TECHNICAL REPORT

Executive Summary – Tax Reform and the Business Environment in Mozambique

A Review of Private-Sector Concerns

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SUBMITTED TO
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Nathan Associates

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Executive Summary

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

Starting Point: Principles of Taxation for Developing Countries

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

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

Main Elements of the Tax System in Mozambique

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

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

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

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

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

Private Sector Concerns

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This analysis suggests several recommendations:

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

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

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

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

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

The main recommendations relating to cash-flow costs are to

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

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

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

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

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

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

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

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

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

Conclusion

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