



**USAID**  
FROM THE AMERICAN PEOPLE

# Investing in Mozambique

## The Role of Fiscal Incentives

February 2009

This publication was produced by Nathan Associates Inc. for review by the United States Agency for International Development.



# Investing in Mozambique

## The Role of Fiscal Incentives

### **DISCLAIMER**

This document is made possible by the support of the American people through the United States Agency for International Development (USAID). Its contents are the sole responsibility of the author or authors and do not necessarily reflect the views of USAID or the United States government.



# Acknowledgments

This report was funded by USAID's Mozambique Trade and Investment Project. The author, Bruce Bolnick, is a Principal Associate at Nathan Associates Inc. He wishes to thank Ashok Menon, the project Chief of Party; Ken Gunn, Gerry Marketos, and Jahir Adamo from Cimpogest, who did the field work and wrote the survey report (available at [www.tipmoz.com](http://www.tipmoz.com)); Rupa Ranganathan, who assisted with development of the questionnaire; and Pooja Pokhrel and Molly James from Nathan Associates who assisted with the analysis. Any errors are solely the responsibility of the author.



# Contents

<b>1. Introduction</b>	<b>1</b>
<b>2. The Policy Debate</b>	<b>3</b>
The Case for Fiscal Incentives	3
And The Case Against	4
<b>3. Taxes and Fiscal Benefits in Mozambique</b>	<b>7</b>
<b>4. Studies of the Tax Burden in Mozambique</b>	<b>11</b>
<b>5. Investment Trends in Mozambique</b>	<b>13</b>
<b>6. Survey Methodology and Coverage</b>	<b>17</b>
<b>7. Survey Findings</b>	<b>21</b>
Motives for Investment	21
Role of Fiscal Incentives	23
Cost of Obtaining Incentives	26
Quality of Information	27
<b>8. Conclusions</b>	<b>29</b>
<b>References</b>	<b>33</b>

## Illustrations

### Figures

Figure 5-1. Foreign Direct Investment Inward Flows to Mozambique, 1990–2007	14
Figure 5-2. Investments Approved by the CPI, 1990–2007	15
Figure 5-3. Investments Approved by CPI, Excluding Mega-projects, 1990–2007	15

### Tables

Table 6-1. Company Characteristics—Survey Responses	19
Table 6-2. Company Characteristics—Planned Investments	20
Table 7-1. Importance of Selected Business Factors to the Investment Decision	23
Table 7-2. Planned Investment Characteristics by Reported Impact of Income Tax Incentives	25

# 1. Introduction

Numerous surveys and studies have been done in Mozambique to identify barriers to private investment—the negative side of the business environment. Yet hardly any information is available on factors that motivate investors to commit resources to business opportunities in Mozambique—the positive side of the business environment. The purpose of the present study is to examine this neglected side of the equation by reporting on survey results from a stratified random sample of companies that obtained investment approvals in 2005, 2006, and 2007 to qualify for fiscal benefits (*benefícios fiscais*) and guarantees on the remittance of funds abroad.

The survey explored a variety of motives for investment, focusing primarily on the effect of fiscal benefits on investment decisions. This is a perpetual source of policy debate, and yet there is a keen lack of empirical evidence on the effectiveness of incentives or the associated benefits and costs under various conditions. Much of the available evidence is circumstantial, anecdotal, or based on problematic econometric techniques.<sup>1</sup>

The best form of evidence would come from econometric studies using microeconomic data based on natural experiments or well-defined control groups. Yet there is also merit in exploring the efficacy of fiscal incentives by seeking evidence directly from investors. This approach is in the spirit of survey work pioneered by the World Bank to obtain detailed information on the characteristics of private sector firms, strengths and weaknesses in the investment climate, the quality of the institutional environment for doing business, compliance costs for paying taxes, and even the prevalence and cost of corruption. A previous study in Mozambique found that most investors do respond candidly to questions about the role of fiscal incentives in *ex post* surveys—even though they might all have argued strongly in favor of incentives *ex ante* (Macamo 2000). Yet this approach has rarely been applied to studying the effectiveness of fiscal incentives.<sup>2</sup> In this light, the present paper can be considered an experiment in testing the value of survey data to obtain microeconomic data on how fiscal incentives affect investment decisions.

The paper is organized as follows. Section 2 reviews the policy debate about tax incentives. Section 3 describes the evolution of the code of fiscal benefits and company tax system in

---

<sup>1</sup> Klemm (2009) reviews the empirical literature. He finds considerable evidence that taxes have a significant effect on FDI in general, and that R&D tax credits do influence expenditure on R&D in developed countries. But he also finds that “there is very little work specifically addressing tax incentives for general investment, particularly in developing countries” (p. 22).

<sup>2</sup> Two such studies are Halvorsen (1995) for Thailand and Canh and others (2004) for Vietnam. These are discussed briefly in section 6 below.

Mozambique, followed in section 4 by a summary of several studies on the tax burden there. Section 5 examines investment trends in relation to changes in the incentive regime. Section 6 explains the survey instrument and sample characteristics, and section 7—the heart of the paper—reports the survey findings. Finally, section 8 summarizes the main points and offers concluding observations.

## 2. The Policy Debate

Should tax incentives be used to attract or stimulate foreign and domestic investment in developing countries? The case against special tax breaks is usually put forth by officials responsible for tax policy and public finance management, with support from their advisors and consultants. The case in their favor is usually advocated with great vigor by officials responsible for investment promotion, with support from their advisors and consultants. Not surprisingly, *potential investors* are also vocal proponents of tax incentives, and frequently demand them as a condition for committing funds to a country with a weak business environment (even if they would invest anyway). Divergent views co-exist, too, in the donor community and even within the World Bank group. Many international experts assist host governments in designing fiscal incentives while others advise governments to scale back or eliminate them.

### THE CASE FOR FISCAL INCENTIVES

The basic argument for incentives is that they are indispensable in attracting investment to developing countries and compensating for other constraints in the business environment. The main arguments are reasonably familiar, and can be stated briefly:

***Enhancing the return on investment.*** Investment decisions are driven by expectations about the prospective risks and returns, specifically *after tax* returns. By lowering the tax burden for designated investors, incentives increase the expected returns and shift the balance in favor of implementing the investments.

***Signaling to investors.*** Tax incentives are a marketing device that can get investors to look seriously at business opportunities in the host country. And getting them in the door is an important first step in investment promotion.

***Tax competition.*** Foreign direct investment operates on a global stage. Each developing country has to compete with comparable destinations for investments that stimulate growth and job creation, including countries that offer attractive incentives.<sup>3</sup>

***Externalities.*** Economic theory justifies interventions to stimulate investments that generate significant positive externalities, such as technology transfer and training, where the private return to investors can be much lower than the overall economic return. As a result, market forces lead to under-investment. Tax incentives are a convenient and practical tool for influencing decisions in favor of such investments.

---

<sup>3</sup> Klemm (2009) contends that tax competition is likely to be a major driving force.

***Compensation for other deficiencies in the investment climate.*** Tax incentives help to offset the costs and risks faced by investors in low-income countries with serious structural and institutional constraints such as poor infrastructure, a weak legal/judicial system, and low labor productivity due to poor education, health, and nutrition.

***Incentives can work!*** In many countries tax incentives have helped attract foreign investment. The widely cited prototype is Malaysia, where generous incentives helped trigger the transition from a poor resource-based economy to a rapidly growing and industrializing “tiger.” Countries as diverse as Mauritius, Ireland, and China followed similar strategies with similar results.

## AND THE CASE AGAINST

Some arguments on the other side of the debate involve technicalities that are less familiar to nonspecialists and therefore merit a bit more explanation for the sake of clarity.

***Limited effectiveness.*** Tax incentives will not affect investments for which the expected profit rate *before tax* falls short of the investor’s risk-adjusted hurdle rate—in other words, investments that are not fundamentally viable. Given the underlying risks and costs of doing business in many low-income countries, many possible investments will be immune on this count to the influence of tax incentives.

Among projects that are fundamentally viable, incentives affect the investment decision only if the tax element flips the expected return from below to above the hurdle rate. For investments with moderate returns, incentives can indeed be a critical factor. But projects with solid fundamentals surpass the hurdle with or without incentives. In such cases the incentives are “redundant,” in that they do not actually affect the investment decision.<sup>4</sup> The fact that investments take place using incentives does not mean that the incentives were a determining factor. Yet they still improve the recipient’s bottom line—at the expense of the Treasury. Hence, the fact that potential investors demand incentives is no indication that the tax breaks are actually needed.

Incentives, however, can be decisive in attracting “footloose” export-oriented investments that could just as well locate elsewhere. If alternative venues offer markedly more favorable conditions, even attractive incentives will be ineffectual. Also, when generous tax holidays trigger this type of investment, beneficiaries tend to leave when the holiday ends or restructure to qualify again for incentives as a new entity.

***Revenue loss.*** One hears that the revenue effect of fiscal incentives may be nil or even positive because there would be no income to tax from the beneficiary projects in the absence of the incentives. As a generalization this is invalid. Revenue losses are likely, and likely to be large. To the extent that incentives are redundant (which is difficult to measure), revenue loss is full and direct. Even where incentives do stimulate new investment, revenue is lost to the extent that a smaller tax break would have done the trick (something also hard to measure).

---

<sup>4</sup> Tax incentives are also redundant when granted to a U.S. company that repatriates profits; this is because the host-country tax break is negated by loss of a home-country tax credit. Tax incentives may also be ineffective if the procedures entail costs or delays that outweigh the benefits.

A second major revenue loss arises from the fact that preferences create loopholes. Any competent tax lawyer or accountant can and will structure corporate transactions to increase the income reported by tax-favored affiliates and reduce that of affiliates that are fully taxed, at potentially great expense to the Treasury.

A third revenue loss occurs indirectly, to the extent that tax-favored investors pull business away from fully taxed competitors. An extreme example nearly occurred in one African country when the government offered a ten-year tax holiday to attract a large investment by a foreign bank. The decision was reversed when government tax specialists pointed out that this tax break would give the new bank a huge advantage over existing banks, which were the largest taxpayers in the country. The foreign bank ended up investing anyway.<sup>5</sup>

***Economic distortions.*** Taxes distort economic decisions and reduce the efficiency of resource allocation. To the extent they are effective, fiscal incentives add to the distortions by drawing resources artificially into favored activities at the expense of others. For example, a generous tax benefit for agriculture may stimulate investment in a project with a 20 percent rate of return instead of one with a 30 percent rate of return. Getting more investment at the expense of productivity is not a formula for sustained growth. In addition, incentives linked to capital create a distortion in favor of capital intensity over job creation. Insofar as tax incentives involve a revenue loss, additional efficiency costs arise from the need to impose higher taxes on non-favored entities or reduce government expenditures that could be used for development purposes.

If tax incentives are well designed to foster activities that produce positive externalities, then the “distortions” may enhance efficiency. The problem is that incentives are more often driven by political considerations or special interest pressures than by careful economic analysis. In addition, where incentives are ad hoc and discretionary, they invite rent-seeking and corruption, which can derail even the most well-intentioned programs (and add to the revenue risk).

***The slippery slope.*** The provision of incentives for certain investors creates a precedent that leads other interest groups to press for comparable treatment. International experience suggests that it is difficult to avoid the slippery slope effect, which leads to a proliferation of incentives, shrinkage of the tax base, and an intensification of other adverse effects.

***Incentives often don't work!*** Just as proponents can cite instances in which incentives have worked, opponents can find many demonstrating the opposite. Thus, a study in 2004 by McKinsey Global Institute concluded that “Governments around the world woo foreign direct investment by offering costly tax breaks, import duty exemptions, land and power subsidies, and other enticements. Yet our evidence suggests that they are largely ineffective.”<sup>6</sup> A Nathan Associates study of tax incentives in the SADC region similarly found that “generous tax incentives rarely stimulate a substantial investment response where the basic climate for doing business is seriously deficient.”<sup>7</sup> This study also cited the examples of Uganda and Indonesia,

---

<sup>5</sup> Source: Personal observation by the author while serving as an advisor in this country.

<sup>6</sup> McKinsey Global Institute (2003), p. 29.

<sup>7</sup> Bolnick (2004), p. 7-1.

where tax incentives were eliminated in favor of broader tax reforms, with no adverse effect on investment trends. Interestingly, even Ireland had poor results from generous tax incentives for many years before it became a magnet for investment; the transformation occurred only after the government adopted broader reforms in the 1980s.<sup>8</sup>

In general, the effectiveness of incentives varies by country and by type of investment. As noted above, footloose export industries are particularly responsive to tax competition among potential host countries with otherwise adequate conditions. In contrast, tax competition is far less important for investments anchored by geography, including activities that target the domestic market or projects involving access to natural resources. For resource-based investments, host countries should seek to maximize their share of value added while allowing the investor to earn a reasonable rate of return.

---

<sup>8</sup> Willis (1999).

# 3. Taxes and Fiscal Benefits in Mozambique

After a failed experiment with central planning following Independence in 1975, Mozambique began a program of market-oriented reforms as early as 1984 with efforts to attract foreign investment. Little was achieved until after a peace accord in 1992 that ended a long period of conflict and signaled the beginning of a new era of stability and development. One hallmark of this transformation was the adoption in 1993 of a new Investment Law (Law No. 3/93 of 24 June) and Code of Fiscal Benefits (Decree 12/93 of 21 July). This regime included a guarantee of property rights, access to foreign exchange for remittance of capital and profits, and generous fiscal incentives for a wide range of economic activities. To benefit from the guarantees and incentives, investors were required to obtain authorization from the Investment Promotion Center (CPI) and, initially, a designated “competent decision-maker” in the government. The minimum investment to qualify for incentives was set at \$5,000 for nationals and \$50,000 for foreigners. This regime was modified several times during the remainder of the 1990s, with special incentives introduced for Special Economic Zones (SEZs) in 1998 and for Industrial Free Zones (IFZs)—another name for export processing zones—in 1999.

During most of that period the standard tax rate on corporate profit (*Contribuição Industrial*) was 35 percent for agriculture, 40 percent for industry (including construction and mining), and 45 percent for the trade and service sectors. Profits distributed in Mozambique were also subject to a surtax (*Imposto Complementar*) at graduated rates up to 40 percent, while profits distributed abroad were subject to 15 percent withholding. Customs duty rates ranged up to 35 percent, including a 10 percent duty on capital goods. After 1998, the company tax rate was reduced to 35 percent for all sectors but agriculture and fisheries, which enjoyed a special 10 percent tax rate. Other special benefits applied to mining, oil and gas, hotels and tourism, and sugar.<sup>9</sup>

Within this tax system, the main fiscal incentives were partial tax holidays and an exemption on customs duties for certain capital goods. Specifically, the “general” incentives included a 50 percent reduction in the company tax and complementary tax for up to 10 years. For qualifying investments in three northern provinces, the reduction was 80 percent for 10 years, and 50 percent

---

<sup>9</sup> Adrien Goorman, Randa Sab and Paulo Ramos, *Moçambique Racionalização dos Incentivos Fiscais*, IMF, August 2000, p. 13. This study was not released to the public (and is therefore not included in the reference list below).

for another 6 years. In four other provinces, investments outside the capital obtained a 65 percent tax reduction for 10 years followed by a 40 percent tax break for 3 more years.

The IFZ package included exemption from customs duty and indirect tax on inputs used for export production, and an unusual “royalty fee” in lieu of income tax, set at 1 percent of gross revenue or a flat rate per square meter of occupied area. For investments in the Zambezi River Valley SEZ (from 1998), the incentives included an exemption from customs duty and indirect tax for both equipment and intermediate goods and a full tax holiday for 5 years followed by an 80 percent reduction thereafter; for undertakings in agriculture and fisheries the full tax holiday applies until 2025.

Under this tax and incentives regime, private investment did increase substantially in the late 1990s (the trends are examined in the next section). There is no doubt that fiscal incentives were essential to the negotiations on two initial showcase projects of enormous strategic value to the country—the Mozal aluminum smelter and the Maputo-Witbank toll road project. More generally, though, one cannot easily disentangle the impact of incentives from the effect of political stability, macroeconomic stabilization (after 1996), and the privatization of hundreds of formerly nationalized enterprises.

One piece of evidence to this effect came from a study conducted by Jose Macamo (2000) for the Ministry of Planning and Finance in 2000, to determine the importance of administrative barriers to investment as viewed through the eyes of a randomized sample of 30 recent investors. The study, a direct precursor to the present one, found that *76 percent of the respondents would have undertaken the same investment without tax and customs incentives*—even though nearly two-thirds saw “strong” administrative barriers to doing business.<sup>10</sup> These findings were widely circulated and cited within the government and the business community.

Also in 2000 the IMF conducted a detailed study for the government on the fiscal incentives regime. Based on calculations from a sample of tax files, the study concluded that the existing package of benefits was “not cost effective.” The IMF team was especially critical of costly tax holidays, recommending instead the use of investment tax credits and accelerated depreciation.<sup>11</sup> The study also proposed reforms to many other elements of the prevailing package of fiscal benefits.

In the wake of these analytical findings, the government in 2002 adopted a comprehensive reform of the income tax and a new Code of Fiscal Benefits. Major provisions of the income tax reform included a reduction in the standard corporate tax rate to 32 percent (with agriculture still at 10 percent) and elimination of the surtax.<sup>12</sup> At the same time, the new Code of Fiscal Benefits was designed “to rationalize the concession of fiscal incentives so that this regime can be more

---

<sup>10</sup> The author of the present paper designed and supervised Macamo’s study.

<sup>11</sup> Goorman et al, (2000), pp. 5 and 13. This recommendation echoed the predominant IMF view of tax incentives, as subsequently expressed in Zee, Stotsky and Ley (2002).

<sup>12</sup> Other elements included the adoption of self-assessment with quarterly payments, and modern provisions to limit the scope for abusive tax avoidance.

efficient and efficacious as an instrument of economic policy” and to consolidate in one legal instrument “a very scattered system of fiscal benefits.”<sup>13</sup>

Exhibit 3-1 outlines the main features of the 2002 package of fiscal incentives. A central feature is that most tax holidays were eliminated in favor of investment tax credits and accelerated depreciation, along the lines recommended by the IMF. A few partial holidays remained in place for agriculture (80 percent reduction in the company tax rate until 2012), mining (25 percent reduction for 8 years), and IFZ entities (60 percent reduction for 10 years).

Companies still must obtain authorization for incentives from the CPI, which also provides investors with information and helps them work their way through other required start-up procedures. The thresholds to qualify for CPI authorization remain the same as in 1993: \$5,000 for domestic entities and \$50,000 for foreign entities. The general incentives apply to a wide range of activities, excluding most wholesale and retail undertakings other than rural commerce and investments involving new commercial infrastructure.

More recently, the government adopted another round of major reforms to the fiscal regime including the elimination of tax holidays for the mining sector under the Mining and Petroleum Act in 2007; amendments to the customs tariff in December 2008 to incorporate provisions of the SADC free trade area and the Economic Partnership Agreement with Europe, allowing duty-free entry for nearly all goods from these trading partners; and a new code of fiscal benefits that scales back many of the previous tax breaks, including “exceptional” benefits for large-scale projects.<sup>14</sup>

In any case, the 2002 regime described above was operational for the investments covered by the present survey, all of which were approved by CPI from 2005 to 2007.

---

<sup>13</sup> Preamble to the Code of Fiscal Benefits, Decree n° 16/2002 of 27<sup>th</sup> June.

<sup>14</sup> Agencia de Informação de Moçambique (AIM), “Mozambique: Customs Duties Slashed,” 17 December 2008, accessed on February 18, 2009 at [allAfrica.com/stories/200812170950.html](http://allAfrica.com/stories/200812170950.html).

**Exhibit 3-1***The 2002 Fiscal Benefits Regime*

The Code of Fiscal Benefits (Decree n° 16/2002 of 27<sup>th</sup> June) was adopted in 2002 to “to rationalize the concession of fiscal incentives so that this regime can be more efficient and efficacious as an instrument of economic policy” and to consolidate into one legal instrument “a very scattered system of fiscal benefits.” For approved investments the Code features the following fiscal benefits:

**GENERAL BENEFITS**

- Exemption from import duty on class K equipment, for goods not produced in Mozambique (or not to satisfactory specifications).
- 5% investment tax credit on new fixed tangible assets—with 10% credit for investments in Gaza, Sofala, Tete, and Zambezia; 15% in Cabo Delgado, Inhambane, and Niassa—for 5 years from date of commencement of the investment (defined as the moment when the procedure to acquire fiscal benefits begins).
- Accelerated depreciation for new immovable assets at twice the normal rate.
- Expensing for specialized “advanced technology” equipment for 5 years from commencement of activity (operations), up to 15% of taxable income.
- Deduction for professional training up to 5% of taxable income for 5 years, or 10% of taxable income for training relating to advanced technology equipment.
- 120% deduction for 10 years for spending on public infrastructure in City of Maputo; 150% elsewhere; 50% for objects of art and culture.

**SPECIAL BENEFITS**

**Agriculture**—80% reduction in the tax rate on profits until 2012.

**Hotel and Tourism**—An additional 3 percentage points of investment tax credit and triple accelerated depreciation for investments approved by 31 December 2007.

**Large-scale projects** (exceeding US\$500 million in designated sectors or in public domain infrastructure concessions)

- Exceptional incentives via contractual regime granted by Council of Ministers for up to 10 years—in lieu of general incentives.
- Investment tax credit of 5% to 10% for the first five years—with 10% to 20% in six designated provinces outside Maputo and 15% to 30% for three others.

**Rapid Development Zones** (Zambezi Valley, Niassa, Nacala, plus Moçambique and Ibo Islands)

- Special incentives covering 18 designated areas of activity, through 2015.
- Import duty relief for Class K and I imports, first 3 years only.
- 20% investment tax credit for 5 years.

**Industrial Free Zones (IFZs)**

- For IFZ developers: duty relief on capital imports.
- For IFZ enterprises : both import duty and VAT relief on imports for projects and operations.
- For developers and enterprises: 60% reduction in the corporate income tax rate for 10 years.

**Mining and Petroleum**

- Import duty relief on Class K imports and other listed items, for 5 years.
- 25% reduction in the corporate income tax rate for 8 years. Availability ended in 2007 with passage of a new Mining and Petroleum Act (Law 13/2007 of 27 June).

## 4. Studies of the Tax Burden in Mozambique

For the period 2005 to 2007 covered by the present survey, the package of fiscal benefits was notably less generous than the one in place when Macamo conducted his survey in 2000. Nonetheless, a study by Bolnick (2004) found that even with the new system the Marginal Effective Tax Rate (METR) for investors with fiscal incentives was low to moderate. The METR is a common measure of the extent to which the overall tax system reduces the rate of return on investment, at the margin. Although some SADC member states offered more generous incentives, Bolnick concluded that the package of fiscal benefits in Mozambique was still “reasonably attractive.”

The study also pointed out that the favorable tax regime for investors with incentives came at the expense of other businesses, who faced the highest statutory tax in the SADC region (combining company tax and personal tax on dividend income), and a METR ranging from 48 to 56 percent for illustrative types of investment. Hence, the tax system sharply discriminated in favor of new investors who qualify for incentives. The study recommended cutting back on special incentives in favor of a more attractive standard tax rate—starting with at least partial relief from the double taxation of dividends.

A similar conclusion was reached in a study by the Foreign Investment Advisory Service of the IFC and World Bank, which used a different methodology to estimate the METR in Mozambique, in comparison to four other countries of the region (South Africa, Rwanda, Tanzania, and Lesotho). The FIAS team found that the standard tax regime in Mozambique imposed “a relatively high tax burden” on most companies, while the incentive regime created a highly competitive to very attractive METR for investments in agriculture, mining, manufacturing, and tourism (but not financial services).

The FIAS study found that the incentives created sharp tax differentials by sector, which fosters an inefficient allocation of resources. They also found that the process of qualifying for fiscal benefits is often “cumbersome and costly.”<sup>15</sup> These costs are addressed in the survey results reported below.

---

<sup>15</sup> The METR results are summarized in FIAS (2006), p. ii. The quote on bureaucratic costs is from p. i of the same report.

The World Bank's annual Doing Business reports on a calculation of the total tax rate on businesses as a percentage of profits for a standardized business case. The calculation takes into account all tax payments incurred by the business, and assumes that the business does not qualify for any investment incentives or special tax breaks. On this basis, the 2009 report (which uses 2007 tax structures) gives a total tax rate of 34.3 percent in Mozambique. This exceeds the figure for several SADC countries, including Zambia (16.1 percent), Botswana (17.1), Lesotho (18.0), and Malawi (31.4). It is in line with the tally for South Africa (34.2), and lower than the rates in Swaziland (36.6) and Tanzania (45.1).

A more recent study for the National Tax Directorate highlighted the discriminatory effect of fiscal benefits (Kuegler 2009). The study estimated that the value of tax benefits accorded to Mozal alone exceeded the total collection of income taxes in 2006, and that even excluding all of the mega-projects the foregone revenue amounted to nearly one-third of company tax collections in 2005. As with many studies of this nature, the calculations assume that these earning streams would all be around to tax in the absence of incentives, which is equivalent to assuming zero additionality and zero effectiveness for the incentives program. A basic concern of the present study is to test this hypothesis directly.

Several other studies provide evidence on the extent to which the tax burden is perceived as a constraint on doing business in Mozambique. In 2003, the World Bank's Investment Climate Assessment (ICA) reported on the results of a field survey of 193 manufacturing firms in all size categories. From this sample, 55 percent of the enterprises viewed tax rates as a "large or severe" problem—though this was only the tenth most serious constraint out of 18 examined in the survey.<sup>16</sup> In 2006 the Ministry of Planning and Development conducted a replication of the ICA survey, covering 137 enterprises from the original study and 21 other manufacturing firms, for a sample size of 158. This time tax rates came out as the fifth most serious obstacle out of 25 items covered, though fewer than half of the respondents judged this factor to be a "major" or "serious" constraint on firm performance and growth.<sup>17</sup>

In summary, prior studies show that the standard tax system has been relatively onerous and perceived as such by a substantial fraction of existing manufacturing enterprises. These results suggest that special fiscal incentives may indeed be a critical consideration for potential investors (though they provide no direct evidence to this effect).

---

<sup>16</sup> Nasir et al., (2003), p. 18. Although the ICA report is dated August 2003, the survey took place in 2002, the year in which the government adopted a new company tax law and a new code of fiscal benefits. Hence, survey respondents would have been assessing the previous tax regime.

<sup>17</sup> DNEAP (2006), p. 15. This report does not provide a breakdown of the scores, but it shows a median score of 2.5 for tax rates, on a scale of 0 to 4, where 3=major constraint and 4=serious obstacle.

# 5. Investment Trends in Mozambique

Before turning to the survey of investment motives, one may reasonably ask whether the reforms adopted in 2002 to scale back fiscal benefits had any visible effect on overall investment trends. The simple answer is that there are not enough data points to isolate the effect of scaling back fiscal benefits from the effect of other factors such as the introduction of a new income tax code and the collapse of two major banks that triggered a serious bout of macroeconomic instability. Even with these caveats in mind, it is still useful to establish the facts about investment patterns before and after the reforms. This section looks, in particular, at annual data on foreign direct investment (FDI) and investment approvals by the CPI.<sup>18</sup>

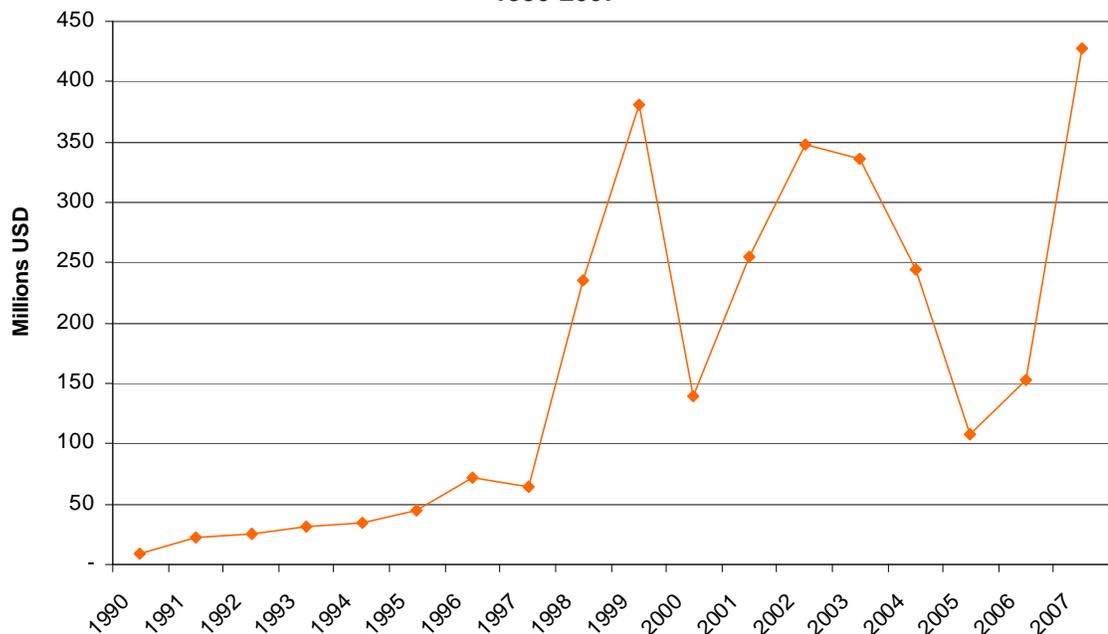
Figure 5-1 shows inward FDI flows to Mozambique for the period 1990 to 2007.<sup>19</sup> Until 1997, when the government succeeded in overcoming the post-conflict surge of inflation, FDI inflows averaged less than US\$50 million per year, mainly relating to the privatization of state-owned enterprises. In the following four years (1998–2001), FDI soared to an average of US\$253 million per year. Flows were also highly volatile due to the “lumpiness” of three mega-projects that dominated the investment landscape—the Maputo-Witbank toll road, the Mozal aluminum smelter, and SASOL natural gas pipeline. It is widely accepted that the government had to offer generous fiscal benefits to attract at least the first two of these showcase projects, and that these concessions were of great strategic value for a very poor country recovering from a long period of conflict.

Following the adoption in 2002 of the new code of fiscal benefits, FDI fell steadily for three years. This decline is partly due to other factors, notably the timing of mega-project inflows and heightened uncertainty created by rising inflation, large budget deficits, and exchange rate volatility over that period. Yet the average level of FDI in the four years after 2002 was nearly identical to the average for the comparable period before 2002, at US\$259 million and US\$253 million, respectively. Furthermore, FDI reached new heights in 2007 after macroeconomic conditions again stabilized, with the 2002 code of fiscal benefits still in place.

---

<sup>18</sup> Equally important would be the data on gross fixed capital formation (GFCF) in the private sector. Unfortunately, the World Development Indicators no longer report a breakdown of GFCF between government and the private sector, and it was not possible (in the time available) to compile a consistent time series of private sector GFCF.

<sup>19</sup> The FDI data are from UNCTAD (2008), Table 31.

**Figure 5-1***Foreign Direct Investment Inward Flows to Mozambique, 1990–2007*

A second principal data source covers projects approved by the CPI, including both foreign and domestic investments. Figure 5-2 shows the CPI time series for the period 1990 to 2007, also in US\$ millions.<sup>20</sup> The CPI data covers both the equity investment and supplementary financing (*Emprestimos/Suprimentos*) for each project. This major advantage is more than offset, however, by two technical factors that greatly diminish the utility of the time series. First, some approved projects never see the light of day. For example, the spike in 2001 included a billion dollar iron and steel factory planned by Enron, which failed shortly thereafter. A second major problem is that the data show investments by year of approval but tell us little about actual capital formation each year. For example, the enormous jump in 2007 includes a \$5 billion Ayr Petro-Nacala refinery project that will take years to implement.

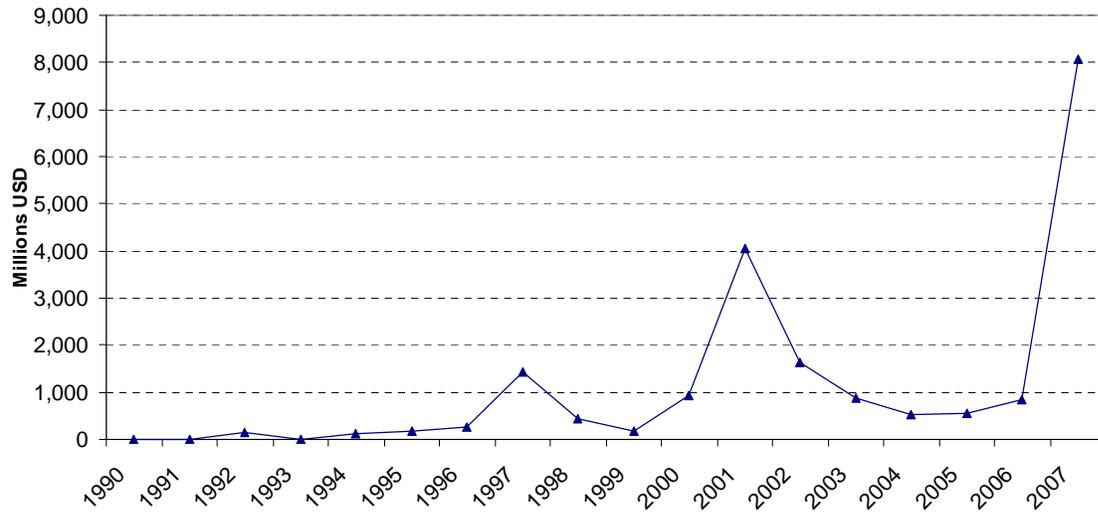
Despite the technical problems, one can interpret the CPI data as indicating the level of interest of investors with serious plans to commit resources to Mozambique. On this basis, it is interesting to see that the CPI data show a pattern following the 2002 reforms that is similar to that noted above for the FDI time series. In particular, total approvals fell in the following two years and remained relatively low in 2005 and 2006. A direct comparison of the four years before and after 2002 shows that the average level of CPI approvals fell by more than half, from US\$1400 million to US\$693 million. But these figures include mega-projects that qualify for the special large-scale regime, which remained unchanged after 2002.

---

<sup>20</sup> The data on investment approvals are from CPI, provided to USAID's Trade and Investment Project in conjunction with prior studies. We are grateful to TipMoz and CPI for providing this information, without which the present study would not have been possible.

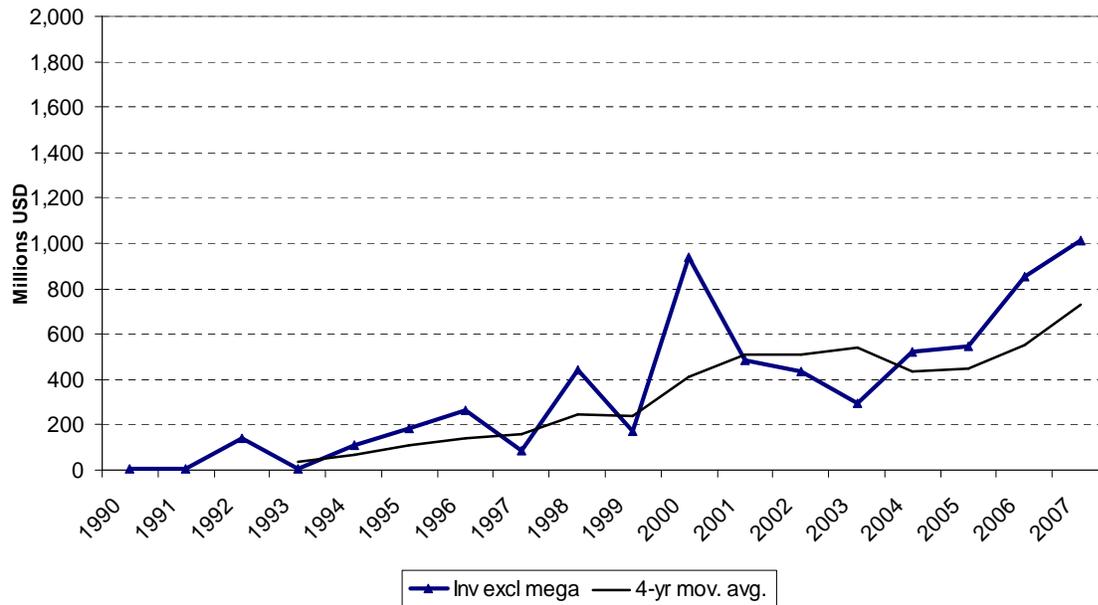
**Figure 5-2**

*Investments Approved by the CPI, 1990–2007*



**Figure 5-3**

*Investments Approved by CPI, Excluding Mega-projects, 1990–2007*



The basic conclusion is that the data on FDI and CPI approvals reveal no drop in investment as a result of the 2002 reforms that scaled back tax holidays in favor of investment tax credits and accelerated depreciation.



## 6. Survey Methodology and Coverage

As noted in the introduction, very few studies have attempted to use direct survey evidence to examine the actual impact of fiscal incentives on investment decisions in developing countries. Halvorsen (1995) conducted one such study for Thailand, but it involved a non-random sample of just 15 firms and focused mainly on their preference among types of incentives. For seven of the investments, Halvorsen also had enough data to calculate rates of return. He found that three of the projects had a low private rate of return and probably would not have been pursued without incentives. Two of them had poor social rates of return, indicating a negative effect on the economy. The other four projects had high private rates of return and would likely have been implemented without the incentives. More recently, Canh and others (2004) surveyed 140 domestic firms in Vietnam, including 70 that benefited from company income tax incentives. Within that group, 84 percent stated that they certainly or probably would have invested even without the incentives. At the same time, 80 percent of this group rated the tax incentives as important or very important.

For the present study, the field team conducted a survey between November 2008 and January 2009, interviewing senior managers at 60 companies that obtained investment approvals from the Center for Investment Promotion (CPI) in 2005, 2006, and 2007.<sup>21</sup> The sample frame focused on the three major economic regions of Maputo, Nampula, and Sofala. Both the sample size and geographic focus were dictated by cost considerations.<sup>22</sup> From this frame the study team drew a 1:5 stratified random sample (with explicit substitution rules to deal with selected companies that could not be contacted). The stratification was designed to obtain a representative sample by year, region, and sector.

The survey questionnaire covered five basic issues: characteristics of the company and the investment project; key factors that motivated the investment decision; fiscal and financial considerations; costs involved in obtaining incentives; and the quality of information available for the investment decision. The questionnaire was developed by the study team over several rounds of iteration, then tested and refined prior to implementation. For every company in the sample,

---

<sup>21</sup> The data are from CPI. See previous footnote.

<sup>22</sup> Due to the geographic limitation agriculture and tourism are under-represented in the sample, whereas industry, construction and transport are slightly overrepresented, compared to the overall set of approved investments. No attempt has been made here to offset these sampling effects by weighting the responses.

the field team interviewed a senior manager who was either directly involved in the investment decision or (in one case) had full knowledge of the motivation for the decision. In addition, the questionnaire was sent to the respondents in advance, along with a cover note explaining the purpose of the survey, so that they would be well prepared to answer all questions.<sup>23</sup>

The questionnaire was designed to provide an internal cross check on responses relating to the effect of fiscal incentives, by addressing the issue in different ways, as discussed below. It also included questions on whether the fiscal benefits affected the nature of the investment—location within Mozambique, capital intensity, size of investment, and use of local versus imported capital goods and inputs—and on attitudes about the value of special incentives versus lower tax rates in general.

Table 6-1 summarizes characteristics of the companies surveyed. Fifteen of the investments were approved in 2005, with 21 approved in 2006 and 24 in 2007.<sup>24</sup> Nearly two-thirds were located in the Maputo region, with the remainder split almost evenly between Nampula and Sofala. One-third (20) of the investments are in manufacturing, followed by 11 in transport and communications, and fewer than 10 in each of the other sectors.<sup>25</sup>

Considering that gestation periods can be long and highly variable across projects, it is not surprising that 13 of the 60 investments have not yet reached the production stage, including two that were approved in 2005. Even so, all but two of the projects are underway, as can be seen in survey responses on actual capital investment to date; for one case of nonresponse on this item the company is already operating, while the second expects production to commence in 2010. These gestation lags would be worth exploring in more detail to find out whether or to what extent the delays are caused by bureaucratic problems versus inherent technological or logistical characteristics of the project. For present purposes, however, the fact that some companies are not yet in production is not a problem, given our focus on the motivation behind the *decision* to invest.

Of the 60 investments, 27 percent are financed fully by foreign capital, with another 30 percent as foreign majority joint ventures. Fifteen percent are joint ventures with majority domestic capital, and 28 percent are fully domestic. One-sixth of the companies have headquarters outside of Mozambique; South Africa is the leading source, with 5 investment projects. The representation of foreign-majority investments in our sample (57 percent) turned out to be lower than in the overall list of CPI approvals for this time period (76 percent), which might affect some results. In retrospect, the sampling frame should have been stratified by source of equity as well as by year, region and sector, to ensure a representative mix of foreign versus domestic investments. This is an important lesson for possible replications of the methodology.

---

<sup>23</sup> Copies of the questionnaire and the cover letter are available from the author upon request.

<sup>24</sup> Dates of approval used here correspond to the CPI database. For several companies this differed from the date given in the survey interview.

<sup>25</sup> The “other” investments are in other areas of the service sector.

**Table 6-1**  
*Company Characteristics—Survey Responses*

Characteristic	No. Companies	% Companies	Characteristic	No. Companies	% Companies
<b>Location</b>			<b>Principal sector of activity</b>		
Maputo	39	65%	Agriculture and aquaculture	5	8%
Nampula	11	18%	Manufacturing	20	33%
Sofala	10	17%	Mineral resources, energy	3	5%
Total	60	100%	Construction	7	12%
<b>Year of investment approval</b>			Finance	3	5%
2005	15	25%	Tourism, hotel, restaurant	4	7%
2006	21	35%	Transport and communications	11	18%
2007	24	40%	Other	7	12%
Total	60	100%	Total	60	100%
<b>Started production (by year of approval)?</b>			<b>Capital investment to date</b>		
2005 - Yes	13	22%	Under \$50,000	0	0
2006 - Yes	17	28%	\$50,000 - \$500,000	14	23%
2007 - Yes	17	28%	\$500,000 - \$1 million	13	22%
2005 - Not yet	2	3%	\$1 million - \$10 million	20	33%
2006 - Not yet	4	7%	\$10 million - \$50 million	9	15%
2007 - Not yet	7	12%	Over \$50 million	2	3%
Total	60	100%	No response	2	3%
<b>Source of capital</b>			Total	60	100%
100% national capital	17	28%	<b>Headquarters outside Mozambique?</b>		
100% foreign capital	16	27%	Yes	17	28%
Mixed capital, majority domestic	9	15%	No	43	72%
Mixed capital, majority foreign	18	30%	Total	60	100%
Total	60	100%			

SOURCE: Survey results.

By matching companies in our sample to the CPI database on investment approvals, we obtain more detailed information on the planned investments and employment levels (Table 6-2). Looking at the distribution by size, 42 percent of the planned investments fall in the range of \$1 million to \$10 million, with 28 percent under \$500,000. Note that the Investment Law establishes a floor of \$500,000 for CPI involvement with foreign investments, and \$50,000 for domestic projects. Two investments exceed \$100 million, one of which also exceeds the \$500 million threshold to qualify for the special regime for large-scale projects, as discussed above. A large fraction of the investment plans (43 percent) reported equity financing only, though there were also 30 percent anticipating a gearing ratio (non-equity to equity financing) of 2 or more, including 8 projects with planned leverage exceeding 10. The median planned gearing ratio was 0.84.

**Table 6-2**  
*Company Characteristics—Planned Investments*

<b>Characteristic</b>	<b>No. Companies</b>	<b>% Companies</b>	<b>Characteristic</b>	<b>No. Companies</b>	<b>% Companies</b>
<b>Planned capital investment</b>			<b>Per worker planned capital investment</b>		
\$50,000 - \$500,000	17	28%	\$1,000 - \$5,000	5	8%
\$500,000 - \$1 million	5	8%	\$5,001 - \$10,000	8	13%
\$1 million - \$10 million	25	42%	\$10,001 - \$50,000	23	38%
\$10 million - \$50 million	10	17%	\$50,001 - \$100,000	8	13%
\$50 million - \$100 million	1	2%	\$100,001 - \$250,000	7	12%
Over \$100 million	2	3%	> \$250,000	8	13%
No response	0	0%	No information	1	2%
Total	60	100%	Total	60	100%
Median	\$2,391,686		Median	\$32,476	
<b>Planned employment</b>			<b>Planned leverage (non-equity/equity capital)</b>		
Under 10	1	2%	Zero	26	43%
11-20	15	25%	Between 0 and 1.00	5	8%
21-50	14	23%	1.00 - 1.99	11	18%
51-100	12	20%	2.00 - 9.99	10	17%
101-200	4	7%	> 10.00	8	13%
> 200	13	22%	Total	60	100%
No information	1	2%	Median	0.84	
Total	60	100%			
Median	50				

SOURCE: CPI database on investment approvals, selection of companies in sample for field survey.

A majority of the investments (63 percent) covered by the survey initially projected creating between 10 and 100 jobs, mostly in the lower half of that range. Thirteen of the investment plans (22 percent) envisioned more than 200 jobs. The survey results indicate that only three of the 60 companies now anticipate falling short of their targets for job creation. Finally, the CPI data show a median capital cost per job of just under \$32,500 for companies in our sample, according to their approved investment plans. Thirteen of them (21 percent) had very low capital intensity, with an anticipated capital cost of under \$10,000 per job. Fifteen others (25 percent) were highly capital intensive, with an anticipated capital cost exceeding \$100,000 per job, including eight above \$250,000 per job.

# 7. Survey Findings

This section reviews the main survey findings relating to investment motivation; the impact of fiscal benefits on the decision to invest; the cost of obtaining the fiscal benefits; and the quality of available information relating to the investment decision.<sup>26</sup>

## MOTIVES FOR INVESTMENT

As a lead-in to the investigation of investment motives, the interview started with questions on target markets. The domestic market in Mozambique was the principal sales target for nine out of ten respondents (n=54), including all but one manufacturing firm. For 43 companies the market in Mozambique was the sole target. Of the companies looking to foreign markets, 8 cited South Africa and 11 cited other SADC countries, with just 2 intending to sell outside SADC.<sup>27</sup> Among the 17 companies planning to export, 9 cater to previously established markets and 8 are pursuing new markets. Clearly, the growing domestic market has been a major draw for investors.

Only seven companies in our sample (12 percent) considered locating their investment in another country. Within this group, three opted for Mozambique due to domestic market potential or lack of local competition, two were motivated by political stability, and one said that the alternative (Angola) was unattractive. (No explanation was recorded for the seventh company.) Only one company in all mentioned incentives as a primary basis for their location decision.

The near absence of identifiably “footloose” investments diminishes the force of the common argument that incentives are needed to cope with tax competition. Judging from our sample there are very few cases for which Mozambique has been competing for investments that could readily locate in other countries. This finding might simply reflect the relative scarcity of footloose entities in the universe of business activities, particularly in a country offering strong economic growth and excellent geography. Another possible interpretation is that the investment climate and tax incentives in Mozambique fall short of what is needed to lure this type of business. Recall, however, that any footloose enterprise could qualify in Mozambique for reasonably generous incentives (as discussed above) by locating in an Industrial Free Zone.

Respondents were next asked to identify the three most critical factors influencing their decision to invest. The most common responses were as follows: growing domestic market (38 times);

---

<sup>26</sup> The results reported here are derived directly from the survey database. In some cases the results differ from those presented in the report from the field survey (Cimpogest 2009) due to retabulation of the data.

<sup>27</sup> Multiple responses were allowed for this question.

lack of local competition (16 times); political stability (14 times); business environment (12 times); and access to neighboring markets (9 times). Again for this question, just one respondent cited “incentives” as a leading factor influencing their decision.

To explore the motives in more detail, respondents were asked to rate each of 25 business factors on a scale of 1 to 5, where:

- 5 = Critical: would not have invested without it.
- 4 = Important: improved the prospects, but not critical to the decision.
- 3 = Positive: a plus, but not very important.
- 2 = Irrelevant: not a consideration.
- 1 = Negative: detracted significantly from the investment prospects

This phrasing is especially important because it focuses on how each item affected *the actual decision to invest*. For present purposes the score of 5 is of central interest, indicating *decisive* factors in motivating the investment.

Table 7-1 summarizes the results. Only two factors—domestic market potential (45 scores of 5) and political stability (33 such scores)—were deemed to be critical by more than a third of the respondents. Next in line were the adequacy of power infrastructure and duty-free imports (each with 16), followed by proximity to port (15). Other critical factors cited by more than 10 respondents were southern Africa market potential (13), ease of repatriation of dividends (13), adequacy of road infrastructure (12), and adequacy of the water infrastructure (11). Just 10 companies rated tax incentives as a critical factor.

At the bottom end of the scale, no factors were rated as negative (score = 1) by more than 10 respondents. Six items, however, were rated as negative by more than 5 investors: the legal system (10 cases); bank finance and access to raw materials (8 each); skilled labor and roads (7 each); and local suppliers (6).

Respondents were also asked about the range of hurdle rates that would be appropriate “for an investment of this kind in Mozambique.” Of those who replied (13 did not), the responses ranged from 10 to 15 percent (6 cases) to over 35 percent (5 cases), with a median (and mean) of 20 to 25 percent. Based on information at the time of the interview, all but two of the respondents were expecting to achieve or exceed their target rates of return.

Notably, 77 percent of respondents plan further investment in Mozambique, and 80 percent have encouraged other people to consider investing in the country, based on their own experience. When asked about the most favorable factors that they mention to other potential investors, the respondents gave answers very similar to those outlined above. Notably, there was no mention of fiscal incentives in this context.

**Table 7-1**  
*Importance of Selected Business Factors to the Investment Decision*

<b>Business Factors</b>	<b>Average Score (1-5)</b>	<b>No. of 5's (=critical) out of 60</b>
Political stability	4.2	48
Domestic market potential	4.5	45
Duty-free imports of capital goods	3.2	16
Adequacy of power infrastructure	3.5	15
Proximity to port	3.3	14
Southern African market potential	3.1	13
Ease of repatriation of dividends	3	13
Favorable exchange rate	2.5	13
Adequacy of road infrastructure	3.1	11
Adequacy of water infrastructure	3.1	10
Company income tax incentives	3.1	10
Access to raw materials/inputs	2.8	9
Access to bank financing in Mozambique	2.7	9
Access to land/quality of land	2.7	8
Support services from CPI	2.8	6
Availability of supporting business services	2.6	6
Protective tariffs	2.3	5
Labor costs	2.8	4
Adequacy of the legal system	2.6	4
Presence of local suppliers	2.5	3
Example of successful megaproject investments	2.7	2
Industrial free zone status	2.1	2
Access to skilled labor	2.8	1
Access to unskilled labor	2.5	1
Government subsidies	2	0

*Note:*

*Definition of scores: 5 = critical (would not have invested without it); 4 = important (but not critical to the decision); 3 = positive (but not important); 2 = irrelevant to the decision; 1 = Negative (detracted significantly from investment prospects).*

*SOURCE: Survey data.*

## **ROLE OF FISCAL INCENTIVES**

The survey questionnaire examined the effect of fiscal incentives through multiple approaches designed to build in cross-checks and obtain a variety of perspectives on the issue. As reported in the previous section, only one of 60 respondents included incentives among the three leading factors influencing the decision to invest in Mozambique; and none of them mentioned incentives among the favorable factors they have discussed with other potential investors. These qualitative

responses suggest that incentives are at best a secondary consideration for the vast majority of investors.

More telling, however, are the results obtained when respondents were asked to score the importance of fiscal benefits. As noted above, 16 respondents (27 percent) claimed that their decision to invest hinged critically on having access to duty-free imports of capital goods, while 10 of them (17 percent) identified income tax incentives as a critical factor. (In seven cases, both incentives were deemed to be critical.) Taking these results at face value, this evidence suggests redundancy rates of 83 percent for tax incentives and 73 percent for import duty relief.<sup>28</sup>

Separately, the survey asked directly whether the company would have invested without fiscal benefits. This straight yes or no question yielded a slightly lower redundancy rate, with 40 companies (67 percent) saying they would have invested without import duty relief on capital goods, and 47 (78 percent) indicating that they did not need income tax breaks.

Those who replied that incentives were essential were asked to explain why. Nearly all of the companies that required import duty relief said that the capital costs would have been too high without this benefit. Similarly, nearly all of the companies that required income tax relief reported that the rate of return would otherwise have been too low. These replies indicate that fiscal incentives made a critical difference for projects of marginal or sub-marginal viability, and otherwise had little effect—confirming what one would expect from the theory.

Given that most of the companies enjoying fiscal benefits would have invested without them, one might conclude that the revenue costs are high relative to the economic benefits of the incentive program. The validity of this inference depends, though, on the characteristics of the respective investments. Table 7-2 compares the attributes of the 10 companies for which income tax incentives were “critical” (call it group C) and the 50 companies for whom they were not (call it group NC). Every company in group C also regarded import duty relief as a critical factor, compared to just 7 in group NC.

---

<sup>28</sup> In answer to another question, 20 respondents claimed that they did not obtain import duty relief, and another 20 claimed not to have obtained income tax benefits. However, Article 3 of the Code of Fiscal Benefits (Decree 16/2002, of 27<sup>th</sup> June) defines eligibility to include all undertakings carried out under the Investment act other than “wholesale and retail commercial undertakings” Even within that sector, benefits apply to rural commerce and undertakings using new purpose-built infrastructure. Based on the company characteristics in the sample, no more than three respondents would have been ineligible for fiscal benefits. Making this adjustment reduces the redundancy rates to 82 percent and 72 percent, respectively.

**Table 7-2***Planned Investment Characteristics by Reported Impact of Income Tax Incentives*

Characteristic	Tax Benefits		Characteristic	Tax Benefits	
	Critical	Not Critical		Critical	Not Critical
<b>Planned capital investment</b>			<b>Location outside Mozambique considered?</b>		
\$50,000 - \$500,000	4	13	Yes	0	7
\$500,000 - \$1 million	0	5	No	10	43
\$1 million - \$10 million	3	22	Total	10	50
\$10 million - \$50 million	1	9	<b>Zero import duty on capital goods critical</b>		
\$50 million - \$100 million	0	1	Yes	10	10
Over \$100 million	2	0	No	0	40
Total	10	50	Total	10	50
Median investment	\$3,120,354	\$2,312,000	<b>Source of capital</b>		
<b>Planned employment</b>			100% national capital	4	13
Under 10	1	0	100% foreign capital	1	15
11-20	2	13	Mixed capital, majority domestic	0	9
21-50	4	10	Mixed capital, majority foreign	5	13
51-100	0	12	Total	10	50
101-200	0	4	<b>Major target market</b>		
> 200	3	10	Mozambique	8	44
No information		1	South Africa	2	8
Total	10	50	Other SADC	2	8
Median number of workers	25	50	Outside SADC	1	4
<b>Per worker planned capital investment</b>			(multiple answers allowed)		
\$1,000 - \$5,000	1	4			
\$5,001 - \$10,000	0	8			
\$10,001 - \$50,000	4	19			
\$50,001 - \$100,000	1	7			
\$100,001 - \$250,000	3	11			
> \$250,000	1	0			
No information		1			
Total	10	50			
Median investment per worker	\$70,010	\$30,769			

SOURCE: Survey results and CPI database on investment approvals for companies in field sample

The most important observation is that group C includes the two largest projects in the sample. Indeed, one of them is a mega-project that far exceeds the total planned investment for all of the others combined, and the second nearly matches the sum of all investments in group NC. Despite the high redundancy rate, it appears that the program of fiscal benefits had a strong impact on total investment. Note, however, that the mega-project is covered by the special regime for large-

scale projects; hence, this one component of the incentives regime accounted for most of the investment impact, by capital value.<sup>29</sup>

Looking at employment plans, the picture is reversed. Even though 3 of 10 investors in group C plan to create at least 200 jobs, the companies in group NC anticipate creating nearly five times as many jobs overall. The difference between the employment and investment effects arises because the investments that depend on incentives turn out to be far more capital intensive, on average, than the others—as one would expect from the theory. In particular the median planned capital cost per job in group C is more than double the figure for group NC, at \$70,010 and \$30,769, respectively.

In addition to showing that the incentives have selectively favored capital-intensive projects, in terms of influencing the investment decisions, the survey also reveals a limited impact on the design of several projects. Thus, eight respondents reported that fiscal benefits allowed their company to increase the size of the investment (this includes three companies in group NC). Three reported that the incentives affected the type of machinery to deploy. And two said that the incentives altered their choice of venue within Mozambique.

The questionnaire also probed respondent reactions to several alternative investment regimes. The main finding is that investors are inclined to support a tax reform program that would eliminate special incentives in favor of significantly lower standard tax rates. In particular, a large majority of the respondents (90 percent) preferred a 20 percent tax rate to the system with a 32 percent tax rate combined with incentives. Half of them regarded a 25 percent tax rate as better than or comparable to the present regime. Only a small minority favored other options involving tax credits for training or for expenditure on infrastructure that would benefit the public.

## **COST OF OBTAINING INCENTIVES**

One concern about incentives programs in developing countries is that the procedures required to qualify for the benefits might entail significant delays or costs. For Mozambique in particular, FIAS found evidence that the process of obtaining fiscal benefits “is often so cumbersome and costly, that many firms feel the benefits are not worth the effort. For foreign investors, this means that they may chose to invest elsewhere; for domestic investors, they may chose to delay investments or decide against investments altogether.”<sup>30</sup> The survey therefore contained a module on the cost of obtaining investment incentives.

Asked whether the process of obtaining fiscal incentives delayed their investment “over and above the time needed for standard registration and start-up procedures,” 46 of the 58 respondents who answered gave a negative reply. Of the 12 others, 10 reported a delay exceeding two months, including one lapse of more than a year.

---

<sup>29</sup> The amount is stated somewhat vaguely in the text to preserve confidentiality of the survey results. This is also one reason for reporting only the medians rather than means in the accompanying table. (Another reason is that the mean are highly skewed due to a few large projects in both groups C and NC.

<sup>30</sup> FIAS (2006), p. i.

A similar number (13) reported incurring “major” extra expenses in obtaining incentives. Nearly all of these companies cited senior management time as the primary expense, followed closely by loss of business due to delays in project implementation. Five companies identified additional consulting fees and finance charges as major extra expenses. Only two companies cited “unofficial payments” as a major expense, though eight reported it as a minor cost. (The survey did not ask about the recipient of such payments.) Eight respondents provided an estimate of the magnitude of the extra expenses. In six of cases the estimate was above 2 percent of the planned investment, with two cases above 20 percent.

Although most companies faced no significant delays or costs in dealing with the approval process, the exceptions indicate that the system does not always work smoothly, and that in some cases the delays and costs are substantial. Furthermore, a very different type of sample frame would be needed to determine the extent to which the bureaucratic costs of obtaining incentives may have caused some investors to locate in other countries, or deterred some investments altogether. This is an interesting topic for future research.

## QUALITY OF INFORMATION

The final set of survey questions addressed one possible source of delays and extra costs, namely, the quality of information on the approval process, investment climate, and business conditions in Mozambique. More than half of the investors in our sample (32) cited other businesses as a primary source of information in making their decision to invest in Mozambique; for another 9 companies this was a useful secondary source. Nine companies listed CPI as their primary source of information, with 25 others citing it as a useful secondary source. In addition, 13 companies referred to market intelligence reports and the internet as important information resources.

Only 8 companies rated the overall quality of information available at the time of their investment decision as excellent (“accurate and comprehensive”). Another 28 rated it as good (“covered most aspects but not comprehensive”). But 20 regarded the quality of information as fair (“relevant but many aspects missing”) or deficient (“poor or wrong”).

The investors were also asked whether they had encountered “any major problems that *could have been prevented through better information or better services* at the outset?” Forty percent answered that they had.

At least half the investors rated five information factors as “especially important”: the tax system; customers and markets; cost and reliability of power and water; fiscal incentives; and labor laws. Three other information needs were rated as especially important by at least a third of the respondents: procedures for starting a business; administrative barriers to doing business; and the legal system.

Perhaps more interesting are the information factors rated by the investors as not only being “especially important” but also “especially lacking.” Prominent members of this set are administrative barriers to doing business and the tax system, followed closely by procedures for starting a business, availability of support services, and labor laws. These are major targets of opportunity for further work by CPI, the government, and local business associations to compile and disseminate information for investors in a more convenient and easily digestible form.



## 8. Conclusions

This paper has addressed two important information gaps relating to the determinants of investment in Mozambique. First, while there is a substantial body of evidence on barriers to investment, there is virtually no information on factors that motivate the actual decision to commit resources to business opportunities in Mozambique—the positive side of the investment climate. Second, governments in countries like Mozambique commonly encounter opposing views on the advisability of offering fiscal incentives to stimulate investment and create jobs. Both sides in this perpetual debate marshal reasonable arguments and intriguing anecdotal examples to support their case. Yet there is a lack of convincing empirical evidence to guide policy decisions, especially in the context of low-income developing countries.

The purpose of this paper, then, has been to examine both of these information gaps by reporting on the results of a sample survey to obtain microeconomic data on the determinants of investment and the effectiveness of fiscal incentives as a stimulus to investment, based on direct interviews with recent investors. Specifically, the survey covered a 1:5 stratified random sample of enterprises that obtained investment approvals in 2005, 2006, and 2007 to qualify for fiscal benefits (*benefícios fiscais*) and guarantees on the remittance of funds abroad.

Among the substantive findings, the following may be highlighted:

- Fiscal benefits are not decisive for most investments. Five-sixths of respondents stated that their decision to invest did not depend on receiving income tax breaks, giving a redundancy rate of 80 percent; for import duty relief on capital goods the corresponding redundancy rate was 73 percent.
- Very few of these projects could be categorized as footloose. Only 12 percent of the investors considered locations outside Mozambique—and zero percent of those regarded tax breaks as critical.
- Fully 90 percent of the investments—and 80 percent of those critically influenced by tax breaks—were driven by domestic market opportunities.
- Nearly all respondents who viewed fiscal benefits as critical explained this by saying that the returns would otherwise have been too low or the costs too high to justify the investment. This implies that the incentives made a difference mainly for projects with relatively low rates of return.
- Four in five investors in our sample reported no major delays or extra costs due to the process of obtaining fiscal incentives; nonetheless, one in five did encounter a significant

burden of red tape, suggesting that the process can be cumbersome enough to drive away some investors, particularly smaller businesses.

These findings have important implications for policy. If most investments that are enjoying fiscal incentives would have been pursued anyway, and if footloose activities are relatively uncommon, then the economic benefits of offering incentives are far less than the advocates would contend and the revenue costs more substantial. The case for incentives is further weakened by the evidence indicating that incentives tend to be most effective for projects with low intrinsic rates of return and projects that are relatively capital intensive. And yet the evidence also suggests that incentives are critical for some investments, including some very large ones. Hence, those who categorically oppose incentives also tend to overstate their case.

A logical implication of these results is that fiscal incentives are most cost-effective when eligibility is carefully targeted to minimize redundancy and screen out projects that are not fundamentally viable. Unfortunately, this is easier said than done. Realistically, it is very difficult to define eligibility rules that are technically sound and yet pragmatic. To the extent that the targeting requires discretion authority, it is equally difficult to control the potential misuse of that authority. These considerations support the case for a simple broad-based tax regime with low to moderate tax rates and few or no special tax breaks for particular types of investment.<sup>31</sup>

From a methodological perspective, there are limitations to survey data. One concern is that a survey may yield false strategic responses on the role of incentives. The present study suggests that this is not in fact a significant problem, given questions with careful wording and tactical framing within the interview. If there were a bias, it would surely work in the direction of overstating the importance of incentives; but this survey—and previous surveys by Macamo (2000) and Canh (2004)—show the opposite result. Also, as noted in the text, the sampling procedure in this case did not yield a fully representative mix of foreign versus domestic investments. If the methodology is to be replicated, the sampling frame should be stratified by source of equity as well as other pertinent characteristics to ensure a representative mix of investments.

Another limitation is the inherent difficulty of obtaining hard data on profits, rates of return, or tax costs in an interview format. Consequently, the survey results do not provide a solid quantitative basis for estimating revenue costs or economic benefits of the incentives program (though most other methodologies are equally weak in this respect).

Also, the sample design for this study only captures enterprises that followed through on their investment plans. In principle, it would be of great interest to extend the methodology to enterprises that registered with CPI and then decided not to commit resources in Mozambique. One would like to know, for example, whether the “runaway” investors chose to go elsewhere because of tax competition. Unfortunately, the runaways are extremely difficult to track down for an interview. The logistical problems might be more tractable if investment agencies were to maintain more systematic data on this group of ephemeral clients.

---

<sup>31</sup> The elimination of special tax breaks is a basic tenet of the flat tax movement. See Bolnick (2008) on whether a flat tax is right for Mozambique.

Despite the limitations of survey research, the World Bank and others have used surveys very productively to address sensitive aspects of the business environment and investment climate. In the present case, the methodology has yielded results that are sufficiently interesting to warrant replication of the approach in other countries in order to build a more complete database of firsthand information on how tax incentives affect actual investment decisions.



# References

- Arndt, Channing, ed. 2009. *Taxation in a Developing Country: The Case of Mozambique*. Routledge Studies in Development Economics.
- Bolnick, Bruce. 2008. Is the Flat Tax Right for Mozambique? Nathan Associates. Available at [www.tipmoz.com](http://www.tipmoz.com).
- Bolnick, Bruce. 2004. Tax Reform and the Business Environment in Mozambique. Nathan Associates. Available at [www.tipmoz.com](http://www.tipmoz.com).
- Bolnick, Bruce. 2004. The Effectiveness and Impact of Tax Incentives in the SADC Region. Nathan Associates.
- Canh, Nguyen Thi, Hoang Tho Phy, Cung Tran Viet, Nick J Freeman and David Ray. 2004. An Empirical Study of Corporate Income Tax Investment Incentives for Domestic Companies in Vietnam. USAID Vietnam Competitiveness Initiative.
- CIMPOGEST. 2009. Incentives for Investment in Mozambique: Sample Survey of Investors and Analysis of Survey Data. Nathan Associates, under USAID's Mozambique Trade and Investment Project.
- Farrel, Diana, Jaana K. Remes and Heiner Shulz. 2004. The Truth about Foreign Direct Investment in Emerging Markets. *The McKinsey Quarterly*, Number 1.
- Foreign Investment Advisory Service (FIAS). 2006. Mozambique: Study on the Impact of Taxes, Customs, Licenses, and other Fees on the Investment Climate.
- Halvorsen, Robert. 1995. Fiscal Incentives for Investment in Thailand. In *Fiscal Incentives for Investment and Innovation*. Edited by Anwar Shah. Oxford University Press for the World Bank.
- Investment Promotion Center (CPI) and Ernst & Young. 2008. Legislation on Investment in Mozambique.
- Klemm, Alexander. 2009. Causes, Benefits, and Risks of Business Tax Incentives. IMF Working Paper WP/09/21.

- Kuegler, Alice. 2009. Uneven Playing Fields: The Application of Tax Incentives in Mozambique, In *Taxation in a Developing Country: The Case of Mozambique*. Edited by Channing Arndt. Routledge Studies in Development Economics.
- Macamo, Jose. 2000. Barreiras Administrativas ao Investimento em Moçambique: Lições aprendidas da Experiência de Investidores Recentes, Ministério do Plano e Finanças. Gabinete de Estudos Discussion Paper No. 17.
- McKinsey Global Institute. 2003. *New Horizons: Multinational Company Investment in Developing Countries*. San Francisco.
- National Directorate of Studies and Policy Analysis (DNEAP), Ministry of Planning and Development. 2006. *Enterprise Development in Mozambique: Results Based on Manufacturing Surveys Conducted in 2002 and 2006*. Discussion Paper No. 33E.
- Nasir, John, Gilberto de Barros, Dileep Wagle, Manju Kedia Shah, Chad Leechor, Pradeep Srivastava, Alan Harding and Vijaya Ramachandran. 2003. *Mozambique Industrial Performance and Investment Climate 2003*. World Bank and the IFC.
- UNCTAD. *World Investment Report 2008*.
- Willis, Emmons, Adele Cooper and J. Richard Lenane. 1999. *1-800-Buy-Ireland*. Harvard Business School Case Study No. 9-799-132.
- World Bank. *Doing Business 2009: Comparing Regulation in 181 Economies*. Washington D.C.
- Zee, Howell H., Janet G. Stotsky and Eduardo Ley. 2002. Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries. *World Development* 30:9, 1497-1516.