



REPUBLIC OF MOZAMBIQUE

TECHNICAL ASSISTANCE REPORT — TOWARDS MORE EFFICIENT NON-RESOURCE TAXATION — A STRATEGY FOR REFORM

January 2023

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Mozambique

Towards More Efficient Non-Resource Taxation: A Strategy for Reform

Artur Swistak, Li Liu, and Ricardo Varsano

Technical Assistance Report | March 2017



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Technical Assistance Report

March 2017

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ACRONYMS

ABV	-	Annual Business Volume
AT	-	Mozambique's Tax Authority
B2B	-	Business to business (transaction)
B2C	-	Business to consumer (transaction)
CFB	-	Code of Fiscal Benefits
CGT	-	Capital Gains Tax
CIT	-	Corporate Income Tax (IRPC)
EU	-	European Union
FAD	-	Fiscal Affairs Department
FDI	-	Foreign Direct Investment
FOB	-	Free on board
GDP	-	Gross Domestic Product
GFS	-	Government Finance Statistics
HBS	-	Household Budget Survey
ICE	-	Tax on specific consumption (excise tax)
IMF	-	International Monetary Fund
INE	-	National Statistics Institute
ISPC	-	Simplified income tax
MEF	-	Ministry of Economy and Finance
METR	-	Marginal effective tax rate
MT	-	Meticals
MW	-	Minimum wage
OECD	-	Organisation for Economic Co-operation and Development
PIT	-	Personal Income Tax (IRPS)
SADC	-	Southern African Development Community
SARS	-	South Africa Revenue Service
TA	-	Technical Assistance
TSC	-	Tax on petroleum products
VAT	-	Value Added Tax (IVA)

PREFACE

In response to a request from the Minister of Economy and Finance, Dr. Adriano Alfonso Maleiane, a technical assistance mission visited Maputo, Mozambique during the period November 15–29, 2016. The mission comprised Artur Swistak (head), Liu Li (both FAD) and Ricardo Varsano (FAD external expert).

The mission met with and delivered this aide memoire to the Minister of Economy and Finance, Dr. Adriano Alfonso Maleiane and to the President of Mozambique's Tax Authority, Ms. Amelia Nakhare, at the closing meeting on November 29, 2016.

During its stay in Maputo the mission met and held discussions with the President of Mozambique's Tax Authority, Ms. Amelia Nakhare and her staff; the Director National at the Ministry of Economy and Finance, Mr. Vasco Correia Nhabinde and his staff, Mr. Danubio Lado and Ms. Suzana Maferane of the Investment Promotion Center; Mr. Audre Clewaus and Mr. Oswalda Wilson at the Ministry of Industry and Commerce; Mr. Carlos Pedro Muscavele; the General Director of the Institute for Promotion of Small and Medium Enterprises, Mr. Claire Mateus Zimba; Mr. Furmino Guiliche, Ms. Monica Magaue and their staff at the National Institute of Statistics.

The mission also held discussions with representatives of the private sector, including representatives of the banking sector and alcoholic beverage industry.

The mission had the privilege to participate in and contribute to discussions at the internal tax policy seminar held at the Mozambique's Revenue Authority and chaired by the President thereof.

The mission is grateful for the collaboration, hospitality and support provided by the Mozambique's Tax Authority, especially staff from General Directorate of Taxes. We particularly thank Mr. Anibal Mbalango, Mr. Zefanias Tamele, and Ms. Avaleria Amos for facilitating the work of the mission.

We are equally grateful for all the support received from Mr. Ari Aisen, IMF's Resident Representative in Maputo, and his staff.

EXECUTIVE SUMMARY

With a deteriorating economic environment, Mozambique faces significant fiscal challenges. Embarking on fiscal consolidation efforts appears inevitable and requires a thorough review of revenue potential. Although revenue generation is of primary concern for the authorities, other factors are equally important for the future of tax policy formulation. A comprehensive approach to modernization of Mozambican tax structures is needed. Unfortunately, tax policy formulation is somewhat impaired – at best ad-hoc policy changes are introduced without giving consideration to consistency and overarching economic policy objectives. There has been no comprehensive tax reform in more than 10 years and the authorities' commitment to implement tax reforms has been limited. However, several specific tax proposals are currently under consideration.

Mozambique's tax-to-GDP ratio – at 23.8 percent in 2015 – is relatively high. It is comparable to the ratios of more developed SADC's member states and one of the highest amongst countries of similar economic structure worldwide. The tax-to-GDP ratio nearly doubled over the last decade, largely on account of CIT and VAT. Unfortunately, the increase in VAT comes from its compromised efficiency rather than better enforcement. CIT growth stems from payments received from the extractive sector, mostly capital gains tax and withholding taxes.

There is some scope to further raise revenue from traditional tax bases, though limited. The best strategy to raise revenue in near term is to eliminate tax exemptions, rather than increasing tax rates. A level playing field for all businesses is critical to increase efficiency and promote growth. Since Mozambique already relies more heavily on income taxes, the focus of the reform should be put on indirect taxes. Wherever possible the VAT base should thus be broadened. For the time being neither increase nor decrease in the VAT rate is a viable option. Over the medium term, as revenue pressures permit, the most distortive tax rates, including CIT, should be reduced. The design of income taxes could also be improved. And improved border controls and the associated reduction of informal trade is a prerequisite for excise tax increases.

There is significant scope to improve the VAT's revenue productivity. The mission estimates the potential VAT at around MT 60 billion, 28 percent more than its current level. This implies that C-efficiency of the VAT could be increased from 0.4 to 0.6. For this to happen the VAT structure needs to be modernized and its base broadened by abolishing the currently widespread exemptions and bringing new bases into the VAT net: fee-based financial services, immovable property and gambling.

It is of the utmost importance to refrain from providing additional VAT preferences. For this reason, the draft VAT amendment should be withdrawn from parliament. If passed, around MT 1.8 billion will be lost in VAT revenue only through zero-rating of passenger transport. Other exemptions will further add to the revenue loss.

Instead, Mozambique should abolish the most distortive and regressive VAT preferences.

With the now improved VAT refund mechanism, there is no need to provide for VAT exemptions and reliefs on business inputs – all input VAT will be recovered through crediting and refunding. VAT preferences provided to improve progressivity of the VAT and help the poor in fact subsidize the rich. They should be immediately abolished, including for revenue mobilization reasons. The cost of zero-rating certain food items amounts to around MT 12 billion. And there is absolutely no reason to provide VAT preferences to the government itself. Only through a reduced rate on public work services the budget may be losing around MT 3 billion. Even if the net gain is nil, the government may close avenues for revenue leakage and, by setting the example, improve the culture of paying taxes. Revisions to border exemptions will be needed – only by exempting imports of political parties and Mozambican miners working in South Africa, Mozambique lost MT 14.4 billion in VAT in 2015. Even more is lost in excises on imports of vehicles by the latter group (MT 17 billion).

To modernize the Mozambican VAT certain improvements to its structure will be needed.

These should encompass: increasing the VAT threshold to MT 4 million, introducing a minimum VAT registration threshold (of MT 750,000), further improvements to the VAT refund mechanism, certain adjustments to the rules on place of supply of goods and services, and allowing for VAT grouping. In addition, it will be important to ensure sufficient funds flowing into the VAT escrow account when the VAT input reliefs for investors are abolished and higher demand for refunds materializes. The current allocation of 16.4 percent of gross receipts may not be sufficient.

Mozambique faces a serious problem of porous borders. Unless the country manages to better control its borders, excises must be such that the price of excisable goods will approximately match those of its neighbors, especially South Africa. Some consequences of this is that it would be temerarious to increase the excises on alcoholic beverages before satisfactory control of the border is established; and the tax on fuels should be increased to align with those of SADC's. Another possible source of revenue is subjecting mobile phone services to excise tax.

Most of the tax incentives offered in the Code of Fiscal Benefits are overly generous and should be eliminated. Mozambique's corporate income tax rate of 32 percent is high and exceeds the regional standards. At the same time, owing to widespread tax incentives, the effective tax rate is half the nominal. It would serve Mozambique well to reduce the nominal tax rate to 30 percent in the short term and to 28 percent in the medium run. The government should immediately undertake a careful analysis of the Code of Fiscal Benefits and conduct a detailed study of tax expenditures toward devising measures to reduce tax incentives.

The changes to the personal income tax introduced in 2013 create inequity and revenue loss. Employees' income is now subject to a final withholding tax even if a taxpayer has other types of income or has more than one source of wage income. The income split reduces the overall progressivity of the tax, subjects taxpayers with identical incomes to different tax burdens and undermines the PIT's revenue productivity. The withholding tax rate schedule should be made compatible with the annual tax schedule and simplification could be achieved by allowing

employees with no other type of income, except those subject to final withholding (like interests and dividends), and only one source of wage income to be subject to final withhold. Other revenue gains could be obtained by reducing the non-taxable income allowance, which is excessively generous, and using tax credits rather than income deduction to grant basic exemption.

Mozambique should build up a compressive presumptive tax regime for small taxpayers by improving the design of the ISPC regime. The eligibility threshold of the ISPC should be extended to MT 4 million and aligned with that of the VAT. The rate of turnover is overly generous and should be increased to at least 5 percent. At the same time, corporate taxpayers and professional service providers should be excluded from the ISPC regime.

The below Table summarizes major recommendations and indicates a time frame in which these should be acted on – from immediately (IM) to short-term (ST) to medium-term (MT).

Major Recommendations	IM	ST	MT
General			
Enhance the tax policy formulation function of the MEF and frame tax policy adjustments and reforms into a broader macroeconomic policy context and objectives		x	x
Avoid ad-hoc changes to the tax regime and develop a comprehensive approach to tax reforms	x		
Undertake a comprehensive tax reform with a view to both increase revenue and enhance efficiency of taxation		x	x
Anchor the tax reform on removing tax exemptions rather than increasing tax rates		x	x
Shift towards more reliance on indirect taxes – modernize the VAT and expand its base to currently untapped base		x	x
Improve border controls and address informal trade before embarking on excise tax increase	x	x	x
Address the issue of regressive indirect taxes through improvements to personal income tax and direct cash transfers		x	x
Reduce the headline CIT rate and curtail tax investment incentives			x
Prepare a detailed report on tax expenditure, evaluating effectiveness of various tax exemptions and reliefs and estimate revenue forgone			x
VAT			
Do not adopt additional VAT reliefs as currently contained in the draft VAT amendment, including those on passenger transport and inputs for agriculture	x		
Do not extend VAT exemptions already expired at the end of 2015	x		
Remove all VAT preferences falling mostly on business inputs, including those for agriculture and other targeted industries (CFB)		x	

Abolish all zero-ratings of domestic supplies		x	
Charge VAT on full tax basis for electricity, fuels, supply of public work services and aeronautical services; do not adopt the proposed relief for piped water		x	
Remove all exemptions that do not fall into the category of education, health and social assistance services		x	x
Do not provide for any VAT preferences for government, political parties and members of parliament		x	
Exempt only margin-based financial services and tax fee-based services under VAT			x
Tax property and casualty insurance under VAT			x
Continue to exempt residential property leases, but tax supply of residential property by developers (new buildings), exempt sales of used residential properties, and tax all sales and leases of commercial property			x
Tax lottery and gambling operators on their net margin under VAT but apply the normal VAT rules on their non-gambling supplies			x
Increase the VAT registration threshold to at least MT 4 million and introduce a minimum registration threshold of MT 750,000 except for exporters		x	
Apply the standard VAT regime to all registered taxpayers, including those below MT 4 million who voluntarily register		x	
Pay VAT refunds in cash and avoid securitization thereof	x		
Ensure sufficient funds in VAT escrow account; reevaluate the ratio of gross receipts funding, including after the VAT reform has been completed		x	
Carefully review and improve rules defining place of supply of services			x
Allow for single VAT registration of taxpayers within the same capital group			x
Excises			
Increase the rate of TSC on gasoline to MT 15.00 and on Diesel to MT 9.00	x		
Improve border controls and address immediately the problem revealed by the bilateral trade statistics (mismatch between South Africa's exports to Mozambique and imports from South Africa to Mozambique)	x	x	x
After understanding and solving the border problem, reform the excises on alcoholic beverages to adopt specific rates on the alcohol content and calibrate them in such a way that consumer prices match those of neighboring countries, especially of South Africa		x	x
Index the specific rates on alcoholic beverages (as well as the rates introduced in 2013 for cigarettes) to inflation		x	
Consider undertaking studies conducive to the introduction of an excise tax on mobile phone usage			x

CIT			
Do not extent the tax benefits subject to the sunset clause in the Code of Fiscal Benefits (CFB)	x		
Increase the depreciation period for residential building to that for commercial and industrial buildings		x	
Undertake a careful analysis of the CFB on its impact on business investment and CIT revenue		x	x
Eliminate most of the tax incentives in the CFB, following recommendations of the above analysis			x
Reduce the statutory corporate tax rate to 30 percent and further to 28 percent in the medium term			x
PIT			
Do not extend the expired tax reduction for agricultural activities	x		
Tax time deposits at the same rate applied to all other financial assets	x		
Correct the non-taxable income allowance so that the one for general income and the one for employment income match each other		x	
Consider reducing the non-taxable income allowance		x	
Eliminate the dependent allowance for wage earners		x	
Substitute a tax credit for the non-taxable income allowance		x	
Reform the IRPS law to make the withholding tax final only for those employees who have a single source of wage income		x	
Simplified Regime			
Assure proper segmentation of taxpayers – align presumptive taxation thresholds with those of VAT		x	
Develop the ISPC tax into a comprehensive presumptive regime – turnover based tax for small taxpayers and a simple lump sum tax for micro taxpayers		x	
Extend the coverage of ISPC by increasing the eligibility threshold to MT 4 million; index it to automatically adjust for inflation		x	
Exclude professional services from the ISPC regime and keep them under the normal tax regime		x	
Eliminate the other simplified taxation regimes that has become obsolete following the introduction of ISPC		x	

Note: IM: Immediately; ST: Short term (6 to 12 months); MT: Medium Term (over next 2 years)

I. INTRODUCTION

1. With a deteriorating economic environment, Mozambique faces significant fiscal challenges. The recently revised budget anticipates an overall deficit of 6.3 percent of GDP and the projected fiscal deficit for 2017 – at 5.5 percent of GDP – continues the trend, rapidly adding to the already elevated stock of public debt. With debt service cost on the rise and limited access to financing the government is left with little options to improve its fiscal stance. Against this background fiscal consolidation appears inevitable.

2. Embarking on fiscal consolidation effort requires a thorough analysis of revenue potential. Although laudable, by no means should increasing revenue be seen as the only viable or sufficient policy measure. Significant savings will likely have to be realized on the expenditure side of the budget. This issue, however, goes beyond the scope of this report. So does the assessment of the level, composition and the macroeconomic impact of the overall fiscal consolidation package.

3. Although revenue generation is of primary concern for the authorities, they report other factors as being equally important for tax policy formulation. Improving business environment, boosting investment, production and employment, and reducing informality lie at the heart of policymakers. In addition, the authorities report increasing concern over purportedly rising income inequality and widespread tax evasion. To address this broad range of issues, a holistic approach to policy formulation is needed including through proper design of tax policies.

4. Yet, tax policy making in Mozambique is almost non-existent. There is no pro-active approach to tax policy formulation, with clearly defined goals and objectives. At best, changes to the tax system are introduced on an ad-hoc basis, most commonly in response to ongoing and pressing problems (e.g., poultry taxation) or short term revenue needs. In 2011-2015 there were nearly 50 tax legislative efforts.¹ In most cases these focused on clarification of terms, adjustment to certain conditions or small changes to specific taxes (e.g., targeted VAT exemptions, increases in excises or final withholding of income tax on wages and salaries). The introduction of a new tax regime for mining and petroleum in 2014 was by far the greatest tax policy achievement in recent years. In contrast, review and comprehensive reform of non-resource taxation tend to lag behind.

5. Tax policy formulation continues to rest with the Mozambique's Tax Authority (AT). The engagement of the Ministry of Economy and Finance (MEF) is limited to formal approval of changes proposed by AT and/or submitting them for approval to the Council of Ministers and parliament if amendments to law are required. Due to a lack of capacity, the MEF does not seem to contribute in a constructive way to tax policy development nor does it initiate any tax proposals. Its contribution is limited to setting annual revenue targets for AT which in

¹ 10 laws, 15 decrees, 7 decisions, 7 ministerial orders and 7 official notices.

turn has to arrange for quick and ad-hoc adjustments to the tax structure to be able to deliver. As such, the macroeconomic evaluation of policy proposals is often missing, overarching policy objectives ignored and the overall quality of tax proposals compromised. Too little emphasis is put on the composition of tax revenue, its efficiency and equity. The MEF recognizes its current weak engagement in the tax policy formulation process and has already started strengthening its capacity² to be able to effectively contribute to the process and to eventually shift the tax policy formulation function from AT to MEF.

6. There has been no comprehensive tax reform in recent years and the authorities' commitment to implement tax reforms has been limited. Apart from the mining and petroleum tax reform cited earlier, little has been done in terms of improvement to the general tax regime. Uptake on recommendations provided in two recent IMF technical assistance (TA) reports – one in 2010 providing for a comprehensive review of the major tax structures (2010 TA Report)³ and one in 2012 focusing on four selected topics⁴ – has been limited. The authorities have not acted on most of the recommendations and only a few appear to have been implemented to date. A number of critical ones thus beg a renewed effort and revisiting.

7. Several specific tax proposals are currently under consideration. These include:

- a) Amendments to the VAT Act aiming to 1) expand VAT territory to the Mozambican Exclusive Economic Zone, 2) provide further exemptions and reliefs on public passenger transport, and inputs to pharmaceutical industry and agriculture sector, and 3) improve certain administrative procedures;⁵
- b) Excise tax increases, including on alcoholic beverages;
- c) Extension of the expired income tax incentives to the agriculture sector beyond December 31, 2015;

² E.g., the MEF is developing a microsimulation model that would allow for assessment of VAT changes on income distribution (MEF receives assistance from University of Essex in this regard).

³ R. Varsano, I. Coelho, A. Martins and O. Shenone, Revenue Reforms to Improve the Business Environment and Mobilize Resources for Development, IMF, May 2010.

⁴ R. Varsano, *Mozambique: Four Topics in Tax Policy*, IMF, May 2012; It covered the issues of 1) taxation of small taxpayers, 2) taxation of treasury securities, 3) stamp tax and 4) transfer-pricing and thin capitalization.

⁵ FAD and LEG conducted HQ-based review of the draft VAT amendment and provided comments on September 21, 2016; The draft VAT amendment has been already submitted to parliament and awaits approval.

d) Potentially new incentives for the poultry industry (the discussion on the tax treatment of this sector has just started and no concrete solutions have been yet tabled).⁶

8. Against this background, the authorities requested a TA mission to undertake a review of the Mozambican tax regime. This report takes a broad perspective and assesses the existing tax structures within the realm of the authorities' overarching objectives of improving the efficiency, equity and simplicity of taxation. Although it is well understood that the major concern for the authorities is to increase revenue in the context of possible fiscal consolidation and to at least partially replace revenue from grants, short term revenue mobilization is not the sole goal for the mission's assessment. It's rather a tax policy reform that will spur economic growth and thus encourage sustainable revenue enhancement over the longer term.

9. The report evaluates major tax structures only. It looks into value added tax (VAT), excises, corporate income tax (CIT), and personal income tax (PIT), and provides recommendations for improvements. Other taxes, including stamp duties and local taxes, customs duties as well as a discussion on potential new taxes or removal of the existing ones are left out and should be subject to a separate assessment. Similarly, natural resource taxes, including the production taxes (or royalties), are not part of the discussion for they have been covered under a separate ongoing stream of TA.⁷ Although the report focuses on fiscal incentives under various taxes it does not attempt to estimate the revenue loss and their overall efficiency, especially with respect to incentives provided under the Code of Fiscal Benefits (CFB). The mission would like to encourage the authorities to undertake a careful analysis of tax expenditures in Mozambique and reform the package of fiscal incentives in the near future. To this end, additional TA may be warranted.

10. This report is structured as follows: The next Chapter provides for a brief overview of tax revenue performance and presents a strategy for a future tax reform. Chapter III focuses on

⁶ The mission had the privilege to participate in the AT internal tax policy seminar, the purpose of which was to identify possible bottlenecks for the Mozambican poultry industry and evaluate the need for further tax incentives to support it. The overarching policy question was: "Why domestically produced poultry is more expensive than imported one and what can be done through tax policy adjustments to lower the price of domestically produced chicken?".

⁷ TA on natural resource taxation has been provided under the IMF's Managing Natural Resource Wealth Trust Fund (MNRW TF). Two TA reports and three technical memoranda have been delivered to date: 1) A. Watson, R. Varsano, C. McPherson, C. Santa Gadea and E. Fuli, Mozambique: Reforming the Fiscal Regimes for Mining and Petroleum, June 2012; 2) A. Watson, A. Swistak, C. Santa Gadea and A. Dourado, Mozambique: A New Fiscal Law for Mining and Petroleum, August 2012; 3) A. Swistak and A. Dourado, Mozambique: Technical Memorandum on Draft Mining and Petroleum Fiscal Laws, June 2013; 4) A. Swistak and I. Keiichiro, Mozambique: Technical Note on Major Issues in Fiscal Reform for Petroleum and Mining Sector, June 2014, and 5) A. Swistak, S. Shelton, N. Vernon and A. Watson, Mozambique: Technical Note on Fiscal Regime Challenges and Risks for LNG Development and Mining Projects, March 2016. The new fiscal regime for mining and petroleum, including a new Mineral Resource Rent Tax, has been adopted in 2014 and is being implemented now. Further TA on the new regime implementation and capacity building in revenue forecasting and monitoring is planned over the next years.

VAT, Chapter IV covers excises, Chapter V deals with investment incentives and selected CIT issues, Chapter VI discusses PIT and Chapter VII reviews small business taxation.

Recommendations:

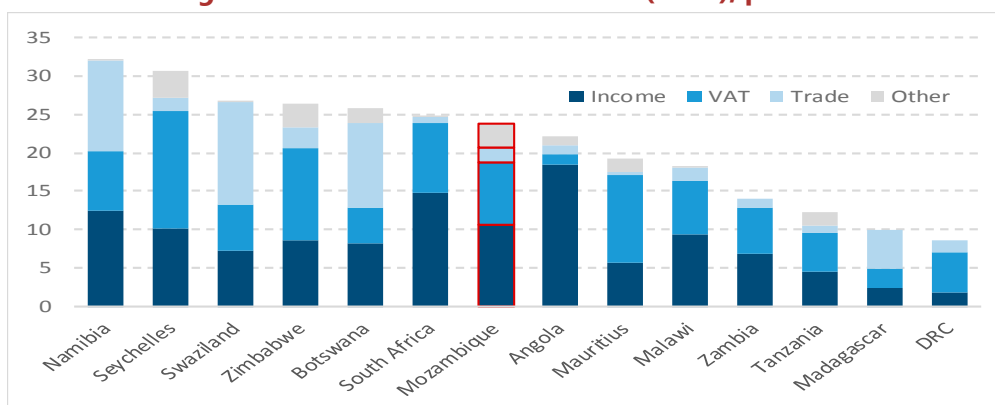
- Explore avenues for tax revenue to contribute to fiscal consolidation effort, yet do not rely solely on tax increases;
- Enhance the tax policy formulation function of the MEF and frame tax policy adjustments and reforms into a broader macroeconomic policy context and objectives;
- Avoid ad-hoc changes to the tax regime and develop a comprehensive approach to tax reforms;
- Embark on a major tax reform with a view to increase efficiency of taxes over a medium term.

II. TAX REFORM: BACKGROUND AND STRATEGY

A. Revenue Structure and Performance

11. Mozambique's tax-to-GDP ratio is relatively high. In 2015 it stood at 23.8 percent of GDP and was comparable to the one achieved by more developed member states of the Southern African Development Community (SADC) (Figure 1). Interestingly, it also features high amongst countries of similar economic structure worldwide. In a sample of 29 low income countries (GDP per capita below U\$ 1,000) that rely heavily on final consumption (accounting for 80 percent of GDP or more) instead of strong capital formation or trade balance, Mozambique features the highest tax-to-GDP, with the bulk of the revenue coming from indirect taxes (Figure 2).

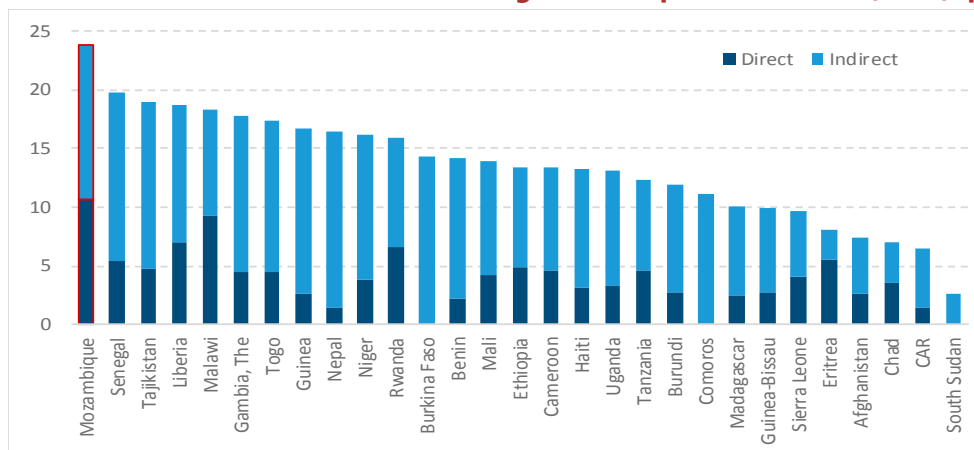
Figure 1. Tax-to-GDP ratio in SADC (2015), percent



Note: Excludes Lesotho

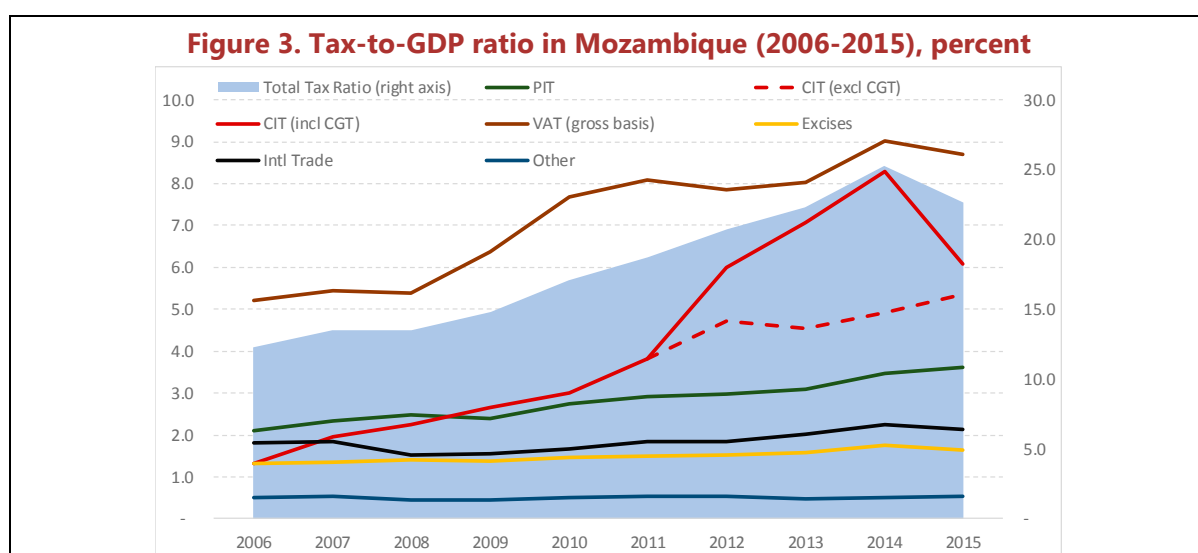
Source: IMF GFS

Figure 2. Tax-to-GDP ratio in low-income, high consumption countries (2015), percent



Source: IMF GFS

12. The tax-to-GDP ratio nearly doubled over the last decade in Mozambique. Figure 3 shows developments in the level and composition of the ratio for 2006–2015. As is apparent, three taxes: VAT, CIT and, to a lesser degree, PIT have been driving the growth of tax collections. Higher PIT stems from real growth in government wage bill and rapid expansion of highly paid expatriate community. Record high collections of capital gains tax (CGT) on transfer of interest in mining and petroleum concessions as well as withholding taxes on payments to non-resident service and finance providers in the extractive sector explain the growth in CIT. The unusually high performance of VAT is, however, puzzling. Without major changes to the VAT design since its introduction in 1999, one has to look for answers in improved tax administration effort. The other, and worrying, explanation is the ill-conceived tax enforcement, including through lack of paying refunds. For more discussion on VAT efficiency, please refer to Chapter III.



13. The “true” tax-to-GDP ratio in Mozambique may be in fact overstated. The First National Survey of Informal Sector in 2004 reports that the informal sector in Mozambique accounts for more than 40 percent of the GDP and is not fully accounted in the official GDP estimates. Although the survey is now somewhat dated, the mission’s interlocutors confirmed that the informal sector is large and growing and still not properly captured by the National Institute of Statistics (INE). Leaving aside the accuracy of nominal GDP value, one would still have to adjust the ratio for the above-mentioned CGT, which is a windfall (or a simple prepayment of CIT), and for VAT recorded on gross basis, i.e., without refunding excess tax credit. The adjusted and “true” tax-to-GDP ratio is thus roughly 4 percentage points lower and amounts to around 20 percent in 2015 – still a relatively high level, compared to other countries.

14. The composition of tax revenue has shifted towards more reliance on direct taxes. Excluding collections of CGT, direct taxes (CIT and PIT) accounted for 41 percent in 2015. Indirect taxes contributed 59 percent of total tax revenue, with VAT being the most important source – 40 percent in 2015. Over the last decade, there has been a gradual shift towards more reliance on

direct taxes – their share grew from 28 percent in 2006 to 41 percent in 2015. With CGT added to the pool of revenue, the growth in share of direct taxes is even more acute – in 2014, at the peak of CGT collections, they contributed 47 percent of total revenue.

15. Also, compared to other countries of similar economic development and countries in the region, Mozambique exhibits strong reliance on direct taxes. As shown in Figure 1 and 2, with over 10 percent of GDP raised in income taxes, mostly CIT, Mozambique is one of the countries most heavily relying on direct taxation. These levels of direct taxation are observed in more developed countries (e.g. the average in the EU is around 13 percent of GDP, with only 2.5 percent of GDP raised in CIT).⁸

B. Tax Reform Strategy

16. There is some scope to further raise revenue from traditional tax bases. Although the bulk of the revenue will come from natural resource sector for the foreseeable future, it is crucial to strengthen non-resource revenue mobilization. A promising, yet relatively unexplored source of revenue, is property taxation. For this to happen Mozambique would have to start working early on formalizing property registration and developing a comprehensive cadaster. In the meantime, however, with already high levels of income taxation Mozambique will have to rely more on indirect taxes. This is not to say there are no opportunities to increase efficiency of income taxes currently in place.

17. The best strategy to raise revenue in the near term is to eliminate tax exemptions, rather than to increase tax rates. Both CIT and VAT rates are already high, by regional and international standards, and there is no scope to increase them further. While raising rates would increase distortions, eliminating exemptions would reduce them, improving efficiency and supporting growth. Priority reforms should include eliminating tax expenditures that are very costly and/or distortive, such as tax holidays, regressive, such as VAT exemptions and reliefs, or benefit solely the government itself.

18. A level playing field for all businesses is critical to increase efficiency and promote growth. Government should not be in the business of picking winners and losers. Mozambique should thus eliminate sectoral tax incentives and special regimes, which by reducing the tax rate on some taxpayers requires others to pay higher rates. Only if all businesses face the same set of tax rules will the private sector be able to allocate capital to its most profitable uses.

19. Since Mozambique already relies more heavily on income taxes, the focus of the reform should be on indirect taxation. Indirect taxes (VAT, excises and customs duties) tend to be more growth-friendly than direct taxes, thus – arguably – the share of indirect taxes in total

⁸ Data for 2013, excludes social security contributions; see: *Taxation Trends in the European Union*, Eurostat 2015, p. 129 (available online at: https://ec.europa.eu/taxation_customs/sites/taxation/files/eco_analysis_report_2015.pdf)

revenue should rise. Among indirect taxes, the VAT is generally the least distortive, as it offers the prospect of not burdening production or consumption decisions if implemented under the best-practice approach. Such a move would also allow to better tax the large informal sector – whereas it is difficult to impose income taxation on informal businesses and no income earners, indirect taxes, especially VAT, are still paid by them (in economic sense). Wherever possible the VAT base should thus be broadened.

20. Nevertheless, the design of income taxes could also be improved. To mitigate the regressive impact of increasing indirect taxes on households' income, the progressivity and coverage of PIT should be improved. It would allow to raise more revenue from high income earners while leaving those at the bottom of income distribution with more disposable income. Improving taxation of individual businesses, including through rationalization of the simplified income tax (ISPC), would also allow for reduction of the informal sector and additional revenue gains. Currently, receipts from category two income (tax on business income) have been gradually falling both in terms of share of total PIT collections and share of GDP. Whereas in 2009 they accounted for 10 percent of total PIT collections in 2015 it was only 6 percent.

21. Over the medium term, as revenue pressures permit, the most distortive tax rates should be reduced. Mozambique's high CIT rate (32 percent) is a significant deterrent to both domestic and foreign investment, and reducing it would enhance Mozambique's attractiveness to investors. As discussed in Chapter V the average effective CIT rate in Mozambique is anyway well below its nominal value. Rather than keeping a high nominal rate and provide distortive exemptions, Mozambique would be better off to lower the rate and apply it uniformly to all sectors, save for extractive industries and, perhaps, telecommunication. On the other hand, the VAT rate should not be reduced, as it can be a highly efficient tax. Domestic consumption is far less mobile than capital investment and therefore a much more stable tax base. The pressing issue of cross-border shopping with South Africa will have to be dealt through tightened border controls rather than rate reduction. In the medium term, once the VAT base broadening is completed, and revenue pressure subdues, one may evaluate anew the need for aligning the Mozambican VAT rate with neighboring countries. For the time being this is not a viable option.

22. Improved border controls and the associated reduction of informal trade is a prerequisite for excise tax increases. Without adequate border controls, there is limited room for higher taxation of excisable goods, especially alcoholic beverages. Although these goods exhibit low price elasticity and could be taxed at higher rates, due to a sizeable and largely uncontrolled informal market any further increase in tax rates would likely lead to revenue loss. One of the moves towards improving efficiency of excisable goods taxation would be to rely more on specific rather than ad valorem rates. Expanding the excise tax base to mobile services usage is an option the authorities should carefully study and perhaps introduce in the medium term.

23. To better inform future policies and tax design Mozambique should prepare a comprehensive study of tax expenditures and publish it regularly as part of the budget.

Such a study would allow policymakers to understand the “true” cost of tax reliefs granted to investors and/or the public and adjust them in cases where benefits do not exceed revenue foregone, i.e. revenue not collected as a result of a tax preference. Public tax expenditure estimates act as an important constraint on policy makers by clarifying the revenue cost of offering tax benefits to particular groups. As discussed later in the report it is especially important to undertake a tax expenditure study with regards to the Code of Fiscal Benefits and the VAT. Also, any new proposed tax expenditure should be subject to a careful cost benefit analysis, including a tax expenditure estimate.

Recommendations

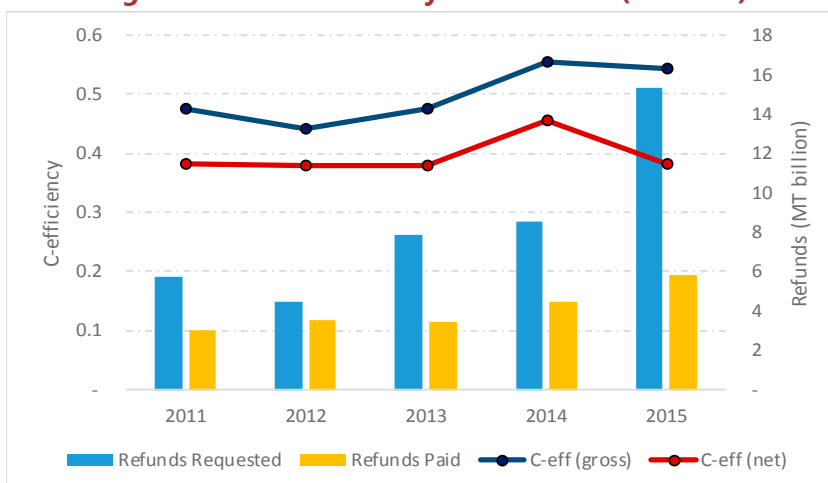
- Undertake a comprehensive tax reform with a view to both increase revenue and enhance efficiency of taxation;
- Anchor the tax reform on removing tax exemptions rather than increasing tax rates;
- Shift towards more reliance on indirect taxes – modernize the VAT and expand its base to currently untapped base;
- Address the issue of regressive indirect taxes through improvements to personal income tax and direct cash transfers;
- Reduce the headline CIT rate and curtail investment tax incentives;
- Prepare a detailed report on tax expenditure, evaluating effectiveness of various tax exemptions and reliefs and estimate revenue forgone from thereof;
- Improve border controls and address informal trade before embarking on excise tax increase.

III. VALUE ADDED TAX

A. Revenue Efficiency and Potential

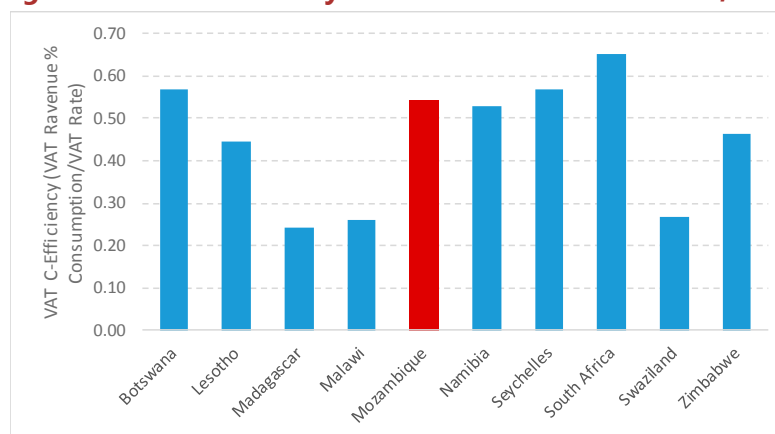
24. The VAT is by far the most important tax in Mozambique. In 2015 it raised 7.8 percent of GDP in revenue, contributing 35 percent of all tax collections. As shown in Figure 3 its revenue productivity has been growing over the years – from 5.2 percent of GDP in 2006 to 9 percent of GDP in 2014. The increasing share of final consumption in GDP only partly explains this remarkable performance. C-efficiency, i.e. a measure of the VAT departure from a perfectly enforced tax levied at a uniform rate on all consumption, also increased in recent years (Figure 4). At 0.54 in 2014 it belonged to one of the highest in the region (Figure 5). In absence of any base broadening measures or rate increases the VAT's growing revenue productivity could be thus easily attributed to an enhanced tax administration effort. This is however misleading.

Figure 4. VAT C-efficiency and Refunds (2011-15)



Source: AT, IMF Staff Calculations

Figure 5. VAT C-efficiency for Selected SADC Countries, 2014



Source: IMF GFS, FAD, AT, IMF Staff Calculations

25. The VAT's remarkable performance is in fact a sign of a gradual deterioration of this tax. Such phenomenon may be explained by two factors: 1) lack of paying refunds, i.e., collecting VAT on gross rather than net basis and 2) a growing number of tax exemptions on business inputs that lead to tax cascading and artificially expand the VAT base.

26. Until 2015 around 50 percent of requested refunds were not paid (Figure 4). 2014 marks a peak in dysfunctionality of this important VAT mechanism. Out of MT 8.5 billion in requested refunds 56 percent (or MT 4.8 billion were rejected) on account of irregularities or illegitimate claims. Only MT 4.4 billion was paid in refunds, with large share of this amount being a clearance of outstanding refunds (authorized to be paid in past years). More importantly however, the amounts of refunds officially requested do not reflect all refunds that would have been demanded had the tax administration had the reputation of paying them. Many taxpayers, knowing the inefficiency of VAT refunding scheme, chose not to claim their excess tax credits. The experience of 2015, when a VAT escrow account was established and refunds started to be paid timely, cannot be more telling – only in 2015 the amount of requested refunds doubled (and reached MT 15.3 billion) despite only 7 percent growth in gross VAT collections. The surge of new requests and the authorities' commitment to clearing the outstanding stock of refunds forced the government to securitize MT 8.2 billion (or 1.4 percent of GDP) of refunds by issuing bonds. Despite those efforts, as of end of September 2016 outstanding refunds still amounted to MT 9.6 billion (or 1.4 percent of GDP).

27. Tax cascading resulting from exemptions on business inputs is yet another structural issue that artificially expands the tax base and increases VAT collections. Although it is currently impossible to quantify the impact of the said tax cascading on VAT collections it is certainly not negligible. Article 15 of the VAT Act provides an extensive list of tax exemptions, many of them being inputs in agriculture and food processing sector (e.g. sugar industry). The recently discussed issue of poultry production (and the authorities' efforts to understand why production of domestic chicken is more expensive than imports of frozen chicken from Brazil) is a clear sign of tax cascading and dysfunctionality of VAT. Unfortunately, the draft VAT amendment, recently submitted to parliament for approval, provides for additional tax exemptions and would thus further aggravate the problem. For more discussion on tax exemptions, including on VAT treatment of agriculture, please see Section III of this Chapter.

28. Low C-efficiency suggest that there is significant scope to improve the VAT's revenue productivity. As shown in Figure 4 the C-efficiency, measured on net basis, amounted to around 0.4 in 2015. A portion of increases would arguably have to come from improvements in tax administration and a better enforcement of the VAT (including through proper segmentation of VAT taxpayers and devoting tax administration's scarce resources to larger taxpayers) but improvements to the VAT design, especially abolishment of the widespread exemptions as well as expanding the tax base to currently not taxed activities (certain financial services, immovable property and gambling). The additional revenue will be generated by closing avenues for leakage, i.e., unintended loss of revenue, resulting from various tax exemptions and

reliefs that, when in place, are difficult to monitor, especially import exemptions of raw materials for various projects or exemptions for political parties.

29. Using the 2015 national accounts data, the mission estimates the potential VAT base in Mozambique at around MT 350 billion. This corresponds to 63 percent of final consumption (both private and public). The estimation assumes that financial, health and education sectors remain largely untaxed as they currently are. If this portion of consumption could be fully taxed, through removal of exemptions and increased tax administration effort, the VAT applied at the current rate should yield around MT 60 billion, 28 percent more than its current level. With this level of collections, the VAT productivity would increase to 10 percent of GDP and its C-efficiency would reach 62 percent. To reach this goal the VAT structure would have to be modernized and its base broadened. These issues are taken up in the sections that follow.

B. Modernization of the VAT Structure

30. The VAT structure has not changed much since the VAT Act was adopted in 1999. Although its design still follows international standards, most importantly: taxation of final consumption, taxation of both goods and services, application of the destination basis and refunds of excess credits, some elements require modernization to enhance the Mozambican VAT's efficiency and make it truly a broad-based consumption tax. To this end certain changes to the registration threshold, refund mechanism, place of supply and taxation of business groups are required. This set of changes is aimed to improve the overall efficiency of VAT rather than solely boost its revenue productivity. Certain measures, e.g., VAT grouping, by limiting tax cascading may result in revenue loss, although likely negligible.

Registration Threshold

31. Businesses with turnover above MT 750,000 have to register for VAT. Those above the registration threshold but below MT 2.5 million may elect to be subject to a simplified VAT – paid at 5 percent of turnover. They issue special VAT invoices but the indicated amount of output VAT may not be used as a credit by businesses subject to standard VAT. There is no minimum VAT registration threshold – all taxpayers regardless of their turnover have the right to voluntarily register for VAT.

32. A proper segmentation of taxpayers is required, including for VAT purposes. Choosing a single registration threshold for VAT is largely an issue of administrative nature as it is usually driven by capacity of tax administrations to properly administer a VAT regime. In an ideal world every business engaging in taxable supplies, regardless of its size, should be subject to VAT. This is however not feasible for AT. The cost of compliance for small business has also to be taken into account. After all, VAT collections from small taxpayers are negligible and AT may well better use its resources to properly enforce VAT paid by larger taxpayers. For more discussion on taxation of small business, i.e., those below the VAT registration threshold please see discussion in Chapter VII.

33. It would serve Mozambique well to increase the current registration threshold to at least MT 4 million (equivalent of U\$50,000 in current terms). Such a move would take out more than half of VAT taxpayers off the AT's books whereas only 2.8 percent of current VAT collections would be lost. As shown in Table 1 taxpayers with turnover higher than MT 4 million account for 97.2 percent of all domestic VAT collections, and 99 percent of total VAT collections. Naturally, some taxpayers with turnover below MT 4 million will voluntarily register but this number should not be overly high.

Table 1. Domestic VAT collections by turnover range (2015)

Turnover range	Number of taxpayers per range	Taxable sales			Tax collected		
		Total per range	Average per taxpayer	Percent of total	Total per range	Average per taxpayer	Percent of total
>750k	8,047	1,571	0.2	0.3	106	0.0	0.5
751k - 2.5m	3,580	5,199	1.5	1.0	285	0.1	1.3
2.5 - 4m	1,264	4,016	3.2	0.8	208	0.2	1.0
4 - 5 m	544	2,436	4.5	0.5	129	0.2	0.6
5 - 10 m	1,544	10,980	7.1	2.1	553	0.4	2.6
10 -100 m	2,658	83,680	31.5	16.2	3,818	1.4	18.0
100m - 1bn	654	174,338	266.6	33.8	7,771	11.9	36.6
<1bn	71	232,859	3,279.7	45.2	8,343	117.5	39.3
Total	18,362	515,077	28.1	100.0	21,212	1.2	100.0

Source: AT

34. Taxpayers with turnover below MT 750,000, unless being exporters, should not be allowed to register at all. Such a solution would greatly help prevent situations where taxpayers register for VAT only to claim VAT on their inputs (usually one-off capital expenses or personal expenses). Data provided by the authorities shows that taxpayers with taxable sales below MT 750,000 reported MT 9.4 billion in input tax credit, out of which MT 4.7 billion was in excess of their output tax. The input VAT claimed represented over 60 percent of their taxable sales whereas this ratio for larger taxpayers is around 20 percent. Taxpayers with turnover below MT 750,000 who are currently registered for VAT should be deregistered and moved mandatorily to the simplified regime. Those with sales between MT 750,000 and MT 4 million should be given a one-off option to remain registered for VAT (as voluntarily registered) or deregister.

35. Small taxpayers who choose to register for VAT should be subject to all standard accounting obligations. Certain administrative concessions could be, however, considered, e.g., less frequent filing and/or payment of tax. Further down the road Mozambique may also consider applying VAT in a simplified way, a solution that is currently practiced in some EU countries, e.g., UK. In such a case taxpayers charge a standard VAT rate on their output (actual sales) and issue regular VAT invoices showing the amount of output VAT but VAT remitted to the tax authority is calculated based on a prescribed rate (varied by sector of activity). This is fundamentally different from a simple turnover tax insofar as taxpayers subject to this simplified method do not have to account for input VAT (hence disincentive to buy from non-taxable

businesses is removed and cost of tax compliance reduced) and businesses buying from such taxpayers can deduct a full amount of VAT paid on their inputs.

VAT grouping

36. The VAT Act requires a single registration for a corporate entity. Whereas branches of a single company, even if located in different provinces, do not have to register separately for VAT, incorporated subsidiaries of the same business group are subject to individual registration.

37. It is not uncommon to allow grouping of taxpayers for VAT purposes. Single registration implies that all branches of a given company operate as a single VAT taxpayer and internal movements of goods and rendering of services do not constitute a taxable supply. This is currently practiced in Mozambique. What is missing is a solution that could be offered to individual businesses belonging to the same business group, so called grouping for VAT purposes. It allows businesses to pool their operations and register as a single VAT taxpayer. Such a mechanism improves their cash flow and eliminates situations where one of the businesses is in a constant refund position and others have positive VAT to pay – these positions could be offset at a group level and only the excess VAT remitted to the tax authority. This solution is especially beneficial for businesses having exempt operations, e.g., financial companies. Having no right to deduct VAT they pay on their purchases (e.g. IT, HR, training or accounting services) they tend to vertically integrate their operations and self-supply to themselves. This is not always the most efficient way of doing business and having provisions for VAT grouping would help address this limitation. VAT grouping may be also beneficial for the extractive sector where upstream and downstream operations, belonging to the same group but separately incorporated, may have different VAT positions.

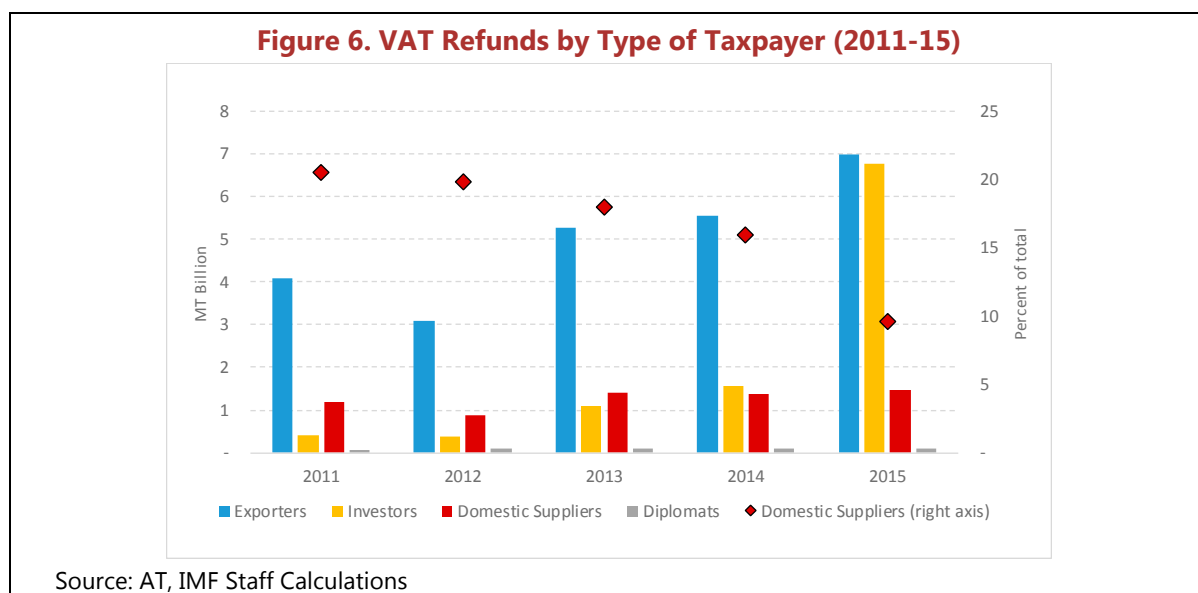
VAT Refunds

38. Excess tax credits are refunded should a taxpayer elect to claim them. There is however a time limitation – excess tax credits have to be first carried forward for 12 months and only then can be claimed. The draft amendment to the VAT Act attempts to shorten this term to 3 months. The AT has 30 days to review and pay the requested refund. If there is a need to further verify a claim the deadline may be extended to up to 6 months. Since 20015 VAT refunds are paid out of an escrow account which is funded by a prescribed share of gross VAT collections – currently 16.4 percent. Refunds are paid on first in first out (FIFO) basis.

39. Paying refunds can be further improved. The mission welcomes recent changes to the VAT refund mechanism and creation of the escrow account. The AT's experience to date shows it has greatly improved paying VAT refunds; delays taxpayers face are now much shorter. Three elements of the VAT refund mechanism could be revisited. First, it is not clear why taxpayers have to wait 12 (or 3 months, as proposed) for their excess credit to be refunded. Carrying forward excess credits puts a strain on their cash flow and undermines its present value. Second, there is no time limit to carrying excess credits. Many countries limit taxpayers' right to claim refunds to

12 or even 6 months, beyond which point taxpayers cannot ask for their excess tax credit to be refunded. Having such limitation in place motivates taxpayers to keep their books up to date and not delay their claim decisions and for the tax authority it provides more certainty and ensures a stable flow of request. Had the AT had such a limit in place the 2015 surge in refund claims would have never materialized. Third, the requirement for AT to process all the refunds in 30 days is unrealistic given its current capacity. A 90-day period would better serve the needs of AT. Nothing prevents AT to establish some “fast tracks” for certain taxpayers (known to AT and in good standing) and pay refunds as soon as possible.

40. It is important to sufficiently fund the VAT escrow account to guarantee smooth operation of the VAT refund mechanism. After the backlog of outstanding refunds has been cleared a new estimation should be conducted. Data shows that refunds requested in the past accounted for around 20 percent of gross VAT receipts, roughly 4 percentage points higher than the current funding. If one takes into account that the refunds requested in the past were artificially downsized (as discussed in Section A) the ratio of refunds to gross receipts may be in fact higher than 20 percent. More importantly, however, with the new VAT refund mechanism up and running, the argument for providing numerous import exemptions e.g., to petroleum and mining companies, or investment projects subject to CFB, disappears. Once these are removed, as recommended, the need for higher refunds may arise. On the other hand, through removal of domestic zero-ratings (e.g., on certain food items, live animals, edible oil, soaps, sugarcane, jet fuel, drilling services for petroleum industry, etc.) and reduced rates (e.g., on public work services, aeronautical services or electricity) refunds currently paid to domestic suppliers should disappear. This is not insignificant - in 2011-2015 refunds requested by domestic suppliers amounted to 17 percent of total requested (Figure 6).



41. Securitization of VAT refunds should be avoided to the extent possible. Taxpayers pay VAT in cash and are entitled to receive refunds in the same form. Compared to not being

refunded at all or with a significant delay the option of receiving government paper is arguably welcome by taxpayers. Nevertheless, it adversely affects their liquidity and also the value of refunds received if they are forced to trade the paper at a discount. The authorities should explore options for raising funds through selling bonds in the open market and use the additional funding to pay refunds in cash. It should be a taxpayer's choice to acquire government paper and not the authorities'.

Place of Supply

42. The VAT Act contains a set of rules on the place of supply of goods and services.

Services supplied by a non-resident entity are subject to the Mozambican VAT through a reverse charge mechanism. The list includes among others banking, financial and insurance services. The draft VAT amendment attempts to expand the list by adding a number of electronic services and "other similar services". There are no specific rules that would refer to triangular services or effective place of enjoyment.

43. Sound rules on place of supply of goods and services are critical to the effectiveness of enforcement of VAT on a destination basis. These rules should provide for a clear answer to the question of where goods and services are taxed in the case of cross-border trade. For goods the problem is of a lesser significance when borders exist. Taxation of services, whose share, including in cross-border trade, is growing, is more complex. The nature of VAT dictates that services should be taxed where they are consumed in economic sense, regardless where performed or where the supplier or customer resides. A textbook question is: where should the VAT be paid in the case of a Mozambican person having personal care service (e.g., hairstyling) performed in Swaziland by a renowned hair stylist living in Zambia, on their way to a wedding in Johannesburg, South Africa? Should it be where the consumer resides (Mozambique)? Or where service provider resides (Zambia)? Or where the service is performed (Swaziland)? Or where it is effectively enjoyed (wedding in South Africa)? Although the example is trivial it shows that establishing the place of supply of services may be a complex issue and a set of more specific rules is needed. For larger transactions the amounts at stake are obviously higher.

44. Current Mozambican solutions with respect to taxation of services tend to rely on two principles. The underlying principle is that services are taxed where the supplier resides, implying that unless there are specific provisions all services provided by Mozambican entities are taxed in Mozambique. The exception to this rule are services listed in Art 6 par. 4 and 8 of the VAT Act. Art 6 par. 4 relies on the principle of place of performance – services related to immovable property, or carried out on movable property located abroad or entertainment and cultural services performed abroad and transportation outside Mozambique have their place of supply outside Mozambique and are thus zero-rated. Art 6 par 8 relies on the principle of customer residence – as long as services listed therein (e.g. advertising, professional, data processing, telecommunication services or leasing of movable property) are provided to a customer established or living abroad.

45. The set of rules on place of supply seems to be incomplete. The list of services deemed to be exported is exhaustive, hence omitting services not mentioned therein, e.g., broadcasting or catering. The relation between principles set in Art. 6 par. 4 and par. 8 is also not clear – it is difficult to construe where scientific services supplied to a company in London but performed in Mozambique will be taxed. In addition, there is no clear distinction between B2B and B2C services, neither whether a customer, even if being a business establishment, is a taxable person or exempt one – Art. 6 par. 8 does not have this qualification whereas Art. 6 par. 7 does. In effect all listed services provided to non-registered customers living abroad are zero-rated (and not taxed abroad). This is not symmetrical and may lead to unwarranted revenue loss. Given the issues listed above, in the interest of protection of Mozambican tax base as well as to ensure efficiency of the VAT, the rules on place of supply should be carefully reviewed and amended as needed. The proposed amendment and inclusion of electronic services in Art. 6 par. 7 of the VAT Act is clearly a move in the right direction. Yet, more is needed.

Denied Input VAT Credits

46. Many VATs deny certain input tax credits incurred in business operations. This is largely to prevent deduction of expenses that represent private or personal consumption on which VAT, as a final consumption tax, should be paid. The problem is more acute in the case of small, owner-operated businesses, where incentives to present personal consumption (e.g., purchase of fuel, computers, even furniture and personal travel) as business inputs are high. This problem is best addressed, as discussed above, by having a relatively high VAT registration threshold and – in general – through audits. Too strict rules on denial of VAT inputs lead to tax cascading and compromise the neutrality and efficiency of the VAT. It is important to strike a fine balance with respect to denial of VAT input credits.

47. On the one hand, the Mozambican solutions appear to be too strict and, on the other hand, too lenient. A clear example of a too strict approach is the lack of input tax credit on fuel other than diesel used in non-passenger vehicles or fuel (including diesel) used in heavy duty trucks in the mining sector (it is allowed for vehicles and machinery used in agriculture). Denial of expenses on telecommunication, other than fixed land lines, is also not warranted. At the same time there is no general rule that would exclude a wide range of typical personal consumption items, e.g., personal care and clothing, or a general rule excluding all goods and services provided to taxpayer's employees (only transport and travel expenses are explicitly excluded). In effect computers, accommodation and mobile phone services provided to employees may be deducted. These expenses are in-kind benefits or additional remuneration for hired labor replacing cash salaries and as such should not be deductible.

Recommendations

- Increase the VAT registration threshold to at least MT 4 million;

- Apply the standard VAT regime to all registered taxpayers, including those below MT 4 million who voluntarily register;
- Abolish the simplified VAT applied at 5 percent of turnover;
- Introduce a minimum registration threshold of MT 750,000, except for exporters;
- Allow for single VAT registration of taxpayers within the same capital group;
- Set 12-month time limit for claiming excess VAT credits;
- Ensure sufficient funds in VAT escrow account; reevaluate the ratio of gross receipts funding, including after the VAT reform has been completed;
- Pay VAT refunds in cash and avoid securitization thereof;
- Carefully review and improve rules defining place of supply of services;
- Consider reviewing the list of non-deductible input tax credits to allow for deduction of non-diesel fuels and diesel fuel for mining machinery, and disallow any credit paid on goods and services provided to taxpayer's employees.

C. VAT Exemptions and Reliefs

48. Mozambique provides for an exceptionally wide range of VAT exemptions and special reliefs. They are listed directly in the VAT Act and additional pieces of legislation, most importantly the CFB. Special reliefs encompass domestic zero-ratings and reductions in taxable value for certain supplies, thus effectively VAT reduced rates. The list of VAT concessions extends far beyond conventional exemptions such as those for health and educational services, diplomatic missions or imports of personal belongings. Table 2 summarizes the most important exemptions and reliefs.

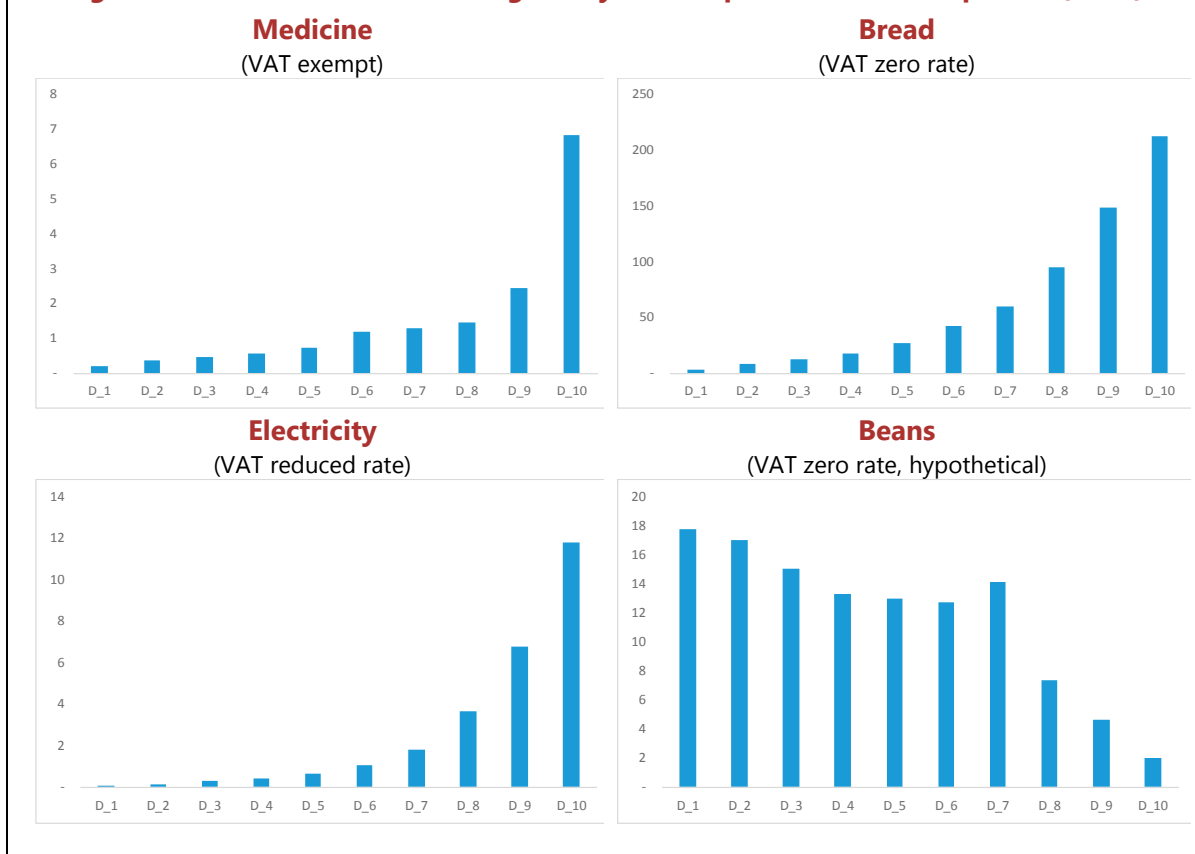
49. Unfortunately, rather than embarking on curtailing the most distortive exemptions and reliefs Mozambique continues to expand their list. Only in 2012, 10 new exemptions aimed to benefit agriculture, sugar producers and oil and soap industry and two zero-ratings of agricultural products were added to the VAT Act. The draft VAT amendment would further add to the list if adopted – three new VAT exemption, five zero-ratings and one reduced rate (marked in red in Table 2) would be put in place. In addition, six exemptions adopted in 2012 with a sunset clause phasing them out at the end of 2015 are planned to be extended by four years, by the end of 2019. No exemptions or reliefs has been abolished over recent years, at least since 2010.

50. VAT tax exemptions and reliefs are not needed and should be avoided. In general countries decide to introduce them 1) to ease the perceived regressivity of VAT and help the poor, 2) to avoid complexity of measuring value added in some sectors (e.g., VAT on margin

based financial services), 3) to address the problem of non-functional VAT refund mechanism in hope that less refunds will be requested, 4) to alleviate tax cascading created by previously introduced tax exemptions, and sometimes 5) to lower the cost of government operations, i.e. lower the price the government pays for goods procured. All of these appear to have been true for Mozambique. Yet, with the improved VAT refund mechanism reasons 3 and 4 have now disappeared and providing for exemptions on inputs, especially to incentivize investment is not good policy. When refunds are paid without significant delay investors will be able to recover all input VAT through standard crediting/refunding mechanism. This way avenues for leakage are also closed and VAT revenue performance improved. For this simple reason all the exemptions provided on inputs, especially but not exclusively those provided in the CFB, should be immediately abolished.

51. The issue of VAT equity is perhaps of the utmost significance in political debate and has to be better understood before introducing VAT preferences. Rather than improving they undermine the fairness of the system. As mentioned above (reason 1) a common justification for adopting VAT preferences is the authorities' desire to improve tax progressivity. Such vertical equity concerns are addressed in Mozambique by relieving from tax goods and services that are consumed mainly by the poor or constitute a large portion of their expenditures, such as basic food staples, medicines, or health services. Contrary to the common perception, however, such measures do not improve equity – providing for tax exemptions and reliefs can make VAT's regressivity even more pronounced as the rich consume more of any given good and in absolute terms they receive a far greater benefit than the poor. The examples of exemptions on medicines, zero VAT rate on bread, and a reduced VAT rate on electricity clearly show that while foregoing revenue the government is subsidizing mostly the rich (Figure 7). In all three cases revenue forgone benefited mostly the top three deciles of Mozambican population – they received 52, 59 and 73 percent, respectively of the total subsidy. Progressivity of the VAT could only be improved if preferences were provided on goods consumption of which decreases while a person's income rises. The 2015 Mozambican household budget survey points to only a few goods that show such characteristic, e.g., cassava flour, fresh cassava, sweet potato or beans. Figure 7 shows that zero-rating of beans, should it exist, would provide more benefits to the poor than the rich, as 52 percent of the total subsidy goes to the bottom 3 deciles, whereas the top three deciles receive 7 percent of the overall gain. However, for administrative reasons, providing VAT preferences on such goods is not recommended.

Figure 7. Distribution of VAT foregone by consumption deciles, MT/person (2015)



52. Equally, it is not a good policy to provide VAT preferences to the government itself.

Currently, a number of VAT exemptions and reliefs benefit solely and directly the public sector and not private consumers. Supplies of equipment and uniforms to the military, firefighting vehicles are exempt and supplies of public work services (e.g., construction of roads, bridges, water pipelines and electrification infrastructure) are subject to a 60 percent reduction in taxable value (effectively a 6.8 percent VAT rate). These are not needed as there is no net gain to the government. In absence of these preferences, the government would have to increase its spending but at the same time it would receive the same amount of VAT in revenue. In fact, due to VAT leakage (unintended loss of revenue, e.g., bogus sales purported to be made to the government or resale of superfluous goods procured by governmental agencies), government could be losing revenue through the existing VAT preferences. There are two other VAT preferences that benefit the government indirectly – tax exemption on imports by political parties and congressmen. Rather than providing these preferences, which are prone to acute abuse, the government could easily compensate political parties and members of parliament through direct subsidies, if needed. After all, such preferences set a negative example and are detrimental to building a culture of paying taxes. If the government and public officials take advantage of the tax system, why others should not be interested in similar benefits? In effect, such preferences expose the authorities to unnecessary pressure from interest groups and general public.

Table 2. Summary of VAT Exemptions and Reliefs in Mozambique (2016)

Description	Introduction Date	Beneficiary	Consumption			
			Final	Intermedate	Domestic	Imports
I. EXEMPTIONS						
Health Services			+		+	+
Medicines and prosthetics			+		+	+
Inputs to medicine production	2016	Pharm. industry		+	+	+
Braille typewriters and printers	2016		+		+	+
Mosquito nets			+		+	+
Social assistance			+		+	+
Security related goods and services			+		+	+
Personal care (nurseries, elderly houses etc.)			+		+	+
Sport and entertainmnet			+		+	+
Cultural and artistic services			+		+	+
Religious and spiritual services			+		+	+
Fundraising activities			+		+	+
Education and vocational training			+		+	+
Financial services, includng insurance			+	+	+	+
Gambling			+		+	+
Supplies of immovable property			+	+	+	+
Rental of residential property			+		+	+
Rental of commercial property			+		+	+
Provision of services in properties in rural zones			+	+	+	+
Goods and services made using own resources (Livestock, fishery and forestry)			+	+	+	+
Intellectual property			+	+	+	+
Newspapers, magazines and books			+	+	+	+
Supplies to military (services, equipment, uniforms, etc.)		Government	+		+	+
Post stamps			+	+	+	+
Waste disposal services			+	+	+	+
Funeral services			+		+	+
Soybean, meat/bone flour, etc. to be used in fodder production	2012	Agriculture		+	+	+
Equipment and tools for agriculture	2012	Agriculture		+	+	+
Seeds, fertilizers, pesticides, etc. (Annex I to VAT Act)	2012	Agriculture		+	+	+
Veterinary medicines	2012	Agriculture		+	+	+
Needles and syringes for veterinary use	2016	Agriculture		+	+	+
Sugarcane	2012	Sugar Indsutry			+	+
Sugar	2012		+	+	+	+
Supplies (inputs, incl equipment and raw material)	2012	Sugar Indsutry		+	+	+
Food oils and soaps	2012	Oil/soap industry		+	+	+
Goods using edible oils and soaps	2012	Oil/soap industry	+		+	+
Inputs used in oil and soap industry	2012	Oil/soap industry		+	+	+
Imports of equipment goods for political parties		Political parties	+			+
Imports of goods for scientific, cultural and social activity				+		+
Imports for Congressmen		Government	+			+
Firefighting vehicles			+			+
Imports of mining/petroleum equipment and goods		Extractive Industry		+		+
Imports for large investment projects				+		+
Imports for investment in rural areas		Agriculture		+		+
Imports of raw materials for manufacturing		Manufacturing		+		+
Imports of goods for agricultural and fishery projects		Agriculture		+		+
Imports for hotel and tourism projects				+		+
Imports for scientific projects				+		+
Imports for projects in Rapid Development Zones				+		+
Imports and domestic supplies for projects in Special Economic Zones				+	+	+
Imports and domestic supplies for projects in Industrial Free Zones				+	+	+
II. ZERO-RATING						
Staple food items (maize flour, wheat, flour, rice, salt, bread)			+	+	+	+
Maize	2012	Agriculture	+	+	+	+
Kerosene			+		+	+
Jet fuel				+	+	+
LPG	2016		+	+	+	+
Bicycles			+		+	+
Condoms			+		+	+
Insecticides			+	+	+	+
Fodder for animals	2012	Agriculture		+	+	+
Goods and services made using own resources (Farming, including poultry farms)	2016	Agriculture	+	+	+	+
Drainage, irrigation, etc. & land spraying services	2016	Agriculture		+	+	+
Public passenger transportation	2016		+		+	+
Packaging and containers used by exporters	2016	Exporters		+	+	+
Services related to research, prospecting, drilling and building infrastruture		Extractive Indsutry		+	+	
Acquisition of goods to relieve natural disaster effects			+		+	
Goods for grants to public institutions pursuing social objectives			+		+	+
III. VAT BASE REDUCTION (REDUCED RATES)						
Fuels (less Fuel Levy)			+	+	+	
Electricity (62 % of base)			+	+	+	
Aeronautical services (85 % of base)				+	+	
Supply of public works (40 % of base)		Governmnet	+		+	
Supply of water through public network (75% of base)			+	+	+	

53. The list of VAT reliefs, as shown in Table 2, is a myriad of different measures, having different consequences in terms of revenue and efficiency loss. This depends not only on the form of relief (exemption, zero-rating or tax base reduction) but also on whether it is applied to final consumption, business inputs, domestic supplies and/or imports. Zero-rating and tax base reductions (reduced rates) do not lead to tax cascading but result in outright revenue loss when applied to consumer goods and services. In case of goods and services constituting business inputs there is no direct revenue loss, though leakage is very likely especially in the case of importation. VAT exemptions are not different when applied on imports – there is no efficiency loss and revenue is lost only when goods and services are imported directly by final consumers. In the case of VAT exemptions applied to domestic supplies, their impact differs depending whether they fall on consumer goods or business inputs. In the latter case they cause tax cascading and affect production decisions. In principle there is no revenue loss and due to tax cascading they may actually lead to base expansion and more VAT collections. When applied to consumer goods VAT exemptions result in partial revenue loss – unlike zero-rating they remove VAT only from the last stage of production or distribution, and not from the entire value chain.

54. Mozambique loses a large portion of its revenue through VAT reliefs and tax exemptions. As shown in Table 3 only through zero-rating of the current basket of products/services it lost MT 12.2 billion or 25 percent of total VAT collections in 2015. With introduction of zero tax rate on passenger transportation it will lose additional MT 1.8 billion. Through reduction of tax base on fuels and electricity the loss of revenue amounts to MT 250 million and since 2017 additional MT 19 million will be lost due to a reduced rate on piped water. Reduced rate on public works is yet another, and significant, source of revenue loss – around MT 3.6 billion. Revenue foregone resulting from various tax exemptions is also large. As shown in Table 4 it amounts to more than MT 1.4 billion (or 3 percent of total VAT collections in 2015). It has to be noted, however, that only a portion of exemptions falling on final consumptions was included. A number of important ones, including on banking services and new immovable property is missing due to data limitations.

Table 3. Revenue foregone: VAT zero-rating and reduced rates (2015)

	Tax rate	Household Consumption	VAT foregone	
			Current	Future
Food products	0	70,589	12,000	12,000
Baby formula	0	56	9	9
Condoms	0	3	0	0
Bicycles	0	881	150	150
LPG & Kerosene	0	610	104	104
Passenger transport	0	12,641	-	1,837
Jet fuel 1/	0	n/a	-	-
Fodder for animals 1/	0	n/a	-	-
Drainage and irrigation 1/	0	n/a	-	-
Packaging for exporters 1/	0	n/a	-	-
Fuels 2/	15.3	14,170	208.92	209
Electricity 2/	10.54	696	41	41
Public works 3/	6.8	38,150	3,644	3,644
Water (piped)	12.75	517	-	19
Aeronautical services 1/	14.45	n/a	-	-
TOTAL			16,157	18,013

1/ Largely business inputs; minimal revenue loss

2/ Only household consumption; actual revenue loss higher as input VAT non deductible plus public consumption

3/ No household consumption; 50 percent of government capital expenditure assumed

Source: INE HBS, IMF, IMF staff calculations

Table 4. Revenue foregone: select VAT exemptions (2015)

Good/service	Household consumption	Share of inputs, percent (assumption)	Revenue foregone
Health services	4,834	20	657
Medicines	657	75	28
Mosquito nets	45	60	3
Social assistance services	452	30	54
Sport and culture	84	40	9
Education services	4,728	40	482
Insurance (exc. life insurance)	955	40	97
Gambling	11	40	1
Books and magazines	600	75	25
Waste disposal services	123	75	5
Funeral services	45	60	3
Sugar	1,622	80	55
TOTAL	14,155		1,420

Source: INE HBS, IMF staff calculations

55. Additional revenue is lost through border exemptions. This category of exemptions does not have to necessarily translate into final revenue loss, as many of them either apply to business inputs, e.g., all fiscal benefits provided for in the CFB, and will be recouped through output VAT on taxable supplies or fall on imports that are traditionally exempt either because of international agreements (e.g., diplomatic missions) or standard customs procedures (e.g., personal allowances, personal belongings, temporary imports, etc.). Nevertheless, some imports constitute final consumption (e.g., exemptions for political parties, or miners returning to Mozambique from South Africa). Only those two exemptions resulted in MT 14.4 billion of VAT loss in 2015 – MT 2.1 billion and MT 13.2 billion respectively. Even more is lost through excise exemption on vehicles imported by the miners (MT 17 billion). Additional risk from exempting imports, even if these are business inputs, comes from leakage, as it is extremely difficult to ensure that exempt goods are used in accordance with the stated purpose.

56. Domestic VAT exemptions on business inputs are especially problematic. As shown in Table 2 there is no shortage of them. They are specifically provided to agriculture, sugar, oil and soap or pharmaceutical industry but also encompass other products that are largely consumed by households but to some extent also by businesses, e.g., waste disposal services, training services, books, or newspapers. As explained earlier, domestic VAT exemptions lead to tax cascading and are in fact not favored by businesses. Since it is impossible to distinguish which goods (and services) are business inputs and which are consumer goods, any exemption, even if introduced with final consumers in mind, e.g., books, newspapers or education services, tend to adversely affects businesses. Once VAT exemptions overwhelmingly fall on business inputs or are introduced with this objective in mind, it quickly turns out that corresponding output exemptions are needed to overcome tax cascading. This leads to the so called preference creep.

57. Recently introduced exemptions and reliefs for agriculture prove the existence of a preference creep. The authorities claim they provide incentives to agriculture to relief it from tax and thus reduce the price of its products. Since agricultural output had been already exempt it turned out necessary to introduce in 2012 exemptions for inputs – from equipment, to seeds, to fodder, to fertilizers. This was arguably needed to address the issue of non-recoverable input VAT or – in other words – to fix previously created problem (exemptions on outputs). Other cherry-picked industries, i.e., sugar industry and oil and soap producers “benefited” from similar policy – first outputs and then inputs used by these industries became exempt. This is a highly inefficient and in fact counterproductive policy. Unless one can assure that all VAT on inputs is removed throughout the value chain, which can be done only through zero-rating, tax exemptions lead to inefficiencies and distortions, including higher prices. The issue of poultry production, recently discussed at the AT’s tax policy seminar is a telling example – despite exemptions on maize, soybeans and other major agricultural inputs producers still complain about the VAT. With processed chicken being taxed, input exemptions are of no benefit for farmers and the chicken industry. Zero-rating of poultry raised using own resources, as proposed in the draft VAT amendment, will not solve the problem as it will not be applicable to the final sale of processed or frozen chicken. Table 5 provides a simple numerical example illustrating that exemptions lead to tax cascading and increase consumer price. By all means the best possible approach to taxation of agriculture and other industries is to tax all goods and services, both inputs and outputs.

Table 5. VAT exemption – numerical representation				
	Value	All sales taxable	Mozambique's approach	Exemption for frozen chicken producer
<i>Tax applied at 10 percent</i>				
<i>Producer</i> Grain	10	1	0	0
Fodder	40	4	0	0
Other	10	1	1	1
Chicken	70	7-1-4-1=1	0	0
<i>Industry</i> Chicken	70	7	0	0
Energy	10	1	1	1
Frozen chicken	90	9-7-1=1	8-1=7	0
<i>Retail</i> Acquisition	90	9	8	0
Sale	100	10-9=1	10-8=2	10
<i>Total tax</i>		3+(1+4+1+1)=10	9+(1+1)=11	10+(1+1)=12

58. If Mozambique decides to remove existing exemptions and reliefs and tax possibly broad range of goods and services, it may consider introducing a flat rate scheme for non-VAT registered farmers. Larger agricultural producers will be VAT taxpayers anyway and will recover all VAT they pay on their inputs through VAT crediting and/or refunds. Smaller farmers may also voluntarily register for VAT. For those not registered and thus exempt a well targeted and direct compensation scheme of input VAT may be adopted. The EU-like special flat rate scheme would allow non-registered farmers to recover their input VAT without breaking the VAT value chain. Under the flat rate scheme businesses buying from exempt farmers calculate deemed output VAT using prescribed rate and issue an invoice on reverse charge basis. The

amount of the deemed VAT is paid to a farmer (as part of the supply price) who does not remit it to the tax authority and keeps it for himself. The buying business deducts the amount of deemed VAT paid to the farmer as an input VAT. The whole transaction is thus neutral for the buying business. For this mechanism to be equitable Mozambique would have to establish an average share of taxable inputs in small scale farming operations and set the flat scheme rate(s) at a reasonable level to ensure there is no overcompensation. Table 6 presents flat scheme rates used by select countries in the EU.

Table 6. VAT flat rate scheme for farmers in EU: Rates (2016)

Country	Rate	Supplies	Country	Rate	Supplies	Country	Rate	Supplies
UK	4.00		Belgium	2.00	Supplies of wood	Italy	2.00	Wood, natural cork
Ireland	5.20			6.00	All other supplies		4.00	E.g. fish, vegetables, fruit
Netherlands	5.40		Germany	10.70	Agriculture		7.30	E.g. horses, sheep, goat,
Cyprus	5.00			5.50	Forestry		7.50	Poultry
Greece	6.00		Spain	10.50	Livestock and fisheries		7.65	Live animal of bovine species
Lithuania	6.00			12.00	Agriculture and forestry		7.95	Live animal of pork species
Portugal	6.00		France	5.59	Milk, poultry, eggs, meat and protein crops		8.30	Certain type of meats
Poland	7.00			4.43	Other products		8.50	Certain type of meat and fat
Slovenia	8.00		Luxemburg	4.00	Forestry		8.80	Eggs, honey, wax, fur
Austria	12.00			12.00	Crop production, stock farming together with cultivation		10.00	Fresh milk (not treated)
Latvia	14.00		Hungary	7.00	Animal products		12.30	Wines of fresh grapes
				12.00	Vegetable products			

59. Finally, in arguing for VAT exemptions and reliefs removal, one has to take the benefit of increased simplicity and compliance. All VAT preferences complicate compliance and tax administration. This is largely through the additional effort to properly delineate between goods and services that fall within the scope of exemption and those which do not. It is not always easy to draw a line between the two. When bread is zero-rated does it encompass breadcrumbs? How one can distinguish between “ordinary bicycles” and toy bicycles? These are not trivial questions for taxpayers tend to interpret the scope of exemptions in an expansionary way whereas tax authorities prefer to limit them. This leads to costly disputes, let alone the revenue loss. Lack of exemptions helps also address the issue of VAT leakage.

Recommendations

- Do not adopt additional VAT reliefs as currently proposed in the draft VAT amendment, including those on passenger transport and inputs for agriculture;
- Do not extend VAT exemptions already expired at the end of 2015;

- Remove all VAT preferences falling mostly on business inputs, including those for agriculture and other targeted industries (CFB);
- Abolish all zero-ratings of domestic supplies;
- Charge VAT on full tax basis for electricity, fuels, supply of public work services and aeronautical services; do not adopt the proposed relief for piped water;
- Remove all exemptions that do not fall into the category of education, health and social assistance services;
- Do not provide for any VAT preferences for government, political parties and members of parliament;
- Improve enforcement, including through the recovery of VAT not paid on goods, especially vehicles, imported by miners working in South Africa upon sale of these goods into domestic market.

D. Bringing New Bases into the VAT Net

60. In addition to curtailing inefficient and distortive VAT exemptions Mozambique could consider bringing financial services, immovable property and gambling into the VAT net. As is common, these items are currently exempt from VAT but some of them are taxed under other taxes. Interest on loans paid to banks, regardless if by individuals or businesses, are subject to stamp duty at 2 percent. Transfer of immovable property is subject to SISA and gambling to a separate gambling tax. As a principle, construction services and building materials are taxable under VAT.⁹

Financial Services

61. Full taxation of financial services remains difficult to achieve. For banks, value added may be defined roughly as the difference between interest received from loans and investments (comparable to sales) and interest paid to depositors (comparable to inputs for businesses), commonly known as the interest “spread”. An invoice-credit VAT cannot tax the spread on a transaction-by-transaction basis and ensure registered lenders can claim corresponding input tax credits, while taxing the full interest charge would amount to over-taxation.

62. However, fee-based financial services do not pose the same observability issue and are increasing included within the VAT base. VAT exemption is then limited only to margin

⁹ Unless a special relief is provided, e.g., supply of building materials and constructions services by a developer declared to be a free zone company.

fees. All fee-based financial services should be taxed under VAT. Taxing them under a separate tax may be cumbersome both for businesses and tax administration.

63. Taxing property and casualty insurance services under VAT is feasible and desirable. Since these are effectively fee-based services there are no administrative complexities in taxing them, an argument often raised against such treatment of insurance services. The value added of property and casualty insurance companies may be defined as the difference between premiums collected and benefits and indemnities paid out. Most modern VATs, e.g., Australia, therefore tax these insurance companies on their net margin by imposing VAT on all premiums and indemnities paid out. The tax credit is allowed for indemnities received by VAT-liable businesses. In contrast to property and casualty insurance, whole life insurance typically embodies a considerable savings element and may be exempt.¹⁰

Immovable Property

64. In VAT terms real property is akin to other durable goods and services. Under a pure VAT all transactions regarding real property by VAT registered taxpayers attract output tax, while purchasers or users of real property are entitled to a corresponding input tax credit when they use it for making taxable supplies. Net VAT revenue is then only collected if the purchaser or user of the property is not a business or uses the property for making exempt supplies. In practice, however, all VATs distinguish between residential property and commercial property, mainly to ensure VAT does not “stick” on the latter.

65. Modern VAT systems tax immovable property. Australia, Canada, New Zealand, and South Africa tax the sale, lease, alteration and maintenance of all real property. However, residential rents (and rental values) and the sale of previously occupied residential property (unless sold by a property developer who is a registered VAT taxpayer) are effectively exempt. Hotels and other places of lodging are taxed unless they provide long-term accommodation. On balance, all construction, repair and maintenance services, related professional services, and the supply of all building material, including those used in construction of residential buildings, are taxable supplies.

66. Sales of used residential building and leases thereof should be VAT exempt. Taxing of new residential property should be considered, in particular to the extent lower income households mostly self-build. Self-builders only bear input tax on the building materials they purchase and on any construction services that they purchase from registered building contractors. Other (re)sales of (non-new) residential property should be exempt. They may be subject, if Mozambique chooses to continue so, to a stamp duty.

¹⁰ For more discussion on VAT treatment of insurance services see S. Cnossen, 2012, *A Proposal to Apply the Kiwi-VAT to Insurance Services in the European Union*, International Tax and Public Finance, forthcoming.

67. Sales and leases of commercial buildings should be taxed. In such a way businesses purchasers or lessees may credit input tax the extent that they use the building for making taxable supplies – immovable property bought or lease paid becomes is a business input and carries no VAT. To this extent no stamp duty should be paid on sales of commercial immovable property. Replacing VAT with a stamp duty (a non-creditable tax on inputs) leads to tax cascading and increases costs of business activity.

Gambling Service

68. Modern VATs tax gambling, although different approaches are taken.¹¹ Modern VATs apply the standard VAT regime to all non-gambling activities (catering, beverages, and restaurant services) of casinos but treat separately the direct gambling/bookmaking/lottery activities because of the particular nature of those transactions. In a casino, for example, the customer acquires a certain amount of tokens, uses them to place wagers and later exchanges for cash his winnings and remaining tokens. The first step can easily be treated as taxable supplies, but problems arise in identifying the casino's input tax. It would be logical to treat the repurchase of tokens as an acquisition by the casino, but since the customer is usually not a VAT taxpayer, there is no input tax credit.

69. Casinos and lotteries should therefore be taxed on their net margin. The margin of the casino or lottery is calculated as the difference (recorded daily or over some other reasonable period) between the cash received for tokens or lottery tickets and the winnings paid out on the redemption of tokens or tickets. The margin should be treated as a VAT inclusive amount. To calculate VAT base for each period, the margin should be multiplied by the tax fraction, i.e., $100/(100 + \text{tax rate})$. Of course, lottery and gambling operators must isolate their turnover from other non-gambling supplies taxed under the normal rules.

Recommendations

- Exempt only margin-based financial services and tax fee-based services under VAT;
- Tax property and casualty insurance under VAT;
- Continue to exempt residential property leases;
- Tax supply of residential property by developers (new buildings), exempt sales of used residential properties;
- Tax all sales and leases of commercial property;
- Do not charge stamp duty on the transfer of a commercial property;

¹¹ For more discussion on taxing gambling and lotteries services see Krever (ed), *VAT in Africa*, 2008, pp. 47–70.

- Tax lottery and gambling operators on their net margin under VAT but apply the normal VAT rules on their non-gambling supplies.

IV. EXCISES

A. Overview

70. Mozambique has an excise tax (ICE, *imposto sobre consumos específicos*), whose base does not comprise oil products, and a separate tax on oil products (TSC, *taxa sobre combustíveis*). ICE assesses, besides the so-called excisable products—alcoholic beverages, tobacco products, and vehicles—, a list of other goods. The list includes some perfumes, cosmetics and toiletries, firearms, jewels, and few other items considered to be luxury goods. TSC base comprises motor and aviation gasoline, diesel oil, jet fuel, fuel oil, and liquefied petroleum gas.

71. ICE rates are ad valorem and TSC rates are specific. The exceptions are the rates for cigarettes, which are specific. For all other tobacco products and alcoholic beverages, although the rates are ad valorem, there are minimum specific rates. The only important exception is beer, which is subject only to ad valorem rates.¹² According to the TSC code, specific rates should be adjusted quarterly for inflation though the rate increase cannot exceed 5 percent.

72. ICE and TSC revenues have grown as a percentage of GDP in recent years but their share in total tax revenue has shrunk (Table 7). It was around 10 percent of total tax revenue before 2009 and has not reached 7 percent since 2012. The revenue from domestic beer peaked in 2012 and has since gradually declined. Other components of the base of ICE showed important revenue gains in 2013 and 2014, likely associated with the rate increases for tobacco products and other alcoholic beverages, but losses in 2015.

Table 7. ICE and TSC Revenues (2006-2015)

Tax	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
MT million										
Tax on Specific Consumptions - Domestic Products	1,122	1,341	1,633	1,794	2,219	2,917	3,044	3,452	3,972	4,070
Beer	851	1,074	1,214	1,386	1,811	2,381	2,495	2,598	2,534	2,910
Tobacco	269	249	278	317	271	384	362	491	697	735
Other products	2	19	141	92	137	152	187	363	740	425
Tax on Specific Consumptions - Imported Products	696	735	1,001	973	1,241	1,325	1,799	2,712	3,719	3,769
Fuel Fee	1,836	2,258	2,509	3,273	4,066	4,636	5,042	5,746	6,642	6,928
Earmarked Revenue	1,273	1,545	1,790	2,367	2,935	3,388	3,699	4,226	4,885	5,037
Free revenue	563	713	719	906	1,132	1,248	1,343	1,520	1,756	1,891
Total Excise Revenue	2,382	2,789	3,353	3,674	4,591	5,490	6,186	7,684	9,447	9,730
Excise Revenue as a Percentage of Total Tax Revenue*	10.15	9.44	9.78	8.79	8.10	7.62	6.99	6.83	6.71	6.93
Percentage of GDP										
Tax on Specific Consumptions - Domestic Products	0.53	0.55	0.58	0.60	0.64	0.76	0.70	0.72	0.75	0.69
Beer	0.40	0.44	0.43	0.46	0.53	0.62	0.58	0.54	0.48	0.49
Tobacco	0.13	0.10	0.10	0.11	0.08	0.10	0.08	0.10	0.13	0.12
Other products	0.00	0.01	0.05	0.03	0.04	0.04	0.04	0.08	0.14	0.07
Tax on Specific Consumptions - Imported Products	0.33	0.30	0.36	0.32	0.36	0.35	0.42	0.56	0.70	0.64
Fuel Fee	0.87	0.93	0.90	1.09	1.18	1.21	1.16	1.19	1.25	1.17
Earmarked Revenue	0.60	0.64	0.64	0.79	0.85	0.89	0.85	0.88	0.92	0.85
Free Revenue	0.27	0.29	0.26	0.30	0.33	0.33	0.31	0.32	0.33	0.32
Total Excise Revenue as a Percentage of GDP	1.73	1.79	1.84	2.01	2.18	2.33	2.28	2.47	2.70	2.50
Source: AT										
* Total tax revenue includes earmarked fees revenues.										

¹² The other exception is spirits with strength not superior to 8,5% volume (position 22.08.90.10).

B. Taxation of Alcoholic Beverages

73. Alcohol excises have the conflicting objectives of raising revenue while reducing consumption of these products to mitigate the associated negative externalities. Though both specific and ad valorem rates may be used—or a combination of both, like in Mozambique—, specific rates serve better the objective of reducing health problems since they stimulate the production of better quality beverages with lower alcohol content. They also make administration easier and evasion more difficult since no valuation is necessary and, for domestic production, flow metering is nowadays a simple practice. The downside of specific rates is that the tax tends to be regressive as it burdens cheaper brands, mostly consumed by the poorer individuals, heavier than more expensive ones. Another negative aspect is that the rates need to be indexed to inflation to avoid revenue deterioration, something that governments sometimes neglect.

74. The global trend is to apply exclusively specific rates related to the alcohol content. All members of the Organisation for Economic Co-operation and Development (OECD), except México, currently use specific rates.¹³ Table 8 summarizes the choices of SADC members. All countries use either an ad valorem rate or a specific rate by liter for wine. Five members tax both beer and spirits according to alcohol content; and Mauritius tax only spirits by their alcohol content. Eight out of the thirteen countries with available information use only specific rates.

Table 8. Types of Excise in SADC members

SADC Countries*	Taxable unit		
	Beer	Wine	Spirits
Botswana	Alcohol content	Volume	Alcohol content
Dem. Rep. of Congo	Ad valorem	Ad valorem	Ad valorem
Lesotho	Alcohol content	Volume	Alcohol content
Madagascar	N/A	N/A	N/A
Malawi	Ad valorem	Ad valorem	Ad valorem
Mauritius	Volume	Volume	Alcohol content
Mozambique	Ad valorem	Ad valorem and volume	Ad valorem and volume
Namibia	Alcohol content	Volume	Alcohol content
Seychelles	Volume	Volume	Volume
South Africa	Alcohol content	Volume	Alcohol content
Swaziland	Alcohol content	Volume	Alcohol content
Tanzania	Volume	Volume	Volume
Zambia	Ad valorem	Ad valorem	Ad valorem
Zimbabwe	Ad valorem	Volume	Volume

Source: DNA Economics and GFA Consulting Group, SADC Review – Study into the Illicit Trade in Excisable Products with Particular Reference to Alcohol and Tobacco Products, SADC, Nov. 2012.

* Angola is not listed. It does not have excise taxes but rather a broad-based turnover tax with varied rates.

¹³ OECD, *Consumption Tax Trends 2014: VAT/GST and excise rates, trends and policy issues*, OECD, Paris, Dec. 2014

75. Mozambique has very porous borders. For example, the main Malawian road is, for a long stretch, the divide between Mozambique and Malawi. There is no natural obstacle separating the two countries. Maputo is about one-hour drive from South Africa and Swaziland. So, there are good conditions for cross-border shopping and, unless customs administration is very efficient, for smuggling. In such circumstances, the only way to avoid smuggling is to have similar prices on the two sides of the border, which require, among other measures, some degree of tax coordination.

76. An analysis of bilateral trade in alcoholic beverages between Mozambique and South Africa illustrates very well this problem. The mission used data provided by the Mozambican AT and data available on the South African Revenue Service's (SARS) website to compare FOB values of exports from South Africa to Mozambique reported by SARS with FOB values of imports from South Africa reported by the AT (Table 9). For total exports of alcoholic beverages, the value reported by SARS is almost three times the value reported by AT and in the case of wines, it is nine times greater. Save for statistical gross error, either exports from South Africa are massively entering Mozambique without paying taxes or a massive carousel-type fraud is taking place in South Africa. More likely, both types of fraud are happening.

Table 9. Imports of Alcoholic Beverages from South Africa as Reported by AT and SARS

Beverage	Bilateral Trade (FOB values in MT 1000)			SAR/MOZ
	Reported by SAR	Reported by MOZ	SAR - MOZ	
Beers	165,250	64,999	100,250	2.5
Wines, liqueurs, and vermouths	116,272	12,797	103,475	9.1
Spirits	150,036	71,066	78,969	2.1
All alcoholic beverages	431,558	148,863	282,695	2.9

Sources: AT and SARS

77. No reform of the taxation of alcoholic beverages should take place before a thorough joint investigation of the border flows and until the problem is fixed. Authorities intend to reform taxation of alcoholic beverages or, at least, increase rates. If this is done before the border problem is understood and fixed, there is the risk of losing rather than gaining revenue and, at the same time, harming domestic producers. The mission recommends that, after solving the problem, government reforms the excises on alcoholic beverages in order to adopt specific rates on alcohol content. Whether this reform should be revenue neutral or revenue increasing depends on careful examination of prices of these goods in Mozambique and neighbor countries, especially South Africa. Excise rates should be set—ideally in concertation with neighbor countries—in such a way as to approximately equalize the consumer prices of these goods in all countries involved.

Recommendations

- Address immediately the problem revealed by the bilateral trade statistics;

- After understanding and solving the border problem, reform the excises on alcoholic beverages to adopt specific rates on the alcohol content and calibrate them in such a way that consumer prices match those of neighboring countries, especially of South Africa;
- Index the specific rates on alcoholic beverages (as well as the rates introduced in 2013 for cigarettes) to inflation.

C. Gasoline and Diesel

78. There are good reasons to tax motor fuels other than for revenue mobilization purposes. Gasoline and diesel are not only important sources of CO₂ emissions that contribute to global warming but also the cause of other local negative externalities. These include air pollution, traffic congestion, traffic accidents, and road wear and tear.

79. Prices of motor fuels in Mozambique are the lowest among SADC members (Table 10). South Africans may cross the border and save 29 percent on purchases of gasoline and 34 percent on those of diesel. Malawian may still do better: 43 and 47 percent savings, respectively. Alternatively, there is room for smuggling fuel into those countries; and there is room to increase either the administered price and/or the TSC rates. Doubling the rates would imply increases of around 15 percent in the price of gasoline and 10 percent in the price of diesel. Diesel would still have the lowest price in SADC and gasoline the second lowest. Additional revenue gains would come, as discussed in Chapter III, from including the TSC in tax base calculation for VAT purposes. Without increasing the TSC rates on petroleum products Mozambique will continue to effectively subsidize foreign consumers, a move no country either can or want to afford.

Table 10. Prices of Gasoline and Diesel in SADC Member (in Meticaís)

SADC Countries	Gasoline	Diesel
Angola	74.18	62.59
Botswana	55.81	52.73
Dem. Rep. of Congo	104.15	103.45
Lesotho	58.81	56.53
Madagascar	89.79	75.75
Malawi	87.15	86.21
Mauricius	80.50	61.13
Mozambique	50.02	45.83
Namibia	59.02	58.70
Seychelles	N/A	N/A
South Africa	70.09	69.89
Swaziland	62.81	62.24
Tanzania	64.52	59.66
Zambia	107.99	89.86
Zimbabwe	104.99	99.33

Source: Globalpetrolprices.com

Recommendation

- Increase the rate of TSC on gasoline to MT 15.00 and on Diesel to MT 9.00.

D. Telecom Services: Possible New Excise Base?

80. Many countries have imposed taxes on mobile phone services. The handsets themselves are taxed practically everywhere by VAT or other sales taxes and, though not everywhere, by import duties. Mobile usage—call, data, and SMS—has good characteristics to be a tax base. It is a large base since the use of mobile phones is widespread and fairly price-inelastic, the tax is simple to administer, easy to collect from few taxpayers, and difficult to evade.

81. Notwithstanding, air time tax is different from taxing other excisable items. Consumption of the latter results in negative externalities, whereas mobile services are credited for providing positive spillovers. The service reaches remote and often poor areas, providing communication and integration for previously isolated population and access to an increasing number of services not available before, like mobile banking and health consultation services. Opponents of the tax allege that it reduces mobile penetration (and, in consequence, economic growth). Proponents allege that telecom service is a natural monopoly and the tax would be borne by the service providers, cutting their economic rents. If this is the case, it would not affect marginal investment decisions.

82. A recent study found that 37 countries out of a sample of 110 impose taxes on mobile usage. 14 countries have introduced or increased excises on usage since 2011, of which four are in Africa, while four countries, among them Uganda and Democratic Republic of Congo, have decreased the excises.¹⁴ Table 11 shows taxation of mobile services in SADC member countries.¹⁵ Though Mozambique has no excise on mobile services, its tax to TMCO (or Total Cost of Mobile Ownership) ratio is in the mid-range of SADC members. This mission has not had enough information to recommend in favor or against the introduction of the excise, but encourages the authorities to undertake a study on effectiveness and feasibility of introducing of excise on mobile service usage.

¹⁴ GSMA and Deloitte, *Digital Inclusion and Mobile Sector Taxation*, GSMA, 2015. GSMA is the association that represents the interests of mobile operators worldwide

¹⁵ The table uses the percentages provided by the source. At least for Mozambique, the handset tax/handset cost data is incorrect since it does not take into account that the import duty is included in the VAT base. The correct number for Mozambique would be 25.8 percent.

Table 11. Taxation of Mobile Telecom Services (in Percent)

SADC Countries*	Tax/TCMO **	Handset tax / Handset Cost	Mobile specific tax / TCMO
Angola	5.6	15	0
Botswana	12	12	0
Dem. Rep. of Congo	22.7	39.5	8
Lesotho	14	14	0
Madagascar	27.2	31	6.6
Malawi	26	16.5	9.5
Mozambique	17.5	24.5	0
South Africa	14	14	0
Swaziland	14	14	0
Tanzania	36	18.6	15.2
Zambia	26.2	31	9.8
Zimbabwe	20.5	28.3	4.7

Source: GSMA and Deloitte, Digital Inclusion and Mobile Sector Taxation, GSMA, 2015.

* Information was not available for Mauritius, Namibia, and Seychelles.

** TCMO is the total cost of Mobile ownership = handset+activation+airtime (calls, SMS, and data).

Recommendation

- Consider undertaking studies conducive to the introduction of an excise tax on mobile phone usage.

V. CORPORATE INCOME TAX

A. Tax Incentives

83. CIT tax incentives are offered through the Code of Fiscal Benefits to encourage investment (Appendix 1). Investment qualifying for the CIT tax incentives include those carried out under the scope of the Investment Law, in addition to investment in: (1) commercial and industrial activities in rural areas, (2) new infrastructures in retail and wholesale commerce, and (3) manufacturing and assembly industries. The general tax incentive provides preferential treatment to encourage investment in all sectors through full expensing, accelerated depreciation, and investment tax credits. The sector-specific tax incentives include reduction in the statutory tax rate for investment in agriculture, hotel and tourism, and special economic zones. Many of these incentives are overlapping, and sometimes apply to very profitable investments such as telecommunication companies in rapid development zones. By benefiting the most profitable sectors/economic activities in Mozambique, these investment incentives lead to unwarranted revenue loss.

84. While tax incentives are often taken for granted as essential to generate business investment, there is plenty of evidence that this is not the case. Figure 8 summarizes findings of surveys of major business investors. It shows that investment conditions (e.g., economic and political stability and quality of infrastructure) are far more important factors in investment decisions by multinational companies than are the availability of tax incentives. The results reported in Figure 8 parallel the consultations between the mission and various members of the Mozambique business community. In those meetings, tax incentives were rarely mentioned, and were never presented as a high priority by any business leader. Their primary concerns were about revenue administration, inefficient and costly regulation, poor infrastructure, currency limitations, and other business conditions.

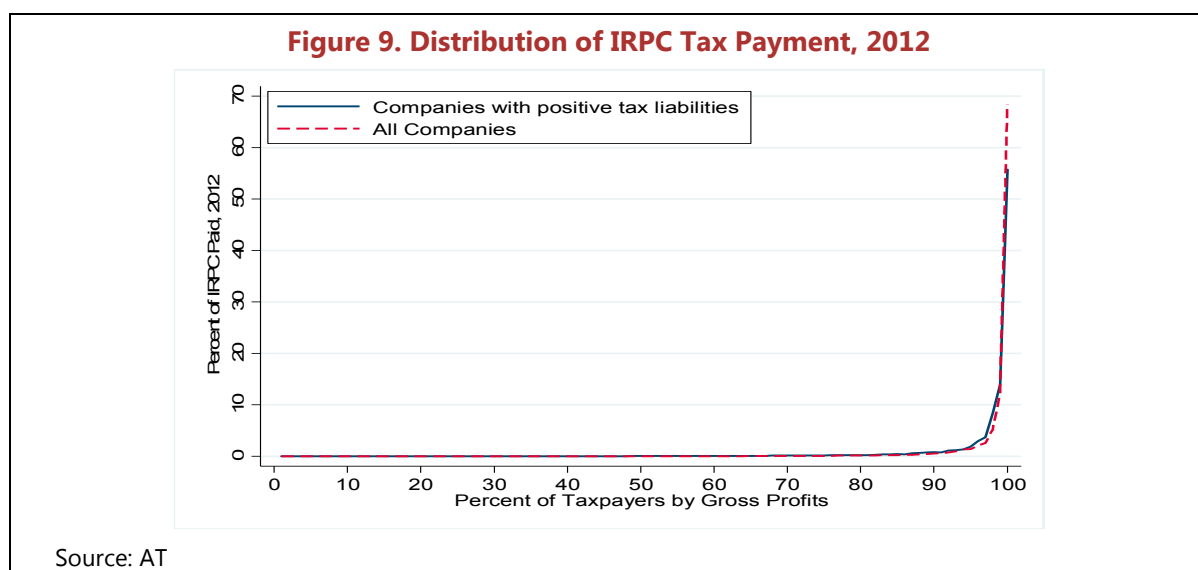
Figure 8. Importance of Tax Incentives from Investors' Perspective



Source: UNIDO; Note: Based on Investor Location Survey, 2010. Left scale = Relative rank; Right scale = Change in rank since 2007.

85. At least in the short run, these tax incentives undermine the CIT tax revenue by creating a very low level of tax burden on large companies. Despite a 32 percent statutory corporate tax in Mozambique, the average tax rate for all companies is about 12 percent as more than 40 percent of companies report negative pre-tax profits and do not pay CIT. For companies with positive CIT liability, their average tax rate is about 22 percent.¹⁶ The average tax rate measures the amount of tax payment for each Meticaís of pre-tax profits, and is a more accurate measure of the true tax burden to companies. Part of the large difference between the marginal tax rate and the average tax rate is due to the generous tax incentives, as they offer numerous tax reductions and concessions to companies.

86. CIT in Mozambique is mostly paid by companies at the top of the profit distribution. This is illustrated in Figure 9, which shows the distribution of tax payments for 2012 in two Lorenz curves. Both curves¹⁷ show a very strong concentration among the Mozambique CIT taxpayers. For example, even considering only the companies with a positive tax liability, the top 1 percent of the taxpayers contributes about 56 percent of the corporate tax. Including all companies, the top 1 percent of companies contributes close to 70 percent of the corporate tax. Overall the top 10 percent of all companies in Mozambique pay close to 96 percent of total tax revenue. Many of them are multinational companies, which consist the key revenue base in Mozambique.

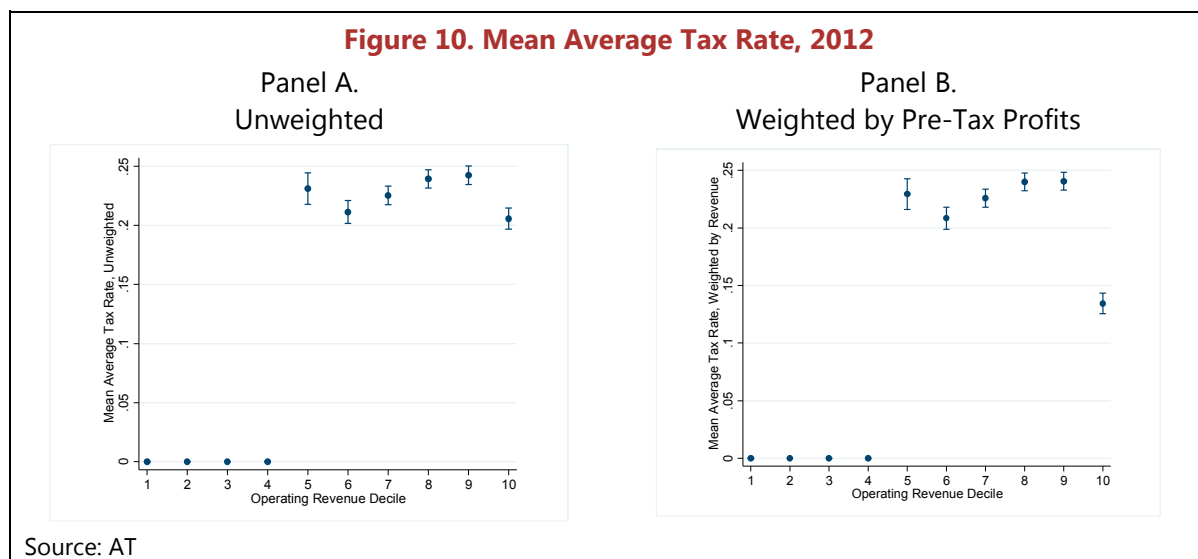


87. The largest companies in Mozambique face a much lower tax burden than the rest of CIT taxpayers. Figure 10 highlights this issue, by plotting the mean average tax rate and the corresponding 95 percent confidence interval across deciles of gross operating revenue in 2012.

¹⁶ Calculation based on IRPC tax data in 2012.

¹⁷ The distribution of tax payments for all companies is depicted by the blue-solid line, while the distribution of tax payments for companies with positive tax obligation is depicted by the red-dash line.

The mean average tax rate is computed as the amount of corporate tax liability relative to pre-tax profits in each profit decile group, either as unweighted (Panel A) or weighted by the level of operating revenue (Panel B). The average tax rate for companies at the top 10 percent of the profit distribution is strikingly lower than the rest of the corporate taxpayers. These largest companies, most of them multinational, benefit the most from the investment tax incentives and from other profit-shifting opportunities that undermine the tax revenue in Mozambique.



88. Initial analysis of the potential CIT base suggests that the gap between potential and actual collection of CIT revenue is likely to be significant. Companies' profits may be derived from their gross value added. This is done by subtracting intermediate consumption from their output (total sales, including exports). After deducting depreciation, compensation of employees (salaries and wages), and taxes on production, a rough measure of profit may be obtained. On an aggregate level, these calculations paint a comprehensive picture of business profitability and may be used as a reliable measure of a potential income tax base. The business activity survey provided by INE contains all these data for specific activities as well as aggregates for the main sectors. Unfortunately, the cost of production exceeds the business volume in a number of sectors including commercial, real estate and other service activities, and prevented a meaningful calculation of the CIT tax base at the aggregate level. An estimate of the potential CIT revenue could be computed at a 32 percent tax rate, assuming perfect tax compliance. The potential CIT revenue could then be compared with the actual tax revenue, both at the aggregate and the sector level. The gap between potential and actual collections will then help to shed light on the amount of revenue foregone due to the investment incentives, as well as the extent of tax avoidance in Mozambique.

89. Overly-generous investment incentives also lead to a very low level of effective marginal tax rate. Table 12 compares the different levels of marginal effective tax rate (METR)

under the various investment incentives offered in the Code of Fiscal Benefits.¹⁸ As a benchmark, section A shows the METRs for four major asset types without any investment incentives. The METRs under the general investment incentives, as shown in Section B, are substantially lower. Combining the general incentives and sector-specific incentives leads to negative METRs in the agriculture sector (Section C), where investment in this sector receives a subsidy from the CIT tax code.

Table 12. Effective marginal tax rate under different investment incentive in Mozambique

Asset Type	Section A: No Incentives	Section B: With General Investment Incentives				Section C: With Additional Sector-Specific Investment Incentives	
		Depreciati on Rate Increased by 50 percent	Investment Tax Credit; First Five Years		Incentives Combined	Agriculture and Fisheries	Hotel and Tourism
			5 percent in Maputo	10 percent Outside Maputo			
Machinery and Equipment	0.3	0.24	0.25	0.21	0.16	-0.02	0.13
Commercial and Industrial Building	0.32	n.a	0.27	0.22	0.22	-0.04	0.19
Residential Building	0.2	n.a	0.16	0.13	0.13	-0.02	0.11
Intangible: Patent	0.29	n.a	0.24	0.19	0.19	-0.03	0.17
Assumptions: real interest rate = 0.05; economic depreciation rate for machinery and equipment = 0.175; economic depreciation rate for commercial building = 0.031; economic depreciation rate for intangible assets = 0.154; Value of Key Tax Parameters according to Decree 72/2013 of 23 December 2013: marginal corporate tax rate = 0.32; Depreciation of the above assets follow a straight line at a rate of 10 percent for Machinery and Equipment, 2 percent for Commercial and Industrial Building, 10 percent for Residential Building, and 10 percent for Intangible assets (patent).							

¹⁸ METR measures the extent to which taxation causes the pre-tax hurdle rate of return on investment to deviate from its normal (minimum) after-corporate tax rate of return, which shareholders could obtain elsewhere. METRs reflect the “tax wedge” on investments that just break even. They are useful to assess how taxes distort the level of investment (scale decisions).

90. The tax code favors investment in residential building by prescribing a short depreciation life of 10 years. This appears to be too generous by international standard, causing the METR for investment in residential building to be 12 percentage point lower than for commercial and industrial building. By favoring investment in residential building, the differential treatment of depreciation is likely to distort investment away from commercial and industrial building.

91. Tax incentives subject to the sunset clause should be curbed within the period prescribed. Many of the benefits included in the CFB are subject to a sunset clause of 5 years, after which they will no longer apply. For example, the 80 percent reduction in the IRPC or IRPS tax rate in agriculture was set to expire on December 31, 2015. In contrast to the ongoing discussion to extend the tax rate reduction in agriculture, the government should use this opportunity to curtail tax exemption by restricting these tax benefits within the effective period prescribed in the sunset clause.

B. Corporate Income Tax Rate

92. Mozambique's 32 percent CIT rate is slightly above the average for low-income countries in the region (Table 13). Its revenue yield is comparable with South Africa, despite that the statutory corporate tax rate is 4 percentage point higher. This suggests that the numerous tax incentives discussed in the previous section undermine its efficiency, as measured by the ratio of CIT revenue to the product of the CIT rate and GDP.

Table 13. Regional Corporate Income Tax Rates and Revenue Efficiency

Country	Year	Standard CIT Rate	Revenue as percent of GDP	Efficiency Ratio
Mozambique	2015	32	6.1	0.19
<i>Low-Income</i>				
Burundi	2013	30.0	2.4	0.08
Ethiopia	2011	30.0	1.6	0.05
Malawi	2014	30.0	3.2	0.11
Tanzania	2013	30.0	3.0	0.10
Uganda	2014	30.0	0.7	0.02
Zimbabwe	2012	25.8	3.6	0.14
Average		29.3	2.4	0.08
<i>Middle-Income</i>				
Botswana	2014	22.0	5.3	0.24
Kenya	2013	30.0	3.8	0.13
Lesotho	2013	25.0	3.3	0.13
South Africa	2014	28.0	5.4	0.19
Swaziland	2012	30.0	1.8	0.06
Average		27.0	3.9	0.15

Source: a) CIT Revenue Data from GFS; b) Rate Data from FAD, KPMG, PwC (via FADTP Rates database);

*CIT Efficiency Ratio = (CIT Revenue as percent of GDP) / (CIT Rate)

93. A high statutory corporate tax rate suggests that the tax saving from shifting profits out of Mozambique to other jurisdictions is likely to be sizable. CIT rate differential indicates the extent of tax saving by engaging profit shifting, after the FDI has already taken place in Mozambique. The current statutory corporate tax rate is 32 percent, which is high comparing to countries with similar levels of GDP in this region (Table 13). For example, the average statutory CIT rate in low-income neighboring countries is below 30 percent, and the average CIT standard rate in middle-income neighboring countries is around 27 percent. Mozambique should reduce its CIT rate for non-extractive and, perhaps, telecommunication sector to 30 percent in the immediate term and should revenue pressures permit, reduce its CIT rate to 28 percent over the medium term. This would align it with the CIT rate in South Africa, its largest trading partner, improving its attractiveness as investment location, and reducing the incentives for profit shifting.

C. Anti-Avoidance Measures

94. The current law does not prescribe any specific transfer pricing rule. Article 49 establishes the arm's length principle, but does not specify the transfer-pricing rules in detail in the law or in any accompanying legislation. The government acknowledges that over-invoicing of services to related-companies and mischarging of coal prices to cross-border transactions are common practices of abusing the current system, among other transfer pricing issues. The tax authority has also noted the urgency to finalize a transfer pricing regulation draft, which has been on-going for more than three years, and publish it for public consultation.

95. The current tax form does not include detailed information on interests to assess whether the thin-capitalization rule has been observed. Article 51 disallows interest deduction if intra-company debt is excessive, and the specific ratio is 2:1 debt to equity ratio. However, there is no specific rule in Mozambique for the banking sector. Most countries either exempt financial institutions from thin capitalization rules, relying on financial regulators to ensure adequate capitalization, or specify a higher ratio aligned with their regulatory requirements. The current tax form also does not contain sufficient information on debt or interest expense to allow for a meaning analysis of company leverage.

Recommendations

- Do not extent the tax benefits subject to the sunset clause in the Code of Fiscal Benefits;
- Undertake a careful analysis of the CFB on its impact on business investment and CIT revenue;
- Conduct a detailed study of tax expenditure, identifying their size, type, their evolution, and the category of taxation to which they apply;

- Eliminate most of the tax incentives in the CFB, following recommendations of the above two analyses;
- Reduce the statutory corporate tax rate to 30 percent and further to 28 percent in the medium term;
- Increase the depreciation period for residential building to that for commercial and industrial buildings;
- Strengthen transfer pricing rules; develop the capacity of the tax authority to administer transfer pricing, including on debt transactions;
- Require reporting of more information in company tax returns to conduct meaningful analysis of risks.

VI. PERSONAL INCOME TAX

A. Overview

96. A global personal income tax (*imposto sobre o rendimento das pessoas singulares, IRPS*) substituted for a set of partial taxes on business income, labor income, and property income in 2002. The IRPS code was fully reviewed in 2007 and amended in 2013.¹⁹ The current progressive rates schedule is the same as that put in effect in 2008 and the law of 2013 moved away of the global income tax by defining the withholding tax on employment income as final.

97. The IRPS legislation classifies types of income in five categories. The first category includes employment income, retirement pensions and alimonies;²⁰ the second, business and self-employment income; the third, capital income and capital gains; the fourth, property income; and the fifth, income from gambling, lotteries, and similar as well as the sum corresponding to increase in wealth not accounted for by income classified in other categories. This categorization does not mean that the IRPS is not global since income of the different categories are pooled and the total is then subject to the schedule of progressive rates. However, as many items of capital income are subject to a 20 percent final withholding (and some to a 10 percent tax), the IRPS is a hybrid of a global and a dual income tax.

98. The 2013 amendment changed substantially the nature of the IRPS. Since 2014, employment income is subject to a final withholding. Therefore, the current IRPS became a tax that, despite a single name, is very similar to the fragmented taxation of income that the IRPS replaced in 2002. Moreover, as shown in Table 14, the IRPS is essentially a tax on labor income.

¹⁹ An IMF tax policy technical assistance mission that visited Maputo in March 2011 recommended the adoption of the global income tax, which was realized by the Decree n° 20/2002, of July 30. Law n° 33/2007, of December 31, fully replaced the previous code. Law 20/2013, of September 23, amended the 2007 law.

²⁰ In Portuguese, the word pension means also alimony.

Table 14. IRPS Revenue

Type of income	Revenue MT million	Percentage of Total
Employment income	18,410	86.4
Business and self-employment income	1,255	5.9
Capital income and capital gains	486	2.3
Rental income	870	4.1
Other income	11	0.1
Non-specified	279	1.3
Total	21,311	100.0

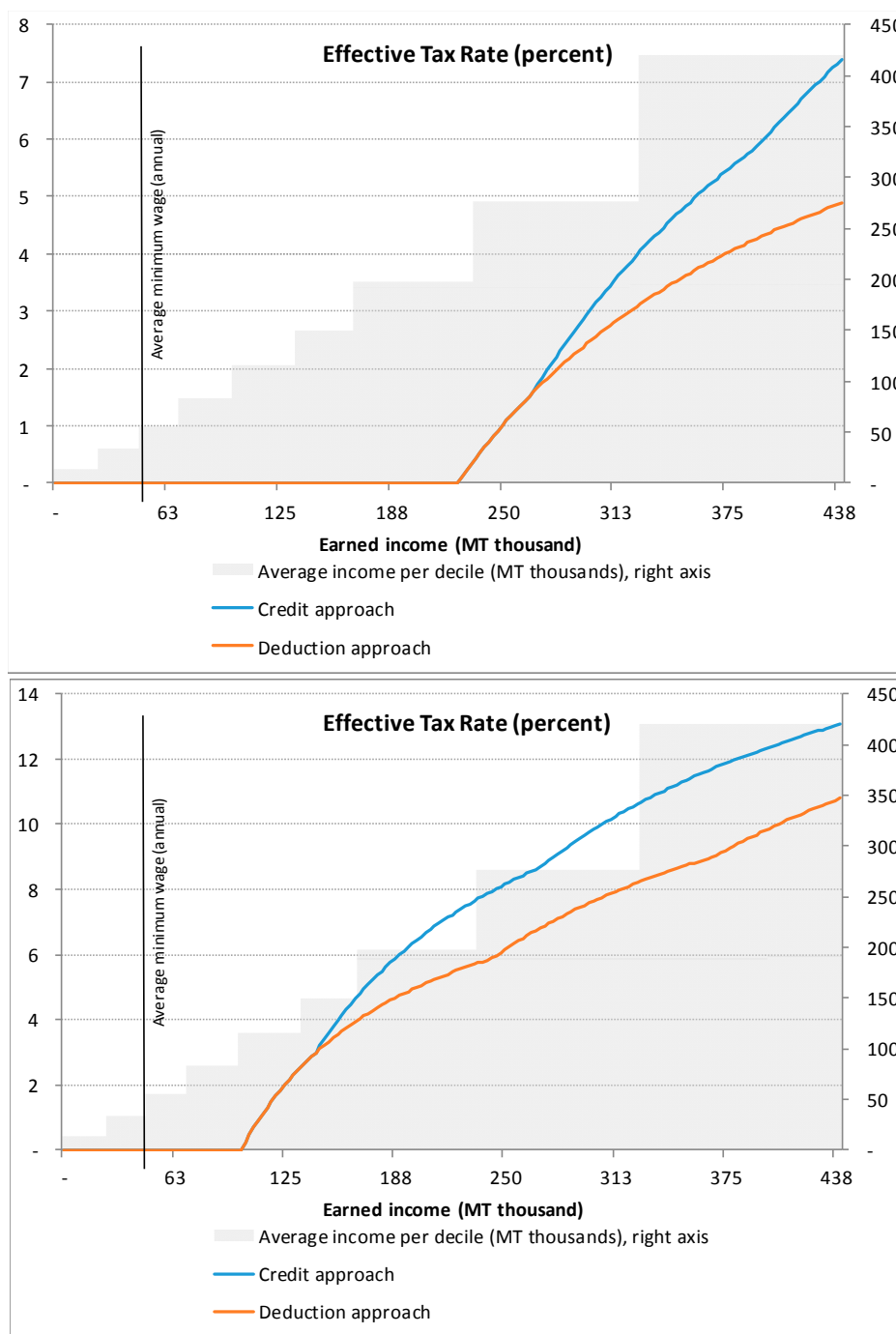
Source: AT

B. Rate Schedules

99. Law 20/2013 provided two rate schedules, one for the source withholding and the other for the annual return, that are almost compatible. Existence of compatible schedules is an important feature since incompatibility may give rise to refunds. The differences are the dependent allowance, that exists for taxation of wages but not for taxation of other types of income, and the non-taxable income allowance, higher for taxation of wages (MT 243,000, annualized) than for other types of income (MT 225,000). The non-taxable income allowances should be equal and the dependent allowance should either be eliminated or made available for all taxpayers. If extended for all, it should keep the form of tax credit, as it is currently for wage earners, rather than deduction from taxable income. Otherwise, taxpayers in high tax brackets are privileged in relation to those in low brackets.

100. Progressivity could be improved and revenue increased with two policy measures. As illustrated in Figure 11, built using the annual schedule, the use of tax credit rather than income deduction for the non-taxable income allowance would improve progressivity of the average rate, which also implies increased revenue. A reduction in the amount of the generous non-taxable allowance, whose current value excludes from taxation people up to the seventh decile of the income distribution, would also increase revenue.

Figure 11. Income Deduction versus Tax Credit and Reduction in Non-Taxable Allowance



Recommendations

- Correct the non-taxable income allowance so that the one for general income and the one for employment income match each other;
- Consider reducing the non-taxable income allowance;

- Eliminate the dependent allowance for wage earners;
- Substitute a tax credit for the non-taxable income allowance.

C. Final Withholding Tax on Labor Income

101. The change in the taxation of employment income introduced in 2013 brought about problems related to horizontal equity as well as revenue losses and reduced progressivity. Until then, income of all categories were equally treated, except certain types of capital income, like interests and dividends, and a few others, that were subject to final withholding. Withholding tax on wages was final only for employees with annual income no greater than MT 100,000 provided they had no other type of income. Currently, the withholding tax is final for all employees, including those that have other sources of income.

102. IRPS is now less progressive for wage earners who also have other types of income. An employee who has, for example, rental income pays less tax under the 2013 law than before, implying also a revenue loss to the government. Before 2014, the taxpayer had an annual exemption for MT 225,000 of his total income. Now he has an exemption of same amount for his rental income and an exemption equal to MT 243,000 for his wages. Moreover, the income split implies that the average rates applied to each part of the income are lower. For example, consider a taxpayer whose annual rental income is MT 1,500,000 a year and the monthly wage is MT 100,000. According to the old rule, he would pay each year MT 650,460; by the new rule he will pay MT 489,300, that is, about 25 percent less.

103. Wage earners without any other source of income may have to pay different taxes on the same amount of annual income, depending on their particular circumstances. Consider, for example, two wage earners whose yearly income is MT 1,200,000 but one has one job while the other has two part-time jobs, each paying MT 600,000 a year. The former will pay annually MT 206,250 while the latter will pay only MT 125,400. Consider also another employee with same annual income but who receives his wages quarterly rather than monthly. His annual IRPS bill will be MT 312,220, far more than the employees in the previous case.

104. The new rule may stimulate self-employed professionals to become employees. Consider an accountant who has 10 clients. Each client pays MT 10,000 a month for his services. The accountant may increase considerably his earnings, at the expense of the government, by asking his clients to hire him as an employee. He will then do exactly the same work for the same businesses, earning the same amount. However, when working as a self-employed professional, the accountant was paying annually an IRPS amount equal to MT 208,050. As an employee of the 10 clients he will pay no tax at all!

105. One of the objectives of the IRPS code amendment of 2013 was to simplify the administration of the tax. However, the text of the amendment is not compatible with this objective. Article 65-A states that the withholding tax is final and article 26, number 3, determines

that employment income is not pooled with other types of income for determining the taxable amount. However, article 52, which determines who has to file annual tax returns, does not excuse wage earners from filing the returns. It excuses only those subject to final withholdings that are considered in article 57.

106. The new rule must be changed to avoid the horizontal inequities and revenue loss.

First, only wage earners that have no other type of income except those that are subject to final withholding tax (article 57) should be excused from pooling their wage income with other types of income. Second, only employees with a single source of wage income should be allowed not to pool their incomes. This can be done either by requiring them to file annual adjustment returns or by determining that those with more than one source of wage income (and income from no other source) should make arrangements so that the employer who is his main source of income receive information from the secondary sources and pools together wage income from all sources for taxation. The mission believes that the first method is safer for the AT.

Recommendations

- In case the dependent allowance is kept, provide it in the form of a tax credit, as it is now, rather than as a deduction from taxable income;
- Amend the 2013 law to excuse employees from filing tax returns, provided they have a single source of employment income and no other type of income except those subject to final withholding taxation;
- Reform the IRPS law to make the withholding tax final only for those employees who have a single source of wage income and whose other types of income are only those subject to final withholding taxation mentioned in article 57.

D. Reduced Rate for Agricultural Activities and Term Deposits

107. A temporary reduced rate for agricultural business, 10 percent, was created in 2007 both for individual businesses and corporations. Initially set to expire in 2010, the incentive deadline was extended to the end of 2015.²¹ This is not an investment incentive but merely a tax reduction for enterprises which are profitable and, thus, do not need an income tax break to continue existing.

108. Most passive income is subject to final withholding taxation at a 20 percent rate.

Two exceptions are interest on time deposits and income from financial papers transacted in the stock exchange, except government bonds. They are taxed at 10 percent. Perhaps there was a sound reason in the past for discriminating in favor of these financial assets; and this mission cannot make a judgement on whether the incentive for the stock exchange transactions should

²¹ Law 34/2007, of December 31, art. 61, n° 2. The incentive was extended by Law 4/2012, of January 23.

be kept or not. However, it could not find or hear any reason for keeping the privileged treatment for term deposits vis-a-vis all other financial assets.

Recommendations

- Do not extend the expired tax reduction for agricultural activities; and
- Tax term deposits at the same rate applied to all other financial assets.

VII. SIMPLIFIED TAX REGIME

109. The ISPC regime was introduced in 2009 (Law 5/2009) as a simplified tax on gross business turnover, in replacement of CIT, PIT and VAT. Taxpayers with an annual business volume (ABV) below MT 2,500,000 in the previous calendar year may elect for the simplified ISPC, which taxes their business volume at a flat rate of 3 percent. Taxpayers with ABV lower than 36 times minimum wage (MW) on December 31 of the year preceding the relevant business year are exempt from tax.²²

110. The ISPC should be viewed as part of a comprehensive approach to taxation of small and medium size taxpayers in Mozambique. Low compliance costs and proper segmentation of taxpayers should create incentives for formalization and ease the administrative cost. If coupled with enhanced tax administration services and non-tax incentives (e.g., easier access to financing, streamlined registration and licensing, state grants and procurement), the ISPC may contribute to increased registrations and higher tax compliance rates amongst those formalized. This, in turn, should help build the culture of paying taxes and change the current social norms in this regards, assuring greater participation of society in delivery of public goods. It should also help reduce inequalities between formalized and informal businesses, boost competitiveness and economic growth.

111. Proper design of ISPC requires segmentation of taxpayers. A special tax regime is a combination of design features, including use of presumptive taxes, and compliance concessions with the underlying objective to lower compliance costs for taxpayers and ease the tax administration effort. Not all taxpayers require these to the same extent. Challenges faced and posed by micro businesses are different from those of medium ones. To properly target an array of tax measures a proper segmentation is required.

112. The ISPC's eligibility criteria is based on turnover, which is the most commonly used yardstick for taxpayers' size. Even if not a perfect one it is a reliable proxy for taxpayer's size and their ability to comply with and pay taxes. Starting with turnover it is much easier to estimate potential profits rather than doing it based on number of employees, registered capital or value of assets. Of course, profits tend to differ depending on businesses' margins which vary by sector, location and other factors. Yet again, these are easier to estimate than labor or capital productivity. Whereas the value of assets or capital may be of interest for financial purposes (i.e., to better measure businesses' ability to take up and pay off debt), it is the level of profits that matters for taxation purposes. Turnover is just a proxy for profits and experience suggests that it is an appropriate measure to differentiate micro and small firms for taxation purposes.

²² The minimum wage on December 31, 2015 was MT 8,750, or US\$ 182.26 at the exchange rate on that day (MT 45.5 = US\$1). Thus, the exemption ceiling in 2015 is an ABV of MT 10,500, or US\$ 230.77. However, following the rapid depreciation of Meticalis in 2016, the exemption ceiling equals to US \$141.89 on the time of drafting this report (MT 74 = US\$1 on November 27, 2016).

113. The current tax code distinguishes micro and small taxpayers from the rest, while commonly there are usually four categories of taxpayers – micro, small, medium and large. All of them have their own distinct challenges but the most important one with regards to taxation is the cost of compliance. These costs tend to be regressive and they impose much higher burden on those on the lower end of profit or turnover distribution. A simplified approach to the taxation of numerous yet not very profitable businesses allows for a more efficient use of its scarce resources elsewhere. Taxpayers in Mozambique are divided into the following category: (1) Micro taxpayers: with annual turnover below MT 750,000; (2) Small taxpayers: with annual turnover between MT 750,000 and 2.5 million; and (3) Medium and large taxpayers: with annual turnover above 2.5 million. There seems to be no clear distinction between the medium and large taxpayers Table 15 presents recommended segmentation of taxpayers based on their turnover.

Table 15. Recommended segmentation of taxpayers

Segment of taxpayers	Suggested turnover level	Alignment
Micro	below 750,000	VAT voluntary registration threshold
Small	750,000 - 4,000,000	VAT mandatory registration threshold
Medium	4,000,000 - X	LTU threshold or lower
Large	above X	LTU threshold or higher

Note: X denotes a chosen LTU threshold

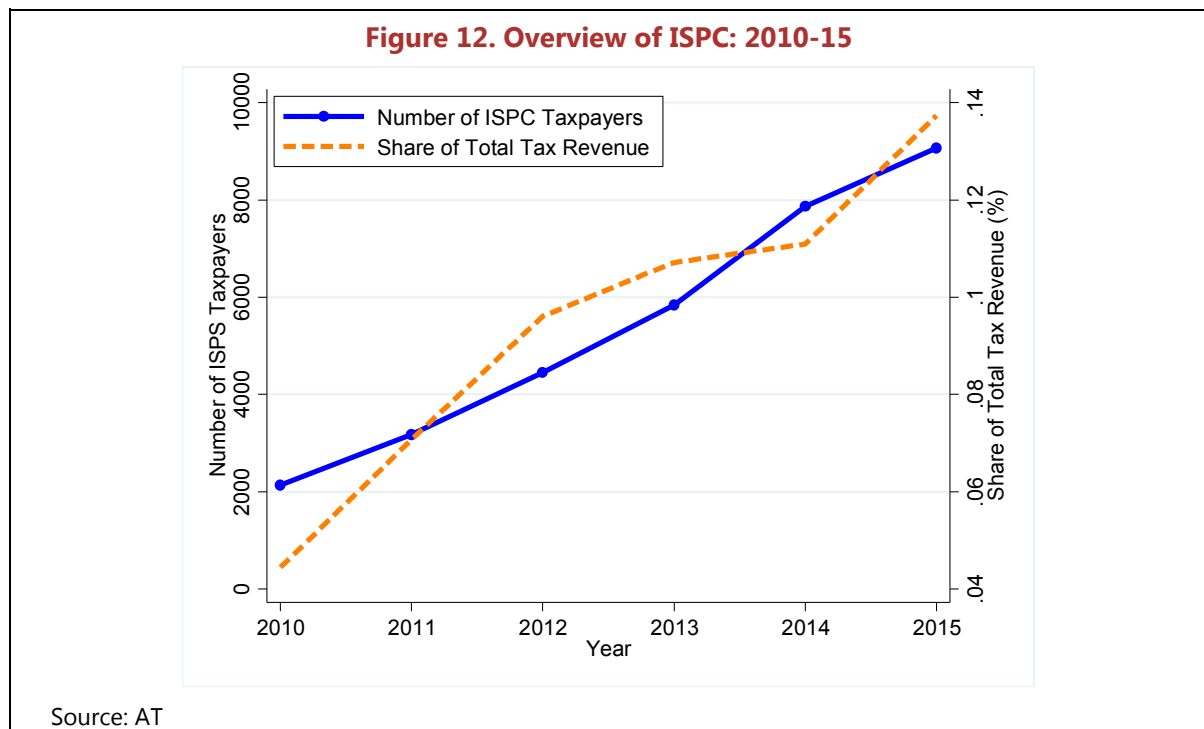
114. The standard practice is to align the ISPC regime with the VAT registration threshold. Businesses below the VAT threshold usually qualify for presumptive taxation, whereas those above are subject to the standard income taxation. There may be some concessions offered to those above the VAT threshold, e.g., simplified book-keeping. The rationale to use the VAT threshold is straightforward – any business that is capable to account for the VAT will be able to do the same with regards to the income taxation. This is especially important if the simplified VAT regime is to be removed with a more comprehensive ISPC regime.

115. The ISPC has gained popularity among small taxpayers since its introduction (Figure 12). The number of ISPC taxpayers has increased substantially at an average growth rate in the number of ISPC taxpayers of around 34 percent between 2010 and 2015, as illustrated by the solid blue line in Figure 12. As of 2015 there are 9,046 taxpayers with positive tax payment under the ISPC regime,²³ representing close to 20 percent of total taxpayers with positive VAT and corporate income tax payment, and with personal income taxation for income outside

²³ The number of taxpayers only include those with positive tax payment, based on tax data provided by AT.

category 1 (i.e., employment income). Moreover, about 1.6 percent of ISPC taxpayers have graduated into the normal CIT regime in 2015.

116. Tax revenue collected under ISPC accounts for a minor share of total tax revenue in Mozambique (Figure 12). Despite the steady increase in the share of tax revenue collected through ISPC between 2010 and 2015, the amount of ISPC tax revenue remains below 0.14 percent of total tax revenue at the end of 2015. Given the nature of ISPC as a presumptive tax, it should not be used as a primary tool to increase revenue. Instead, the ISPC should be employed to simplify the tax code for small taxpayers (and to lower the administrative burden of auditing such taxpayers), and to encourage proper account keeping and entries into the formal sector.



117. The effectiveness of the ISPC is somewhat compromised by several other types of simplified regimes that target at the same group of taxpayers (Table 16). These simplified tax regimes were already in place prior to the introduction of ISPC, and when adopted, implied a higher tax burden for small taxpayers than the ISPC. The coexistence of the alternative simplified tax regimes creates unnecessary complication, and should be abolished to streamline the simplified tax system for small taxpayers.

Table 16. Simplified Tax Regimes Available to Small Taxpayers

Tax	Eligibility	Implication
1. ISPC	Exempt if ABV \leq MT 315,000; A flat fee of tax rate of 3.0 percent of ABV up to MT 2,500,000.	In lieu of corporate income tax, personal income tax and VAT.
2. Simplified (or exemption) VAT regime	Exempt if ABV \leq MT 750,000; A flat rate of 5 percent of ABV if ABV is above MT 750,000 and below MT 2,500,000.	Taxpayer can no longer claim VAT paid on input purchases.
3. Simplified IRPS regime	Personal allowance of 315,000. Taxable income shall be 0.2 or 0.3 of ABV depending on the activity.	The tax amount shall not exceed 2.1 percent of ABV (for activities subject to the coefficient of 0.2) or 4.2 percent of ABV (in case the coefficient is 0.3).
4. Simplified IRPC regime	ABV \leq MT 2,500,000; Taxable profits shall be: <ul style="list-style-type: none"> • 0.2 of ABV derived from sales of merchandise and products; • 0.2 of ABV derived from sales and provision of lodging, restaurant, and beverage services; • and 0.30 on the remaining earnings 	This implies an effective tax rate on turnover of between 6.4 and 9.4 percent.

118. Small taxpayers remain below the eligibility threshold to benefit from the ISPC in Mozambique (Figure 13). Panel A of Figure 13 shows the distribution of ISPC taxpayers by turnover bins of MT 10,000 during 2009–2015,²⁴ where a substantial number of taxpayers remain below the eligibility threshold in order to benefit from the ISPC regime.²⁵ The extent of bunching has also increased significantly since the introduction of the ISPC regime (Figure 13, Panel B). During this period, the eligibility threshold remained at MT 2,500,000 despite of a relative high inflation rate in recent years (and 10 percent in 2015). Without indexing for inflation, setting the threshold at the nominal level effectively restricts growth of small taxpayers facing significant compliance costs under the normal regime.

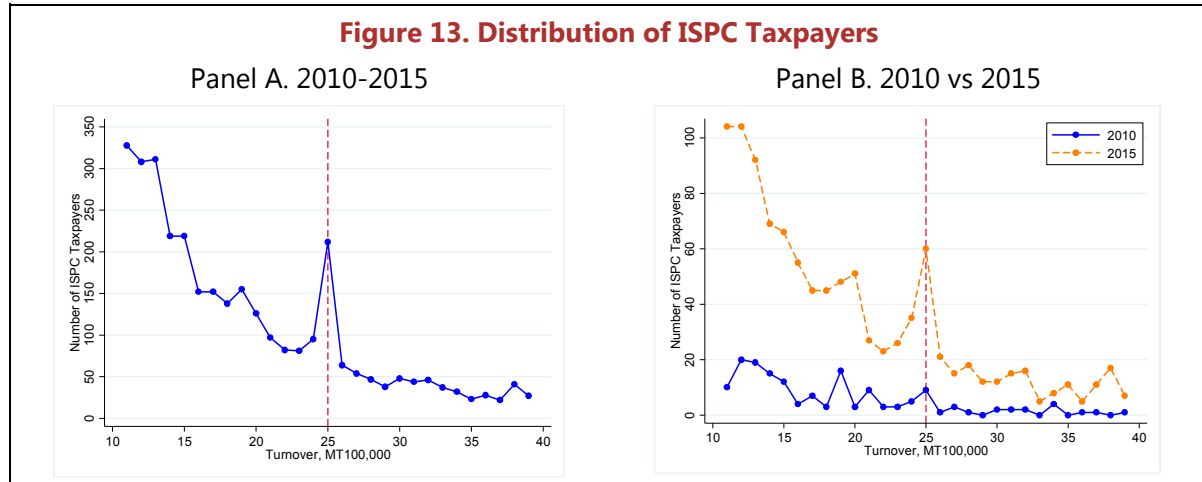
119. Increasing the ISPC eligibility threshold to MT 4 million would cost approximately 0.06 percent of total tax revenue, or less than 0.03 percent of GDP in revenue. Increasing the eligibility threshold to MT 4 million would extend the coverage of ISPC to most taxpayers in

²⁴ For example, the first dot shows that there are about 340 ISPC taxpayers with turnover between MT 1 and 1.1 million.

²⁵ There is a small number of ISPC taxpayers above the threshold, possibly due to the registration requirement is applied to turnover in the previous year instead of current year.

(continued...)

Mozambique. The revenue cost of extending the eligibility threshold is rather minor, implying a loss of around MT 200 million in VAT²⁶ compensated with additional revenue of MT 120 million in ISPC. Additional revenue loss in corporate income tax is negligible, as analysis below shows that companies at the lower end of profit distribution often do not pay corporate income tax.



120. Raising the ISPC tax rate to 5 percent would compensate for the revenue loss from the threshold increase. The government can further compensate the revenue loss from increasing the threshold by raising the ISPC rate to 5 percent. This is adjusted given that the ISPC replaces both VAT and income taxes. Corporate businesses and professional service providers (individuals) should be exempted from the ISPC and be kept under the normal tax regime. This is to prevent the group of most sophisticated taxpayers from gaming the tax code. The net revenue consequence of increasing the rate and extending the coverage of ISPC is minor, which is approximately MT 240 million additional tax revenue per year.

Recommendations

- Assure proper segmentation of taxpayers – align presumptive taxation thresholds with those of VAT;
- As a part of coherent tax strategy, introduce a definition of large taxpayers based on turnover and possibly, on employment and asset size;
- Develop the ISPC tax into a comprehensive presumptive regime – turnover based tax for small taxpayers and a simple lump sum tax for micro taxpayers;
- Extend the coverage of ISPC by increasing the eligibility threshold to MT 4 million; index it to automatically adjust for inflation;

²⁶ Assuming that all VAT taxpayers with turnover between MT 2.5 and 5.0 million will be removed from VAT register (i.e. they do not chose to voluntarily register for the VAT).

- Remove the exemption threshold based on minimum salary;
- Exclude professional services from the ISPC regime and keep them under the normal tax regime;
- Charge a flat fee on a semi-annual or annual basis for micro taxpayers with turnover below MT 750,000;
- Eliminate the other simplified taxation regimes that has become obsolete following the introduction of ISPC.

Appendix 1. Summary of Corporate Income Tax Incentives in the Code of Fiscal Benefits (Law 4/2009)

The Code of Fiscal Benefits became effective in 2002, and offers a wide range of tax incentives that lower the effective corporate income tax to investment carried out under the scope of the Investment Law, in addition to investment in:

- Commercial and industrial activities in rural areas
- New infrastructures in retail and wholesale commerce
- Manufacturing and assembly industries

Box 1. Various types of major IRPC tax incentives in the Code of Fiscal Benefits

Type of Tax Incentives	Applicability	Rate
I. General Incentives:		
1. Direct deductions from taxable profits	1) Investment in qualified equipment using new technology;	100 percent deduction; i.e. fully expensing in the first five tax year
	2) Cost of investment in professional training	
2. Accelerated depreciation	1) New immovable assets;	Increase in the depreciation rate of 50 percent
	2) Machinery and equipment in industrial and agro-industrial operations	
3. Investment tax credit*	1) Investment in machinery and plant in the city of Maputo	5 percent of investment to be deducted from IRPC for a period of five tax years
	2) Investment in machinery and plant outside the city of Maputo	10 percent of investment to be deducted from IRPC for a period of five tax years
II. Sector-specific Incentives:		
Agriculture and Fisheries		
1) 80 percent reduction in the IRPC tax rate by 2015 and by 50 percent between 2016 and 2025.		
Hotel and tourism		
1) Reduction by 3 percentage points of the investment tax credit and accelerated depreciation is reduced from triple to double.		

Rapid Development Zones

- 1) Investment tax credit of 20 percent for 5 years.

Industrial Free Zones

- 1) IRPC tax exemption for 10 years;
- 2) IRPC 50 percent tax reduction from the 11th to 15th year and 25 percent for the rest of the project life (reductions and deadlines are smaller in the case of a single company).

Basic Infrastructure Creation

Investment in roads, railways, airports, water supply, electricity, "among others."

- 1) IRPC tax reduction of 80 percent in the first five years;
- 2) 60 percent for 6 to 10 years; and 25 percent from the 11th to 15th year.

Science and Technology Parks

- 1) IRPC tax exemption in the first five years;
- 2) 50 percent tax reduction from 6 to 10 years and 25 percent from the 11th to 15th year.

Special Economic Zones

- 1) IRPC tax exemption for 5 years (for operators responsible for creating infrastructure in the Zone) or three years (for companies establishing themselves in it);
- 2) IRPC tax reduction of 50 percent in the next 5 years;
- 3) and 25 percent IRPC tax reduction throughout the life of the project (for operators in the Zone) or for an additional 5 years (for companies).

**Exclusion restriction applies according to Article 15 para 6.*

Fiscal Affairs Department

International Monetary Fund
700 19th Street NW
Washington, DC 20431
USA

<http://www.imf.org/capacitydevelopment>