



Mozambique:

Study of the Impact of Tax and Licenses on Five Priority Sectors

Aide Memoire

July, 2006

FIAS
a joint service of the International Finance Corporation
and
the World Bank

At the request of the Ministry of Industry and Commerce, FIAS was asked to carry out a study of the effective tax burden in five sectors.¹ The appraisal was extended to include an analysis of tax and customs administration issues, as well as license fees, which affect the business environment. This study is part of a joint FIAS / Department for International Development (DFID) study of eight countries in Africa examining revenue authorities and the tax impact on business. The government, in particular the Ministry of Industry and Commerce, is keen to determine whether the current tax/incentive/license scheme regime in each of the sectors studied is conducive to growth goals and whether these sectors are competitive domestically and internationally.²

This study aims to provide the government with information it seeks through use of marginal effective tax rate calculations carried out in each of the identified sectors and through qualitative analysis about the appropriateness of the tax /incentive scheme carried out by sector experts. Again, the lens through which the tax system is analyzed in this study is responsible growth, not revenue maximization. To this end, the final report will provide analysis and recommendations aimed at improving the effectiveness of the tax and license regime to responsibly promote growth in each sector and will also present cross-country analysis from which international competitiveness will be assessed.

An additional and important component built into this study has been a capacity building exercise, with the group of international consultants tasked to work closely with a counterpart group to transfer the knowledge and methodology underlying such an analysis. FIAS consultants held a workshop in Maputo on Thursday 27th July, which focused on the techniques used in the qualitative and quantitative analysis of the tax/incentive schemes on the five sectors chosen.

The mission worked liaised closely with Ministry of Industry and Commerce, Ministry of Finance (General Tax Directorate, DGI), and Ministry of Planning and Development over the period 14th-28th July and met with government officials, private investors (foreign and local), the Confederation of Business Associations in Mozambique (CTA), trade groups and associations, and the donor community. The mission wishes to express its gratitude to the Government of Mozambique for its close collaboration and cooperation in support of the mission and project.

This aide memoire is divided into three sections. The first section presents the key findings of the study. The second section provides a preliminary analysis of the effective tax burden on the overall tax system and on each of the five sectors studied and the small business regime. The final section outlines next steps. Following the text, the aide memoire includes annexes showing a summary of the contribution of taxes to the total tax take, and the METR results and simulations under different scenarios (vis-à-vis other countries in the region).

¹ Agriculture, manufacturing, mining, financial sector, and tourism.

I. Preliminary Results

After two weeks of data gathering and analysis, the team of tax policy, license and sector specialists offers the following preliminary results, based on the marginal effective tax rate and sector investigations:

Summary of Key Findings

The structure of the overall tax system and investment code is broadly appropriate and conducive to growth of the five sectors studied; however problems remain with specific tax instruments, investment incentives and tax administration which negatively affect the business environment.

While the private sector acknowledges that tax administration has improved over the last five years, substantial capacity constraints remain in both the tax and customs administration.

On a sector-by sector level, outside the CPI Fiscal Benefits regime, our METR analysis indicates that capital investment in the financial services sector is the most highly taxed, followed by mining, tourism, and manufacturing. Under the CPI regime the order changes somewhat: Mining is the least taxed, then agriculture, manufacturing, tourism and finance. (Annex 3).

The marginal effective tax burden on small businesses under the simplified IVA regime face a very high METR on capital of 78% due to the higher cost of finance as compared to large firms, and their inability qualify for CPI Fiscal Benefits because they are too small to qualify (Annex 3).

The investment code provides for standard incentives for all sectors but requires a minimum level of investment. The fiscal incentive regime is complex and yet excludes many benefits which would be of more interest to investors. Mozambique would benefit by having few investment incentives and a more uniform and transparent tax regime.

The DGI does not have an effective program of information dissemination, and has yet to reach small businesses especially in informal sector, thereby missing a potentially large source of growth in the economy.

The problems of excessive licensing and discretionary fines are still a major concern for investors.

II. Preliminary Analysis

Since 1998 Mozambique has implemented several significant tax instruments over the last five years. Notwithstanding this progress, the private sector has the following concerns regarding the current tax regime:¹

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

A. Overall tax regime: Instruments and Policy

1. Tax regime

Since 1998 the Government of Mozambique (GoM) has been phasing in a comprehensive tax reform program to modernize and strengthen the tax system. The arsenal of taxes available to the government is now equivalent with most tax authorities across Africa, and include:

- The value added tax (*Imposto sobre o Valor Acrescentado*, or IVA) at 17%
- Income tax for corporations (*Imposto sobre o Rendimento das Collectivas*, or IRPC) at 32%
- Income tax for individuals (*Imposto sobre o Rendimento das Pessoa Singulares*, or IRPS) at increasing rates up to 32%
- Withholding taxes at 20%
- Stamp Duty (*Imposto do Selo*) at rates from 0.02% to 4%
- Specific Consumption (Excise) Tax (*Imposto sobre Consumos Específicos*, or ICE)
- Fuel Tax (*Taxa de Combustíveis*) currently 3,811 per liter Mtn for petrol and 3,505 Mtn per liter for diesel.

There are also fiscal implications of license fees and fines on business.

2. Macroeconomic perspective (or mix of tax instruments)

Annex 2 shows that Mozambique relies heavily on import taxes (duty and IVA), totaling 41% of revenue. This surprising given the trade weighted average import tariff is only

¹ Taken directly from Bolnick (2004) “Tax Reform and the Business Environment in Mozambique: A Review of Private-Sector Concerns”. This report provides a review of the validity of these concerns.

9%. Using comparable 2004 data, the share of import taxes in Tanzania (32%) or Zambia (29%).

In contrast, Mozambique raises a relatively small share of revenue (28%) from income and profits, despite the IPRC rate of 32%. In South Africa this figure is 57%, Zambia 48% and 30% in Rwanda.

The fuel levy plays an important role in raising revenue in Tanzania, raising 7.3% of revenue as compared to 5.7% in Rwanda and 4.6% in Tanzania.

B. Overall effective tax impact¹

Investments that go through the CPI are provided with Fiscal Benefits, Exchange Control Benefits (the right to repatriate profits) and Import Duty benefits. Typically all foreign investors go through the CPI as this allows them greater freedom in their operations. The requirement to get the benefits through the CPI is only when their investment is more than 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 from these benefits as this condition places an additional burden of compliance on them.

This special CPI Fiscal Benefits regime affects the Marginal Effective Tax Rates significantly. Hence the METRs have been computed for investments through the CPI and the normal regime.

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 20% for the financial sector for investments made through the CPI.

Separate METRs have been calculated for small business and they face very high marginal rates of tax on capital. It is assumed that large businesses have access to international capital markets and as a result their financing costs are considerably lower. Sector-wise descriptions of the METR, as well as qualitative issues affecting them, are given below.

C. Sector Effective Tax Impact

1. Agriculture

Agriculture in Mozambique faces many significant challenges, including poor rural infrastructure, land tenure issues and difficulty in meeting the standards required for exports.

¹ Appendix 1 provides a full description of the METR analysis.

There is no shortage of studies and reports into the obstacles and policy responses needed to stimulate growth in the agricultural sector. ***Tax is rarely, if ever, raised as a major issue hindering development.*** This is not surprising given the other challenges the sector faces and the significant tax benefits which accrue to the sector. IPRC is effectively 2% (80% of 10% until 2010) for those who benefit from the Fiscal Benefits code. The majority of inputs and outputs are IVA exempt or zero rated (although IVA remains on some inputs, notably fuel and electricity). In addition, large scale investments have been able to negotiate bespoke tax arrangements, for example in the Zambeze River Valley. Finally, one of the largest tax burdens commercial agriculture routinely encounters is on fuel (import duty at 5%, IVA at 17% and the *taxa de combustiveis*); although this is an input tax and not a tax on capital. However, the sector has recently been able to lobby for 50% reduction in the *taxa de combustiveis*.

Certain crops also have industry specific tax regimes, such as the 18% export tax on unprocessed cashew nuts and the variable import levy on sugar. These public policy instruments have been widely analyzed and the arguments for and against are broadly known.

Fishing (mainly shrimp) is an important industry in Mozambique, especially for export earnings. Again, the industry's largest tax contribution is through IVA, import duty and the *taxa de combustiveis* on fuel. The industry has been able to negotiate a 50% reduction in this levy, up to a maximum amount per ship (as determined by the Ministry of Fisheries). The industry also pays a license fee for access to the (renewable) shrimp resource as well as for by-catch. The fishing industry, and larger agro-processing operations (especially those exporting) face many problems common across the private sector, including VAT refunds, duty drawback problems and fines.

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.

2. Mining

Mining is currently subject to a panoply of special tax regimes and exemptions. All mining projects are exempted from customs duties on imported materials, equipment and spare parts throughout the project life, and are also exempt from IVA and excise taxes on imported materials, equipment and spares during the exploration and development phase. 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% reduction in the corporate income tax rate until 2010, as well as the flexibility to negotiate their own tax regime. 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 stones, 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 can negotiate an investment tax credit that reportedly can reach 25%, 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 rendered ineffective because the long development lead time for most mining projects exceeds the five-year limit for loss carry-forward.

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 \$5,000.

The new fiscal regime for mining (drafted in 2003 but yet to be passed¹) 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 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.

Most provisions of the proposed new mining fiscal regime represent a clear improvement over the existing system. It 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.

The new draft law, however, allows mining companies to apply royalty payments as a tax credit. This is contrary to standard international practices, which allow deduction of royalties from taxable income but not their application as a tax credit. Mining companies do not receive such a benefit elsewhere and do not expect it in Mozambique.

¹ We are aware of a recent comprehensive review of resource taxation undertaken by a joint World Bank, IMF and DFID funded initiative.

The cost of applying royalties as a tax credit would be more than three times as high as applying them as a deductible expense.

The METR for the 'normal' mining 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 (described above) which 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.

3. Manufacturing

Manufacturing firms in Mozambique are subject to the general tax regime, under which they are particularly burdened by high administrative costs and uncertainty arising from discretion in tax administration. Manufacturing businesses fall under three categories: (i) mega-projects and *zona franca* firms which benefit from special fiscal incentives; (ii) other manufacturing such as food processing, beverages, leather products and apparel, plastics which can apply for the general incentive scheme, and (iii) small and micro enterprises that manufacture handicrafts, furniture etc. which are either below the minimum tax thresholds or avoid taxes and operate in the informal sector.

In general, firms in the manufacturing sector acknowledge the improvement in the tax system in recent years. No special tax regime for manufacturing sector, so 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 IVA 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 IVA invoices), and that there is discretion in determining assessments and penalties. Also, it is perceived that requirements such as the 10-year allowance to check past accounting records are not practical or necessary.
- ***Complicated and time-consuming procedures.*** For example, some manufacturing firms claim to not take advantage of tax and duty incentives 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 IVA refunds, some eligible small/medium sized businesses have stopped claiming IVA credits.

- ***Non-refunding of excess advance corporate tax.*** Firms are required to pay quarterly advance corporate tax payments based at 80% of taxable income from 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.
- ***Delays in IVA refunds.*** Manufacturers face delays on IVA refund claims which can range between three months to four years. This problem is more severe for suppliers to IVA exempt industries (e.g. Mozal) and exporters (e.g. textiles). IVA refund claims currently trigger automatic audits. Anecdotal evidence suggests that some firms are able to expedite IVA refunds through informal payments. Yet, there has been recent progress in refunding claims, including a legal amendment (decree yet to be issued) to allow the off-setting of IVA credit against other tax liabilities. Until such measures are implemented, delays will constrain the cash flow of firms especially given that the cost of capital is high.
- ***Breaks in IVA chain.*** A significant issue for domestic firms relates to not being able to claim input IVA due to sales to IVA exempt businesses or due to non-registration and non-compliance of many small suppliers or buyers. Firms in agro-business that source inputs locally from farmers that are mostly not IVA registered are also unable to claim IVA on inputs.

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 which provides duty free inputs to firms that add at least 20% value in production. Eligibility is restricted to firms with sales of more than Mtn 3 million in six specified sub-sectors¹. The scheme applies to imports of raw materials and intermediate goods that are *not* available domestically. According to the Ministry of Industry and Commerce, the application process takes 15 days. However, the scheme is biased towards large firms which qualify for the exemption and can meet the high administrative requirements (for example firms claim that assembling required documentation takes far longer).

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 under the Fiscal Benefits code, 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

¹ Textiles, clothing and footwear; food processing; other agro-based industries; metal mechanical, chemicals, plastics and rubber

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.

4. Tourism

The tourism industry receives favorable treatment in the investment code compared to investments in a number other sectors; however these incentives provide very little benefit. Accelerated rates of depreciation have limited impact due to limitations on loss carry forward. Investments tax credits are also not applicable to most capital equipment and machinery in the sector and customs duty exemptions are only applied to items in class K almost all of which are not imported by the tourism sector.

Poor local production and the high reliance on imports place a relatively significant burden on the profitability of all tourism businesses and have an impact on the viability of investments. Greater impact is felt in highly elastic sub-sectors such as the leisure beach tourist market, which have to compete with other beach destinations such as Zanzibar, Thailand and Mauritius, where import duties have little or no effect. This is also further exacerbated by relatively higher IVA rates vis-à-vis other major competitors such as Mauritius, Seychelles, Thailand and Maldives.

The main issue amongst tourism businesses, especially in outlying areas, relates to the inconsistent and irregular administration, collection and monitoring of taxes, invariably resulting in unjustifiable, excessive and regular (yearly) fines and penalties. Formal legal recourse is usually not sought due to the laborious, time consuming and costly legal process, usually resulting in settlements through informal payments.

Although tax can be considered as an impediment to growth there are a number of other factors of equal or greater importance impacting on the sector. These include: cost and access of flights, poor infrastructure, administrative barriers, bureaucracy, low labor productivity, lack of skilled staff, limited international marketing and exposure and high cost and limited access to finance.

IVA is applicable to all goods and services in the tourism sector which increases the compliance and simplicity of IVA, 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-IVA and IVA revenue generating products and services.

Yet IVA is not working equitably and efficiently in the tourism sector. Large proportions of suppliers to the tourism sector are informal and not IVA-registered, resulting in a break in the IVA chain. Although IVA tax revenue is lost through this process, revenue is gained through the introduction of a 20% withholding tax on purchases from non registered suppliers or purchases from suppliers' with non compliant invoices. This tax is not only an effective means of raising revenue (thus combating revenue lost through the IVA system)

but also, theoretically, promotes formality by encouraging non-registered vendors to drop prices or form part of the formal system.

Tourism bears an METR of 40% in the 'normal' regime. Under the CPI regime on the other hand the METR drops to 16%. 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 (including furniture, fixtures and fittings) and as hotels are building intensive the actual tax benefit is lower than the additional rate suggests. 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 faces a very high METR of 78% due to the higher cost of credit as they do not have access to foreign credit markets.

The setting up of a tourism business remains complex, time consuming and costly which places considerable burden on foreign investors and on smaller businesses in the tourism sector. Business start-up and registration processes consist of many unnecessarily complex and sometimes discretionary procedures requiring approvals from multiple sources, this coupled with the lack of definitive guidelines, makes it almost impossible to undertake this process without assistance from professional service providers.

Operators receive frequent yearly inspections from various authorities. Clear guidelines on requirements and standards upon which inspections are based are not available. Inspections are highly discretionary and subjective resulting in liberal interpretation of the laws by inspectors. Fines are a frequent occurrence especially in tourism businesses in the outlying areas. In cases where fines are issued the main purpose does not seem to be to correct the issue but more as a means of raising revenue or an opportunity to settle the issue through informal payments.

5. Financial Sector

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.

Financial services are exempt from IVA; they are instead subject to stamp duty, which is applied at different rates to financial transactions. The current Code of Stamp Duty, which came into effect in April 2004, lists more than 120 transactions subject to stamp duty. 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. The most recent Stamp Duty code and schedule was introduced without prior consultation with financial institutions and without any period to allow institutions to adapt their IT and accounting

systems. 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, it is not clear the DGI has adequate IT and human resource capacity to manage a system of such complexity.

Stamp duty is payable immediately when a transaction takes place, even if the transaction is subsequently cancelled or its value reduced. In such cases, 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 reconciliation.

Financial institutions are required to pay estimated corporate income tax in advance, amounting to at least 80% 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.

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 bear a lower METR of 20% 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.

6. Customs

Mozambique's trade policy is among the most progressive in SADC. The top tariff is only 25%, the average applied tariff rate is 12.1% and the trade-weighted average tariff is only 9%. Mozambique has eliminated specific tariffs in favor of ad valorem duties. Mozambique's effective rate of protection, while still offering significant protection, in most sectors is lower than for most of its Southern African neighbors.

Customs administration 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 far worse than the OECD average of 12.6 days for exports and 14 days for imports and worse, too, 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 small 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 Intertech Co., at considerable cost to importers; 3) lack of a properly-functioning duty drawback/duty suspension and IVA rebate system. In addition, a long-term Customs reform contract carried out by Crown Agents endowed Mozambican Customs with a proprietary Crown Agents trade management information system (TIMS) in preference to ASYCUDA or another system that might be more commonly used and which would offer greater compatibility with other countries' systems. Since Crown Agents shifted from an operational to an advisory role, corruption has reportedly increased, and revenue collection has dropped somewhat.

The World Bank Group has already provided some financial support to construction of a dry port adjacent to the Ressano Garcia customs post on the main road border between Mozambique and South Africa. The dry port may be expanded to accommodate rail traffic as well, and should substantially reduce clearance times. Additional Bank Group support should focus on training and capacity building for Customs officers and management and for customs brokers and agents, and may also include financial and technical support for introducing better IT and management information systems and training Customs personnel in their use.

7. Small Business

The narrow tax base in Mozambique is attributed to, amongst other factors, tax policies and administration that create disincentives for business registration. The administrative burden of complying with tax obligations falls relatively more heavily on smaller than larger businesses. As a result, many small businesses operate in the informal economy (estimated at above 40% of GDP in Mozambique). About 90% of the approximate 32,000 private sector firms in Mozambique are small (when defined as less than 10 employees). However, there is no uniform definition of a small business under the IRPC, IRPS and IVA as reflected by the different thresholds.

There is no special income tax regime for small businesses leading to high compliance costs. Small businesses are taxed under the general corporate tax (IRPC). We understand that a majority of small entrepreneurs are sole proprietors and thereby subject to the individual tax (IRPS). While maximum rates of the IRPC and IRPS are harmonized, the lower bands of IRPS and the high dividend tax under IRPC (32% for local firms) effectively reduce the incentives for incorporation.

The majority of small businesses are unable to keep proper records, maintain the necessary documentation, and cannot afford qualified accountant services. 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. 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).

The income tax code includes a simplified system for small enterprises without proper accounts. 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. Where small businesses find these bookkeeping requirements still too complicated, taxable income is determined through indirect assessments based on simple standard indicators for different types of businesses. In practice, since income (or turnover for IVA) has to be estimated for small businesses without adequate accounts, this leads to venues for negotiation and discretion by tax officials.

Small business under the Personal Income Tax (IRPS) are eligible to a presumptive regime on entrepreneurial or professional income. This regime allows simplified accounts and income is presumed to be 20% of revenue from the sale of goods and 30% of other revenue.

There are also provisions in the income tax code to encourage firms to formalize. Firms can withhold income of unregistered suppliers at 20% of turnover. This is higher than the 17% tax on sales under the IVA regime (which can be deducted), or 5% under the simplified IVA regime.

A simplified IVA regime exists for small businesses. Under the simplified IVA regime, a business with a turnover below Mtn 250,000 is levied a 5% tax on sales. Businesses with turnover below Mtn 100,000 are exempt from IVA. Over 40% of all IVA registered taxpayers (46,800) fall under the simplified regime, consisting largely of sole proprietors (18,600) and also corporations (560). While this reflects the low threshold for IVA registration, the actual number of *active* taxpayers under this system may be significantly lower.

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

In addition, taxes are 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 tax obligations levied on businesses include, for example, signage tax, where small businesses complain that they are un-informed of such requirements are thereby levied penalties for non-compliance (Section D).

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.

D. License Fees and Fines

Sub-national level. Mozambique is in the process of creating autonomous municipalities (*autarcias*) throughout the country. At the moment, there are 43 municipalities established covering most of the larger cities. Smaller towns and the countryside are governed by the provincial government on behalf of the state government. Business costs at the municipality level include:

- Annual business tax;
- Daily business tax for small businesses;
- Property tax;
- Residential tax;
- Other licenses.

Each municipality sets these taxes and fees individually within a range set by the state in the Laws and Decrees on the Municipalities.

Annual business taxes. Each business has to pay annual taxes to the municipality. The tax is calculated by the location and per square meter of the business premise.

Daily business taxes for small businesses. Small businesses in markets or on the streets are taxed by day. The tax is a very low flat rate, administered by the Municipal Police.

Property Taxes. The property tax is calculated by the value and the size of the location. The tax is not very high and many municipalities, like the City of Maputo, have problems to collect the tax due to low capacity.

Other Licenses. Municipalities have the right to create certain licenses for activities in the borders of the city. Some of these licenses are business related, for example, annual licenses for using advertising signs on the business building or car, the unloading of trucks on the street, the use of space in front of the business location.

Municipalities part of the process to decide on applications for the Business license from the Ministry of Industry and Commerce (see below).

National level. The main license for business activity is the License from the Ministry of Industry and Commerce. This license must be obtained by any business that is not licensed by a line-ministry (e.g., Ministry of Tourism). Although the GoM recently enacted a new law on licensing it is still the case that essentially all economic activities require licensing. As pointed out in previous FIAS studies of administrative barriers to investment (1996 and 2001), this heavy approach to licensing is increasingly anomalous

in the global market economy and tends to deter investment. Currently, the license is issued for small and medium businesses at the provincial level while large businesses are licensed at the state level in Maputo. After a business submits an application, a commission containing representatives from the Ministries of Health, Environment, Industry, and the City Council will inspect the premise and issue a report with recommendations. The Ministry of Industry and Commerce will issue a decision based on the report. A license fee must be paid to the Ministry of Finance.

To speed up the process, the Ministry is in the process of setting up “One-Stop-Shops” for licenses at the provincial level. Where established, businesses confirmed that the situation has slightly improved but said also that facilitation is not simplification and that most problems are caused by complicated and non-transparent procedures. To ensure operation before the license is issued, a provisional license valid for 3-months can be obtained. Renewal of the final license is necessary. Compliance will be ensured through inspections by the Ministry of Industry and Commerce. ***The inspectors are entitled to keep 25% of all fines issued. It is not clear how those funds are distributed within the inspectorate among the employees.*** It appears that there is a common fund that will be distributed according to a formula among employees of the inspectorate.

Issues. In general, businesses do not consider municipal taxes or activity licenses as high or problematic.

However, the ***municipalities’ involvement in the commission to issue the business license*** from the Ministry of Industry and Commerce may cause considerable problems. The councils appear to have considerable discretion. There is a lack of transparency about the requirements for each type of business and some businesses reported requests for bribes.

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 requirements and decision criteria are non-transparent. Businesses often do not know about the decision criteria. The laws do not describe requirements clearly and the Ministries do not issue such information.

Unreasonable inspection services. Related to the lack of transparency are the problems caused by inspection services. The conditions cited in two previous FIAS studies of admin barriers to investment have not improved. Businesses often do not know the requirements to be fulfilled and become an easy target for fines. Although the Ministry states their task in educating businesses about the requirements, businesses have the strong feeling that they are deliberately kept in the dark to allow for more fines.

Inappropriate incentives for inspectors. Inspectors appear make a considerable part of their income through collection of fines. Therefore, they have a strong incentive to collect as much revenue in fines as possible.

Among the many businesses interviewed by FIAS, the most common complaint was that fines were assessed on what appeared to be an arbitrary basis. The fines are said to be often quite severe.

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.

High fines. Fines are kept high for the mentioned reasons. When in doubt, the highest allowable fine is usually chosen by the inspector.

FIAS would recommend that the new Ministry of Finance policy be extended to all government inspectorates. Further, all regulations that businesses are expected to comply with should be made publicly available. Inspectors should be required to prepare a written report for all inspections, with a copy for the business that was the subject of the inspection, stating the objective infractions and citing the law or regulation that is applicable. Businesses should have an opportunity to rectify the problem or appeal before a fine is issued.

Inappropriate incentives have a negative impact on two levels: the inspector him or herself and the Ministry as a whole is interested in high fines. This affects the willingness of the entire Ministry to reform, not only the inspectorate. It also means that reform has to target also the budgetary rules. Finally, reform needs to take into account that the inspectors may try to replace the lost income from fines by corruption. Because, we should not forget, the inspectors have still the stick of imposing fines even if part of the fines do not end up in their pockets after reform.

III Proposed Next Steps

FIAS will produce a draft report to present to the government within 6 weeks, during which the tax team will complete the METR comparator country analyses and complete the tax policy and license analysis. The report will include conclusions and policy recommendations based on international best practice where appropriate.

Simultaneously, the FIAS team will give the Ministry of Commerce and Industry, and Ministry of Finance a complete METR spreadsheet/program which can be used to do further analysis. Technical support for this program will be supplied by the FIAS team.

The FIAS team benefited from several diagnostic reports on the investment climate in Mozambique, including the ‘Bolnick’ report for the CTA, the World Bank’s Investment Climate Assessment and the Diagnostic Trade Integration Study (DTIS). The priority for Mozambique, with support from development partners, would appear now to be in the area of implementation.

Annex 1: Marginal Effective Tax Rate Analysis

The underlying economic assumption for our METR analysis is that any “real” capital investment is feasible only with the expectation that the rate of return to capital is sufficient to cover the cost of capital from the point of view of a capital investor. The cost of capital includes financing cost, replacement cost, and tax cost. METR is the tax cost as a share of the cost of capital net of replacement cost and net of the rate of return required by a “financial” investor who provides funding to the real capital investor. METR is different from the statutory income tax rate because it takes into account not only income tax but also other taxes affecting the cost of capital (such as an indirect tax on capital inputs), and it considers not only statutory tax rates but also various tax allowances that make the effective tax rate differ from the statutory tax rate. Finally, tax regimes interact with non-tax economic and business conditions and often produce unexpected but explainable variations in tax cost measured by METR for different business sectors. Accordingly, the METR is a useful quantitative tool for designing a tax structure that minimizes tax distortions among business sectors and so produces a more efficient, fair and simple tax structure.

It is important to emphasize that the METRs calculated for this study measure the effective tax burden on *capital*, and that other taxes that corporations pay that do not impinge on the rate of return to capital, such as payroll taxes, are not reflected in the METR on capital. Results of METR analysis can be found in Table 1 of the statistical appendix

Preliminary calculations of the METRs on capital for Mozambique are provided for several sectors and four asset types in Table 2. It is important to point out that this table is based on several underlying assumptions, each of which can substantially alter the results. A more detailed discussion of these assumptions will take place in the final report, however at this point it is worth highlighting two of them. The first is that the METRs presented in Table 2 are for domestic investments; that is investments that are financed by domestic shareholders and not by foreign multinationals or branch plants.

Annex 2. Mozambique tax instruments. Comparison with Lesotho, South Africa, Tanzania and Zambia.

Year 2003/4	S. Africa	Rwanda	Zambia	Tanza- nia	Lesotho*	Mozam- bique**
Type of tax (%)						
1. Direct taxes	59.9	30.6	47.6	29.22	24	28
1.1. Tax on income and profit	57.3	30	47.6	29.22		28
1.1.1. Companies	18.3	13.7	6.6	7.86	5	11
- Large companies		7.2				
- Small enterprises		3.3				
- Arrears		3.2				
1.1.2. Individuals	36.9	14.4	37.0	15.93	18.00	17
1.1.3. Others	2.1	1.9	4.0	5.43	1.0	
1.2. Property taxes	2.6	0.6		0.79		
2. Taxes on goods and services	36.0	50.1	41.1	58.61		52
2.1. Excise taxes	10.7	14.2	13.0	15.38		12
2.1.1. Beer		5.2				4
2.1.2. Wines & Liquors		0.3				
2.1.3. Petrol		5.7				8
2.1.4. Cigarettes		1.4				1
2.1.5. Lemonade		1.4				
2.1.6. Vehicles		0.1				
2.1.7. Powder milk		0.1				
2.2. Turnover tax / VAT	25.3	33.3	28.1	38.61	17.00	40
of which: on imports		16.9	17.5	22.10		24
2.3. Road Fund / Fuel Levy		2.7		4.62		
3. Taxes on international trade	3.3	19.3	11.2	14.48	60.00	17.2
3.1. Export tax	0.0	0.0				0.3
of which coffee		0.0				
3.2. Import tax	3.3	15.7	11.2	9.53		16.9
3.3. Other	0.8	3.6				2.6
Total tax revenue	100.0	100.0	100.0	100.00	100.00	100
Grants in percentage of total revenue	0	46.5	17.1	41	n/a	48%
Tax revenue as percentage of GDP, est.)	25	14.0	18.0	12.03	44.5	14.5

* Data for Lesotho is estimate for the year 2005-06

** Based on Data for first half of 2006

Annex 3. Marginal Effective Tax Rates for Asset Categories and Sectors

Large Firms					
	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 Firms – Investment through CPI					
	Manufacturing	Tourism	Agriculture	Mining	Finance
METR Equipment	2%	-19%	-9%	-4%	7%
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%	20%

Small Firms¹ (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%

Comparison of METR across countries and sectors					
	Rwanda	South Africa	Tanzania (with cess)	Lesotho	Mozambique (through CPI)
Agriculture	7%	5.7%	23.1%	18%	6%
Manufacturing	7%	21.3%	15.3%	11%	11%
Tourism	13%	13.9%	14.9%	43%	16%
Finance	28%	29.8%	28.9%	51%	20%

¹ It is assumed that the Small Firms operate as companies (IPRC) not sole proprietors (IPRS).