

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

Mozambique

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SUMMARY OF ACRONYMS

Exchange Rate: Mt 24,193 (Mtn 24.19) : US\$

AER	Average Effective Tax Rate
ATM	Central Revenue Authority
CPI	Mozambique Investment Promotion Authority
CTA	Confederation of Business Associations of Mozambique
DGA	General Directorate of Customs
DGI	General Directorate of Tax Administration
DNIA	National Directorate of Taxes and Audit
GDP	Gross Domestic Product
ICE	Excise Tax
IDE	Foreign Direct Investment
IMF	International Monetary Fund
IRPC	Corporate Income Tax
IRPS	Individual Income Tax
IS	Stamp Tax
IVA	Value-Added Tax
METR	Marginal Effective Tax Rate
MIT	Ministry of Industry and Trade
NUIT	Single Taxpayer Identification Number
PARPA	Action Plan for the Reduction of Absolute Poverty
RA	Revenue Authority
SACU	Southern Africa Customs Union
SADC	Southern African Development Community
SME	Small and Medium Enterprises
URTI	Domestic Tax Reform Unit
WDI	World Development Indicators
ZIFs	Industrial Free Trade Zones

This report forms part of a multi-country study FIAS has been undertaking in collaboration with the United Kingdom Department for International Development(DFID), to determine whether the tax policy and tax administration regimes in Africa are conducive to economic growth. A key focus is on the opportunities created by bringing informal firms into the tax net and appropriate tax policies for small enterprises. FIAS undertook a pilot study of Zambia, published in December 2004.¹

On behalf of the Government of Mozambique, the Ministry of Industry and Commerce (MIC) requested that FIAS conduct a similar study of the effective tax burden on five key sectors in the economy. The purpose was to investigate whether these sectors are competitive domestically and internationally, as regards the impact of the tax regime. This study provides the government with information it seeks through both quantitative and qualitative analysis. The quantitative analysis uses ‘marginal effective tax rate’ calculations carried out in each of the identified sectors. It also offers cross-country analysis allowing the assessment of international competitiveness. The qualitative analysis involves firm level interviews and secondary sources. A third component built into this study is a capacity building exercise, with the group of international consultants tasked to work closely with counterpart team from the Ministries of Finance to transfer the knowledge and methodology underlying such an analysis.

In the specific case of Mozambique, building on lessons learned from previous studies, the impact of licenses, associated fees, customs and sub-national taxes were included in the analysis.

¹ The Swedish Agency for International Development co-funded the Zambia study.

Summary of Key Issues and Recommendations

Issues	Recommendations
General	<ul style="list-style-type: none"> • 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. • 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: <ul style="list-style-type: none"> • Consider the indefinite carry forward of losses. • As a medium term strategy consider reducing IVA rates to 14%. • Continue to reduce customs duties to the maximum rate of 20% then to 15%. • 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; • Continue efforts to combat corruption and remove the subjectivity and discretionary nature of the inspection process and simplify the compliance process. • Reform the remuneration of government officials vis-à-vis inspections & fines.
Agriculture Sector (METR 16%, 6% with CPI)	<ul style="list-style-type: none"> • Recognize that taxation is not the major impediment to growth in the sector, and resist pressure for even more generous tax incentives. • Focus instead on generic tax reform (e.g. IVA refunds, customs etc.) which will greatly assist the sector as well as the whole economy.
Mining Sector (METR 51%, 5% w/CPI)	<ul style="list-style-type: none"> • Ratify and implement the new mining tax law as soon as possible. • Eliminate the special 10% withholding tax provision for mining companies in the new law in favor of an economy-wide reduction. • Pursue a tax treaty with South Africa.
Manufacturing Sector (METR 40% or 11% w/ CPI)	<ul style="list-style-type: none"> • Phase out special customs regime for manufacturers. • Provide tax-payers with better information on procedures and requirements for obtaining IVA refunds. • Speed up IVA refunds by putting in place a risk-profiling system for selective audits. • Focus IFZs on the provision of infrastructure and reducing compliance costs, rather than on tax incentives.
Tourism	<ul style="list-style-type: none"> • METR 40%, 16% w/ CPI
Financial Sector (METR 57%, 46% w/ CPI)	<ul style="list-style-type: none"> • Abolish stamp duties on financial transactions. • Abolish the tax exemption on government and listed securities. • Introduce a capital gains tax.
Small Businesses (METR 71-79%)	<ul style="list-style-type: none"> • Define small businesses by a common level of turnover for IRPC, IRPS, and IVA. • Increase IVA threshold, and allow businesses below threshold to either opt-in for the normal regime OR simplified regime of 5% of sales. • Consider tiered corporate tax regime for small businesses. • Educate SMEs on possibilities for IVA opt-in and requirements for compliance. • Increase outreach activities targeting small businesses.
Customs	<ul style="list-style-type: none"> • Fully implement the Central Revenue Authority. • Replace the Crown Agents TIMS System with ASYCUDA. <p>Eliminate pre-shipment inspection as quickly as possible.</p>
Sub-National Taxes	<ul style="list-style-type: none"> • Municipalities should focus efforts on developing and disseminating requirements and decision criteria for business licenses.
National licensing regime	<ul style="list-style-type: none"> • 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. • Improve information on the licensing regime and its transparency. • Involve all relevant institutions in information disseminated to the public. • Revise the legal framework on general business licensing & inspections. • Reform remuneration of inspection staff so that this is not based on fines handed out.

EXECUTIVE SUMMARY

This FIAS/DFID report forms part of a series of studies 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.²

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.

² 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.

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

Recent reforms to the manner in which officials from the revenue authorities are remunerated (moving away from a remuneration based on percentage of fines handed out and toward a merit based system) should improve relations with the private sector, although there is as yet no tangible evidence of it. Similar reforms to other Governments Ministries and Departments with the power to dispense fines to businesses should follow.

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.

Recommendations & Analysis

General Recommendations

- **Move gradually towards across the board lower tax rates thus eliminating the need for sector based incentives.** While allowing all business to access the tax benefits under the CPI, in the medium to long term Mozambique needs to move towards a more broadly applicable and evenly applied tax regime, by gradually reducing tax rates. In order to compensate for current and future reductions in tax and loss of tax revenue, the Government could consider introducing higher yearly land leases, especially on prime properties and could also consider raising excise taxes, which currently are slightly low in comparison to other African countries in the region.
- **Pursue 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.
- **Provide tax-payers with better information on procedures and requirements for obtaining IVA refunds.** In order to reduce delays in IVA refunds arising from improper documentation, the tax administration should increase efforts to inform businesses on requirements for filing claims. This recommendation is especially pertinent to the mining and manufacturing regimes.
- **Consider putting in place a risk-profiling system for selective audits to reduce delays in IVA refunds.** Various approaches can be considered to reducing delays in IVA refunds such as preferential treatment for compliant taxpayers (such as in Tanzania or Pakistan). 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. Again,

this recommendation is especially pertinent to the mining and manufacturing regimes.

- **Consider the indefinite carry forward of losses.** In order to provide some benefit to the tourism industry the provision for losses carried forward should be unlimited. This will allow benefit to be obtained from incentives on accelerated depreciation and from investment tax credits.
- **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.
- **Continue to reduce customs duties to the maximum rate of 20% then to 15%.** 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.
- **Clamp down on corruption and remove the subjectivity and discretionary nature of the inspection process and simplify the compliance process.**

Sector Specific Recommendations

Agriculture

- **Resist pressure from the sector for even more generous tax incentives.**³ 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.
- **Instead, focus on generic tax reform in areas such as IVA refunds, customs etc.** which will greatly assist the sector as well as the whole economy. Agricultural enterprises, especially those which export, are most vexed about tax issues which affect all exporters (e.g. IVA refund delays, customs procedures etc.)
- **Maintain unchanged the IVA treatment now afforded the agricultural sector.** This benefit, unlike the reduced corporate income tax rates, benefits small

³ Indeed the IMF (2006a) recommend removing the 80% reduction in IPRC benefit, while maintaining it for those enterprises which have already benefited.

as well as large farmers.

- **Conduct further research into the introduction of a rural land tax.** There 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 un-level 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**;
- **Introduce a capital gains tax** that would tax capital gains at a lower rate than ordinary income.

These measures would lead to a net increase in government revenue, since the increase in revenue from income on government and listed securities – estimated at about US\$43.5 million annually – would far outweigh the estimated \$10 million in annual stamp duty revenues.

Abolishing the income tax exemption on government and listed securities could also increase banks' propensity to lend to enterprises, including SMEs, while introducing a low capital gains tax (rather than treating capital gains as income) could increase incentives for all kinds of financial institutions as well as other enterprises and individuals to make direct investments in productive business activities. Introduction of a lower capital gains tax, which could be applied to all investments of more than a year's duration, could also provide an incentive for more companies to list shares on the Mozambique Security Exchange.

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.
- **Allow and educate small businesses on possibilities for IVA opt-in and requirements for compliance.** In addition to allowing opt-in for the normal IVA regime, the government could consider disseminating simple and accessible information on possibilities for IVA opt-in, and procedures for compliance.
- **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.

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.**
 - Abolish the current incentives faced by inspectors.
 - 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.

1. INTRODUCTION

Background

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy and its administration on the business climate in southern Africa.

The success over the last decade in establishing semi-autonomous revenue authorities (RAs) in various countries in the region has achieved increased tax collection. An unforeseen consequence of creating RAs may have been to strengthen RA incentives to maximize revenue generation while weakening the authority of ministries of finance to formulate tax policy for broader national needs - especially business development, investment and growth for sustainable poverty reduction. There has been little focus on the possible business and growth impacts of revenue targets and internal performance incentives.⁴

This project therefore aims explicitly to develop a deeper understanding of African RAs' impact on business. 'Doing Business 2006'⁵ showed that countries that tax highly and have complex regulations (and hence provide strong incentives to evade), generally receive lower tax revenues than countries with low rates, broader tax bases and less onerous administrative burdens. Reflecting on examples of successful policy reform, this series of studies will suggest reforms in both tax policy and administration that may stimulate savings, investment and growth – such as through selectivity/disciplining of rents/security of rents, and tax exemptions.

This study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice.

Previous studies by FIAS have shown that sub-national taxation and 'non-tax' user fees (such as fees for licenses and associated fines), can form as large a burden for businesses as the formal tax system. This is especially the case for small businesses. Taking this into account, the methodology in Mozambique was expanded to include analysis of these issues.

⁴ In the case of Mozambique, legislation to form the Central Revenue Authority has been passed by Parliament, but has yet to be enacted.

⁵ See www.doingbusiness.org, The World Bank's Doing Business database provides objective measure of business regulations and their enforcement.

This study recognizes that maintaining revenue for necessary government expenditures is critical, and that any tax policy or administration reforms (including those in this report) need to take into account the revenue implications. However, ‘investment friendly’ tax reforms need not threaten the fiscal base and may indeed enhance it. Simpler tax systems encourage compliance and discourage evasion and avoidance; lower tax rates can spur growth leading to increased revenue collection in the medium to long term; and the elimination of expensive incentives can boost revenue in the short term.

This project appreciates that tax may be only a small part of the wider picture of what affects the incentives to invest. Other factors may include economic governance, trade tariffs, security etc.

Context of the Study in Mozambique: Growth and Investment

Average annual economic growth in Mozambique between 1996 and 2004 was 8.5%, driven by new mega-projects, investment from neighboring countries, buoyant donor support, and agricultural growth. More recently however, growth has begun to slow (Table 2) while still remaining impressive (IMF 2005).

Table 2 shows strong economic growth in 2005 at 7.5%. The outlook for 2006 and 2007 is favorable, with growth expected at 7.9 and 7.3 per cent respectively, sustained by a new wave of mega-projects in titanium mines as well as strong growth in construction and agriculture.

The Government of Mozambique’s first Poverty Reduction Strategy Paper (the Plano de Acção para Redução da Pobreza Absoluta or PARPA) ran from 2001-2005. This has been succeeded by the ‘PARPA II’ covering the period 2006-2009.

Both documents envision broad based economic growth as the primary means of achieving the goal of poverty reduction. Under PARPA II the Government of Mozambique’s priorities for reform are (i) consolidate macroeconomic stability through a gradual strengthening of the fiscal position to increase credit to the private sector and maintain a competitive exchange rate while monetary restraint helps anchor inflationary expectations, and (ii) institutional reforms and good governance to buttress the investment climate and ease the constraints on growth.

These two very important and worthwhile objectives highlight why analysis of the impact of tax on the investment climate is so important. The two goals stated in PARPA II *could* be in direct opposition to each other. If strengthening of the

fiscal position came about through higher tax rates and more aggressive tax collection, this would raise revenue in the short term but negatively impact on the investment climate (and in turn revenue collection) in the longer term. Finding the correct balance between tax rates and tax administration, which both raises sufficient revenue while still providing a positive business environment, is therefore a critical challenge for the Government going forward.

Box 1: ‘Key Strategies & Activities for Employment and Business Development.’ Taken from the Action Plan to the Plano de Acção para Redução da Pobreza Absoluta

“The present strategy for reducing poverty and fostering economic growth is based on the assumption that private initiative by citizens, families, firms and other institutions, is the engine of development, with the State being responsibility for the provision of services and infrastructure that are essential for the realisation of these initiatives. Employment derives essentially from the multiple initiatives of citizens, families, firms and other private institutions. Obviously, initiatives of public institutions also provide employment. However, activities of the private sector are increasingly the source of job creation and opportunities for employment.

Measures which contribute to the promotion of employment and business development:

- Labour legislation
- Commercial law
- **Improve the business environment**
- Deepen the restructuring State companies
- Small Industry Support Fund”

Source: Government of Mozambique: <http://www.govmoz.gov.mz/parpa/eindex.htm>

Table 2: Mozambique: Economic Data 2001 - 2005

	2001a	2002a	2003a	2004a	2005b
GDP at market prices (MT bn)	76.5	96.9	113.8	137.4	153.2
GDP (US\$ bn)	3.7	4.1	4.8	6.1	6.6
Real GDP growth (%)	13.1	8.2	7.8	7.2	7.5
Consumer price inflation (av; %)	9.1	16.8	13.4	12.7	7
Population (m)	18.3	18.7	19.1	19.4	19.8
Exports of goods fob (US\$ m)	726	809.8	1,043.90	1,503.90	1,745.30
Imports of goods fob (US\$ m)	997.3	1,476.50	1,648.10	1,849.70	2,242.30
Current-account balance (US\$ m)	-657.2	-869.1	-816.5	-607.4	-760.6
Foreign-exchange reserves excl gold (US\$ m)	713.2	802.5	937.5	1,131.00	1,054.10
Exchange rate (av) MT:US\$	20,703.60	23,678.00	23,782.30	22,581.30	23,061.00

^a Actual. ^b Economist Intelligence Unit estimates. Source: Economist Intelligence Unit 2005

Sector contributions to growth

This study focuses on five sectors in order to allow cross country comparison: agriculture, mining, manufacturing, tourism and financial services. Table 3 illustrates the various component contributions to Mozambique's (formal) GDP.

Table 3: Mozambique: Sector contribution to total GDP, 2000-2004 (in % of total GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(as a %age 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 (2006)

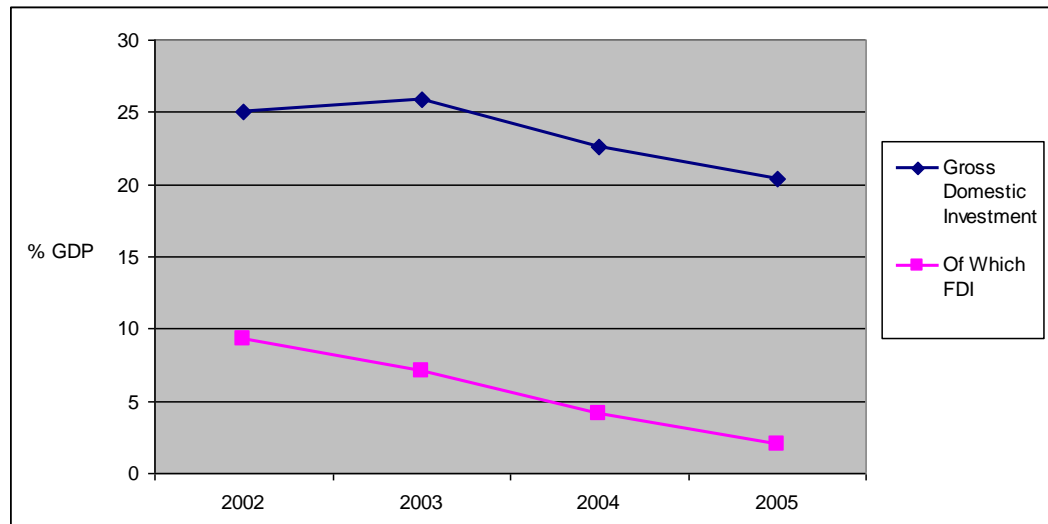
The commercial sector is the most important sector in the Mozambican economy; in 2005, it accounted for 20.8% of economic activity. The transportation and communications sector represented 14% of GDP in that same year, reflecting the growth in mobile telephone services and maritime transportation. As Table 3 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.

Agriculture ranks second in economic importance. In 2005, agriculture represented more than 16% 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 (not reflected in Table 3).

Manufacturing has grown significantly in importance in the past decade, from 7.4% of GDP in 1995 to 15.7% in 2005. The growth of this sector also reflects the behavior of foreign direct investment (IDE), including investments in mega-projects. The biggest IDE project is the Mozal project. In recent years, it has accounted for an average of about 6% of GDP. 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.

Investment in Mozambique

Figure 1. Mozambique Gross Domestic Investment



Source: IMF (2006)

Investment, primarily supported by foreign direct investment in mega-projects, (Mozal I and II and the gas pipeline to South Africa) grew at an average rate of 11% during 1996–2004, higher than the country’s overall GDP growth rate. The mega-projects also explain Mozambique’s buoyant performance in exports, which grew at an average rate of about 29% during 1997–2004.

Mozambique’s success at attracting mega-projects has put “Mozambique on the map.” However, as Figure 1 illustrates, 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 business climate in Mozambique

The World Bank’s ‘Doing Business’ project provides a good starting point for assessing Mozambique’s investment climate. Table 4 shows that compared to its nearest and most immediate peer economies, South Africa and Mauritius, Mozambique has a long way to go in terms of improving the investment climate across a range of fronts. The challenges facing the investment climate in Mozambique are summed up by the poor rankings for starting a business (111th), registering property (117th) getting Credit (118th), protecting investors (116th), trading across borders (101st).

Table 4: Doing Business 2007 – Mozambique’s Ranking Performance

Economy	Ease of Doing Business	Starting a Business	Dealing with Licenses	Employing Workers	Registering Property	
Mauritius	32	30	49	64	156	
South Africa	29	57	45	87	69	
Mozambique	140	153	103	157	105	
Economy	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
Mauritius	83	11	11	21	109	67
South Africa	33	9	74	67	43	65
Mozambique	83	83	80	141	168	126

Table 5 shows that on taxes, Mozambique does better than the regional average on all three tax indicators. However, there is much room for progress. The figures for Mauritius and South Africa show how much progress Mozambique could make in simplifying the tax code and its implementation.

Table 5: Mozambique’s Doing Business Indicators for Tax vs. the Region

	# Payments	Time (hours per year)	Total Tax Payable (% of gross profit)
Mozambique	36	230	39.2
South Africa	23	350	38.3
Mauritius	7	158	24.8
Sub-Saharan Africa	40.9	336.4	71.2

Besides the previous work of FIAS (1996 and 2001), a number of other analytical studies have been undertaken recently to identify the investment climate constraints in Mozambique, including the World Bank’s Investment Climate Assessment for Mozambique in 2003. These and other studies show that tax rates and tax administration are serious impediments to doing business in Mozambique. In the Investment Climate Assessment, tax rates and tax administration are the seventh and tenth most commonly cited business constraint respectively. However, corruption (which is often linked to tax administration) is the third most commonly cited business constraint in Mozambique.

In 2004 the leading business chamber in Mozambique the Confederation of Business Associations in Mozambique (CTA) commissioned a report to investigate the validity of their concerns over the tax system in Mozambique.⁶ Those concerns are:

- The new tax laws are too complex for local conditions;
- Tax rates are too high;

⁶ See Bolnick (2004).

- The tax base is too narrow;
- Tax administration is inefficient, arbitrary, and prone to corruption;
- The tax system unduly impairs business cash flow and raises financing costs;
- Various tax provisions tilt the playing field against many domestic producers; and
- Public information on the tax system is highly inadequate, and public–private dialogue has been insufficient.

Bolnick finds there is evidence to support each of these concerns and raises over 50 recommendations in response (see Annex E). It is not the intention of this report to repeat the excellent analysis undertaken by Bolnick, but rather to corroborate the analysis and provide an insight into how the tax regime impacts and ‘bites’ at the sector level.

Within Government, the National Directorate of Studies and Political Analysis (DNEAP) in the Ministry of Planning and Development, has carried out a number of studies looking at certain specific taxation and revenue issues over the past years and is in the process of trying to finalize and bring these together into one study. These use a variety of methodologies and focus on a number of specific issues.

Tax Policy and Tax Administration in Mozambique

In March 2006 the IMF Fiscal Affairs Department undertook a comprehensive analysis of the tax system in Mozambique. FIAS understands that a draft report, “Post Reform Evaluation of the Tax System” has been compiled – although the contents remain confidential at this stage. Good tax policy and best practice from the public sector perspective (a traditional strength of IMF analysis) would also be of significant benefit to the private sector. This reflects the fact that sound tax policy, using global research and experience, tends to produce similar recommendations whether taken from the government or private sector viewpoint.

Similarly to Bolnick (2004), it is not the intention of this report to repeat or second-guess the analysis being undertaken by the IMF in March 2006, but rather to provide a private sector perspective and an analysis of how the tax regime impacts at a sector level.

Tax Policy

Under the Constitution of Mozambique (2004) the Assembly of the Republic has exclusive authority to define the principles of tax policy. The fiscal system, tax incidence, rate, or exemptions cannot be enacted by mere Government decree

alone. 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.” This provides a both a measure of legislative stability as well as allowing changes that the legislature deems necessary.

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). In 2006 a General Tax Law was adopted.

Mozambique has concluded Double Taxation Treaties with A double taxation agreement with South Africa is still under negotiation although 16Q

Tax Instruments

This study will concentrate on taxation whose burden falls on the corporate sector. The main tax instruments and their rates currently applicable in Mozambique are:⁷

- The Individual Income Tax (IRPS) 10% to 32%.
- Corporate Income Tax (IRPC): 32%.
- Value Added Tax (IVA): Standard rate 17%, with some zero rated products and exempt sectors).
- Customs Duties: 0%-25%; see Table 7.
- The Excise Tax (ICE): 20%, 35%, 50%, or 75%.
- The Stamp Tax:
- Tax on Fuels: Rates vary from 591 Mt/l for fuel oil to 5,962 Mt/l for leaded fuel.
- Local Government Taxes (inc. Local Personal Tax, Property Tax, Economic Activity Fees, Commerce and Industry, Labor Income Tax).

Tables 7 and 8 provide data on Mozambique’s customs duties and IVA rates – with a comparison to other countries in the region.

⁷ Annex A, taken from IMF (2006a), provides comprehensive breakdown of each tax instrument.

Table 6: IVA (VAT) rates in SADC countries

Country	VAT Rates (%)	Corporate Income Tax Rate (Headline Rate) %
Botswana	10	25
Kenya	16	
Lesotho	8, 14, 15	0, 15, 25
Madagascar	5, 20	
Mauritius	15	25
Malawi	17.5	30
Mozambique	17	32
Namibia	15, 30	35
South Africa	14	29
Tanzania	20	30
Uganda	17	
Zambia	17.5	
Zimbabwe	15	

Table 7: Regional (Nominal) Customs Tariff Rates

Goods	Capital goods	Raw materials	Semi-finished goods	Finished goods
Rwanda	0%	5%	15%	30%
Uganda	0%	0%-7%	15%	15%
Kenya	0%	0%-3%	5%-15%	20%-35%
Mozambique	5%	2.5%	7.5%	25%
SACU	0%	0%	10%	20%
Zambia	0%	0%-5%	15%	25%

Source PWC Lesotho Datacard 2005/2006

Investment Incentive Regime in Mozambique

Investments processed through the CPI are provided with benefits in the form of tax incentives, Exchange Control Benefits (the right to repatriate profits) and Import duty benefits. Typically all foreign investors go through the CPI as they cannot repatriate profits out of the country without this certificate. Permission from the CPI allows the investor greater freedom in their operations as it helps in its dealing with the various government departments. The qualifying investment to avail benefits through the CPI is US \$50,000. Domestic investors can qualify for these benefits on application to the CPI with investments of value greater than an equivalent of US \$5,000. One of the requirements for applying to the CPI is that the firms have audited accounts. This precludes many small investors even with an investment over \$5,000 from these benefits as this condition places an additional burden of compliance.

Investments made through the CPI regime receive tax incentives in the form of rate reduction, accelerated depreciation and investment tax credits. These

incentives are defined in the Code of Fiscal Benefits that does not form part of the standard tax code. Mega Projects (i.e. investments above US \$500 million) qualify for even higher benefits. In the past investment incentives were negotiated with the government, though the Code of Fiscal Benefits outlines the tax incentives that apply in general.

Annex A provides a description of the incentives available under the Fiscal Benefits Codes.

Tax Administration

Following publication of the PARPA in 2000, the GOM recognized that to achieve the objectives 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 gave each greater autonomy in carrying out their functions.

Further reforms included passing of legislation for the creation of a single semi-autonomous Revenue Authority - the Mozambique Central Revenue Authority (ATM) - which will consolidate the administration of domestic and customs taxes. Box 2 illustrates the pro's and con's of such institutions, which are generally found to have been a success.

Box 2: National Revenue Authorities (RAs)

Semi-autonomous national RAs have been adopted widely, in both developed and developing countries, to the extent that creating such an authority is often considered a gauge of a country's commitment to reform. The semi-autonomous character of revenue authorities is considered essential to address the twin problems of corruption and low capacity. A semi-autonomous body need not be subject to normal civil service salary scales and can thus attract and retain a higher caliber of employee, while at the same time paying a living wage that can reduce the temptation to engage in corrupt practices. Autonomy is also seen as an explicit promise to taxpayers that the system will henceforth be more businesslike, fair, and non-political.

A comparative study of national revenue authorities in Asia, Africa and Latin America revealed several common and essential features of revenue authorities:

Legal character: All semi-autonomous RAs are created by laws that define the legal character of the RA concerned. All are situated within the public sector, though they may take different forms. For instance, Peru's RA is a decentralized public organization. The South Africa Revenue Service (SARS) is a public sector organization outside the public service. The Kenya Revenue Authority (KRA) is a government corporate body while Venezuela's RA is an autonomous institute. Of these four, all except for Venezuela's RA have their own separate legal character and can own assets. RAs without a separate legal status tend to be more subordinate to ministries of finance and political influence. Similarly, the right to own assets strengthens the managerial autonomy of the tax administration.

Governance structures: All of the semi-autonomous RAs established to date follow any one of two governance models: the chief executive officer (CEO) model or the board of directors (BOD) model. The CEO model was adopted by almost all of the Latin American countries while the BOD model is popular in Africa and Asia.

Financing: Semi-autonomous RAs generally receive budgets which are set as fixed or variable percentages of their actual collections. However, some RAs, like SARS, are funded through legislative appropriations like any other government agency. Funding via a fixed percentage of collections can increase an RA's autonomy, but can also lead to a lack of accountability.

Personnel systems: Autonomy in hiring, firing, rewarding and motivating its staff is viewed by many as perhaps the most critical feature of semi-autonomous RAs.

Accountability mechanisms: Greater administrative and financial independence must be accompanied by the establishment of accountability mechanisms. A good accountability system should include: (1) code of ethics for all employees (2) a strong internal audit unit with a high profile within the revenue authority to enforce the code of ethics, (3) independent external audit of the revenue authority itself, and (4) clear reporting relationships to other government agencies.

Sources: OECD (2001), Manasan (2002) and Kidd and Crandall (2006)

Tax revenue performance

From a macroeconomic perspective, tax policy in Mozambique has been increasingly effective at raising revenues, as measured by tax/GDP ratios. The current revenue/GDP is 13.2%, up from 12.6% in 2000-2002 (IMF 2006).

However, response to tax reforms and tax modernization programs beginning in 2000, has been smaller than expected. The IMF (2006) contend that there is plenty of room for increasing tax revenue. Reviewing several methodologies they conclude that actual revenue collection in 2001 and 2002 amounted to only half of potential collection.⁸ The, current revenue/GDP ratio is one of the lowest in Africa (together with Tanzania, and Uganda).

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

Mozambique's reliance on external donor flows could provide a disincentive to raise additional revenue by expanding the tax base or raising tax rates. In this situation aid flows would be helping to keep tax rates lower than otherwise, which can be seen as a pro-business outcome.⁹ However, the GOM is committed to raising the tax base and the PARPA II includes a strategy to strengthen the fiscal position underpinned by an average increase in revenue of 0.5 % of GDP per

⁸ The Government of Mozambique would appear to agree as the medium-term fiscal program calls for revenue to reach 17 % of GDP by 2010.

⁹ See Adam and Bevan (2001).

annum (IMF 2006)¹⁰. The planned creation of the Central Revenue Authority to encompass inland taxation, customs and excise, is in part a response to address these issues.

Table 8: Mozambique: Share of Revenue by Tax Instrument (% GDP).

	1999	2000-2002	2003	2004	2005
Total revenue	12.0	12.6	12.9	12.3	13.2
Tax revenue	11.0	11.2	12.0	11.3	10.8
Income taxes	1.7	2.0	2.8	2.6	2.9
IRPS	n.a.	n.a.	n.a.	n.a.	n.a.
IRPC	n.a.	n.a.	n.a.	n.a.	n.a.
Taxes on goods and services	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.	1.1	1.0	1.0	1.0	0.4
Tax on Fuels	1.5	1.1	1.1	1.2	0.4
Taxes on Foreign Trade	2.0	2.0	2.0	1.7	1.8
Other tax revenue	0.4	0.3	0.3	0.3	0.3
Non-tax revenue	0.9	1.3	1.0	0.9	0.5

Source: IMF (2006)

1/ Includes the stamp tax, and fees

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

¹⁰ Refer to footnote 9.

2. ANALYSIS OF THE EFFECTIVE TAX BURDEN IN MOZAMBIQUE

Assessing the effective tax burden - an introduction

A quantitative assessment of the effective tax burden in Mozambique requires a standardized metric, which takes all provisions of the tax code and incentives scheme in place to look at what a hypothetical new entrepreneur would face if he or she were to invest today in that sector. At the same time, qualitative analysis is also needed to determine how the tax/incentives scheme is applied in practice. This section presents both the qualitative and quantitative analyses of five key sectors in the economy—agriculture, manufacturing, tourism, mining, and finance—to present a comprehensive picture the absolute and relative tax burden.

Quantitative analysis of the effective tax burden

The Marginal Effective Tax Rate (METR) is the effective tax on an incremental investment by a business. It encapsulates the effect of the complicated tax code to an incremental investment. As a result it is a very useful parameter that summarizes the impact of the tax system on the decision of an investor to infuse capital into his or her business. The METR calculated for this study uses all the parameters of the tax system that affects the return on capital. Other factors that affect business but do not affect the rate of return on capital are not reflected in this calculation.

The calculation of the METR is based on what a rational investor faces in the market. If for example, the rate of return from the market as given by alternative investment opportunities is 10%, then any investment into the business is carried out if the rate of return from that investment meets or exceeds this rate known as the required rate of return. The tax system distorts the rate of return accruing to the investor from this investment in various ways. Corporate tax, depreciation allowances, investment tax credits, and other aspects of the tax code, changes this rate of return of the investment. As a result, an investment is carried out only if it's after-tax rate of return matches or exceeds the returns from alternate investment opportunities. In the equilibrium, investors invest up to the point that the after-tax rate of return just matches the market rate of return.

The METR is defined as the proportion of the pre-tax rate of return that is accounted for by the tax code. If for example, the tax system reduces the after-tax rate of return on an investment such that only a pre-tax rate of return of

15% could generate a post-tax rate of return of 10% (the required rate of return), the METR is given by, $(15\% - 10\%) \div 15\%$ or 33.3%. As a result the METR gives us one number that describes the overall burden that the tax system imposes on the investment.

The METR provides different information from the commonly used measure of the burden of the tax system on business, the average effective tax rate (AETR). The AETR, defined as the income from capital divided by the tax paid, while providing useful information about the burden of taxes on the business in the present, measures the average over taxes on income from all past investment and tax credits on the current investment. The METR on the other hand is a forward looking measure that looks at the burden faced on a new investment into the business. As investment in capital is a key driver of productivity, the METR provides a useful methodology to measure this burden faced by capital in its various forms.

Calculation of the METR

The various Inputs into the calculation of the METR¹¹ are as follows:-

- The statutory income tax rate
- The rates of depreciation for different capital assets
- Additional depreciation allowances if any
- The inflation rate
- The domestic tax rate on Interest and Dividend
- The capital gains tax rate
- Tax benefits given to certain sectors
- Implicit VAT tax on capital
- The international interest rate
- Sector-wise debt-equity ratio
- Sector-wise composition of capital assets

¹¹ The model being used has been developed by K. McKenzie, Professor, Department of Economics, University of Calgary, Canada. A Detailed description of the model can be found in McKenzie, Mansour and Brûlé (1997). "The Calculation of Marginal Effective Tax Rates," Working Paper, Technical Committee on Business Taxation, Department of Finance, Canada

Box 3: METR vs. AETR

The METR must be differentiated from the AETR, the Average Effective Tax Rate. The AETR, defined as the tax paid divided by the income from capital is commonly seen in income analysis. This measure is less useful because it measures the average burden of taxes on income from all past investment and tax credits on the current investment.

The METR is a more useful than the AETR because marginal factors determine investment decisions and not average factors. The METR is a forward looking measure that looks at the burden faced on a new investment into the business. As investment in capital is a key driver of productivity, the METR provides a useful methodology to measure this burden faced by capital in its various forms.

The METR is calculated using the economic concept that taxpayers maximize profits and as a result invest up to the point where the marginal benefit of the incremental investment equals its marginal cost. When undertaking this calculation, it incorporates all the tax provisions that impact the return from the investment. The AETR on the other hand calculates the tax impact of specific investments undertaken and only incorporates the tax provisions that are impacted by the investments that are already undertaken. As a result the METR is the most appropriate measure to assess the impact of the tax system on investment.

METR and non-tax parameters

The METR is highly sensitive to non-tax parameters such as the interest rates. The METR is most useful when used as a tool to **compare** the burden imposed by the tax system across different capital assets or across different sectors of the economy. It is not particularly useful to see it in terms of absolute levels¹². Therefore, when comparing across countries, non-tax parameters are kept constant as far as possible. For example, the interest rates might vary across countries due to various reasons, but only the tax aspects that cause this difference are incorporated into the METR.

When a comparison of the METRs is made, the interest rate in the local country is taken to be inflation *plus* international real interest rate, when the country operates as a small open economy.¹³ When the economy is considered closed, the interest rate in the local country less the tax imposed on it, when reduced by inflation, is assumed equal to the international interest rate. As a result in the closed economy model, the tax system imposes a wedge between the international interest rate and, the local interest rate *less* inflation. As this translates to a higher interest rate in the local country, the METRs calculated using the closed economy model takes into consideration the differential interest rates across countries that are explained by the taxation

¹² For example a zero METR does not necessarily imply that the tax collected is zero, as in the case of a 100% investment allowance.

¹³ This is a valid assumption because any interest rate that is different from this can be arbitraged away in the financial markets when the economy is open.

of interest income. All other non-tax factors that impose a wedge between the after-tax interest rate and inflation *plus* international real interest rate are not a part of the calculation. As a result local credit constraints, country risk premium, etc. that might result in high cost of doing business in a country are not included in the analysis.

Therefore, in the case of a large investor with access to international capital markets, the interest rate for borrowing to finance business is lower than one without this access. The applicable rate of interest in this case is taken to be the international interest rate (4%) *plus* inflation (5%) which is 9%. As this implies a lower required rate of return on any new investments, the METRs are much smaller for large firms. We have used a small open economy model to analyze these investors, though the large economy version is also provided for comparison purposes.

In the case of small businesses that only have access to local finance the interest costs are higher. The required rate of return on new investments in this case has to be much higher than the large investors in order to make up for the higher borrowing cost. In order to analyze small business, the interest rate entailed by the closed economy is more appropriate. This implies an interest rate of $(4\%+5\%)\div(100-35)\% = 13.9\%$ ¹⁴, assuming that the interest income to domestic taxpayer is taxed at a marginal rate of 35%.

Capital Asset Ratios and Debt-Equity ratios

The two input parameters into the model, the debt equity ratio and the sector-wise composition of assets are very important in determining the METRs. For the purpose of the calculation these ratios are taken as exogenous. In reality, these parameters are also a function of the tax and economic parameters.

Hence there is need to fix this at an arbitrary but reasonable value. The debt-equity ratio, for example, is a function of the extent of risk that an investor faces and his expected returns from the investment, both of which depends on the tax system. The same applies to the sector-wise composition of capital assets. While the capital asset composition depends on the nature of the business, the differential effective tax rates on asset types distorts the investment in different assets. (This only affects the total METR which is a weighted average of the separate asset-wise METRs). When the sector-wise ratio of debt to equity and the capital asset ratios for the country being studied are available, it is not unreasonable to use this ratio as an input into the model when one is analyzing the METR across sectors within an economy. But, when comparing across countries these ratios are kept fixed and the tax system is analyzed from that stand point.

¹⁴ The identity used here is $R_c(1-t)=\pi + R_i$, where R_c is the interest rate in the country, R_i the international interest rate, π is the rate of inflation in the country and t is the Personal Income Tax rate.

Limitations of the METR analysis

The METR analysis while being a very useful parameter to measure the burden on investment across capital assets and sectors has its limitations. First, it only measures the burden on capital investment. It does not measure the burden of other taxes such as payroll taxes, custom duties, etc. that do not affect the calculation of the METR on capital.

Second, it is an analysis of the tax code as it exists in the statute books and does not incorporate the actual implementation of the tax code which might vary widely due to compliance reasons and the way the tax administration operates.

Third, the METR analysis does not incorporate revenue considerations of the government. While a lower METR is good for encouraging investment, this is only a one sided view, as lower taxes also implies lost revenue for the government. The economic literature suggests that the optimal tax on capital is zero; but this is only true when economic efficiency is the only consideration. When equity is also a consideration a zero METR need not be the optimal choice. Also, the METR analysis does not incorporate issues of incidence. It is assumed that the burden on capital is borne by capital, though in reality, part of this could be passed on to labor. Like-wise taxes other than those imposed on capital such as payroll taxes can also be passed on to capital. For the purpose of this study incidence issues are not taken into consideration.

Fourth, in order that the METR analysis can be used to provide broad information of the tax burden faced by different sectors of the economy, it limits the input parameters to those mentioned above. Hence highly nuanced tax benefits faced by a small number of taxpayers are generally not incorporated into the METR analysis, though it can be done in these individual cases.

Despite these limitations, the METR analysis is one of the very few tools that allow us to quantitatively summarize the impact of the complicated tax system on investment. As a result it is used on a regular basis to analyze tax systems all over the world and very useful in comparing tax systems. The approach used in this report uses the analysis developed by Hall & Jorgenson (1967), King & Fullerton (1984) and Mintz (1995)¹⁵.

A few technical assumptions for the METR calculations used in this paper are also worth noting. First, as discussed previously, given the assumption of capital mobility in a “small open economy”, we use an international real interest rate (G-7 average).

¹⁵ Mintz (1995), King, Mervyn and Fullerton (1984).

Second, due to the lack of country-specific data, we use Canadian capital weights within any given business sector to estimate METR. This may sound problematic since Mozambique is not Canada. However: it allows cross-country comparisons; capital and technology are increasingly mobile; absolute capital weights may vary across country but relative weights vary far less (e.g. manufacturing uses more machinery and less land compared to agriculture); lastly, capital weights are not available in most African countries, including Mozambique.

Third, since the METR takes into account tax impact *at the margin*, any tax levied as a fixed amount that is not in proportion to the size of capital or income will not affect METR calculations. Therefore, any tax levied as a fixed amount will be excluded from our calculations. Such taxes include mainly local levies on immovable property including buildings, mining concessions, and farmland.

METRs for Mozambique - Overview

The effect of the Mozambique Tax system on investment decisions has been analyzed. Over all the METRs for Mozambique ranges from 16% for the agriculture sector to 57% for the Financial sector under the normal regime, and a low of 5% for the Mining sector to a high of 46% for the Financial sector, for investments made through the CPI. Separate METRs have been calculated for small Business and as their source of funds are primarily local; they face very high marginal rates of tax. Sector-wise description of the METR and the factors impacting them are been given below.

All these special regimes affect the Marginal Effective Tax Rates in a big way. Hence the METRs have been computed for investments through the CPI along with the normal regime. This is shown in Table 9 and in more detail in Annex C.

**Table 9: Marginal Effective Tax Rates for Asset Categories and Sectors:
Small Open Economy Model**

Large Companies					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	46%	46%	16%	56%	71%
METR Building	34%	41%	14%	43%	41%
METR Land	8%	8%	38%	-195%	8%
METR Inventory	29%	29%	9%	32%	29%
METR Total	40%	40%	16%	51%	57%
Large Companies – Investment through CPI					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	2%	-19%	-9%	-4%	61%
METR Building	13%	23%	-2%	7%	30%
METR Land	8%	8%	43%	-76%	8%
METR Inventory	29%	29%	2%	24%	29%
METR Total	11%	16%	6%	5%	46%

The Sector analysis below explains how and why each sector METR varies.

As this is the fifth in the series of country studies, it is possible to compare Mozambique’s METRs to those in South Africa, Lesotho, Rwanda and Tanzania. When comparing across six Southern African countries (Table 10 and Annex D), the METRs highlight the following:

- That under the ‘standard’ tax regime, Mozambique investors face a relatively high tax burden (relative to peer economies and competitors).
- However, when the Fiscal Benefits Code is applied (applicable to all investors with approval from the CPI) Mozambique’s tax regime is competitive.

Table 10: Mozambique’s METRs vis-à-vis Regional Peer Economies

	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%

Table 10 could be interpreted that Mozambique's tax regime is competitive and there is no need to lower rates of IPRC or VAT.¹⁶ However, while the METR rates under the CPI regime are competitive, 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%.
- For larger firms, negotiating the bureaucracy to access to the 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.

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. VAT refunds, customs procedures) and other government departments that investors must deal with on a daily basis.

Recent reforms to the manner in which officials from the revenue authorities are remunerated (moving away from a percentage of fines given and toward a merit based system) should improve relations with the private sector. Similar reforms to other Governments Ministries and Departments with the power to dispense fines to businesses should follow.

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.

METR and Tax Administration – Delayed VAT Refunds

The METR analysis in general summarizes the formal tax system. But, this can also be used to incorporate the actual working of the tax administration if adequately modeled. For example, VAT being a tax on consumption, should not have any impact on capital investment. However, if exporting firms and firms incurring large capital expenditures who are entitled to refunds of their input tax credit are either not refunded at all or are refunded with substantial delay (not compensated with interest on the accumulating refund), then this imposes an additional burden on capital which can be calculated using this model.

¹⁶ Indeed the IMF (2006a) argue against premature lowering of the tax rate and Bolnick (2004) argues for rates to be lowered in the medium term and when financially prudent to do so. Mozambique's competitive METRs under the CPI regime support this analysis.

VAT in Mozambique is paid every month on the amount of tax collected from purchasers after subtracting out the VAT paid on inputs into the business. This is positive for most firms, but in the case of exporting firms and those firms that incur large upfront capital expenditures, this can be substantially negative. In general, net credits carry over for 12 months, so that VAT credits may automatically be extinguished by VAT liabilities during this period. VAT refunds can be claimed immediately in case the VAT credit exceeds 50 MT.

The FIAS team was informed that VAT refunds remain a serious problem with delays going up to one year.¹⁷ A large number of refunds became payable to infrastructure companies, those building roads and bridges extremely vital to the Mozambican economy. These companies have substantial refunds locked up with the Tax Administration that severely undermines their ability to carry on their business.

Refunds due have to be paid by the tax administration within one month of filing the return. In theory, the tax administration has to compensate the taxpayer with interest on the amount of refund that has been issued after the mandated one month. Firms have complained that this never happens in practice as the tax administration makes use of a clause that compensatory interest would not be paid if there is even a minor discrepancy in the VAT return. They mention that not surprisingly, these minor discrepancies revealed mostly on the 29th of the month, one day before the refunds become due.

When VAT refunds are not paid, this implies an implicit sales tax on capital at the VAT rate of 17%. If refunds are delayed by 1 year, and not compensated with interest, then the implicit sales tax is 2.35% which is the opportunity cost of the refund due to the firms for one year¹⁸. It has been suggested in previous studies on the Mozambican tax system that reducing the number of refund claims by raising the threshold for claiming automatic refunds or by limiting the scope of the zero-rated taxpayers¹⁹. Another possible way to reduce the pressure of refunds on the tax administration is to raise the threshold for the Simplified VAT regime above 250 million MT so that a larger number of taxpayers fall within the 5% tax on turnover regime without benefit of claiming credit on input taxes. The government informed us that this was being actively considered. While such a turnover tax is indeed inferior to a full VAT as far as efficiency of the tax is considered, the lower rate of 5% as compared to 17% which is the VAT rate compensates for this inefficiency to some extent.

¹⁷ In line with Bolnick (2004), who also found VAT refunds to a major complaint of the private sector.

¹⁸ The implicit Sales Tax is given by $X \cdot (1 - 1/(1+r))$, where $X=17\%$, the VAT rate and r is the interest rate which is taken to be 16%.

¹⁹ Bolnick (2004)

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).

Conclusion

The government of Mozambique is committed to attracting investment and has put in place an attractive tax incentive package. Unfortunately, while in letter, the law is very committed to making Mozambique an attractive investment destination, in spirit this is not the case, as the tax administration and other government departments make life for the investor extremely uncomfortable. The FIAS mission was informed of taxpayers facing a number of problems by the arbitrary application of the various laws. Interestingly, most of the complaints have not been about the tax administration, but about officials from other government department that an investor has to deal on a daily basis.

The METR analysis has shown that the CPI regime provides a tax environment that is attractive for the investor. However, administrative problems such as delayed refunds can undo many of these benefits. Further, if in practice, an investment benefit cannot be used as the procedures are very cumbersome, the actual METRs are higher. The Tax administration of Mozambique is going through a very crucial phase with the setting up of an Independent Revenue Authority. This should provide a boost to its efforts to bring about the reforms in tax administration that are currently needed.

Sector Analysis

Agriculture

Agricultural sector growth, which averaged 6.6 % a year between 1996 and 2004, was lower than average overall GDP growth. The main contributors to growth were food grains (maize), sugar, tobacco, cashews, and cotton:

The fishing industry (primarily prawns) remains very profitable in Mozambique and is a significant employer and export earner, although it has been growing at a slower rate than agriculture since 1996..

Summary of the tax and incentive system

The agricultural sector, as is common in most tax regimes, receives favorable tax treatment. These are detailed below.

Box 4: The Great Cashew Controversy in Mozambique

Much has been written on whether the 18% export tax on raw cashews helps or hinders the development of the cashew sector as a whole (e.g. Bolnick 2004, La Fleur 2006, McMillan et. al. 2002).

There are 1.2 million small cashew farmers with an estimated 53 million cashew trees. Cashews account for 7% of Mozambique's export earnings. In the early '90s the World Bank argued that the export tax on unprocessed cashews supported a non-viable processing industry, helped breed corruption, and that the cost was born by one million small farmers. Reform would increase the price to (poor) small farmers, improve incentives to raise harvest, revitalize cashew orchards, induce the processing industry to restructure and enhance competition among traders. World Bank conditionality (applied to a 1996 adjustment loan) ended the administrative allocation of raw nuts to processors, ended export restrictions of unprocessed nuts and reduced the export tax to 20% with an intent to phase out over 3 years.

As a result the cashew processing industry collapsed as they were unable to compete for raw cashew, lacked the financing necessary for restructuring and faced labor law constraints. It was also widely reported that farmers became worse off, as they failed to respond to higher prices with higher output and became the victims of monopsony traders. As a result there was a strong backlash by the industry, labor, civil society etc. and in '99 the Government successfully passed a bill to keep the export tax at 18%.

McMillan, Rodrik, Welch (2002) argued that while the reforms did raise farm-gate prices and raw cashew exports did increase, that the net (static) benefits were negligible and there were negligible gains to farmers because the World Bank neglected to consider the market structure. Dynamic benefits were also weak because of the poor supply response. Benefits to farmers were largely offset by costs to factory workers who lost their jobs.

The findings of McMillan *et. al.* have been contested, however. La Fleur (2006) for example estimates that:

- The direct value of the subsidy to the processing industry is \$1.2 million higher than the estimated added value of \$ 1.9 million from the processing of the raw nuts into kernels for exports.
- The income loss to the cashew producers would be 6.9 times higher than the estimated added value of exporting kernels.
- The subsidy to the processing industry is equal to \$1.6 for each dollar of value added by exporting processed kernels.
- The total income loss to the 800,000 cashew producing families at present prices is estimated at \$13.3 million.
- The loss of demand for goods and service as well as the loss of capital for investment will have a multiplier effect that will lower the economic activity of all the rural cashew areas.

Yet the central problem for the cashew industry is not solved through the repeal or maintenance of the export tax. The industry is plagued by low volume and low quality. Trees are old, diseased, lack maintenance and have a low yield. The pre-existing local cess tax (where-by all raw cashew nut buyers, whether buying to export raw cashew nut or to process cashew kernel domestically, are obliged to pay up to 5% on farm gate price of raw cashew nut

to local governments), potentially creates as much of a disincentive to grow cashews as the 18% export tax – and yet it has not been analyzed in as much depth.

To a certain extent the cashew controversy has created space for renewed interest in industrial policy (for example with the variable sugar levy). Yet the Mozambique cashew case is *not* a template for trade policy as tool for industrial protection.

The agriculture sector has a reduced corporate income tax rate of 10%. Further, the agricultural sector benefits from the following specific investment incentives:

- Exemptions on imported goods
- Reductions of 80% on the rate of tax on company profits, until 2012
- Investment tax credits until 2012
- Accelerated depreciation until 2012.

The 80% 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.

Agricultural cooperatives are exempt from income tax.

Value Added Tax

The agricultural sector (which includes farming, forestry, livestock raising, and fishing) receives 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.

In order to lighten the upstream tax burden, an exemption (internal and on imports)²⁰ also exists for almost all agricultural inputs (141 scheduled items). Agricultural enterprises devoted essentially to exports are given the option to give up the exemption so that they can recover all the upstream tax they had paid.

Decrees have also been issued exempting the transfer of goods and rendering of services within the context of sugarcane and corn production, when earmarked for the industry.

Other taxes / relief

Mechanized farming (individual farmers or companies that maintain organized books of account or observe the simplified bookkeeping system), and consumption by fishing boats (small-scale non-industrial, semi-industrial,

²⁰ 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.

and industrial) all benefit from fuel tax incentives.²¹ These incentives are not awarded automatically, but must be applied for in advance. They provide a 50% 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.

Box 5. Should the Agricultural sector be exempt from VAT and/or other taxes?

It is a common feature that agricultural enterprises are taxed relatively lightly. The sector receives 'special' treatment because:

- In many developing countries agriculture is outside the formal sector
- Farmers are remotely located making education and compliance difficult
- Agriculture has seasonal revenues
- The rural / agricultural sector is relatively poor, and providing special tax benefits to this sector is perceived a social benefit
- Exempting, or zero-rating, VAT in agriculture is seen as a way to pursue wider social objectives such as lowering the price of food, and supporting poor communities (predominantly rural).

Many of these features are not unique to agriculture and there is no *a priori* evidence that agriculture deserves special treatment. The reality however, is that special provisions are usually provided. With VAT specifically, the 'cleanest' system is to zero-rate agricultural inputs, (as happens in Mozambique), although this creates its own problems in terms of defining what is destined for agricultural use or not. Another option is to exempt inputs from VAT although this can lead to 'exemption creep'. Once in place such schemes are very hard to undo and there are few examples of any country, developed or developing, which effectively moves toward graduating agriculture to a standard tax system. Complications are compounded when thresholds are introduced in an attempt to capture tax on value added from larger farmers (not a particular problem in Mozambique given then very small scale of the commercial agricultural sector).

Source: 'The Modern VAT', Ebrill, L., Keen, M., Bodin, J-P and Summers, V. (2001)

The Tax and Incentive Regime in Practice

Tax is not a major issue constraining investment in this sector. Other factors are more important in driving growth and investment, issues such as land tenure reform, access to credit and poor rural infrastructure.

Corporate Income Tax

In practice, very few farmers pay corporate income tax. Non-compliance is due to a combination of a lack of understanding of tax obligations and

²¹ 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.

geographical remoteness. Such a situation is common in countries with a large number of smallholder farmers.

It is only larger (incorporated) farmers who benefit from the reduced rate of 10% and possibly even 2%. Further, much large scale agricultural enterprises have been able to benefit from other Fiscal Benefits such as those accruing to the Zembeze valley.

VAT

The VAT treatment benefits all commercial farmers who purchase inputs and sell their outputs. **Unlike the preferential 10% income tax rate, the zero-rating of many agricultural inputs and outputs benefits small-holders as much as larger agricultural enterprises.**

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.

Other Issues including compliance (administration) costs

The fishing industry and to a lesser extent the organized farming sector argue that the fuel tax incentive is insufficient and cumbersome to administer. The quantities established in advance for each of the sectors by Government are inaccurate.

Yet the incentive is generous and it appears inconsistent that this sector received any further benefit in the future.

Box 6: Should Mozambique introduce a land tax?

Hughes (2006) argues that Mozambique should introduce a land tax as an economic incentive for more efficient use of land resources. Specifically, recommendations are:

- Land taxes should have a minimal differentiation between different categories of user and use. (Tax difference should be based on agricultural potential – rainfall patterns, soil types and access to infrastructure and not crop or activity)
- There should be no special exemption for agricultural incomes or profits from the general taxation of income and profits.
- Small holders with 5 or 10 hectares and communities should be exempt from any form of land taxation.
- Raise the land tax to Mt300,000 per hectare (\$12)
- All of the land under a title should be taxed and not just the cultivated area.

- Cattle breeding should not have a lower tax rate – the idea is to have higher value, capital and land intensive activities and not promote low value, low capital and land extensive investments
- There needs to be a limit to community areas exempt for the land tax
- The land tax should be on both titled and untitled land.

While taxing rural land is fraught with difficulties they can be a good way to help improve local finance, provide an excellent incentive to develop un-used land, deter "idle speculation", and encourage efficient public finance thru competition among municipalities. They are no panacea however, and it takes time and effort to build the institutional capacity to administer them fairly. There are some experiences from recent history which offer some insights (see Ahene (2000), and Khan and Khan (1998)):

- In the case of rural land taxation, decentralization of valuation and enforcement activities promotes efficiency.
- Site-value taxation is preferable to flat-rate taxation,
- Research and data management systems for comprehensive and accurate valuation are critical to the success of such systems.

METR Analysis of the Tax Regime

The Agriculture sector is entitled to the low tax rate of 10%. This is the only sector that gets a special rate of tax under the normal regime. For investments in agriculture that go through the CPI, the tax rates are further reduced by 80% which brings down the corporate tax rate to 2%. **The METR for the Agriculture sector is 40% in the normal regime while that for investments through CPI is as low as 6%.** Small business agriculture faces a very high METR of 71% despite the low tax rate. The combination of high financing cost and the distortion to investments due to the regular tax code raises the METR considerably. In the case of an investor in the agriculture sector is entitled to VAT refund but does not get it for one year, the METR becomes 9%, rising to 12% for a two year delay and becoming 26% when the refund is not given credit at all.

Recommendations

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 to enhance rural development would be better focused on land tenure security, rural infrastructure and enhanced extension services.

- ***Recognize that taxation is not the major impediment to growth in the agricultural sector.*** Therefore resist pressure from the sector for even more generous tax incentives.²²

²² Indeed the IMF (2006a) recommends removing the 80% reduction in IPRC benefit, while maintaining it for those enterprises which have already benefited.

- Instead, *focus on generic tax reform* in areas such as VAT refunds, customs, fines etc. which will greatly assist the sector as well as the whole economy.
- *Maintain unchanged the VAT treatment now afforded the agricultural sector.*
- Conduct further research into the introduction of a rural land tax.
- *Continue to monitor and evaluate the costs and benefits of specific sector regimes* such as those applying to sugar and cashews. Resists the temptation to enter into more bespoke crop specific tax regimes.

Mining

Mining represents a small, but rapidly-growing part of Mozambique's economy. Mozambique's mineral exports were just \$7 million in 1998, but they exceeded \$200 million, or 3.6% of GDP in 2005, not including the estimated \$915 million in aluminum exports from Mozal. Mining accounts for about 7% of formal private sector employment.

Taxation of the mining sector is therefore an important issue, since the tax regime can substantially influence the pace and magnitude of FDI in a sector that accounts for a growing proportion of national income, exports, tax revenues and employment.

A December 2002 review of mining taxation in Mozambique concluded that *"the current Mozambique mineral sector tax system is not attractive to investors, but is not prohibitive...Many mining companies consider Mozambique a higher risk, higher cost country...Most...will find the current Mozambique mining tax system minimally acceptable"*²³

Clearly, mining taxation has not been so onerous as to choke investment flows, but it is possible that investment flows into the sector have been smaller than they would have been with more favorable tax treatment. This is not an argument to provide over-generous incentives but rather to examine the competitiveness of Mozambique's mining tax system relative to other potential investment destinations and to structure tax treatment and incentives in a way that maximizes the total benefit to Mozambique's people and economy.

²³ J.M.Otto 2002, *Position of the Mozambique Taxation System as Compared to Mining Taxation Systems in Other Nations*, Colorado School of Mines, December 2002.

Summary of the tax and incentive regime

Mining in Mozambique is subject to a panoply of special tax regimes and exemptions.

Corporate Income Tax - Negotiated Agreements

Mining projects involving a direct investment of \$500,000 or more are eligible to sign a “mineral agreement,” which allows them certain statutory benefits, including a 25% corporate income tax rate until 2010, as well as the flexibility to negotiate their own tax regime.

All mining projects are exempted from customs duties on imported materials, equipment and spare parts throughout the project life, and are also exempt from VAT and excise taxes on imported materials, equipment and spares during the exploration and development phase.

Royalties

Smaller mining companies, which do not have a special agreement, pay a royalty of 10% of the sale value on diamonds, 6% on other gemstones, 5% on gold and other precious metals, and 3% on all other minerals. The Mining Act of 2002 exempts larger companies (those holding mineral agreements) from royalties, though in practice Government negotiates royalties for large projects on an individual basis.

Larger mining companies receive a 25% investment tax credit, while smaller projects get credits of 5% to 15%, depending on the region. Accelerated depreciation (generally 25% straight-line) is available to all projects, and the allowed basis for depreciation is twice the actual asset value. Losses can be carried forward for a maximum of five years.

Many of these incentives are of limited value to investors, mainly because the long development lead time for most mining projects exceeds the five-year limit for loss carry-forwards.

Most mining projects apply for CPI incentives not because of the value of the incentives themselves but because of the more liberal conditions pertaining to repatriation of profits and access to foreign exchange – normally, the Central Bank Governor must approve all foreign supply or service contracts worth more than \$5000.

The main points of difference between Mozambique’s current mining tax regime and common practices in other developing countries are: 1) high and variable royalties and, 2) high withholding taxes.

Otto (*ibid.*) placed Mozambique in the highest-taxing quartile of companies for base metals mining, with a total effective tax rate of 52.2%, and in the second-highest quartile for gold mining, with a total effective tax rate of 59.9%. One issue, as identified by Otto, is that the relatively high royalty applied by Mozambique is regressive when mineral prices are low, thus increasing the effective tax rate precisely when mining companies are most vulnerable, and also increasing the effective tax rate on less profitable and smaller companies.

Though the royalty undeniably constitutes a regressive tax, it is hard to support the contention that the royalty basis should be changed to reflect net profits or some other measure. If a mining royalty is intended to compensate the state for loss of a non-renewable resource, the tax should reflect some measure of the value of that resource rather than any given company's relative efficiency or inefficiency in extracting it. If one accepts the argument that mining, because of its unique nature, should be taxed differently from other industries, it is hard then to argue against a royalty based on the value of minerals extracted. There is, in any case, no uniformity or consensus that would suggest an international "best practice" in this matter.

An international survey of mining taxation conducted by Price Waterhouse Coopers (PWC) shows a variety of different royalty bases (e.g., a flat amount per unit, a percentage of gross income, a percentage of net income) applied by different countries or even by different states or provinces within a single country.²⁴ For example, an unprofitable gold mine in Ontario (Canada) would pay no income tax or royalty because the provincial royalty is based on net profits. The same mine in Argentina or Brazil would pay a royalty, because Brazil imposes a gold mining royalty of 3% of gross revenues and Argentina's royalty is 3% of "net smelter return," a measure similar to gross revenues. Western Australia allows mining companies to choose among a flat royalty fee per unit of production, a percentage of gross revenues and a percentage of net revenues for base metals. South Africa is one of the few big mining countries not to impose royalties at a national or provincial level (mines have traditionally paid royalties to land owners, especially in tribal areas), but a new mining royalty bill has been tabled and is certain to pass in some form.

It is all but impossible to establish a direct correlation between the existence, basis or rate of mining royalty and the effective tax rate in a given jurisdiction. Argentina, which imposes a 3% royalty on gross revenues, is in the lowest tax quartile of countries surveyed by Otto, while Ontario, which imposes a royalty of 20% of net profits but exempts the first C\$500,000 in profits, is in the highest quartile.

²⁴ B. Parsons, 1998, *Comparative Mining Tax Regimes: A summary of Objectives, Types and Best Practices*, Global Mining Group, Pricewaterhouse Coopers, 1998.

There is, however, a very strong argument to be made in favor of non-discrimination and transparency, and indeed most countries impose a uniform and transparent royalty. In this, Mozambique is far from conformity with best practices. Negotiating special tax regimes with most investors increases the effective tax rate on smaller investors that do not qualify for special treatment, while the common knowledge that Mozambique does negotiate taxation on a case by case basis induces all potential investors to bargain as hard as they can for a more favorable package. One result is that the “headline” mining royalties of 10% on diamonds, 6% on other gemstones, 5% on gold and 3% on base metals appear high by comparison to other countries’ royalties. Even if few companies actually pay such high rates, the appearance of high royalties could dissuade some investors while increasing the importance for all potential investors to push for special concessions.

Withholding taxes, it is true, may be an issue for the mining sector, but no more than for all other sectors of the Mozambican economy, since withholding taxes are the same for all sectors. As is so common in Mozambique, larger projects are able to negotiate special incentives that may include withholding tax reductions or exemptions. For mining, which is heavily dependent on foreign technical expertise, the 20% withholding tax imposed on services provided by foreigners may be a bigger issue than withholding taxes on dividends, though in an industry so dependent on foreign capital the withholding tax on dividends is surely significant.

Mining Taxation Worldwide

Almost all countries with significant mineral resources provide special tax treatment for the mining sector. Such regimes need not include, though many do include, special incentives for mining investment, but most mining tax regimes have been designed to accommodate the special character of mining projects, which typically include:

- Depletion of non-renewable resources;
- Environmental impacts;
- High risk;
- High capital investment requirements;
- Long exploration and development lead-times;
- Volatility of mineral prices; and,
- Foreign exchange risk.

According to a 2001 comparative international study of mining tax regimes²⁵,

²⁵ J.V.M. Sarma and G. Naresh 2001, “Mineral Taxation Around the World: Trends and Issues,” *Asia-Pacific Tax Bulletin*, International Bureau of Fiscal Documentation, January 2001.

“It is a well-recognized fact that government intervention through tax policy instruments is essential for optimal exploration of mineral reserves, maximization of mineral rents, maintenance of environmental standards, and for providing incentives for reinvestment of mineral rents. In each country, there exists a gamut of levies, each with a plethora of components, along with other methods such as equity sharing. These taxes and non-taxes impinge on the mineral sector at various stages of prospecting, exploration, trade and final consumption. The high risk, high capital-intensity characteristics coupled with long gestation lags involved in mineral activity call for special tax treatment of the sector.”

Box 7 shows the main features of mining tax regimes worldwide and explains the reasoning behind them.

Box 7: Special Tax Incentives for the Mining Industry and their Rationale

- □ **Exploration expenses.** A lengthy and costly exploration program will precede the start-up of a mine. Exploration expenses are incurred before taxable income is available and thus governments provide special provision for how pre-production (pre-income) exploration expenses are handled for future income tax purposes.
- □ **Mine development.** Mine development is capital intensive and an operation will initially need to import large quantities of diverse equipment from specialized suppliers. Many governments recognize the capital intensity of the industry and provide various means to accelerate recovery of capital costs once production commences.
- □ **Equipment imports.** With regard to equipment import dependency, governments often provide a mechanism where equipment imported during mine construction is effectively free of duty (zero-rated, exempted, refundable, ...). Likewise, most countries provide some sort of relief from value added tax on equipment purchases, particularly if the mine product is destined for export.
- □ **Export sales.** Mine products are often destined for highly competitive export markets. Most countries effectively impose no or low export duties on minerals and provide a means whereby VAT on export sales is either not applied or applied in a way that allows for a refund or credit.
- □ **Commodity price cycles.** Mines produce raw materials that are prone to substantial price changes on a periodic, business cycle related basis. Thus, many countries allow certain types of taxes, usually royalties, to be waived from time-to-time, by a designated government officer, for projects experiencing short-term financial duress and provide for the carrying forward of losses.
- □ **Post production expenses.** After mining ceases and there is no income, a mine will incur significant costs relating to closure and reclamation of the site. There is a trend for governments to require a set-aside of funds for closure and reclamation in advance of closure and to provide some sort of deduction for this set-aside against current income tax liability.
- □ **Stabilization.** Many mining projects will have a long life span, and companies will attempt to minimize their tax risk exposure by stabilizing some or all of the relevant taxes for at least part of that life-span. Governments provide tax stability through a number of different legislated and negotiated approaches.
- □ **Negotiated agreements.** When the level of investment is particularly large, a government may enter into a negotiated agreement, including special tax provisions, with the mine that has the effect of supplanting general laws, including laws that address tax matters.
- □ **Ring fencing.** Most countries allow a company to consolidate books from all operations for determining income tax liability. In instances where negotiated agreements are in force,

income from an operation governed by an agreement may be “ring fenced” even though the general tax law does not impose ring fencing restrictions.

Source: derived from J. Otto et al, Global Mining Taxation Comparative Study (2nd edition), Colorado School of Mines, Golden: 2000.

Proposed New Mining Tax Regime

A new fiscal regime for mining companies was drafted in 2003, but has yet to be passed. This regime offers several improvements over the existing system. It offers full foreign exchange convertibility, fixes the mining royalty at 10% for diamonds and 3% for all other minerals (with no special exemptions for large projects). Mining projects under the proposed new law will be subject to 10% instead of the normal 20% withholding tax on dividends paid to non-resident shareholders, while interest and other financing charges paid to non-resident creditors will be exempt from withholding. Capital gains would also be taxed at 10%. The new draft law extends loss carry-forward provisions from 5 years to 10 years. The new law would also allow prospecting and development expenditures to be depreciated on a straight line basis or for the life of the mine starting in the first year of production. The new draft law also eliminates most ring-fencing and allows consolidation of accounts for determination of taxable income among multiple mining titles and/or mining and processing installations held or operated by a single title-holder.

METR Analysis of the Mining Tax Regime

The mining sector has a tax regime that is quite different from the other sectors. Mining pays a royalty of 3% (for coal and mineral sands) to the government. **The METR for the normal regime is 51% which is the second highest among all sectors.** Investments in the mining sector in general goes through the CPI and hence qualifies for the special tax benefits. The tax benefits include a higher tax credit of 10% which investments in the mineral rich states are entitled to. The mining sector also benefits from a 25% reduction in corporate tax. These benefits along with the accelerated depreciation lower the METR to 5%. This is the lowest METR for any sector under the CPI regime and makes investments in the mining sector through the CPI very attractive. The METR for small business in the mining sector has not been calculated as such a scenario is unlikely. For the mining sector a one year delay in issue of refund increases the METR to 15% which increases to 48% when the refund is not given at all. When the delay is two years the METR is 22%.

Recommendations

- ***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.

- ***Pursue a tax treaty with South Africa.*** South Africa is not only Mozambique's largest trading partner but also its largest source of FDI 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.

Manufacturing

Manufacturing firms are comprised of (i) mega-projects and other *zona franca* firms which benefit from special fiscal incentives; (ii) domestic-market oriented manufacturing such as food processing, beverages, leather products and textiles/apparel, and plastics which are subject to the general tax system and can apply for the general incentive scheme, and (iii) small and micro manufacturing enterprises that are either below the minimum tax thresholds or avoid taxes and operate in the informal sector.

The manufacturing sector accounted for almost 14% of GDP in 2005, up from 7% of GDP in 1995. During 1996-2004, the sector grew on average at over 17% per annum. **This strong growth was driven by FDI in mega-projects, in particular the Mozal aluminum smelter which accounts for about 6% of GDP, as well as sub-sectors such as processed food and beverages.** Many of key constraints identified in past surveys²⁶ of manufacturing firms still hold: lack of access/high cost of finance, uncertain policy environment and regulatory/administrative barriers, and inadequate infrastructure (electricity, transportation).

²⁶ Investment Climate Assessment, World Bank (2003).

Summary of tax and incentives in the manufacturing sector

Firms in the manufacturing sector in Mozambique are subject to the general tax regime, as detailed in Annex A.

Special Customs Regime for Manufacturers

The special customs regime for manufacturers was introduced in 2003 to promote investment in the manufacturing sector, under the *Regulation of Customs Regime for Added Value (Transformation) Industry*. The scheme provides exemption of customs duties on imported materials to firms that meet the following eligibility criteria:

- Annual sales of more than Mtn 3 million (previously Mtn 6 million).
- Value added for the final product is at least 20%.
- Operate in six sub-sectors: agro-industry; food processing; textiles and clothing; metal/ mechanical; graphics; chemicals, plastics and rubber.

The scheme applies to imports of raw materials and intermediate goods that are not available domestically. Beneficiaries are still required to pay VAT when importing goods.

Mozal Industrial Free Zone

The Mozal Industrial Free Zone was created in 1997 in Belulane, province of Maputo. Activities carried out in the zone are aluminum smelting for export (Mozal) as well as construction. The main tax benefits are exemptions from the corporate income tax, the VAT, excises, customs duties on imported capital goods, the stamp tax, the real property transfer tax, and the municipal tax on rental income. A 1% substitute corporate income tax has been levied on Mozal since two years after its creation. Allowable deductions include expenses related to staff training, and improvement of the infrastructure of the free zone. Below certain limits, foreign employees and suppliers of services and information and technology to Mozal benefit also from exemptions in the personal and corporate income taxes, respectively.

The Tax and Incentive Regime in Practice

Tax Administration

While firms in the manufacturing sector acknowledge the improvement in the tax system in recent years, they are still burdened by high administrative costs and uncertainty arising from discretion in tax administration. Since no special tax regime exists for the sector, the key problems faced with tax administration are common across the private sector, and include:

- **Uneven application of tax regime.** It is a widely held view that some businesses are able to negotiate fiscal incentives, while less-influential/smaller/domestic manufacturers are unable to gain special incentives and are thereby at a competitive disadvantage. It is also believed that firms are selectively targeted and some more heavily inspected. As a result, businesses perceive that they are subject to unfair competition with informal competitors.
- **Lack of guidelines to fully comply with tax requirements.** From the perspective of tax authorities, the key problems found in tax returns relate to incorrect classification of disallowed expenditure and lack of issuance of proper VAT invoices from businesses. According to some businesses, particularly smaller ones, they are inadequately informed about some of the requirements (e.g. name of print shop that produced VAT invoices), and that there is discretion in determining assessments and penalties.
- **Complicated and time-consuming procedures.** For example, some manufacturing firms claim to not take advantage of tax and duty incentives offered by CPI due to complex procedures, further tilting the playing field towards larger and more sophisticated firms. Another example cited is the long process for transferring management fees (getting required tax certificates and preparing documentation for the Central Bank can take 30 days). Similarly, given the complexity and delays in claiming VAT refunds, some eligible small/medium sized businesses have stopped claiming VAT credits.
- **Non-refunding of excess advance corporate tax.** Firms are required to pay quarterly advance corporate tax payments based at 80% of taxable income of the previous year. However, businesses (both large and small) complain that refunds are not obtained when profits are lower in the given year, or that the process to prove that taxable income is lower is lengthy. Businesses also claim to have incurred large penalties because they were unable to pay the advance tax due to poor financial performance.

Special Customs Regime for Manufacturing

The special customs regime for manufacturers aims to support the sector, but creates an un-level playing field. There are currently 60 firms registered under the scheme. According to the Ministry of Industry and Commerce, the application process takes 15 days. However, the scheme is biased towards large firms which can qualify for the exemption and can meet the high administrative requirements (for example, firms claim that assembling required documentation takes far longer). According to manufacturers, the scheme is complex, costly and bureaucratic, and that as a consequence many

companies do not apply. Such schemes also create pressure to extend exemptions to other sectors.

VAT issues

Manufacturers face delays on VAT refund claims ranging between three months to four years for the firms interviewed. The most affected firms are those that are suppliers to VAT exempt industries such as Mozal, and for exporters (e.g. textiles). Firms can apply for VAT refunds if they carry over credit for 12 months without offset or have a credit of more than Mtn 50 million. Statutory deadlines for refunds are commonly 30 days, but vary between 24 hours in Peru to 90 days in France (though an administrative performance standard reduces this to 30 days).

While the tax administration is required to process claims within one month, it can hold back reimbursement for six months when documentation is inadequate (Decree No. 29/2000). Most firms attribute delays in refunds to government claims of improper documentation. In addition, delays are believed to be due to inadequate budgetary allocation for payment of refunds in the government (due to short-term cash shortfalls, or lack of suitable forecasting and monitoring systems). Delays also occur because all VAT refund claims currently trigger automatic audits. However, anecdotal evidence suggests that some firms are able to expedite VAT refunds through informal payments.

Yet, there has been recent progress in refunding claims.²⁷ In some cases, firms experience fewer delays in refunds. In addition, the government is putting in place a system to allow the off-setting of VAT credit against other tax liabilities (decree yet to be issued). Many countries allow VAT refunds to be offset against other tax liabilities. VAT refunds can be offset against other tax debts owed by the claimant (such as income tax), and in some countries against non-tax debts and customs duties. Some countries issue “tax credit certificates” which firms may use to pay other taxes (e.g. Uruguay). Offsetting arrangements require appropriate accounting systems that provide a consolidated and current view of taxpayer’s profiles across all taxes (see Box 8).

²⁷ Of the 194 manufacturing firms surveyed in 1992, 24 firms reported being owed refunds, and the average amount owed was more than 13% of annual sales and the average delay 99 days (Investment Climate Assessment, World Bank, 2003).

Box 8: Offsetting VAT Refunds against other tax liabilities

VAT refunds should be offset only against other *tax* liabilities. It is administratively cumbersome to apply excess VAT credits to non-tax debts owing to the state. Second, as a general rule, VAT refunds should not be offset against anticipated tax liabilities (i.e., taxes assessed but not yet due for payment), given the negative effect that this offsetting may have on a taxpayer's cash flow. However, if a taxpayer has a history of noncompliance (including failure to file income tax returns or pay amounts when due, or engages in other activities to avoid meeting tax obligations), the tax authority may consider offsetting even though amounts are not yet due for payment. Third, offsetting should be adopted only if a tax authority has established an adequate taxpayer accounting system and debt management infrastructure (i.e. integrated computerized accounting systems to provide a consolidated view of a taxpayer's *liabilities and entitlements across all taxes*).

Source: Extracted from IMF 2005.

Another possible approach to reduce delays is to introduce a risk-management system to reduce the processing time of refund claims. Under this system, traders with good compliance histories obtain accelerated VAT refunds. This is considered to be the most appropriate approach in dealing with VAT refund problems in review of 36 countries by the IMF. The success of this system relies heavily on developing profiles for each taxpayer (an improved system would keep records of compliance history and audit results of all taxes, including VAT).

However, until such measures are properly implemented, delays will constrain the cash flow of firms especially given that the cost of capital is high. The lack of a systematic approach to refunds discourages the domestic sourcing of inputs for export activities and leads to cash flow problems for firms. Delays in refunds for VAT on domestic inputs constrain the development of domestic linkages, since the implicit interest cost of VAT paid increases the implied cost of exports. This has led many companies to import inputs to avoid local purchases and VAT payments.

Another VAT-related issue for domestic firms relates to breaks in the VAT chain, which a common problem in many countries in Sub Saharan Africa. Firms are not able to claim input VAT due to sales to VAT exempt businesses or due to non-registration and non-compliance of many small suppliers or buyers. For example, firms in agro-business that source inputs locally from farmers that are mostly not VAT registered are also unable to claim VAT on inputs. Likewise, small suppliers to VAT exempt mega-projects, such as Mozal, are unable to deduct output VAT. In practice, many firms operate outside the VAT system.

Mozal Industrial Free Zone Incentives

Since mega-projects have been granted free industrial zone (IFZ) status with special tax incentives, their contribution to the government's fiscal revenue has been marginal. The IFZ legislation was intended to attract labor intensive manufacturing, and qualifying firms are required to employ at least 250 Mozambicans. However, IFZs have instead attracted capital intensive mega projects. Mozal (which produces aluminum ingots using imported ore) directly employs over 1,000 workers. By contrast, labor-intensive textiles and apparel firms in export processing zones are the largest employer in Lesotho (50,000 employees in 2004).

International best practice shows that tax incentives when offered as part of IFZs risk undermining the tax system without generating sustainable growth and investment. Tax holidays suffer from weaknesses such as: rewarding founding of a company rather than investment, attracting footloose industries, eroding tax base and encouraging tax avoidance by transfer pricing. Industrial zones in countries such as Mauritius, South Africa, Botswana, and Lesotho, have contributed significantly to addressing land and infrastructure constraints. Industrial zones have also encouraged industrial clustering, which has enabled similar industries to be situated near each other, and has fostered backward and forward linkages.

METR Analysis

The METR for Manufacturing under the normal regime is 40% while it is much lower at 11% under the CPI regime. The combination of the Investment tax credit of 5% and the accelerated depreciation of twice the regular rate drastically lowers the METR. On the other hand, small business manufacturers who finance their operations from the domestic market and do not go through the CPI regime face an extremely high METR of 78% primarily due to the higher finance costs. The analysis for small business also assumes that they follow the simple regime for VAT and hence pay VAT of 5% on total sales. In case of delayed VAT refunds, the METR for an investor under the CPI regime goes up to 19% from 11%; rising to 25% for a two year delay. In case the VAT refund is not granted at all, the METR becomes much higher at 48%.

Recommendations

- ***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, when Mozambique joins SADC. Nevertheless, the tax administration may review the current need for the scheme given that its complexity is dissuading entrepreneurs from using it. Critically, the scheme creates an un-level playing field, and generates a 'perception' of unequal

treatment and discretion amongst sectors and within the manufacturing sector itself.

- ***Provide tax-payers with better information on procedures and requirements for obtaining VAT refunds.*** In order to reduce delays in VAT refunds arising from improper documentation, the tax administration should increase efforts to inform businesses on requirements for filing claims.
- ***Consider putting in place a risk-profiling system for selective audits to reduce delays in VAT refunds.*** Various approaches can be considered to reducing delays in VAT refunds such as preferential treatment for compliant taxpayers (such as in Tanzania in the region; or Pakistan, see Box 9). 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 VAT credits against other tax liabilities.
- ***Focus IFZs on the provision of infrastructure and reducing compliance costs, rather than on tax incentives.*** As suggested by international experience, IFZs are best suited for the provision of infrastructure and one-stop-shop facilities for administration/ taxation/ customs, rather than a vehicle for tax incentives.

Box 9: Application of “Gold” Status Scheme for VAT Refunds in Pakistan

Pakistan implemented a risk-management system in the late 1990s to improve the processing of VAT refunds, especially for exporters in the textile sector. The system was further improved, and basic computer applications were developed to provide information on traders’ compliance history, using information from the VAT, income tax, and customs administrations.

Under the scheme operating in Pakistan, refund claimants are categorized in three main groups: (1) “gold” for claimants exhibiting minimal revenue risk; (2) “silver” for moderate risk claimants; and (3) “others,” representing those of high or unknown risk. The table below outlines the type of criteria used in categorizing taxpayers. Gold refund claimants normally have their claims approved for payment, without a pre-refund audit, within 3-5 days. Silver claimants are assigned an upper refund limit, where claims not exceeding the limit are subject to a brief desk review and approval is given within 15 days. Post-refund audits are conducted at least once a year on two or three claims submitted in the past 12 months by gold and silver claimants. If the post-refund audits detect persistent inaccurate claims, the gold or silver status of a claimant is withdrawn.

Refund claims from taxpayers without gold or silver status are processed (paid or denied) within the statutory deadline. Claims are selected for pre-refund verification in the following circumstances:

- The claim is a first-time refund claim.
- The claim exceeds a value prescribed by the tax administration.
- The claim deviates from the regular refund pattern of the claimant.
- Previous claims have been rejected or reduced as a result of verification checks.
- The claimant has a record of poor compliance in relation to VAT and other taxes (e.g., non-filing, and late payment).

Requirements to Qualify as a “Gold” and “Silver” Taxpayer

Gold	Silver
Exporters with at least three years’ export history and net wealth exceeding a specified amount	Exporters with at least one year export history and net wealth exceeding a specified amount
Proper books of account for at least the last three years	Proper books of account for the duration of taxable activities (or three years, whichever is the lesser)
No evidence of fraud or significantly overstated refund claims in the past three years	Consistent pattern of export activities and products
History of accurate and timely tax remittance for all taxes and duties	History of accurate and timely tax remittance for at least the past 12 months
Bank certification that accounts are in good standing	No evidence of fraud or overstated credit claims in at least the past four refund claims
Records audited by the tax office for six of the past 24 months	Records audited by the tax office for three of the past 24 months

Source: IMF, 2005

Tourism

Despite its profile and potential, tourism is currently not a significant contributor to the Mozambican economy. The direct contribution to the economy of tourism is estimated at only 2.5% of GDP in 2003 according to the WTTC.

Since 1992 the tourism industry has recorded significant growth reaching 440 000 arrivals in 2003. Mozambique's tourism industry remains significantly under developed and does not feature as one of the top 10 tourist arrival destinations in Africa. Tourism demand is dominated by visitors from South Africa, accounting for 46% of all visitors to Mozambique. Mozambique currently receives a very limited number of continental European visitors amounting to only 49 000 visitors of which more than half (26 000) emanates from Portugal. Mozambique also receives only a relatively small number of leisure tourists (32%) with business dominating as the main purpose of visit accounting for 42% of visitors.

Mozambique's tourism industry has significant unrealized potential. Mozambique however, faces a number of obstacles which are restricting current and future growth in the sector. These factors impact both upon the competitiveness of Mozambique as a destination and on its ability to attract and cater for increased tourist demand. The main constraining factors covered in depth in the recent FIAS/OECD "Tourism Sector Value Chain Analysis Report (December 2005)" are: the lack of availability, reliability, frequency and cost of air services, high cost and poor quality and availability of basic utilities, poor tourism infrastructure (roads, airports, rail services) poor local production coupled with relatively high duties on imported goods, long and difficult land identification and acquisition processes, high cost and lack of availability of finance, cumbersome, lengthy and costly importation processes, high business compliance costs associated with dealing with and conforming to the regulatory environment, limited tourism product development and poor marketing of the country.

Summary of the tax and incentive regime

Corporate tax

Corporate tax in the tourism industry is applied at the standard rate of 32%. Currently there are no exceptions or reductions in the corporate tax rate even for companies with investment certificates from CPI.

In the past a number of companies were given tax holidays and a 15% reduction in the corporate tax rate for investments registered and approved by CPI.

The carrying forward of losses is limited to 5 years as in other sectors of the economy.

There is a minimum profit tax of 30 million MT for companies not in a profitable situation. If no profit is registered for 3 years this amount cannot be recovered.

Withholding Tax

Items purchased from unregistered vendors are not considered legitimate expenses, deductible for corporate tax purposes, unless a 20% withholding tax is paid over to the authorities for all such purchases. Also in cases where invoices do not comply with the regulations relating to layout, printing and information requirements these expenses can only be legitimized through the payment of a 20% withholding tax.

Value Added Tax

The standard rate of 17% is applicable to most services in the tourism industry, with the exception of:

- The international transportation of passengers is zero rated;
- The services provided by a tour operator or travel agent in arranging and booking the international transport of passengers is also zero rated;
- Services carried out by guides or visits at museums belonging to the state or other non-profit entities;
- The export of a service, which is defined as the supply of services for use or consumption outside of Mozambique, is zero rated for VAT;

Tour operators are liable for paying VAT on their gross margin only and not on the value of their entire invoice.

Incentives

Projects registered and approved by CPI benefit from the following investment incentives:

- No duties on the importation of Class K items which are defined as large capital equipment, most of which are not applicable to the tourism industry.
- Accelerated rates of depreciation equal to 3 times
- The tourism industry benefits from an additional 3 % investment tax credit over and above the standard investment tax credits applicable (5% for all provinces except for Gaza, Sofala, Tete and Zambezia provinces where 10% applies and Cabo Delgado, Inhambane, and Niassa Province where 15% applies). Investment tax credits are applicable for the period of 5 tax years allowing these amounts to be deducted from corporate tax paid (IRPS) during this period.

➤ The tourism industry benefits from accelerated depreciation rates of 3 times the standard depreciation rates, compared to 2 times for generic CPI projects. Accelerated depreciation is applicable to all immovable assets, vehicles and other tangible fixed assets used in the tourism industry.

Duties and Excises

Standard rates of duty apply to the tourism sector namely: 0% on essential goods, 2.5% on raw materials, 5% on capital goods and fuel, 7.5% for intermediate goods and 25% on consumer goods. Concessions are given to imports from SADC countries where the maximum rate has been reduced to 20%.

Tourism Levy

No tourism levy is currently in effect in Mozambique, however the private sector is currently pushing for the introduction of a 2% tourism levy and a reduction of VAT by the same margin.

Airport Taxes

A variety of taxes are levied in relation to air travel, airport departure taxes are levied at \$8 for domestic flights and \$20 for international departures.

Tax and incentive regime in practice

Corporate Income Tax

Corporate tax in the tourism sector in Mozambique is one of the highest in the region, with only Namibia and Zambia applying a higher rate. Currently the corporate tax burden on the sector is very low where a limited number of operators pay corporate income tax. This is largely due to the infancy of the sector, the inherent low profitability and other factors in Mozambique which further reduce profitability, such as: high cost of capital, lack of basic utilities in outlying areas, poor local production and relatively high import duties.

Depreciation rates in the standard tax regime are very low in comparison to other countries and do not accurately reflect the real life of assets.

Depreciation Rates in the CPI incentive regime, however offer relatively significant benefit, however this benefit is reduced when the restrictions on carry forward of losses are taken into consideration.

Table 11: Depreciation Rates in the Tourism Industry in Africa

Country	Initial Capital Allowance	Depreciation Rates
Mozambique	None	Accelerated depreciation equal to 3 times the standard rates (straight line method). Standard rates: Buildings 2%, Equipment 16.66%, Machinery 10 – 16.66%, and furniture 10%.
Botswana	25% on buildings	Buildings depreciated at a rate of 2.5%, plant and machinery is depreciated at: 10% for long life, 15% medium life and 25% for short life (straight line method)
Kenya	100% on hotel buildings	Hotel buildings are depreciated at a rate of 4% - (straight line method), plant and machinery of 12.5% to 37.5% (declining balance)
Namibia	20% on commercial buildings	Buildings depreciated at a rate of 4% for 20 years, machinery, vehicles and other movable assets are depreciated over 3 years (straight line method);
Rwanda	50% on new or used assets incl. vehicles (registered investors)	All investors hotel buildings are depreciated at 5% thereafter and machinery and equipment at 25% (straight line method)
South Africa		Hotel buildings depreciated at 5%, capital expenditure on internal renovations of hotels at 20% (straight line)
Swaziland	50%	Initial investment allowance of 50% on hotels;
Tanzania	50% on plant and machinery	Standard rates of 37.5% on vehicles, 12.5% on furniture fixtures and equipment (declining balance) and 5% on buildings (straight line)
Uganda	20% on hotel buildings	Buildings depreciated at 5% thereafter (straight line), 35% on light vehicles, 30% heavy vehicles, 20% on all other assets(declining balance)
Zambia	10% on buildings	5% wear and tear allowance on the cost of the building and 50% depreciation on machinery in tourism enterprises (straight line method)

Withholding Tax

A large proportion of purchases, especially in outlying areas (such as fresh fish, thatching grass, wooden products, arts and crafts and general groceries from local convenience stores) are bought from un-registered vendors or vendors with non-compliant invoices, resulting in the need to pay withholding tax in

order to justify these expenses. The private sector argues that this discourages purchasing from smaller informal vendors as it results in a higher price paid. This however is unlikely to be the case, assuming that these goods are also available through registered vendors the market is likely to regulate itself so that the price paid to unregistered vendors including withholding tax paid will be equal or lower than the price before VAT from a registered vendor. If this is not the case then none of the operators will purchase from the informal vendors which will force them to reduce their prices, if they wish to sell their products to operators.

This is a very novel and efficient type of tax with low administration and collection costs, it also compensates for the ineffectiveness of VAT, customs duties and the lack of collection of corporate taxes from the informal sector. This tax should also in theory encourage smaller operators to enter the formal system through pressure exerted on them by the larger registered operators who prefer to buy from registered vendors, in order to be able to claim input VAT. This however has not necessarily been the case possibly due to a lack of education, complexity of the VAT system and the lack of incentives for larger operators to do so. The formal private sector in the tourism industry sees it rather as a deterrent to purchasing from informal vendors than as a way to bring informal vendors into the system. Part of the problem is that operators do not accept the 20% withholding tax and do not include it as a given cost when negotiating with or deciding on whether or not to purchase from informal vendors. The only problem with this tax is that it penalizes operators buying from non-registered vendors and does not impose the same penalties on consumers buying from unregistered vendors. This may act as a discouragement for vendors to enter the formal sector, especially if they can survive by selling only to consumers.

Value Added Tax

The standard VAT rate of 17% applicable to certain services in the tourism industry in Mozambique is only very slightly above the average amongst most countries in Africa. However, when compared to some of Mozambique's major competitors, such as South Africa, Kenya, Mauritius, Seychelles and Thailand it is high and has an impact on the competitiveness of the products by contributing to a the high prices of tourism products.

The argument for a reduction in VAT is largely linked to price elasticity. Considering that the tourism industry in Mozambique is currently dominated by beach based tourism products, which are generally considered as highly price elastic, it seems applicable to opt for a lower VAT rate in the sector. The main argument for a reduction in VAT centers around increasing the competitiveness of tourism products by a reduction in price brought about by a reduction in VAT. If VAT were reduced this would not necessarily result in lower prices and an increase in competitiveness, operators may chose not to

lower prices and opt rather for an increase in profitability. A slight reduction in VAT will not significantly increase the competitiveness of Mozambique, time may be better spent in improving other areas which can have a significantly greater impact, such as improvements in air access and a reduction in flight costs.

Box 10: The treatment of VAT in the tourism sector

The key economic point is that the ability of tourists to substitute between services offered by different countries can quite plausibly imply highly elastic demand for services that are broadly the same in different countries. This high elasticity points to a lower tax rate. This argument applies most obviously to facilities—palm-fringed beaches, for instance—that are much the same in different countries. Where facilities are genuinely unique, however, the same consideration will point to a high rate, naturally implemented as an excise or entrance fee.

A strong case can thus be made for setting a low tax on generic tourist services, perhaps even at a zero rate. Or to discriminate between less elastic domestic demand and more elastic foreign demand, tax might be rebated to non-residents (as with hotel tax in Canada): this, of course, is potentially troublesome to administer.

At the same time, there are arguments against taxing generic tourist services at a low rate. The first is the administrative: multiple rates [within a sector or system] complicate administration and compliance, and create opportunities for abuse. The second is that there is a coordination problem: the elasticity of demand for tourist services offered by any particular country may be much greater than that for the services offered collectively (regionally). While the service offered by any particular game park is unique, for example, that offered by game parks in general is much more so. Thus, all countries could gain by collectively agreeing to raise the tax rate applied. This argument points to regional coordination. Finally, to the extent that such services are purchased by foreigners, who presumably appear in policy makers' objective function with a lower weight than do their own nationals, the social loss from raising taxes on these goods will be reduced: taxing foreigners is always attractive.

Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF, 2001, p. 120.

VAT is applicable to all goods and services in the tourism sector which increases the compliance and simplicity of VAT, especially with regards to tourism packages. In other countries the application of multiple rates within a single tourist package increases the complexity of the calculation and monitoring of input costs between non-VAT and VAT revenue generating products and services. This results in higher administrative and compliance costs, which outweigh any benefits received.

Export services, by definition, are zero rated in Mozambique, however this is currently not being applied by the private sector to tour operator services associated with the packaging and brokering of tours to Mozambique. In doing so this has further added to creating a more simplistic VAT system in the sector.

In Mozambique VAT is not charged on commissions and services associated with the issuing and booking of international travel are, which is in accordance

with international best practice and keeps down the price of international travel. Recently in South Africa this has also been extended to the service fees payable by the traveler to the travel agent²⁸. This is in response to the changes occurring in the world-wide travel industry and in South Africa, where airlines have reduced commissions (from 7% to the current 1% in South Africa), thus forcing travel agents to charge fees for their services direct onto the customer as they can no longer rely on commissions from airlines as a source of income.

A large number of small operators are operating outside the VAT net, due to the lack of understanding of VAT and the complexity of the compliance process. VAT is therefore not working equitably and efficiently in the tourism sector. Large proportions of suppliers to the tourism sector are informal and not VAT-registered, resulting in a break in the VAT chain.

Input VAT cannot be claimed on a number of expenses which impacts negatively on the tourism sector. Cell phones are widely used to conduct business, especially in remote areas where fixed lines are not available. Based on the current law VAT is payable but cannot be claimed on these items. On fuel VAT inputs can only be claimed on 50% of fuel expenses for light motor vehicles, however according to the tax authorities if accurate records are kept the entire amount, if justifiably for business purposes, can be claimed.

Incentives

A large number of established operators benefited from 5 years of tax holidays, however due to the nature of the industry most operators did not receive any benefit there from as their operations failed to make a profit during this period. The current incentive regime also provides little benefit to tourism operators. Investment tax credits although beneficial are only applied to machinery and certain equipment, most of which are not used by the tourism industry. Accelerated depreciation in theory considerably reduces taxable profits in the early years of operation. However due to low inherent returns in the sector profits are usually not declared in the first 4 to 5 years of operation. This coupled with and the five year restriction on losses carried forward this also provides little benefit to the sector. Duty concessions on class K items reduce the current rate from 5% to zero, which in monetary terms provides little benefit. In effect the industry receives almost no benefit from this concession as the industry imports very few items falling under this classification.

Incentives are not guaranteed and are therefore discretionary to qualifying projects which conform to minimum CPI requirements. A uniform and evenly applied lower tax rate across all sectors is more beneficial than sector based

²⁸ South African Revenue Service ruling “Value-Added Tax: Travel Agents” reference 28/3/20, 3 May 2005

discretionary incentives. Mauritius has recently moved from an incentive based environment to a more evenly applied tax system which has seen the reduction in various taxes across the board in order to reduce disparity across sectors and to create a more transparent, simplistic and conducive investment environment.

Box 11: Mauritius Tax Reform Towards a Broad Based Lower rate Flat System

In the past Mauritius had a system of discretionary incentives which were given to projects approved by the Mauritius Board of Investors in a number of sectors: manufacturing, tourism, information technology and communications, international financial centre operations, infrastructure projects, agriculture and integrated resorts. Projects needed to apply and submit full details of the project for approval: business plan, experience of promoters, markets, financial structure and forecasts, job creation.

The main incentives for tourism projects holding an investment certificate through the Board of Investors (qualifying projects must have a total investment exceeding Rs 10 million (\$340 000) were as follows:

- A reduced corporate tax rate of 15%;
- No tax on dividends received by shareholders; and
- No customs duties on imports

In the recent budget speech of 8th June 2006 the government announced a move away from the highly discretionary, administratively cumbersome system to a more simplistic, transparent evenly applied broad based system that removes discrimination. The key changes relating to the investment climate are as follows:

- The new regime moves away from different tax rates for different sectors to a lower based flat corporate tax rate. The rate will be gradually reduced over three years from 25% to 15%. All sectors by 2009 when then be on the same corporate tax rate of 15%.
- Depreciation rates will be simplified with lesser bands at higher rates based on the declining balance system, which will simplify bookkeeping. Rates will be 50% for electronic and computer equipment, 30% for hotels and 35% for other plant and machinery;
- The 25% investment allowance will be abolished and annual allowances on buildings of 5% will be currently extended to other commercial premises;
- A time limit on losses carried forward under the old system will be restricted to 5 years. Losses under the new regime will be carried forward indefinitely;
- Existing conditions relating to tax credits and tax holidays will be removed;
- All sector based concessions on customs will be eliminated and replaced by a simplifying system with less bands and lower customs duties across the board. Most items used by sectors receiving incentives in the past will either be significantly reduced or reduced to a zero rate. Most items in the tourism sector will either be at a rate of 15% (furniture, fixtures, fittings, operating equipment and general equipment) or zero.

In order to reduce revenue losses and create some sort of neutrality the government of Mauritius has increased excise duties on alcohol and cigarettes and introduced higher land leases on beachfront properties so that residential property leases will be in line with commercial property leases on the beachfront. This will raise considerable revenue for the government and help facilitate further development of the beachfront.

Duties and Excise

Duties on their own are not high relative to other Southern African countries but when coupled with VAT the effective rates increase and become excessively high especially when excise duties are applied. High duties and excise have significant negative impact on the tourism industry in Mozambique raising the cost of tourism products and significantly impacting on the competitiveness and profitability of the sector. A large proportion of goods imported by the sector are considered consumer goods and some are considered luxury items thus attracting the highest rates of duty and high excise taxes.

This places Mozambique at a distinct disadvantage relative to other destinations which either have stronger local production or benefit from lower rates of duty in the tourism industry, such as: South Africa, Kenya, Mauritius and Tanzania. This is especially evident in the start up of businesses where duties can place significant extra burden on the viability of projects. Due to the high cost of imported items and the significant burden placed on tourism businesses informal purchases, cross border smuggling and corruption at border posts is prevalent.

The relatively recent reductions in excise duties have brought excise rates in line and in some cases lower than other countries in the region.

Table 12: Excise Duty Rates on Alcohol in the Region

Country	Malt Beer	Wines	Spirits	Cigarettes	Petrol	Diesel
Mozambique	40%	40%	65%	65%	0%+	0%+
Kenya	Ksh38/l	45%	Ksh100/l or 65%	0%	Ksh19/l	Ksh8.5/l
Malawi	65%	65%	65%	60%	20%	20%
Rwanda	57%	70%	70%	60%	37%	37%
South Africa	23%*	140c/l	<50%*	252c/10	3.91c/l	3.8c/l
Zambia	70%	125%	125%	115%	60%	30%
Uganda	60%	70%	70%	130%	610 c/l	3817c/l

**Based on the calculations made above on an average bottle of beer and the minimum price of a bottle of spirit*

+ Covered by a separate tax on fuel

Source: Customs and Excise and government departments of South Africa, Malawi, Zimbabwe, Kenya and Tanzania.

Departure Tax

International departure tax in Mozambique is on par with other competitive destinations in the region, however Mozambique still requires tourists to pay departure tax upon departure and does not include it in the cost of the ticket. This practice is regressive and has been

eliminated by most countries. This creates a significant inconvenience on the part of tourists and impacts negatively on the tourists perception of the competitiveness, accessibility and desirability of the destination.

Table 13: Departure Taxes: Mozambique in comparison with the region

Mozambique	Lesotho	Botswana	South Africa	Rwanda	Tanzania	Zambia
\$20	M20 (+-\$3)	\$20	R116 (+-\$19)	\$20	\$20	\$20

General Administration

Administration issues especially in the outlying and main leisure tourist destinations are by far the biggest tax issue experienced by operators. Inspection processes are highly discretionary and subjective. Fictitious revenues seem to be raised in an attempt to force operators to pay high fines. Due to the excessive nature of fines, where usually the maximum penalty of 10 times the amount is imposed, and time consuming and costly nature of legal recourse fines are invariably being settled through informal payments. Issuing of fines seem to be a regular occurrence and are generally expected by operators each year. This practice creates an environment whereby operators are encouraged to evade and under declare tax payable in order to compensate for the fines which they will have to pay. This results in a losses of revenue to government as settlements are often reached informally between inspectors and tax payers.

In cases where fines are justified the reasons can usually be attributed to complex and non-transparency and the subjective nature of assessments. Rules and regulations are not clearly defined and stipulated and in some cases are open to interpretation. In addition the calculation of amounts owed is based on unrealistic principles and criteria, which in most cases are not shared or explained to operators.

Even for arbitrary and first time offenses maximum penalties seem to be applied by inspectors.

Smaller foreign operators in the main tourist areas on the coast tend to get harassed more than larger operators and are seen as “soft targets:”. They are less likely to challenge the assessments due to time taken, cost involved and the lack of understanding of tax processes. In addition they also cannot afford the services and professional advice and support of the larger accounting firms.

One of the most common reasons for fines amongst operators seems to be the need to have to set up a different chart of accounts which conforms to the Portuguese system and is different to general international practices. In addition accounts need to be kept in Portuguese, must be hand written and

cannot be more than 3 months out of date. Operators mentioned that standard fines per offence of this nature amounts to either 10 or 20 million (old) Metical.

Unnecessarily complex requirements also need to be met for invoices to be considered valid, such as: tax registration number, written in Portuguese, printed by the government printer or an approved printer showing the printers name, authorized number and tax number on the invoice, can be computer generated but only through a government approved invoicing software and must have the words “computer generated” on it. Small operators especially find it difficult to comply resulting in a large proportion of supplies bought from small and large vendors by the tourism industry being disallowed due to invalid invoices.

The general unnecessarily complex nature of tax compliance increases the occurrence of arbitrary, discretionary and subjective interpretations by tax officials, fueling corruption and creating inconsistencies in administration and collection.

METR Analysis of the tax regime

Tourism bears an METR of 40% in the normal regime. Under the CPI regime on the other hand the METR drops to 16%. This is still high compared to regional peers (see Tables 1 and 9), because of the relatively high corporate tax rate.

Under the CPI regime, the tourism sector enjoys an additional 3% investment tax credit as compared to investments in other sectors. But, this tax benefit does not include any investment in buildings and as hotels are building intensive the actual tax benefit is lower making the tax credit have minimal effect on the METR. This sector also enjoys accelerated depreciation of three times the normal depreciation. Both of these tax incentives bring down the METR by more than half. A small business tourism investor who does not avail of the CPI regime is burdened by very high METR of 78% due to the higher cost of credit as they do not have access to foreign credit markets. In the case where an investor in this sector is entitled to a VAT refund but gets it only after one year, the METR rises from 16% to 19%, and to 21% for a two year delay. When the VAT refund is not given at all, it rises to 33%.

Recommendations

The tax system applicable is largely consistent with the overall tax system. Corporate tax and VAT rates are high in comparison to regional peer economies. Incentives provided under the incentive regime in the tourism sector are ineffective and provide little benefit due to restrictions imposed and because they are discretionary and discriminate against small and medium sized

businesses. The greatest areas of impact in the sector from a tax perspective are the relatively high customs duties, the discretionary and subjective nature of the compliance process which leads to unsubstantiated and excessive fines.

- ***Focus on generic tax reform, as outlined above***, in areas such as VAT refunds, customs etc. which will greatly assist the sector as well as the whole economy.

Financial Services

Overview

Mozambique overall has a weak and undeveloped financial sector, with total assets of about 8.5% of GDP and a high level of dollarization.

According to a 2005 assessment by the African Development Bank²⁹, “net loans constitute only about 40% of total banking assets, and the aggregate loan to deposits ratio decreased from 68% in 1997 to 51% in 2003. At the same time, dollarization continues to rise. While only 44% of deposits and 30% of loans were in foreign currency in 1997, these ratios rose to 49% and 68% respectively in 2003.

These figures mean that Mozambique’s financial sector, especially its banks, contributes relatively little to creation and expansion of enterprises in agriculture, manufacturing, tourism and other critical sectors on which future economic development depends. Instead of providing credit to small and medium enterprises, or even to large ones, a disproportionate share of the assets held by of Mozambique’s financial institutions is invested in immovable property and government securities. Increased dollarization indicates that a growing portion of bank lending is to companies that import most of their inputs and export most of their outputs. Although the contributions of such companies to the domestic economy are not negligible, they arguably are smaller than those of companies with more developed backward and forward linkages in the domestic economy.

There are many reasons for these linked phenomena, including unclear property rights and land title, and poor functioning of the judiciary, both of which increase lending risks to banks. But taxation of the financial sector, and the penalties and incentives built into the tax system, also play an important part in limiting domestic companies’ access to credit. Reform of some features of the tax system that limit financial institutions’ ability and willingness to lend to or invest in private enterprises could be a high priority.

²⁹ African Development Bank (AfDB), 2005, *Republic of Mozambique: Financial Sector Technical Assistance Project Appraisal Report*, June 2005.

Industry Structure

Banking

Mozambique's financial sector is relatively underdeveloped. As is the case in most underdeveloped financial systems, the sector is dominated by banks, which represent about 95% of total financial sector assets.³⁰ Total bank assets, however, are small, amounting to about \$2 billion, or 9.5% of GDP. This is far lower as a percentage of GDP than most other Southern African countries (in Malawi, for example, bank assets amount to about 12% of GDP, in Botswana 25%, and in Zimbabwe 39%).³¹ The four largest banks jointly hold between 85% and 90% of total bank deposits, with the rest divided among about 8 smaller banks.

The largest bank, Banco Internacional de Moçambique (BIM), accounts for about 40% of total bank deposits, Standard Bank has a market share of about 20%, BCI-Fomento about 18% and Banco Austral about 10%.

Previously state-dominated, the banking system is now almost entirely privatized, although the government directly owns about 23% of BIM and indirectly (via three other state-owned financial institutions) another 10%. All of the banks, including the smaller ones, are majority foreign-owned. BIM is majority-owned by the Portuguese BCP group, Standard Bank Mozambique is owned by Standard Bank South Africa, BCI-Fomento is owned by another Portuguese financial group, BPI, and Banco Austral is owned by the South African banking group ABSA, which itself was acquired in 2005 by Barclay's. The smaller banks too are mostly foreign-owned, reflecting a diversity of Portuguese and South African, as well as Malaysian and Mauritian investments.

Leasing

Mozambique has three leasing companies, each of them a subsidiary or affiliate of a commercial bank. Total leasing company assets were estimated at about USD 75 million in 2003, representing about 3% of total financial sector assets.

Insurance

Mozambique's insurance sector is small, comprising just five companies, and consisting principally of non-life insurance. The government nationalized the sector in 1977 and created a state-owned monopoly, Empresa Moçambicana de Seguros (EMOSE). In 1991 the sector was opened to private

³⁰ International Monetary Fund, 2004, Republic of Mozambique: Financial System Stability Assessment, IMF Country Report No. 04/52, March 2004.

³¹ AfDB 2005, op. cit.

sector participation and in 1998 EMOSE was privatized. At the same time, the Inspecção Geral de Seguros (IGS) was set up to regulate the insurance industry. Total insurance premiums collected in 2003 amounted to just 1% of GDP, of which EMOSE's share was around 50%.

Pensions

The state-owned INSS (Instituto Nacional de Segurança Social) is a state-owned body responsible for all formal sector non-government employees. Another state scheme covers the estimated 170,000 public sector employees. INSS, which also regulates the private sector pension sector, estimates that there are 800,000 formal private sector employees in the country; however some 545,000 are registered with the scheme and fewer than 165,000 are active contributors. INSS, which operates on a pay-as-you-go basis, is funded through mandatory contributions of 7% of salaries, of which the employee generally pays 3% and the employer 4%, and of which about 50% goes to INSS for pension purposes and 50% for other social security payments such as unemployment and accident insurance. A new law, passed by Parliament but not yet signed into law, would raise the 7% contributions to 10% and would expand coverage to self-employed workers. INSS does not release financial statements; however, given its pay-as-you-go status, it would not be in a position to invest substantially in private sector activities.

Microfinance

There is a plethora of microfinance institutions in Mozambique, which together count about 55,000 clients. Microfinance assets, however, amount to no more than 1% of total banking sector assets and are overwhelmingly (more than 80%) concentrated in Maputo and its surroundings. Four microfinance institutions account for more than 80% of total microfinance assets and nearly 60% of the total number of loans. A World Bank program has provided a line of credit to promote Mozambican entrepreneurs, but it has financed very few projects mainly because the funds are channeled through existing commercial banks, which apply the same requirements and policies as they do to their own funds.

Venture Capital

Two venture capital funds reportedly exist. Mozambique Investment Company (MINCO) is part of the Aureos Capital system, which in turn is funded by CDC Capital Partners. MINCO has made a very few investments, which include a construction company, an office park and an insurance company.

GCI is a venture capital fund owned and operated by BCI-Fomento, which reportedly has made a small number of investments.

Financial Markets

Mozambique has a nascent financial market, with a stock exchange, - the Bolsa de Valores de Moçambique (BVM) – which started trading in 1999. Only eight instruments are currently traded on the BVM:

- One share issue in the brewery, Cervejas de Moçambique
- Five corporate bond issues from M-Cel, TVM, the cement company Cimentos de Moçambique and BIM (2);
- Two government bond issues.

Trading is very thin and government bonds account for more than 50% of total market capitalization.

Issues in Taxation of the Financial Sector

The two principal issues in the current system of taxation in the financial sector are:

1. Stamp Duty
2. Exemption from taxation of proceeds from investment in Government securities or government or private issues listed on the BVM.
3. Advance Payment of Income Tax

Financial service providers such as banks and insurance companies are subject to normal corporate income taxes of 32%, with few exemptions. Several foreign investors that acquired domestic financial institutions in the late 1990s or early 2000s received a five-year exemption from corporate income tax, but new tax legislation in 2002 eliminated this incentive, so that all institutions are or will soon become subject to normal income taxes.

Stamp Duty

Financial services are exempt from VAT, but are instead subject to stamp duty, which is applied at different rates to almost every conceivable financial transaction. The current Code of Stamp Duty, which came into effect in April 2004, lists more than 120 transactions subject to stamp duty. Some of these are specific duties (e.g., 2,500,000 MT to obtain a license of appointment and a log book for an independent customs agent), but most are *ad valorem*, or a percentage of the transaction value. Not all of these apply to financial institutions, but 25 of them apply specifically to the banking sector and 9 to insurance companies, with rates that range from 0.02% on short-term bank guarantees up to 4% on issuance of credit cards.

Portugal, from which much of Mozambique's tax legislation is derived, has a complex system of stamp duties, and is one of the only European countries to

impose stamp duties on transactions other than property or share purchases. In Portugal, as in Mozambique, over 100 different kinds of transactions are subject to stamp duty; these include loans and loan interest, guarantees, insurance premiums, credit card payments, bills of exchange and a wide range of other financial instruments and property transactions, at average rates of 4% to 6% (though sometimes more than 10%).

Banks, which engage in a wide range of transactions, consider stamp duty their most important tax problem. Although stamp duties apply to a wide range of non-bank transactions such as property sales, the financial sector nevertheless contributes more than half of all stamp duties collected, which in 2005 amounted to Mt 272 billion (about \$10.8 million).

Table 14: Stamp Duty Collections by Financial Sector 2005

Item	(Mt billion)	%
Total Stamp Duty Collected	272.0	100.0
From Financial Sector	143.3	52.7
- Banks	118.6	43.6
- Insurance companies	24.7	9.1

Sources: DGI, IMF

Government introduced the most recent Stamp Duty code and schedule in 2004 without conducting any prior consultations with financial institutions and without any delay in implementation to allow institutions to adapt their IT and accounting systems to the changes. As a result, all financial institutions were subjected to hefty fines during their phase-in period. Although the banks and insurance companies have by now accommodated the changes, there is scant evidence that the DGI has adequate IT and human resource capacity to manage a system of such complexity.

Stamp duty paid on transactions that are subsequently canceled or diminished in value can be difficult to recover. The duty is payable immediately when a transaction takes place; however, if the transaction is subsequently cancelled or its value reduced the payment can be credited against future stamp duty payable, **but only for those transactions falling under the same number or point in the schedule.** In cases in which a given category of transaction is relatively rare, this can result in unnecessary delays in recovery and reconciliation.

The main issue for banks is less the cost of the duties themselves than the difficulty of administering them, and the cost to their customers. For the most part it is banks' customers who are liable for stamp duty on the various financial transactions to which they are party. For their part, the banks collect the taxes on behalf of government, which requires substantial investment IT and human resource capacity and increases the cost of each transaction.

In an increasingly globalized financial system, stamp duties can reduce the competitiveness of Mozambique's financial sector and, by increasing their cost of capital, can also reduce the competitiveness of Mozambican companies in other industries.

The Stamp Duty Code approved by Decree 6/2004 of 1 April 2004 was amended by Decree 38/2005 of 29 August 2005. **The amended code changes almost nothing of relevance to the mining or financial sectors, though it does raise the rate imposed on policies and premiums for "any other class of insurance"** - i.e., anything other than life, accident, health, motor vehicle, transport, guarantee and credit insurance - from 5% to 6%. In addition, the amended act eliminates stamp duties on most licenses and documents related to customs clearance. These include ships' licenses, permits to load or offload cargoes, and customs clearances. Almost all of these are specific, rather than ad valorem taxes, which previously ranged from MT 50,000 (about \$2) for customs documents to MT 2.4 million (about \$1000) for licensing of ocean-going vessels. Although they represent an improvement over the previous stamp duty code, these changes are likely to have a very small effect on reducing the cost and delays associated with customs clearance, nor will they do much to reduce the overall complexity and costs of administering the stamp duty.

In Africa, companies might seek to list on an exchange in a country in which stamp duty is lower or does not apply, especially as exchanges in certain countries seek to become regional markets. As shown in Box 13, South Africa imposes a stamp duty of 0.25% on transfer and issue of shares and on various other instruments including leases (though mortgage bonds are exempt), but these rates are lower than in Mozambique, where share transfers are subject to 0.4% stamp duty, property leases to 2%, and mortgage bonds to 0.3%. Mauritius, though it imposes high stamp duties (up to 10%) on property transfers, imposes none on share transfers or other financial transactions. Botswana, another Southern African exchange with regional ambitions, imposes no stamp duties on financial transactions.

Mozambican companies, instead of listing their shares on the BVM, could increasingly be drawn to list on other stock exchanges in the region, which offer lower transaction costs and a lower cost of capital.

Abolishing the stamp duty is likely to be politically contentious. However, as Bolnick (2004) points out stamp duties raise relatively little revenue, equivalent to 0.2% of GDP and 1.8% of government revenue (or about \$10 million annually) and recommends their abolition and replacement by minimal fees intended to cover administrative costs.

In spite of the growing trend towards abolition of the stamp duty and the small contribution stamp duty makes to total revenue, it would be irresponsible to

recommend abolishing this tax without suggesting some replacement for lost revenues. It is possible that abolishing the stamp duty would increase the volume and value of financial transactions and other economic activity via the multiplier effect, which could more than offset the lost stamp duty revenues; however, this has yet to be demonstrated.

Exemption from Taxes on Income and Capital Gains on Government Securities and Listed Securities

In 2004, Government exempted income from government securities and listed securities from all taxes with the intention of promoting development of a secondary market in government debt and of Mozambique's stock exchange, the BVM. This represents a substantial benefit to banks and other financial institutions, most of which hold 40% or more of their assets in tax-exempt securities.

It also represents a significant cost to Government. Tax revenues lost as a result of this exemption amount to roughly \$43.5 million per year.

** \$2 billion in total financial sector assets, of which \$800 million are held in government debt or other listed securities. With a T-bill interest rate of 17%, total income amounts to \$136 million. If taxed at the normal 32% corporate income tax rate, this income would yield an additional \$43.5 million in tax revenues.**

The more fundamental question is whether the exemption produces a positive net effect on private sector development and economic growth. Although development of the BVM and of a secondary market in government debt is a worthy goal, one effect of the exemption is to give financial institutions a further incentive to invest in lower-risk vehicles such as government debt and corporate bonds instead of undertaking riskier lending to SMEs.

This problem is not unique to Mozambique. In many developing countries, especially in Africa, banks are reluctant to lend to SMEs, and they typically impose collateral requirements and high interest rates that few SMEs can afford. Although short-term financing can be readily available, medium and long-term lending is much rarer. In Mozambique, even medium-term lending is almost nonexistent. This phenomenon is due, in part, to a lack of credit information in such markets, but it is also attributable to the high returns financial institutions can earn on relatively safe investments in government and corporate securities.

In Mozambique, the T-Bill rate is about 17%, the prime rate is 22% and the average lending rate is about 25%. A real 8% risk premium might be sufficient to encourage some medium-term lending, but the tax exemption effectively reduces the risk premium to about 2.5%.

** 25% taxed at 32% yields an after-tax return of 19.5%, only 250 basis points above the “risk-free” after-tax return of 17% **

Few, if any, other countries specifically exempt government debt or listed securities from income tax. Many municipal bonds in the United States are free of federal, state, and/or local taxes, but this exemption is intended to enable state and local authorities to raise funds, mainly for investment in infrastructure. Additionally, some bonds issued by federal agencies are exempted from state and local taxes. Otherwise, instead of distinguishing between types of assets, governments tend to distinguish between long-term and short-term investments. Most governments tax interest as ordinary income while subjecting capital gains to lower tax rates or exempting them from tax altogether, with the intent to encourage long-term investment.

Advance Tax Payments

Financial institutions are required to pay estimated corporate income tax in advance, and must pay at least 75% of taxes paid in the previous year. In 2004 this resulted in substantial overpayments by most institutions, because the tax law had changed to exempt investment income from Treasury bills and listed securities from income tax, which effectively reduced their tax liability by as much as 50%. Most financial institutions assumed that they would be allowed to credit these overpayments to their final tax bill, but the DGI reportedly refused, insisting on full and immediate payment, and imposing large fines and interest penalties on late payers.

Box 12: Pro’s and Con’s of Stamp Taxes

Stamp duties have a long history. They were introduced in Holland in 1624 and in the UK in 1694, but equivalent taxes have been traced back to the Roman Empire. Typically, stamp duty is levied on the purchase of certain assets. In the UK and many former British colonies (though not in the United States, which has no stamp duties), stamp duties are assessed mainly on purchase of residential property and on purchase of shares.

Stamp duties are often criticized for increasing transaction costs, which can reduce economic efficiency and discourage investment. In many countries like Ireland and the UK, where housing prices have increased rapidly, stamp duties are seen as a further impediment to entry into the housing market by first-time buyers since they effectively raise the purchase price of a property. This may be true, although many countries impose similar taxes on share or property transfers without calling them stamp duties.

Nevertheless, the international trend is to abolish stamp duties and similar taxes or to reduce them substantially, especially on share transfers. Moves towards greater integration of capital markets (in Europe especially) could cause countries that tax these transactions more highly to lose substantial business to competitors in lower-tax countries. According to the Chairman of the London Stock Exchange, “Although London has the lowest direct trading costs...when Stamp Duty is added to the equation the picture is reversed. Stamp Duty is grit in the wheels of the UK market and the Government should take steps to abolish it.” Stamp duties on financial transactions in general are a greater issue for competitiveness and investment

attractiveness than those on immovable property, since investors and financial intermediaries have much greater flexibility in locating and structuring financial transactions than property purchases. In sophisticated capital markets, investors have moved into derivatives – effectively buying the income from shares without buying the underlying shares - as a way of avoiding stamp duties.

Stamp duties also increase the complexity of the tax system. As the Treasurer (Finance Minister) of Australia stated in his 2006-2007 Budget Speech, “A certain level of complexity will always be associated with raising revenue on a broad series of transactions and a wide and diverse population base. Even the simplest tax system will be associated with a rising level of complexity as markets become more and more sophisticated. Nevertheless, it is important to ensure that the tax system is as simple as possible. Complexity increases the costs of transactions, which in turn reduces production possibilities and consumption opportunities.” *Source: Gibson-Smith (2006) and Costello (2006)*

Box 13: International Comparison of Taxes on Financial Transactions

Argentina: Transfers of shares are subject to a 100-basis-point stamp duty when made through a written agreement.

Australia: The states impose a transactions tax of six basis points on transactions engaged in by financial institutions. The maximum duty is A\$1,500 on any transaction. An additional stamp duty was removed in 1991, at which time the tax was 30 basis points.

Austria: Three types of taxes exist. A capital duty and a securities tax apply respectively to any increase in a company’s capital stock and any initial issue of interest-bearing securities. A transactions tax also applies to exchanges in Austria, or elsewhere if one party is Austrian. The rate is four basis points for government bonds and 15 basis points for equities. Taxes can be reduced by trading off the exchange.

Belgium: An exchange tax applies to transfers of financial securities. The tax ranges from a high of 35 basis points to a low of 8.5 basis points. Taxes are subject to maximum amounts and can be avoided by trading outside the country.

Brazil: Borrowers, purchasers of securities or foreign currency and purchasers of insurance pay tax. The rate varies from a low of 0.4 basis points on borrowings to a high of 150 basis points on longer-term debt. A punitive tax of 13000 basis points was levied on some foreign exchange transactions. It has subsequently been abolished for some transactions. At the end of 1994, a temporary 25-basis-point tax on banking transactions was removed.

Canada: There is no FTT.

Chile: There is no FTT, but a stamp duty is applied to a limited set of financial transactions.

China: In Shenzhen economic zone a 60-basis-point tax is applied to stock transactions.

Colombia: A limited set of transactions is subject to a stamp duty. The initial issue of stocks and bonds and their transfer are not subject to stamp duty or FTT.

Denmark: All shares sold by a resident of Denmark are subject to a 50-basis-point tax; it was 100 basis points prior to 1995. Financial institutions are not subject to the tax and new issues and transfers due to mergers are not taxed. A stamp duty applies to the issue of new bonds or loan agreements. The rate is 30 basis points for registered securities and 100 basis points for bearer bonds. Non-residents are not subject to Danish tax.

Finland: A 160-basis-point stamp duty applies to the transfer of securities off the exchange. Transfers between non-residents are not subject to duty. A 50-basis-point transactions tax was eliminated in 1992.

France: France levies a stock exchange tax on the transfer of securities at a rate of 30 basis points for small trades and 15 basis points on large trades. These rates apply to both resident buyers and resident sellers so a small trade between two French residents triggers a total tax of 60 basis points. It is only recently that non-residents have been exempted from this tax. Taxes can be avoided by trading outside the country. There is a maximum tax of 4,000 francs per trade and very small trades get a full tax rebate.

A registration tax of 480 basis points was levied on equity capital prior to 1993; it is now 100 basis points. In certain instances another 100-basis-point exchange tax is levied.

Germany: All Germany's taxes were abolished in 1991. Prior to that year, residents paid as much as 18.5 basis points on the sale of stocks while non-residents paid a six-basis-point tax.

Greece: A 30-basis-point transfer tax is imposed.

Hong Kong: Stamp duties are levied on registration documents for financial transactions. The duties are in some instances fixed, ranging from HK \$3 to HK \$20, and in some instances *ad valorem*, ranging from 25 basis points to 300 basis points.

India: Increases in share capital are subject to registration duty and transactions are subject to stamp duties.

Italy: The transfer of ownership of securities is subject to a registration tax which is levied at a fixed amount. Stamp duties are also applied at a rate of five basis points in certain circumstances. These can be avoided by trading outside the country.

Japan: Securities transactions taxes are levied at rates of 30 basis points for shares and three basis points for government bonds in the event of a sale. These rates were as high as 55 basis points prior to 1990. Transfers by way of gift, bequest or merger are not subject to tax. Securities companies pay a lower tax rate and there is no tax on government money market securities. These taxes can be avoided by trading outside the country.

Luxembourg: No FTT is levied.

Malaysia: A 30-basis-point transfer stamp duty on purchases and sales of securities was eliminated in 1992. A five-basis-point clearing fee is imposed, to a maximum of \$100. It may be avoided by trading off the exchange.

Mauritius: No stamp duty or other FTT on transfer of shares

Mexico: There is no FTT on the transfer of shares.

Mozambique: 0.4% (40 basis points) stamp duty on share transfers. Stamp duties of 4.0% on credit card debt, 2.0% on other loans, 0.2% to 0.3% on guarantees, 0.4% to 0.5% on loan value, 2% on interest payments, 1.0% on other financial fees, 1% on life, accident and health insurance, 3% on guarantee insurance and 5% on credit insurance.

Netherlands: No FTT is levied on transactions although every new issue of shares is subject to a capital duty. The Netherlands did impose an FTT in the 1980s at over 100 basis points. It was abolished on 1 July 1990.

New Zealand: Stamp duties are levied on the issue and transfer of financial securities. A transaction levy was eliminated in 1992. A five-cent duty applies to all cheques.

Norway: No FTT is levied.

Portugal: All financial transactions are subject to a stamp tax, applied at varying rates. Incorporation of a new company triggers a stamp tax and registration fee.

Singapore: A stamp duty of 20 basis points was applied to financial transactions prior to 1992. A wide variety of instruments were exempt from the tax and there was a maximum that was applied to debentures. A registration fee is also imposed on new share capital. Other fees equal to 15 basis points are in existence but these can be avoided by trading off the exchange.

South Korea: An FTT of 50 basis points is levied on transactions, although it may be reduced or eliminated by Presidential decree.

Spain: A 600-basis-point transactions tax applies when control of a company changes hands.

Sweden: The Swedish system of transactions taxes was abolished in 1991. At one point the turnover tax was as high as 200 basis points for equities.

Switzerland: A stamp duty applies to the purchase of securities. It is 15 basis points for Swiss securities and 30 basis points for foreign securities. Certain transactions are exempt. These taxes can be avoided by trading outside the country. Rates have been reduced since 1985.

Taiwan: The seller of securities pays an FTT of 30 basis points on the sale of shares and 10 basis points on other transactions. This tax rate was as high as 60 basis points prior to 1993.

United States: There is no FTT. The Securities Exchange Commission charges a modest fee of about 0.03% and some states levy small taxes. Until 1965 the United States levied a stamp tax on the issue and transfer of equities and bonds. The rate was 10 basis points or less.

United Kingdom: A stamp duty of 50 basis points applies to the sale of stock and other securities. This duty applies only to domestic securities and a previous government budget proposed the elimination of this duty.

Sources: Ministry of Finance, Japan, www.lowtax.net, International Marketing Council of South Africa

METR Analysis of the Financial Services Sector

Financial Services suffers the highest METR among all sectors of 57%. The primary reason is that financial services are exempt for the purpose of VAT and as a result bear the implicit sales tax on capital inputs. Financial services pay tax on their income at the regular rate of 32%. Investment in the financial services that go through the CPI bears a lower METR of 46% due to the accelerated depreciation benefits and investment tax credit. The METR for small business has not been calculated as such a scenario is unlikely. As the financial services are exempt from VAT, the effect of the delay of VAT refund has not been discussed.

Recommendations

Any serious recommendation with respect to sectoral taxation must be based on a principle of revenue neutrality. Any suggestion that a given tax be abolished or reduced must, therefore, be accompanied by a proposal to compensate for any lost government revenues.

The ideal solution for the financial sector would therefore be:

- ***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;***
- ***Introduce a capital gains tax that would tax capital gains at a lower rate than ordinary income.***

These measures would lead to a net increase in government revenue, since the increase in revenue from income on government and listed securities – estimated at about US\$43.5 million annually – would far outweigh the estimated \$10 million in annual stamp duty revenues.

Abolishing the income tax exemption on government and listed securities could also increase banks' propensity to lend to enterprises, including SMEs, while introducing a low capital gains tax could increase incentives for all kinds of financial institutions as well as other enterprises and individuals to make direct investments in productive business activities. Introduction of a lower capital gains tax, which could be applied to all investments of more than a year's duration, could also provide an incentive for more companies to list shares on the BVM.

Small Business Sector

About 90% of the approximate 32,000 private sector firms in Mozambique are small³². In addition to costs of complying with the tax system, constraints faced by small businesses include lack of access to: capital, skilled labor including in management, modern technologies, and modern methods and techniques. IFC's SME financing and technical assistance facility and SME Linkage Program (with CPI) aim to address some of these constraints by increasing access to finance, enhancing sustainable linkages between SMEs and larger private sector investments, opening access to new markets by building technical capabilities of businesses, and reducing administrative barriers to investment.

Summary of Small Business Tax Regime

Mozambique does not have a separate income tax regime for small businesses, unlike many countries. Small businesses are taxed under the general corporate tax (IRPC). The majority of small entrepreneurs are sole proprietors and thereby subject to the individual income tax (IRPS). Under the IRPS, firms with incomes below Mtn 2.4 million are exempt. There is no uniform definition of a small business under the IRPC, IRPS and VAT as reflected by the different thresholds.

The income tax code does include a simplified system for small enterprises without proper accounts, under the following methods:

- Small businesses which lack organized accounts and have a turnover of less than Mtn 1.5 million can follow a *simplified system of recording accounts* (Article 109, IRPC). This system requires businesses to keep books for recording:
 - Acquisition of goods and/or raw materials and consumables;
 - Sales of goods and/or products manufactured;
 - Services rendered;
 - Expenses and operations connected to investment assets.
- Alternatively, small businesses which have not chosen the simplified accounting system, nor the general determination of taxable profit (Section II, IRPC), are included in the *simplified determination of taxable income* (Article 54, IRPC). This method applies where small businesses find the above bookkeeping requirements still too complicated, and taxable income is determined through “indirect” assessments based on technical and scientific indicators for different types of businesses. In the absence of the issuance of such indicators by the Minister of Finance, income is presumed by

³² Defined as less than 10 employees by INE, Mozambique.

multiplying the coefficients 0.20 to the value of sales of goods and products and 0.30 to remaining income.

A simplified VAT regime exists for small businesses. Under the simplified VAT regime, a business with a turnover below Mtn 250,000 is levied a 5% tax on sales (except sales of investment or capital goods). There is no reimbursement of VAT on inputs, and payments are quarterly. Businesses who do not maintain proper accounts and whose annual turnover is below Mtn 100,000 have an exempt status in the VAT system.

The Small Business Tax Regime in Practice

The narrow tax base in Mozambique is attributed to, amongst other factors, tax policies and administration that create disincentives for business registration. As a result, many small businesses operate in the informal economy, estimated at above 40% of GDP in Mozambique³³. This is because the administrative burden of complying with tax obligations falls relatively more heavily on smaller than larger businesses. Small businesses face an ‘inverse economies of scale’ impact of paperwork and procedures required for tax authorities (see Blazic 2004).

Corporate Tax

The lack of a separate income tax regime for small businesses leads to high compliance costs. The majority of small businesses are unable to keep proper records, maintain the necessary documentation, and cannot afford qualified accountant services. As such, they are unable to comply with the administrative requirements of the standard regime. There is also the added cost from the risk of severe penalties or illicit payments to tax officers if businesses fail to keep proper accounts. More positively, there are provisions in the income tax code to encourage firms to formalize, through the withholding tax on income.

While there are simplified accounting and presumptive systems within the Income Tax Code, in practice, since income (or turnover for VAT) has to be estimated for small businesses without adequate accounts, this leads to venues for negotiation and discretion by tax officials.

It is acknowledged by both government officials and businesses that the system of bringing small firms into the standard regime – which is good practice – is not accompanied by sufficient services such as training on tax accounting and compliance or other incentives (reduced tax rates, access to finance etc).

³³ Doing Business database, 2005.

Small entrepreneurs face disincentives to incorporate their businesses.

Most small businesses are sole proprietors, and therefore subject to personal income tax (IRPS), rather than corporate profit tax (IRPC). While the maximum rates of the IRPS and IRPC are harmonized, the lower bands of IRPS and the high dividend tax under IRPC effectively reduce the incentives for incorporation.

International experience suggests that tax regimes for small businesses should be as simple as possible. The objective of a simplified system is not revenue collection but primarily to encourage businesses to register with tax authorities and formalize. This objective needs to be carefully balanced with maintaining justifiable administrative costs of collection and compliance undertaken by revenue authorities. Simplifying tax regimes should be accompanied with developing the capabilities of small businesses (see section on Outreach). Countries in Sub-Saharan Africa have tried to set-up simple tax regimes for small businesses defined up to a turnover level, which is consistent with the threshold required for VAT registration (see Box 13).

Table 15: Small Business Tax Regimes in Sub Saharan Africa

Country	Regime
Mozambique	METR small manufacturing firms: 78% simplified VAT, closed-economy Corporate tax: simplified accounting or indirect assessments or presumptive 20% sales of goods. Simplified VAT regime: 5% on total sales.
South Africa	METR small manufacturing firms: 51% non-VAT registered closed-economy Small businesses with annual gross income < R6 million benefit from tax concession under the Small Business Corporations (SBCs) corporate income tax provisions: 0% applied up to taxable income of R35, 000, 10% on taxable income in excess of R35, 000 and up to R250, 000, and the full 29% rate on taxable income in excess of R250, 000. Small manufacturing businesses are able to write-off machinery and equipment immediately, at 100%, rather than the typical write-off rate of 20% per annum. Other, non-manufacturing, SBCs can write equipment off at a 50:30:20 percent rate over three years. No VAT opt-in for SBCs with turnover less than R20, 000; optional registration for corporations with turnover between R20, 000-R300, 000.
Zambia	METR 20-25% overall 3% turnover tax for businesses with turnover less than K 200 million. No opt-in for VAT.
Rwanda	METR small manufacturing firm: 49% non-VAT registered, 18% VAT registered 4% turnover tax for businesses with a turnover less than RWF20 million. Opt-in for VAT.
Tanzania	METR small manufacturing firm: 31-37% non-VAT registered open-economy, 7-16% VAT registered open-economy, 37-41 non-VAT registered closed-economy. Automatic presumptive regime for MSSEs with turnover < TSH 40m, based on a low turnover tax for MSSEs with records or a lump sum tax to MSSEs without: Average effective rate: Records 1.1 – 2.3% No Records: 1.2 – 3.6% Although voluntary VAT registration is possible below the TSH 40m threshold, in practice most MSSEs do not register for VAT.
Lesotho	METR small manufacturing firm: 52% non-VAT registered, 38% VAT Registered (closed-economy) No small business regime, but small firms may use cash accounting.

	VAT opt-in for firms below the registration threshold of M500,000. Poor record management leads to low self-assessment compliance and friction over LRA assessments.
Madagascar	METR small manufacturing firm: 55% VAT registered closed-economy, 64% Impôt synthétique closed-economy Impôt synthétique of 6% of turnover for firms with turnover less than 6 mn d'Ar. Standard regime for firms with turnover 6-50 mn d'Ar., except TST in lieu of VAT. Can opt-in for VAT below 50 mn d'Ar. threshold.

Note: METR ranges reflect different sectors and assumptions (e.g. ability to opt-in for VAT, open/closed economy)

Source: FIAS METR Studies.

VAT registration for Small Businesses

There is a high level of registration under the simplified regime, which reflects the low threshold for VAT registration (Mtn 100,000-250,000). Over 40% (19,160) of all VAT registered taxpayers (46,800) fall under the simplified regime, consisting largely of sole proprietors (18,600). Corporations (560) under the simplified regime only account for 1% of all VAT registered taxpayers, or 4% of all VAT registered corporations. However, the actual number of active taxpayers under this system may be significantly lower.

The VAT registration threshold for the general regime is relatively low in Mozambique (Mtn 250,000), and this effectively compulsorily subjects more small business to VAT requirements than may have the capacity. Table 16 provides comparative data for countries in the sub region.

Table 16: VAT Registration Thresholds in Africa

COUNTRY	REGISTRATION THRESHOLD	US\$ EQUIVALENT (APPROX)
MOZAMBIQUE	MTN 250,000	10,000
LESOTHO	M 500,000	82,000
BOTSWANA	P 250,000	46,000
KENYA	K SH 3,000,000	42,000
MALAWI	MK 2,000,000	15,000
NAMIBIA	\$ 200,000	33,000
RWANDA	RWF 15,000,000	26,000
TANZANIA	Tz SH 40,000,000	33,000
SOUTH AFRICA	ZAR 300,000	49,000
UGANDA	UG SH 50,000,000	27,000
ZAMBIA	K 200,000	60,000

The objective of the simplified regime is to free small businesses from the administrative burden of complying with the VAT system. Countries such as the UK have adopted several schemes designed specifically to reduce the administrative burdens of VAT for small businesses, including a flat rate as in Mozambique (see Box 14).

Box 14: VAT Simplification Schemes in the UK

To reduce the administrative burden of VAT, small businesses can mix the three following schemes, thereby tailoring a solution for their particular business needs.

- The Flat Rate Scheme is open to any small business with an annual turnover of up to £150,000*. The scheme allows businesses to calculate the VAT they owe by applying a single percentage – determined by their trade sector – to their turnover. There is a lower percentage for businesses during their first year of trading. The Flat Rate Scheme can save time, make VAT returns simpler to complete, and allow businesses to see how much VAT they owe at any point.
- The Cash Accounting Scheme is open to small businesses with an annual turnover up to £660,000*. Cash Accounting Scheme businesses only have to pay VAT when they themselves have been paid by their customers – but similarly they can only reclaim VAT when they have paid their suppliers. This scheme helps businesses’ cash-flow and gives automatic relief on the VAT element of bad debts.
- The Annual Accounting Scheme is also open to small businesses with an annual turnover up to £660,000*. Annual Accounting Scheme businesses complete just one VAT return each year instead of the normal four. The VAT itself is paid ‘little and often’ – in installments over the year with a final balancing payment. This scheme cuts VAT administration for businesses and the smaller regular payments can ease the cash-flow impact of VAT.

* 2004-05 turnover figures.

Source: “Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business”, HM Customs and Excise, UK, 2005.

Small businesses below the general VAT registration threshold do not have the option to register for the general VAT instead of the simplified regime. As a result, small businesses cannot claim VAT on their inputs, and buyers of their products and services cannot deduct input VAT. This system creates breaks in the VAT chain, arising also from the fact that many small businesses purchase their inputs from the informal sector.

Box 15: Allowing small enterprises “opting-in” to a VAT regime despite compliance costs

There are important circumstances in which it is commercially advantageous to be fully liable for VAT. This includes firms selling zero-rated items and those selling to other firms registered for VAT in order to reclaim tax paid on inputs. For these reasons, it is common to allow firms to register for VAT voluntarily. The right is subject, typically, to provisions guarding against temporary or fraudulent registration simply to obtain refunds: deregistration is commonly restricted, for instance. Indeed, there is a sense in which a reduction in the threshold is self-enforcing: the more firms that are subject to VAT the greater the likelihood that a trader will find themselves selling to registered traders and so will find it advantageous to register too.

Even when it is commercially advantageous to be below the threshold, however, the extent of that advantage should not be overstated. Small traders will be unable to recover VAT on their inputs: it is only their own value added, not the full value of their sales, which escapes

taxation. Nevertheless, there clearly is potentially some cause for concern. In particular, firms characterized by a high ratio of value added to sales and selling to unregistered purchasers—small traders providing services directly to final consumers being the key group here—are likely to find it worthwhile to be exempt from VAT. Thus equity considerations would tend to point toward higher thresholds than would otherwise be the case.

Source: Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF, 2001, p. 120.

Other Taxes

Taxes are also levied by local municipalities which add to the multiplicity of tax obligations. For example, small traders are subject to a small daily tax from the municipality. Other local tax obligations levied on businesses include, for example, signage tax, where small businesses complain that they are un-informed of such requirements and are thereby levied penalties for non-compliance.

Outreach

Small businesses complain about the lack of adequate availability of tax information. Programs carried out by the DGI have focused on one-off schemes to try to formalize informal traders, instead of more systematic and broad-based efforts to educate taxpayers on tax obligations and preparation of declarations. As a result, small businesses significantly lack adequate taxpayer services such as information on procedures and requirements for tax compliance, and are largely operating under the radar.

In many countries, tax administrations assist taxpayers to understand their tax obligations and entitlements (see Box 16 and Box 17). In particular, support is given to new businesses and potential taxpayers that are in the informal sector and who may not be fully aware of the tax registration requirements.

Box 16: Services for Small Taxpayers

The lack of an adequate number of private sector firms specializing in tax advisory work is a major drawback in most countries, especially in transition economies. Although large taxpayers usually have access to local branches of international accounting firms and some local firms, the small and medium taxpayers as well as individuals, generally, do not have this facility. This puts pressure on the revenue administration to double up as a tax adviser. For instance, the Volgograd tax administration in Russia has created an advisory service run by current and retired employees, who help taxpayers prepare returns and face audit queries, for a small fee. Ostensibly a Chinese wall exists between the advisory and administrative branches of the tax administration, but the potential for conflict of interest in this arrangement is obvious. Efforts are also being made in Russia to create and strengthen Taxpayer Associations and to catalyze the establishment of a tax advisory services profession.

Source: Extracts from “The Nuts and Bolts of Revenue Administration Reform”, J. Gill, World Bank, 2003.

Some countries provide a “small businessman’s kit” to small businesses that register with the revenue authority for the first time for this purpose. Such efforts lowers tax administration costs in the long run and also contribute to portraying a positive image of the tax authorities. For example, in 2005, the UK government launched the ‘Getting Started in VAT: Guidance for small businesses’ CD ROM providing simple, easily accessible information for businesses newly-registered and considering registering for VAT. See Box 17 for the UK’s efforts in reaching out to the small business sector through the establishment of a small business tax unit.

Box 17: Tax Administration for Small Businesses in the UK

The UK Government created a small business unit in 2004 to reduce the administrative burden of taxes and improve the relationship with the tax authorities. The vision adopted by HM Revenue and Customs is that businesses will understand their tax liabilities more easily and:

- provide information only once, with information, where possible, flowing seamlessly from business systems to those of the new department without the need for forms or returns;
- benefit from a range of modern flexible payment options that suit their business needs;
- spend less time dealing with inspections, with no inspection without a reason and all enforcement activity informed by more sophisticated risk assessment;
- enjoy a single point of contact with the new department for all their tax affairs, either on-line or by phone. This will give them or their advisor access to the details of their tax account – the same details the department’s staff will see; and
- benefit from coordinated, clear and helpful support and education that will help them comply with their tax obligations at key stages in the development of their business.

The department also aims to improve businesses’ understanding of the tax system by:

- tailoring support and education so businesses get their tax right from the start. New and growing businesses are offered help when they need it most (such as at start-up, when they become VAT registered, or when they take on their first employee).
- a guide to tax for business start-ups – bringing together information about direct and indirect taxes in a user-friendly and convenient way for the first time;
- working in tandem with the British Chambers of Commerce to provide better targeted information on the VAT Flat Rate Scheme so that all eligible businesses are aware that they can use it to save up to £600 a year in reduced paperwork and compliance costs; and
- providing a CD Rom on VAT for new businesses, which this will replace large volumes of paper notices and leaflets, with a modern, interactive, electronic package of advice, support and guidance.

Source: “Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business”, HM Customs and Excise, UK, 2005.

METR Analysis for Small Firms

METRs have been calculated for small as well as large business. Calculations assume that the small business are incorporated and pay tax at the flat rate of

25% or 10% whichever applicable. In the case of large business, it is assumed that the marginal investor is foreign, while in the case of small business, it is assumed that investors only have access to local financing. METRs for Mozambique have been computed both for the open and closed economy case.

Recommendations

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

- To create a ‘culture of compliance’ and increase incentives for business formalization through simplification of the tax system;
- To improve the capacity of small entrepreneurs to comply with requirements of the tax system by providing or encouraging education and training; and
- 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 VAT.*** Currently, the thresholds for VAT (Mtn 100,000 for simplified, Mtn 250,000 for normal), IRPC (Mtn 1.5 million) and 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) VAT threshold with the small business simplified corporate tax regime (see below).
 - For IRPC, designating a zero rated band at the bottom end for small firms so as to harmonize with personal income tax.
- ***Increase VAT threshold, and allow businesses below threshold to either opt-in for the normal regime OR simplified regime of 5% of sales.*** In order to reduce breaks in the VAT chain, the tax administration could consider allowing an opt-in for VAT for businesses that have the capacity to meet the reporting requirements of the normal VAT regime.
- ***Consider tiered corporate tax regime for small businesses.*** Small businesses are unable to comply with the standard corporate tax regime, as indicated by anecdotal evidence of evasion by those under the system. Various options could be considered in addition to the existing system of simplified

accounting indirect assessments, such as presumptive taxes based on 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.
- Middle tier: presumptive turnover tax which covers all tax obligations (including municipal taxes) and opt-in for VAT (simplified or normal). In Madagascar, for example, an *impot synthétique* of 6% of turnover which covers all tax obligations (including VAT) is applied to very small businesses; 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 VAT 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.

- ***Allow and educate small businesses on possibilities for VAT opt-in and requirements for compliance.*** In addition to allowing opt-in for the normal VAT regime, the government could consider disseminating simple and accessible information on possibilities for VAT opt-in, and procedures for compliance.

- ***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 (Box 18).

Box 18: Outreach to Small Taxpayers

Revenue administrations in many countries have undertaken activities to make potential taxpayers aware of the general concept of taxation and why they should pay tax. For example, efforts to make compliance easier for taxpayers have included publishing pamphlets and creating web pages giving information on tax laws, rules and procedures and changes; organizing seminars and workshops for taxpayers, providing assistance to taxpayers in filling up tax returns, looking up their accounts to see how much they owe and clarifying doubts on legal and procedural matters; setting up telephone hot lines to answer questions; appointing floor walkers to assist taxpayers waiting in queues; and keeping tax offices open for longer on days when there are filing deadlines.

Source: Extracts from “The Nuts and Bolts of Revenue Administration Reform”, J. Gill, World Bank, 2003.

3. ECONOMY WIDE (NON-SECTOR SPECIFIC) ISSUES

Customs Administration

Overview

Mozambique's trade policy is among the best and most liberal in the SADC region. The top tariff is only 25%, the average applied tariff rate is 12.1% and the trade-weighted average tariff is only 9%, far lower than most SADC and COMESA countries.

In 2002, Mozambique's Council of Ministers approved legislation to accept Article 7 of the GATT and move from the Brussels system of valuation to the more uniform and transparent WTO system, which generally accepts the invoice value of imported goods as opposed to the Brussels Definition of Value, which establishes a notional "fair market value" independent of the actual price paid.

Mozambique has eliminated specific tariffs in favor of ad valorem duties, in contrast to most of its SACU and SADC counterparts. Tariff escalation remains high, resulting in a high effective rate of protection for local industries and an anti-export bias, but Mozambique's effective rate of protection in most sectors is lower than for most of its Southern African neighbors.

Issues and Challenges

Customs nevertheless poses a severe problem for companies that must import or export. The main challenges are: 1) physical infrastructure and capacity at border crossings; 2) human capacity and training among Customs officers and brokers/agents; 3) IT resources; and, 4) corruption.

According to the World Bank *Doing Business* report for 2006, it takes 41 days to clear an import or an export shipment in Mozambique. This is better than the African average but worse than Mauritius (16/16), South Africa (31/34), or Namibia (32/25). For Mozambique to offer an attractive and competitive alternative to South African ports, export clearance times and procedures must improve.

Assembly and processing of documents accounts for about half of the delay for both imports and exports. Obtaining finance and effecting duty payments takes a long time for most smaller traders although Customs has the capacity to receive

online payment notification from banks and encourages traders and agents to use this method rather than paying by cash or cheque.

Other problems include: 1) a high rate of inspection of both export and import shipments, reportedly between 70% and 80%; and, 2) continued reliance on pre-shipment inspection for imports, handled by Intertek, a British company, at considerable cost to importers.

As discussed above, Mozambique in 2004 passed legislation creating a new Central Revenue Authority (ATM), which would unite the DGI and DGA in a single entity within the Ministry of Finance. The ATM was intended to become operational in 2006, but implementing regulations have not yet been drafted and the organization has not yet been set up. Though not a panacea, a well-managed revenue authority can increase national export and investment competitiveness while at the same time increasing total revenue collection.

A centralized RA, by pooling taxpayer information between customs and tax authorities, can better identify patterns of compliance or non-compliance, which in turn can enable it to employ more sophisticated risk management techniques and eliminate the need for very high audit and inspection rates. The end result can be faster customs clearance times and increased export and investment competitiveness.

Mozambique has undergone a long-term program of customs reform. In 1997, Crown Agents were awarded a contract, funded by the UK Department for International Development (DFID), to restructure the DGA. In the early years of the contract, Crown Agents employees, most of them expatriates, filled line management positions in the DGA while training their eventual Mozambican replacements. Starting in 2002-2003, Crown Agents began to transfer operational and management responsibilities to national customs officers and reverted to a purely advisory role. At this time, though DFID funding remained significant, Government began to fund an increasing portion of DGA's operating budget. The Crown Agents contract ended in July 2006 and DGA apparently has not requested any further technical assistance from DFID or other donors.

The results of this reform initiative are mixed. On the one hand, DGA has substantially greater human resource capacity and skills than it did previously, as well as IT and administrative systems that function much better. At the same time, revenue collection has reportedly dropped and corruption is said to have increased since Crown Agents shifted from an operational to an advisory role. In addition, Crown Agents installed a proprietary Crown Agents trade management information system (TIMS) in preference to ASYCUDA (the internationally accepted system developed by UNCTAD) or another system that might be more commonly used and which would offer greater compatibility with other countries' systems. TIMS is a legacy system that can be upgraded and maintained only by

Crown Agents, and this may create a dependency that DGA is not keen to see continue. DGA already is thinking of replacing TIMS with another, more open, system.

A Diagnostic Trade Integration Study (DTIS) carried out in 2004 under the Integrated Framework for Trade-Related Technical Assistance to LDCs, a joint program of the World Bank, IMF, UNCTAD, UNDP, WTO and the International Trade Centre, identified corruption, poor data collection, insufficient human resource and IT capacity, lack of transparency, poor interagency co-ordination, and lack of a client service mentality among Customs officers as some of the main problems still endemic in Mozambique's customs administration. A well-managed Central Revenue Authority can help to address many of these issues; however, it is all but certain that a new Central Revenue Authority will require substantial technical and financial assistance to put in place the systems and structures needed to make an appreciable difference.

The World Bank Group continues to provide financial support to improve customs infrastructure. One of the main problems cited by DGA and outside experts is heavy congestion at the Ressano Garcia border crossing on the main road border between Mozambique and South Africa. World Bank support will finance construction of a dry port adjacent to the Ressano Garcia customs post, which should reduce clearance times considerably. The dry port may also be expanded to accommodate rail traffic as well as road transport, since the main Maputo Corridor rail line passes close to the existing customs post.

Increasing the efficiency of customs clearance at Ressano Garcia will require more than physical infrastructure. The DGA estimates that a move to 24-hour operation, considered essential if the Maputo Corridor is to compete effectively against alternative routes, will require an additional 120 trained customs officers. Efficient operations will also require IT systems for electronic payment of duties and taxes through the banking system and training of importers, exporters, customs officers and agents in use of the system.

Recommendations

- ***Fully implement the Central Revenue Authority (ATM) legislation.*** Properly designed and managed, the ATM has the potential to increase revenue collection, improve the professionalism and capacity of tax and customs officers, and reduce corruption. Successful implementation may require foreign technical assistance as well as financing of new, integrated IT systems.
- ***Replace the Crown Agents TIMS System with ASYCUDA or another standard international customs management information system.*** Continued dependency on Crown Agents for system maintenance and upgrades, and

incompatibility with other common systems reduces the DGA's flexibility. Outside financing and TA may be required, although UNCTAD provides both the ASYCUDA system and the necessary installation, maintenance and training services at reasonable cost.

- ***Eliminate pre-shipment inspection (PSI) as quickly as possible.*** PSI increases the cost of imports and reduces export competitiveness in industries that depend on imported inputs. Reliance on PSI also can serve as a disincentive to reform and upgrade domestic customs capacity and operations. Although PSI is, in some cases, necessary, it should never be more than a temporary expedient. The WTO recommends that it be used for a maximum of three years, which should give national customs authorities sufficient time to upgrade their capacity to an acceptable standard. In Mozambique, Intertek have provided PSI since 1992, prior to which SGS conducted pre-shipment inspection on behalf of the Mozambique government. Especially following nearly 10 years of intensive technical assistance in Customs reform provided by Crown Agents, there is no reason to continue to use PSI services from Intertek or any other provider.
- ***Accelerate completion of the Ressano Garcia dry port and accompanying improvements to clearance procedures.***

Business Licensing on Municipal and National Level

Introduction

FIAS has already undertaken work on administrative barriers to investment (including licenses) in 1996 and 2001. Those reports recommended drastically reducing the number of licenses required to operate a business. It is disappointing that such little progress has been made against this objective in the last ten years.

Most problems with licensing occur at the national level. While sector licensing was not subject of the study, it became clear during the mission that the licensing regime of sectors like tourism need also to be reformed.

Taxes, fees and their implementation on sub-national level

Autonomous local governments

The state organization has four levels. Three levels are implementing state legislation: the elected state government, the appointed provincial governors in 10

provinces (and Maputo City) and the appointed administrators in 128 district governments. The state organization is stipulated in the State Organization Law 8/2003 and Decree 11/2005. In addition, the Constitution allows in Article 271 a fourth level of administration: autonomous municipalities (autárquia).

Mozambique is in the process of creating such autonomous entities throughout the country. The Constitution and the Local Authority Finance Law 11/1997 govern the rights and obligations of municipalities vis-à-vis their citizen, and the relation between the state and municipalities.

Political autonomy. Municipalities are responsible in the following areas:

- Rural and urban equipment;
- Basic sanitation;
- Electricity;
- Transportation;
- Education and instruction;
- Culture and sports;
- Health;
- Social Action;
- Environmental management.

The Ministry of Local Governments in Maputo supervises the municipalities to ensure that they act within their legal powers.

At the moment there are 33 municipalities established covering most of the larger cities. Areas, which are not part of a municipality, are governed by a provincial or district governments depending on the issue. Therefore, it must be differentiated between businesses located inside and outside a municipality. Only businesses located in the boundaries of a municipality are subject to municipality taxes and fees. These taxes and fees occur in addition to any taxes and fees charged by the provincial government on behalf of the state. Furthermore, it should be noted that most taxes and fees differ from municipality to municipality.

Financial autonomy. Local governments enjoy financial autonomy to a certain extent. Law 11/1997 includes a list of compulsory municipal taxes and fees and sets a range for them with lower and upper limits. Revenues from municipal taxes and fees go directly into the budget of the municipality. In addition, a transfer from the state to the local governments is paid. Criteria for the transfer are the size of the municipal population, area of territory, tax performance index and weighted development index. The dependence of municipalities from the state varies. Some municipalities depend almost entirely on the transfers from the state, others like Maputo or Vilankulo only to 40%.

However, municipalities suffer from a constant shortage of revenues. Officials from the City of Maputo, for example, are aware that the difficult budgetary

situation needs more creative thinking and different ideas like concessions to private entrepreneurs for the management of parking space, outsourcing of market management etc. are under discussion. One problem is also the low assessment of buildings for property taxes and the fact that the state does not pay property taxes for their buildings.

There is a reform of Law 11/1997 currently discussed at Cabinet level that will introduce new compulsory municipal taxes including business licensing fees, a tax on communication and maybe a transfer of the industry licensing from the Ministry of Industry and Trade to the municipalities to set off the lost revenues from the recent abolishment of the municipal tourism tax.

Municipality charges

Municipalities are empowered to set certain municipal taxes and fees. For some taxes, the state prescribes lower and upper limits. Municipalities are allowed to and usually do charge the following taxes and fees to businesses:

Business tax. Businesses have to pay a municipal tax. In Maputo, there are three categories: sole proprietors, companies and small businesses. Other municipalities charge according to physical size of the establishment. In Inhambane, for example, a business has to pay 100,000Mt. application fee, and 2,500Mt per surface square meter of the business location in the city and 500Mt. per square meter outside the city.

Daily tax for small businesses and market taxes. In Inhambane, small businesses without a fixed location pay a daily tax of 3,000 to 20,000Mt. per square meter on the central market and 2,000 to 20,000 Mt. per square meter on other markets depending on the offered product.

Property taxes. Local governments have full autonomy in setting property taxes. Real estate owner (individual or company) must pay annually property tax between 0.2 percent to 1 percent of the assessed value of the property. There are different assessment criteria for old and new buildings.

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.

Other licensing fees. Each municipality sets by decision of the local assembly a list of activities that need to be licensed by the local government and the licensing fees. The activities range from vehicle licenses to unloading a truck, using public space, using a car or façade for business signs. Inhambane has 14 pages of spreadsheets listing activities, which need to be licensed by the local

administration including construction permits, vehicle licenses, the right to hold animals etc. Annex A lists the business related fees for Inhambane as an example.

In addition, municipalities charge a local personal tax - in Maputo, for example, of 50,000Mt. per person over 18 year - and a labor income tax.

Inspections. The Municipal Police is in charge of inspecting businesses regarding licensing requirements and payments. Fines are paid fully into the municipal budget.

The licensing regime on state level

Regarding taxes on state level, it is referred to the section on general and sector taxes. Additional costs occurring to businesses are the fees to be paid for a business and sector licenses.

Business license

The business licensing regime was recently revised by new legislation on Industrial and Commercial Licensing in 2003 and 2004. Applicable legislation is the Decree 39/2003 (Industrial Licensing Regulations), Decree 49/2004 (Commercial Licensing Regulations) and the Ministerial Diploma 199/2004 (Industry and Trade Inspection Regulations). The reform aimed reducing the time for obtaining a business license, simplifying the licensing procedures, decentralizing licensing powers, and adopting the principle of educative inspections. However, this did nothing to alter the out dated concept that ‘everything that is not specifically and officially authorized is prohibited’.

In case the line-ministry issues operational licenses like in the case of tourism or telecommunication companies, the sector license replaces the general (commercial) business license. However, if trade, wholesale or retail is involved, for example, if a hotel also contains a shop, then an additional commercial license must be obtained.

Aside from sector specific licenses, an entrepreneur needs to obtain a license from the Ministry of Industry and Trade before commencing business. Some exemptions apply though. Businesses are categorized as industrial or commercial with each of the groups being further classified. Licensing requirements and procedures depend on the classification of the business.

Industrial license

Every manufacturing establishment if not categorized as micro business must obtain an industrial license from the Minister of Trade and Industry or the

Provincial Governor. Manufacturing establishments are categorized as large, medium, small and micro businesses. The criteria for categorization are stipulated in the Decree and an establishment is classified if at least two criteria described below are applicable.

Table 17: Categorization of manufacturing establishments and competent licensing authorities

Category	Initial investment (US\$)	Power capacity (KvA)	No. of employees	Competent authority
Large	>10m	>1,000	>250	Minister of Indus. and Trade
Medium	>2,5m, <10m	>500, <1,000	>125, <250	Minister of Indus. and Trade
Small	>25,000, <2,5m	>10, <500	>25, <125	Provincial Governor
Micro	<25,000	<10	<25	Not licensed, only registered.

Source: Art. 3 (1), 8 and 13 of Decree 39/2003.

Purpose of the industrial license is ostensibly to ensure manufacturing standards and health, sanitary, safety and environmental conditions according to the decree.

An application with the following content must be submitted before commencing of business or even before installation of the factory in case of a newly established factory to the Local Industry and Trade Authority (large and medium) or the Provincial Director (small):

- Letter of request containing coordinates of the owner and the business;
- Industrial project documents including topographical plan, layout of industrial site, detailed project specifications, and approved environmental impact assessment if applicable.

The competent authority has to analyze and consider the project and issue a project approval/denial within 30 days. Small manufacturer are exempt from project approval but have to submit the project documents to the Local Industry and Trade Authority nevertheless. Micro establishments are exempt from project approval and site inspection unless it is a food or pharmaceutical industry.

After project approval, the applicant has 180 days to start installation off the facilities. Once installation is completed, the applicant must send a written request for inspection to the competent authority. Within 6 days, the competent authority shall inspect the site regarding technical and functional conditions, health, hygiene, safety and any other standard applicable to the kind of operation. The inspection will be conducted by the Local Industry and Trade Authority and an inspection report will be submitted to an Inter-ministerial Commission to

evaluate the establishment and decide on the application which is then issued with indefinite validity by the Ministry of Industry and Trade. Members of the Inter-ministerial Committee are representatives from:

- MIT;
- Supervising ministry in the specific case;
- Ministry of Health;
- Ministry for the Coordination of Environmental Action;
- Ministry of Labor;
- Fire Service;
- Secretary from the licensing authority;
- Others to be determined on case-by-case basis.

Commercial license

Before commencing operation, the following businesses need a commercial license issued by the Ministry of Industry and Trade:

- Commercial activities listed in Annexes I and II of Decree 49/2004. The four pages long annexes contain very detailed descriptions of commercial activities and include basically every commercial activity except manufacturing; Each listed activity must be licensed separately as well as every outlet/branch in a different province.
- Representations of foreign businesses;
- Foreign trade operators (importers and exporters).

Commercial activities are broken down into four categories (permanent, temporary, market stands, and itinerant trade). Exempt from the obligation to obtain a commercial license are activities that are governed by special legislation and rural commercial activities.

An applicant for a license to conduct a commercial activity has to submit to the Ministry of Trade and Industry:

- Letter of request; the content is prescribed in the licensing Decree;
- Business visa or residency permit, if foreigner;
- Drawing of the premise;
- Public deed of incorporation, if company;
- Lease contract or title deed of premise;
- Proof of tax registration.

Before issuing a license for commercial activities, a site inspection will be conducted by a commission including representatives from:

- Licensing entity (chair);
- Local administrative authority;
- Local health authority;

- Fire service;
- Others to be determined on case-by-case basis.

Provincial Governors are in charge of licensing all commercial activities except market stalls and itinerant trades, which are licensed on district level. Foreign business representations are licensed by the Minister of Industry and Trade. The inspection shall be completed and the license issued by the provincial governor within 15 days and the district within 8 days. Officials from the Ministry of Industry and Trade acknowledged that in the past it took up to 45 days to obtain an industry or commercial license. However, it aims to reduce the licensing time to 19 days in the near future. In the meantime, the applicant can request a provisional declaration valid for 60 days. Interviews with private sector representatives and business facilitators give a mixed picture. Licensing times differ from 1 to 2 weeks for provisional declarations and 2 weeks up to 3 months for issuance of the license. Most interviewees agreed that the inspection causes the delays because the members of the Commission are difficult to be coordinated.

The commercial license for commercial activities has indefinite validity. Renewal is not necessary. However, facilitators mentioned that renewals are necessary whenever new legislation is issued and this has happened quite often in the past. For example, licenses had to be renewed with new legislation in 1979, 1998 and 2004. An appeal against a licensing decision can be submitted to the Ministry.

Inspections

General rules on inspections are stipulated in the licensing decrees and principles and guiding rules regarding the inspection service are governed by Ministerial Diploma 199/2004. The inspections are conducted by the Department of Inspection/Supervision of the General Inspectorate within the Ministry of Industry and Trade. Inspections are conducted as routine and random inspections by at least two inspectors and with preference for joint inspections of several involved authorities. Five days after each inspection, an inspection report must be submitted to the inspected business. Routine inspections are supposed to be educational according to the new legislation and first violations should result only in a reprimand. Measures to respond to violations are reprimands, fines, and order of suspension and closure of the premise. Fines can be imposed by the Inspector General of the Ministry of Trade and Industry, suspension by the National Director of Industry and closure by the Minister and the Provincial Governors only. The violator has 15 days to pay the fine at the Tax Department before the matter goes to court.

The inspected business has to pay for the transport of the inspectors. While the law stipulates a flat transport fee of 5,000 Mt., interviewed businesspersons said the actual transportation cost had to be reimbursed. This can be far beyond 5,000Mt. if the business is in a remote province and inspectors have to come from Maputo.

Most businesspeople said that they have no information on the applied standards and requirements for issuance of the license. In fact, many anecdotes were told about surprising requirements and made up violations causing delays and high fines often apparently used to extract bribes. Stories of that kind came up so often that it seems to be a pattern. At least, the educational inspection as an aim of the Decrees of 2003 and 2004 was not confirmed by the experience of the private sector.

Licensing fees, fines and penalties

The laws and orders stipulate the licensing fees, fines and penalties. Fees and fines for industrial licenses are calculated as percentages and multiples of the minimum wage of an industrial worker (MW) and for commercial licenses of a public servant. Minimum wage for industrial workers and public servants is currently 1,443,167 Mt. (2006). Ministerial Diploma 89/2005 sets commercial licensing fees according to business activity and location, for example:

- Retail (with import and export): 45% of minimum wage (Maputo, Matola, Beira, Nampula and Nacala); 36% of minimum wage (Pemba, Quelimane, Tete, Inhambane, Maxixe, Xai-Xai, Chimoio and Chókwè); 27% (Lichinga and other cities), 13.5% for villages and 4.5% for rural areas.
- Services: 89% of minimum wages (Maputo, Matola, Beira, Nampula and Nacala); 67% (Pemba, Quelimane, Tete, Inhambane, Maxixe, Xai-Xai, Chimoio, Chókwè), 45% (Lichinga and others cities), 9% Villages and 5% rural area'.
- Wholesale: 36% of minimum wages (Maputo, Matola, Beira, Nampula and Nacala); 26% (Pemba, Quelimane, Tete, Inhambane, Maxixe, Xai-Xai, Chimoio, Chókwè), 22.5% (Lichinga and others cities), 9% Villages and 4.5% rural areas.

Table 18: License Fees and Fines

License	License Fee		Inspection Fee*	Fines
Industrial License	Large	5 x MW	13 (6+7) x MW plus 5000 Mt/km transport cost	10 to 80 times MW - doubled for first and tripled for second repetition.
	Medium	4 x MW	11 (4+7) x MW plus 5000 Mt/km transport cost	
	Small	2 x MW	6 (2+4) x MW plus 5000 Mt/km transport cost	
	Micro	1 x MW	(-)	
Commercial License (commercial activity)	For retail between 4.5% and 45% of MW, for services between 5% and 89% of the MW and for services between 4.5% and 36% of MW.			0.2 to 20 times MW - tripled for repetition.

** Inspection fees combine regulatory inspection fee, payment to Inter-sector Commission and a flat fee for transport contributions for the inspectors*

The licensing decrees stipulate that the Ministry of Planning and Finance, and the Ministry of Industry and Trade shall adopt a joint Ministerial Diploma concerning the use of fees and fines. However, such a Ministerial Diploma was not made available to the mission. In fact, interviews with the Ministry of Finance suggest that such an agreement has not been made so far. For the time being, it appears that the Ministry of Trade and Industry keeps (like all other line-ministries) the revenues from fines in its own funds. There is no transparency regarding the amount and use of such revenues in the state budget. Information about the amount of revenues was not made available.

One-Stop-Shops

To speed up the process, the Ministry is in the process of setting up so called “One-Stop-Shops” for general business as well as sector licenses at the provincial level. This means that applicants come to one location in which all involved authorities seconded an administrator. Applications and information on the procedure and requirements should ideally be available at this location. Where established, businesses confirmed that things have slightly improved but they also said that facilitation is not simplification and the root of most problems is caused by complicated and non-transparent procedures.

Box 19: Experience with a One-Stop-Shop in Inhambane

Inhambane province has set up a One-Stop-Shop in Inhambane City for tourism establishments since the vast majority of businesses in the province are tourism related. In one building are administrators from various line-ministries available on certain days during the week. One of the most daunting tasks was to collect reliable information about the procedure, responsibilities, and requirements. One reason for the lack of information was the discretionary application of criteria and requirements. None of the practice could be provided to the public because it may change from license to license and even from inspector to inspector. Therefore, the first tasks was to

make all authorities involved in the licensing of tourism establishment agree on the procedure, application requirements, decision criteria, detailed standards applied etc. This alone took several months and the final sheet includes 12 steps with each step requiring the submission of 1 to 5 documents and an applicable time limit ranging from 8 to 90 days.

Another problem is still that the seconded administrators can often not decide but have to go through the internal process within their line-ministries. Consequently, the One-Stop-Shop is in some respects an additional layer of bureaucracy on the way to a license: a “One More Stop Shop”.

Although the situation has improved, businesses are still ambiguous about the actual progress achieved through the establishment of the One-Stop-Shops. Much more in sectors and regions in which the efforts made by the Inhambane province has not been made.

Source: Interviews with officials of the OSS in Inhambane province, 2006.

Sector licenses

Each line-ministry issues licenses to businesses operating within its responsibilities. The licensing fees are set by the line-ministries and paid into the general budget.

Inspections

General business license and sector licenses do not expire and need therefore not be renewed. The state tries to ensure compliance through inspections. The Ministry of Industry and Commerce has an inspectorate that is in charge of the initial report to issue the license and routine inspections. The use of fines is opaque. Everyone agrees that inspectors are entitled to keep 25% of all fines imposed. It is not clear how those funds are distributed within the inspectorate among the employees, and within the Ministry. In addition, the remaining 75% are not paid to the general budget and appear to stay in the budget of the inspecting ministry, usually the Ministry of Industry and Trade. Again, these revenues do not appear explicitly in the state budget and there is no transparency about the amount and the detailed use of the funds.

Analysis

As FIAS found in 1996 and 2001, licensing on municipal level is not perceived by businesses as problematic. From a business perspective, municipal taxes or activity licenses are not perceived as high or problematic in terms of time or complex procedures. Inspections are conducted by the Municipal Police and focus on the payment of taxes and fees and not on regulatory standards. In fact, it appears that municipalities concentrate mainly on the revenue side of licensing fees and taxes.

However, interviews with mayors and municipal administrators left the impression that they use a **high degree of discretion** in their decisions on business applications. One mayor said that if he thinks the planned business is not of use in the foreseen location, he does not issue a business license. He gave the example of a hairdresser who should not open up shop in a street or area in which a hairdresser is already established. Information on requirements and procedures were not made available to the public.

National licensing has several shortcomings and is seen as a serious impediment to doing business. There are three overarching issues that came up in all interviews with private sector representatives and facilitators and were often admitted by officials: the lack of information and transparency, discretionary decision making and bribery. Specific shortcomings were identified in three areas: licensing legislation, implementation of the legislation and inspections. It should be noted that most businesses and facilitators acknowledged that things have slightly improved over past with the introduction of One-Stop-Shops and more accountable officials. However, the private sector representatives also said that these were only marginal improvements so far.

Overarching issues concerning national licensing. The following issues were mentioned by almost every interviewed businessperson and facilitator providing illustrative anecdotal evidence. Such evidence could not be proved but the fact that so many persons had similar experience gives solid ground for its existence. The overarching issues are linked in the sense that the lack of information and transparency gives the administration room for discretionary decision-making, particularly in the area of fines and violations, and provides an ideal ground to extract bribes. Again, the private sector acknowledged improvements in the last years, but opaque rules and requirements, discretion and bribery are still problems.

- **Catch-all approach inefficient and unnecessary.** Every business needs one if not several general business licenses from the MIT before commencing operation. Even businesses which do not pose any risk to the public or the environment that justify pre-inspections and licenses like those conducted in offices or shops need authorization. The existing negative in Annex I of the licensing decree of activities required to be licensed is in fact a positive list because it includes all possible business activities. Using licensing for these low risk activities is inefficient and does not add value to the economy. Instead, it is an unnecessary burden to new entrepreneurs.
- **Lack of information and transparency.** One theme of almost all interviews with businesspersons and facilitators was that there was no reliable information on the requirements, standards, and procedures available. The administration does not give the businesses the chance to

behave lawfully because the necessary information is not published. In a time consuming and often expensive process, businesses learn about standards only after a violation has been stated and a fine had to be paid.

- **Discretionary decision-making.** The lack of information makes the decision criteria look often arbitrary to the applicant. If no information is available on the requirements and criteria, then the official will use his or her own judgment. This is neither fair to the applicant nor to the official who is left alone in the process. One interviewed businessperson, for example, said that his license application failed because the submitted business letter was not according to standards. But, first, he was not aware of any standards, second, whenever he asked, there were no standards available. In his case, the logo was at the wrong place and when he rectified it, the date was in the wrong part of the letter. Use of discretionary power was particularly mentioned in the inspection process if it comes to the definition of standards as well as setting the fines.
- **Corruption.** High statutory fines and discretionary assessments provide an ideal ground for extracting bribes. In fact, many interviewed businesses assumed and experienced that the legislation, the lack of information and the power of inspectors are used to ask for bribes. As mentioned above, businesses often acknowledged that things have improved. Nevertheless, the situation is far from being acceptable.

Specific shortcomings of the national licensing regime. The most pressing issue, which deserves high priority, is the poor implementation of the existing legislation. Though only general business licensing has been closer examined, it became clear that most of these shortcomings are also applicable on the area of sector licensing.

- **The legal framework is incomplete and has several shortcomings.** The government made great efforts to adopt new general business licensing legislation in 2003 and 2004. In general, the adopted Decrees and Diploma are well drafted and provide the basis to ensure compliance of manufacturing and commercial businesses with health, safety and environmental standards. The inspection Diploma sets the right guidelines with educational inspections, and inspection standards.

However, some legislative shortcomings still exist:

- **Licensing classification system is complex and license obligation of each outlet unnecessary.** Decree 49/2004 for commercial licenses includes in Annex I a three pages long classification system that appears extremely detailed. Each of the classes needs to be licensed and businesses conducting more than one class need more than one license. The same is valid if a business expands its activities in different classes. Furthermore, every outlet in a different province than the headquarters needs a

- separate license. There is no added value of this practice in terms better safety, health or environmental standards. Again, the value of this rule apart from revenue generation is unclear.
- **Legislation missing regarding the use of fees and fines.** While the Decrees stipulate that the Ministry of Planning and Finance and the Ministry of Industry and Trade agree in a Ministerial Diploma on the use of fees and fines, there was no such agreement available. It is unclear if such a Diploma exist. If so, it should be made public.
 - **No administrative provision in place to set uniform detailed application of the Decrees.** Administrative provisions should guarantee that each official applies laws and regulations in the same way. This provides certainty to the applicant and the officials. However, such administrative provisions on requirements, decision criteria and procedures are not available.
 - **Fees and fines appear high.** The statutory fees and fines are fairly high and give inspectors much power over businesses. This is also compounded by the fact that businesses themselves must pay for the transportation of the inspectors. Licensing and inspections should primarily be as a public service not a burden to businesses. It is in the interest of the public to ensure compliance with standards. Therefore, the public pays most of the occurring costs in many countries.
 -
 - **Poor implementation of legal framework.** There is a large gap between the licensing legislation and its implementation. Most businesses complain that the law is often not known by the administration and not applied. Considering that the laws were adopted several years ago, it should be expected that the transition phase is over and the administration applies the Decrees 39/2003 and 49/2004 fully. The most important issues were:
 - Time-consuming procedure. It takes at least 4 weeks to obtain the license. Delays are often caused by unreasonable requirements and applicants have to push authorities to conduct the inspections and issue the decision. The statutory time limits are not applied in the experience of business and business facilitators. This is often caused by delayed inspections.
 - One-stop-shops have only limited impact. One-stop-shops are only as good as the underlying procedures. They can have a positive impact on the dissemination of information and forms, and the reduction of visits to the administration. However, when the underlying procedures are suboptimal, then one-stop-shops cannot do much about it. In fact, there is also the risk that the shops add

- an additional layer of bureaucracy. This appears to have happened in some of the provinces according to the private sector.
- Inspections and fines are applied without regard of the law. This issue will be addressed under the topic inspections, however, it should be mentioned here that the standards and requirements are in the experience of businesses often applied without regard of the laws.
 - **Inappropriate inspection regime.** The inspection regime caused the most complaints from the private sector. Some of the complaints dated from incidents way back before the Ministerial Diploma 199/2004 was adopted and they may not occur nowadays. Other events were fresh and suggest that many of the problems still exist. The following shortcomings were identified:
 - Wrong incentives lead to a lack of information about applicable standards and excessive fines. Though the new inspection Diploma supports the approach of educational inspections, reality suggests that the incentive structure for inspectors is counter-productive. An important part of the inspectors' salary is made of a percentage of fines. Though there was no official Decree on this matter available, officials said that 25% of the fines are paid out to inspectors. Therefore, inspectors have no interest in educational inspections or even in providing information to businesses. Businesses feel they are often kept purposefully in the dark about standards, requirements and applicable fines. At the Ministry of Finance, a new policy has raised salaries for Tax Inspectors while eliminating any sharing of revenue from fines. Although this is a relatively new reform, whose impact has yet to be assessed, it seems such a policy mitigates the incentive for inspectors to try so aggressively to find fault with a business.
 - Wrong incentives to inspecting Ministries lead to lack of reform commitment. According to the Ministry of Planning and Finance, the use of fines is non-transparent. They do not end up in the general budget. Instead the revenues are kept in the budget of the inspecting Ministry. There is no information about the amount and how the revenues are spent. The ministry as a whole has no interest to increase transparency about those revenues and reduce income from fines caused by better compliance. The ministry has also no interest in deciding in appeals against imposed fines for the same reason.
 - Applied standards are sometimes made up and imposed fines are often at the highest statutory limit if not above it. Caused by the wrong incentives, inspectors tend to impose high fines and the private sector feels that they have to pay always the highest possible fine if not one that is beyond the law. Appeals are time-

consuming and are decided within the ministry. There is no confidence that the ministry will overrule the inspection report for the above reason.

- Corruption exists. The power of inspectors to impose high fines give them also the opportunity to ask for bribes or the inspected business an incentive to offer bribes. The situation regarding corruption has improved according to many businesses. However, it is still part of the inspection regime.

Recommendations

Municipalities should aim 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.

The National licensing regime has only been examined for the industrial and commercial license. The first recommendation would be to launch a project that looks at the entire licensing regime including all sector licenses or at least those in the most important sectors.

As FIAS observed in 1996 and 2001, there is a need for wholesale de-licensing at the national level. Specifically:

- ***Abolish licenses for all businesses that do not pose any significant risk to safety, health and environment.*** Licensing should be only used in situation in which a business activity poses a significant higher risk to the public or the environment than regular daily behavior. Offices, shops, retail and wholesale, should not need a license. The general approach should be that every business can start without a license unless a specific risk for safety, health or environment exist.
- ***Improve information on licensing regime and its transparency.*** The licensing institutions should make a strong effort to disseminate reliable information on the requirements, standards, and procedures. Leaflets, internet information, newsletters, brochures etc. should be used to ensure that the private sector has all information to act lawfully.
- ***Discretionary decision-making.*** It is important that all involved institutions are part of the effort and agree on the information disseminated to the public. Once decision criteria and requirements are published, officials would have to apply them. This should narrow the space for discretionary decisions.

- ***Continue efforts to combat corruption.*** Lowering the fees and fines will have already a positive effect on corruption. In addition, independent and effective supervision of licensing implementation is an important element to diminish the possibility to request and offer bribes.
- ***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 retail outlets.*** The classification system could be reduced to less than a handful of different business without the current degree of detail. Also, one license for one business should cover all activities within one of the streamlined classes and all outlets no matter in which location.
 - ***Adopt a Ministerial Diploma on the use of fees and fines that ensures that both are part of the general budget.*** This should end the practice of paying inspectors part of the imposed fines and allowing the inspecting institution to keep the fines for their budget.
 - ***Adopt administrative provisions/guidelines to set uniform detailed rules for each license and type of inspections.*** Goal of such administrative provisions would be to increase consistency and reliability of licensing and inspecting authorities. The provisions should be made publicly available to increase certainty on the part of businesses. Business associations may be involved in the development of the provisions/guidelines.
 - ***Review fees and fines.*** The statutory fees and fines should be reviewed and set at a lower level. Transportation costs for inspections should rather be paid by the state than the inspected business.
- ***Focus on better implementation of the legal framework.*** The gap between the licensing legislation and its implementation need to be closed by the following measures:
 - ***Shorten time-consuming procedure by selective inspections.*** The mandatory inspection before issuing the license is time-consuming and probably not necessary for each business. Particularly since the inspection has only a limited value as a snapshot of the situation. The fact that each business is most likely inspected during the next 12 months makes it less important that it is also inspected before the license is issued. In addition, it should be reviewed if joint inspections are really the most efficient way of conducting inspections. Joint inspections are costly and difficult to coordinate. Therefore, the inspections might be done on an individual basis by institution.

- **Assess the impact of one-stop-shops.** It should be assessed if the concept of one-stop-shops is in all provinces adding value. After the assessment shortcomings should be addressed in the light of what and what not one-stop-shops can possibly achieve. This should be done in an inter-ministerial effort.
- **Strengthen the supervision of inspectors and inspecting institutions.** An independent review of the performance of inspectors and inspecting institutions shall be introduced in form of independent and efficient appeal bodies.
- **Restructure the inspection regime.** Priority should be given to address shortcomings of the inspection regime. Measures should include:
 - **Abolish the current incentives.** Inspectors should not receive any part of the imposed fines as remuneration. This practice has been successfully abolished for tax inspectors and should be expanded to other inspectors too. At the same time, inspectors' salaries should be adjusted to ensure that the remuneration is appropriate and the change does not lead to more corruption.
 - **Increase transparency of the revenues from fines and transfer them to the general budget.** All non-tax revenue accruing to 'line Ministries' should be paid to the Consolidated Fund of the Ministry of Finance and be under their budgetary control.
 - **Applied standards are sometimes made up and imposed fines are often at the highest statutory limit if not above it.** Caused by the wrong incentives, inspectors tend to impose high fines and the private sector feels that they have to pay always the highest possible fine if not one that is beyond the law. Appeals are time-consuming and are decided within the ministry. There is no confidence that the ministry will overrule the inspection report for the above reason.
 - **Continue efforts to fight corruption.** This includes introduction of independent supervision and appeals against actions of inspectors.

Annex A: Tax Instruments in Mozambique³⁴

The Individual Income Tax (IRPS)

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

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 MT are not subject to tax. Later they are given a specific deduction that corresponds to 50 % 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

³⁴ Taken from IMF 2006

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 MT, 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 there from 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 % if held for less than 12 months; 60 % if held for between 12 and 24 months; 40 % if held for between 24 and 60 months, and 30 % 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 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 amusement³⁵ and increases in assets not included in the other categories³⁶ 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

³⁵ Such as lotteries, raffles, pari-mutuel betting, lotto, totolotto, bingo, drawings, competitions and other.

³⁶ 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.

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.

The tax rates are moderately progressive, as shown in Table A1, 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 % 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 MT, 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.

Table A1. Progressive Rates, Individual Income Tax (IRPS)

Income Brackets (in MT)		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 % for stock dividends and other income obtained by non-residents, and 10 % 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 % 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% of total tax revenue (Table A2). 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 A2: 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.

Corporate Income Tax (IRPC)

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 gaming 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.

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,"³⁷ 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.

³⁷ Art. 54 of the IRC Code.

The general tax rate is proportional, 32 %, and there is a lower rate, 10 %, for agricultural activities, including livestock raising. Provision is also made for a separate, additional taxation, at 35 %, 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 % 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.

The VAT

The VAT (Value-Added Tax) is a general tax on consumption that took effect on June 1, 1999 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 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 %, was fixed at 17 %.

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*³⁸ 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 whenever "because of circumstances attributable to the taxpayer, it is impossible to verify the legitimacy of the requested reimbursement."³⁹

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.

³⁸ Initially, this figure was 10 million, but it has been updated.

³⁹ 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 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 *meticaís*. 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 *meticaís*. The obligations are greatly simplified and the amount of tax to be paid is determined by the application of the coefficient of 5 % 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.

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)⁴⁰ 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.

⁴⁰ 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.

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.
- Decree No. 4/2002 exempted transfers of goods and rendering of services within the context of sugarcane production, when earmarked for the industry. 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:

- 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. 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.⁴¹

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.”⁴²

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 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.

The Excise Tax (ICE)

The Excise Tax (ICE) was introduced in 1998⁴³ 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 %, 35 %, 50 %, or 75 %. The ICE is not assessed on fuels, because they are subject to a 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*.

⁴¹ 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.

⁴² Decree No. 55/2004, of December 10 (Art. 11, No. 1 (k) of the VAT Code).

⁴³ Decree No. 52/98, of September 29, approved the ICE Code.

Shortly thereafter, in 1999⁴⁴ all ICE rates were lowered. The 20 % and 35 % rates were cut by 5 %age points, to 15 % and 30 %, respectively. The 50 % and 75 % rates were reduced by 10 %age points, to 40 % and 65 %. 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 2002. 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 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 % 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 % of total ICE revenue.

Customs Duties

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 1999 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 % 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 % for essential goods (Class E), 2.5 % for raw materials (Class M), 5 % for capital goods (Class K) and for fuel (Class N), 7.5 %

⁴⁴ Decree No. 31/99, of May 24, which took effect on June 1, 1999.

for intermediate goods (Class N), and 25 %⁴⁵ for consumer goods (Class C). The maximum duty has now been cut to 20 % 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 2002⁴⁶ 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 SADC. The SADC was founded in 1980 and has 14 members⁴⁷ that are also members of the Common Market for Eastern and Southern Africa (COMESA)⁴⁸ and/or the Southern Africa Customs Union (SACU)⁴⁹

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.

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:

⁴⁵ Beginning January 1, 2003. The rate was initially set at 35%, and later at 30%.

⁴⁶ Decree No. 29/02, of December 26.

⁴⁷ Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar (since August 2005), Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe.

⁴⁸ 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.

⁴⁹ SACU is a customs union that includes South Africa, Botswana, Lesotho, Namibia, and Swaziland.

Table A3. 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

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 % of the revenue from gasoil and 50 % of the revenue associated with auto gasoline goes to the highway fund;
- 5 % 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 %. 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:

Table A4. 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.⁵⁰ These incentives are not awarded automatically, but must be applied for in advance. They provide a 50 % 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.

⁵⁰ 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.

Municipal business licensing fees (Inhambane)

	Designacao	Taxa	
		Fixa M. Central	Annual Outros Merc.
1	Senha para venda em Mercado publico ou no local na sua falta designado por metro quadrado e por dia:		
	a) Produtos agricolas	3,000	2,000
	b) Produtos agricolas com alpendre (sombra)	5,000	5,000
	c) Produtos alimentares de Mercearia	15,000	10,000
	d) Produtos alimentares de Mercearia com alpendre (Sombra)	20,000	10,000
	e) Roupa usadas	10,000	10,000
	f) Roupa nova	20,000	20,000
	h) Mariscos (Peixe de primeira)	5,000	4,000
	l) Mariscos	3,000	2,000
2	Inscricao de Engenheiros, Technicos Responaveis de Obras e de Tecnicos para elaboracao de projectos de construcao	2,500,000	
3	Renovacao Inscricao de Engenheiros, Tecnicos Responsaveis de Obras e de Tecnicos para elaboracao de projectos de construcao	1,500,000	
4	Registo de empreiteiros	5,000,000	
5	Renovacao de Registo de Empreiteiros	5,000,000	
6	Registo de Metres de Obra	2,500,000	
7	Renovacao de Registo de Metre de Obras	2,500,000	
8	Registo de pessoal dos matadouros incluindo proprietario por cada individuo registrado		
	a) Ate 3 Pessoas	500,000	
	b) Por cada um alem de 3	150,000	
9	Registo de pessoal dos talhos. Leitarias e padarias:		
	a) Ate 3 Pessoas	500,000	
	b) Por cada um alem de 3	150,000	
10	Registo de vendedor ambulante, de conta alheia incluindo as que negociam em artigos ou generos de consumo imediato, por cada vendedor registrado	1,800,000	
11	Registo de vendedor ambulante, de conta incluindo os que negociam em artigos ou generos de consumo imediato	1,000,000	
	a) taxa menal de vendedor ambulante	300,000	
12	Registo de engrachadores por cada um (annual)	150,000	
13	Registo de fabricantes de generos de consumo imediato por cada pessoa	300,000	
14	Registo de vendedores ambulantes de lataria	200,000	
15	Multa a vendedor ambulante nao inscrito	200,000	
16	Licenca de porta aberta por inicio de actividade	500,000	
17	Taxa de porta aberta ate meia noite (Quiosques, Discotecas e Clubes)		1,500,000
18	Taxa de porta aberta ate madrugada (Quiosques, Discotecas, Clubes e associacoes)		2,000,000
19	Para realizacao de clemencies, festas populares e danças tradicionais ou retuais com caracter publico, por cada 24 horas	200,000	
20	Licenca de Estaleiro de venda de lenha por mes	200,000	
21	Licenca de Forno caseiro por mes	150,000	

22	Licença de bancas do Mercado Muele-1, Pre-fabricada por mes	120,000	
23	Licença de Estaleiro de Venda de Material de Construção Conventional por mes	900,000	
24	Licença de Estaleiro de Venda de Material de Construção nao Conventional por mes	300,000	

Source: Municipality of Inhambane, 2006.

General Fiscal Benefits

Fiscal Benefit	Details
Investment Tax Credit	<ul style="list-style-type: none"> • Usual rate is 5% of the total new investment in tangible fixed assets. • This benefit is valid for 5 years. • Tax credit not used in any year could be carried forward during the benefit period. • Investment projects in Gaza, Sofala, Tete and Zambezia provinces are allowed higher tax credit of 10%. • Investment projects in Cabo Delgado, Inhambane and Niassa province are allowed an even higher tax credit of 15%. • Investment in buildings, passenger vehicles, leisure equipment, and investments not directly associated with productive activity; do not qualify for the tax benefits. • Investment in advanced technology do not get the investment tax credit, rather they qualify for a deduction up to 15% of taxable income.
Accelerated Depreciation	<ul style="list-style-type: none"> • The usual rate is depreciation of two times the normal rate set by law.
Professional Training	<ul style="list-style-type: none"> • Investment expenditure for professional training of Mozambican workers are allowed to be deducted up to a maximum of 5% of taxable income. • This deduction is only allowed for the first five years of commencement of activity. • The allowed deduction rises to 10% for corporations in the case of training for use of advanced technology.
Tax Deductible expenditure	<ul style="list-style-type: none"> • Expenditure in public utilities is allowed to be deducted 120% in case the expenditure is carried out in Maputo and 150% for the rest of the provinces.
Exemption from Real Property	<ul style="list-style-type: none"> • Undertakings are allowed a 50% reduction in the rate of real property transfer tax when acquiring

Transfer Tax	immovable property within the first 3 years of authorization of investment.
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Sector Specific Fiscal Benefits

Agriculture	<ul style="list-style-type: none"> • Reduction in tax rate by 80% • Exemption from payment of Import duties on certain equipment (Class K) subject to certain conditions such as when goods imported are not produced within Mozambique.
Hotel and Tourism	<ul style="list-style-type: none"> • Additional investment tax credit of 3%, totaling 8%. • Accelerated depreciation of up to 3 times the normal rate for new immovable assets used in the business. • Exemption from payment of Import duties as in the case of Agriculture.
Mining	<ul style="list-style-type: none"> • Reduction in Corporate Income Tax by 25% for a period of 5 years from commencement of production for investments exceeding US\$ 500,000. • Exemption from custom duties on import of materials and equipment for prospecting and exploration. • These imports also benefit from exemption from VAT.

Fiscal Incentives for Mega Projects (investment above equivalent of US\$ 500 million)

- These incentives are approved by the Council of Ministers subject to execution of a contract between the state and the promoter.
- Eligible for all the general fiscal benefits but extended to a period of 10 years.
- The projects have satisfy certain criteria such as promote development, reduce regional imbalances and create sufficient jobs (500, or 1000 in 3 years).
- The projects benefit from exemption from import duties (class K goods).
- Investment tax credits range from 5% to 10% of the total investment realized valid for 5 years. Investment Tax credits are higher for investments in less developed provinces ranging from 10% up to 30%.

Industrial Free Zones

- Enterprises situated in these Zones are entitled to exemption from customs duty and VAT.
 - Enterprises situated in such Zones benefit from 60% reduction in the Corporate Income Tax for a period of 10 years.

Annex B: An Overview of the METR Methodology

A General Discussion

The concept of a marginal effective tax rate was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VATs, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. METR analysis is based on the standard neoclassical model of investment in which the level of investment is a function of the “cost of capital” faced by a firm – the minimum or “hurdle” rate of return that an investment must earn to be profitable. Although earlier research was mixed on the issue, the most recent empirical evidence confirms the basic assumption of this model – which investment does in fact react inversely to changes in the cost of capital (Gordon and Hines, 2002). METR analysts, such as King and Fullerton (1984), Broadway, Bruce and Mintz (1984) and many others, have taken the basic neoclassical model and modified it to take into account the net effect of all the provisions of a tax system on the cost of capital to the firm.⁵¹ The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

The METR terminology naturally provides some insight into the nature of this tool. A METR is *marginal* because it is based on analysis of a prospective incremental investment – one that just breaks even, with its after-tax cost equal to its after-tax returns.⁵² It calculates the *effective* tax burden in that it captures the net effects of all the provisions of the tax system, rather than focusing on a single characteristic such as the maximum statutory corporate tax rate. And it is a *tax rate* in that it is defined as the difference between the gross of tax and net of tax returns to an investment – the “tax wedge” between gross and net returns created by the tax system – expressed as a percentage of the gross return.

The calculation of a METR requires careful specification of the characteristics of an investment in a specific asset in a specific sector, including the time path of its returns, the rate of economic depreciation of the asset, how the asset is financed, the economic environment in which it occurs, including the inflation rate, interest rates, and returns to equity, and all of the features of the current or proposed tax

⁵¹The analysis in this paper most closely follows the approach in Broadway, Bruce and Mintz (1984). For an application of the King and Fullerton (1984) approach to Burundi, see Zodrow (1993).

⁵²METR analysis is thus not well suited to analyzing tax effects on investments that generate above-normal returns.

system that affect both the after-tax returns and the after-tax costs attributable to the investment, including all tax depreciation allowances, investment credits, interest deductions, special exemptions, etc., allowed under the income tax as well as any other taxes that impinge on investment decisions. Given this information, the analysis calculates the effective tax rate on a marginal or breakeven investment under the assumptions of profit maximization by the firm, competitive markets, and perfect certainty (e.g., with respect to future returns and inflation rates).

Several additional assumptions underlying the METR approach should be noted. For example, METRs assume that firms are profitable, so that if the effective tax rate on an investment is negative (it is subsidized at the margin), the resulting losses can be used currently to offset other income. METR calculations are typically static; that is, they usually assume that the tax system in place at the time of investment remains unchanged for the life of the investment, and that inflation, when included in the analysis, also remain constant. Since the analysis typically assumes that assets depreciate at a constant rate but last forever, strictly speaking this implies that the analysis assumes the tax system and inflation rate remain fixed forever. In addition, the calculation of METRs is partial equilibrium in nature. Thus, some rate of return in the economy must be taken as fixed; in the context of a small open economy such as that of Lesotho, it is natural to take as fixed an interest rate that is determined in international capital markets. The return to equity, inclusive of an equity premium, can also be treated as determined in international markets.

Another implication of the partial equilibrium nature of METR analysis is that it cannot be used to analyze the shifting of business taxes to consumers or workers (that might occur with market adjustments in the context of a general equilibrium model of the economy). Instead, METRs typically implicitly reflect rather simplistic assumptions regarding tax incidence – which capital taxes on specific assets are borne by the owners of those assets, that taxes on labor are borne by labor, and that general consumption taxes are borne by consumers. Accordingly, to the extent that these incidence assumptions are incorrect, reported METRs levels and differentials may be somewhat misleading. METRs also typically do not take into account issues of tax administration, compliance and evasion, as they describe the tax system as it would operate if it were effectively administered and enforced. Again, to the extent that certain types of taxes (e.g., taxes on capital assets rather than capital income) are more easily enforced than others or are plagued with less tax evasion, the reported METRs may be misleading with

respect to the effects of the tax system as it actually affects investment decisions and tax revenues.⁵³

Finally, as noted above, a METR is defined as the tax wedge between the gross of tax and net of tax returns earned by a marginal investment, expressed as a percentage of the gross return. (The "gross" and "net" terminology refers to returns before and after taxes; both types of returns are defined net of actual economic depreciation.) The net return can be measured at the company or "entity" level, in which case only entity level taxes (including withholding taxes) are considered. Such calculations are sometimes referred to as "open economy" METRs, since the taxation of saving at the level of the saver is ignored. Alternatively, the net return can be measured at the level of the "saver" or provider of funds; in this case, the calculation includes taxation at the individual level. Such calculations are sometimes referred to as "closed economy" METRs since the source of investment funds is assumed to be domestic savers. Since the focus of this report is on tax effects on investment, including foreign direct investment, and Lesotho closely approximates a small open economy, the METRs presented are calculated solely at the business level (including, in some cases, withholding taxes on repatriations of funds from Lesotho subsidiaries to their foreign parents).

The basic concept of a METR can be illustrated with the following simple example. Suppose a business makes a marginal investment in a capital asset that just breaks even taking into account all taxes in the system, and earns a return of 10% net of depreciation but before any taxes. Suppose further that, after accounting for all taxes, the net real return received by the firm and paid to its investors is 7%. In this case, the METR on the investment is 30%: $0.3 = (0.10 - 0.07)/0.10$.

B Issues Illuminated by METR Analysis

The primary applications of METR analysis are twofold. First, the results of an METR analysis show the net effect of all components of the tax system on the *level* of the taxation of capital income generated by the marginal investment analyzed. Thus, a METR provides a measure of the actual tax burden on a prospective investment attributable to the existing (or proposed) tax system. Moreover, an appropriately weighted average of the METRs on specific types of investments can be constructed to provide a measure of the overall level of taxation of capital income in the economy, showing how the tax system distorts

⁵³Note also that since METRs are calculated for marginal investments they are not a particularly good indicator of the tax revenues that are raised from taxing capital income, which depend heavily on the taxation of inframarginal and other investments that earn above-normal returns.

investment decisions (and, if individual level taxes are considered, saving decisions as well) and thus introduces inefficiencies or “excess burdens” into the economy.⁵⁴

Second, by considering a wide variety of investments that differ by asset, method of finance, investor or economic circumstances, METR analysis provides an indicator of the tax differentials that arise across different types of investments, that is, it shows how taxes affect the *composition* of investment. In particular, a METR analysis shows how the tax system results in a variety of distortions of investment decisions, thus creating additional efficiency losses, beyond those associated with simply taxing capital income at a uniform effective tax rate. The most commonly cited distortion is across types of assets, as differential taxation of different types of assets induces businesses to invest too heavily in tax-advantaged assets and too little in tax-disadvantaged assets. This of course translates into distortions across business sectors, as the tax system favors sectors with production processes that use tax-favored assets intensively and penalizes businesses that use relatively heavily taxed assets intensively. The following subsections discuss these distortions and a wide variety of others, all of which can be analyzed with an appropriately designed METR analysis.

Distortions of the Level of Investment and Saving

METRs provide an indication of the overall level of taxation of various forms of capital income and thus indicate how the tax system affects investment and saving decisions. Because they consider many aspects of the tax system, METR analyses often give very different results regarding the effects of the tax system on investment decisions than would a simple examination of statutory tax rates (or special preferences) in isolation. Effective tax rates that are far above or below the statutory rate indicate potential areas for reform, as relatively high positive rates

⁵⁴Note that “distortions” of investment decisions must be measured relative to some benchmark. In general, a tax system would not distort investment decisions only if the METR were zero on all types of investment; this would occur, for example, under an ideal consumption-based tax (Zodrow and McLure, 1991). In this case, METR differentials – and the associated distortions of investment decisions – would be measured relative to a benchmark tax rate of zero. However, under an income-based tax, the benchmark level of taxation of capital income is typically the statutory income tax rate. In this case, the distortion of saving/investment decisions implied by the taxation of capital income at the statutory rate is in a sense taken as given, and the distortions attributable to tax differentials are measured relative to the statutory income tax rate. In addition, note that this discussion assumes that efficiency requires a tax system that is neutral across assets. This need not be true. For example, tax differentials may be desirable to correct for negative production externalities (e.g., pollution) or to offset other inefficiencies in the economy (e.g., inefficiencies in the taxation of labor income). These complications are ignored in the analysis, as they are best addressed with specific tax policies as needed (e.g., taxes on effluents or reform of the system of labor income taxation) rather than through the ordinary income tax system applied to capital income; for further discussion, see Gugl and Zodrow (2004).

act as a deterrent to investment, while negative METRs suggest that the tax system stimulates investments that are socially undesirable because they earn a return lower than the opportunity cost of funds.

Distortions of the Allocation of Investment

METRs are also very useful in identifying the extent to which the tax system distorts investment allocation decisions by asset and by business sector (given the benchmark level of taxation of capital income in the tax system). Apart from the arguments for differential taxation noted above, most public finance economists would argue that competitive markets are generally efficient in allocating resources. The implication of this view is that tax differentials are generally undesirable because the associated distortions of investment allocation decisions result in reduced productivity of investment; that is, a disproportionate amount of capital is allocated to those sectors and assets in which tax treatment is relatively favorable rather than to those sectors and assets where investment would be most productive in the sense of generating output valued by consumers. In other words, the tax system should generally be characterized by "economic neutrality" with respect to investment allocation decisions, or METRs that do not vary according to the type of asset or business sector.

In addition, METR analysis demonstrates the extent to which certain types of preferential treatment confer an advantage to the tax-favored activity. Indeed, METR analysis can be used to determine whether the effects of "preferential" treatment of certain forms of investment are in fact consistent with the intent underlying such treatment. For example, in some cases such as certain types of tax holidays, supposedly preferential treatment results in METRs that are actually higher than those under the ordinary income tax system. Similarly, a preferentially low tax rate in a sector can have the effect of increasing METRs if depreciation deductions and other investment allowances under the regular tax system are sufficiently generous.

Method of Finance

MTR analysis is useful in determining whether the tax system favors one form of finance over another. Under a market-based approach to tax reform, such distortions are also undesirable as they imply a tax-induced alteration of the allocation of risk-bearing in the economy. For example, a tax bias toward debt finance may increase the overall indebtedness of firms and thus increase the likelihood that costly bankruptcies – or perhaps even more costly government bailouts – will be incurred during an economic downturn.

In addition, tax differentials across methods of finance may discriminate against certain types of firms. For example, a tax system that results in an unusually high

METR on new share issues will discourage investments by firms that tend to use new issue finance to a disproportionate extent, including new enterprises that have little retained earnings and limited access to debt finance. Again, most public finance economists would argue that neutrality with respect to firm financing decisions is a desirable property of tax system.

Choice of Organizational Form

METR analysis identifies the extent to which the tax system distorts decisions regarding the choice of organizational form. Typically, firms may be organized as corporations subject to the corporate income tax or non-corporate entities that are taxed on a “pass through” basis, with business income attributed to the individual owners and taxed under the personal income tax. Economic neutrality with respect to decisions regarding organizational form is also generally desirable, so that firms may select the form of business organization that best meets their needs without worrying about differential tax consequences.⁵⁵

C Effects of Inflation

An important benefit of METR calculations is that they can be used to demonstrate how tax rate differentials, as well as the level of capital income taxation, vary with the rate of inflation. Unless a tax system is completely indexed for inflation, the pattern of METRs will be different for each expected steady state rate of inflation. The fluctuations of METRs with inflation can be considerable, especially for large differences in the expected inflation rate. Note that such variation in METR levels and differentials with inflation adds an element of complexity to investment decisions, as it makes it more difficult to interpret the effects of the tax system on alternative investments. Such uncertainty is likely to reduce the overall level of investment at any given inflation rate.

⁵⁵As in the case of resource allocation, there may be externalities associated with the choice of organizational form; for example, tax enforcement may be less costly for firms that are publicly held corporations.

Annex C: Marginal Effective Tax Rates on Capital in Mozambique

Marginal Effective Tax Rates for Asset Categories and Sectors

Open Economy Model

Large Companies					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	46%	46%	16%	56%	71%
METR Building	34%	41%	14%	43%	41%
METR Land	8%	8%	38%	-195%	8%
METR Inventory	29%	29%	9%	32%	29%
METR Total	40%	40%	16%	51%	57%

Large Companies – Investment through CPI					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	2%	-19%	-9%	-4%	61%
METR Building	13%	23%	-2%	7%	30%
METR Land	8%	8%	43%	-76%	8%
METR Inventory	29%	29%	2%	24%	29%
METR Total	11%	16%	6%	5%	46%

Marginal Effective Tax Rates for Asset Categories and Sectors Case of Delayed VAT Refunds

Large Companies – Investment through CPI – VAT refund delayed by one year					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	18%	4%	11%	15%	61%
METR Building	13%	23%	-2%	7%	30%
METR Land	8%	8%	43%	-76%	8%
METR Inventory	29%	29%	2%	24%	29%
METR Total	19%	19%	9%	15%	46%

Large Companies – Investment through CPI – VAT refund delayed by two years					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	29%	18%	23%	26%	61%
METR Building	13%	23%	-2%	7%	30%
METR Land	8%	8%	43%	-76%	8%
METR Inventory	29%	29%	2%	24%	29%
METR Total	25%	21%	12%	22%	46%

Large Companies – Investment through CPI – VAT refund not given					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	60%	57%	58%	59%	61%
METR Building	13%	23%	-2%	7%	30%
METR Land	8%	8%	43%	-76%	8%
METR Inventory	29%	29%	2%	24%	29%
METR Total	48%	33%	26%	48%	46%

**Marginal Effective Tax Rates for Asset Categories and Sectors
Small Companies & Closed Economy case**

Small Companies ⁵⁶ (registered under Simplified VAT)			
	Manufacturing	Tourism	Agriculture
METR Equipment	79%	79%	72%
METR Building	77%	78%	71%
METR Land	75%	75%	73%
METR Inventory	76%	76%	70%
METR Total	78%	78%	71%

⁵⁶ It is assumed that the Small Manufacturers operate as companies rather than sole proprietorships.

Annex D: Cross-country analysis

For purposes of comparison, Tables C1-C4 provide the METRs on capital income in Lesotho, South Africa, Rwanda, Tanzania and Zambia (all assuming large firms, in an open economy).

The METRs are calculated for the general tax system in each of these countries and reflect only provisions available either to all firms or to all firms within one of the sectors analyzed in the report; that is, the report does not consider incentives granted to specific firms within a sector or to other categories of firms such as exporters or firms in tax-favored regions. Since the treatment of mining is relatively idiosyncratic, the comparison examines the tax treatment in the other four sectors – manufacturing, tourism, agriculture and financial services. Full details of the tax data used to compile these tables can be found in the relevant FIAS report at <www.fias.net>

Table D1: 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%

These results suggest that METRs in Lesotho are generally higher than those in South Africa, Zambia, Tanzania and Rwanda, except in Manufacturing where Lesotho is very competitive.

In Tourism and Financial Services, Lesotho’s METRs are the higher than economies studied so far by FIAS in Africa. These seemingly anomalous results (given Lesotho’s low headline corporate tax rates) highlight the importance of looking at how the tax structure as a whole impacts on the marginal tax on capital (i.e. taking into account depreciation allowances, etc.)

However, care needs to be taken before generalizing that “despite Lesotho’s new low corporate income tax rates it remains a high tax location for investment outside manufacturing”. Such a conclusion would be erroneous because it is very difficult to determine one standard tax regime across countries, against which to benchmark METRs. Further, this result needs to be put into context (i.e. is tax a

driving force behind the investment decision or not – see the Tourism chapter for more details).

Finally, it is worth noting that METRs in developed (OCED) countries are not necessarily lower than developing countries. The average METR on manufacturing in Canada for example is 35.5%, in Australia 29.4%, New Zealand 30.1% and India 23.2%. All of these are higher than the METR in manufacturing in Tanzania (15.3%).

Commentators typically believe that developed countries can sustain higher effective tax rates on capital than less developed countries, simply because developed economies have other characteristics that are attractive to capital investment. Less developed economies, on the other hand, need to impose low taxes on capital in order to overcome the lack of these other factors and attract capital.

Annex E: Recommendations from Bolnick (2004)

	Bolnick
IRPS	<ul style="list-style-type: none"> • Establish a joint public/private task force to identify detailed provisions of the IRPC and IRPS codes that can be simplified without a significant loss of revenue or administrative control.
IRPC	<ul style="list-style-type: none"> • Raise the threshold for the <i>normal company tax</i> to perhaps \$200,000 per year of turnover (implying a net income level of about \$40,000 per year). • Adjust the threshold annually to compensate for inflation, to avoid dragging smaller entities into systems that exceed their capabilities. • Accelerate implementation of the indirect tax regime under IRPC by conducting necessary studies and issuing ministerial diplomas to determine the appropriate indicators. • Establish a joint public/private task force to identify detailed provisions of the IRPC and IRPS codes that can be simplified without a significant loss of revenue or administrative control. • Reduce the IRPC rate and the maximum IRPS rate from 32 % to 25 %, as fiscal conditions allow. • As a priority, reduce the double taxation of dividend income by adopting provisions to integrate the company tax and the individual tax on dividends, at least partially.
VAT	<ul style="list-style-type: none"> • Raise the registration threshold for the <i>normal VAT</i> regime to perhaps \$50,000 per year of turnover. • Raise the registration threshold for the <i>simplified VAT</i> regime to perhaps \$25,000 per year of turnover, to eliminate tax obligation for very small and micro enterprises. • Adjust these thresholds annually to compensate for inflation, to avoid dragging smaller entities into systems that exceed their capabilities. • <i>Contingent on the fundamental need for prudent fiscal management:</i> Reduce the standard VAT rate from 17 % to 14 %. • Enhance the transparency of VAT refund administration by publishing monthly reports on claims and approvals. • Provide clear and regular information to the public about procedures and requirements for VAT refunds. • Adopt risk-based selective audits for inspecting VAT refund claims, including “gold card” treatment of regular exporters with a track record of accurate claims. • Conduct a system audit of VAT refund procedures to ensure that valid claims can be paid without separate approval from the Treasury. • Reduce the volume of refund claims by increasing the threshold for claiming immediate payments, while reducing the carry-forward period for credit positions to 3 months; the volume of refund claims can be further reduced by eliminating “complete exemptions” (zero-ratings) for manufactured products that are not exported. • Activate the public-private Task Force on VAT refunds. • Issue the guidelines for the indirect regime in the new income tax code. • Take urgent steps to expedite VAT refunds, as discussed in the previous section. • Re-assess provisions of the VAT code involving refunds for large capital outlays. • Enforce statutory provisions for the government to pay interest on overdue refund

	<p>payments.</p> <ul style="list-style-type: none"> • Consider amending the stipulated interest payment to establish an interest rate that more closely reflects the actual cost of funds to the business community, such as the prime rate plus 2 percentage points, rather than MIBOR plus 2 percentage points.
Excise	
Customs	<p><i>Contingent on the fundamental need for prudent fiscal management:</i></p> <ul style="list-style-type: none"> • Reduce the maximum import duty to 20 %, and then to 15 %. This would lower the combined rate of VAT plus duty on imports of consumer goods from 46 % to 35 % (which is still high, in terms incentives for tax compliance).
Stamp Fees	<ul style="list-style-type: none"> • Revoke the stamp tax (while applying minimal fees as necessary to cover the cost of essential administrative services).
Incentives	<ul style="list-style-type: none"> • Limit the scope of special tax incentives, and use the revenue so gained to reduce general tax rates. • Continue the program of phased tariff reductions, with the objective of achieving a regime with lower and more uniform tariffs, to reduce the distortions that foster inefficiency and impair backward linkages. • Replace the special customs regime for manufacturing with a low uniform tariff on business inputs (K, M and I). • Review provisions of the income tax code and the code of fiscal benefits to provide stronger incentives for training. • Enhance capacity for tax policy analysis, to ensure that incentive programs are highly cost effective, with a minimum of distortionary side effects—especially side effects that discourage job creation.
SME Tax	<ul style="list-style-type: none"> • Introduce a simple unified tax for very small and micro enterprises, in lieu of the simplified. • VAT and simplified IRPS; exempt entities with an estimated income (based on indirect indicators) below the regular threshold for income tax liability. • Avoid the false expectation that large amounts of revenue can be raised by taxing micro and small enterprises— along with the trap of diverting large administrative resources to this function.

Other (Institutional) Recommendations

- Work with nongovernmental institutions and organizations to establish comprehensive and sustainable training programs for taxpayers and accountants.
- Establish a sustained public information campaign highlighting problems that taxpayers commonly encounter.
- Adopt a public education approach in handling first-time errors in complying with the new tax code, in place of the current penalty approach.
- For targeting higher-income tax evaders, consider introducing a presumptive tax based on objective outward signs of lifestyle.

- Pursue ongoing programs to strengthen and modernize tax administration; in particular, intensify staff training and efforts to fight corruption in the tax service.
- Mobilize special teams to inspect and audit groups that are especially prone to evasion, and (in customs) to perform random checks on import clearances.
- Build capacity in Ministry of Planning and Finance for careful economic and fiscal analysis of alternative instruments for stimulating investment; based on this analysis, eliminate or reduce loopholes and selective incentives that are not cost effective.
- Enhance fiscal transparency by adopting tax expenditure budgeting and issuing regular public reports on the fiscal cost of tax incentives.
- Maximize domestic retention of resource rents from the exploitation of mineral resources and renewable natural resources. This is a top priority.
- Consider the adoption of a corporate Alternative Minimum Tax.
- Enhance tax compliance by pursuing ongoing programs to reform public expenditure management and improve public service delivery.
- Amend the new regime on tax infractions (*Regime Geral de Infracções Tributárias*) to reduce the range of discretion and establish more transparent rules for determining the magnitude of tax penalties.
- End the sharing of tax penalties with officers involved in the decisions.
- Adopt a tough anti-corruption program, including heavy sanctions for errant tax officials.
- Implement the planned Revenue Authority, ensuring that it is adequately funded and professionally managed, without political interference.
- Undertake and publish periodic corruption surveys.
- Allocate staff and financial resources to producing and distributing public information about the tax system, including copies of the tax codes with an up to date consolidation of amendments, and information on regulations and procedures.
- Develop a multi-media public information campaign including radio and television spots on tax issues (as done for traffic violations) and posting of all major tax documents (including authorized English translations) to a well-publicized website.
- Train tax officers, including tax inspectors, to integrate education functions into every contact with the public.
- Assist other institutions and organizations to establish affordable education programs for the public on taxation.

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