PARPA II Review—The Tax System in Mozambique

Nathan Associates Inc.

September, 2009

Abstract

This study is part of a wider evaluation of government performance in achieving the PARPA II objectives, with the ultimate goal of promoting rapid, broad-based and sustainable growth to improve standards of living and welfare for the people of Mozambique. In particular, the study examines the impact of the tax system on revenue mobilization, investment, savings, job creation, and private sector development, with special attention small and medium enterprises, as well as the issue of tax equity. The study draws on a review of the tax laws and other documents and studies relating to the tax system; an analysis of data on revenue performance, including international comparisons; and extensive field interviews conducted in July 2009.

Principal features of the tax system accord well with best practices for developing countries, including reliance on a broad-based value added tax, a modern income tax, with moderate import duties, excise taxes on selected products, and a simplified tax for small contributors (ISPC). The government has also made notable progress in improving tax administration since the establishment of the Revenue Authority (AT) in 2006. Nonetheless, serious challenges remain in the area of modernizing tax administration.

The study therefore finds few opportunities to achieve sizeable revenue gains through changes in tax policy, but huge potential for improving the revenue yield by strengthening tax administration, through measures that will broaden the effective tax base, allocate AT resources more efficiently, and facilitate taxpayer compliance.

Based on the analysis, the study identifies 12 priority issues for the next PARPA period, and recommends corresponding measures for consideration by the government. On the central issue of establishing a medium-term revenue target, the study suggests options ranging from 16..5 to 18.5 percent of GDP depending on the desired balance between revenue enhancement and tax relief for the private sector. Other priority issues relate to reducing tax rates; tax policy analysis; functional integration of tax operations; e-taxation; risk management; simplification; taxpayer services; the tax culture; tax training; EITI implementation; and donor coordination.

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Main Findings on the Tax System

Since 1998, all of the main tax instruments have undergone deep reform. Principal features of the system are now well aligned with best practices for developing countries, including primary reliance on a broad-based value added tax and a modern income tax, supplemented by excise duties on selected products and moderate import duties. The government has made notable progress, too, in improving tax administration since establishing the Revenue Authority (AT) in 2006. As a result, most of the PARPA II tax objectives have been realized, including the central aim of boosting revenue from 14.0 percent of GDP in 2005 to 16.2 percent by 2009. The actual figure for 2009 will fall short of this mark due to weak economic conditions, but AT data show that the ratio reached 16.4 percent in 2008. Other achievements include enacting a new General Tax Law clarifying rules for tax collection and taxpayer rights; rationalizing fiscal benefits, in particular ending the special regime for large projects; passing a new Municipal Finance Act; ewasing the burden on small businesses by increasing tax thresholds and enacting a Simplified Tax for Small Contributors (ISPC); and strengthening the tax regime for the mining and petroleum sectors. Several objectives, however, are still works in progress. These include integrating tax and customs information systems; tax collection via the banks; improving audit revenues relative to total revenue; modernizing tax administration; and implementing tax courts.

There is little scope for revenue gains through further tax policy measures, but great potential for increasing revenue by broadening the effective tax base, allocating AT resources more efficiently, and facilitating taxpayer compliance through further measures to modernize tax administration. These include functional integration of tax and customs operations; automation of procedures and systems; risk management; human resource management; and development of a service culture among tax officials. Most of the required measures are incorporated in the AT's Strategic Plan for 2009-2010. To be effective, it is essential that the reforms are carefully planned, properly sequenced, adequately funded and well managed.

The tax system in Mozambique is reasonably progressive. The poor bear very little of the tax burden as a result of high thresholds for entering the tax net (relative to per capita income), the low tax rate on small contributors via the ISPC, the progressive rate structure under the individual income tax, and the structure of zero ratings and exemptions for basic necessities under the VAT. However, import duties and excise taxes on goods consumed by the poor have regressive effects.

Taking into account the strong revenue growth since 2000, the likely effects of recent policy reforms, prospective reforms to tax administration, and the natural responsiveness of revenues to economic growth, it should be possible for the government to achieve a revenue ratio of 18.5 percent of GDP by 2015, including tax and non-tax revenues. International benchmarks suggest, however, that it is very difficult for low-income countries to boost revenue beyond 18 to 19 percent of GDP without special conditions such as oil wealth. In setting the medium-term revenue target, the government should strike a balance between public and private resource requirements for national development, job creation and sustainable growth. This consideration suggests that a portion of the revenue gain from reforms and the underlying economic dynamics should be used to reduce tax rates, rather than aiming solely for a maximum revenue ratio.

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Main Findings: Impact on Private Sector Development

Standard tax rates on businesses in Mozambique are now slightly above the regional and international averages, due to the global trend towards lower company taxes. Nonetheless, the prevailing tax rates should not be a deterrent to most investments, because other aspects of the business environment are far more important in determining the viability of most projects. Lower tax rates would, however, increase the capacity of existing firms to finance expansion and improve productivity by boosting net earnings and cash flow. One case where tax rates have a critical effect is on internationally mobile ("footloose") investments that could easily go to other countries; these investments, however, should be covered by the fiscal benefits applying to IFZ enterprises, which are highly competitive. In contrast, the effective tax rate is very burdensome for investments that lack special incentives and face double taxation of dividend distributions to individual shareholders. This feature of the tax code creates a disincentive for incorporation.

The tax system affects the efficiency of investment, as well as the level. Special tax breaks under the Code of Fiscal Benefits tend to have the greatest impact on investments with relatively low rates of return, since projects with an intrinsically high return would be undertaken anyway. The fiscal benefits also tilt the playing field in favor of new investors who qualify for tax breaks, relative to existing businesses and other investors—especially small businesses. Similarly, tax benefits that lower the cost of imported capital tend to encourage capital intensity and import dependence, which inhibits the extent of job creation and domestic linkages. Business linkages to small enterprises are also hindered, in less obvious ways, by the need for registered entities to obtain proper tax receipts from suppliers under the VAT and income tax, as well as provisions for 20% withholding tax on various transactions.

The quality of tax administration also has an important effect on investment and business operations. Indeed, concerns about arbitrary and punitive enforcement practices by tax officials, complexity of the tax system, lack of taxpayer services, and difficulties in recovering refunds are far more prevalent than complaints about the level of taxes. These problems particularly affect small and medium size enterprises: the primary engine of job creation for the economy.

Tax rates, compliance costs and complexity of the tax system also affect decisions by small businesses to formalize. The Simplified Tax (ISPC) passed in 2009 should go a long way towards reducing these tax-related barriers, if effectively implemented. The VAT, too, creates incentives for formalization, for any small enterprises that wish to do business with VAT-registered companies. Incentives to formalize are also influenced by the cost of non-compliance, which is determined by the AT's capacity to enforce registration requirements.

The effect of the tax system on saving is complex. Higher taxes could reduce business and household saving but increase government saving, leaving an ambiguous net effect in the short run. In the medium to long term, however, the most important consideration is how the tax system affects the growth of income, which is the primary determinant of saving.