TAXATION IN THE AGRICULTURAL SECTOR IN MOZAMBIQUE

AN ANALYSIS OF VAT EXEMPTIONS AND OTHER TAX ISSUES

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AN ANALYSIS OF VAT EXEMPTIONS AND OTHER TAX ISSUES

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FOREWORD

I was asked by the SPEED project to conduct a 2 week mission in Mozambique to analyze the effect of the Value-Added Tax (VAT) on the agricultural sector, (Contract No. EDH-I-00-06-00004-00). Specifically, I was tasked with analyzing the effects of various exemptions and zero-rating on agricultural production in Mozambique. I was also asked to evaluate the effects on small-scale farming of the "*taxa liberatoria*" (a 20% income withholding tax on unregistered taxpayers.)

ACKNOWLEDGMENTS

While in Mozambique, I was assisted by Hipólito Hamela of CTA, Mozambique's Confederation of Economic Associations, Brigit Helms, Chief of Party at SPEED, and the able staff in the SPEED office. Special thanks to Carrie Davies of ACIS, who tirelessly answered my remaining questions when I returned to the U.S. While in Mozambique, I met with representatives from agricultural associations, agricultural producers and processing firms, accountants, and the Mozambique Revenue Authority. I met with people in Maputo, Nampula, and Beira. A list of individuals I met with while in Mozambique is in Annex A.

ABBREVIATIONS

VAT—Value Added Tax

SADC—South Africa Development Community

ISPC—Simplified Tax for Small Taxpayers

IRPC—Corporate Income Tax

IRPS—Personal Income Tax

MF—Ministry of Finance

SPEED—Support Program for Economic and Enterprise Development

EXECUTIVE SUMMARY

There is concern that the VAT and withholding taxes in Mozambique are adversely affecting the agricultural sector. To examine the effects of VAT on agriculture, I examined the following problem areas of VAT:

- Exemption and zero-rating
- Registration Thresholds
- VAT Refunds

I also examined issues arising from the "*Taxa Liberatoria*", a 20% withholding tax applied to unregistered taxpayers with income arising from business and professional income.

I discovered the following:

1. The requirement of "documented expenses" for income tax purposes and the "*taxa liberatoria*" are the two biggest tax issues adversely affecting the agricultural sector. The income of thousands of smallholder farmers and the agriculture production of these farmers could be protected by dealing with this issue. If these issues are not dealt with soon, the market for small farmers could drastically diminish. If these problems are not addressed, it may become cheaper for firms to import agricultural products than buy from local farmers. In fact, there are reports that maize is now exported to Malawi where the produce is properly documented and then it is re-imported into Mozambique. This arises because buyers cannot legally buy from unregistered farmers without paying substantial taxes, either through the 20% "*taxa liberatoria*" or through fines that increase costs 67 percent.

RECOMMENDATIONS:

A. *Stop requiring* ***registration*** *for ISPC on those with turnovers less than the minimum threshold for* ***payment*** *of ISPC.*
B. *The Revenue Authority needs to develop and approve invoices that can be issued by purchasing firms on behalf of the supplier, at a minimum for the agricultural sector, but ideally for all sectors. These invoices will serve to document expenses by firms buying agricultural products from smallholder producers who are not registered taxpayers. These expenses will be deductible for income tax purposes. No VAT liability will be incurred from these purchases, because the seller is exempt from VAT. Firms making these purchases should be required to keep a spreadsheet with relevant information by supplier and remit that information to the tax authority on a quarterly basis. The Revenue Authority can then go after anyone who should be registered for ISPC and is not.*
C. *Develop rules so that "taxa liberatoria" is not applied to smallholder farmers.*

2. Agriculture in Mozambique is protected through exemption and zero-rating. The use of non-standard language creates confusion between what is exempt and what is zero-rated. This confusion is exacerbated by poor taxpayer service and taxpayer education functions in the Revenue Authority.

RECOMMENDATIONS:

A. *Amend the VAT law and clearly state which supplies are exempt and which are zero-rated. Avoid the temptation to increase the number of exemptions and zero-rating of domestic supplies. It is not necessary for protection of the agricultural sector.*
B. *Develop a taxpayer service function in the Revenue Authority, including creation of brochures on VAT issues, a taxpayer education program, and training of Revenue Authority workers in taxpayer service and education. Develop a functional web site for the Revenue Authority, with tax laws in both Portuguese and English, downloadable tax forms, taxpayer information, etc.*
C. *Develop and implement a VAT training program for Revenue Authority employees, especially with respect to the audit function.*

3. All firms or persons carrying on commercial activity in Mozambique are required to be registered for either the VAT or the ISPC (Simplified Tax for Small Contributors). There is no VAT registration threshold, although there is a VAT ***payment*** threshold. Most VAT revenue is collected from a relatively small proportion of taxpayers. Requiring everyone to register is a waste of not only scarce tax administration resources, but also firm resources, as compliance costs for small and medium-sized firms are quite large.

RECOMMENDATIONS:

A. *VAT registration should be required of all firms with turnover greater than or equal to Mt 2.5 million per year. Firms with turnover less than that should be exempt from VAT. Firms should be allowed to voluntarily register for VAT. Firms with low turnovers but that nevertheless deal with registered VAT traders may want to do this, so that VAT paid on inputs can be credited against VAT charged on output.*
B. *Eliminate the Simplified VAT scheme. It is unnecessary with the ISPC, (Simplified Tax for Small Contributors.)*

4. Like in many emerging economies, the VAT refund system in Mozambique is not working properly. While improvements have been made in the last 5-6 years, there are still many firms complaining that they wait months for refunds, and that valid refund claims are routinely denied for technicalities. When the VAT refund system breaks down, the VAT becomes a tax on production rather than a tax on final consumption. This increases production costs and creates inefficiencies, causing the tax system to

unduly influence production decisions. In addition, delays in the VAT refund process create opportunities for corruption.

RECOMMENDATIONS:

A. *Develop a model to forecast refund requests and ensure sufficient funds are available for legitimate VAT refund claims.*
B. *Publish monthly reports on VAT refund claims and approvals.*
C. *Allow firms with excess VAT credits to use them to offset other taxes already incurred.*
D. *Defer by one month the payment of VAT on large imports of capital goods for registered entities with audited accounts.*
E. *Develop and adopt a risk-based selective system for auditing VAT refund claims. Amend the VAT law to create more flexibility in the refund verification process. Establish a system of automatic refund payments for regular exporters and other firms regularly in an excess credit position who have established a good record of filing accurate refund claims.*
F. *Establish a system whereby firms with professionally audited accounts can file refund claims electronically.*

This report elaborates on these findings and provides the evidence and data that support these findings and recommendations.

CHAPTER ONE: THE VAT

INTRODUCTION

In a study for CTA and USAID/SPEED, Hipólito Hamela identified ways in which the VAT in Mozambique may be adversely affecting the agricultural sector, which comprises approximately 25% of GDP in Mozambique (Hamela, 7). In particular, he discovered an issue arising from purchases from farmers with no taxpayer identification number, or NUIT. I was tasked with analyzing the effects of various exemptions and zero-rating on agricultural production in Mozambique, as well as other tax issues which might be impacting agricultural costs, including the "*taxa liberatoria*", an income withholding tax.

This report begins with an overview of the VAT and a discussion of the problem areas of VAT: registration thresholds; exemption and zero-rating; and VAT refunds. I also provide some numerical examples to show how VAT is calculated and demonstrate the economic effects of the tax. In Chapter 2, I describe the VAT in Mozambique, and place Mozambique's VAT particulars in the context of the South African Development Community (SADC). I describe the main issues with VAT and other taxes in the agricultural sector, using examples from those I interviewed, and I make recommendations for dealing with these tax issues.

VAT: A PRIMER

The value added tax (VAT) is used in 130 countries, and is a major source of government revenue, accounting for 25% of global tax revenue collections (Harrison and Krelove, 4). The VAT is, assuming full forward- shifting of the tax, a tax on final consumption which is collected in pieces, at each stage of production.[1] A defining characteristic of the invoice-credit form of VAT is that firms can credit VAT paid on inputs against VAT charged on outputs. For example, assume a VAT rate of 17% and suppose Firm A sells its output to Firm B for Mt 100. Firm B sells its output to the final consumer for Mt 200 (Chart 1). Under a credit-invoice VAT, Firm A will charge Firm B Mt 17 and remit the tax to the tax authority. Firm B charges the final consumer Mt 34, so the consumer pays Mt 34 in tax. Firm B will credit the Mt 17 paid to Firm A and remit Mt 17 to the tax authority. Neither Firm A nor Firm B has any economic incidence of the tax, as it was fully shifted forward to the consumer. Note that the tax was collected in two pieces, once from each producer (or supplier.)

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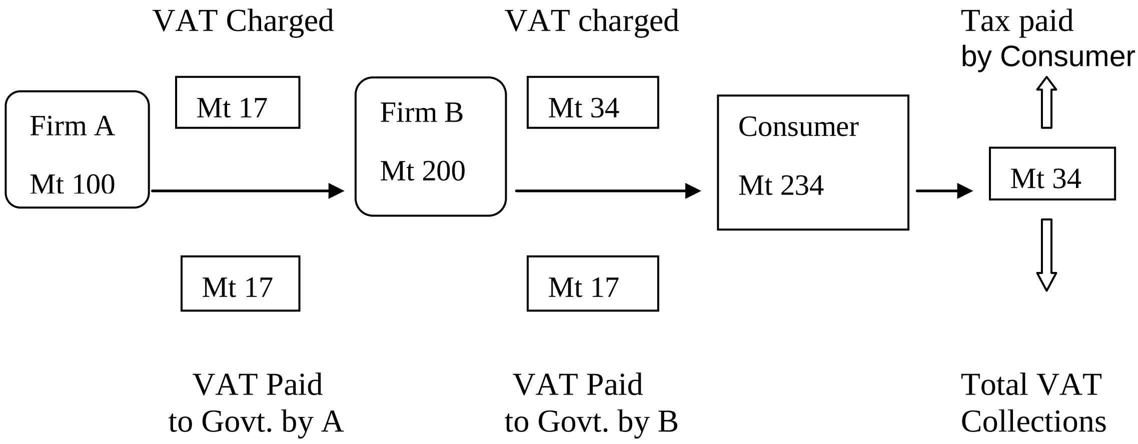
[1] In general discussions of a value-added tax, the ability to shift the tax forward is a standard, simplifying assumption. Ability to shift the tax forward is a function of both demand and supply elasticities, and is therefore an empirical issue. In this report, I make the standard assumption about ability to shift, but it is important to recognize this for what it is: a simplifying assumption and not fact.

FIGURE 1: HOW VAT WORKS



At the end of the chain, the final price to the consumer is increased by the amount of the tax. The VAT is, in this way, equivalent to a retail sales tax; however, the VAT is superior to a retail sales tax in at least two ways:

1. The VAT should not create distortions in production decisions. Allowing credits for VAT paid on inputs against VAT charged on outputs means that tax is not paid on inputs, so the VAT is not a cascading tax, and production decisions are unaffected because the tax does not change input costs.
2. Revenues are protected, because the tax is collected at every stage of the production chain, rather than only at the end of that chain. When revenue is collected at one point only, missing that point means missing 100% of the revenue. Alternatively, if the VAT is uncollected at one stage, only the revenue from that stage is lost.

Developing and transition economies have been encouraged to replace retail sales taxes with a VAT for these reasons, as well as other administrative advantages of the tax, including the supposed "self-enforcing" aspect of the VAT. In theory, because a firm reduces the VAT owed to the government by the VAT it pays to suppliers, firms will want to do business with other VAT registered firms, and will demand a VAT invoice for all purchases, because without the invoice no credit can be taken.[2] In practice, the VAT is not an easy tax to administer, and the claims that it is "self-enforcing" are over-stated, as is evidenced by the sophisticated schemes for evading VAT in many countries.[3]

There are three common problem areas with the VAT: defining (and limiting) exemptions and zero-rating; setting the VAT registration threshold; and issuing VAT refunds. In Annex 2, I explain these issues in detail, and describe "best practices" for dealing with them.

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[2] Indeed, this feature of the VAT is contributing to some extent to the problems faced in the agricultural sector in Mozambique.
[3] For example, Sri Lanka reportedly lost almost 10% of VAT receipts from one tax avoidance scheme. See Michael Keen and Stephen Smith, "VAT Fraud and Evasion: What Do We Know, and What Can Be Done?" IMF Working Paper 07/31. February 2007.

ISSUES WITH VAT: EXEMPTION AND ZERO-RATING

Consumption taxes are generally seen as regressive, in the sense that a uniform consumption tax rate will tax the poor, who spend most of their income, more heavily than the rich. Most countries take some measures to reduce the effect of consumption taxes on goods and services defined as "necessities." These measures generally take the form of reduced rates, exemptions and zero-rating.

Good tax design rests on three "legs": equity, efficiency and administrability. One measure of equity is horizontal equity: people with the same ability to pay should pay roughly equal amounts of tax. When there is a large informal sector, or when people are excluded from the tax sector, horizontal equity can be affected. For example, income tax will generally not be paid by individuals operating in the informal sector. One advantage of a broad-based consumption tax is that it captures those individuals in the tax net. For example, when a small shopkeeper purchases supplies from a registered VAT taxpayer, the shopkeeper will pay VAT on those supplies. A well-designed, broad based VAT can increase equity in the tax system, especially when income taxes are collected predominantly from wage earners in the formal and government sectors.

Efficiency of a tax system is generally measured in terms of the number of distortions created by the tax. If a tax causes a firm to choose different inputs or to produce different goods than it would absent the tax, then the tax has created an economic distortion and economic efficiency has been affected.[4] A VAT is preferable to a retail sales tax precisely because it removes the tax from inputs and, assuming full shifting of the tax, creates no distortions in the production process. This result will breakdown if there are breaks in the VAT chain caused by exemptions.

Exemptions

Exemptions in VAT take two forms:

1. exemptions of firms
2. exemptions of specific goods and services

Firms may be exempt through registration thresholds or by sector. For example, in some countries the agricultural sector is exempt from VAT. In general, exemptions granted to firms or sectors are done because the administrative costs of applying VAT outweigh the revenue gains. Reasons for exempting firms through registration thresholds are discussed in a following section. Exemption of specific goods and services is normally done to make the VAT more equitable, to lessen the burden of the tax on the poor.

It is important to understand that exempting a firm or sector from VAT is *not* relieving that firm from VAT. An exemption means that VAT is not *charged* on supplies. It does not mean that VAT is not *paid.* A firm that is exempt or that supplies exempt goods will pay VAT on inputs used to produce those supplies, and because the firm does not charge VAT on output, it will not credit the

[4] Taxes may *increase* economic efficiency when there are negative externalities which the tax may correct. In the absence of such market failures, distortions caused by taxes are generally seen as reducing efficiency.

VAT paid on inputs against VAT charged on supplies. If the firm is in the middle of the production chain, the VAT will cease to become a tax on final consumption and will become a tax on inputs. (See Table 2, Cases 3, 4 and 5.) This is why exemption of a sector may make sense when administering tax in that sector is too difficult. To the extent that firms in the sector purchase inputs subject to VAT, there will be partial taxation of that sector, even though it is exempt from VAT. When most producers in a sector (e.g. agriculture) are small, exemption can take the form of a high VAT registration threshold. Using the threshold to effectively exempt a sector means that the small producers, from whom it is costly to administer the tax, will be *partially* taxed, and large producers will still be in the tax net and their value added will be subject to tax. (See the following discussion on VAT registration thresholds.)

The effect of VAT exemption on consumer prices is an empirical question. Exemption through final retail sales may generally result in lower consumer prices relative to subjecting the good to tax (See Table 2, Case 5), but the final effect will be dependent upon the level of cascading and the ability of firms to shift those costs forward. The effect on price of changing the status of a good from taxable to exempt in an existing VAT regime is less certain. Governments normally move a good from "taxed" to "exempt" status in an attempt to lower consumer prices, but the price of a newly defined exempt good could decrease, increase or remain the same. When the price remains the same, (or increases), it is the supplier rather than the consumer who reaps the benefit of the change in tax policy.

A final issue that arises with respect to exemptions is the treatment of input credits when a firm produces both exempt and taxable supplies. The input credit can only be taken with respect to goods that are taxable. This issue is generally handled by pro rating the input tax paid based on the proportion of taxable sales to total sales. It is important to realize that taxable sales include sales of zero-rated goods. So for example, if a firm has total sales of 1000 and taxable domestic taxable sales of 250 and exports (zero-rated) of 250, then total taxable sales are 500, and taxable sales comprise 50% of total sales. The firm can then credit 50% of VAT paid on inputs against VAT charged on output. These apportionment rules can get complicated to administer, but they are vital when exemptions exits in the tax law. This is but one example of why having a well-functioning taxpayer service and education program is vital for the successful operation of a VAT.

Zero Rating

To truly remove VAT from a good, the good must be zero-rated. (See Case 6 in Table 2). Zero-rating a good means that the good is taxable (not exempt), and it is taxed at a rate of zero. A firm supplying zero-rated goods will charge VAT on the supply at the stated rate of zero. The firm now has VAT charged on supplies and can credit the VAT paid on inputs against the VAT charged on supplies. The VAT paid on inputs is therefore fully recovered and the VAT remains a tax on consumption, not production. In a destination based VAT (which means goods are taxed at the place of consumption), exports receive a zero-rating and are therefore free of domestic consumption taxes.

Zero-rating domestic supplies of goods for distributional and equity reasons create two major problems. First, it increases the number of taxpayers likely to be in excess credit positions and thereby needing VAT refunds. These firms are generally non-exporters, who can be more difficult to monitor for fraudulent claims, increasing the administrative costs of VAT refunds, and increasing the likelihood of VAT refund arrears. Second, as the number of taxpayers who may be in an excess credit position increases, the tax administration may find the fraud issue unmanageable, which will only exacerbate the refund delays for firms with legitimate claims. (See a following section for discussion of the VAT refund issue.)

Best Practice With Respect to Exemptions and Zero-Rating

- ***Limit the number of exemptions and resist "exemptions creep."*** Policy-makers generally face mounting pressures to exempt more and more goods, and are asked to use exemptions and zero-rating for investment incentive purposes. These measures erode the VAT base and reduce revenues. They make the law more complex and increase administrative and compliance costs, and convert the VAT from a tax on consumption to a tax on production.
- ***Limit zero-rating to exported goods only.*** Zero-rating domestic production can greatly increase the number of firms requiring refunds, which increases administrative costs and creates opportunities for "negotiation" with tax officials. When refunds are not paid promptly, the VAT increases the cost of production.

A numerical example can help clarify the issues of exemption and zero-rating. Assume the following:

- There are 4 "firms" in the chain: a small farmer, a processor, a wholesaler and a retailer. The farmer uses zero purchased inputs to produce raw peanuts (labor is the only input.) The processor purchases the farmer's peanuts and some additional inputs and produces processed peanuts. The wholesaler purchases the processed peanuts and some additional inputs and produces peanut candy. Finally, the retailer purchases the peanut candy and some additional inputs and sells the candy to the final consumer. Assume that the mark-up, or margin, at each stage is 15%.
- There are six cases: (1) No tax; (2) 17% VAT applied universally; (3) 17% VAT, farmer exempt; (4) 17% VAT, peanuts (raw and processed) exempt; (5) 17% VAT, all peanut products exempt; and (6) 17% VAT, zero-rate on peanuts (raw and processed).

CASE 1 **- BASE CASE: NO TAX**

Assume the Farmer sells his output for Mt 100.00. The Processor adds Mt 20 of other inputs and sells her output (after adding 15%) for Mt 138.00. The Wholesaler adds Mt 20 of other inputs and sells output (after adding 15%) for Mt 181.70. The Retailer adds Mt 20 of other inputs and sells output (after adding 15%) to the final consumer for Mt **231.96**. A

TABLE 1: BASE CASE

CASE 2: 17% VAT, no exemptions

Now assume that a VAT of 17% is imposed (t = .17). In Table 2, I show the amount of VAT charged and paid, using the prices from Table 1. **It is assumed that the tax can be shifted completely onto the purchaser.** Each firm pays to its supplier an additional charge of 17% [1] and charges the purchaser of its output an additional 17% [2]. Each firm remits to the Revenue Authority the difference between the VAT charged on its supplies and the VAT paid on its inputs [3]. Note that the crediting of VAT paid on inputs against VAT charged on outputs means that the tax does not fall on inputs, and therefore the VAT does not change the cost of inputs. Because the tax is passed on completely to the final consumer, the final price received by the producer is unchanged by the tax. Note that the final consumer price has increased by 17% from the base case.

TABLE 2: 17% VAT, NO EXEMPTIONS

CASE 3: 17% VAT, Farmer exempt (or 1st transaction exempt) (with no right to deduct input tax)

Now assume that the Farmer (or equivalently the first agricultural transaction) is exempt from VAT. This means the Farmer will not charge VAT on his supplies. The Processor will not have VAT paid on peanuts to credit against VAT charged on output. Note that input prices do not change for the Processor, even though VAT is not charged on the peanuts. The Mt 17 collected by the Revenue Authority in Case 1 from the farmer is now collected at the second stage of production, from the Processor. [2] Note that the final Consumer Price is unchanged from Case 1 and total VAT Revenue is unchanged from Case 1. When the farmer (or the first transaction in the chain) is exempt from VAT, as long as the farmer does not purchase any supplies subject to VAT, the outcome is unchanged from the case where all in the chain are subject to VAT. (Note that if the tax cannot be shifted fully this result will not be true.) When small farmers purchase few inputs, or purchase those inputs from small traders who are also exempt from VAT, this scenario is plausible. If the farmer has paid VAT on inputs, then exempting the farmer will cause the price of inputs to increase, because the VAT paid on those inputs cannot be credited against VAT charged (because VAT is not charged by exempt suppliers.) This case is shown in Case 3.

TABLE 3: 17% VAT, EXEMPT FARMER

CASE 4: 17% VAT, Exempt (with no right to deduct input tax) Peanuts, Raw and Processed

In this case peanuts, both raw and processed, are exempt from VAT (with no right to credit input tax.) Neither the Farmer nor the Processor charges VAT on supplies. The Processor has purchased other inputs subject to VAT, and because that tax payment cannot be deducted from VAT charged (because VAT is *not* charged due to exempt status), that VAT payment becomes an additional cost. The final price of processed peanuts increases from Mt 138,00 to Mt 141,91 (because the Mt 3,40 in VAT paid on inputs is not creditable, it becomes an input cost.) Exemption has increased the costs of the "other inputs" in this example, and the firm may decide to use different inputs to avoid this cost, creating a ripple effect in the economy. This increase in price is passed down the chain of supply, and the final price to the consumer is now *higher* than in the case where all are subject to VAT. The important point to note is that ***exemption*** does not relieve a good or producer from VAT. Exemptions are often provided as a way of making the VAT less regressive, for example basic foodstuffs, medicines, etc. are often exempt. Exemption will only relieve a good from VAT if the supplier has purchased no inputs subject to VAT (as in Case 2.)

TABLE 4: 17% VAT, EXEMPT PEANUTS

CASE 5**: 17% VAT, Exemption (with no right to deduct input tax) of All Peanut Products**

In this case, all peanut products, from raw peanuts to peanut candy, are exempt from VAT. At no stage in the supply chain does a firm charge VAT; however, after the initial farmer, each producer purchases supplies which are subject to VAT. Because each supply is VAT exempt, no input tax is creditable. The VAT paid on inputs becomes a cost of production. The price at each stage of production is shown in Table 1, labeled **Cost + 15% CASE 5.** Note that the price consumers pay increases over the no tax case, from 231.96 to 245.53. This happens because exemption does not relieve producers from VAT, and VAT paid on inputs becomes a cost of production, passed on to consumers.

TABLE 5: 17% VAT, All Peanut Products Exempt

CASE 6**: 17% VAT, Zero-Rating (exempt with right to deduct) on Peanuts, Raw and Processed**

In this case, peanuts, both raw and processed, are subject to VAT, but at a rate of zero. Zero-rated goods are taxable goods, and so VAT paid on inputs can be credited against VAT charged on output. Because the rate at which the supplies are taxed is zero, 100% of VAT paid on inputs is refundable to the supplier. Zero-rating is primarily used for exports, so that no VAT is imbedded in the price of the export. A destination-based VAT taxes goods at the place of consumption. Goods exported are not consumed in the taxing jurisdiction and are therefore not subject to VAT. Zero-rating removes the VAT from the good. In this case, the processor is owed a refund by the Revenue Authority. Note that because the final good, peanut candy, is subject to VAT, the price paid by the consumer for peanut candy is unchanged from Cases 2 and 3. Note also that VAT revenues are unchanged when peanuts are zero rated. The VAT is a tax on final consumption, and zero-rating an input has no effect on the total value added in the production process. Zero-rating domestic production does mean that firms will find themselves in an excess VAT credit position, like the Processor in this example. The Revenue Authority will have to pay many more VAT refunds when domestic supplies are zero-rated. This is a serious consequence of zero-rating domestic supplies. VAT revenues are unchanged from Case 2, but only collected at the last 2 stages.

TABLE 6: 17% VAT, ZERO-RATE PEANUTS, RAW AND PROCESSED

SUMMARY OF NUMERICAL EXAMPLES

In Table 7, I summarize the results from the numerical examples, and add a final case, where the product is zero-rated to the retail level. In Case 4, when peanuts are exempt, the VAT paid on inputs becomes a cost, and the final consumer price *increases* over the case where the VAT is applied universally. Note that the final consumer price and VAT revenues are no different in cases 2, 3, and 6. When the final product is subject to VAT, exempting inputs at the beginning of the chain and zero-rating the inputs produces the same result with respect to the final retail price and VAT revenue. The *difference* is that the government has to refund VAT in the zero-rated case. If this refund is not paid in a timely manner (or at all), then the VAT owed to the firm becomes a cost, much like Case 4, where the product is exempt. When the zero-rate extends to the retail level, the consumer price is identical to Case 1, where there is not VAT; however, the government must now pay a refund of 10.20. This case demonstrates the difficulty of zero-rating domestic supplies. While zero-rating domestic supplies does “get the VAT out,” it does so only if VAT refunds are being paid promptly. If they are not, the effect will be more like the exemption case (Case 4), and the cost of VAT payments not refunded will be included in the price of the final product.

TABLE 7: SUMMARY OF NUMERICAL EXAMPLES

CASE	Consumer Price	VAT Collected	VAT Refund
1: No VAT	231.96		0
2: 17% VAT,	271.39	39.43	0
3: 17% VAT, Exempt Farmer	271.39	39.43	0
4: 17% VAT, Exempt Peanuts	277.44	43.71	0
5: 17% VAT, Exempt to retail	245.53	10.2	0
6: 17% VAT, Zero-rated peanuts	271.39	39.43	3.4
17% VAT, Zero-rated to retail	231.96	0	10.2

ISSUES WITH VAT: REGISTRATION THRESHOLDS

A key component of a VAT law is defining who must register and therefore be liable for collection and payment of VAT. While on the surface this may seem a trivial issue, history has shown that adopting a threshold that is too low, and hence requiring large numbers of taxpayers to register for VAT, has proven a major weakness of VAT systems. Ghana's low VAT threshold was cited as a reason for its failure in 1995 (Ebrill et al, 113). When the VAT was re-introduced in 1999, it was with a much higher threshold ($75,000) (Ebril et al, 114).

Some tax administrations start with the belief that every firm should be required to register for VAT. This places great strain on the limited resources found in most tax administrations, and it does so at a very high cost. Generally, a relatively small number of firms generate a large proportion of VAT revenues (Table 8.) For example, in Georgia, Pakistan, Sri Lanka and Uganda, upwards of 88% of turnover is generated by 10% of the firms. In these countries, almost 100% of turnover can be captured in the tax base with only 30% of firms. These numbers are typical for developing and transitional economies (Bird and Gendron, 85).

TABLE 8: DISTRIBUTION OF TURNOVER IN SELECTED COUNTRIES

Largest (percent)	Egypt	Georgia	Pakistan	Sri Lanka	Uganda
0.5	45	--	71	50	--
1	47	65	80	60	--
5	64	83	94	84	--
10	--	93	98	89	88
20	89	98	--	--	94
30	95.4	--	--	98	97

Source: Ebrill, Keen, Bodin and Summers. 2001 *The Modern VAT,* (International Monetary Fund) p. 118.

Any [small] revenue lost from setting a high threshold is typically more than offset by the ability of the revenue authority to concentrate on those medium and large-scale firms which produce 95% (or more) of turnover, and hence VAT revenue. The effect of requiring registration of smaller firms is compounded because smaller and medium sized firms often keep poor records. Requiring these firms to register for VAT results in a waste of tax administration resources, as more is spent on compliance costs, by both the firm and tax administration, than is ultimately raised in revenue. Bird and Gendron recommend a registration threshold amount around $100,000 (p. 85).

It is important to note that firms not required to register for VAT are exempt from VAT. While these firms pay VAT on inputs, because they are not registered VAT taxpayers they do not charge VAT on output. They therefore have no VAT charged on supplies against which to credit VAT paid on inputs. VAT paid on inputs becomes a cost. (See the discussion in the previous section.)

Best Practice With Respect to Registration Thresholds

- ***Set the registration threshold high.*** Do not require every firm to be registered for VAT. Direct scarce tax administration resources where they are most valuable. As the economy grows, and as tax administration capacity increases and taxpayers become more educated and familiar with VAT, the threshold can be decreased to include more firms.

ISSUES WITH VAT: VAT REFUNDS

With the credit-invoice VAT system, firms that pay more VAT on input purchases than they charge on taxable supplies are entitled to a refund from the tax authority. Firms that export will routinely be in an "excess credit" position with respect to VAT, as will firms that supply goods zero-rated for domestic consumption. Excess VAT credits are also an issue for new businesses, which often make large capital purchases while producing small amounts of taxable output. Payments of refunds as a percent of gross VAT collections vary considerably by country. (Table 9.) In general, the rates are far lower in emerging and transitional economies than in developed economies. This difference is largely due to inadequately functioning VAT refund systems in transitional and emerging economies.

TABLE 9: VALUE OF VAT REFUNDS IN ADVANCED, TRANSITIONAL, AND EMERGING ECONOMIES*

(In percent of gross VAT collections)

Advanced Economies		Transitional Economies		Emerging Economies		Others	
Canada	50.3	Bulgaria	21.5	Chile	28.8	Algeria	24.3
France	21.2	Hungary	48.2	Colombia	4.1	Bolivia	10.4
Ireland	24.9	Latvia	49.1	Indonesia	12.4	Cambodia	2.8
Netherlands	50	Romania	24.7	Mexico	32.1	Cameroon	8.8
New Zealand	35.5	Russia	44.6	Morocco	5.1	El Salvador	9.6
Sweden	48.6	Slovak Rep.	53.9	Peru	19.8	Kenya	7.2
United Kingdom	40.9	Ukraine	24.1	South Africa	39.5	Mozambique	2.7

Source: Harrison and Krelove, "VAT Refunds: A Review of Country Experience." p.9.

*Average refund level over a four-year period (1998 to 2001).

The VAT refund system has been referred to as the "Achilles heel" of VAT (Harrison and Krelove, 4). When the refund system is not functioning properly, VAT becomes a tax on inputs and production rather than a tax on final consumption. Under those circumstances, the tax can become a substantial burden, hindering economic activity and growth.[5] Most VAT laws require that VAT refunds be paid within 30 days, and this is the practice in developed countries. In developing countries, however, it can take months or a year or more for refunds to be paid. This time delay is a real cost to firms, who are essentially making an interest-free loan to the government. Even though most VAT laws require interest to be paid on overdue refunds, those payments are often not forthcoming.

Delays in VAT refunds generally stem from two factors: 1) Tax administration capacity; and 2) State Budget pressures.

Issues of Tax Administration Capacity

The tax authority has legitimate reasons for being careful with VAT refunds. Fraudulent refund claims are a major area of lost VAT revenues (Keen and Smith, 3). Nevertheless, inability of the tax authority to distinguish fraudulent claims is not a valid reason for denying legitimate VAT refund claims. This fear often results in lengthy verification of every refund claim, which leads to delays of payment or even denial of legitimate refund claims for inconsequential technicalities. A more effective way to deal with refunds is for the revenue authority to employ a risk management strategy, whereby only high-risk claims are subjected to the level of scrutiny now given everyone.

This is, to a great extent, an issue of tax administration capacity. As Harrison and Krelove state:

> The tax administration's role in a self-assessment environment is to, first, assist taxpayers to understand their obligations and entitlements and, second, to take action against non-compliers— particularly those exhibiting the highest revenue risks. To do this, the tax administration must be organized appropriately, with adequate resources, and have in place compliance programs based on a balanced mix of education, assistance, enforcement, and verification. To the greatest extent possible, VAT systems should be supported by clear and simple laws and procedures that facilitate revenue administration and minimize taxpayer effort and compliance costs. Importantly, administrations should be provided with appropriate enforcement tools, including powers to conduct audits, reassess and collect liabilities, and impose penalties" (20).

State Budget Pressures

VAT refunds are delayed when there are no funds to pay them. While budgetary pressures are real and tax authorities are under tremendous pressure to meet revenue targets, it is important to remember that excess VAT credits are revenues that do not belong to the government. They are overpayments and the monies belong to the firms. Revenue authorities must develop forecasting

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[5] There are two very good papers that explain the economic effects arising from poorly functioning VAT refund systems: "VAT Refunds: A Review of Country Experience" by Harrison and Krelove, and "Briefing Note: The Economic Costs of VAT Refund Delays in Mozambique" by Bruce Bolnick. I briefly summarize the Bolnick paper in parts of this report. The entire report can be obtained through the link: http://www.speed-program.com/economic-costs-of-vat-refund-delays-in-mozambique.

techniques so they know how much to budget for refunds to insure that the funds are available. Refunds tend to follow discernible patterns, and the demand for refunds can be planned and budgeted for. While VAT refunds can be paid from VAT revenues or from the general budget appropriations, it is vital for the success of VAT that adequate funds be available to pay refund claims in a timely manner, regardless of their source.

Best Practice With Respect to VAT Refund Policy (Harrison and Krelove, 35.)

- ***The number of VAT payers should be kept at a level that can be realistically managed by the tax administration.*** A high VAT registration threshold should be maintained until the tax authority is sufficiently developed to administer a larger number of VAT payers and refund claimants in a self-assessment environment.
- ***VAT registration applications should be subject to proof of identity and other basic checks*** designed to prevent fictitious traders from entering the VAT system and stealing from the government through the refund system.
- ***Suitable forecasting and monitoring systems should be established to anticipate refund levels and make sufficient funds available to meet all legitimate refund claims when they occur.*** Given that a pattern of refund claims tends to develop within countries over time, authorities should be able to predict, with some degree of certainty, the level of refunds they might reasonably expect to pay throughout the year.
- ***Refunds should be processed (i.e., paid, offset, or denied) within a reasonable statutory period (e.g., 30 days of the date on which a refund claim is made).*** The statutory deadline may be extended in special circumstances, where (1) a filed VAT return is incomplete; (2) the taxpayer has outstanding tax returns; (3) the taxpayer has failed to respond within a reasonable period to verification enquiries; or (4) the tax authority suspects, on reasonable grounds, that the VAT return is inaccurate and/or the taxpayer is engaged in fraudulent activity, in which case the taxpayer should be subjected to audit and/or investigations. The tax administration should report publicly on its performance in meeting the statutory deadline for processing refunds.
- ***Interest should be paid on late refunds*** to compensate taxpayers with legitimate refund claims for being deprived of their working capital.
- ***Excess VAT credits should be offset against VAT and other tax arrears,*** except where an outstanding amount is subject to a genuine dispute. To support this, the necessary taxpayer accounting and debt management systems need to be in place.
- ***Immediate refunds of excess VAT credits should always be paid promptly to exporters*** or to enterprises that export a large share of their products (e.g., where at least 50 percent of the turnover is attributed to export sales). As appropriate, other taxpayers may be required to carry-forward their excess credits for six months. If at the end of this period an amount of excess credit remains, that amount should be refunded to the taxpayer.
- ***Verification of VAT refund claims should be a component of a wider audit program*** aimed at achieving broad coverage of taxpayers and compliance issues. Pre-refund audits should be limited to high-risk cases only (e.g., the first refund claim by a new registrant), while lower-risk claims should be subjected to selective post-refund audits.

- ***Preferential treatment should be given to regular exporters with sound compliance histories.*** Some tax administrations assign an *approved refund level* within their computer systems for taxpayers with sound compliance records and accounting practices. Others categorize refund claimants according to their compliance history and perceived level of risk. Low risk claimants receive automatic refunds, often within a few days of filing their claims. Selected higher risk taxpayers are required to substantiate their claims.
- ***Appropriate sanctions should be consistently applied to taxpayers who falsely claim refunds***, or do not comply with record-keeping requirements. Refund-related fraud should be prosecuted through the criminal justice system.
- ***Taxpayers should be entitled to appeal, on reasonable grounds, a decision by the tax administration to withhold a refund.*** Such appeals should be considered by an independent tribunal and dealt with promptly.
- ***The tax administration should provide clear information to taxpayers explaining their rights and obligations, and the procedures for making a refund claim.*** VAT returns and refund claim forms should be simple, have clear instructions, and be filed through means convenient to taxpayers.

CHAPTER TWO: THE VAT (IVA) IN MOZAMBIQUE

Mozambique adopted a VAT in 1998. It has been amended several times since then, with a major overhaul of the legislation in 2007. As I show in Table 10, VAT revenues as a percent of GDP have risen 28% since 2009, while VAT's contribution to total tax revenue has increased 6%. In their study, Bird and Gendron report an average VAT/GDP ratio of 14.1% and an average percent of VAT in total revenues of 34.5%. VAT as a percentage of GDP in Mozambique is well below this average, yet the VAT in Mozambique is an important revenue raiser, accounting for 46% of all tax revenues in 2011. Using VAT/GDP and VAT/Revenues as measures of a VAT's performance relative to other countries is problematic, because GDP measurements typically do not include informal sector economic activity, and the level of the informal economy varies from country to country. For that reason, two other measures have been developed to measure the revenue raising performance of the VAT.

The first is VAT productivity (VAT as a percent of GDP divided by the standard VAT rate). In Mozambique, this rate has increased from .38 to .48, or 26%, from 2009 to 2011. This means one percentage point of VAT collects revenues equivalent to .48% of GDP. Bird and Gendron report VAT Productivity rates for selected countries, with values ranging from a low of .1 (Brazil) to a high of .61 (Jamaica) and an average value of .36 (p. 32).

The second measure is VAT efficiency (VAT as a percent of Private Consumption divided by the standard VAT rate). This value has also increased significantly in Mozambique, from .52 in 2009 to .77 in 2011. A VAT efficiency measure of 1 would indicate a uniform tax on all consumption. Bird and Gendron report an average VAT Efficiency rate of .49 in the countries they examined, with a low of .16 (Bolivia) and a high of .93 (Jamaica) (p. 32). By both these measures, Mozambique's VAT is performing reasonably well.

TABLE 10: VAT PERFORMANCE IN MOZAMBIQUE, 2009-2011

Percent	2009	2010	2011
VAT/GDP	6.38	7.73	8.19
VAT/Total Rev	37.02	38.61	39.46
VAT/Tax Rev	43.09	44.99	45.61
VAT Productivity	0.38	0.45	0.48
VAT Efficiency	0.52	0.70	0.77

Source: Author's calculations. Data from IMF and Mozambique Ministry of Finance

In SADC countries, the standard VAT rate varies from a low of 12% to a high of 18%. Mozambique's rate of 17% is just above the SADC average of 16.58% (Table 11). The major difference is that Mozambique does not have a registration threshold. All firms are required to be registered for VAT in Mozambique (or alternatively the simplified tax, ISPC). In the other SADC countries, threshold amounts vary (in $US) from $20,000 to $119,000.

TABLE 11: SADC VAT RATES and REGISTRATION THRESHOLDS

Country	Standard VAT rate	Registration Threshold ($US)
Angola	no VAT	----
Botswana	12%	62,750
DRC	no VAT	----
Lesotho	14%	60,000
Madagascar	20%	94,000
Malawi	17%	23,627
Mauritius	15%	102,000
Mozambique	17%	no threshold
Namibia	15%	24,000
Seychelles	no VAT	----
South Africa	14%	119,000
Swaziland	no VAT	----
Tanzania	18%	20,000
Zambia	16%	40,000
Zimbabwe	15%	60,000
Average	**16.58%**	**60,538**

Source: http://www.sadc.int/tifi/tax/chapter/2/ and various Ministry of Finance web pages.

CHARACTERISTICS OF MOZAMBIQUE VAT

EXEMPTIONS AND ZERO RATING

Instead of clearly listing "exempt goods" in one section of the law and then listing goods that are zero rated, the VAT law in Mozambique lists "exempt goods" in Article 2, Section 9. In Article 19, the law defines which transmissions of goods are eligible for deduction of VAT paid on inputs. This is non-standard VAT language and it creates much confusion.[6]

Article 19, paragraph 1. b) v. reads as follows:

> v. Transmissions of goods covered in Article 9, number 7, paragraph b); number 10; and in number 13, subparagraphs d) and f); number 12 f).

The Mozambique law then *effectively* creates zero-rated goods, but never states that there are 2 VAT rates: the standard rate of 17% applied to everything not exempt or zero-rated, and a rate of

[6] I met with a representative from one firm who had no idea his main product was zero rated, and that it had been classifies as such since 1998. Ostensibly his accountants are aware of this, but it is revealing to note that he had a copy of the VAT law, was familiar with it, but had never put Articles 9 and 19 together.

zero, applied to exports and domestic supplies of certain goods. Under the current law, to discern if an exemption is actually zero-rated, one must flip back to Article 9 and pick out the correct paragraphs. Terms that are used to mean zero-rated include “fully exempt,” and “exempt with right to deduct input tax.” Terms used to describe true exemption include “partially exempt” and “exempt without the right to deduct input tax.” Whenever one is discussing exempt and zero-rated goods, it is imperative that a meeting of the minds occur with respect to the terminology. This would not be necessary if standard language were used in the law. This could be easily remedied by using the terms exempt and zero-rated in the regulations.

There are anecdotal reports from both businesses and private accountants that there is confusion over whether goods are exempt or zero-rated. There is a perception that different tax offices interpret the law differently, and that the ability of a firm to lobby a tax office affects that firm’s treatment. This underscores the need for taxpayer education and taxpayer service functions in the Mozambique Tax Authority.

There is also an issue of exemption with respect to “mega projects,” which are given certificates that exempt them from being charged VAT. Each of these projects has its own piece of legislation creating its special exemptions, etc. The task of sorting through that legislation to see which supplies are exempt is left to the supplier, and medium-sized firms do not have the capacity to do this. So tax exemptions are creating an unlevel playing field, squeezing smaller and medium-sized firms out of the market.

Finally, it appears that firms producing both taxable and exempt supplies have not been pro rating input credits. The tax authority has recently realized this and is demanding the additional VAT owed because of improper input credits allowed in the past. This is creating confusion among taxpayers, and distorting economic decisions. I have a communiqué from one firm stating it will no longer be making supplies of exempt goods because of this issue. Pro rating of input credits is the correct method when both taxable and exempt supplies are made. Apparently, the tax officers did not understand the law. This is another example of the need for taxpayer service and education and improved training in tax administration. VAT is not a simple tax to administer, and Revenue Authority employees deserve to have excellent training in the tax. Enhanced training means the law will be administered more uniformly across tax offices, which will improve competition in the private sector by eliminating unfair advantages caused by uneven tax administration. In the end, both taxpayers and the government will benefit from enhanced training of tax administrators.

RECOMMENDATION: Amend the VAT law and clearly state which supplies are exempt and which are zero-rated. Avoid the temptation to increase the number of exemptions and zero-rating of domestic supplies. It is not necessary for protection of the agricultural sector.

RECOMMENDATION: Develop a taxpayer service function in the Revenue Authority, including creation of brochures on VAT issues, a taxpayer education program, and training of Revenue Authority workers in taxpayer service and education. Develop a functional web site for the Revenue Authority, with tax laws in both Portuguese and English, downloadable tax forms, taxpayer information, etc.

RECOMMENDATION: Develop and implement a VAT training program for Revenue Authority employees, especially with respect to the audit function.

VAT in the Agricultural Sector

A careful reading of the current VAT law in Mozambique reveals that it effectively removes VAT from agricultural products and agricultural inputs, through zero rating of domestic supplies and imports. The following domestic supplies in the agricultural sector are zero rated (based on the exemptions listed in Article 2, Section 9 and the list of "right to deduct" items in Article 19):

1. *The supply of corn, corn flour, rice, bread, iodized salt, infant formula, wheat, wheat flour, fresh or chilled tomatoes, potatoes, onions, frozen mackerel, kerosene, and bicycles, common preservatives, and insecticides;*
2. *The supply of animal feed for animals slaughtered for human consumption;*
3. *Supplies of goods to be used as inputs for production of oils and soaps, industrial activity resulting from the production of food oil and soaps, made by its factories;*
4. *The supply of goods and services used in the production of sugar and sugar processing.*

The following agricultural supplies are exempt from VAT:

1. Supplies of goods and services, made in the framework of an agricultural activity, forestry, livestock and fisheries, including the transformation of goods made with the producer's own products from using his own resources, provided that the transformation is performed by equipment normally used in agriculture, forestry, livestock and fisheries;
2. The supply of equipment, seeds, breeding, fertilizers, pesticides, herbicides, fungicides and the like for agriculture, as well as nets, hooks and other fishing gear for fishing, constants of the Customs Tariff and detailed in Annex I and part of this Code (imports of these goods are also exempt from VAT);
3. Inputs for animal feed production (soya, soya cake, fish meal, meat meal, vitamins, etc.etc.) to be used as raw materials in production of animal feed for breeding of food animals and food animals;
4. Supplies of sugar (imports also exempt);
5. Supplies of raw materials, intermediate products, parts, equipment, components, made by the national sugar industry (imports also exempt);
6. Supplies of food oils and soaps;

Basic foodstuffs and most inputs to agriculture are either zero-rated or exempt. The exemption of agriculture activities is standard VAT practice in developing and transition economies. The zero-rating of basic foodstuffs completely removes VAT from those supplies. In general, the VAT should not be placing an excess burden on producers in the agricultural sector.

REGISTRATION THRESHOLDS (VAT AND ISPC)

The VAT law in Mozambique does not have a registration threshold. There is a payment threshold, but not a registration threshold. The mindset of the Revenue Authority is that everyone should be registered for taxes. Currently, firms with turnover less than Mt 2.5 million but greater than Mt

750,000 can elect to be taxed under the Simplified VAT, which is not a VAT at all, but a 5% turnover tax. Firms with turnover less than

Mt 750,000 do not have to pay Simplified VAT. Firms with turnover less than Mt 750,000 are exempt from *paying* VAT, but are still required to register.

Alternatively, individuals engaged in a commercial activity with annual turnover less than Mt 2.5 million may register for the ISPC, a simplified personal income tax, in lieu of VAT registration. All taxpayers must be registered for either the VAT or ISPC, even if annual turnover is so low that no tax will be assessed. The tax base of ISPC is turnover, and the tax rate is 3%. While everyone must register for ISPC, only those with annual turnover greater than 36 times the minimum salary (using the maximum of the several minimum salary classifications) are liable to pay the tax. In 2011, the minimum salary was Mt 5320, making the threshold for ISPC payment Mt 191,520. To put this amount in perspective, a maize grower would have to sell 35,000 kg. of maize (assuming a price per kilo of Mt 5.4) before needing to pay any tax. In reality, the ISPC replaces the Simplified VAT regime. No one would register for a 5% turnover tax when a 3% alternative exists.

To reiterate, the rules for VAT registration in Mozambique are basically as follows:

1. All who are engaged in commercial activity are required to register for VAT.
2. Those with turnovers less than Mt 750,000 charge no VAT, so are effectively exempt from VAT.
3. Those with turnovers between Mt 750,000 and Mt 2.5 million may elect to be taxed under the Simplified VAT regime, a 5% turnover tax.
4. Those with turnover greater than Mt 2.5 million are subject to the 17% VAT.

As discussed earlier in this report, VAT registration should be reserved for firms with a fairly high turnover and for exporters and importers. The current VAT law violates this principle. Data on the number of VAT taxpayers and percentage of revenue generated were unavailable, but it is highly unlikely that Mozambique is different from most countries: at least 80% of VAT revenues are generated by a small number of firms. The limited resources of tax administration should be concentrated on those firms, and on the firms that routinely export and import, regardless of their size. VAT registration should not be used as tool to track taxpayers.

RECOMMENDATION: VAT registration should be required of all firms with turnover greater than or equal to Mt 2.5 million per year. Firms with turnover less than that should be exempt from VAT. Firms should be allowed to voluntarily register for VAT. Firms with low turnovers but that nevertheless deal with registered VAT traders may want to do this, so that VAT paid on inputs can be credited against VAT charged on output.

RECOMMENDATION: Eliminate the Simplified VAT scheme. It is unnecessary with the ISPC, (Simplified Tax for Small Contributors.)

VAT REFUNDS

The Mozambique Revenue Authority says refunds happen within 30 days, *if* the company has its paperwork in order. According to the Revenue Authority, 79% of firms that request a refund get it. Taxpayers tell a different story. One accountant told me on average it takes 6-8 months for his clients to receive VAT refunds, when statutorily they are due within 30 days of application for the refund. I spoke with firms that have VAT refund arrears ranging in amounts from Mt 112 million to Mt 500,000, with delays ranging from 8 months to 3 years. It seems that large, exporting firms with other tax advantages are having less trouble getting refunds (but even some of them report months long delays). This uneven treatment by the Revenue Authority creates a competitive advantage for those firms. This appears to be another example of small and medium sized firms being put at a disadvantage by the way taxes are administered. Some firms have stopped requesting refunds, under the [mistaken] belief that those refunds not claimed can be written off as expenses.

As clearly explained in the Bolnick paper in Annex 2, delayed VAT refunds create real costs to firms, and they transform the VAT from a tax on consumption to a distorting tax on production. Under these circumstances, the VAT will affect productivity and efficiency. One firm I spoke with estimates that the carrying cost of unpaid VAT refunds is 5%, and the company has added that cost into its prices.

Companies complain that tax officers find small things wrong on paperwork to delay issuing refunds. Taxpayers also complain that applying for a refund opens them to all kinds of scrutiny for *all* taxes, not just VAT. That scrutiny may be justifiable, depending on the firm; however, a firm that is an exporter or supplying zero-rated goods domestically will routinely find itself in an excess credit position, and assuming its books and records are routinely in good order, it should not be subjected to such skepticism by the Revenue Authority.

For example, refunds are denied to Firm A when the firm that charged the VAT (Firm B) has not remitted the collected tax to the government. For example, Firm A buys supplies from Firm B and pays the VAT charged on the invoice. Firm A is an exporter and is owed a refund on the VAT remitted to Firm B. If Firm B has not paid its VAT liability, Firm A is denied a refund. This is a misapplication of Article 18, number 5 in the VAT law which states: “Credit for VAT is disallowed when the supplier has not remitted the VAT payments to the Revenue Authority, when the purchaser ***should have known*** the supplier was not able to pay VAT collected” (emphasis my own.) This clause (a recent amendment to the VAT law), is an anti-abuse measure and is fairly standard in VAT law; however, the revenue authority is being accused of applying it indiscriminately, not bothering to ascertain if, in fact, the firm “should have known” the supplier would not remit VAT collections. The Revenue Authority will also deny refunds when the supplying firm goes out of business, ostensibly because the firm applying for a refund now has a VAT registration number on its invoices that is no longer valid.

Data on VAT refund arrears is not available, so the extent of the problem is not ascertainable. This is in and of itself an issue. The Revenue Authority should be publishing information on VAT refunds. It is an important aspect of transparency and is important for creating confidence in the system. It is also a means to hold the Revenue Authority accountable. As pointed out earlier, VAT refunds are monies which belong to the firm, not the government. When VAT refunds are delayed, opportunities for corruption are created. There is anecdotal of evidence of some firms making deals with tax officials for VAT refunds, and the tax official gets a portion of the refund. Firms report sending employees to Maputo to lobby tax officials for refunds, and they pay to have their documents moved from the bottom of the stack to the top.

RECOMMENDATION: Develop a model to forecast refund requests and ensure sufficient funds are available for legitimate VAT refund claims.

RECOMMENDATION: Publish monthly reports on VAT refund claims and approvals.

RECOMMENDATION: Allow firms with excess VAT credits to use them to offset other taxes already incurred.

RECOMMENDATION: Defer by one month the payment of VAT on large imports of capital goods for registered entities with audited accounts.

RECOMMENDATION: Develop and adopt a risk-based selective system for auditing VAT refund claims. Amend the VAT law to create more flexibility in the refund verification process. Establish a system of automatic refund payments for regular exporters and other firms regularly in an excess credit position who have established a good record of filing accurate refund claims.

RECOMMENDATION: Establish a system whereby firms with professionally audited accounts can file refund claims electronically.

CHARACTERISTICS OF OTHER TAXES AND TAX ADMINISTRATION THAT AFFECT AGRICULTURE

ISPC (Simplified Tax for Small Contributors) and "*Taxa Liberatoria*"

The Simplified Tax for Small Contributors is on individuals or collective persons performing small-scale agricultural, industrial or commercial activities, including services. It is applicable for those with turnover less than Mt 2.5 million per year. The tax is 3% of turnover or a maximum of Mt 75,000 and is payable on a quarterly basis. Those with turnover less than 36 times the minimum salary (currently Mt 191,500) are exempt from payment of ISPC, but must still register and report monthly purchases (Article 24, ISPC Law.). ISPC registered taxpayers pay ISPC in lieu of VAT, corporate income tax (IRPC) or personal income tax (IRPS).[7] Like VAT, the ISPC law requires everyone to register, although payment is exempt if the taxpayer's turnover is below the minimum. An individual engaged in commercial or agricultural activity who is not registered for either VAT or ISPC may be subject to "*Taxa Liberatoria*".

[7] There are some categories of income that still require payment of IRPS.

"*Taxa Liberatoria*" is a 20% withholding tax that anyone doing business with an unregistered person or firm is supposed to pay.[8] In theory, the purchaser of goods or services withholds 20% of the contract price and remits that to the Revenue Authority.[9] A firm doing business with a non-registered person or firm must withhold the "*taxa liberatoria*" in order for the expense to be allowed as a tax deductible expense for income tax purposes. The income tax law only allows "documented expenses" as deductible for tax purposes, and a documented expense is one where there is an official invoice. Official invoices are obtained from the Revenue Authority and are given only to registered taxpayers. If a firm does business with an unregistered person or firm and claims the expense, the fine is 35% of the undocumented expense, and the deduction is disallowed for computing taxable income, which means another 32% of the expense is added to the tax bill (for an IRPC firm.) This increases the cost of every Mt 1 purchase to Mt 1.67.

Firms buying from small farmers are especially hard hit by the combination of the ISPC and "*Taxa Liberatoria*". Many small farmers sell limited quantities of produce in the market, and most would fall beneath the threshold for ISPC. Many are illiterate and have no formal ID which makes registering for tax purposes impossible. Moreover, it seems nonsensical and costly to have to register for a tax and provide documentation of purchases when no tax will ever be owed. Nevertheless, the law requires that they be registered.

The tax authority treats firms unevenly with respect to this issue, and firms have responded in different ways. Some firms who buy from small farmers have had their purchase expenses disallowed and have been fined for having undocumented expenses. Other firms have developed their own invoices which the local tax authority accepts, while other firms have had those invoices rejected by the local tax authority. Some firms have had their own employees register for ISPC and then funnel all farm purchases through those employees, and the firm pays the 3% tax. Some firms have refused to buy from farmers who are not registered. Still other firms have encouraged farmers to register, even helping them fill in the paperwork. One firm that took this approach was called by the local tax office and he was asked to stop sending all these people to be registered. They were overwhelming the tax office staff.

In the agricultural sector, this 20% withholding tax increases costs by as much as 17% (after taking account of the company income tax). If a firm does not have to apply the withholding tax, it creates a distinct competitive advantage. I was told that the Ministry of Finance has exempted some transactions and firms from the "*taxa liberatoria*", including grain buyers, large scale buyers of commodities, and cotton buyers. The tobacco industry is also exempt. In general, large companies get special treatment with respect to the withholding tax. Tax policy is disadvantaging small and medium-sized firms.

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[8] There is disagreement about whether "*Taxa Liberatoria*" is applied only to services. The law applies to income classified as "*segunda categoria*", which is "*rendimentos empresariais e profissionais*" which translates as "business and professional income." Sales of products would seem to qualify as business income.

[9] The 20% withholding tax becomes a 25% additional expense in the agricultural sector because farmers will not accept 80% of the market price. The firm has to gross up the price to take into account the withholding tax, which increases the effective rate to 25% [(1/.8) – 1].

One firm I spoke with was waiting on a ruling from the tax office as to whether the invoices it used in 2011 would be accepted for tax purposes. In 2010, the firm paid the penalty on undocumented expenses, but its margins are too small to continue that additional expense. This firm buys cereals (maize, sunflower seeds and soybeans) from 10,000 small farmers. These purchases account for 20% of their business. I was told if the tax office did not approve the invoices they would have to stop these purchases and concentrate on other aspects of their business, meaning 10,000 farmers will lose the income earned from those sales.

A milling firm I interviewed used to buy from 60 farmers, with purchases averaging Mt 30,000-60,000. Now it only buys from small traders who are ISPC registered. The company would prefer to buy directly from the farmer and develop a relationship to increase quality, and improve farming practices. By not buying directly from the farmer, the person I spoke with estimates that farmers are losing about $500,000 (10,000 tons at MT 1500 cost per ton) per year because they must go through a middleman who is ISPC registered. This is a cost to farmers arising from tax authorities not accepting invoices arising from transactions with non-registered taxpayers.

Not only is there a cost to farmers, but there is a cost to the government for these requirements. All these registrants take valuable time from tax officers for very little revenue. With 11 million adults in the country and, 1.5 million registered individual taxpayers in Mozambique, fewer than 15% of adults are registered taxpayers. According to the Revenue Authority, of those 1.5 million registered taxpayers, 95,049 are registered for the ISPC. In the first quarter of 2012, Mt 11,448,050 were collected from the ISPC. This is an average of Mt 120 per person, or US$5.00. The minimum turnover for ISPC is Mt 191,500, which implies an average quarterly payment per person of Mt 1,436.25, or 12 times what was received in the first quarter of 2012, assuming everyone was at the *minimum* turnover threshold. Again, the general rule is to not waste time and money chasing small amounts of tax revenue. If the VAT is functioning properly, many of these small traders will be taxed when they purchase things, and so are captured in the tax net that way.

RECOMMENDATION: Stop requiring registration for ISPC on those with turnovers less than the minimum threshold for payment of ISPC.

RECOMMENDATION: The Revenue Authority needs to develop and approve invoices that can be issued by purchasing firms on behalf of the supplier, at a minimum for the agricultural sector, but ideally for all sectors. These invoices will serve to document expenses by firms buying agricultural products from smallholder producers who are not registered taxpayers. These expenses will be deductible for income tax purposes. No VAT liability will be incurred from these purchases, because the seller is exempt from VAT. Firms making these purchases should be required to keep a spreadsheet with relevant information by supplier and remit that information to the tax authority on a quarterly basis. The Revenue Authority can then go after anyone who should be registered for ISPC who is not.

RECOMMENDATION: Develop rules so that "*taxa liberatoria*" is not applied to smallholder farmers.

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ANNEX A: MEETINGS/CONTACTS

Maputo

Jane Grob, TechnoServ
Brigit Helms, SPEED
António Gomes, Pelouro de Agro-negócios
João Jeque, APAMO
João Fragoso, Engenheiro Agronomo
Angelina Mahurak, Pelouro de Agro-negócios
José Alves, Agro Alfa
Horácio Jeremias Simão, Mozambique Revenue Authority
Hermínio Sueia, Mozambique Revenue Authority
Esther Palácio, IMF
Philip Ashcroft, Moz Foods
José Carvalho, Merec Industries
John Farrell, FF Wire

Nampula
Silvano Martins, Condor Cashews
G. Murarti, Casa Damodar
M. Yunuss A. Gafar, Gani Commercial, LDA.
G. Murard, Casa Damodar
Vusi Mahaja, New Horizons Lmt.
Benjamim do Nascimento, CLUSA
Randolph Fleming, AgriFuturo
Anabela Mabota, Agri Futuro

Beira
Carrie Davies, ACIS
Arlito Cucu, Green Resources
Prakash Prehlad, CTA
Jorge Fernandez, Contabil, LDA
Theo DeBruin,
Rui Ribeiro, Nutre (Formally Prio Foods)

Chimoio

Danilo Satar Adam, Deca. LDA