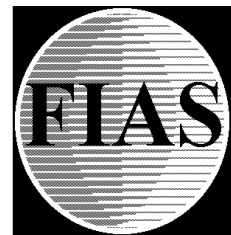


Study on the Impact of Taxes,  
Customs, Licenses and other Fees  
on the Investment Climate

*Executive Summary and  
Operational Report*

Mozambique

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Foreign Investment Advisory Service  
A joint service of the International  
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## Summary of Key Issues and Recommendations

Issues	Recommendations
<b>General</b>	<ul style="list-style-type: none"> <li>• The MIT must engage with the Ministry of Finance, DGI and DGA to ensure that taxation and licensing provide a positive business climate in Mozambique.</li> <li>• Through a cross Government tax policy working group, prioritize and implement recommendations from this study, as well as previous analysis (e.g. Bolnick 2004). FIAS's suggestions of priority reforms would be:</li> <li>• Consider the indefinite carry forward of losses.</li> <li>• As a medium term strategy consider reducing IVA rates to 14%.</li> <li>• Continue to reduce customs duties to the maximum rate of 20% then to 15%.</li> <li>• Move gradually towards across the board lower tax rates thus eliminating the need for sector based incentives. In the interim allow <i>all</i> investors to benefit from CPI tax benefits;</li> <li>• Continue efforts to combat corruption and remove the subjectivity and discretionary nature of the inspection process and simplify the compliance process.</li> <li>• Reform the remuneration of government officials vis-à-vis inspections &amp; fines.</li> </ul>
<b>Agriculture Sector (METR 16%, 6% with CPI)</b>	<ul style="list-style-type: none"> <li>• Recognize that taxation is not the major impediment to growth in the sector, and resist pressure for even more generous tax incentives.</li> <li>• Focus instead on generic tax reform (e.g. IVA refunds, customs etc.) which will greatly assist the sector as well as the whole economy.</li> </ul>
<b>Mining Sector (METR 51%, 5% w/CPI)</b>	<ul style="list-style-type: none"> <li>• Ratify and implement the new mining tax law as soon as possible.</li> <li>• Eliminate the special 10% withholding tax provision for mining companies in the new law in favor of an economy-wide reduction.</li> <li>• Pursue a tax treaty with South Africa.</li> </ul>
<b>Manufacturing Sector (METR 40% or 11% w/ CPI)</b>	<ul style="list-style-type: none"> <li>• Phase out special customs regime for manufacturers.</li> <li>• Provide tax-payers with better information on procedures and requirements for obtaining IVA refunds.</li> <li>• Speed up IVA refunds by putting in place a risk-profiling system for selective audits.</li> <li>• Focus IFZs on the provision of infrastructure and reducing compliance costs, rather than on tax incentives.</li> </ul>
<b>Tourism</b>	<ul style="list-style-type: none"> <li>• METR 40%, 16% w/ CPI</li> </ul>
<b>Financial Sector (METR 57%, 46% w/ CPI)</b>	<ul style="list-style-type: none"> <li>• Abolish stamp duties on financial transactions.</li> <li>• Abolish the tax exemption on government and listed securities.</li> <li>• Introduce a capital gains tax.</li> </ul>
<b>Small Businesses (METR 71-79%)</b>	<ul style="list-style-type: none"> <li>• Define small businesses by a common level of turnover for IRPC, IRPS, and IVA.</li> <li>• Increase IVA threshold, and allow businesses below threshold to either opt-in for the normal regime OR simplified regime of 5% of sales.</li> <li>• Consider tiered corporate tax regime for small businesses.</li> <li>• Educate SMEs on possibilities for IVA opt-in and requirements for compliance.</li> <li>• Increase outreach activities targeting small businesses.</li> </ul>
<b>Customs</b>	<ul style="list-style-type: none"> <li>• Fully implement the Central Revenue Authority.</li> <li>• Replace the Crown Agents TIMS System with ASYCUDA.</li> </ul> <p>Eliminate pre-shipment inspection as quickly as possible.</p>
<b>Sub-National Taxes</b>	<ul style="list-style-type: none"> <li>• Municipalities should focus efforts on developing and disseminating requirements and decision criteria for business licenses.</li> </ul>
<b>National licensing regime</b>	<ul style="list-style-type: none"> <li>• Abolish current catch-all licensing approach and keep licensing obligation only for business activities posing a <u>significant</u> risk to safety, health and environment.</li> <li>• Improve information on the licensing regime and its transparency.</li> <li>• Involve all relevant institutions in information disseminated to the public.</li> <li>• Revise the legal framework on general business licensing &amp; inspections.</li> <li>• Reform remuneration of inspection staff so that this is not based on fines handed out.</li> </ul>

This report forms part of a series of studies by FIAS designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in southern Africa. In the case of Mozambique, the study was expanded to include an analysis of customs, and ‘non-tax’ fees, such as licenses.

Mozambique’s success at attracting mega-projects has put “Mozambique on the map.” However, both foreign direct investment and total investment in Mozambique have started to decline. While projections for 2006 and 2007 are for a recovery, it is clear that Mozambique must continue to analyze and reform the investment climate in order to maintain impressive growth rates. The tax environment (both policy and administration) are crucial in this regard.

### **Summary of Marginal Effective Tax Rate (METR) analysis in Mozambique**

Table 1 shows the METRs for large firms in Mozambique compared to those already calculated for this series of FIAS studies. The METRs highlight the following:

- That under the ‘standard’ tax regime, Mozambique investors face a relatively high tax burden.
- However, when the Fiscal Benefits Code is applied (applicable to all investors with approval from the Mozambique Investment Promotion Authority - CPI) Mozambique’s tax regime is competitive.<sup>1</sup>

Access to the Fiscal Benefits Code raises its own problems for investors:

- Small businesses cannot access the benefits as they fall below the required threshold for minimum size. Indeed the METR for small firms ranges from 71-78% far in excess of those for medium and large enterprises and high by regional standards.
- For larger firms, negotiating the bureaucracy to access benefits under the Fiscal Benefits Code (requiring CPI approval) is often so cumbersome and costly, that many firms feel the benefits are not worth the effort. For foreign investors, this means that they may chose to invest elsewhere; for domestic investors they may chose to delay investments or decide against investments altogether.

Table 1 highlights also the sector differences in the METRs. Agriculture provides the most attractive investment regime as regards tax, and financial services the

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<sup>1</sup> Similar conclusions to Bolnick (2004) who found Mozambique’s headline rates of corporate income tax and VAT slightly higher than the region, but access to the CPI regime and Fiscal Benefits Code complicates the analysis.

least attractive. Of concern for Mozambique, is the high METR for tourism investments, even under the CPI regime, as compared to other countries and peer economies in the region. The reason for this is discussed in full below.

**Table 1: Comparison of METRs in Mozambique vs. Region**

	Rwanda	South Africa	Tanzania	Lesotho	Mozambique	Mozambique (with CPI)
Agriculture	7%	5.7%	23.1%	18%	16%	6%
Manufacturing	7%	21.3%	15.3%	11%	40%	11%
Tourism	13%	13.9%	14.9%	43%	40%	16%
Financial Services	28%	29.8%	28.9%	51%	57%	46%

Note: Rwanda figures assumed access to a investment incentive regime available to many, but not all businesses.

Mining figures not included because of the vast differences between METRs depending on the mineral mined and bespoke project specific mining agreements.

More generally, the FIAS mission interviewed many taxpayers facing a number of problems by the arbitrary application of the various laws. Complaints from the private sector are predominantly about tax *administration* (e.g. IVA refunds, customs procedures, fines) and other government departments that investors must deal with on a daily basis.

METRs have been calculated for all the sectors for the base case and for the case when VAT refunds have been delayed by one year and for two years. This shows that for a delay of one year in issuing refunds, the METRs for a business under the CPI regime becomes higher by a few percentage points. In the case when VAT refunds are not issued at all, *all the tax benefits of the CPI regime are completely undone by the non-refund of VAT which acts as an implicit Sales Tax on capital*. In this case the METRs are even higher than investors going through the normal regime (and who get their refund in time).

## Recommendations & Analysis

### General Recommendations

This Executive Summary and Operational Report is taken from the full report (available from FIAS). It highlight ten key recommendations and provides a short summary of the key sector-wide and economy-wide issues.

**Recommendation 1:** This is not the first report which the Ministry of Industry and Trade (MIT) has received on necessary reforms to improve the business environment. FIAS produced reports in 1996 and 2001 on administrative barriers

to investment. In 2004 Bolnick produced an excellent report for the leading business association in Mozambique (CTA) addressing their specific concerns on taxation. There has been very little progress on any of these reports. MIT must engage within Government on these issues and (with appropriate support from development partners) make concerted effort to take forward the recommendations of this and previous reports. Given there are some many recommendations in this and other reports, it is important that the Government prioritize which reforms to take forward.

**Recommendation 2:** Given that accessing the CPI is so critical to making Mozambique an attractive place to invest, and that the current system discriminates against small businesses (as well as creating administrative costs for businesses and the GOM), the most logical reform would be to make the Fiscal Benefits Code (a) automatic to all investors and (b) a little less generous so as to protect against revenue loss.

**Recommendation 3:** Pursue with greater urgency a tax treaty with South Africa. South Africa is not only Mozambique's largest trading partner but also its largest source of foreign investment and external financing, and one of its principal sources of foreign management and technical services, especially in the mining sector. A double taxation treaty with South Africa would therefore, reduce the effective tax burden on South African companies that invest in Mozambique and place technical and management staff in their Mozambican operations. This recommendation is especially pertinent to the mining sector.

**Recommendation 3.** Tackle the chronic non-payment of VAT refunds (as outlined also in Bolnick 2004). Do this by (a) providing tax-payers with better information on procedures and requirements for obtaining IVA refunds. (b) Put in place a risk-profiling system for selective audits to reduce delays in IVA refunds. Under this system, regular claimants with a track record of complying fully with tax obligations get immediate payment (with random audits). This will complement the efforts to put in place a system to allow the off-setting IVA credits against other tax liabilities.

**Recommendation 4.** As a medium term strategy consider reducing IVA rates to around 14%. In line with the Bolnick (2004), this recommendation is contingent on the need for prudent fiscal management. However, due to the high elasticity nature of the tourism products and the international competitive nature of the tourism industry, IVA rates should be revised when prudent to do so.

**Recommendation 5:** Allow the indefinite carry forward of losses. This will allow benefit to be obtained from incentives on accelerated depreciation and from investment tax credits to all sectors equally.

**Recommendation 6:** Continue to reduce customs duties to the maximum rate of 20% then to 15%. While clearly a thorough revenue impact study would be required before such a move, a reduction in customs duties will not necessarily result in a reduction in customs receipts as it is more likely to result in an increase in demand and a reduction in smuggling, by reducing the incentive to do so. Customs duties place the most significant burden on the tourism industry by reducing profitability and competitiveness of the sector.

**Recommendation 7:** Reform the remuneration of inspectors in all of Government, so that personal rewards are no longer tied to the amount of fines handed out, and ensure that all revenues from fines are paid directly to the consolidated fund, not the line Ministry responsible for the fine collection. The DGI and DGA recently undertook such reforms, and their extension to line Ministries with inspection and fining powers should improve relations with the private sector.

**Recommendation 8:** Increase outreach activities targeting small businesses. With the aim of increasing voluntary compliance, tax administrations through local tax offices could increase small taxpayer educational activities on tax compliance. Concurrently allow and educate small businesses on possibilities for IVA opt-in and requirements for compliance including disseminating simple and accessible information on possibilities for IVA opt-in, and procedures for compliance.

## Sector Specific Recommendations

### Agriculture

- **Resist pressure from the sector for even more generous tax incentives.**<sup>2</sup> Taxation is not a major impediment to the success of the agricultural sector, as such there is little in the way tax reforms which could help the sector expand and grow. Efforts would be better focused on land tenure security, rural infrastructure and enhanced extension services. Focus instead on generic tax reform in areas such as IVA refunds, customs etc. which will greatly assist the sector as well as the whole economy.
- **Maintain unchanged the IVA treatment now afforded the agricultural sector.** This benefit, unlike the reduced corporate income tax rates, benefits small as well as large farmers.
- **Conduct further research into the introduction of a rural land tax.** There

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<sup>2</sup> Indeed the IMF (2006a) recommend removing the 80% reduction in IPRC benefit, while maintaining it for those enterprises which have already benefited.

is strong, but not as yet compelling, evidence that a land tax would provide an incentive to develop un-used land, and deter "idle speculation".

- **Continue to monitor and evaluate the costs and benefits of specific sector regimes such as those applying to sugar and cashews.** One of the biggest arguments against providing specific crops with bespoke tax agreements is that it encourages proliferation of similar special treatment for others sectors. Government should resist this.

## Mining

- **Ratify and implement the new mining tax law as soon as possible.** The proposed new law would reduce the disparity in tax treatment between large mining projects and smaller projects. It would render the mining tax regime more transparent and would provide stable and consistent tax treatment that would conform more closely to international best practices, would reduce disparities in tax treatment between mining and other sectors, would reduce the marginal effective tax rate on the mining sector, and would increase the mining sector tax base.

- **Eliminate the special 10% withholding tax provision for mining companies in the new law in favor of an economy-wide reduction.** Mozambique's withholding tax of 20% is high for all sectors. Reducing the level for mining companies while preserving it for other sectors could create additional revenue pressures that would make it more difficult to achieve a more widespread reduction in the withholding tax rate.

## Manufacturing

- **Phase out special customs regime for manufacturers as tariffs on inputs are lowered and made uniform.** The special customs regime is expected to exist only until 2008. Nevertheless, the Government should review the current need for the scheme given that its complexity is dissuading entrepreneurs from using it. Critically, the scheme creates an uneven playing field, and generates a 'perception' of unequal treatment and discretion amongst sectors and within the manufacturing sector itself.

- **Focus ZIFs (Industrial Free Trade Zones) on the provision of infrastructure and reducing compliance costs, rather than on tax incentives.** As suggested by international experience, ZIFs are best suited for the provision of infrastructure and one-stop-shop facilities for administration/ taxation/ customs, rather than a vehicle for tax incentives.

## Financial Services

- **Abolish stamp duties on financial transactions**, including bank loans and guarantees, insurance policies and premiums, share issuance and credit cards;
- **Abolish the tax exemption on government and listed securities**, to increase banks' propensity to lend to enterprises, including SMEs;
- **Introduce a capital gains tax** that would tax capital gains at a lower rate than ordinary income, in order to increase incentives for all kinds of financial institutions as well as other enterprises and individuals to make direct investments in productive business activities.

## Small Business Sector

**Mozambique already has simplified systems for small business within the corporate tax regime and IVA, which if further simplified, would encourage increased compliance.** The main objectives of a small business tax regime should include:

1. to create a 'culture of compliance' and increase incentives for business formalization through simplification of the tax system;
2. to improve the capacity of small entrepreneurs to comply with requirements of the tax system by providing or encouraging education and training; and
3. to promote economic growth through small business development.

In view of the above objectives, Mozambique could consider the following measures to further improve the small tax regime:

- **Define small businesses by common level of turnover and align thresholds for IRPC, IRPS, and IVA.** Currently, the thresholds vary: for IVA it is Mtn 100,000 for simplified, Mtn 250,000 for normal; IRPC it is Mtn 1.5 million and for IRPS Mtn 2.4 million. Harmonizing the thresholds would help define small businesses and treat them equally across different taxes. This would also include:
  - Aligning (higher) IVA threshold with the small business simplified corporate tax regime.
  - For IRPC, designating a zero rated band at the bottom end for small firms so as to harmonize with personal income tax and to encourage entrepreneurship as a source of income.
- **Increase the IVA threshold, and allow businesses below the threshold more latitude to choose among existing regimes (either opt-in for the normal regime OR the simplified regime of 5% of sales).** In order to reduce breaks in the IVA chain, the tax administration could consider an opt-in for businesses that have the capacity to meet the reporting requirements of the normal IVA regime.

- **Consider tiered corporate tax regime for small businesses.** Small businesses are unable to comply with the standard corporate tax regime, as indicated by the extent of evasion by those under the system. Various options could be considered in addition to the existing system of simplified accounting, options such as indirect assessments based on presumptive taxes as a percentage of turnover. A possible tiered regime based on turnover levels could be:
  - Lowest tier: exemption from corporate income tax for micro-enterprises below threshold level to be determined. (Thresholds most logically would match those for IPRS).
  - Middle tier: presumptive turnover tax which covers all tax obligations (including municipal taxes) and opt-in for IVA (simplified or normal). In Madagascar, for example, an *impot synthetique* of 6% of turnover which covers all tax obligations (including IVA) is applied to very small businesses – though it is not clear that this percentage is appropriate, and may be on the high side.
  - Upper tier: presumption of costs for income tax (as in current IRPC), and option for either simplified or normal IVA regime. This precedes the full graduation to the standard regime. However, this tier is also allowed an opt-in to the standard corporate income tax regime for small businesses below the presumptive threshold, if they comply with record keeping and compliance obligations.

## **License Fees, User Fees and Fines**

Recommendations in this area underline and re-enforce the work undertaken by previous FIAS teams in 1996 and 2001. Those reports recommended drastically reducing the number of licenses required to operate a business – but little progress has been made against this objective.

- **Municipalities should focus efforts on developing and disseminating requirements and decision criteria for business licenses.** Each municipality should issue information on the requirements for obtaining a business license in its territory. This would not only improve the knowledge of the private sector on what to expect but also ensure consistent application and less discretion. The state may help municipalities in this effort.
- **It would be beneficial to launch a project that looks at the entire licensing regime** including all sector licenses or at least those in the most important sectors. The National licensing regime in this study has only been examined for the industrial and commercial license.
- **The national licensing regime should address overarching and specific shortcomings by:**
  - **Abolish licenses for all businesses that do not pose any significant risk to safety, health and environment.**

- **Improving information on licensing regime and its transparency. Discretionary decision-making.**
- **Continue efforts to combat corruption.**
- **Revise the legal framework on general business licensing and inspections by addressing the following issues:**
  - Revise classification system for commercial licenses and the licensing obligation for outlets.
  - Adopt a Ministerial Diploma on the use of fees and fines that ensures that both are part of the general budget.
  - Adopt administrative provisions/guidelines to set uniform detailed rules for each license and type of inspections.
  - Review fees and fines with a view to lowering them .
  - Streamline the classification system for commercial licenses and the licensing obligation for retail outlets.
  
- **Focus on better implementation of the legal framework.** The gap between the licensing legislation and its implementation needs to be closed by the following measures:
  - Shorten time-consuming ex-ante procedure by selective ex-port inspections.
  - Assess the impact of one-stop-shops.
  - Strengthen the supervision of inspectors and inspecting institutions.
  
- **Restructure the inspection regime.**
  - Increase transparency of the revenues from fines and transfer them to the general budget. Applied standards are sometimes fabricated and imposed fines are often at the highest statutory limit if not above it.
  - Continue efforts to fight corruption.