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MOZAMBIQUE

POST-REFORM EVALUATION OF THE TAX SYSTEM

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ACRONYMS

| | |
|--------|---|
| ATM | Mozambique Tax Authority |
| CI | Business Profits Tax |
| CIF | Cost Insurance and Freight |
| COMESA | Common Market for Eastern and Southern Africa |
| CRM | Constitution of the Republic of Mozambique |
| CTA | Confederation of Business Associations of Mozambique |
| DFID | Department for International Development (United Kingdom) |
| DGA | General Directorate of Customs |
| DGI | General Directorate of Tax Administration |
| DNA | National Directorate of Customs |
| DNIA | National Directorate of Taxes and Audit |
| EGRSP | Comprehensive Strategy for Public Sector Reform |
| FAD | Fiscal Affairs Department |
| GDP | Gross Domestic Product |
| GNP | Gross National Product |
| HIPC | Heavily Indebted Poor Countries |
| ICE | Excise Tax |
| IDE | Foreign Direct Investment |
| IMF | International Monetary Fund |
| IRPC | Corporate Income Tax |
| IRPS | Individual Income Tax |
| IS | Stamp Tax |
| IV | Vehicle Tax |
| NUIT | Single Taxpayer Identification Number |
| PARPA | Action Plan for the Reduction of Absolute Poverty |
| SACU | Southern Africa Customs Union |
| SADC | Southern African Development Community |
| SECO | State Secretariat for Economic Affairs (Switzerland) |
| URTI | Domestic Tax Reform Unit |
| VAT | Value-Added Tax |
| WDI | World Development Indicators |
| ZIFs | Industrial Free Trade Zones |

PREFACE

In response to a request from Mozambican authorities, a mission from the IMF Fiscal Affairs Department (FAD) visited Maputo from March 1 to 15, 2006, to provide technical assistance in evaluating, from the tax policy standpoint, the tax system resulting from the reforms that have been being carried out since 1997. The members of the mission were: Mr. Ricardo Varsano, Technical Assistance Advisor from the FAD, who headed it; Ms. Irene Yackovlev (FAD); Ms. Maria Odete de Oliveira and Mr. Renato Villela dos Santos (both the latter are members of the FAD panel of experts). Ms. Joanna Zaffaroni, Administrative Assistant from the FAC, assisted the mission from March 8 to 15, 2005.

The mission had working meetings with Mr. Manuel Chang, Minister of Finance; Mr. Aboobacar Changa, Chairman of the Tax Reform Commission and advisor to the finance minister; Mr. Amade Abdul Aziza, Director of the National Directorate of Taxes and Audit; Mr. Antonio Barros dos Santos, Director General of Customs of Mozambique; Mr. Rafique Jusob, Director of the Investments Promotion Center; Mr. Gregor Binkert, a specialist at the World Bank; Ms. Telma Loforte, an economist at the State Secretariat for Economic Affairs (SEC), of Switzerland; Mr. Simon Vanden Broeke, Economic Affairs Counselor at the Department for International Development (DFID) of the United Kingdom; Mr. Kekobad Patel, Chairman of Tax/Customs Reform at the Confederation of Business Associations of Mozambique (CTA); Mr. Ibraimo Ibraimo, General Partner of Ernst & Young; Mr. João Martins and Ms. M. Isabel Fernandes, associate directors of PriceWaterhouseCoopers; Ms. Filomena Ribeiro, former Director of VAT Central Services; Mr. José Sulemane, Director of the National Directorate of Studies and Policy Analysis at the Ministry of Planning and Development; and Mr. Gedeão Alberto, chief of the Revenue Department of the City of Maputo.

The mission analyzed pertinent legislation, gathered data from government documents, and benefited from meetings with government officials and members of their respective teams, representatives of the private sector and donors, in order to understand and analyze the tax system of Mozambique. Section I of this report gives a brief description of Mozambique's economy and its tax system. Sections II, III and IV deal with direct taxes, indirect taxation, and other taxes and, levies, respectively. Section V discusses three distinct topics: taxation by local governments, tax incentives, and the tax treatment of micro and small businesses.

The mission would like to thank Mr. Aboobacar Changa who, designated by the finance minister to be the contact point for the mission, did everything possible to facilitate its work. The mission also thanks Ms. Fernanda Teixeira, a consultant from the IMF Statistics Department and Mr. José Roberto Fernandes Júnior, an FAD consultant, for their assistance with its work. Lastly, the mission wishes to express its gratitude to the FAD consultants in Maputo, Mr. Alfredo Peralta and Mr. António Teixeira, who took an active part in the mission, Ms. Emmy Bosten, Coordinator for Technical Assistance of the IMF Resident Representative Office in Maputo, and Ms. Massiquina Calu, Administrative Assistant at that office.

EXECUTIVE SUMMARY

Not until 1992, when the civil war ended, was Mozambique able to begin its economic growth and poverty-reduction efforts. Since then—because of appropriate government policies that include economic stabilization and liberalization, as well as structural and institutional reforms—it has been able to attract a substantial flow of private capital and donations that has helped raise average annual GDP by about 8 percent.

An important change has also occurred in the sectoral composition of the economy. Taking 1997 as the starting point, participation by the secondary sector rose by 17.4 percent to 28.0 percent in 2005. As counterpart, there was a reduction in participation by the primary sector, from 34.1 to 20.5 percent. Not much changed during this period in participation by the tertiary sector, which is responsible for approximately half of Mozambique's product. Trade is the primary activity in this country, accounting for slightly more than 20 percent of GDP. According to a recent study, in 2000, the informal economy was responsible for 40.3 percent of GNP, a percentage somewhat lower than the average for a sample of 23 African countries (42 percent).¹

These circumstances indicate, if not conditions favorable to taxation, at least more favorable conditions than prevail in most of the countries of the region, where agriculture, more difficult to tax than other sectors, and informal activities play more important roles in the economy. Indeed, a recent mission from the IMF's Fiscal Affairs Department (FAD)² estimated Mozambican society's taxation capability, i.e., how much revenue could potentially be collected in this country, at on the order of 22 percent of GDP, similar to that of Kenya and higher than most of its neighbors, but still much lower than that of South Africa and Swaziland.

In order to convert this potential capacity into funds that could be put to use in the cause of development and poverty reduction, the government has been implementing, since 1997 when the customs reform began, a comprehensive reform of the tax system and the institutions responsible for administering it. Import duty rates underwent an important revision in 1999, while at the same time a modern value-added tax was introduced as a replacement for the cascade tax.

¹ Friedrich Schneider (2002), "Size and Measurement of the Informal Economy in 110 Countries around the world," paper presented at a workshop held at the Australian National Tax Centre, Australian National University, Canberra, Australia, July 17. (Available at http://rru.worldbank.org/documents/paperslinks/informal_economy.pdf).

² Ricardo Varsano *et al.* (2005) "Tanzania – Tax Policy Issues and Reforms," aide-mémoire by the mission. December.

Soon after the Domestic Tax Reform Unit (URTI) was established in 2001, a legislative effort began that resulted in the passage of the new Framework Law on the Mozambican Tax system, the creation of an Individual Income Tax and Corporate Income Tax (IRPS and IRPC), Regulations on the Vehicle Tax (IV), the rationalization of tax benefits, the introduction of a single taxpayer identification number (NUIT), and new codes for the Sisa (Real Property Transfer Tax) and the Stamp Tax (IS). Now, in 2006, a General Tax Law has been adopted. In the administrative realm, the Customs Policy Coordination Council, the General Directorate of Customs, and the Tax Administration were created, and a law was passed that orders the creation of the Mozambique Tax Authority (ATM), which will consolidate the administration of domestic and customs taxes.

Despite all this modernization of the tax system and its administration—or perhaps because of it—the rise in tax revenues has been smaller than expected. The ratio between revenues and GDP—the tax ratio—which had been increasing gradually since 1996 after a sharp drop, has been falling again in the last two years. At the same time, both the FAD mission report and the report prepared by the FAD on taxation in Mozambique³ indicate that there is plenty of room for increasing tax revenue. Using various methodologies, they conclude that actual revenue collection in 2001 and 2002 amounted to only half of potential collection.

Although the topic lies outside our area of focus, this mission could not fail to notice how fragile the present tax administration is. As a result, we found it tremendously difficult to generate the data needed for our analysis. It is an administration that seems to be at the halfway point, having lost the ability to work in the old way but not yet mastered the new techniques. That is why, and because of a trade policy that was programmed with a view to the formation of a free trade area—and, later, a customs union and common market—in the Southern African Development Community (SADC), the mission recommends that:

- Rates for the VAT, IRPS and IRPC should not be cut, as the private sector would like to see happen, until the ATM has been consolidated and, in the case of the VAT, until actions designed to broaden the tax base—both through repealing unjustifiable exemptions and, especially, by making procedures operational that ensure better taxpayer compliance with obligations—have ensured, for two consecutive years, that revenue from that tax exceeds the established goals;
- The rates of the Excise Tax (ICE) on tobacco, beer, other alcoholic beverages and vehicles should be raised, as had been recommended previously by the FAD technical assistance mission that visited Maputo in 2001.

Trade policy as programmed for the coming years leads to suggest that, unless other steps are taken, there would be an important loss of revenue from import duties, starting immediately

³ Ricardo Varsano et al. (2005), op. cit. and Osvaldo H. Schenone (2004), “*Moçambique – Uma Metodologia para Estimar a Arrecadação Tributária*,” draft, May.

with the planned reduction, from 25 to 20 percent, of the highest rate now in effect. In subsequent years, a gradual reduction is anticipated in rates applicable to imports from SADC member countries, until they disappear in 2012, except for imports from South Africa, in which case the deadline is 2015. Since import duty revenue represents approximately 1.7 percent of GDP, and imports from the SADC area account for 40 percent of the total value of imports—imports from South Africa alone for 37 percent—the proposed increase in the rates of the ICE, which now brings in about 1 percent of GDP, will not be enough to offset the loss of revenue that will occur over the next ten years. Since there is strong resistance to an increase in the VAT and IRPC and IRPS rates, gains will have to be made in the efficiency of customs revenue collection, especially the VAT, particularly by improving the inspection and control of import transactions at the borders.

Another possible source of additional revenue would be a reduction in the tax expenditure that originates with incentives. Note, however, that the 2002 Tax Benefits Code rationalized the incentives system in Mozambique and although some aspects still need to be corrected, the revenue gains that would be realized from such a reduction are insignificant. True, the cost in terms of tax expenditure based on tax incentives is still very high, but this is because of benefits granted to megaprojects, especially the Mozal project, about which nothing can be done without the consent of the businessmen.

Following are the mission's principal recommendations as regards tax benefits:

- Give preference to incentives related to size of the investment and to policy objectives, such as the investment tax credits (CFI), accelerated amortizations and replacements of fixed assets, and exemptions from import duties on Class K goods, over reductions or exemptions from income taxes.
- Eliminate regional differentiations in CFI rates.
- Propose, or support proposals for, the negotiation of a code of conduct for granting investment incentives within the SADC area.
- Eliminate all exemptions from the VAT that are related to investment encouragement policy, and all exemptions from the Sisa, except in the case of the Industrial Free Trade Zones (ZFI's), and the IS.
- Maintain the possibility for case-by-case negotiations of benefits to be granted to large-scale projects, but direct negotiating efforts toward a focus on incentives and on minimizing the length of time during which those incentives may be enjoyed, using as a pattern the generic benefits in the 2002 code.
- Eliminate the system of "rapid development zones," while guaranteeing the vested rights of companies that have won incentives so far, but not extending the time frames for the other specific benefit regimes or creating new ones.

The mission has studied each of the main taxes in the Mozambican tax system, paying special attention to aspects identified by the URTI as deserving preferential attention in this analysis. Following are the principal recommendations:

IRPS and IRPC

- Reduce the benefit provided for pension income, thereby achieving greater tax justice vis-à-vis earnings from current work.
- Eliminate the provision that does not tax capital income from interest on demand or time deposits, and require that they be subject to tax withholding when received.
- Increase the number of deductions related to the individual and family situation of the taxpayer. However, the deduction should continue to be a lump sum, not itemized.
- Provide a simplified tax return model form for those who receive only Category One income. Exempt from the requirement to file a return those who have earnings from only one source, when the entire amount of those earnings is subject to withholding.
- Update and rationalize the regulations on amortizations and replacement of fixed assets, providing for a limited number of taxes and extending their application to a generic group of goods.
- Act quickly to approve a new General Accounting Plan that meets current needs.
- Approve, and publish annually, the monetary indexation coefficients and simplify the regulations under which capital gains that are reinvested in the purchase of new fixed tangible assets are not taxed.

VAT and ICE

- Avoid making frequent changes in the rules in the VAT Code, thereby giving investors legal security, and stability in the way that the tax is managed by the tax administration.
- Maintain the features inherent in the mechanics and functioning of the VAT; otherwise, the advantages in terms of neutrality and the obtaining of tax revenues inherent in that tax may be lost.
- Reject any suggestion that the country move toward a multiple-rate system, whether to only two rates, or more.
- Repeal the following VAT exemptions:
 - (a) First transfer of oils and soaps by the respective industrial facility and their inputs—Decree No. 22/2001 of August 14;

(b) Internal transfers of oils and soaps, regardless of the identity of the transferring party—Decree No. 55/2004, of December 10;

(c) Transfers of domestically-produced corn intended for industrial use-- Decree No. 22/2001 of August 14;

(d) Imports of equipment classified as Class K goods under the Tariff Schedule when intended for investment in undertakings authorized by the Investments Act and its Regulations--Decree No. 55/2004, of December 10.

- Unilaterally or in negotiations with donors, look for a way to finance, by budgetary appropriation, payment of the portion of the cost of public works built with funds from donations that corresponds to the VAT.
- Rationalize the assessment of the ICE by removing from the list of goods subject to it those on which collection is insignificant, while reinforcing control over alcohol and alcoholic beverages, tobacco, and vehicles. Together, these three are responsible for almost all the revenue.
- Restore the ICE rate of 75 percent on tobacco, alcohol, and alcoholic beverages and the 50 percent rate on beer.
- Raise the ICE rates for vehicles and, if thought useful for administrative purposes, adopt specific rates (that would not require appraisal of the vehicle).

Other Taxes

- Eliminate the assessment of the IS on rent payments, acquisition of ownership of real estate, bets on casino gaming, and casino admission fees.
- Eliminate the estate tax and gift tax, but incorporate into the Municipal Sisa Tax or the Sisa that is levied in areas where there is no autonomous local authority the conveyance of real estate that does not involve payment, making such transfers subject to the same rates as imposed under those taxes.
- Resume the automatic updating of the Fuels Tax rates and, at the same time, gradually update the monetary adjustment of the rates that was not done in 2005.

As for local government taxes, the mission endorses the general lines of the URTI proposal for a reform of the Local Authority Finance Law, including provisions that grant the autonomous local authorities greater financial autonomy. However, the mission calls attention to the risk inherent in transferring taxing authority to local governments that have little or no ability to manage their own revenues, and recommends maintaining the

responsibility for collecting local authority taxes with the DGI as long as the local government to which they belong is not, in the opinion of the trustee authority, able to do so.

With regard to the tax treatment of microenterprises and small businesses, the mission proposes creation of an autonomous tax system that would be valid simultaneously for the VAT and the IRPS or IRPC. The system would have three regimes:

- Full exemption for those that are considered to be micro-operators, who will be required to retain their purchase documents and record them in a very simple ledger.
- A system for the presumption or estimate of the tax owed, for those whose volume of business exceeds that of those who are exempt, but is lower than those who fall under the normal regime.
- Normal VAT taxation regime and presumption of costs for Income Tax purposes as a final stage prior to full application of the standard regime found in the VAT and Income Tax codes.

Lastly, the mission believes it is necessary to establish, as a complement to the ATM and its study office, a tax policy office within the Ministry of Finance to advise the minister on formulation of tax policy and on decisions on the subject. This office is necessary because in performing their essential function, which is to maximize efficiency in tax collection, tax officials naturally tend to assign greater weight to the ease with which taxes are collected and to the financial interests of the government than to the quality of the taxation and the economic interests of this country.

I. INTRODUCTION

A. The Economy of Mozambique

The Present Situation

The Republic of Mozambique won its independence from Portugal in 1975. Shortly thereafter, a lengthy civil war broke out that did not end until 1992, when a peace treaty was signed by the warring parties. Since then, Mozambique has experienced a period of accelerated recovery, with an emphasis on economic growth and the reduction of poverty as the means of consolidating the peace. After having followed a socialist development model for some years, economic policy turned toward the market during the 1990s.

The Mozambican economy has experienced strong growth since 1994. On average, real GDP growth in the past 12 years has exceeded 8 percent a year. The inflation rate has also been falling; the average in 2005 was 7.2 percent.

Reasonable macroeconomic policies and a sustained program of structural reforms have helped this country obtain assistance from the international community in its battle against poverty. After having participated in the HIPC Initiative for Heavily Indebted Poor Countries, Mozambique has achieved greater flexibility in using its budgetary resources. By responsibly using the funds obtained from debt relief and foreign aid, Mozambique has been able to promote economic activity.

The commercial sector is the most important sector in the Mozambican economy; in 2005, it accounted for 20.8 percent of economic activity. The transportation and communications sector represented 14 percent of GDP in that same year, reflecting the growth in mobile telephone services and maritime transportation. As Table 1 shows, contrary to the situation in other countries of the region, the tertiary sector in Mozambique is responsible for more than half of the economic activity. This structural feature emphasizes the importance of the VAT as a source of revenue. This point will be discussed later in this report.

Agriculture ranks second in economic importance. In 2005, agriculture represented more than 16 percent of GDP. Even though it has declined in terms of relative importance, this sector is still crucial to the development of Mozambique. However, a substantial part of this sector consists of subsistence farming, which is of no use as a productive source of tax revenue.

Manufacturing has grown significantly in importance in the past decade, from 7.4 percent of GDP in 1995 to 15.7 percent in 2005. The growth of this sector also reflects the behavior of foreign direct investment (IDE), including investments in megaprojects. The biggest IDE project is the Mozal project. In recent years, it has accounted for an average of about 6 percent of GDP. As is discussed in the section on tax incentives, although they have

expanded tremendously, the contribution that megaprojects make to the country's tax revenue is limited by the conditions under which the contracts were originally negotiated with the government. The terms agreed to guarantee that the tax benefits granted will remain in effect for many years to come.

Mozambique has been able to reduce poverty in its territory. The poverty index (measured by the percentage of poor people in its population) fell from an estimated 69.4 percent in 1996-97, to 54.1 percent in 2002-03. The government's success in this area reflects a successful implementation of macroeconomic stabilization policies and structural reforms, and significant aid from the international community. Mozambique also has experienced an expansion in its agriculture, as well as in employment opportunities in rural areas. Consequently, Mozambique is now one of the African countries that exhibits the least inequality. Even so, to achieve the principal Millennium Development Goal (MDG), which is to cut the poverty rate in half by 2015, the Mozambique economy will have to grow by at least 5 percent a year.

Even so, the development of Mozambique still depends heavily on continued international assistance. Foreign donations amounted to 7.7 percent of GDP in 2005, equivalent to 62 percent of tax revenue or 56 percent of the government's total revenue. Excluding these donations, the fiscal deficit in 2005 was 13.3 percent of GDP.

In order to achieve its goals in terms of poverty reduction, and to ensure the continuity of international assistance, Mozambique is preparing the second version of its Action Plan for the Reduction of Absolute Poverty 2006-05 (PARPA II). PARPA II sets a goal for increased State revenues from 13.9 percent of GDP in 2005 to 15.9 percent in 2009. To attain this, Mozambique will need to improve tax administration while continuing the process of tax policy reform.

Table 1. Nominal GDP, 1997-2005

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---------------------------|--------------------------------|------|------|------|-------|-------|-------|------|------|
| | (as a percentage of total GDP) | | | | | | | | |
| Primary Sector | 34.1 | 30.2 | 28.0 | 23.5 | 22.1 | 22.3 | 22.1 | 21.2 | 20.5 |
| Agriculture | 25.2 | 22.9 | 21.0 | 16.8 | 15.8 | 16.8 | 16.5 | 16.3 | 16.0 |
| Childraising | 2.0 | 1.9 | 1.8 | 1.7 | 1.6 | 1.5 | 1.4 | 1.2 | 1.1 |
| Forestry | 2.9 | 2.4 | 2.7 | 2.6 | 2.8 | 2.5 | 2.7 | 2.5 | 2.3 |
| Fishery | 3.9 | 3.0 | 2.5 | 2.4 | 1.9 | 1.5 | 1.5 | 1.2 | 1.2 |
| Secondary Sector | 17.4 | 21.5 | 22.2 | 24.0 | 25.3 | 24.0 | 25.5 | 26.6 | 28.0 |
| Mining | 0.3 | 0.3 | 0.1 | 0.3 | 0.3 | 0.3 | 0.3 | 0.9 | 0.2 |
| Manufacturing | 9.6 | 10.9 | 11.5 | 12.0 | 13.6 | 12.0 | 12.6 | 13.5 | 13.7 |
| Electricity and Water | 0.8 | 2.0 | 2.8 | 3.0 | 3.2 | 3.8 | 4.4 | 5.3 | 6.0 |
| Construction | 6.7 | 8.3 | 7.7 | 8.7 | 8.2 | 7.9 | 8.1 | 7.0 | 8.0 |
| Tertiary Sector | 49.0 | 48.1 | 49.0 | 52.0 | 53.2 | 54.2 | 52.5 | 52.0 | 51.3 |
| Commerce | 22.5 | 21.5 | 21.2 | 20.6 | 21.9 | 24.0 | 21.7 | 21.2 | 20.8 |
| Services | 0.6 | 0.8 | 0.8 | 0.9 | 1.0 | 0.9 | 0.9 | 0.7 | 0.7 |
| Restaurants and hotels | 1.2 | 1.1 | 1.2 | 1.3 | 1.4 | 1.3 | 1.2 | 1.3 | 1.2 |
| Transportation, Communic. | 8.9 | 9.2 | 9.5 | 10.4 | 10.8 | 11.3 | 12.5 | 13.9 | 14.2 |
| Financial services | 3.2 | 2.7 | 2.0 | 4.0 | 3.7 | 3.8 | 3.7 | 3.2 | 3.0 |
| Vehicle rental | 2.6 | 2.3 | 2.2 | 1.9 | 1.5 | 1.2 | 1.1 | 1.0 | 1.0 |
| Corporate services | 1.1 | 1.3 | 0.9 | 0.7 | 0.7 | 0.6 | 0.5 | 0.4 | 0.4 |
| Public services | 4.5 | 5.1 | 6.9 | 7.4 | 7.3 | 7.1 | 6.8 | 6.6 | 6.8 |
| Public admin, Defense | 2.5 | 2.7 | 3.6 | 3.6 | 3/7 | 3.6 | 3.4 | 3.2 | 3.1 |
| Education | 1.5 | 1.8 | 2.5 | 2.7 | 2.6 | 2.5 | 2.4 | 2.5 | 2.7 |
| Health | 0.4 | 0.5 | 0.8 | 1.1 | 1.1 | 1.0 | 1.0 | 1.0 | 1.1 |
| Other services | 4.2. | 4.1 | 4.3 | 4.9 | 4.8 | 4.1 | 4.1 | 3.5 | 3.3 |
| GDP at factor cost | 100.6 | 99.8 | 99.2 | 99.5 | 100.6 | 100.6 | 100.1 | 99.8 | 99.8 |
| Import duties | -0.6 | 0.2 | 0.8 | 0.5 | -0.6 | -0.6 | -0.1 | 0.2 | 0.2 |
| PIE at market prices | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Source: IMF

B. Comparison with Other African Countries

Compared with neighboring countries, the tertiary sector of Mozambique's economy is responsible for a greater participation in GDP, particularly, as has already been said, in the areas of commerce, transportation, and telecommunications. One of the economies in the region that most closely resembles Mozambique's structure is Kenya, where participation by the tertiary sector is 54.9 percent of GDP, while Mozambique's is 51.3 percent.

The size of the secondary sector, which in some cases is even double that exhibited by other countries in the region, such as Tanzania and Malawi, also stands out (see Table 2). This is due to the manufacturing sector, where the production of some megaprojects, such as Mozal, is reflected.

Table 2. Composition of GDP in Five African Countries, 2004

| | Mozambique 1/ | Tanzania | Kenya | Uganda | Malawi |
|--------------------------------|---|----------|-------|--------|--------|
| | (as a percentage of GDP at factor cost) | | | | |
| Primary sector | 20.5 | 46.7 | 26.3 | 33.1 | 40.1 |
| Agriculture | 20.5 | 46.7 | 26.3 | 33.1 | 40.1 |
| Secondary sector | 27.9 | 18.5 | 18.7 | 21.2 | 16.0 |
| Mining | 0.2 | 3.0 | 0.2 | 0.8 | 1.1 |
| Manufacturing | 13.7 | 8.6 | 13.0 | 9.0 | 11.1 |
| Electricity and water | 6.0 | 1.6 | 1.6 | 1.4 | 1.4 |
| Construction | 8.0 | 5.3 | 3.9 | 10.0 | 2.4 |
| Tertiary sector | 51.4 | 34.7 | 54.9 | 45.8 | 43.9 |
| Commerce, hotels & restaurants | 22.7 | 16.8 | 12.7 | 14.1 | 21.5 |
| Transportation & Communic. | 14.2 | 5.4 | 6.3 | 6.9 | 4.7 |
| Public Administration | 6.8 | 5.9 | -- | 4.4 | 8.9 |
| Real estate | 1.2 | 4.3 | 8.4 | 3.8 | 1.5 |
| Financial services | 3.0 | 5.6 | 10.6 | -- | 8.6 |
| Other services | 4.2 | 1.3 | 16.8 | 16.5 | 2.2 |
| Bank services, etc. | -0.7 | -4.6 | -- | -- | -3.4 |
| Total GDP (at factor cost) | 100 | 100 | 100 | 100 | 100 |

Source: IMF

1/ In the case of Mozambique, the data are for 2005.

C. The Tax System in Mozambique

The System

Tax Structure, and Central Government Revenues

In Mozambique, tax revenues as a proportion of GDP have remained relatively stable at about 11 percent of GDP during 1997-2005. As Table 3 shows, revenues recovered between 1999 and 2003 until they reached 12 percent of GDP, but fell in the next two years, to 10.8 in 2005.

Despite the restrictive factors that the Mozambique economy has had to deal with, particularly the civil war, tax revenues rose between 1987 and 1993. The increase in revenues from indirect taxes and receipts related to foreign trade contributed to a satisfactory tax collection performance.

In 1993, the government introduced a package of tax policy measures aimed at reducing the tax burden on companies and individuals and encouraging investment and exports. The reduction in tax rates on foreign trade, together with a deterioration in the performance by the customs administration, contributed to a significant decline in revenues related to foreign

trade. As a result, tax revenues fell 2.5 percent of GDP [Portuguese unclear] between 1993 and 1996.

Table 3. Government Revenues, 1987-2005

| | 1987 | 1993 | 1996 | 1999 | 2000-02 | 2003 | 2004 | 2005 |
|---------------------------------|------|------|------|------|---------|------|------|------|
| Total revenue | 9.9 | 13.6 | 10.8 | 12.0 | 12.6 | 12.9 | 12.3 | 13.2 |
| Tax revenue | 8.4 | 12.4 | 9.9 | 11.0 | 11.2 | 12.0 | 11.3 | 10.8 |
| Income taxes | 2.2 | 2.0 | 1.9 | 1.7 | 2.0 | 2.8 | 2.6 | 2.9 |
| IRPS | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| IRPC | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Taxes on goods and services | 4.3 | 6.7 | 5.3 | 7.0 | 6.9 | 6.9 | 6.9 | 5.8 |
| Excise Tax | -- | -- | -- | -- | -- | -- | -- | 0.6 |
| Value-Added Tax | -- | -- | -- | 2.7 | 4.8 | 4.7 | 4.7 | 4.4 |
| Tax on Cons. of Imported Prods. | n.a. | 1.9 | 1.2 | 1.1 | 1.0 | 1.0 | 1.0 | 0.4 |
| Tax on Fuels | n.a. | 0.8 | 1.0 | 1.5 | 1.1 | 1.1 | 1.2 | 0.4 |
| Taxes on Foreign Trade | 1.4 | 3.5 | 2.1 | 2.0 | 2.0 | 2.0 | 1.7 | 1.8 |
| Other tax revenue | 0.5 | 0.3 | 0.6 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |
| Non-tax revenue | 1.5 | 1.2 | 0.9 | 0.9 | 1.3 | 1.0 | 0.9 | 0.5 |

Source: Mozambican authorities and data estimated by IMF staff.

1/ Includes the stamp tax, and fees

2/ Includes the Sisa, social security contributions, dividends, etc.

In response to the decline in revenue, authorities launched a tax reform in 1996. It centered on improving administrative efficiency, broadening the tax base, and moderating tax rates in order to improve collection.

In 2000, the Government of Mozambique developed its Action Plan for the Reduction of Absolute Poverty, known as PARPA. As part of the PARPA, it was thought necessary to develop a Comprehensive Strategy for Public Sector Reform (EGRSP) that would strengthen the performance and financial management by the Mozambican State. An improvement in the management of public funds, particularly the collection of more budgetary resources and their transparent, effective use, was considered to be a fundamental pillar of the reform.

It was recognized that to achieve the objectives laid out in the EGRSP in the area of tax reform, major changes would need to be made in the National Directorate of Taxes and Audit (DNIA) and the National Directorate of Customs (DNA). The national tax directorates were converted to two general directorates – the General Directorate of Tax Administration (DGI) and the General Directorate of Customs (DGA), a change that would give each greater autonomy in carrying out their functions.

From the customs side, the process was accomplished rapidly, starting in 2000. The National Directorate of Customs was re-organized as a paramilitary organization whose objective was to improve personnel discipline and transparency in tax collection. That decision was a response to the actions of organized crime and the contraband that was supplying the

informal sector of the economy, since coordination between the customs posts and law enforcement agencies was poor. After the restructuring of the customs posts, the reform unit was dissolved and the DNA became the General Directorate of Customs (DGA).

On the internal tax side, the DNIA and the Domestic Tax Reform Unit (URTI) joined forces in 2002. As in the case of the DGA, the DNIA became the DGI.

Beginning in 1996, discussions took place about creating a single tax agency, the ATM, or Mozambique Tax Authority. A draft of the law setting up the ATM was sent to the National Assembly for approval in 2004, but then had to be withdrawn. Finally, at the beginning of 2006, two laws were passed: Law 1/06, which established the ATM, and Law 2/06, the General Tax Act. It was determined that the DGI and DGA would be merged to form a single tax authority. The expectation is that this would strengthen both institutions and result in a more efficient tax authority. It is anticipated that the ATM will begin operating before the end of 2006.

The mission believes it is necessary to establish, as a complement to the ATM and its study office, a tax policy office within the Ministry of Finance to advise the minister on formulation of tax policy and on decisions on the subject. This office is necessary because in performing their essential function, which is to maximize efficiency in tax collection, tax officials naturally tend to assign greater weight to the ease with which taxes are collected and to the financial interests of the government than to the quality of the taxation and the economic interests of this country.

Local government tax structure

Mozambique has 33 autonomous local authorities (*autarquias*) that are responsible for providing public services at the local level, services that are to be financed from their own budgets. Local government financing is obtained through two main mechanisms: (i) the system by which a small portion of the State's tax revenue is redistributed to local governments; and (ii) local taxes, including the Local Personal Tax (*Imposto Pessoal Autárquico*), the Local Real Property Tax (*Imposto Predial Autárquico*), several levies on business (*Taxas por Actividade Economica*), the Local Tax on Commerce and Industry (*Imposto Autárquico de Comércio e Indústria*), and the Labor Income Tax – Section B (*Imposto sobre Rendimentos de Trabalho – Secção B.*)

D. Comparison of Tax Collection in Several African Countries

In comparison with other countries in the region, tax collection by the central government, measured as a percentage of GDP (Table 4), is the lowest of the countries shown. Mozambique, Tanzania, and Uganda have in common not only the lowest revenues among the countries shown in the table, but a level of income tax collection that is less than 4 percent of GDP. And in Mozambique, we also find the lowest collections in terms of excise taxes—these are only 0.8 percent of GDP.

Table 4. Comparison of Revenue in Several Countries of the Region

| | Mozambique 1/ | Tanzania 2/ | Kenya 2/ | Malawi | Uganda | Zambia 2/ | South Africa |
|-------------------------------|------------------------|----------------|-------------|--------|--------|--------------|-----------------|
| | (as percentage of GDP) | | | | | | |
| Total revenue | 13.2 | 13.6 | 21.3 | 23.5 | 12.6 | 18.4 | 23.5 |
| Tax revenue | 10.8 | 12.4 | 19.5 | 20.3 | 11.7 | 17.7 | 22.9 |
| VAT | 4.4 | 5.2 | 4.8 | 6.5 | 3.9 | 5.3 | 6.3 |
| Income taxes | 2.9 | 3.5 | 6.9 | 8.7 | 3.4 | 7.9 | 13.5 |
| IRPC (Corporate Income Tax) | 1.9 | 1.2 | 3.2 | 2.5 | 0.9 | 1.2 | 5.2 |
| IRPS (Individual Income Tax) | 1.0 | 2.0 | 3.8 | 4.4 | 1.5 | 6.7 | 7.7 |
| Taxes on Foreign Trade | 1.8 | 0.9 | 1.7 | 2.8 | 1.0 | 2.1 | 0.8 |
| Specific taxes | 0.8 | 1.9 | 2.2 | 2.7 | 3.4 | 2.4 | 2.2 |
| Tax on Cons. Imported Prods | 0.4 | 1.0 | 1.2 | 2.2 | ... | ... | ... |
| Tax on Fuels | 0.4 | 0.9 | 1.0 | ... | 2.0 | ... | ... |
| Other | 0.9 | ... | ... | ... | ... | ... | ... |
| Per capita GDP (current US\$) | 250 | 279 | 459 | 143 | 240 | 354 | 5,326 |

Source: World Development Indicators (WDI), IMF, Varsano 2005.

1/ Mozambique revenues for 2005.

2/ Data from 2004/05 for Tanzania and Kenya, data from 2004 for Zambia. Other countries: 2003.

3/ Malawi does not have a VAT, the figures are for the “surcharge.”

E. Potential Collection, the Tax Gap

There is room for growth in tax revenue in Mozambique. Two recent fiscal years, of different types, attain similar results: actual tax collection by the central government in recent years is only half of the tax revenue that could potentially be obtained.

Schenone (2004)⁴ estimated the potential collection for three taxes (VAT, income tax, and import duties) whose revenues together make up about 80 percent of total effective collection. He constructed the potential base for each of the taxes by applying the taxation rules to macroeconomic aggregates and/or microeconomic data obtained from household surveys and foreign trade statistics. He applied the current rates to the figures obtained and, after comparing estimated collection with actual collection, concluded that the total actual collection of the three taxes was 50.1 percent and 50.7 percent of the 2001 and 2002 potential, respectively.⁵

⁴ Osvaldo H. Schenone (2004), “*Mozambique—Uma Metodologia para Estimar a Arrecadação Tributária*,” draft, May.

⁵ Note that the IRPS and IRPC did not take effect until 2003. The simulations used actual revenues from the income taxes that existed at that time; those were replaced in 2003.

Using a different methodology, Varsano *et al.* (2005)⁶ estimated the tax gap for a sample comprised of 23 African countries. Under that approach, a country's actual tax collection is considered to be a function of the taxing capability of its society, i.e., the maximum collection that would be possible to extract from it (which depends on the economic, social, institutional, demographic, and other characteristics of the country) and of the effort exerted in mobilizing funds for public use (determined by the tax laws and strictness with which the tax administration enforces them). The study concluded that Mozambique's tax effort (ratio between actual collection and taxing capability) was, in 2001 and 2002, equal to 49.5 and 50.6 percent, respectively.⁷

The approach used in Varsano *et al.* (2005) offers only an overall result. On the other hand, it has the advantage of permitting pertinent international comparisons, since the differences that always exist among the tax systems of different countries do not affect the results obtained. Table 5 compares the results obtained for Mozambique with those of other countries in southeastern Africa. We see that Mozambique's tax effort is comparable only to that of Uganda. If we assume the taxing capability of Mozambique and the tax effort by the other countries in the sample to be constant, setting a goal for tax income at 17 percent of GDP in 2010 would require only a medium tax effort (78 percent). And so, if we use the tax effort by the countries in the region as a standard, we can see, once again, how much room there is for the growth of tax revenue in Mozambique.

The methodology used in Schenone (2004) obtains results for each of the taxes and permits us to determine, for each of them, how much of the difference between potential collection and actual collection is due to the law (exemptions and non-assessments) and how much to non-compliance (evasion). The study finds that the latter portion is much larger than the former. The implication is that although there is room for achieving an expansion of the revenues through tax policy measures, the prospects are much greater for measures that increase the efficiency of the tax administration.

Indeed, although the topic lies outside our area of focus, this mission could not fail to notice how fragile the present tax administration is. As a result, we found it tremendously difficult to generate the data needed for our analysis, but the reality is the inadequate ability to generate managerial parameters and instruments that enable the government to properly monitor the taxpayers. It is an administration that seems to be at the halfway point, having

⁶ Ricardo Varsano *et al.* (2005) "Tanzania—Tax Policy Issues and Reforms," aide-mémoire by the mission. December.

⁷ We should note that the results of both studies were derived from data obtained rapidly, and are preliminary. We should also emphasize that taxing capability and potential tax collection—the denominators—are concepts that are similar, but not identical. The first corresponds to the amount of taxes potentially "supplied" by a society, and the second to the amount "demanded" by the tax laws.

lost the ability to work in the old way but not yet mastered the new techniques. From what we were told, there are two basic problems that must be addressed in order to complete the transition: insufficient information technology support from programs that do nothing more than record revenues, and the need to train a team to use more advanced software programs when these become available.

Table 5. Ratios between Tax Revenue and GDP for Countries of Southeastern Africa, for Selected Years
In Percentages

| Country (1) | Year (2) | Revenue/GDP Ratio (3) | Taxing Capability (4) | Tax Effort (3)/(4) |
|----------------|-------------|--------------------------|-----------------------------|-----------------------|
| Mozambique | 2002 | 11.0 | 21.8 | 50.6 |
| South Africa | 2001 | 24.6 | 28.2 | 86.9 |
| Burundi | 1999 | 13.2 | 14.0 | 94.2 |
| Malawi | 1990 | 17.4 | 20.8 | 84.1 |
| Mauritius | 2001 | 15.3 | 25.4 | 60.0 |
| Kenya | 1998 | 21.1 | 22.5 | 93.9 |
| Ruanda | 1992 | 8.6 | 13.0 | 66.5 |
| Swaziland | 2000 | 26.7 | 30.7 | 86.8 |
| Tanzania | 2004 | 12.4 | 17.2 | 72.1 |
| Uganda | 2001 | 10.6 | 20.9 | 50.5 |

Source: Varsano et al. (2005)

II. DIRECT TAXATION

According to Law No. 15/2002 of June 26, which laid the foundation for the tax system, direct taxation includes the Individual Income Tax (IRPS) and the Corporate Income Tax (IRPC).

The Framework Law also establishes the principles to be adhered to in the assessing of both kinds of income tax—the subject of the tax, exemptions/deductions, and rates. These were the basis of the body of regulations found in the IRPS and IRPC Codes.

A. The Individual Income Tax (IRPS)

Features

The IRPS was introduced in 2002,⁸ and is a single, progressive tax on the total amount of the income of natural persons.

⁸ Decree No. 20/2002 of July 30.

The process of determining taxable income involves two distinct phases: an analytical phase in which distinctions are drawn among categories or sources of income, and a concise phase of aggregating in order to determine total taxable income.

The intent of the analytical phase is, via a differentiated system of specific deductions for each category, to administer different treatment for each income source. And so the deduction that each source is specifically entitled to is deducted from the gross income of a given category, to arrive at the respective net income. The sum of the various net incomes will be total net income and the taxable income to which the tax rates will be applied, progressively in accordance with a table of income brackets, to determine tax liability. The subtraction from the tax liability of a deduction related to the personal and family situation of the taxpayer yields the amount of tax owed.

Five categories were established:

Category One pertains to income from “work for others,” and pensions and annuities, or income that can be considered equivalent to these. In the case of work done for others, gross income consists of the remunerations, regardless of how each is designated, that were received or made available to the individual because of his/her employment bond. The specific deduction consists, essentially, of the contributions to the social security system. As regards pensions in general (retirement, old age, disability or survivor, and family support allowances), and temporary income payments or lifetime annuities, we find that those who report an annual sum equal to or less than 168 million *meticaïs* are not subject to tax. Later they are given a specific deduction that corresponds to 50 percent of aggregate income.

Category Two covers business income (commercial, industrial, or agricultural activities) and income from professions practiced on a self-employed basis. (Net) income is determined by one of the following methods:

1. Organized books of account;
2. A simplified bookkeeping system; and
3. Rules resulting from the simplified system for determining income.

Under the first two procedures, earnings are ascertained by referral to the rules applicable to companies as laid down in the IRPC Code. Under the third procedure, applicable residually to taxpayers whose annual volume of business does not exceed 1.5 million *meticaïs*, the result is presumed. It is obtained by multiplying the coefficients 0.20 and 0.30, respectively, by the value of goods or products sold and by the remaining earnings.

Category Three covers income from capital, and capital gains. No deductions are allowed on income from capital. Only half the value of capital gains (the annual balance of losses and gains realized), gains from sale of real estate, from intellectual or industrial property and

financial instruments derived therefrom is counted in determining taxable income. The portion of capital gains resulting from transfers of equity investments in companies and other securities that is counted varies, depending on how speculative the holding is: 75 percent if held for less than 12 months; 60 percent if held for between 12 and 24 months; 40 percent if held for between 24 and 60 months, and 30 percent when held for 60 or more months. The entire amount of capital gains from an assignment, in return for payment, of rights inherent in contracts on real property is considered for purposes of determining taxable income.

Category Four relates to income from real estate. It consists of rents received in return for making rural and urban buildings available for use, income from the assignment of the right to operate commercial or industrial establishments, as well as from the establishment of lesser *in rem* rights to real estate (for example, usufruct rights, rights to the surface only, the right to use and occupy a dwelling). Deductions from gross income received in this category are allowed are for maintenance expense, expenses incurred to preserve the property, and interest on loans taken out for construction of a personal residence that also generates rent that is included as income in this category.

Category Five encompasses gains from social games of amusement⁹ and increases in assets not included in the other categories¹⁰ No deductions are permitted on these kinds of income.

The aggregation of the net incomes in these five categories to determine taxable income suffers limitations when net income is negative: in the second and third categories a negative balance does not operate. Instead, positive income reported in the same categories during the next five years can be used to offset the loss, and the same thing happens with capital gains on equity investment held in companies and securities for a period of two years.

Assessment of personal taxes makes a distinction between taxpayers who are residents of Mozambique and those who are not. The former have a personal or universal tax obligation, while the latter's liability is restricted to income deemed to have been obtained in Mozambique, the respective elements or factors of geographical connection being established.

Although the tax is levied on the income of each individual person, the family unit, when it exists, has been chosen as the economic unit for tax purposes. It consists of a husband and wife (even those joined in a *de facto* marriage, according to the law), and their dependents.

⁹ Such as lotteries, raffles, pari-mutuel betting, lotto, totolotto, bingo, drawings, competitions and other.

¹⁰ Indemnifications for unproven real damages and loss of profits, as a counterpart to non-competition commitments, and increases in assets that have not been justified and are determined indirectly.

The tax rates are moderately progressive, as shown in Box 1, below. In taxing a family unit, and to avoid increasing the effective rate that would result from the accumulation of the incomes of its members, the family quotient method is applied in a mitigated fashion: the divisor is 1.85 when one of the spouses has earned an income equal to or greater than 95 percent of the aggregate income, and is 2 in other cases. It is the results of the division of the combined income by either of these quotients that determines the rate bracket for family unit income. The minimum taxable income was established at 24 million *meticaís*, which corresponds to 24 monthly minimum wages. Provision was made for this figure to be updated periodically to reflect the trend in wages and salaries.

Box 1. Table of Progressive Rates, Individual Income Tax (IRPS)

| Income Brackets (in <i>meticaís</i>) | | Rates* % |
|--|---------------|-------------|
| Up to | 28,000,000 | 10 |
| 28,000,001 | 112,000,000 | 15 |
| 112,000,001 | 336,000,000 | 20 |
| 336,000,001 | 1,008,000,000 | 25 |
| 1,008,000,001 | and above | 32 |

*Marginal rates.

Source: Mozambican authorities.

Not covered by the progressive taxation are, in general, income earned by non-residents (except for income from real estate), most of the income from capital, and all gaming winnings received by residents. Those are subject to proportional rates *de natureza liberatória* i.e., payment of those final tax rates releases the taxpayer from further obligations as regards that taxable income. However, residents have the option to add income obtained on capital to their other income in order to apply the progressive rates. The *taxas liberatórias*, or final tax rates, are 20 percent for stock dividends and other income obtained by non-residents, and 10 percent for residents.

Provision has been made for withholding of taxes, a widespread practice in the case of Category One income and whenever the payer source has, or is required to have, an organized set of account books. These withholdings are treated as payments against the tax that will ultimately be owed. They operate by deduction from tax liability. However, they also are classified as final taxation in cases where withholding at the source serves to release the taxpayer from further tax liability. Provision is also made for payments of estimated tax, in installments (three), equivalent to 80 percent of the tax (attributable to this category of income) of the tax owed in the previous year, for those who receive Category Two income.

Taxpayers who are residents of Mozambique are also able to claim as deductions from tax liability certain aspects of their individual and family situations, and receive a credit for taxes paid under legal international double-taxation. These deductions cannot exceed the amount of tax liability.

Deductions related to a family situation were established as lump sum figures:

- Mt 600,000 per unmarried taxpayer or taxpayer who is legally separated in terms of bed and board;
- Mt 480,000 per married taxpayer, and those not legally separated;
- Mt 200,000, when there is only one dependent;
- Mt 300,000, when there are two dependents; and
- Mt 400,000 for three or more dependents.

Deductions related to double taxation have been established as a general rule, even though there may be no double-taxation avoidance agreement with the State that was the source of the income. The proportional assessment method was adopted.

IRPS revenue is concentrated in Category One, which corresponds to about 90 percent of total tax revenue (Table 6). This tax having been adopted in 2003, it is not surprising that the tax collected is concentrated on earnings from work done for others, pensions and the like since it is precisely these taxpayers who have their taxes withheld monthly by the payer source.

Table 6. IRPS Revenue by Category

| Items | 2004 | | 2005 | |
|----------------|--------------------|-----------------|--------------------|--------------|
| | Mt 10 ⁹ | % | Mt 10 ⁹ | % |
| IRPS | 2,291.7 | 100.0 | 3,065.9 | 100.0 |
| Category One | 2,116.9 | 92.4 | 2,695.1 | 87.9 |
| Category Two | 165.2 | 7.2 | 251.1 | 8.2 |
| Category Three | 9.6 | 0.4 | 14.0 | 0.5 |
| Category Four | (not available) | (not available) | 101.7 | 3.3 |
| Category Five | (not available) | (not available) | 3.5 | 0.1 |

Source: DGI.

Analysis

The decision by Mozambican authorities to adopt the IRPS as a single tax on all income received by individuals marked a major change from the previous situation, which was based on types of income: the Business Profits Tax (CI), the Labor Income Tax (IRT-Section A), the tax on earnings attributable to the activities of production or services cooperatives (IRT-Section B), and the tax on other income—the Complementary Tax (IC). This last tax covers income received by individuals who are not subject to the CI, to Section A or B of the IRT, or to the Local Authority Commerce and Industry Tax, as well as income on capital and capital gains resulting from the transfer, in return for payment, of equity investment in companies that are not subject to the CI.

The design of the Mozambican IRPS benefits from the experience gained with these kinds of taxes when they were adopted during the second half of the last century. It was then believed to be the most proper way of taxing personal income by making it possible, through the progressive formula, to adhere to the principle of taxing those who are better able to pay taxes, as revealed by income received from all sources.

Although this is a very recent tax, it is pertinent to mention certain important aspects that merit attention.

The benefit allowed for pension income in Category One is too high when compared with the treatment of income from “work for others.” While the only deductions from the latter are social security contributions and union dues, in the case of pension income the earnings corresponding to 14 annual minimum wages (Mt 168 million) are exempt from taxation and, furthermore, there is a deduction of 50 percent of the aggregate income (for those in brackets above the exempt level).

The absence of taxes on income from capital resulting from interest on demand or time deposits also appears to be unjustifiable. In fact, it runs counter to recommendations made by the previous IMF mission.¹¹ This exemption, although it does not appear in the chapter on real tax incidence, is found in the chapter on tax rates, specifically in the article on final tax rates.¹²

The deduction for interest on loans taken out for purchase of a personal residence which, despite the designation, are not occupied by the owner but instead rented out and generating income that is included in aggregate income, **should be clarified.** Otherwise it may lead to deviations from the underlying reasoning.

The system of coefficients used in taxing the income of a family unit is too complicated for the tax administration. If 2 were used as the coefficient for all situations, thereby eliminating the use of 1.85 as the coefficient for situations in which 95 percent or more of the family unit’s income is earned by just one of the spouses, greater simplicity and transparency would be achieved. Moreover, in an economy like Mozambique’s, the social purpose of the measure is at the very least questionable because, by and large, the poorest family units are the ones where the income earned and to be considered as a taxable whole results essentially from the employment of only one spouse. The mission recommends that studies be done to show how much revenue might be lost by eliminating the 1.85 coefficient, and if the loss is

¹¹ Coelho et al. *Para uma Reforma do Sistema Tributário e sua Administração*. March 2001.

¹² Art. 67, No. 7, of the IRPS Code: “The income referred to in parts (a) of Section 3 and (c) of Section 5 is not subject to taxation by the IRPS.”

found to be minor, the coefficient could be eliminated and the coefficient 2 be used for all cases.

Regarding rate levels, it does not seem wise to reduce them in any way. The mission believes that the conditions are not yet right for adopting any reduction in tax rate. It would be better to wait until the process of assessing the tax has become consolidated and procedures made operational to ensure better taxpayer compliance, thereby assuring the volume of revenue that is a necessary condition of such a reduction.

The exclusive tax on gaming winnings seems very low, since it has been set at 10 percent. It is true, however, that item 13.3 on the Stamp Tax Schedule calls for an additional tax of 5 percent on such earnings (prizes from games of social amusement), but even so, the tax does not seem high. However, if the Stamp Tax is abolished, the idea of raising the 10 percent rate should be revisited.

As regards deductions from tax liability, given the private sector's dissatisfaction with the absence of deductions for health and education expenditures, the possibility of increasing the deductions related to personal and family situations could be considered. The deduction should still be a lump sum, not broken down by type of expense, because the latter solution would greatly increase the administrative costs and complicate compliance.

Some of the rules in the IRPS Code need adequate implementing regulations, otherwise they perhaps cannot be applied, and so these regulations need to be developed. One urgent matter is the periodic publication of the monetary indexation coefficients necessary to determine capital gains (or losses). Also needed are current rules on calculation of amortizations and replacements of fixed assets, and an updated and adapted Accounting Plan, particularly for those who receive Category Two income (see below for analysis of the IRPC).

The fact that calculation of tax owed is based on the delivery of an identical annual tax return for all taxpayers makes it more complicated for those who owe taxes to file those returns and increases the cost of managing and controlling tax services. It would be a good idea to furnish a simplified tax return model for those who receive only Category One income. A different filing date could be set, one that is earlier than the date for filing the other kind of return (covering income from other categories, even if Category One income is also included). At the same time, the situations in which the requirement for recipients of Category One income (earnings from “work for others”) to file a return is waived¹³ should be reformulated to cover all those taxpayers who have only that kind of income, paid by a single entity and entirely subject to withholding at the source. The associated control function would be achieved by an analysis of the Model 20-H tax return, which all entities that make payments to others must file. It would also be advisable to require the Public Administration to file that same form for the wages and salaries it pays to government employees.

¹³ Art. 54 of the IRPS Code.

Recommendations

- Reduce the benefit provided for pension income, thereby achieving greater tax justice vis-à-vis earnings from current work.
- Eliminate the provision that exempts from tax capital income from interest on demand or time deposits, and require that this income be subject to tax at an exclusive final rate when received.
- If the resulting loss of revenue would be small, eliminate the use of 1.85 as the coefficient for married couples and use 2 as the coefficient in all cases.
- Increase the number of deductions related to the individual and family situation of the taxpayer. However, the deduction should continue to be a lump sum, not itemized by type of expense.
- Refrain from reducing tax rates until revenue conditions are present that would permit a reduction.
- Produce the regulations necessary for application of certain of the rules contained in the IRPS Code; in particular, periodically publish the monetary indexation coefficients needed to calculate capital gains (or losses).
- Provide a simplified tax return model form for those who receive only Category One income. Set a different filing date that is earlier than the filing date of the other type of tax return (covering income from other categories, even if Category One income is also included).
- Exempt from the requirement to file a return persons those who received only Category One income when it was paid by only one source and the entire amount is subject to withholding.

B. Corporate Income Tax (IRPC)

Features

The IRPC was introduced in 2002, along with the IRPS, during the reform of direct taxation. In general terms, this is the natural successor to the former Business Profits Tax (CI) with respect to Group A companies that are taxed on their real and total profits, obtained annually, shown in the account books, and adjusted as provided in that Code.

The IRPC is assessed on all public or private companies that have a principal place of business or actual management in Mozambique. However, it is true that the State, the local

governments, and law enforcement and social security institutions are exempt. Besides entities that have their own legal identity, others are also subject to the tax: those who, although they lack such identity receive income that is not subject to IRPS or IRPC directly on behalf of their natural person or legal entity members. Also subject to this tax are non-resident legal entities, whether or not they have a legal identity, if they receive income in Mozambique, whether or not that income is attributable to a stable establishment located in Mozambique.

The distinction lies in the scope of the tax obligation: a personal or universal obligation for residents, and an effective liability limited to income from Mozambique sources, for non-residents. The law sets out the connection criteria to be used for this purpose.

A system of fiscal transparency was established with respect to companies that have no separate legal identity, professional companies, and family-owned companies that simply administer assets. Its objectives are neutrality, the curbing of tax evasion, and the elimination of double taxation on distributed profits. Within these companies, the taxable matter is determined according to IRPC rules, but it is then attributed to the partners, be they natural persons or collective bodies, in whose name that taxable matter will be taxed (under the IRPS, if the partners are individuals and under the IRPC if they are legal entities).

The tax period is the calendar year, but provision has been made, in certain situations authorized in advance, for the adoption of a 12-month period that does not coincide with the calendar year.

Also exempt, in addition to the State, autonomous local authorities, and institutions in the social security system, are associations deemed to be affected with a public purpose and agricultural, arts and crafts, and cultural cooperatives, as well as income that is subject to the special tax on gaming¹⁴ and income derived directly from the pursuit of cultural, recreational and athletic activities by associations legally constituted for the pursuit of those activities.

With respect to determination of taxable income, a distinction is drawn between entities whose principal activity is commercial, industrial, or agricultural and those that do not engage primarily in such activities. For the latter, the tax will be assessed on the sum total of the various kinds of income classified by category under the IRPS, and for the former (which includes stable establishments maintained by non-residents) there is a broadened set of rules intended to tax real and actual income by reference to taxpayer books of account organized as required by the General Accounting Plan, with certain fiscal adjustments as determined by the Code. To this end, the costs and earnings are identified that, although in terms of bookkeeping were taken into consideration in determining income for the year, are not acceptable for tax purposes or, if accepted, are permitted only partially rather than for their entire amount.

¹⁴ Established by Law No. 8/94 of September 14.

In general, tax liability is determined and declared by the taxpayer. It is also the taxpayer's responsibility to pay the IRPC (without waiting for a notice of assessment). The Tax Administration becomes involved in cases where no return was filed. However, provision is made for an indirect determination of income, using indices of return on capital, average margins of profit, or technical coefficients for consumption or incorporation of costs in production when inconsistencies are found in the account books that cannot be resolved by specific technical corrective measures. Also considered as a means of indirect determination of earnings is the "Simplified Regime for Determining Taxable Profit,"¹⁵ applicable to taxpayers who do not maintain organized books of account, are not covered by the simplified bookkeeping system, and whose annual volume of business in the previous year did not exceed 1,500,000 *contos*.

The deduction for tax losses has been expanded. Now they can be carried forward for as many as five years.

There is no special system for consolidating company profits, but special rules exist for the conversion, merger, spin-off and liquidation of companies.

The general tax rate is proportional, 32 percent, and there is a lower rate, 10 percent, for agricultural activities, including livestock raising. Provision is also made for a separate, additional taxation, at 35 percent, of confidential or undocumented expenses, regardless of whether such expenses are allowed to be claimed as costs for tax purposes.

Withholding is required for several categories of income. In the case of non-residents, this is usually the only payment required, and for residents, it is merely a payment on account. Similarly, and in order to shift the tax payment dates closer to the dates when the income was obtained, a system was adopted for installment payments of estimated tax to be made during the same year, a total of three, in an amount equivalent to 80 percent of the IRPC that was owed for the previous year.

The obligation to file an annual return and deposit the tax owed voluntarily at taxpayer initiative, has been simplified by the requirement that a more detailed annual declaration of accounting and tax information be sent at the same time and that a separate file be prepared that combines all the pertinent data and its supporting documentation.

Analysis

The IRPC honors the generally accepted principles of taxation of the income of legal entities, so as to ensure that taxation does not act as an obstacle to the positioning of the Mozambican economy in the world market.

¹⁵ Art. 54 of the IRC Code.

With respect to the former CI, the IRPC represents a broadening of the tax base, a reduction in the applicable proportional rate and the necessary coordination between the taxing of legal entities and the taxing of natural persons under the IRPC. It constitutes taxation based on added-income, as opposed to income from production that was the basis for the CI.

As regards tax benefits available to legal entities, there are only a few exemptions in the IRPC Code, although they are of a more durable character, since the remainder are laid down in the Tax Benefits Code.¹⁶

The following aspects of the determination of the taxable income of commercial companies (companies whose principal activity is commercial, industrial, or agricultural) should be noted:

- Double taxation of profits distributed between companies that are residents of Mozambique has been eliminated or attenuated in two ways. When the equity investment is equal to or greater than 25 percent and was held for two years prior to the distribution of profits, those profits will not be counted in determining taxable income. They are deducted in their entirety from the results ascertained from the books of account. In other situations, there is an option to deduct from tax liability 60 percent of the IRPC that was assessed against the distributed profits.
- The calculation of amortizations and replacements of fixed assets is done, as a general rule, using the straight-line method, although other methods are permitted (particularly the diminishing amounts method) when justified in advance and acceptable to the Tax Administration. Although the rules refer to specific complementary legislation that will stipulate the maximum rates allowed for each item of the fixed assets, and other tax aspects of amortizations and replacements of fixed assets, that legislation has not, so far, been produced. The directives issued in 1967 and 1968 are still being used. They are seriously out of date as regards rate level and in terms of the kind of assets to be amortized. It is recommended that they be updated and rationalized by establishing a limited number of rates, each of which is applicable to a generic group of goods.
- Calculation of the funding of loan loss provisions accepted for tax purposes is a statistical procedure. The receivables resulting from the company's normal activities as they stand at the end of the year are added up. Every year, a rate of 1.5 percent is applied, up to a cumulative ceiling of 6 percent, to the total amount of the provision. Although the law does not specifically say so, the rule seems to be that it is mandatory that the provision be used to cover uncollectible receivables, inasmuch as only those that remain unpaid after going through a process of formal collection,

¹⁶ Decree No. 16/2002, of July 27.

bankruptcy, or insolvency can be considered as direct costs. Be that as it may, it would be desirable to clarify the rules for funding, using, and replenishing the loan loss provision in order to simplify interpretation, both for the taxpayers and for the staff in charge of audits and enforcement, especially in light of the fact that the system was completely modified in 2003 because of changes introduced by Decree No. 61/03, of December 19.

- Determination of capital gains or losses involves use of monetary indexation coefficients that have not yet been produced. It is vital, and urgent, that these be published in order that the amount of such gains may be properly determined. Furthermore, the regulations under which capital gains are not taxed if they are reinvested in the respective tangible fixed assets need to be simplified.
- Income received from outside Mozambique, the entire amount of which is included in the taxable income of resident entities, benefits from a tax credit for the amount of tax paid in the source State. The ceiling on that credit is the fraction of the IRPC that would be assessed on those earnings. It is believed, however that the deduction must not exceed the amount of IRPC owed. The option available under the law to offset, during the next five years, the amount that could not be deducted in the first year because of insufficient taxable income cannot be used here.
- Because the amount of income taxable by the IRPC is determined by reference to the accounting rules in the General Accounting Plan, it is urgent that the revision of that plan be approved quickly, since the version now in effect is quite out of date and clearly inadequate to satisfy IRPC requirements.
- Some rules to combat harmful fiscal practices were established. They address the following subjects: transfer prices, payments to entities that are residents of countries that have favorable tax systems, attribution of profits to companies that are residents of companies that have favorable tax systems, and undercapitalization. The system is complicated and requires explanatory materials as well as proper, time-consuming, training of personnel.

On the subject of the tax rate, and despite private sector proposals that it should be reduced, conditions do not seem to be right for this. Management of this tax has not yet been consolidated either among the taxpayers or within the Tax Administration. This circumstance is highlighted by the gaps mentioned here in the area of determining taxable income. Once the revenues inherent in the proper performance of obligations in general, and especially the obligation to pay, then there could be room for the sought-after reduction.

Recommendations

- Update and rationalize the regulations on amortizations and replacement of fixed assets, providing for a limited number of taxes and having each apply to a generic group of

goods.

- Clarify the rules on funding, using, and replenishing loan loss provisions.
- Eliminate the option for offsetting, during the subsequent five years, the amount of tax related to the elimination of international double-taxation that could not be deducted during the original year because of insufficient tax liability.
- Act quickly to approve a new General Accounting Plan that meets current needs.
- Approve, and publish annually, the monetary indexation coefficients and simplify the regulations under which capital gains reinvested in the purchase of new fixed tangible assets are not taxed.
- Produce explanatory administrative treatises that would inform people about the interpretation that the DGI may require.
- Do not reduce the 32 percent tax rate until the revenue conditions that would permit this are present.

Indirect Taxation

Under Law 15/2002 of June 26, which established the foundations of the tax system, the term “indirect taxation” refers to taxes on expenditures and is composed of the VAT, the Excise Taxes (ICEs) and Customs Duties.¹⁷

III. INDIRECT TAXATION

A. The VAT

Features, Evolution, and Present Situation

The VAT (Value-Added Tax) is a general tax on consumption that took effect on June 1, 1999.¹⁸ and replaced the previous Sales Tax (a cumulative multi-phase levy) and the Consumption Tax. It is assessed against transactions in goods, provision of services, and imports, from production or importation until consumption, and is levied at all phases or

¹⁷ Art. 66. Law 15/2002 repealed the earlier Law No. 3/87 of January 19 and Law No. 8/88 of December 21.

¹⁸ Decree No. 51/98 of September 29.

stages of the production and distribution of goods and services. In international trade, the tax obeys the principle of destination. Exports and analogous transactions are fully exempt or taxed at a zero rate. Imports are taxed, but that tax may be deducted. Imports of goods that are exempt internally are an exception. They are assured neutral treatment and benefit from the exemption. The single rate, which the Framework Law provides may be as high as 25 percent, was fixed at 17 percent.

The taxable base for domestic transactions is composed of the price paid, or to be paid, by the purchaser of the goods, the recipient of the services, or by a third party on behalf of either of these. This price includes fees or taxes except the VAT itself, plus all the accessory expenses that are charged to the customer (excluding discounts), indemnifications for nonperformance of contracts (provided so declared by a court), sums paid on behalf of or for the account of another person and booked in proper third-party accounts, and returnable commercial packaging. The taxable value of an import is the customs value, which includes the CIF value (cost of insurance and freight), plus import duties and similar taxes other than the VAT itself.

The VAT is paid spontaneously in each tax period (every month) by subtracting from the amount of VAT collected from purchasers of goods and services (the paid VAT) the VAT that was included in the price of goods and services purchased for use in the business (the deductible VAT). The result, if positive, will be paid at the Treasury's collection offices, accompanied by the periodic tax return. If the result is negative, that sum will, as a rule, be carried forward to subsequent periods for offset against future tax owed. If no offset occurs within 12 consecutive months, and the taxpayer still has a credit of more than 50 million *meticais*¹⁹ he may apply for reimbursement. The same thing happens if a company goes out of business, or shifts to a special regime set up for small operators (which does not entitle the taxpayer to a deduction), or whenever the amount of the credit exceeds 50 million.

The customary maximum period for paying out the reimbursement was initially set at 90 days from the date of the request, with shorter periods (30 days) for exporters and for reimbursements associated with investment projects authorized by Law No. 3/93 of July 24, during the project implementation phase and until activities get underway, provided the credit exceeds 50 million *meticais*, whether or not one year has elapsed.

The interval for paying the reimbursement was shortened under Decree 55/2004 of December 10, from 90 to 30 days following submission of the request. Failure to receive reimbursement within the deadline gives the taxpayer the right to receive penalty interest, but this interest is not attributed unless a specific request for its calculation is made. The Tax Administration may, however, suspend the payment of reimbursements for six months

¹⁹ Initially, this figure was 10 million, but it has been updated.

whenever “because of circumstances attributable to the taxpayer, it is impossible to verify the legitimacy of the requested reimbursement.”²⁰

There are special programs for small, or extremely small business operators –one system of exemption and one system of simplified taxation. These always provide for an option to withdraw and an option to use the normal taxation system.

The exemption system covers taxpayers who do not maintain organized books of account, have not executed transactions in international trade, and whose annual volume of business does not exceed 100 million *meticaïs*. This means that these micro-operators are treated as if they were end users: they do not pay the tax in their downstream transactions, but neither do they deduct it on their upstream operations. Therefore, the State is only abdicating its right to tax the respective margin, or value-added.

The simplified tax system requires satisfying the same conditions of eligibility except for the volume of business, which must be above the threshold of the exemption regime but may not exceed 250 million *meticaïs*. The obligations are greatly simplified and the amount of tax to be paid is determined by the application of the coefficient of 5 percent to the sales figure (except sales of investment or capital goods). The taxpayer is not entitled to deduct tax paid on the upstream transactions.

The most distinctive trait of the development of this tax in recent years has been the introduction of a number of exemptions, for both internal transactions and imports.

When the tax was adopted in 1999, there was a group of simple exemptions (no right to deduction) for services provided to citizens. These were dictated by political and social considerations (medical services and medicines, including those for veterinary use, public education and vocational training, protection of children, young people, and the elderly, the needy, public trash removal services, etc.) and/or technical reasons (financial transactions, insurance transactions, real estate rentals and sales—the latter subject to a separate tax on property—the Sisa). Full domestic exemptions were initially enacted for a group of essential products consumed by the neediest families—corn flour, rice, and bread. There were also a few exemptions applicable to international trade, or to special customs regimes.

²⁰ This procedure was introduced in 2000 (Decree No. 29/2000) to permit tighter control of reimbursements requested by taxpayers when the documentation they submitted contained mistakes that would hamper the deduction exercise (such as invoices improperly issued, problems with supplier taxpayer identification numbers, suppliers who did not turn over the paid VAT to the Treasury). Reimbursement is then delayed until the situation is resolved by the supplier and may even be denied (based on the joint liability of the purchaser) if the mistakes could not be corrected by working with the supplier. This happens even when the purchaser has proof that he paid the tax to the supplier.

The agricultural sector (which includes farming, forestry, livestock raising, and fishing) received a simple exemption on transfers of goods that resulted from production, including the first level of processing of those products when done by the farmer using methods normally used in farm operations. Because this was a simple exemption, and in order to lighten the upstream tax burden, an exemption (internal and on imports)²¹ was established for almost all agricultural inputs (141 scheduled items). Agricultural enterprises devoted essentially to exports were given the option to give up the exemption so that they could recover all the upstream tax they had paid.

Later, after the visit by the IMF mission in March 2001, the following exemptions were introduced.

Full exemptions:

- Decree No. 47/2001 of December 21 expanded the exemption on basic or essential foodstuffs to include not only transfers of corn flour, rice, and bread but also iodized salt, powdered milk for nursing babies up to one year of age, wheat, wheat flour, fresh or chilled tomatoes, and frozen horse-mackerel. Also exempted were transfers of lamp oil, jet fuel, mosquito nets, ordinary bicycles, and condoms.
- Decree No. 22/2001, of August 14, exempted the first transfer (by the respective factories) of goods resulting from industrial production of cooking oil and soaps. Although this was a full exemption, the decree also exempted the goods to be used as raw materials in the cooking oil and soaps industry, goods found in the Tariff Schedule and listed in detail in Annex II to the VAT Code (31 schedule positions that appear to cover all the raw materials used by that industry). An exemption was also granted on their importation.²²
- Decree No. 4/2002 exempted transfers of goods and rendering of services within the context of sugarcane production, when earmarked for the industry.²³ The exemption is only internal and does not apply to imports. The grounds for this are dubious, given the exemption for agriculture already mentioned here.

Simple exemptions:

²¹ The exemption on transfers of animal feed, which is a full exemption, covers only feed resulting from internal production and does not apply to imports.

²² Art. 9, Nos. 34 and 35, Art. 11, 1(a).

²³ Art. 9, No. 37

- Transfers of cooking oil and soaps in general, regardless of the transferring party. This complements the exemption granted on industrial production of cooking oil and soaps. However, this exemption does not apply to imports; it appears as a simple exemption, not complete like that other one.²⁴ The attached rules and regulations are complicated and not well justified;
- Transfers of domestically-produced corn intended for use as raw material by the industry. This exemption is limited to the domestic production input and so does not apply to imports. According to the decree that created this exemption—Decree No. 22/2001 of August 14, it was supposed to be temporary, in effect only until 2004. Nevertheless, it was extended. Once again, it is hard to see the justification in light of the exemption granted agricultural products by Art. 9, No. 31 (where domestically-produced corn is already included);
- Transfer of sugar and purchases of raw materials, intermediate products, pieces, equipment, and components by the Mozambican sugar industry.²⁵

Exemptions for imports

- In 2004, an exemption was introduced for “imports of equipment goods classified under Class K of the Tariff Schedule when earmarked for investments in enterprises authorized under the Investments Act and its implementing Regulations.”²⁶

As regards public works contracts and subcontracts, where the State owns the project, the due date of the tax was postponed to the moment when part or all of the price is received by the contractor (Decree No. 27/00 of October 20). The purpose of this change in the general rule that the tax becomes due when the invoice for the service is issued was to make up for the financial repercussions of the State’s customary tardiness, as customer, in paying the public works contractors.

Officials are considering revising the VAT Code, primarily to update the amounts of the reimbursements and, especially, the systems applicable to small taxpayers. They are also studying various issues, and proposals for reformulating the VAT. One of these issues is the problem that taxpayers who have establishments that are geographically situated in different tax districts have in meeting their tax obligations. Another is the problem of paying the VAT on public works projects financed by donors. Proposals deal with possibly simplifying the tax

²⁴ Decree No. 55/2004, of December 10, Art. 9, No. 38, and Art. 11, No. 1, at the end of (a).

²⁵ The exemption was introduced by Decree No. 55/2004 of December 10, which added Art. 9-A to the VAT Code and also applies to imports.

²⁶ Decree No. 55/2004, of December 10 (Art. 11, No. 1 (k) of the VAT Code).

and perhaps reducing the amount of the tax and/or introducing a reduced rate in exchange for expanding the base, especially by incorporating into the taxpayer base producers who are now operating in the informal economy.

Analysis

The new Constitution of the Republic of Mozambique (CRM), promulgated on November 16, 2004, established the principle according to which no crime is present and no punishment can be imposed unless a law defining the act as such existed prior to the commission of the action said to be illegal and applies it to the creation of a tax and the regulation of its essential elements (incidence, rate, tax benefits, taxpayer guarantees). It extends that same principle, i.e., *nullum crimen nulla poena sine lege*, in terms of the pre-eminence of law, to payment and collection of taxes.²⁷ The Assembly of the Republic now has exclusive authority to define the foundations of tax policy and the fiscal system.²⁸ No longer can tax incidence, rate, or exemptions be enacted by mere Government decree. The Constitution also established the principle that “the base of tax incidence cannot be broadened, nor tax rates made more burdensome, within the same financial year.”²⁹ This represents a useful contribution to maintenance of a desirable legislative stability, while not prohibiting changes that the legislature deems necessary.

VAT regulations in Mozambique, found in the articles of the VAT code and complementary legislation, are quite exhaustive. Advantage should be taken of this fact in order to maintain the satisfactory regulatory stability that assures legal certainty and security and therefore builds trust in the minds of taxpayers, as well as helping to simplify matters for the Tax Administration in designing and consolidating its management, oversight, and control methods.

It is advisable that changes to be made be limited to what is essential, i.e., periodic updating of monetary amounts (such as volume of business and size of the tax credit) owing to devaluation of the currency and now, particularly, to changes resulting from the new family of *meticaís* (changes in the value and designation of the monetary unit). The proliferation of legislative changes is not recommended. The regulatory channel should be used to clarify the interpretation of the law and/or explain the proper way to comply.

The changes made by the Government in the meantime, through decrees, are essentially situated at the level of exemptions. These are proliferating, usually without any basis other than strictly financial considerations, and are replacing the VAT that is paid and deductible

²⁷ Art. 127, No. 2, of the CRM.

²⁸ Art. 179, part (o), and Art. 180 of the CRM.

²⁹ Art. 127, No. 4, of the CRM.

with an upstream exemption. These are exemptions designed primarily to benefit the domestic industry, and operate mainly at the input level. Prominent among these is the exemption on imports of equipment goods classified in Class K of the Tariff Schedule and earmarked for enterprises authorized by the Investments Act and its implementing Regulations.³⁰ Some exemptions are only domestic, which impairs the general principle of non-discrimination, through the VAT tax, between domestic and imported products. Other exemptions raise problems of interpretation and seem, in part, to be copies of others that already exist.

In the VAT, the right to deduct the tax paid on acquisitions, whether of raw materials, subsidiary goods, consumer goods, equipment, or even services, ensures the “cleanliness” of the tax burden. This is the mechanism that should always be used—never the upstream exemption. Exemptions complicate oversight of the tax because they create problems that are difficult (sometimes impossible) to control, and frequently open the way to fiscal diversion or even fraud. Certainly they possess a magnetic attraction that will soon lead to pressures to grant the same benefit to other cases. Furthermore, the latitude of some of the exemptions being granted will have negative effects on the size of the tax base. They work against the creation of conditions that would make it possible to consider reducing the rate, a decision that should be made only if there is an increase in the tax base.

The proliferation of upstream exemptions (whose sole reason is to avoid the financial costs of payment until the date of the reimbursement) distorts the mechanics and functioning of the VAT with the qualities it possesses and may possibly transform this taxation into a monophasic tax on sales, with all its well-known vulnerabilities in terms of fraud and tax evasion. And when the exempt goods are inputs used by taxpayers whose operations are exempt and not entitled to deduction, or taxpayers covered by special small-business regimes, then this is not merely a financial operation--the revenue from the tax is, in fact, lost.

The fact that the tax period is short—only one month—and since under normal conditions, reimbursements are paid within 30 days, means that the correct policy on imports is to grant the right to deduction, rather than exemption, even when new investment is involved. If the investors are trusted parties and the procedures inherent in execution of the investment are subject to normal controls, reimbursements can be granted quickly, even in the case of new taxpayers. The right course is always to further improve the efficiency of the reimbursement process, instead of compensating for the difficulties of obtaining reimbursement by awarding upstream exemptions.

Another change that would greatly complicate the mechanics, oversight, and control of the tax would be to abolish the unitary treatment at the principal place of business or

³⁰ Law No. 3/93, of June 24 and Decree No. 14/93 of July 21. Decree No. 55/2004, of December 10 introduced this exemption in its Art. 11, No. 1, part (k).

establishment chosen for centralization of a taxpayer's operations. Different treatment means creating several taxpayers (each geographically differentiated establishment) and having to assign different taxpayer numbers and taxing/deducting the transactions that took place among them.

The road to the desired reduction of the tax rate must be, as Mozambican officials themselves acknowledge, an expansion of the taxable base. Therefore, no measures of any sort should be adopted that have the opposite effect—such as exemptions, especially full exemptions, i.e., those that entitle the taxpayer to a deduction. One analysis of the so-called “efficiency ratio” of the tax for 2005, calculated by dividing the weight of VAT revenues in GDP (4.9 percent), yields a result of 28.8, revealing a declining trend in recent years (according to IMF figures for 2002, the ratio was 32 in that year).

It is the judgment of this mission that the conditions needed for making any reduction in the VAT tax rate are not present. At the very least, the country should await consolidation of the ATM and reinforcement of the results of actions aimed at expanding the taxable base, both through non-proliferation, and even repeal, of unjustifiable exemptions and, especially by adopting procedures that ensure more complete compliance by taxpayers as a necessary condition that would guarantee increased revenue from the tax.

As for the option for a system of diversified rates, particularly the introduction of a reduced rate on the grounds that this would attenuate the regressiveness of the tax by introducing a reasonable degree of personalization, it is important to keep in mind that whether there is just one rate or several rates, the taxation of consumption or spending will still be regressive. This is because the propensity to consume of the economically weaker classes is higher than among those in the stronger economic strata. In relative or percentage terms, this means that the former bear a heavier tax burden. Furthermore, it must not be forgotten that in absolute terms, both groups benefit from lower tax rates, but since the latter spend much more than the former, they will always end up getting a bigger benefit. It also happens, and this can be readily understood, that the loss in revenue resulting from the adoption of a lower rate can be offset by an increase in the level of the normal rate, or by an expansion of the base—which necessarily comes at the cost of revoking some exemptions. Complementarily, one must not forget that unless it is a “sponge” rate,³¹ a lower rate may increase the number of tax credit situations, with the resulting inconveniences.

Beyond that, and in the present situation, the shift to a two-rate system would undoubtedly provoke serious difficulties in application of the tax, in terms of both administrative costs and the cost of compliance. The existence of a low rate would require developing the list of products and services that are included in its scope of application, entailing complicated administrative tasks, notable problems with interpretation, and evasive maneuvers carried out

³¹ A tax whose level is established so as to enable it to absorb the tax paid on the inputs, which may be subject to the normal rate.

to obtain tax savings. Invoicing would become complicated because, of course, it would require the goods and services subject to each of the rates to be shown separately, along with the price and tax for each. Determination of the amount of tax would be complicated for retailers who sell both exempt goods and items subject to two different rates; it would require skilled personnel and complicated procedures. The same would happen in booking downstream and upstream operations (costs under each heading, as well as the tax paid, would need to be broken down by rate, as would the various categories of gains and the tax paid on each), and with the periodic VAT tax return, which would have to separate, by rate, the taxable bases and the tax paid. The same would happen with purchases, and with the tax paid and deductible. And remember that afterward, the low rates always have a magnetic attraction; they unquestionably lead to pressures from both consumers and businessmen to expand the lower rate's scope of application.

Exemptions on internal transactions that benefit the neediest final consumers or, in any case, the essential goods and services that are most important in terms of social policy, were already based on the same reasons that can be invoked in favor of creating a lower tax. The problems of managing a system that features more than one positive rate, both in terms of fiscal administration costs and costs of compliance for taxpayers in general, associated with the creation of conditions that foster an increase in tax evasion without having a significant effect on the regressiveness of the tax, strongly recommend against this solution, which has even more disadvantages than the lowering of the single tax rate.

The provision of social services by NGOs is, in most cases, exempt from VAT under the same terms as identical actions by public entities, on the condition that those entities satisfy the requirement to qualify as not-for-profit organizations pursuant to Art. 108 of the VAT Code. It would be better not to take the exemption route, but instead lend support in terms of public spending in order to make the process more transparent. Still, if Mozambican authorities decide to grant an exemption, it is best to define its boundaries clearly so as not to include goods that are easily diverted into private or final consumption; only the inputs vital to the rendering of the exempt services should be included.

In the agricultural sector, the downstream exemption, accompanied as it is by an exemption on almost all inputs, does not create major tax accumulation problems. Proof of this is the fact that the option to renounce the exemption, established for farmers who primarily produce for export when they feel the burden of the VAT upstream and want to clear it away in order to improve the competitiveness of their products on the foreign market, has practically never been exercised.

Officials mentioned the problem of the VAT is owed on public works projects financed by donors who will not agree to pay the VAT. This is a complicated subject that Mozambican officials need to discuss with the sources of financing. We should point out that this mission favors a solution that would not compromise the principle that the VAT should be paid.

The subject of the treatment of tourists with respect to the VAT is raised only with respect to purchases in Mozambique that tourists take with them when they leave. The goods and

services purchased and consumed in Mozambique should be taxed normally, because this is a tax on consumption and expenditures and it is assessed against these activities regardless of the identity of the consumer. The tax is objective—it distinguishes only taxable transactions.

The only question is whether, out of obedience to the international trade principle of the destination, the tax burden should be lifted on items which, although acquired in Mozambique, will not be used or consumed here but taken to another country by a tourist. There are two alternatives: either exempt the internal purchase, or do not exempt the purchase but refund the tax paid, provided that proof is shown at the customs post on departure that the item has left Mozambican territory. The presumption is that the item will be taxed on entry into the destination country, because that is where consumption will occur. The general rule for exemption is already provided in the VAT Code (Art. 12, No. 1, part (b)). All that needs to be done is to issue the implementing regulation in accordance with the solution chosen.³²

Recommendations

- Avoid making frequent changes in the rules in the VAT Code, thereby guaranteeing that it contains a comprehensive set of rules for taxing expenditures, giving legal certainty and security to Mozambican and foreign investors and affording stability in the management of this tax by the tax administration.
- Maintain the features inherent in the mechanics and functioning of the VAT; otherwise, the advantages in terms of neutrality and the obtaining of tax revenues inherent in that tax may be lost.
- Repeal the following exemptions:
 - (a) First transfer of oils and soaps by the respective industrial facility and their inputs—Decree No. 22/2001 of August 14;
 - (b) Internal transfers of oils and soaps, regardless of the identity of the transferring party—Decree No. 55/2004, of December 10;
 - (c) Transfers of domestically-produced corn intended for industrial use-- Decree No. 22/2001 of August 14;

³² The regulation is provided for in Art. 2 of Decree No. 77/98 of December 29, which approved the Regulations on Collection, Payment, and Reimbursement of the VAT, but has not yet been issued.

(d) Imports of equipment classified as Class K goods under the Tariff Schedule when intended for investment in undertakings authorized by the Investments Act and its Regulations--Decree No. 55/2004, of December 10.

- Maintain the principle of unitary treatment at the principal place of business or establishment selected for centralization of operations.
- Maintain the 17 percent tax rate until: (i) the ATM has become consolidated; and (ii) actions designed to broaden the tax base—both through revoking unjustifiable exemptions and, especially, by implementing procedures that ensure better taxpayer compliance with obligations—have ensured, for two consecutive years, that revenue from that tax exceeds the established goals. The reduction should correspond, at most, to a renunciation of revenue equal to the average surplus over goals for two years. Further reductions can be made if the surplus with respect to the goals persists.
- Reject any suggestion that the country move toward a multiple-rate system, whether to only two rates, or more.
- Avoid granting exemptions on purchases by NGOs, despite the important role they play that was cited to justify the internal exemption established for services they render to the community.
- Maintain unchanged the treatment now afforded the agricultural sector.
- Unilaterally or in negotiations with donors, look for a way to finance, by budgetary appropriation, payment of the portion of the cost of public works built with funds from donations that corresponds to the VAT.
- Tax normally the goods and services purchased and consumed within Mozambique by tourists, lifting the tax burden only on goods that, although purchased in Mozambique, will not be used or consumed here but will be carried out of the country by the foreign tourist.

B. The Excise Tax (ICE)

The Excise Tax (ICE) was introduced in 1998³³ as part of a reform of indirect taxation. It is assessed on a fairly long list of goods (about 140 items), both imported and domestically manufactured, by reference to a schedule that gives the name of the item and its tax classification, and indicates which of four rates applies to each—20 percent, 35 percent, 50 percent, or 75 percent. The ICE is not assessed on fuels, because they are subject to a

³³ Decree No. 52/98, of September 29, approved the ICE Code.

separate tax that is known as the tax on fuels, although its official name was changed from *imposto sobre os combustíveis* to *taxa sobre combustíveis*.

Evolution and Present Situation

Shortly thereafter, in 1999³⁴ all ICE rates were lowered. The 20 percent and 35 percent rates were cut by 5 percentage points, to 15 percent and 30 percent, respectively. The 50 percent and 75 percent rates were reduced by 10 percentage points, to 40 percent and 65 percent. At the same time, new goods were added to the list—musical instruments, games, toys, and some sports equipment (bringing to 188 the number of items on the list of products taxed by the ICE).

The ICE rates were revisited again in 2002³⁵ (see Box 2). During this process, some items were deleted from the list: untreated fur-bearing hides and skins (position 4301), helicopters, aircraft, and other vehicles for locomotion by air (8802), miscellaneous musical instruments (9201, 9202, 9203, 9204, 9205, 9206, 9207, 9208, and 9209). This same decree made the General Directorate of Customs (DGA) solely responsible for determining the amount of tax payable, overseeing the payment, and collecting the ICE on alcohol and alcoholic beverages, beer, wine, and tobacco. That function had previously been performed by the DNIA (now the DGI), leaving the DGI in charge only of the determination of tax payable on the remaining products, on the domestic scene.

The evolution of the revenue from the Excise Tax shows continued growth. In 2005, total collections amounted to about 1 percent of GDP (1,553.2 million *meticais*), nearly all of it collected by the DGA. The importance of ICE collection within Mozambique on domestic products other than alcoholic beverages and tobacco has been falling; it now represents only 0.15 percent of total ICE revenue.

Analysis

The ICE plays a role complementary to the VAT. It increases the tax burden on a group of products whose consumption the authorities want to discourage for social reasons, as is the case with tobacco and alcoholic beverages, or for environmental reasons, such as with automobiles or mineral oils. Here, part of the initial objective was to supplement the single-rate taxation by the VAT with respect to a group of less essential, or superfluous goods, since there was no augmented tax on those items.

³⁴ Decree No. 31/99, of May 24, which took effect on June 1, 1999.

³⁵ Decree No. 37/02 of December 11, which took effect on January 1, 2003.

Box 2. Reduction in Rates Achieved by Decree 37/02, Percentages

| PRODUCT | Decree 31/99 | Decree 37/02 |
|--|--------------|--------------|
| Wines in general, vermouth and un-denatured ethyl alcohol, having an alcohol content by volume equal to or greater than 80% | 65 | 40 |
| Automotive vehicles for transporting 10 or more people, including driver | 40 | 30 |
| Automotive vehicles for passengers, and other automotive vehicles designed primarily for transportation of persons, including mixed-use vehicles, having an engine displacement larger than 2000 cm ³ but smaller than 3000 cm ³ | 40 | 30 |
| Automotive passenger vehicles and other automotive vehicles designed primarily for transportation of persons, including mixed-use vehicles, having an engine displacement larger than 3000 cm ³ | 65 | 30 |
| Motorcycles in general | 30 and 40 | 15 |
| Motorcycles with greater piston displacement | 65 | 30 |
| Motor boats | 65 | 40 |
| Firearms | 65 | 30 |
| Articles used for indoor games | 40 | 15 |
| Sporting goods, fishing poles, reels, and other articles of amusement | 40 | 15 |

Source: Mozambican authorities.

In Mozambique, the list of this second type of goods is still very long, even after the 2002 rationalization. It includes products like perfumes and cosmetics, flowers, artificial foliage and fruits, pearls, precious stones and jewelry in general, works of art, and antiques.

The revenue collected on these goods within Mozambique is very small, and it is believed that the same is probably true with imports, although data has not been made available as to the breakdown on collection by products. Therefore, we still believe that the list should be cut back and rationalized so as to focus on alcohol, alcoholic beverages, and tobacco, for which the initial rates (75 percent) should be restored, and on vehicles (automobiles, motorcycles, boats and aircraft) on which the tax rates should be raised. Thus we go back to the recommendation by the 2001 mission. These tax rate increases are recommended in order to offset, at least partially, the planned reduction in customs tariffs.

Recommendations

- Rationalize the assessment of the ICE by removing from the list of goods subject to it those on which collection is insignificant, while reinforcing control over alcohol and alcoholic beverages, tobacco, and vehicles. Together, these three are responsible for almost all the revenue.
- Restore the initial 75 percent rate, replacing the present 65 percent, on tobacco in positions 2402 and 2043 of the ICE tax table attached to the respective Code.
- Restore the initial 75 percent rate on alcohol and alcoholic beverages in positions 2204, 2205, 2206, and 2207 of the of the ICE tax table. This rate is currently 40 percent.

- Restore the initial taxation of beer at 50 percent, replacing the current 40 percent rate.
- Raise the ICE rates for vehicles and, if thought useful for administrative purposes, adopt specific rates (that would not require appraisal of the vehicle).

C. Customs Duties

Taxes on foreign trade and regional integration

Features, evolution, and present situation

Under the Framework Law on the Mozambican Tax System, taxes on foreign trade consist of customs duties (import duties plus a surcharge).

The reform of the customs duty system took place simultaneously with the introduction of the VAT, in 1999³⁶ and led to a simple tariff schedule with only five tax rates, as recommended by the IMF mission that assisted with the process.

A zero percent tax was established for exports of goods. For cashew nuts, and for non-tax reasons related to protecting the sector in light of the liberalization of exports, the Cashew Nut Overvaluation Tax created by Decree No. 17/91 is still being charged.

The import duty rates are 0 percent for essential goods (Class E), 2.5 percent for raw materials (Class M), 5 percent for capital goods (Class K) and for fuel (Class N), 7.5 percent for intermediate goods (Class N), and 25 percent³⁷ for consumer goods (Class C). The maximum duty has now been cut to 20 percent on imports from SADC countries. A reduction on imports from other countries is planned for later in 2006.

A Customs Services Fee is also assessed on imports. It is a flat fee on imports that are exempt from payment of duties and other levies. At present, the fee is US\$50.00

The Tariff Schedule and the respective preliminary instructions were revised in 2002³⁸ because of the need to adapt it to the evolution in world trade and the commitments that Mozambique had assumed internationally, particularly those stemming from preferential treatment agreements signed with Zimbabwe and Malawi, and this country's role in the

³⁶ Decree No. 30/99 of May 24

³⁷ Beginning January 1, 2003. The rate was initially set at 35 percent, and later at 30 percent.

³⁸ Decree No. 29/02, of December 26.

SADC. The SADC was founded in 1980 and has 14 members³⁹ that are also members of the Common Market for Eastern and Southern Africa (COMESA)⁴⁰ and/or the Southern Africa Customs Union (SACU)⁴¹

SADC is at present a preferential trade area, but plans call for it to become a free trade zone in 2008, a customs union in 2010, and a common market in 2012. The commitment assumed by Mozambique under the SADC Protocol is to eliminate the duties on imports from Community countries, some of them by 2008 and all by 2012 (except with respect to South Africa, for which an additional three years is allowed for elimination of those duties still remaining after 2008). At present, the initial negotiation phase is still in progress and no agreement has been reached about common external tariffs.

Analysis

Import duties account for about 16 percent of the State's tax revenues, in other words, approximately 1.7 percent of GDP, down from the level that had prevailed until 2003. The decline is due to the reduction in tax rates and, according to customs officials, it was largely because of an improvement in control procedures, especially computerization, that the decline was not even greater.

The general lowering of the highest duty, from 25 percent to 20 percent, that is to occur this year, as well as the customs dismantling under way within the SADC, will inevitably bring about a further reduction in the ratio between revenue and GDP. In 2003, the most recent year for which data could be obtained, imports from the SADC accounted for 40 percent—imports from South Africa alone for 37 percent—of the country's total imports. The increase in ICE rates on the key products that make up its base, recommended here, may recover the short-term losses at least partially, but will not be able to counter the additional customs dismantling that will begin as early as next year.

Unfortunately, the data that the mission was able to obtain are scanty and not reliable, so it is impossible to predict the size of the losses. At the same time, there is obvious resistance to an

³⁹ Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar (since August 2005), Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe.

⁴⁰ COMESA is a preferential trade area whose members are Angola, Burundi, Comoros, the Democratic Republic of the Congo, Eritrea, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Namibia, Ruanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, and Zimbabwe.

⁴¹ SACU is a customs union that includes South Africa, Botswana, Lesotho, Namibia, and Swaziland.

increase in the domestic tax rates, and the private sector is actually demanding reductions. Therefore, we are left with the possibility of substantially increasing the efficiency of the two components of the tax administration—the DGI and DGA—in order to collect more domestic taxes.

In the case of the DGA, the task is made more difficult by the fact that Mozambique's borders are very long and very vulnerable. Both the long land border and the unprotected coastal waters make it easy for people to resort to contraband and smuggling, thus contributing heavily to a decline in revenues. It is very difficult to find data or make estimates of this activity, but it is pertinent to make a recommendation for improving the effectiveness of inspection, control, and the associated administrative procedures, although the subject lies outside this mission's terms of reference. The harmonization and, if possible, even an achievement of uniformity of procedures with the neighboring countries, especially South Africa (and particularly the "dry port" of Ressano Garcia) would reduce the costs of compliance and administrative costs, and curb fraud and tax evasion.

One must keep in mind that there is yet another factor in the erosion of customs revenues: the tax incentives that operate in this arena which, when taken together with the VAT, resulted in a loss of about 530 million *contos* in revenue in 2004, and 606 million *contos* in 2005 (import duties alone represented 462 million *contos* in 2005), according to information obtained from the DGA. Those incentives were almost entirely absorbed by Law 3/93 of June 24 (The Investments Act, which includes the Tax Benefits Code), Law No. 14/02 of July 26 (the Mines Act), and Law 3/01, of February 21 (the Petroleum Act).

Recommendations

- Partly offset the loss of customs revenues from import duties that will occur because of the tariff dismantling process by increasing the ICE tax rates (as recommended above).
- Review the exemptions from import duties along the same lines as recommended for the VAT, as well as the tax benefits. Their complete elimination would boost revenue by 0.3 percent of GDP.
- Take steps to increase efficiency in the collection of customs revenue, especially the VAT, by improving the oversight and control of imports at the borders.

IV. OTHER TAXES AND FEES

Under the Framework Law of the tax system, the following taxes complete the tax system of Mozambique: the IS (Stamp Tax), the Tax on Estates and Gifts, the Sisa (Real Property

Transfer Tax), the Special Tax on Gaming, the National Reconstruction Tax, the Vehicle Tax, and other specific taxes and fees established by law.⁴²

A. The Stamp Tax

This tax is assessed on documents, contracts, books, papers, and certain acts listed in the general IS schedule. The taxpayers are the entities that have an economic interest in those matters.

The majority of the fees are specific, but there are several kinds of documents and acts that are taxed *ad valorem*, notably those involved in the following situations:

Box 3. Stamp Tax *Ad Valorem* Rates

| | (In percentages) |
|---|------------------|
| Purchase of the right of ownership of real estate | 0.20 |
| Rents | 2.00 |
| Other insurance policies | 3.00 to 5.00 |
| Accident insurance policies | 1.00 |
| Maritime and shipping insurance | 2.00 |
| Gaming bets | 5.00 |
| Leases | 2.00 |
| Collateral guarantees, sureties | 0.02 to 0.30 |
| Lottery tickets | 5.00 |
| Credit cards | 4.00 |
| Loans for use of durable goods | 2.00 |
| Purchase and sale of shares | 0.40 |
| Loans | 0.03 to 0.50 |
| Civil deposit | 0.2 |
| Admission to casinos | 50.00 |
| Interest (other than paid on Mozambican government bonds) | 2.00 |
| Fishing and hunting licenses (on the amount of the fee) | 10.00 and 5.00 |
| Trademarks and patents | 10.00 |
| Lottery prizes | 5.00 |
| Foreign government bonds | 1.00 |
| Credit instruments | 0.10 to 0.30 |
| Title or permits for concession of the use of land (on the amount of the fee) | 10.00 |

Analysis

Despite the changes made in the IS Code in 2004 and 2005⁴³ during which, for example, the use of the revenue stamp was eliminated and the table of assessments was amended, this

⁴² The Vehicle Tax and the Sisa are discussed in Chapter V (Local Governments). The Local Authority Personal Tax is also discussed there; it is similar to the National Reconstruction Tax. The mission has no recommendations to make concerning the Special Tax on Gaming.

⁴³ Decrees No. 6/2004, of April 1, and 38/2005, of August 29.

continues to be one of Mozambique's most difficult tax to administer and control. Moreover, because of the bureaucratic burden associated with the many different ways it is collected, this is the tax that creates the most work and greatest distress for the taxpayer.

Even so, for the time being there can be no consideration of eliminating the tax because, given the exemptions from income tax and VAT on financial transactions, the stamp tax is practically the only tax currently assessed on such transactions. As we can see from Table 7, the financial sector is responsible for more than half the revenue from this tax.

Table 7. Revenue from the Stamp Tax on the Financial Sector – 2005

| Item | (Mt 10 ⁹) | % |
|---------------------|-----------------------|--------------|
| Total Tax | 272.0 | 100.0 |
| Financial Sector | 143.3 | 52.7 |
| Banks | 118.6 | 43.6 |
| Insurance companies | 24.7 | 9.1 |

Source: DGI

Recommendations

- Eliminate the tax on rents, since these are already taxed by the IRPS.
- Eliminate the tax on the acquisition of the right to own real estate, since this is already taxed by the Sisa
- Eliminate the tax on gaming bets and casino admission fees, offsetting the loss of revenue by increasing, respectively, the IRPS final tax rate and the rate of the Tax on Gaming.

B. Tax on Estates and Gifts

Acts by which title to property is transmitted without payment are subject to taxation, at *ad valorem* rates. The rates vary according to the degree of family relationship, so that persons more closely related to the giver are taxed more moderately. The tax is levied by the central government.

The complexity of this tax, combined with the high potential for evasion that we see occurring in most countries, could lead to an initial conclusion that it might be better to cease trying to collect it. The mission suggests that the tax be eliminated without, however, entirely giving up collecting it [Portuguese unclear].

Recommendations

- Incorporate into the Municipal Sisa Tax, or the Sisa that is levied in areas where there is no local authority (see Chapter V on Local Governments), transfers of real estate that do

not involve payment and make them subject to the same rates as applied for those taxes.

- Eliminate the assessment on the other goods.

C. Tax on Fuels

The tax (*taxa*) on fuels was created by Law No. 15/2002, of June 26 (The Framework Law on the Tax System) and regulated, in 2003, by Decree No. 56/2002, of December 24, thereby repealing the earlier tax (*imposto*). It took effect on January 1, 2004.

It is assessed against all fuels (auto gasoline, aviation gasoline, jet fuel, gasoil, fuel oil, LPG, and analogous petroleum products that have different names), whether produced domestically or imported, when sold in Mozambique.

The revenue from this tax is dedicated as follows:

- 75 percent of the revenue from gasoil and 50 percent of the revenue associated with auto gasoline goes to the highway fund;
- 5 percent of the revenue from gasoil is earmarked for development projects in the transportation sector; and
- the rest of the revenue goes into the central budget.

The tax is paid by the refiners, importers, and distributors. The internal determination of the tax payable is done by the taxpayers at the time of sale at the refinery door (or offshore facility), and the determination of the tax payable on imports is done by the DGA.

The law includes a clause that calls for automatic adjustment, every quarter, according to the change in the inflation rate. The maximum is 5 percent. However, after the recent surge in the world price of oil, in order to prevent the full impact of that increase from being passed on to domestic prices, this update was done only once in 2005.

Following are the rates currently in effect:

Box 4. Tax Rates on Fuels

| | |
|-------------------|-------------------|
| Aviation gasoline | Mt 3,600.82/liter |
| LPG | Mt 511.89/kg |
| Aviation gasoline | Mt 3,600.82/liter |
| Leaded gasoline | Mt 5,962.00/liter |
| Unleaded gasoline | Mt 3,577.23/liter |
| Jet fuel | Mt 775.39/liter |
| Gasoil | Mt 3,289.36/liter |
| Fuel oil | Mt 591.82/liter |

Source: DGI

Mechanized farming (individual farmers or companies that maintain organized books of account or observe the simplified bookkeeping system), consumption by the mining industry (when it uses gasoil-powered generators to produce the electricity needed for mining), consumption in generators that produce electricity in the districts (managed by local authorities) and consumption by fishing boats (small-scale non-industrial, semi-industrial, and industrial) all benefit from incentives.⁴⁴ These incentives are not awarded automatically, but must be applied for in advance. They provide a 50 percent reduction in the rate that applies to gasoil, for quantities established in advance for each of the sectors.

Quantification of the benefits awarded required completion of tax returns by the beneficiaries and by the distributor companies.

Recommendations

- Realign domestic and world prices of petroleum and their derivatives by gradually performing the monetary indexation that was not done in 2005.
- At the same time, resume the automatic quarterly updating.

⁴⁴ Ministerial Instrument (*Diploma*) No. 118/2005, of June 13, in force temporarily until December 31, 2005 but recently extended (Ministerial Instrument No. 51/2006, of February 22) to remain in effect until June 30, 2006.

V. OTHER TOPICS

A. Local Governments

According to the Constitution of the Republic, the Mozambican State is a unitary state, subdivided administratively into 11 provinces. The Constitution also provides for units of autonomous local authority—the local *autarquías*—whose purpose is to organize participation by the citizens in the solution of problems and the development efforts in their respective territories.⁴⁵

At present, there are 33 local authorities, and another 57 are expected to be created in the coming years. At the time of the last census, slightly more than 38 percent of the country's population lived under the jurisdiction of local governments. (See Table 8).

The local governments are endowed by the Constitution with political, administrative, financial, and property-related autonomy. Politically speaking, the head of the executive branch and the government's legislative body are directly elected. In other areas, however, this autonomy is not complete because local governments are subject to the tutelage of the State, exercised by the Ministries of Planning and Budget, Finance, and Government Administration. This function may be delegated to the provincial governors.⁴⁶

Financing the local governments

The Present Situation

Local authorities are responsible for providing services in areas typically associated with local governments, as shown in Box 5. In order to handle these responsibilities, the Local Authority Finance Law (Law No. 11/97, of May 31) defined the taxes that local governments have authority to impose, and established the Local Authority Compensation Fund (FCA), which passes between 1.5 percent and 3 percent of the State's tax revenues on to the local government budgets.

The factors that determine how the FCA funds are distributed, according to the aforementioned law, are:

- Size of the local government population;

⁴⁵ Art. 271 of the Constitution of the Republic of Mozambique

⁴⁶ The administrative guardianship is expressed, according to Art. 277 of the Constitution, by verification of the legality of the administrative actions taken by local government offices and, in specific cases provided for in the law, also by verification of the merits of such actions.

- Area of territory administered;
- Tax performance index; and
- Weighted development index.

**Table 8. Local Governments in Mozambique, and their Populations
(1997 Census)**

| Province Municipality | Population | Population as % of Population of the Province / Of the Country | |
|--------------------------|------------|---|---------|
| | | Participação Percentual na População da Província | Do País |
| Província Município | População | | |
| Niassa | 756.287 | | 4,95 |
| Lichinga | 85.758 | 11,34 | 0,56 |
| Cuamba | 126.380 | 16,71 | 0,83 |
| Metangula | ... | ... | ... |
| Cabo Delgado | 1.287.814 | | 8,43 |
| Pemba | 84.897 | 6,59 | 0,56 |
| Montepuez | 149.181 | 11,58 | 0,98 |
| Mocimboa da Praia | 75.001 | 5,82 | 0,49 |
| Nampula | 2.975.747 | | 19,48 |
| Nampula | 303.346 | 10,19 | 1,99 |
| Angoche | 228.526 | 7,68 | 1,50 |
| Ilha de Moçambique | 42.407 | 1,43 | 0,28 |
| Nacala | 158.248 | 5,32 | 1,04 |
| Monapo | 226.968 | 7,63 | 1,49 |
| Zambézia | 2.891.809 | | 18,93 |
| Quelimane | 150.116 | 5,19 | 0,98 |
| Guruè | 197.179 | 6,82 | 1,29 |
| Mocuba | 214.748 | 7,43 | 1,41 |
| Milange | 335.728 | 11,61 | 2,20 |
| Tete | 1.144.604 | | 7,49 |
| Tete | 101.984 | 8,91 | 0,67 |
| Moatize | 109.103 | 9,53 | 0,71 |
| Manica | 974.208 | | 6,38 |
| Chimoio | 171.056 | 17,56 | 1,12 |
| Manica | 155.731 | 15,99 | 1,02 |
| Catandica | ... | ... | ... |
| Sofala | 1.289.390 | | 8,44 |
| Beira | 397.368 | 30,82 | 2,60 |
| Dondo | 117.719 | 9,13 | 0,77 |
| Marromeu | 69.895 | 5,42 | 0,46 |
| Inhambane | 1.123.079 | | 7,35 |
| Inhambane | 52.370 | 4,66 | 0,34 |
| Maxixe | 93.985 | 8,37 | 0,62 |
| Vilankulo | 113.045 | 10,07 | 0,74 |
| Gaza | 1.062.380 | | 6,95 |
| Xai-Xai | 99.442 | 9,36 | 0,65 |
| Chibuto | 164.791 | 15,51 | 1,08 |
| Chokwè | 173.277 | 16,31 | 1,13 |
| Mandlakazi | 161.147 | 15,17 | 1,05 |
| Maputo | 806.179 | | 5,28 |
| Matola | 424.662 | 52,68 | 2,78 |
| Manhiça | 130.351 | 16,17 | 0,85 |
| Maputo Cidade | 966.837 | 100,00 | 6,33 |
| Autarquias | 5.881.246 | | 38,49 |

Source: Coelho et al., 2001.

**Box 5. Powers of the Local Governments
(Law No. 11/97, of May 31)**

Special Powers

- (a) Rural and urban equipment
 - Green spaces, botanical gardens
 - Highways and roads, including sidewalks
 - Affordable housing
 - Public cemeteries
 - Public services facilities operated by local governments
 - Markets and farmers' markets
 - Firefighting
- (b) Basic sanitation
 - Water supply
 - Sewer systems
 - Trash collection, waste treatment, street-cleaning
- (c) Electricity
 - Electricity distribution
 - Street lighting, other lighting in public areas
- (d) Transportation
 - Urban and rural road network
 - Public transportation within the local government's territory
- (e) Education and instruction
 - Preschool education facilities
 - Elementary education
 - School buses
 - Equipment for basic education of adults
 - Supplementary activities
- (f) Culture, Leisure Time activities, and Sports
 - Cultural centers, libraries, and museums
 - Cultural heritage, including scenic and urban areas of special interest
 - Campgrounds
 - Facilities and equipment for sports and recreation
- (g) Health
 - Primary health care facilities
- (h) Social Action
 - Assistance to vulnerable population groups
 - Group housing
- (i) Environmental management
 - Protection or restoration of the environment
 - Forestry, planting and protection of trees
 - Establishment of municipal preserves

The local governments may invest in public projects in cooperation with the State, through prior agreements.

Because of the precariousness of the available statistics, especially at the local government level, in practice the revenue-sharing via the FCA is done. [Portuguese unclear]

Local governments also receive 75 percent of the revenue from the Vehicle Tax on vehicles registered in their territories.⁴⁷

In addition to providing for the aforementioned transfer of revenues, the Local Authority Finance Law stipulates that local governments may impose the following taxes:

- Local Personal Tax (*Imposto PESSOAL Autárquico*)
- Local Real Property Tax (*Imposto Predial Autárquico*)
- Economic Activity Fees (*Taxas por Actividade Económica*)
- Local Tax on Commerce and Industry (*Imposto Autárquico de Comércio e Indústria*)
- Labor Income Tax – Section B (*Imposto sobre Rendimentos de Trabalho – Secção B.*)⁴⁸

The Local Personal Tax

This tax is assessed on both Mozambican and foreign individuals aged 18 to 60 who reside in the territory of the local authority and receive income that is subject to any central or local government taxes. The rates are set by the local authority's legislative body and must not exceed, in each year, the equivalent of 20 percent of the monthly minimum wage for workers in industry, i.e., Mt 200,000.00 (equivalent to approximately US\$8.00).

The following are exempt from this tax:

- Physically handicapped persons;
- Citizens in military service;
- Full-time students, up to a certain age;
- Pensioners who have no income other than their pensions;
- Peasant women or female domestic workers; and

⁴⁷ Article 68 of the Local Authority Finance Law.

⁴⁸ These last two taxes were repealed when the IRPS and IRPC were adopted, and so they will not be discussed in greater detail here.

- Foreigners working for the countries of their respective nationalities, when there is reciprocal treatment.

By decision of the local legislative body, taxpayers who have suffered the effects of natural disasters or other exceptional circumstances may be temporarily exempt from this tax.

A simple exercise can be done to obtain a very rough estimate of the potential revenues from this tax. Taking exemptions into account, in 2004, the male population between 20 and 59 years of age was approximately 292,000 in the city of Maputo and about 3,733,000 in the rest of the country. If the maximum tax allowed by law were to be charged, revenue collection in the capital and in the rest of Mozambique would be, respectively, Mt 58.473 million and Mt 746.537 million. In the case of Maputo, revenues from that tax in 2004 totaled Mt 4.052 million, just 6.9 percent of potential revenue.

Although it is not very likely that this potential could be achieved, the results indicate that additional efforts to collect the tax properly may be well rewarded.

In addition, as the report by the 2001 technical assistance mission pointed out, “There is also a possibility that payment of this kind of tax, as a minimum contribution to the financing of the State, might be perceived by the taxpayer as an exercise of good citizenship, which would not only facilitate collection but could be psychologically important in a country where preservation of the national unity and sovereignty are still very much on people’s minds. Furthermore the tax could play the role of an educational tool with respect to taxation.”⁴⁹

The Local Real Property Tax

The Local Real Property Tax is levied against the assessed value of an urban property located within the territory of the local government that belongs to an individual or company and is used for some purpose other than agriculture, forestry, or livestock raising. The assessed value will be determined according to the appraisal regulations found in the law, which are established by Council of Ministers decree. Until the regulations are approved, provisional appraisals will be done according to the rules established for the purpose of real estate sales under the management of the Administration of Government Real Estate (*Administração do Parque Imobiliário do Estado*).

For purposes of appraisal and graduation of the tax rates, properties are classified as follows:

- Residential
- Commercial, industrial, or for use in professional activities
- Independent; and
- Land available for construction.

⁴⁹ Coelho et al., 2001.

The tax rates applied by each local government are fixed by their respective legislatures and vary from 0.2 percent to 1 percent of the assessed value of the properties.⁵⁰

There are exemptions for:

- Humanitarian associations and other not-for-profit entities;
- Diplomatic or consular facilities, when there is reciprocal treatment;
- The local authority and its services; and
- A precariously-constructed dwelling occupied by its owner.

As an incentive to the construction or acquisition of owner-occupied housing, exemptions from the tax rate and bonuses may be granted for up to 10 or 15 years, respectively.

Economic Activity Fees, other fees and tariffs

The tax on economic activity is assessed on the practice of all commercial or industrial activities, including provision of services, provided pursued in an establishment that is licensed to deal with the general public. This assessment does not conflict with the charging of permit fees provided for in law, or service fees and licensing fees. The rates of this tax are specific, graduated by the legislature according to the nature of the activity and the location and size of the site occupied. The tax per establishment may not exceed an annual amount equal to 20 times the national monthly minimum wage for workers in industry (a ceiling equivalent to US\$800.00).

Local authorities may, also, charge fees for licenses, and tariffs and fees for providing various services. The tariffs and fees for services are established by the local authority's legislature and must, whenever possible, be set so as to recover costs.

Income Surtaxes

Income surtaxes (*derramas*) are extraordinary taxes that can be assessed only as stipulated in an authorization by the Council of Ministers. These surtaxes are levied on the taxpayer's tax liability under the CI (Business Profit Tax) and the Urban Rental Income Tax (*Contribuição Predial*) and may not exceed 15 percent of the principal amount of those taxes. Revenue from these taxes may be used only for investment projects undertaken by the local authorities or extraordinary expenses for rehabilitation of infrastructures and repair of the effects of public disasters, under the conditions expressly laid down in the authorization document.

The City of Maputo

It was not possible to obtain data on the revenues collected by the local authorities, except for the city of Maputo (Table 9). In 2004 and 2005, total local government revenues were

⁵⁰ Land within the urban zones of cities that is available for construction but not being used may be taxed at a progressive rate, according to the number of years that it remains unused.

divided equally among taxes collected by the city itself and transfers received from the State.⁵¹ However, given the special nature of Mozambique's capital city, it is not likely that the pattern of financing observed here is being repeated in other parts of the country.

**Table 9. Revenue Received by the City of Maputo
(in Mt millions)**

| Item | 2004 | | 2005 | |
|---|----------------|--------------|----------------|--------------|
| | Monetary Sum | Percentage | Monetary Sum | Percentage |
| TOTAL REVENUE | 195,046 | 100.0 | 222,373 | 100.0 |
| CASH REVENUES | 165,679 | 84.9 | 170,503 | 76.7 |
| Tax Revenue | 51,854 | 26.6 | 46,094 | 20.7 |
| Taxes on Goods and Services | 42,637 | 21.9 | 33,271 | 15.0 |
| Local Real Property Tax | 17,623 | 9.0 | 21,536 | 9.7 |
| Vehicle Tax (75%) | 25,015 | 12.8 | 11,735 | 5.3 |
| Local Personal Tax | 4,022 | 2.1 | 5,708 | 2.6 |
| Economic Activity Fee | 4,825 | 2.5 | 6,621 | 3.0 |
| Other Tax Revenues | 369 | 0.2 | 493 | 0.2 |
| Non-tax revenue | 66,264 | 34.0 | 52,276 | 23.5 |
| Fees for Licenses Awarded | 41,259 | 21.2 | 45,246 | 20.3 |
| Tariffs and Fees for Services Rendered | 20,619 | 10.6 | 3,413 | 1.5 |
| Other non-tax revenue | 3,387 | 1.7 | 3,618 | 1.6 |
| Dedicated Revenues | 0 | 0.0 | 21,570 | 9.7 |
| Local Authority Compensation Fund (FCA) | 48,519 | 24.9 | 50,309 | 22.6 |
| CAPITAL REVENUE | 29,367 | 15.1 | 51,870 | 23.3 |
| Disposal of Local Government Property | 5 | 0.0 | 0 | 0.0 |
| Other Capital Receipts | 78 | 0.0 | 671 | 0.3 |
| Income from services owned by the local government | 60 | 0.0 | 0 | 0.0 |
| Income from securities and real property | 18 | 0.0 | 671 | 0.3 |
| Income from equity investments | 0 | 0.0 | 0 | 0.0 |
| Proceeds from Transfers of Capital in Public Entities | 26,528 | 13.6 | 51,199 | 23.0 |
| Donations | 2,756 | 1.4 | 0 | 0.0 |

Source: Department of the Revenue, City of Maputo

The Maputo City Council's Department of the Revenue is responsible for collecting the taxes mentioned earlier, and for another 24 taxes, or fees on economic activity, for licenses and for services provided by the city. In 2004 and 2005, many of these levies produced zero revenue.

⁵¹ For purpose of this calculation, the transfer is considered as being 75 percent of the Vehicle Tax liability.

At present 17 people work in this department⁵², but only two are responsible for outside auditing of compliance with city taxes.

The Mozambique Government's Proposal for Reforming Local Government Finances

Because of the 2002 reform of income taxes, the Local Authority Finance Law (Law No. 11/97) and the Local Government Tax Code (Decree No. 52/2000) need to be amended to make them compatible with the IRPS and IRPC codes. In addition, Mozambican officials believe it is important to give local governments more financial autonomy and to reduce their dependence on funds transferred from the State budget.

The proposal by the Ministry of Finance to amend the local government tax system can be summarized as follows:

Transfer to local governments the authority over the Vehicle Tax.⁵³ Today, that tax is collected by the central government and assessed on light and heavy automobiles up to 25 years old, passenger motorcycles as old as 15 years, private motorized aircraft, and recreational motorboats for private use. Exempt from this tax are State, local governments, foreign governments, personnel from diplomatic and consular missions, and foreign or international organizations. The amount of tax is defined in a table by the Ministry of Finance and varies according to the type of vehicle, engine displacement, cargo capacity, passenger capacity, maximum takeoff weight, or age, as appropriate.

Establishment of a **Municipal Sisa Tax** that would be levied on conveyance of the ownership of real estate situated in the territory of the local government when the transfer involves payment. The tax would be paid by the person to whom the property is transferred. At present, the Sisa is charged on those same transactions by the State. The tax rate is 2 percent on the higher of the declared value of the transfer or the assessed value of the real estate. A surcharge of 20 percent of the tax payable is charged and the proceeds are passed on to the local government in whose jurisdiction the property is located. If the Sisa were replaced by the Municipal Sisa Tax, this surcharge would be eliminated. The State would continue to levy the Sisa only in areas of the country where there are no local governments.

Amendment of the rules on the **Local Personal Tax**, to eliminate the exemption for peasant women and female domestic workers.

⁵² Including the department heads.

⁵³ 75 percent of the revenue from this tax, as we mentioned earlier, is transferred to the local authority in whose territory the vehicle is registered. Under this proposal, the local governments would collect the entire tax within their respective jurisdictions and the State would collect that tax in areas of the country where there are no local governments.

Amendment of the **Local Real Estate Tax** so that it is levied on the assessed value of urban properties, provided that this value does not depart from the normal market price. In addition, it is planned to exempt urban buildings that are up to 10 or 15 years old, provided they are used as dwellings, as a means of encouraging the building of housing.

Introduction of an **Improvement Contribution** (*Contribuição Melhoria*) in situations where infrastructure works performed by the local authority have benefited the real property.

Eliminate the **Local Tax on Commerce and Industry** and the **Labor Income Tax – Section B**, from the local government tax system. Analogous taxes at the national level were repealed when the IRPS was introduced to prevent double taxation. Now the same needs to be done at the local government level.

Elimination of the **Income Surtaxes**. These have become irrelevant because of the repeal of the Business Profits Tax, the Rental Income Tax, and the Tax on Tourism (on which this surcharge was assessed) during the income tax reform. In addition, in the case of disasters, the central government can access the contingency reserves normally provided in the annual budgets of the Republic.⁵⁴

If the recommendations presented above are followed, the mission would endorse the general lines suggested by the URTI relating to the reform of the Local Authority Finance Law, even as regards giving local governments greater financial autonomy. However, we would call attention to the risk inherent in transferring taxation authority to autonomous local authorities that have shown little or no ability to administer their own revenues.

Recommendations

- Keep the responsibility for collecting the local authority taxes in the hands of the DGI for as long as the guiding authority believes that the respective local government is not in a position to do so.
- Permit the creation of new local autonomous authorities only in cases where a minimum fiscal administration capacity is present, principally an ability to administer taxes.
- Establish vehicle assessed values and Vehicle Tax rates on a nationwide basis.
- Eliminate the exemption from local personal tax that was granted to pensioners (Art. 17(d) of the Local Government Tax Code) and the exemption for peasant women and female domestic workers.

⁵⁴ Elimination of these surtaxes has already been recommended, by the 2001 mission.

- Refrain from granting an exemption from the local real property tax on buildings more than 10 years old; doing so would significantly erode the tax base inasmuch as it affects the higher-value buildings that are more easily appraised.
- Define in the body of laws the objective criteria for assessing the Improvement Contribution, such as the possibility that in determining the amount of the tax, part or all of the cost of the investment might be apportioned equally among the beneficiary properties.

B. Tax Incentives

After the end of the civil war, in 1992, officials thought it necessary to encourage investment. The government put its trust in tax benefits as the principal mechanism for attracting investment to Mozambique. And so, after the Investments Act was passed in June 1993, a Tax Benefit Code was approved that remained in effect, with few changes, until 2002.⁵⁵ The 2002 code consolidated the rules on tax incentives that had been enacted by several different decrees. Its provisions apply to investments by both individuals and legal entities under the Investments Act, as well as under the Mines and Petroleum Act.⁵⁶

The Present Situation

The Tax Benefit Code that was in effect prior to 2002 had established incentives related to the Business Profits Tax (CI) and the Complementary Tax (IC) that consisted of reductions in either the rate or the amount of the tax, as well as deductions from tax liability. For example: (i) reductions of the tax rates on the CI and IC ranging between 50 and 80 percent during the investment recovery period, a maximum of 10 years, for both new ventures and the rehabilitation of suspended projects; (ii) a 100 percent reduction on the CI and IC during the first two fiscal years and 80 percent during subsequent years until the investment is recovered, for a maximum of 10 fiscal years, for investments in existing projects that had been destroyed by acts of war; and (iii) a deduction of up to 100 percent from tax liability under the CI, for investments in rehabilitation and/or expansion of companies already operating, for five fiscal years. Expenditures on works considered as of “public utility,” the purchase of works of art, and vocational training of workers were also among the items that could be deducted from one’s tax liability.

The Tax Benefit Code approved by Decree 16/2002 concentrated in a single piece of legislation both generic tax benefits and special regimes. One of the positive aspects of the

⁵⁵ Law No. 3/93, of June 24, and Decree No. 12/93, of July 21, as amended by Decrees Nos. 37/95, of August 8, and 45/96, of October 22 and repealed by the current Code (Decree No. 16/2002, of June 27).

⁵⁶ Law No. 14/2002, of June 26, and Law 3/2001, of February 21.

new Code is that the incentives are quite clearly defined. The granting of tax benefits depends only on whether the investors formalize the classification of their projects which, while on the one hand lends transparency to the project, on the other hand it reduces their selectivity, leaving room for projects to be encouraged that may not be economically viable after the tax benefits expire.

The new code also sought to tie the investment to the value of the incentives. For the first time in Mozambique, it introduced investment tax credits (CFI) that are deductible from income tax. The advantage is that this program relates the size of the benefit to the size of the investment. Along those same lines, accelerated amortizations and reinvestments in fixed assets also are aimed at associating the tax benefit with the sums invested.

Exemptions from import duties and VAT on imports were restricted almost exclusively to Class K goods (capital goods). Even if the exemption is more favorable to undertakings that make intensive use of capital goods in the production process, restricting the exemptions on import duties to Class K equipment is a positive step in tax benefit policy.

Analysis

Even if tax benefits do in fact encourage investment, in most case the decision to invest is based on a much broader set of factors. Investors consider all those factors that affect project profitability, such as availability of natural resources and infrastructure, quality of the manpower available, and the country risk. Therefore, in many cases tax incentives are merely an additional bonus for an investor who, even without the incentives, would locate the project in Mozambique. There are cases in which the intensity of taxation does indeed play an important role, but very often what makes a tax system attractive in the eyes of an investor is its transparency, sound administration, and, especially the stability of the rules.

Another issue to consider is the way that profits are treated in the country where the investor is domiciled. If that country adopts the system of universal taxation of income, giving credit for taxes paid in other countries on business profits, a reduction or exemption granted in Mozambique is not actually an incentive, inasmuch as it reduces the amount of the credit given in the country of origin of the capital. All that occurs is a transfer of tax revenue from one country to another.

One alternative to the use of incentives would be to expand the government's efforts in educating and training its labor force, developing the infrastructure needed for production, and providing the public services that companies need in order to operate. Increased public investment can be achieved through public-private partnerships, coordination with donors, and awarding tax benefits to those private enterprises that invest in public works.

Generic Benefits

The generic incentives in the new Tax Benefits Code are shown in Box 6. Note that the code favors incentives in the form of investment credits and accelerated amortization. As we have said, these have an advantage over the approach taken in the previous code—which granted income tax exemptions or reductions—they relate the size of the investment to the size of the

incentive. In contrast, tax exemptions and reductions tie the incentive to the size of the profit and so are not much of a benefit for companies that usually do not earn profits during the installation phase. We can, therefore, say that the 2002 Tax Benefit Code made a significant improvement in the quality of the tax incentive system.

Box 6. Tax Benefits Code, Decree No. 16/2002

| Type of Tax Benefit | Tax Rate | Ceiling |
|--|----------|----------------------------|
| Exemptions | | |
| 1. <i>Import duties</i> on Class K equipment goods | 0% | Up to 100% of the tax base |
| 2. <i>VAT</i> on imports of Class K equipment goods | 0% | Up to 100% of the tax base |
| 3. <i>Stamp tax</i> on formal acts related to establishment of the company, changes in its capital and in the Articles of Association during the first five years after the start of the investment or operations. | 0% | Up to 100% of the tax base |
| Reductions | | |
| 1. <i>SISA Tax</i> on purchase of real estate for industrial, agroindustrial, or hotel use, provided acquired within the first three months of the date the investment was authorized or operations begin. | 50% | -- |
| Deductions from Income Tax | | |
| 1. <i>Investment Tax Credit (CFI)</i> on total investment made during the first five fiscal years, from income tax liability | 5% | Up to 100% of the tax base |
| 2. In Gaza, Sofala, Tete and Zambézia provinces: <i>Special CFI rate</i> on the total investment made during the first five fiscal years, from income tax liability. | 10% | Up to 100% of the tax base |
| 3. In Cabo Delgado, Inhambane, and Niassa provinces: <i>Special CFI rate</i> on the total investment made during the first five fiscal years, from income tax liability. | 15% | Up to 100% of the tax base |
| 4. <i>Deduction on sums invested in specialized equipment</i> intended for modernization and introduction of new technologies, during the first five years after the start of the investment or operations. | 100% | Up to 15% of the tax base |
| 5. <i>Deduction on sums spent on vocational training</i> for Mozambican workers, during the first five years after the start of the investment or operations. | 100% | Up to 5% of the tax base |
| 6. <i>Deduction on the sums spent on vocational training in the use of equipment</i> considered as high-tech by Mozambican workers during the first five years after the start of the investment or operations. | 100% | Up to 10% of the tax base |
| Accelerated amortizations and reinvestments in fixed assets | | |
| 1. Deduction of up to double the normal tax rate legally stipulated for calculation of the <i>amortization and reinvestment</i> in new buildings used in the pursuit of authorized undertakings. | -- | Up to 100% of the tax base |
| Fiscal Costs | | |
| 1. Expenses related to construction of works of public utility in Maputo, during the first 10 years | 120% | Up to 100% of the tax base |
| 2. Expenses related to construction of works of public utility in other provinces, during the first 10 years | 150% | Up to 100% of the tax base |
| 3. Purchases of Mozambican art works. | 50% | Up to 100% of the tax base |

Source: Mozambican authorities.

With respect to accelerated amortization, currently restricted to real estate, we would recommend this benefit be extended to Class K equipment. Especially in the case of industrial projects, investment in Class K equipment is a much more important factor in the development and viability of the company than the site where it is situated.

Even if the tax incentives lead to increased investment, the economic benefits derived from that investment must be evaluated net of the costs to society. Tax benefits impact the allocative efficiency of the economy, because it is their nature to favor certain activities or localities over others, thereby distorting relative prices and the allocation of resources.

The regional differentiation in the rates for deducting investment tax credits, even if the interval for using them is only five years, may diminish allocative efficiency and even encourage a company to locate in a region where its long-term viability is in doubt. That is why we recommend that the differentiation be eliminated.

Often even a country's authorities are not convinced of the effectiveness of tax incentives, but feel compelled to offer them in order to compete with neighboring countries. This competition among neighboring countries to attract investment can lead to what has been called a "race to the bottom," i.e., a situation in which, in the battle over the siting of projects, all the participants drown, more and more rapidly. The way to prevent this is to establish regional cooperation in order to harmonize tax incentives and so break the vicious cycle. One way to do this would be to negotiate a "Code of Conduct" among the countries of the regional bloc for the granting of tax incentives.

In the past, South Africa tried to lead an effort within the SADC to adopt a code of conduct, but did not have sufficient support from other countries in the region. The mission recommends that in order to protect its system of incentives which, despite a few necessary repairs, is already of good quality, Mozambique should try to forge the alliances necessary to generate a new proposal for a code of conduct applicable to the granting of investment incentives within the SADC.

Exemptions from import duties on Class K capital goods help reduce the purchase cost of those goods and can stimulate investment in the latest technologies, which would have an important impact on Mozambique's development. The cost of these exemptions in terms of lost revenue is rather low, since the general rate applicable to that class of goods is 5 percent and is expected to be reduced in 2007 and 2008 to 3 percent and zero, respectively. The mission recommends it be maintained. On the other hand, as discussed in subsection 2.2 of this report, the VAT exemption on those same goods should be abolished.

The available deduction on the purchase of Mozambican works of art, as a fiscal cost, should be eliminated. The cost of promoting Mozambican art would be more transparent if it were done via a direct tax credit stipulated in the budget, instead of a deduction against the fiscal costs of the venture. At the same time, it is very likely—almost certain—that this deduction has absolutely no impact on the ability to attract investment to Mozambique.

As proposed in government studies, the responsibility for collecting the Sisa will be shifted to the local autonomous authorities, a change that this mission supports. Therefore, it would be a good idea to cancel the reduction in the Sisa rate on investment projects in order to ensure revenue for local governments and avoid problems with control. The exemption from the IS, which is of negligible benefit to investors, complicates its administration and so should be abolished.

Benefits for Large Projects

At first glance, the efforts by the Mozambican government to attract very large projects appear to have been quite successful. The contribution by megaprojects to GDP in 2004 was 7.83 percent of the total, and their share of exports, in terms of value, exceeded two-

thirds 2005. However, a breakdown of the results shows that just one venture—Mozal—is responsible for more than 80 percent of those contributions.⁵⁷

Mozal produces aluminum ingots. It imports the ore and uses the electricity generated by the Cahora Bassa hydroelectric plant to process it. In 2004, its net assets exceeded US\$2 billion, and its receipts were on the order of US\$1 billion. It had a net profit of US\$272 million, and directly employs 1,080 workers.⁵⁸ Although it has not been possible to obtain from the tax administration specific figures on the amount of foregone revenue from the megaprojects, a very rough estimate of that sum can be made.

Inasmuch as the company is exempt from the IRPC but is required to pay the government 1 percent of its gross receipts (Table 10), and arbitrarily assuming that its taxable profit, subject to a 32 percent levy, is equal to half the net profit, we arrive at a conservative estimate of IRPC revenue on the order of US\$37.5 million, i.e., a tax expenditure of US\$34,700 per year per job directly created, equivalent to almost 700 minimum wages per year per direct employee.

Judging by this result, the volume of tax expenditures associated with huge projects is extremely high. Inasmuch as the megaprojects are largely dependent on the availability of natural resources that are specific to Mozambique (water power, sands, natural gas), it is highly likely that these ventures would have gone forward even under a less favorable tax system. Tax incentives, if at all necessary, should be restricted to supporting the installation and initial phase of operations of those projects.

Contrary to the generic benefits, which provide for relatively short intervals for taking advantage of the incentives, the contracts negotiated between the government and the investors in megaprojects call for excessively long periods—there is one case of a 50-year exemption, and there is a clause that guarantees indemnification if changes in the law were to impact the profitability of the enterprise. Little can be done except to avoid the future repetition of contracts of this type.

⁵⁷ Export data obtained from the DGA. GDP figures from the CPI.

⁵⁸ KPMG, *100 Maiores Empresas de Moçambique*, [The 100 Largest Companies in Mozambique], 2005 edition.

**Table 10. Mozambique: Taxes Deposited by the Megaprojects, 2003-05
(in Mt million)**

| | MOZAL | | | SASOL | | |
|-------------------|--------|---------|---------|-------|-------|--------|
| | 2003 | 2004 | 2005 | 2003 | 2004 | 2005 |
| Total | 54,144 | 107,829 | 239,452 | 0.682 | 5.654 | 64.395 |
| IRPS | 31,874 | 64,941 | 96,768 | 0.682 | 0.851 | 3.053 |
| Final tax rate 1/ | 22,270 | 42,888 | 142,684 | 0.000 | 0.000 | 0.000 |
| Royalties | 0.000 | 0.000 | 0.000 | 0.000 | 4.803 | 61.342 |

Source: Ministry of Finance

1/ Final tax rate is 1% of gross income

2/ [Portuguese unclear] Royalties are 5% of gross income from production of gas.

Table 11 shows the customs benefits granted to major investment projects in 2004 and 2005. These figures do not include Mozal. Even so, the benefits made available to megaprojects and to others under the Mines Act and Petroleum Act together represented 606,000 *contos* in 2005, equivalent to 10.5 percent of the CIF value of imports.

**Table 11. Mozambique: Customs Tax Benefits Granted, 2004–05
(in Mt million)**

| | 2004 | | 2005 | |
|-----------------|------------|---------|------------|---------|
| | Exports 1/ | Benefit | Exports 1/ | Benefit |
| Megaprojects 2/ | 3354,4 | 379,2 | 4303,6 | 420,4 |
| Mining industry | 899,3 | 138,0 | 1369,5 | 168,5 |
| Industry | | | | |
| Petroleum | 106,2 | 14,7 | 120,6 | 17,3 |

Source: URTI

1/ CIF value.

2/ Tax benefits granted to Vodacom, Kenmare Moma, Sasol and Mcel. Mozal is not included.

Specific Benefits

In addition to the generic benefits and the incentives for very large projects, already discussed here, there are also some specific benefits, and others granted under the Tax Benefits Code under the Mines Act and the Petroleum Act.

Agriculture

The agricultural sector benefits from the following specific investment incentives:

- Exemptions on imported goods;

- Reductions of 80 percent on the rate of tax on company profits, until 2012;
- Investment tax credits until 2012.
- Accelerated depreciation until 2012.

The 80 percent reduction in the tax rate applied to the profits of companies creates a huge incentive to attribute to agricultural activities profits that actually were earned from other activities. One example would be the possible use of transfer prices to attribute to an agricultural company profits actually obtained from marketing of farm products. The mission recommends that this tax be reduced immediately, while guaranteeing the benefit until 2012 for those ventures that already have it.

Hotels and Tourism

The following specific incentives apply to the rehabilitation, construction, expansion, or modernization of hotels, and the development of national parks or preserves:

- Exemption from import duties on Class K equipment goods.
- Tax credit equal to the general tax credit, plus 3 percentage points, upon payment of income tax, for projects approved no later than December 31, 2007.
- Accelerated amortization, with application of up to triple the normal rates established in law, for projects approved no later than December 31, 2007.

The differentiation in the investment tax credit rates, which gives preference to certain business sectors, promotes allocative inefficiency. The specific benefits granted to hotels and tourism should not be renewed. To prevent such extension from becoming a *fait accompli*, the acceptance of projects for evaluation from July 1, 2007 to December 31, 2007 should be suspended, and the change should be announced to the public immediately.

Rapid Development Zones

The following regions of Mozambique are considered to be “rapid development zones”: The Valley of the Zambeze, Niassa Province, District of Nacala, the islands of Mozambique and Ibo. The system applied to these zones is to remain in effect until December 30, 2015. The following activities, if pursued within a rapid development zone, are eligible for specific benefits: agriculture; exploitation of flora, fauna, and forests; telecommunications; certain kinds of construction;⁵⁹ industry, and others.⁶⁰ In addition to the general benefits granted by

⁵⁹ The exemptions for construction are limited to infrastructures intended for public use, residential dwellings, farm infrastructure, and infrastructures for tourism.

the law, the following benefits are available to authorized companies in rapid development zones:

- Exemptions from customs duties on imports of Class K and Class I goods during the first three years of project implementation;
- Investment tax credit of 20 percent on the total investment made during the first five fiscal years;
- An exemption on the Sisa tax—50 percent of the normal rate, for five years as established in Art. 21 of the Tax Benefits Code; and a 100 percent exemption from Sisa if the taxable matter is infrastructure.

Owing to the difficulty and the cost of exercising proper administrative control over this system, whose benefits hardly go beyond the generic, the mission recommends immediate abolition of rapid development zones, while assuring the vested rights of the companies that have already obtained incentives.

ZFIs

Companies operating under the ZFI regime are eligible for the following benefits:

- Exemption from customs duties on imports of all articles related to their operations. The exemption from customs duties extends to the VAT and the Excise Tax;
- Reduction of 60 percent in the IRPC rate, for a period of 10 years;
- Exemption from the Sisa on the purchase of real estate.

The mission recommends the elimination of the IRPC reduced rate incentive.

Investments under the Mines Act

- Exemption from customs duties, VAT and the Excise Tax on imports of all articles related to mine prospecting, research, or exploitation and on exports of mineral resources.
- Until 2010, a 25 percent reduction in the income tax rate during the first five years of production, if the amount invested is more than US\$500,000.

Investments under the Petroleum Act

⁶⁰ The other sectors include silviculture, aquaculture, livestock, water supply, transportation, education, and health care.

- Exemption from customs duties, VAT and the Excise Tax on imports of goods intended for use in petroleum operations.
- Temporary importation, with suspension of payment of duties and other customs and tax levies, on goods intended for petroleum operations, such as drills, machinery, equipment, aircraft, and ships. Exemption from export duties on those goods.
- Exemption from duties on exports of petroleum produced in Mozambique.
- Until 2010, a 25 percent reduction in the income tax rate during the first eight years following the start of production.

In the case of investments under the Mines Act and the Petroleum Act, these are new and risky activities for Mozambique and require a high initial investment. They are receiving more modest benefits, for a much shorter time, than were granted in the past to megaprojects. On the other hand, if they are successful, they will reap high profits as soon as production begins, which may happen before the benefit period ends. The mission recommends that, except for the VAT exemption, which should be abolished, these incentives be maintained until the end of the period stipulated in the law. However, we do not believe that period should be extended. The mission also suggests that a requirement for payment of a surtax on royalties related to the production obtained throughout the period when the tax benefits are in effect be incorporated into these regimes.

Recommendations

- Identify and quantify, periodically, the tax expenditure resulting from the various incentives, in order to make the cost of the concessions transparent.
- Give preference to incentives related to the size of the investments and to policy objectives, such as the CFI, accelerated amortizations and reinvestments, and exemptions from import duties on Class K goods, over income tax reductions or exemptions.
- Eliminate the regional differentiation in the CFI rates.
- Propose, or support proposals aimed at negotiating a code of conduct for granting investment incentives in the SADC area.
- Eliminate all exemptions from VAT related to investment promotion policy.
- Eliminate the exemptions from the Sisa, except in the case of the ZFIs, and from the IS.
- Do not create new specific benefits or extend the periods of effectiveness for those that exist.

- Maintain the possibility for case-by-case negotiations of benefits to be granted to large-scale projects, but direct negotiating efforts toward a focus on incentives and on minimizing the length of time during which those incentives may be enjoyed, using as a pattern the generic benefits in the 2002 code.
- Eliminate the reduction in income tax rate that is available to agricultural enterprises and to those located in ZFIs, but guarantee vested rights.
- Eliminate the system of rapid development zones, while guaranteeing the vested rights of companies that have won incentives so far.
- Add rules to the incentive programs under the Mines Act and Petroleum Act so as to require payment of a surtax on royalties related to the production obtained throughout the period when the tax benefits are in effect.

C. Taxation of Small Taxpayers

The private business sector has been trying to make the Mozambican authorities aware of the need to create proper conditions for including in the tax system a group of extremely small economic operators, nearly all of whom work as street vendors and who so far have been almost entirely ignored by the tax authorities. In some cases, however, they may already be known to other public officials, particularly because of the license fees they pay to the municipalities where they work. The justification cited by private business is that such a solution would expand the tax base and boost the associated revenue, thus creating conditions for cutting the tax on other taxpayers, while also eliminating the distortions in competition that taxpayers whose businesses fulfill their legal obligations are suffering.

Analysis

A discussion about the informal economy in which the economic operators work and the steps that could be taken to combat it must recognize three different situations: (i) the micro businesses, which do not have even the minimum administrative structures capable of satisfying the requirements of any kind of taxation, however rudimentary; (ii) the small operators, who are now covered by simplified taxation regimes that differ for purposes of indirect taxation (VAT) and direct taxation (IRPS or IRPC); (iii) the medium-sized and large operators that, although sufficiently organized administratively to comply with tax obligations, do not do so, or do so very inadequately. Particularly obvious is their failure to issue proper invoices, documents vital to the mechanics and functioning of the VAT and the accurate quantification of earnings or volume of business for purposes of the IRPS or IRPC.

As regards the informality that characterizes this last group, which we could call “informality found in the formal sector” it is not actually a problem of tax policy. but rather, simply, a question of tax administration that justifies the taking of urgent measures to halt such practices.

The treatment of the micro operators, all of whom it is intended to capture in the fiscal net should, in the opinion of this mission, be demystified. There is practically no benefit in having a multitude of “poor” taxpayers in the fiscal net, because the administrative costs involved would be much higher than the revenue that can be collected from them. The alleged difficulty in integrating commerce that might be achieved between the micro operators and those who pay taxes within the normal taxation regimes (whether the VAT or the income tax) does not seem to be a very significant problem. After all, the latter will always have the possibility of recourse to registered taxpayers to make their purchases, thereby ensuring that they can satisfy the requisites required for both claiming a deduction on VAT already paid and for winning acceptance of those purchases as costs incurred during the year for purposes of determining taxable income. Consequently they avoid the autonomous, cumulative and high taxation on expenses that either were not documented or are confidential.

Incidentally, in this way Mozambique could succeed in getting the transactions by street vendors processed only with the final consumers, thereby guaranteeing, under normal conditions, that the tax revenue would extend to their respective suppliers. Only the VAT and income tax revenue on the margin charged by those micro taxpayers would be lost. The correct course then, in the mission’s opinion, is to reinforce the controls over sales to those operators or the imports of the goods they sell. This would especially mean ensuring compliance among the “formal” taxpayers and in action by the DGA, if that were the case, to completely remove from the tax system those informal operators whose volume of business is equal to or less than a given sum. Some control over [Portuguese unclear] could be exercised by joint action with the officials who oversee the pursuit of commerce and the collection of the fees paid for use of public spaces where the vendors work. They could be “automatically” registered on the basis of that data and required to keep their purchasing documents in good order, recording them in a very simple kind of purchase ledger that at any moment, if desired, would enable the Tax Administration to estimate their volume of business for purposes of either keeping them in the system or excusing them from it. The regime, applicable both for VAT and income tax, would be one of full exemption from payment of the tax and release from meeting obligations, except for the one mentioned earlier.

Above that volume of business, and up to another limit to be established after the proper studies have been made, taxation would be done via a system involving presumption of a margin, very simplified, using only two coefficients: one for sales of merchandise and products and another for other earnings, including services, along the lines of the simplified regimes now provided for in the IRPS and IRPC, and also in the VAT (although there is only one coefficient, 5 percent). The purpose of this regime is more than just enabling the collection of significant amounts of revenue or creating a pattern for transition from a regime of exemption to a regime of normal taxation. The mechanics of the regime would work this way: starting from those coefficients, arrive at another coefficient or percentage that, applied to the volume of business, would directly yield the amount of tax to be paid. That tax would be the total tax on the taxpayers for purposes of both taxes. In addition to the obligation for

payment, there would be simplified obligations as to bookkeeping, in very elementary ledgers in which only purchases and sales would be recorded.

Lastly, once that level of business volume has been reached, the taxation rules would differ for purposes of the VAT and the income tax (IRPS or IRPC). For VAT purposes, and inasmuch as in most situations the mechanics of the tax do not present notable difficulties, the taxpayer would fulfill the necessary obligations of invoicing/determining the tax payable and deduction, delivering the difference to the State. Payment would be quarterly, and the tax return would be filed annually. As regards income tax, and given the greater complexity of determining taxable profit and tax liability, a system would be used that by requiring the recording of sales, would presume the costs fiscally allowed as attributable to the pursuit of the activity, presupposing, obviously, and in the interest of simplification, the absence of a change in warehoused inventory.

The objective of this taxation that, if implemented, would obviously result in the abolition of special tax regimes for small or extremely small VAT and income tax (IRPS or IRPC) taxpayers, would be the recognition that in tax matters too, the excellent is the enemy of the good. The “good” here would be to free up physical and human resources to improve the efficiency of the fiscal machine, recognizing the desirability of avoiding raising false hopes that large sums of revenue would result from the taxation of micro and small companies, and directing the efforts to the creation of special teams, well-trained in technical matters, to inspect and audit certain groups that are especially likely to engage in tax evasion and fraud, in order to put into operational programs that will strengthen and modernize the Tax Administration.

Recommendations

- Create an independent tax system for micro and small economic operators, one simultaneously valid for the VAT and the IRPS or IRPC.

- The system would have three separate regimes:
 - (a) Full exemption for those that are classified as micro-operators, who will be required to retain their purchase documents and record them, in sequence by date, in a very simple ledger used only for that purpose.

 - (b) A system for the presumption or estimate of the tax owed, for those whose volume of business exceeds that of the operators who are exempt, but lower than would place them in the normal regime, distinguishing only between sales of merchandise and other earnings.

 - (c) Normal VAT taxation regime and presumption of costs for Income Tax purposes as a final stage prior to full application of the standard regime found in the VAT and Income Tax codes.

- Carry out studies to define the parameters to be used in creating a tax system along the proposed lines.