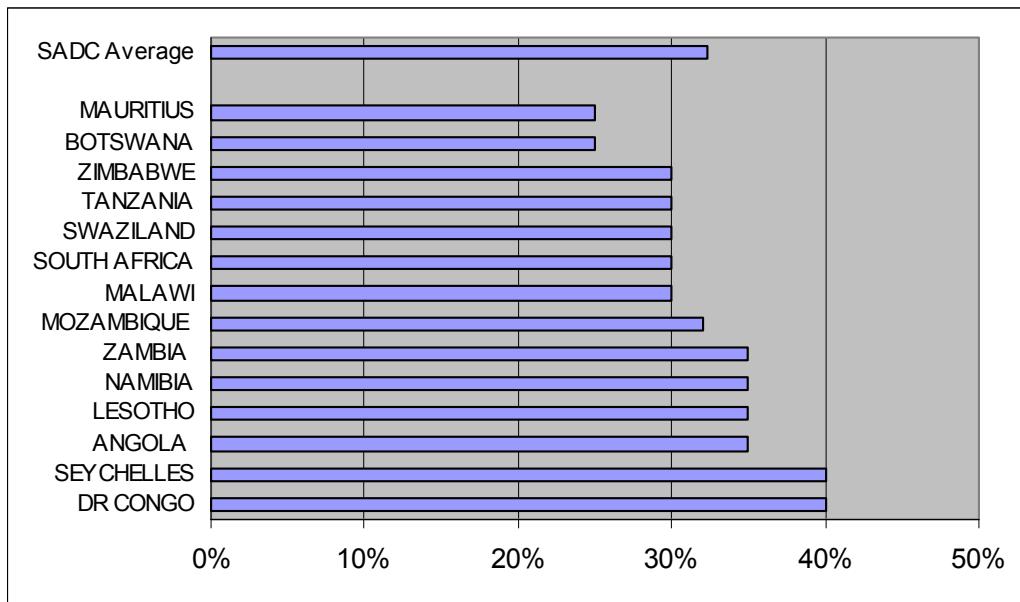
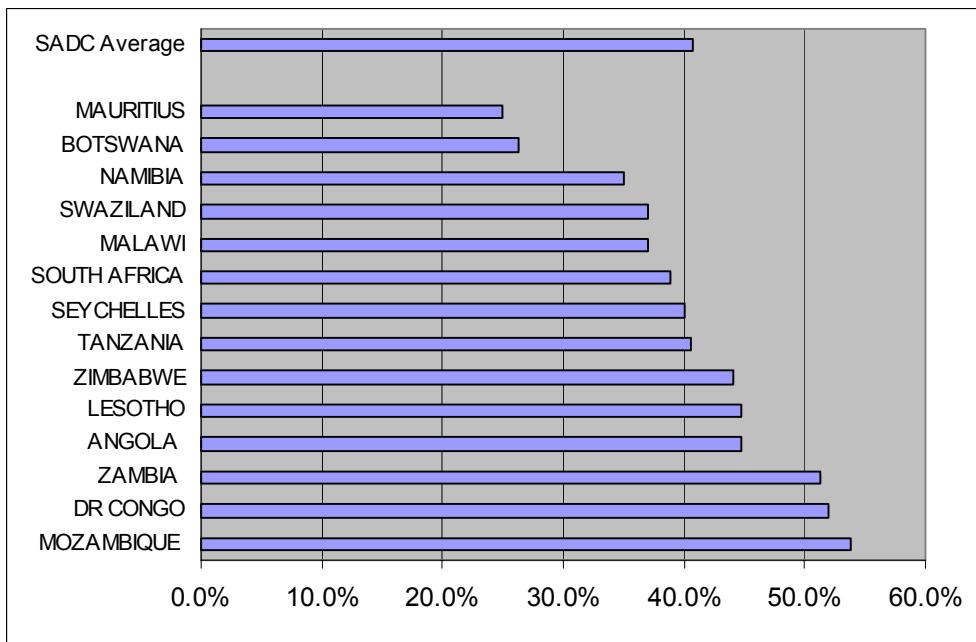


Figure 4-2b
Standard company + Dividend Tax Rates in the SADC Region, 2003



SOURCE: Bolnick (2004), with updated data for Mozambique.

Note: This figure uses dividend tax rates applicable to earnings that accrue to domestic shareholders.

The METR differs across investment projects. For example, an investment in machinery and equipment will face a different METR than an alternative project that involves investment in land, machinery, and vehicles. This is because of differences in the depreciation allowances for various types of capital. The METR also depends on the degree of financial leverage for an investment, due to the deductibility of interest expenses. To take into account this variability, the present analysis examined four illustrative project scenarios,³¹ each characterized by: a 20 percent real rate of return on equity; annual reinvestment to maintain a stable capital stock; full payout of annual net earnings; and the sale of net assets at the end of ten years, subject to capital gains tax. For an investment with local ownership, the average METR is 56 percent. This means that the tax system reduces the return on investment by more than half. An honest taxpayer who seeks a 20 percent real rate of return in Mozambique will reject any project that is expected to earn less than 45 percent before taxes.³² For a foreign-owned investment, the average METR across the four illustrative project scenarios is 48 percent. In this case, an investor seeking a 20 percent real rate of return after taxes requires a return before taxes of 38 percent.³³ These results suggest that the “tax wedge” under the standard tax system in Mozambique is one of the highest in the region,³⁴ and a serious deterrent to any investor who actually faces these rates.

However, the analysis changes dramatically when we take into account the code of fiscal benefits. For a foreign investor who benefits from accelerated depreciation, a 5 percent investment tax credit for five years, duty free imports of capital goods, and a 40 percent reduction in the company tax rate for ten years, the METR is just 18 percent. (If the investor is from Mauritius, the METR is just 4 percent, due to a tax treaty between the two countries and a zero tax on dividends at home.) For a domestic investor, the METR is still significant, at 30 percent, due to the taxes on dividend income and capital gains. Translate this into a business decision: an investor seeking a real return of 20 percent after taxes requires a 29 percent real return before taxes.

In short, the standard company tax regime in Mozambique imposes a very high marginal effective tax rate on income from a business investment. Under the *fiscal incentive regime*, investors face moderate to low marginal effective tax rates. While several SADC member states offer far more generous incentive packages—in a few cases, total tax remission—the package of fiscal benefits in Mozambique is reasonably attractive.

The problem is that the low to moderate incentive rates for new investors come at the expense of very high rates for other businesses. The tax system therefore discriminates strongly in

³¹ The scenarios combine two types of debt structure (0 percent and 50 percent debt financing) and two types of capital structure (100 percent plant and equipment, and 50 percent building plus 50 percent plant and equipment).

³² The 45 percent before rate of return is reduced by 56 percent due to taxes, leaving an after-tax rate of return of 20 percent, which is the financial target.

³³ The METR figures reported in Bolnick (2004) used out of date tax parameters for Mozambique, due to deficiencies in the SADC tax database.

³⁴ See Bolnick (2004) for regional comparisons.

favor of new investors, while adding layers of complexity to the investment process. It would be far better to offer highly attractive standard tax rates--starting with at least partial relief from the double taxation of dividends—and fewer special tax breaks.

Interestingly, actual corporate tax collections amounted to only 6.3 percent of recorded net profits for non-agricultural enterprises in 2001 (the latest year for which these data are available). This suggests that large amounts of business income escape the tax net—and that the same revenue (or more) could be collected with lower statutory tax rates, if income taxes were applied more uniformly and administered more effectively.³⁵

Turning to the individual income tax (IRPS), the new tax code sets the top rate at 32 percent. This is slightly below the SADC regional average of 34 percent (Bolnick 2004), and the global average of 33 percent for low income countries (Keen and Simone, 2005). The idea of equating top rates for the company tax and the individual income tax is sound policy, to reduce opportunities for tax evasion through restructuring the form in which income is earned. The top tax rate begins to apply at an income of MT 1008 million (approximately \$50,000); this is reasonable for a low-income country, perhaps generous.³⁶

The main problem with the individual income tax rates is that the maximum rate jumped abruptly from 20 percent to 32 percent in 2002. This is an extraordinary discontinuity in terms of size and timing. Simultaneously, the new tax code closed off some loopholes, accentuating the effective tax increase on individual incomes. Normally, major changes of this sort are phased in over a period of years, and base-broadening measures are paired with rate reductions. The private sector has good reason to squawk about the transition process.

Finally, some of the withholding tax rates appear to be excessive. A 20 percent *withholding* rate corresponds to a 32 percent tax on income only if the recipient's taxable income equals 62.5 percent of the gross receipt. For activities with a profit margin well below 62.5 percent, the same 20 percent withholding rate represents an excessively high tax on income. Note that the simplified regime assumes that profits are of 30 percent of gross revenue for activities outside the trading sector. To be consistent, the withholding rate on payments to such entities should not exceed 10 percent.

³⁵ This inference is “suggested,” rather than demonstrated, because the figure appearing in the national accounts is not directly comparable to the tax base. First, the enterprise sector is much broader than the corporate sector (though formal corporations are likely to earn the vast majority of enterprise income). Second, taxable income is different from net profit as tabulated in the national accounts, due to capital allowances, loss carry-forward, and other technicalities. A large part of the gap between the actual tax yield and the statutory tax rate, however, is surely explained by the broad provision of investment tax incentives.

³⁶ By comparison, in Portugal, the 34 percent bracket is reached at an income level of Euros 15,683, and the top rate is 40 percent. Source: http://www.worldwide-tax.com/portugal/por_incom.asp.

RECOMMENDATIONS ON TAX RATES

In summary, neither the VAT rate nor the standard income tax rate is out of line with standards for the region, or for low-income countries. Still, the basic rates are not especially attractive, except for investments covered by the code of fiscal benefits. Furthermore, when one takes into account the interaction between various elements of the tax system, the overall tax burden is high indeed, for both direct and indirect taxes.

Mozambique would be in a far better position to foster private sector development if the government would offer more attractive standard tax rates. In particular, the following targets are reasonable *medium-term strategic objectives, contingent on the fundamental need for prudent fiscal management*:

- Reduce the standard VAT rate from 17 percent to 14 percent.
- Reduce the maximum import duty to 20 percent, and then to 15 percent. Combined with the prior recommendation, this would lower the combined rate of VAT plus duty on imports of consumer goods from 46 percent to 35 percent (which is still high, in terms incentives for tax compliance).
- Reduce the IRPC rate and the maximum IRPS rate from 32 percent to 25 percent, as fiscal conditions allow.
- As a priority, reduce the double taxation of dividend income by adopting provisions to integrate the company tax and the individual tax on dividends, at least partially.

The hard part is finding a way to pay for these rate reductions. There are four possible options:

- *"Supply-side" dynamics.* Tax rates can be reduced without compensating measures if lower taxes fuel faster growth. In this case, the tax reductions could be self-financing. This theory has strong adherents, but it is a hope rather than a plan. A variation on this theme is a suggestion to negotiate special donor financing to fill the interim revenue gap that would arise due to a slow supply response. This is also a risky option, because the supply-side revenue dynamics may not materialize before the special donor funding ends. In any case, donor funding for Mozambique is on a declining trend, relative to GDP, so the extra financing is not likely to be available.
- *"Elastic" taxes.* The slow-but-sure approach is to ensure that the tax structure is "elastic," in that the ratio of revenue to GDP will rise automatically with economic growth. This is achieved partly through a progressive income tax schedule. In addition, VAT revenue should expand relative to GDP with monetization and formalization of the economy, and as rising incomes expand expenditure on taxable transactions as a percentage of total consumption. With an elastic tax system, automatic revenue growth can be used in part to improve public services, and in part to cut tax rates.
- *Laffer curve tax cuts.* If certain tax rates are above the peak of the Laffer curve, revenues can be increased by lowering these rates. This is particularly likely for some of the excise taxes

(ICE), but also possible for class C imports (consumer goods) in general. The fiscal authorities should undertake technical studies to identify items for which tax rates exceed the revenue-maximizing level. It is unlikely, though, that large revenue gains can be obtained this way.

- Widen the tax base through a combination of new revenue measures and improved tax administration. These options are discussed in the next two sections.

A critical implication of this analysis is that the government must strengthen its capacity for estimating revenues and evaluating the revenue impact of potential tax policy measures. Any major proposal to cut tax rates requires careful planning to avoid the risk of revenue losses that could jeopardize macroeconomic stability.

Narrow Tax Base

The business community contends that the cost of financing public services falls disproportionately on a small number of heavily taxed formal enterprises (including their role as agents for withholding tax), while large sums of money remain outside the tax system due to tax evasion, corruption, ineffective tax administration, and tax laws that discourage the registration of informal enterprises. The implication is that there is ample scope for widening the tax base in order to pay for lower tax rates overall. Drawing on this logic, considerable discussion has focused on finding ways to bring the informal sector into the tax net. This section begins by addressing this issue, and concludes that large revenue gains should *not* be expected from this source. Hence, we also examine a variety of other instruments for broadening the tax base.

TAXING THE INFORMAL SECTOR

A large fraction of economic activity clearly remains outside the tax system. Most of the compliance gap can be explained by widespread poverty, tax equity, and inherent constraints on tax capacity due to limited administrative resources, high rates of illiteracy, a large rural population, and widespread auto-consumption. Basically, it makes a great deal of sense *not* to tax multitudes of very poor people. Thus, the VAT system exempts basic goods consumed heavily by the poor, and the income tax code excludes individuals earning less than MT 24 million per year. As a matter of principle and administrative reality, informal entities with incomes below this threshold should not be in the tax net.

More specifically, detailed national accounts tables for 2001 (obtained from MPF) show that value added in the enterprise sector, excluding agriculture, represented 48 percent of GDP. This can be viewed as the theoretical maximum base for the company income tax plus IRPS withholding by employers. Private consumption, excluding auto-consumption, amounted to 57 percent of GDP. This can be considered as the theoretical maximum tax base for indirect

taxes. Thus, about half of GDP is out of bounds for any realistic expectation of mobilizing revenue. Similar conditions are found in all low income countries, without exception.

Within this set of taxable activities, it is entirely normal for the bulk of income tax and VAT revenue to come from a relatively small number of formal enterprises. The reason is simply that incomes and transactions tend to be highly concentrated. According to Ebrill, *et al.* (2001, 117), a rule of thumb for VAT systems around the world is that 90 percent of the revenue derives from 10 percent of the taxpayers. A similar phenomenon applies to most income tax systems. Terkper (2003) cites a pair of “80/20” rules: 80 percent of the revenue comes from 20 percent of taxpayers, while 80 percent of the administrative cost in many jurisdictions is devoted to ineffectual efforts to tax small and medium enterprises. These statistics underpin the widespread emphasis on creating large taxpayer units, as an early component of tax reform in many countries.

Applying Terkper’s logic, the tax system can be improved by having tax officers concentrate on handling a few thousand files efficiently, rather than trying to cover tens of thousands of very small taxpayers. A recent study by Ernst & Young (2004b) notes that more than 13,000 enterprises were registered for the normal VAT regime in Mozambique in 2004, and more than 10,000 were registered for the simplified regime. (Nearly 12,000 were recorded in the exempt regime.) Yet those filing under the simplified regime accounted for just 0.4 percent of the revenue. As discussed earlier in the section on tax system complexity, there is a strong case for raising the thresholds for tax coverage, which would actually narrow the coverage of the tax base, but with little effect on revenue. Indeed, the revenue effect is likely to be positive, because administrative resources could be deployed more effectively.

Nonetheless, efforts to bring informal entities into the tax net are still important. Terkper (2003) points out, tellingly, that tax evasion among small and medium taxpayers “can adversely affect revenue and compliance among all taxpayers.” He makes a useful distinction between three “hard-to-tax” groups:

- “Small and vulnerable taxpayers that should be exempted from most tax obligations;
- “Other small taxpayers that pay presumptive taxes in lieu of income and consumption taxes; and
- “Large and medium entities that are capable but fail to comply and for whom presumptive measures must be used primarily as a control mechanism.”

As just discussed, the first group should remain outside the tax net. The second one is the proper domain for the simplified VAT and income tax regimes, or a new single tax in place of these two separate regimes (see section on tax system complexity). It is group three that poses the central challenge for base broadening. Indeed, much of the anger about tax evaders in the informal sector centers on competition from enterprises that operate well above the margin of subsistence. One approach that merits consideration is a presumptive tax based on *objective* “outward signs of lifestyle.” Thuryoni (1996, chapter 12) describes a system like this in

Lesotho, where the tax authorities are legally mandated to estimate taxable income for non-filers or suspected under-reporters using a formula based on indicators such as air travel, value of principle and secondary residence, children in private schools, and value of motor vehicle. The success of any effort to apply a presumptive tax to relatively well off tax evaders requires well trained and honest tax officials, backed by a high level of political support.

The value added tax, itself, is a device for taxing the informal sector. This base-broadening characteristic arises by virtue of the fact that VAT is levied at each stage in the supply chain. An unregistered trader or producer may escape VAT on sales, but the government still collects the tax on any inputs purchased from a registered supplier. In addition the VAT has built-in incentives for enterprises to register voluntarily. Any vendor who wants to sell to a VAT-registered entity is under pressure to provide a proper VAT invoice. Otherwise, the customer cannot legally claim credit for the VAT component of the purchase cost. The customer can reduce its costs by purchasing instead from a registered vendor.

As an indication of this base-broadening effect, note that VAT revenue equaled 5.5 percent of GDP in 2003, compared to 3.3 percent of GDP raised in 1998 by the circulation tax. This large increase in revenue cannot be explained in terms of a higher tax rate (as explained in section B, above).

Moreover, there is evidence that the effective coverage of VAT in Mozambique is fairly good compared to other low-income countries. A common index of VAT collection efficiency—the ratio of VAT to GDP, adjusted for the tax rate—is higher in Mozambique than the average for sub-Saharan Africa, and well above the index value for neighboring low-income countries.³⁷ Also, Ernst & Young (2004b) reports that the number of registered VAT filers in Mozambique increased between 2002 and 2004 by 43 percent for the normal VAT regime, and by 64 percent for the simplified VAT regime.³⁸ These figures show that the VAT service is succeeding in widening the tax net—perhaps beyond the point where it is worthwhile to expand coverage.

The new income tax code also has built-in provisions to capture some of the income accruing to unregistered enterprises. The main device is a relatively broad requirement for formal sector companies to withhold tax on provision for withholding tax on payments to contractors.³⁹

³⁷ The index is defined as the ratio of VAT/GDP to the VAT rate. An index value of 1.00 means that VAT is collected on 100 percent of GDP. The index value for Mozambique in 2003 is .32, compared to an average of .27 for sub-Saharan Africa (Ebrill, *et al.*, 2001), and values of .28 for Zambia, .24 for Malawi, and .21 for Tanzania. To some extent, the relatively high index value for Mozambique could reflect the severity of the backlog of VAT refunds.

³⁸ These figures represent the number of registered filers. The Ernst & Young Study did not report the number of *actual* filers.

³⁹ The IRPC and IRPS also incorporate base-broadening features unrelated to the informal sector problem, such as a relatively comprehensive definition of taxable income, and limitations on certain deductions that are prone to abuse. These provisions are one cause for complexity of the income tax codes.

Registration of medium and small enterprises should be part of the plan for expanding the tax base. But one should not expect large revenue gains from adding multitudes of small informal entities to the system. The search for revenue enhancement must focus elsewhere.

OTHER AVENUES TO BROADENING THE TAX BASE

Three main avenues for broadening the tax base are stronger tax administration, elimination of loopholes and special incentives, and new tax instruments.

Putting aside the issue of micro and small enterprises, weak tax administration allows more substantial businesses to evade or avoid their full tax obligations. The associated revenue loss is a major impediment to reducing tax rates. Important reforms to strengthen tax administration are in various stages of implementation or planning, including the establishment of a central revenue authority, the creation of large taxpayer units with specially trained officials, computerization of tax records and procedures, and the linkage of files across tax services. Also, the introduction of self-assessment procedures should allow tax administrators to allocate staff more efficiently, by facilitating risk-based inspection and audit practices rather than requiring full scrutiny of every return.

One key requirement is a more concerted training of tax officers. Another is to pursue stronger programs to stem the hemorrhage of revenue due to corruption. Special teams might also be mobilized to target relatively high-income groups that are prone to evasion or avoidance, such as non-resident entities doing business in Mozambique, independent professionals (lawyers, doctors, consultants), landlords, and local staff of foreign embassies and agencies.⁴⁰ In the customs arena, special teams performing random real-time checks on import clearances might significantly reduce smuggling or false declarations. Some countries have solicited technical assistance to create high-powered audit teams to crack down on tax cheats, while simultaneously providing on-the job training for local tax auditors. Such devices may have a high pay-off in broadening the tax base by reducing evasion.

A second avenue for base broadening is the elimination or reduction in loopholes and selective tax breaks. To some extent this has been achieved already via the new tax codes and fiscal benefit packages enacted in 2002. Nonetheless, a large part of the gap between actual and potential revenue in Mozambique, as in most other countries, probably reflects tax provisions that have been adopted for industrial policy purposes, without adequate regard for the revenue costs. These can be enormous, because wealthy corporations and individuals constantly seek ways to take advantage of special tax breaks to shelter income that should be fully taxed.⁴¹ Investment incentives also generate large revenue losses if tax-favored businesses gain sales and income at the expense of fully taxed competitors. Finally, the

⁴⁰ Apologies to friends in these positions.

⁴¹ For examples, see Bolnick (2004), chapter 3.

administration of special incentives impairs revenue simply by diverting tax personnel to tasks other than tax collection. In any case, the evidence is mixed as to the effectiveness of special tax breaks. Where conditions for profitable investment are absent, the unintended costs of fiscal incentives may far outweigh actual benefits.

The revenue losses from incentive programs are hard to measure. At a minimum the government should move towards issuing regular reports on “tax expenditures,” using established methods for computation, as soon as data systems are in place to support the analysis. Fiscal transparency is a cornerstone for improving the tax system. More generally, the capacity for tax policy analysis needs to be strengthened to ensure that special tax breaks are cost effective and genuinely serve the public interest.

The third basic approach to broadening the tax base is through new revenue measures. One possible measure, discussed above, is a presumptive tax based on outward signs of lifestyle, to catch high income tax evaders.

Probably the largest potential revenue gains, however, can come from emulating Botswana – where revenue from the exploitation of natural resources (and earnings on the prudent investment of prior resource revenue) has financed a large expansion of public services and enabled the government to lower other tax rates. In developing mineral resources such as natural gas, titanium sands, coal, and gemstones, as well as renewable resources such as timber and fishing, the government should bargain skillfully for retention of a large share of resource rents. These are not footloose investments that could just as well move to Bangladesh or El Salvador. They should not require generous fiscal incentives.

Another option that may be worth consideration is an alternative minimum tax (AMT)⁴² on corporate turnover or net assets. The idea is to ensure that every company makes at least a minimum contribution to financing infrastructure, market-supporting institutions, and human capital investments. If pursued, the AMT should be applied at a very low tax rate.

A final consideration is that efforts to broaden the tax base are intimately connected to the quality of government expenditure. If taxpayers feel that their tax payments are wasted or misdirected then compliance will be low, and tax reforms will be far less effective. Programs to improve public expenditure management and increase efficiency in the delivery of public services go hand in hand with tax reform.

RECOMMENDATIONS ON BROADENING THE TAX BASE

In summary, the following recommendations emerge from the analysis of options for broadening the tax base:

⁴² The reason this is called an “alternative minimum” tax is that it applies in lieu of the standard company tax, for companies that report losses for tax purposes, or income so low that their tax bill is less than the AMT.

- Avoid the false expectation that large amounts of revenue can be raised by taxing micro and small enterprises – along with the trap of diverting large administrative resources to this function.
- For targeting higher-income tax evaders, consider introducing a presumptive tax based on objective outward signs of lifestyle.
- Pursue ongoing programs to strengthen and modernize tax administration; in particular, intensify staff training and efforts to fight corruption in the tax service.
- Mobilize special teams to inspect and audit groups that are especially prone to evasion, and (in customs) to perform random checks on import clearances.
- Build capacity in Ministry of Planning and Finance for careful economic and fiscal analysis of alternative instruments for stimulating investment; based on this analysis, eliminate or reduce loopholes and selective incentives that are not cost effective.
- Enhance fiscal transparency by adopting tax expenditure budgeting and issuing regular public reports on the fiscal cost of tax incentives.
- Maximize domestic retention of resource rents from the exploitation of mineral resources and renewable natural resources. This is a top priority.
- Consider the adoption of a corporate Alternative Minimum Tax.
- Enhance tax compliance by pursuing ongoing programs to reform public expenditure management and improve public service delivery.

Problems with Tax Administration

Problems with tax administration are cited as a major impediment to private sector development in Mozambique. Inadequate control of tax evasion was discussed above in conjunction with measures to broaden the tax base. This section focuses on three other problems: delays in processing VAT refunds; discretionary assessments and penalties; and the underlying problem of corruption in the tax system.

VAT REFUNDS

Many problems with tax administration, as seen by the business community, mirror concerns about tax evasion, as seen by the revenue authorities. Fair and effective revenue mobilization requires diligent inspections and audits, vigilant detection of improper efforts to exploit tax loopholes, and tough penalties for violations of the tax law. The VAT refund mechanism is a prime example. VAT systems everywhere are vulnerable to fraudulent refund claims. Improper claims arise from false export declarations (including “round tripping,” where goods are exported to generate a refund claim and then smuggled back to the country of origin), or invalid invoices that overstate the amount of VAT paid on inputs. Mozambique is

no exception to this rule.⁴³ The VAT service is therefore on firm ground in trying to handle refund claims carefully.

Yet there are major problems with way the VAT refund system is being administered. One hears from the business community example after example of prolonged delays, sometimes exceeding one year, along with implicit or explicit demands for side payments to grease the wheels.

One first-hand report cited companies that are owed \$40 million in VAT refunds. Another cited an overdue refund of \$1 million, plus accumulated interest of \$250,000.⁴⁴ If these figures are accurate, refund arrears—being money that does not belong to the government—may account for as much as 10 percent of total VAT revenue for 2004. Equally important, many businesses incur substantial financing costs due to VAT refund delays (these costs are discussed in the next section). Especially for exporters, the added cost undermines the advantage of the VAT system, which is designed to improve competitiveness by eliminating domestic indirect taxes on export sales.

Senior tax officials often respond to these arguments by contending that the average processing time for VAT refunds is well within the legally mandated period of 45 days. They also claim that processing times are improving, and that long delays are attributable to improper documentation, or disputes arising from improper refund claims.

Thus, there is a sharp divergence between what the private sector says about long and costly delays, and statements by the government. One clear conclusion is that the VAT refund process suffers from a fundamental lack of transparency. The VAT service can easily clarify the facts by issuing regular public reports on refund claims (sidebar). Information on VAT refund delays is reported regularly to the IMF, which is concerned about monitoring government liabilities. The public has at least an equal right to know, especially given the

VAT Refund Reports: A Proposal

The VAT service can enhance transparency, strengthen incentives for improving efficiency of the refund process, and help the public separate rumors from facts, by issuing Monthly Reports on VAT Refunds. At a minimum the reports could provide monthly data on:

The monthly number and amount of refund claims (pedidos de reembolso)

- Received
- Accepted for processing
- Returned for further documentation
- Outstanding, within the legal time frame
- Outstanding, beyond the legal time frame

For claims approved during the month,

- Average time to approval, from date of initial claim submission;
- Average time to approval, from date the claim was accepted for processing.
- % approved within legal time frame
- % approved beyond legal time frame
- Interest paid on overdue approvals

Similar monitoring reports would improve transparency in other areas of tax administration, such as the processing of import and export shipments, and income tax refunds.

⁴³ In the course of field work, the author saw evidence of refund claims that were partially denied by the VAT service. The claims were supported by a list of VAT payments on the purchase of inputs. But some of the items were purchased from suppliers who were VAT exempt or not registered (so that VAT could not legally be charged on the transaction). Other parts of the refund were rejected due to lack of documentation to substantiate that VAT had been paid. This evidence suggested that the VAT service did a proper job of inspecting the refund claim, examining the “invoice trail,” and finding invalid or unsubstantiated elements.

⁴⁴ For obvious reasons, the sources cannot be identified here. Even though these are firsthand reports, they were not documented.

widespread perception that these delays are a serious burden on the private sector. Greater transparency will also create more effective incentives for the VAT service to fix the problems.

The government's argument that refund delays are due to problems with documentation points to a second clear conclusion: the authorities must provide taxpayers with better information on procedures and requirements for obtaining refunds. The government should issue pamphlets and media reports providing examples of common problems encountered in the refund process, along with simple explanations about how taxpayers can avoid these problems. When the VAT was launched in 1998-1999, the government ran an impressive campaign to educate the public about the system. Today, it is difficult to obtain any information at all. Even though the monthly VAT declaration form (*Modelo A*) provides a very simple procedure for initiating a refund request (*pedido de reembolso*), more information is needed about documentation required to substantiate a request.

Another major problem is the procedure used to process refund claims. Currently, every claim is subject to scrutiny. This system can be greatly streamlined by converting to risk-based selective inspections. In particular, a regular exporter with a track record of submitting accurate claims should be accorded "gold card service," resulting in immediate payment of any claim up to a designated ceiling—subject to random audit and penalties for non-compliance.⁴⁵ At the other end of the spectrum, thorough inspection of every small claim may cost more than it is worth in potential revenue gains. Random selective inspections are usually more cost-effective than comprehensive inspections, providing for a more efficient allocation of administrative resources. In both of these cases, a reasonable change in procedures can result in prompt refunds for many clients and better service for all, without any serious revenue risk. These approaches are most effective with computerized taxpayer records. Upgrading of the information technology for the VAT service should therefore be a top operational priority.

A separate procedural problem is that refund requests from outside Maputo are referred to the capital for decisions. Authority for approving and paying refunds should be delegated to provincial offices as quickly as training programs and control systems allow.

The VAT refund process is also criticized on grounds that refund payments, once approved, are treated as expenditures that require funding from the Treasury. As a matter of principle, this is indefensible. Approved refunds involve money that rightly belongs to the taxpayer, not the government. In any case, the National Director for Budget and Planning says that the budget has no line item for VAT refunds; the revenue is booked on a net basis, so refunds should be paid out of current receipts, without requiring treasury approval. A thorough system audit may be needed to establish whether the treasury's cash management system is consistent with the budget treatment of tax refund. If not, the system needs to be fixed.

⁴⁵ This term is from Ebrill *et al.* (2001), chapter 15.

VAT refund delays may also be related to problems with the design of the VAT code, which overloads the system with too many claims. Refund claims arise when a registered entity pays more VAT on procurements than it owes on sales. This is called a “net credit” position (*excesso*). For most viable businesses, taxable sales almost always exceed the value of procurements. Exporters are different because they owe zero VAT on their sales (*isenção completa*); hence, they qualify for refunds virtually every time period.

The VAT website (www.iva.mz) states that refunds for non-exporters should only arise in “exceptional circumstances,” such as start-ups that incur large initial procurement costs along with low sales, or entities that undertake a large capital investment relative to sales. Even for entities that encounter a transient net credit position, most VAT codes require a carry-forward several months, after which credit positions usually self-extinguish. This system avoids the administrative headache of handling frequent claims for small refunds. Under the VAT code in Mozambique, net credits carry over for 12 months. If anything, this is an excessively long period. But refunds can be claimed *immediately* if the credit exceeds MT 50 million. This low limit defeats the purpose of the carry-forward, allowing small refund claims—most of which would be resolved by a few months of carry-forward—to clog the system.

A contributing factor is that the VAT system in Mozambique provides for an unusually broad set of exemptions. Goods such as wheat flour, bread, rice, and “common” bicycles are granted “complete exemptions,” or zero ratings.⁴⁶ The intent is clearly to make the system more equitable. But from an administrative point of view, zero-rating producers who pay VAT on their inputs generates more VAT refunds for processing. Zambia and Kenya dealt with the equity problem without expanding the scope for VAT refunds, by exempting *unprocessed* foods and excluding small and micro enterprises from the VAT registration net. Processed products for the domestic market were not zero-rated.

The general point is that reducing the number of refund claims—by raising the net credit limit or narrowing the scope of zero-ratings—will improve turn-around times for all those taxpayers who do qualify for refunds. To repeat the message from the IVA website: refunds should be exceptional, not commonplace.

Two other points merit brief attention. First, a huge backlog of refund claims evidently arose in 2000 due to the urgent need to rebuild infrastructure following the devastating floods that year. The government engaged emergency construction services without a clear plan on how to handle VAT liabilities. As a result, the tax was collected on imports of construction materials and equipment, and to this day the refunds have not been cleared. These arrears have badly tarnished Mozambique’s reputation as a place to do business. In retrospect, the problem could have been avoided with a simple decision by the government to pay the tax to itself via offsetting book entries, with no net effect on the budget.

⁴⁶ VAT Code, Article 19 as amended in Decree 16/99.

Second, there is no excuse for further delay in establishing the long-discussed public-private Task Force to investigate the VAT refund problem. To resolve the impasse on this hot-button topic, which has cost the government a considerable loss of credibility, the VAT service should take the lead in making sure that the Task Force succeeds.

DISCRETIONARY IMPLEMENTATION

The business community is also highly critical about the degree of discretion exercised by many tax officials in determining assessments and penalties. Discretion leads to unpredictable tax bills, arbitrary fines, and corrupt practices. A recent survey of 100 firms in Inhambane found that unofficial payments cost the median firm an average of 5 percent of gross revenue –which represents a much higher share of net profit. Respondents identified customs and tax officials, along with traffic police, as the most corrupt public officials in that province (Berlin University of Technology 2003). While the problems may be unusually severe in Inhambane, the issue is prevalent throughout the country.

In the course of field interviews, some highly qualified tax professionals stated that their clients do not have any serious problems with errant tax officials. But others said the opposite. The author heard of rampant negotiations with tax officers; companies driven out of business by competitors who pay bribes in lieu of taxes; a company that sought clarification from one tax official only to be fined by another; a foreign enterprise that was hit with an enormous fine for a violation that did not exist, according to his attorney; and businesses that encountered unexplained re-assessments and penalties. A senior tax official stated that every tax office is required to provide a written explanation for each judgment against a taxpayer, and trained to do so. Nonetheless, examples abound of administrative abuses and corruption in the tax system, as perceived by entrepreneurs, accountants, and attorneys. The perception, itself, adversely affects the investment climate, and tax compliance.

What are the main sources of discretionary implementation of the tax code? Many businesses believe that tax officials levy arbitrary assessments in order to meet revenue targets. While plausible, this is difficult to substantiate. More obvious problems arise from structural and administrative features of the system. For example:

Both the simplified VAT regime and the simplified income tax regime are based on turnover. But many small enterprises lack skills to provide accurate information on total sales. This is an open invitation to discretion and negotiation. The recommendation made earlier to raise the thresholds for VAT and income tax eligibility will go a long way to remedy this problem.

The indirect regime in the income tax code is designed to deal with enterprises that cannot provide minimally acceptable accounting registries. But guidelines have not yet been issued for determining income in these cases. This, too, creates huge opportunities for discretion by tax inspectors in dealing with vulnerable small enterprises.

The new code of tax penalties (*Regime Geral de Infracções Tributárias*) provides an extraordinarily broad range of fines for many infractions. For example, the penalty for lack of required financial records (Article 23) ranges from 3 million to 1000 million meticais per violation. The code stipulates that penalties should depend on the gravity of the offence, and exceed the economic benefit of the transgression to the taxpayer. It also distinguishes between simple and grave offenses. Yet inadvertent mistakes can easily be classified as “grave” offenses. Especially when taxpayers are adjusting to a new tax code, they should not be subject to enormous penalties for errors that might be made in good faith. This is a stellar example of how the tax system can create tremendous uncertainty, even for honest businesses.

Information from multiple sources suggests that tax inspectors personally receive a share of fines and penalties (*multas*) that they levy. The idea of providing incentives for diligent inspections is laudable, but this is an awful way to go about it. Direct sharing—combined with a lack of public information, highly discretionary penalties, and ineffective appeals procedures—promotes harassment of taxpayers, classification of simple errors as “grave” offenses, and imposition of excessive penalties. The practice should be ended.⁴⁷

CORRUPTION

Many of the problems with tax administration are integrally related to corruption. This issue cuts across the entire range of public services. It is especially serious in the context of the tax system, because this is the most important financial interface between government and the private sector. Furthermore, in the absence of effective controls, dishonest taxpayers have an inherent incentive to evade tax obligations (the famous “free-rider” problem), while dishonest and tax officials have an incentive to facilitate or encourage this practice in exchange for a share of the gains. This is not the place for an extensive discussion of anti-corruption programs, but several points are worth making. Steps that can be taken to reduce corruption in the tax system include better pay and better training for tax officers; improved information technology in tax administration; measures to minimize discretion in the application of tax laws; effective disciplinary systems with heavy sanctions (including jail terms) for errant tax officers; better public information about the tax system; and an efficient systems for tax appeals.

Establishment of the new Revenue Authority can go a long way towards dealing with these issues—if it is carefully structured, adequately funded, professionally managed, and free from political interference. Another valuable measure (echoing the discussion of VAT refunds)

⁴⁷ The Ministry of Industry and Trade (MIC) recently restructured its system for allocating funds obtained from penalties to eliminate the personal incentives for abusive inspections. This model should be emulated throughout the government, as part of the solution to the widespread problem of corruption.

would be to increase transparency by undertaking and publishing periodic corruption surveys that cover tax administration, as well as other areas of public service.

RECOMMENDATIONS ON TAX ADMINISTRATION

This analysis of impediments to private sector development due to poor tax administration suggests twelve major recommendations to improve the processing of VAT refunds, reduce discretion in tax assessments, and fight corruption in the tax service:

- Enhance the transparency of VAT refund administration by publishing monthly reports on claims and approvals.
- Provide clear and regular information to the public about procedures and requirements for VAT refunds.
- Adopt risk-based selective audits for inspecting VAT refund claims, including “gold card” treatment of regular exporters with a track record of accurate claims.
- Conduct a system audit of VAT refund procedures to ensure that valid claims can be paid without separate approval from the Treasury.
- Reduce the volume of refund claims by increasing the threshold for claiming immediate payments, while reducing the carry-forward period for credit positions to 3 months; the volume of refund claims can be further reduced by eliminating “complete exemptions” (zero-ratings) for manufactured products that are not exported.
- Activate the public-private Task Force on VAT refunds.
- Issue the guidelines for the indirect regime in the new income tax code.
- Amend the new regime on tax infractions (*Regime Geral de Infracções Tributárias*) to reduce the range of discretion and establish more transparent rules for determining the magnitude of tax penalties.
- End the sharing of tax penalties with officers involved in the decisions.
- Adopt a tough anti-corruption program, including heavy sanctions for errant tax officials.
- Implement the planned Revenue Authority, ensuring that it is adequately funded and professionally managed, without political interference.
- Undertake and publish periodic corruption surveys.

Cash-Flow Costs

The tax system can also impede private sector development (and enhance incentives for tax evasion) by imposing unnecessary cash-flow costs on businesses. Such costs can be a serious problem for businesses with weak balance sheets, low profit margins, and limited access to

working capital, particularly when interest rates are high. This section examines cash-flow issues relating to VAT and the income tax.

CASH-FLOW AND THE VAT

The problem of VAT refund delays was already discussed at length. Here our concern is to assess the cost of these delays to the taxpayer. Conventional wisdom suggests that the cost is very high. This perception is supported by widely cited figures about the amounts overdue. In the absence of government reports on refund delays, these figures are hard to confirm, but one can easily examine the impact of VAT refund delays using illustrative examples.

Using the simple example outlined in Exhibit 4-1, including an interest rate of 27 percent per annum for financing working capital, a business that encounters an average 3-month delay in obtaining VAT refunds incurs excess financing charges of \$0.52 per \$100 of turnover. If the cost is passed to the consumer, the sales price would be higher by just 0.5 percent, which is unlikely to cause serious disruptions.

However, if the product price is externally determined—as is the case for many exporters, as well as firms selling domestically at an import parity price—then the firm must absorb the extra cost. In the example cited, the extra financing charge from an average 3-month delay *cuts net profit by one-fourth*. A 6-month delay would cut net profit in half, and a 12-month delay would eliminate net profit altogether. This simple example shows that the cash flow cost of refund delays can indeed be a very big problem, particularly for exporters who face stiff market competition and operate on thin profit margins. One of the main advantages of the value added tax is to remove the competitive disadvantage of domestic indirect taxes on exporters; refund delays work at cross purposes with this objective.

A related cash-flow issue is the handling of VAT credits arising from the purchase of capital goods. This is not a serious problem for small incremental investments, since the credit for VAT paid on the capital goods will quickly be offset by VAT liabilities on sales. However, when capital outlays are large relative to taxable sales, a refund will normally be required. Long delays then increase the effective cost of capital goods and reduce the return on investment. For example, with a 27 percent market interest rate, a 12-month delay in obtaining the VAT refund would increase the capital cost by 5 percent. The magnitude of this effect is moderate, but not insignificant. Many countries adopted special rules to defer or quickly recoup VAT paid on the purchase of capital goods (Ebrill *et al.* 2001, 155-165). The simplest method is simply to charge zero VAT on capital goods, but this can lead to a revenue loss to the extent that such goods are purchased by non-registered companies or by final consumers (since some capital goods have dual use). In either of these cases, the VAT foregone on the purchase of capital goods is not recovered by VAT charged downstream. Schemes restricted to VAT-registered entities are more appropriate, but harder to administer.

In any case, the fiscal authorities should seriously examine alternatives to the system prevailing in Mozambique for refunding VAT on the purchase of capital goods.

Exhibit 4-1

Excess Financing Costs from VAT Refund Delays: An Illustrative Example

To illustrate the financial effect of VAT refund delays, consider a simple example. Suppose that a firm has \$100 of final sales, with a 25 percent gross profit margin. Thus, the cost of goods sold is \$75. Let purchased inputs account for 60 percent of this cost, or \$45. At a tax rate of 17 percent, the firm then pays \$7.70 in VAT on its inputs. Let the firm be zero-rated and eligible for a full refund, but unable to recover it for 3 months, on average. With an interest rate of 27 percent per annum—approximately the prevailing rate in Mozambique—the cost of financing a 3-month delay is $27\% \times 3/12 \times \$7.70 = \$0.52$ per \$100 of final sales. If the average delay were 12 months, the financing cost would be \$2.07 per \$100 of final sales.

If the financing charge can be passed along to consumers, then the firm will have to increase its product price by 0.52% for a 3-month refund delay, and 2.07% for a 12-month delay. These amounts are not much to scream about. The picture is bleaker, however, when one compares the financing charge to *net* profits. Since the income tax rate is 32 percent, net profits are 68 percent of the gross margin less

depreciation. Let's assume that depreciation charges average 10 percent of the capital stock, and that the capital stock is 4 times value added (in other words, the capital-output ratio is 4). With these parameters, the *net* profit margin is just over 2 percent of gross sales revenue. Thus, the cost of financing a 3-month delay in the VAT refund absorbs over one-fourth of net profits. If the average delay is 12 months, net profits disappear altogether.

If the purchased inputs are imported, then import duties may also apply. Then the amount of VAT paid, the VAT refund due, and the cost of the refund delay are all increased by the average duty rate on those inputs.

Other things being equal, each of the following factors increases the share of net profit absorbed by the financing cost: a longer refund delay; a higher interest rate; a lower gross profit margin; higher capital intensity; a higher depreciation rate on capital; a higher ratio of purchased inputs to total costs; a higher import share; and a higher duty rate on imported inputs.

All of these cash-flow problems can be mitigated if the government would simply honor its statutory commitment to pay interest on overdue refunds. In reality, the government does not make these payments. This is a scandalous breach of the law on the part of the government, which should be the target of loud and persistent complaints from the business community. In addition, the interest rate applied to both overdue tax payments and tax refunds is MIBOR plus 2 percent, far less than the actual cost of working capital to the business community. By using this low interest rate, the government fails to compensate businesses for excess financing costs caused by refund delays—while simultaneously providing an incentive for businesses to delay the remittance of tax payments as a cheap source of working capital. If the government were to pay interest on overdue refunds at a rate reflecting the cost of working

capital to the business community, delays would be much less costly to the taxpayers, and much more efficiently handled by the government.

Some members of the business community object to the very idea of paying VAT up-front on purchases and then recovering the payments out of the tax due on sales. Yet this is the heart of a successful VAT system. A single-stage sales tax, once the most popular form of indirect taxation, is far more difficult for authorities to enforce effectively because there is no trail of interlocking invoices, and nothing at all gets collected when the final seller evades the system. Consequently, the tax base is narrower, and other tax rates have to be higher to generate any given revenue target. This vital feature of the value added tax should not and will not be altered.

Finally, some businesses object to the payment of VAT on top of import duties. This apparent double taxation is the normal structure for the VAT. Recall that the VAT is intended as a tax on consumption. Import duties are part of the supply price to consumers. Hence, it is appropriate to include the import duty in the base for calculating VAT. The same is true for excise taxes. Besides, if this were not done, then the VAT would favor imports over domestic supplies (whose cost structure includes duties paid on imported inputs). Thus, it is not advisable for the government to alter this provision of the IVA code.

CASH-FLOW AND THE INCOME TAX

Turning to the income tax code, the main cash-flow issue encountered in field interviews is the obligation of corporate taxpayers to self-assess and remit quarterly advance payments, estimated as 80 percent of taxable income from the previous charge year.⁴⁸ Previously, provisional payments were semi-annual, based on 75 percent of the previous year's taxable income.⁴⁹ This is not a major change, and in any case the new rules are in line with international standards. Collecting estimated payments quarterly is good public policy, to smooth out revenue flows and minimize the erosion of real revenues due to inflation.

Other aspects of the income tax system that involve cash flow costs include the sharp increase in withholding tax on wage income, which led some employers to raise wages, and uncertainties about the arbitrary imposition of heavy penalties. These issues were discussed earlier.

RECOMMENDATIONS ON CASH-FLOW ISSUES

The main recommendations relating to unnecessary cash flow costs imposed by the tax system are to:

⁴⁸ IRPC code, Articles 90-93

⁴⁹ For Groups A and B, as defined under the former business profits tax.

- Take urgent steps to expedite VAT refunds, as discussed in the previous section.
- Re-assess provisions of the VAT code involving refunds for large capital outlays.
- Enforce statutory provisions for the government to pay interest on overdue refund payments.
- Consider amending the stipulated interest payment to establish an interest rate that more closely reflects the actual cost of funds to the business community, such as the prime rate plus 2 percentage points, rather than MIBOR plus 2 percentage points.

Tax Provisions That Tilt the Playing Field

The *World Development Report 2005* (95) explains that “tax structures often benefit favored groups, distorting competition and foisting higher taxes on others.” Tax provisions that favor some producers over others undermine the principles of efficiency and equity. In practice, it is hard to avoid some differentials, such as the advantage that informal operators have over registered enterprises. As discussed earlier, this is one of the most prevalent concerns of business leaders in Mozambique. In most cases, though, tax differentials are the result of policy choices. If these choices are based on a thorough analysis of benefits and costs, they can be good public policy. An example would be carefully calibrated fiscal benefits that stimulate net new investment (which would not otherwise be made) in activities bearing large positive externalities, such as new technology. Too often, however, adverse effects on efficiency and equity are unintended consequences of well-intended tax preferences that are introduced without adequate consideration of the impacts.

This section briefly examines three important tax policies that tilt the competitive playing: the code of fiscal incentives; differential rates of effective protection created by the structure of import duties; and the special customs regime for manufacturing. The discussion also examines how the tax system works against the compelling need for rapid job creation by creating a bias in favor of capital intensive investments.

TAX INCENTIVES (*BENEFÍCIOS FISCAIS*)⁵⁰

The tax code is a convenient tool for social and economic engineering. As a result, tax incentives are widely used to encourage investments in particular sectors, regions, or activities. Do such incentives achieve the intended results? Is their overall impact beneficial to economic development? Tax incentives have been highly successful in some countries, such as Malaysia, Ireland, Costa Rica, and Mauritius, when accompanied by a consistent framework

⁵⁰ This section is based on Bolnick (2004), which provides a detailed analysis of the economics of investment tax incentives.

of supportive policies and institutions.⁵¹ In many other contexts, however, incentives have been ineffective—or even counterproductive, in that they complicate tax administration and create loopholes that companies and wealthy taxpayers use to evade taxes, while stimulating little new investment.

Investment tax incentives grant new investors a strong advantage over competing producers.⁵² Moreover, by reducing the tax yield from new investments, incentives necessitate higher taxes on other entities, thereby accentuating the disadvantage faced by domestic competitors. Tax incentives also create a strong incentive for companies to shut down existing capital stock in favor of new investment, even if this is wasteful in terms of efficiency. Often, incentive programs encourage transient investments, which shut down once the incentives end, as well as investments of low productivity, which are only viable due to the tax break. (High-return investments generally do not require tax breaks, since they will proceed on their own merit. In this case, incentives are largely redundant. They simply transfer money from the treasury to business owners, with no ultimate effect on the investment decision.)

For all these reasons, the starting point for using tax policy to stimulate private sector development should be to establish an attractive overall tax system with moderate tax rates that apply even-handedly to broad tax base. Equally important, the tax system must generate revenue growth to finance improvements in the investment climate, in the form of infrastructure, market-supporting institutions, and human capital. To the extent that special tax incentives tilt the playing field against established producers or impair revenue mobilization, their impact on development is less than meets the eye.

Tax incentive programs therefore must be designed carefully to ensure that the benefits outweigh the costs. Capacity building to improve tax policy analysis in the Ministry of Planning and Finance is therefore a central priority.

EFFECTIVE RATES OF PROTECTION

This paper focuses mainly on income taxes and the value added tax. But import duties are too important to leave out of the discussion about how taxes tilt the competitive playing field. In this case, the tilt favors domestic producers over import competition, so one does hear many objections from the private sector. In any case, the government has been steadily lowering trade barriers. Duty rates in Mozambique are currently among the lowest in the region, including a maximum tariff of 25 percent on consumer goods, and a trade-weighted average

⁵¹ Bolnick (2004) discusses these cases, and also gives examples from Indonesia and Uganda where the abolition of tax incentives had no discernible effect on investment flows.

⁵² *Indirect* competition occurs when new investments produce goods or services that are substitutes to some extent for the output of existing producers. If the tax incentives are limited to pure “pioneering” investments that do not compete against existing enterprises, or to dedicated exporters, which similarly do not compete in the domestic market, then this bias does not arise.

tariff of about 9 percent. These rates are set to decline further through the SADC trade protocol, and a policy commitment to reduce the maximum duty rate to 20 percent in 2006.

As tariff distortions are less serious in Mozambique than in many other developing countries, the point of raising the issue here is not to suggest that radical changes are needed. Rather, the purpose is to explain how import taxes affect economic efficiency, in order to support continuation of the trade reforms, and guard against pressures for back-tracking.

Import duties serve two obvious purposes: first, to raise revenue, and second, to create a margin of protection for domestic producers. The revenue motive is questioned by specialists in tax policy for developing countries, on grounds that a broad-based consumption tax such as VAT can raise the same revenue with fewer distortionary effects that reduce productivity and retard growth. Thus, protection is the primary justification for import duties. The debate centers on the extent and pattern of protection.

The concept of Effective Rate of Protection (ERP) is commonly used for analyzing this issue. The ERP is a measure of the extent to which import duties shelter domestic producers from import competition. It is determined by the level of import duties and by the *difference* between the duty rate on imported inputs and on imports of competing final products. Even with a relatively moderate duty of 25 percent on competing imports, the ERP can exceed 100 percent for industries where the domestic content is relatively low, and inputs are imported duty free. Exhibit 4-2 explains how this works.

An ERP of 100 percent means that the tariff schedule shields domestic producers from import competition (apart from smuggled goods) even if their operations cost twice as much as in other countries. A 25 percent tariff can therefore foster highly inefficient production. An escalated tariff schedule—with low duty on inputs and higher duty on outputs—tilts the playing field in favor of activities with low domestic content, and so discourages backward linkages. In addition, import taxes create an anti-export bias by drawing capital and labor into the production of importables,⁵³ even if where such investments are fundamentally unproductive.

On balance, a gradual program of moving towards lower and more uniform tariffs can enhance productivity, stimulate exports, and improve the prospects for long-run growth, while still offering moderate protection to domestic producers.

Special Customs Regime for Manufacturers

An important example of how the tariff schedule can be used to tilt the playing field is the special customs regime for manufacturers (*indústria transformadora*) established in Ministerial Diploma No. 99/2003. This regime allows qualified firms in six sub-sectors to import required

⁵³ Importables are goods that can be obtained as imports.

capital goods, raw materials, and intermediate goods duty free.⁵⁴ The value of the special regime to beneficiaries is self-evident, as it reduces their costs while allowing them to maintain their product price (which is often determined by the duty-inclusive cost of competing imports).

Exhibit 4-2

Import Duties, Effective Rate of Protection, and Economic Efficiency

The effective rate of protection (ERP) measures the extent to which import duties shelter inefficient domestic producers from import competition. Consider a domestic firm that produces cooking oil worth \$100 per unit in the world market. If the import duty on cooking oil is 25 percent, then the firm can charge the *metical* equivalent of up to US\$125 and still compete against imports in the domestic market. Suppose the firm uses imported inputs that cost \$60 in the world market, bearing an average duty rate of 2.5 percent, the cost of the inputs in the domestic market is \$61.5. This firm can meet or beat import competition as long as the margin between the output price and the cost of imported inputs does not exceed $\$125 - \$61.5 = \$63.5$, the domestic value added, or VAd. In the world market, competitive producers convert the same inputs into cooking oil with a value added margin of VAw = $\$100 - \$60 = \$40$.

The ERP is the difference between VAd and VAw, expressed as a fraction of the latter, which represents the international competitive standard. In this case, the ERP is

$$\text{ERP} = (\$63.5 - \$40)/\$40 = 59\%$$

This is called the effective rate of protection, because it shows the extent to which domestic

Production is protected, in the sense that the transformation process can operate at 59 percent higher cost (in this example) than international rivals and still compete in the domestic market. The level of the ERP depends on the duty rates applied to imported outputs and the respective inputs. The ERP also depends strongly on the domestic content of the production activity. The following calculations show how powerful the protection effect can be, assuming the same duty rates as given above:

<i>Domestic content</i> ⁵⁵	<i>ERP</i>
20%	115%
40%	59%
60%	40%
80%	31%
100%	25%

Lessons. The lessons from this analysis are remarkable. First, the tariff differentials in place in Mozambique can shelter highly inefficient activities. Second, protective tariffs favor investments with low domestic content; this distortion discourages the development of backward linkages. Third, very high levels of protection can be delivered without reducing the duty on imported inputs to zero.

SOURCE: Adapted from Nathan Associates (2004), *Mozambique Diagnostic Trade Integration Study*.

⁵⁴ The six sectors are agro-industry, the food industry, textiles and garments, metals and machinery, graphics, and chemicals, plastics and batteries. Qualified firms must have annual sales of at least MT 6 billion (approximately \$300,000), with value added of at least 20 percent. The diploma also establishes rather complicated paperwork requirements.

⁵⁵ Domestic content is defined as the difference between the value of the product and the cost per unit of imported inputs (valued at world market prices).

A recent paper by LaFleur (2004) correctly points out that the special customs regime tilts the playing field in two ways. First and foremost, the regime discriminates against smaller firms that do not qualify for the exemption, and unsophisticated firms that cannot manage the extensive paperwork requirements. This creates a huge competitive advantage for larger enterprises, which are typically more capital intensive. As a result, the regime may indirectly reduce job creation for the economy as a whole.

Second, to the extent these special exemptions reduce government revenue, taxes for other entities have to rise. This does not mean that other tax rates rise, but that opportunities for more balanced tax cuts are foregone. The special tariff regime also increases the degree of tariff cascading and thus the effective rate of protection for qualified companies, with all of the implications discussed in the previous section. LaFleur's recommendation to replace this system with a uniform minimum (non-zero) duty rate for all inputs is well taken.

Tax Bias Against Labor-intensive Investment

The discussion in the previous paragraph mentions that the special customs regime benefits large enterprises, which tend to be relatively capital-intensive, to the detriment of smaller enterprises, which tend to be more labor intensive. This is extremely important, because rapid job creation is essential for sustainable poverty reduction. Policies that impair labor-intensive activities make it more difficult to improve employment opportunities for the expanding labor force, and eventually boost real incomes throughout the economy.

Unfortunately, this is not the only element of the tax system that creates a bias against labor intensity. The Code of Fiscal Benefits is replete with provisions such as investment tax credits, initial investment allowances, and accelerated depreciation, which link the benefits to capital outlays. These incentives tend to be most valuable for capital-intensive investments.⁵⁶ More surprising is the provision (in Article 18 of the Code) that restricts the deductibility of training costs to 5 percent of taxable income. This is of no use to companies that are in a tax loss position—which is typical of new investments in the early years. In any case, this provision is out of line with the general presumption that there are significant externalities from training, implying that legitimate training activities should be encouraged rather than restricted. Indeed, many SADC countries offer special tax incentives to stimulate training and employment.

⁵⁶ The bias against labor-intensity is just one criterion for evaluating tax incentive instruments. As emphasized by Zee *et al.* (2001) and Bolnick (2004), capital allowance instruments are preferably in many ways to other forms of tax incentive, such as tax holidays.

RECOMMENDATIONS ON TAX PROVISIONS THAT TILT THE PLAYING FIELD

Like most tax systems, the regime in Mozambique has many provisions that distort incentives and favor certain activities over others. Some tax preferences may be justifiable, but most reflect a combination of political pressure and inadequate tax policy analysis. Prospects for efficient private sector development and poverty reduction would be enhanced by taking steps to improve the neutrality of the tax system, and reduce the “tilt” that discourages exports, backward linkages, and labor-intensive investments. The main recommendations following from this analysis are:

- Limit the scope of special tax incentives, and use the revenue so gained to reduce general tax rates.
- Continue the program of phased tariff reductions, with the objective of achieving a regime with lower and more uniform tariffs, to reduce the distortions that foster inefficiency and impair backward linkages.
- Replace the special customs regime for manufacturing with a low uniform tariff on business inputs (K, M and I).
- Review provisions of the income tax code and the code of fiscal benefits to provide stronger incentives for training.
- Enhance capacity for tax policy analysis, to ensure that incentive programs are highly cost effective, with a minimum of distortionary side effects—especially side effects that discourage job creation.

Inadequate Public Information and Dialogue

Many of the problems discussed above could have been resolved by now with better communications between the tax authorities and the private sector. Instead, deficiencies in the provision of tax information and in the quality of public-private dialogue on tax issues pose yet another problem that requires attention.

PUBLIC INFORMATION

The availability of tax information to the public is poor. Even though every legal document is published in the *Boletim da República*, neither an index nor back issues are easily accessible.⁵⁷ When the new income tax codes were issued in 2002, authorities did a very good job of organizing seminars around the country, through a local consulting company. The seminars provided participants with a solid introduction to the new codes. Yet one-shot seminars are

⁵⁷ The tax laws are said to be available on CD-ROM from a local company called Pandora.

not a substitute for the production and distribution of regular information to the public, including clear explanations of common tax problems.

Tax codes themselves can be obtained on the internet,⁵⁸ but most of the electronic documents do not consolidate the amendments enacted by subsequent decrees. Accountants and lawyers who specialize in taxation maintain full files, but this solution is too expensive for most taxpayers. Also, taxpayers can arrange meetings with local tax officials to seek clarifications, but this does not solve the general problem of making it easy for the average taxpayer to understand and comply with the tax laws.

The information problem is exemplified by a visit made by the author to the VAT office in Maputo, seeking material on procedures for obtaining VAT refunds. Aside from tax forms, there were no manuals, flyers, brochures, or copies of the laws and regulations on any VAT issue, either in Portuguese or in English.⁵⁹

According to a senior official in the General Tax Directorate (DGI), the government has plans to improve the flow of information to the public through better websites and a quarterly magazine offering facts, advice, and examples to the public. These measures cannot come too soon. Furthermore, the tax services need to change the mindset of tax officials, to integrate educational functions into daily interactions with taxpayers, including tax inspections. These points may be generally accepted, and yet implementation can be difficult due to funding, staffing, and management constraints.

PUBLIC-PRIVATE DIALOGUE

Business leaders constantly criticize the ineffectiveness of public-private dialogue on income tax and VAT policy (though consultation with customs seems to have improved). There is certainly no lack of contact. On a formal level, the annual Private Sector Conference provides a regular venue for discussing impediments to business development, including tax issues. As noted above, the tax authorities arranged seminars around the country to introduce the new tax codes. Tax authorities also participate in other intermittent discussions with the private sector, including meetings with the CTA. Furthermore, individual entrepreneurs frequently visit the fiscal authorities to discuss tax problems and lobby for pro-business reforms.

⁵⁸ See: www.mic.gov.mz/docs/doc/index.htm and www.mozlegal.com. For major provisions, one can also refer to global tax compendia published annually by accounting firms such as Ernst & Young and PricewaterhouseCoopers. The code of fiscal benefits for investors is a prominent exception. It is readily available from the CPI, and on the internet at www.cpi.co.mz (among other locations), in both Portuguese and English.

⁵⁹ A very helpful tax officer told me that he might be able to get permission from his chief to photocopy some materials, if I could come back in two or three days. Obviously, this is not a viable system for dealing with the public's general need for information. When the IVA was introduced, the service produced an excellent set of brochures and flyers. Interestingly, *IVA Boletim* No 1, from May 1999 headlines the message that "O dialogo e a tonica principal" (dialogue is the principle tonic). None of this material is now available, and the dialogue has not worked.

The problem is therefore the quality of the discussions, on both sides of the table. From the point of view of the private sector, the government has not been receptive to their views about problems with the tax system. As a symptom, they point to the fact that the government sought CTA comments on drafts of recent tax reform decrees on very short notice, and only after major decisions had essentially been determined. From the government's point of view, the business community may well be viewed with a degree of suspicion as representing special interests rather than the public good. To overcome this perception, business representatives need to be well prepared to present their case for particular reforms in terms of overall effects on public policy objectives.

Experience in other countries strongly suggests public-private dialogue on tax policy can be very productive. Consultations can help to improve the design of tax policy, because business leaders bring important knowledge about many technical issues, and insights about how the system affects the taxpayers. At the same time, consultations can deepen the private sector's understanding of the motivation for various tax provisions, beyond direct consideration of business interests. Finally, an effective dialogue may help to forge a consensus on a vital fiscal policy issues. Government participants should therefore view consultations as an important mechanism for learning about problems, educating a major constituency, and strengthening the coalition in favor of good tax policy. The consultations may also serve to improve tax compliance by creating a more cooperative, less adversarial relationship. In the process, however, officials do need to be cautious about distinguishing between special pleading of the business lobby and important insights from the business community for improving the tax system.

RECOMMENDATIONS ON PUBLIC INFORMATION AND DIALOGUE

To improve the quality of public information and dialogue, the government should consider the following measures:

- Allocate staff and financial resources to producing and distributing public information about the tax system, including copies of the tax codes with an up to date consolidation of amendments, and information on regulations and procedures.
- Develop a multi-media public information campaign including radio and television spots on tax issues (as done for traffic violations) and posting of all major tax documents (including authorized English translations) to a well-publicized website.⁶⁰
- Train tax officers, including tax inspectors, to integrate education functions into every contact with the public.

⁶⁰ Preferably with a fast server. The VAT website, for example, has quite a bit of material, but it is extremely slow.

- Assist other institutions and organizations to establish affordable education programs for the public on taxation.

5. Conclusions

The objective of this paper has been to evaluate a series of issues raised by business leaders about elements of the tax system which they perceived to be impeding development of the private sector, and thus overall economic development and poverty reduction. The paper examines seven inter-related concerns: that the new tax codes are too complex for local conditions; that tax rates remain too high; that the tax base is too narrow; that tax administration is inefficient, arbitrary, and prone to corruption; that the tax system imposes onerous financing costs on businesses, by making undue demands on cash flow; that the tax system tilts the playing field against many domestic producers; and that public information and public-private dialogue regarding the tax system have been highly inadequate.

The basic findings are, first, that recent tax reforms in Mozambique are solidly in line with best practices for low income developing countries; and second, that despite the proper overall direction of the reforms, every one of the concerns raised by the business community warrants serious attention.

Based on this analysis, the paper offers nearly 50 recommendations for consideration by the CTA and the government. Some recommendations point to reforms that are already in the works, such as the establishment of an autonomous revenue authority, improvements in public information about the tax system, and further reductions in the maximum tariff rates. Most of them, however, involve technical, administrative, or procedural measures that do not appear to be on the current agenda.

Perhaps the most fundamental recommendations are that the government needs to develop much stronger capacity for tax policy analysis, and a more effective dialogue with stakeholders such as private sector organizations. These steps are instrumental in helping the government to achieve revenue targets more efficiently and equitably, while at the same time improving the climate for productive private investment.

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Appendix. Persons Contacted

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