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Tax Reforms and Macroeconomic Stabilisation in Mozambique

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Abstract

Between 1997 and 2003 several tax reforms were carried out in Mozambique in order to increase tax revenues. This study analyses the revenue and stabilisation effects of these tax reforms. The revenue effects are evaluated through both the quality of the reforms – through their accordance with the recommendations of uniform taxation – as well as the quantitative effects on the level and composition of tax revenue. The stabilisation effects are evaluated through a comparison of the change in the fiscal deficit with the changes in the current account deficit and the rate of inflation. The major conclusion drawn in this study is that the implemented tax reforms increased tax revenues significantly and contributed to a slight reduction of the fiscal deficit, which in turn contributed to macroeconomic stabilisation to some extent. If expenditure efficiency can be improved and if additional revenue-generating reforms can be implemented, tax revenues can contribute to stabilisation to a larger extent in the future.

Keywords: Mozambique; Tax Reforms; Stabilisation; Uniform Taxation; Fiscal Deficit; Current Account; Inflation.

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Abbreviations and Acronyms

AIM	News Agency *(Agencia de Informação de Moçambique)*
BM	The Central Bank *(Banco de Moçambique)*
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CRA	Central Revenue Authority
DfID	Department for International Development
DNIA	National Directorate of Taxes and Audit *(Direcção Nacional de Impostos e Auditoria)*
ERP	Economic Rehabilitation Program
ICE	Excise Tax *(Imposto sobre Consumos Específicos)*
IMF	International Monetary Fund
INE	National Statistics Institute *(Instituto Nacional de Estatisticas)*
IRPC	Company Income Tax *(Imposto sobre Rendimento das Pessoas Collectivas)*
IRPS	Personal Income Tax *(Imposto sobre Rendimento das Pessoas Singulares)*
KPMG	Klynveld Peat Marwick Goerdeler
MPF	Ministry of Planning and Finance *(Ministério do Plano e Finanças)*
MTEF	Medium Term Expenditure Framework
MZM	Meticais (Local currency, MZM 23300 = US$ 1, Jan 2003)
NUIT	Single Tax Identification Number *(Número Único de Identificação Tributária)*
PARPA	Action Plan for Reduction of Absolute Poverty
PAYE	Pay-As-You-Earn
PER	Public Expenditure Review
PSIA	Poverty and Social Impact Analysis
PSR	Public Sector Reform
SADC	Southern African Development Community
SDC	Swiss Development Cooperation
Sida	Swedish International Development Cooperation Agency
URTI	Tax Reform Unit *(Unidade de Reformas Tributária dos Impostos Internos)*
UTRA	Customs Reform Unit *(Unidade Técnica para Reestructuração das Alfandegas)*
VAT/IVA	Value-Added Tax *(Imposto sobre o Valor Acresentado)*
WBAD	World Bank Africa Database

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Chapter 1 Introduction

Developing countries with serious macroeconomic imbalances need to stabilise their economies in order to sustain economic growth, a growth that is essential for the fulfilment of the development agenda. Reduction of the fiscal deficit – through fiscal and monetary policy measures – is a vital component in the stabilisation process. Where expenditures have been cut as far as prudently possible, tax revenues have received increased attention. The tax systems in many developing countries are underdeveloped, generating low levels of revenue with high costs for distortions such as inefficiency and inequity. Revenue-generating tax reforms could therefore contribute both to macroeconomic stabilisation and the reduction of distortions.

Even though Mozambique has experienced strong economic development in recent years, the economy continues to bear the characteristics of a stereotype developing economy with large internal and external imbalances, and heavily dependent on external financing. In the government's reform agenda – drawn up in the socio-economic strategy paper: the Action Plan for the Reduction of Absolute Poverty (PARPA 2001-2005) – macroeconomic stability is an important objective. Setting up an efficient and revenue-generating tax system will be a crucial measure in the fulfilment of this objective.

Tax reforms in developing countries have been widely covered in the academic literature with issues concerning for example: micro and macroeconomic implementation (Khalilzadeh-Shirazi and Shah et al., 1991; Shome et al., 1995); tax administration (Bird and Casanegra de Jantscher et al., 1992) and economic development (Bird, 1992). Macroeconomic stabilisation issues have also been widely covered (e.g. Polak, 1957; Taylor, 1988; Cook and Kirkpatrick, 1990; Tarp, 1993). In spite of the great attention that both of these concepts have attained per se, they remain largely de-coupled. Most texts ignore the critical role played by tax reforms in achieving stabilisation. My contribution fills a gap in the

literature by linking tax reforms and stabilisation, and is, as far as I know, the first concerning this particular issue in Mozambique.

The purpose of this study is to evaluate the revenue and stabilisation effects of the tax reforms carried out in Mozambique between 1997 and 2003. Questions of particular interest are:

- Have the implemented tax reforms increased tax revenues?
- Have the revenue effects of the tax reforms contributed to macroeconomic stabilisation?

This evaluation is mainly quantitative in its character even though the quality of the implemented reforms is analysed through qualitative recommendations as well. The discipline of science can be characterised as objective positivism trying to explain social phenomena through the generalisation of observable and measurable data. The method is inductive where comprehension is achieved through the interpretation of empirical data. By applying the theoretical framework onto the empirical data, causality is explained and discussed.[1]

The sources used in this study are both primary and secondary, and were collected during a field study in Mozambique in April and May 2004. The primary data was collected through ten taped interviews with various people working on economic issues and tax reforms in Mozambique.[2] The interviews served as a complement to the secondary data consisting of: official and unofficial government documents; discussion papers; tax legislation; statistical appendixes from both national and international economic units; and articles concerning the Mozambican tax system. The World Bank Africa Database (WBAD, 2004), together with recent statistics collected from the National Statistics Institute (INE, 2004), were the most important secondary sources.

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[1] Lundahl and Skärvad, 1999, pp.39-42; pp.74-80; pp.155-157; pp.206-210.
[2] Consulted people can be found among the references.

This study is divided into the following parts. The theoretical framework will be presented in chapters 2 and 3, where chapter 2 defines macroeconomic stabilisation; describes the IMF response to macroeconomic instability; and outlines the role of tax reforms in the stabilisation process. Chapter 3 focuses on important aspects of revenue-generating tax reforms in developing countries. Chapter 4 provides background information about the structure of the Mozambican pre-reform tax system. Chapter 5 describes the tax reforms carried out between 1997 and 2003. The revenue effects of the tax reforms are analysed in chapter 6 by reconnecting to the theoretical framework in chapter 3. The stabilisation effects of the tax reforms are analysed in chapter 7 by reconnecting to the theoretical framework in chapter 2. Finally, chapter 8 provides the conclusions and a brief discussion on policy implications.

Chapter 2 Theoretical Framework Part I – Stabilisation

This chapter is structured as follows; 2.1 defines stabilisation, 2.2 overhauls the IMF response to instability and 2.3 describes the role of tax reforms in stabilisation programs. The theoretical framework in this chapter will serve as our instrument when assessing the stabilisation effects of the Mozambican tax reforms in chapter 7.

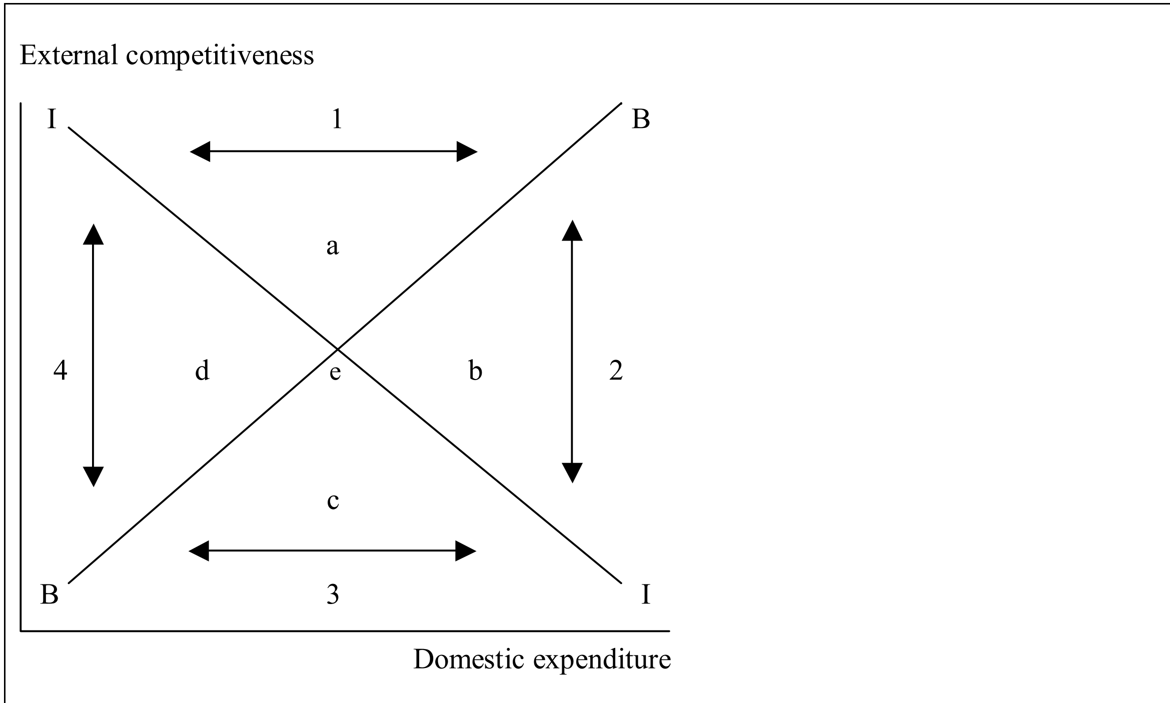
2.1 Stabilisation

In a small open economy, instability can be defined as an internal and/or an external imbalance. Internal balance is a situation where domestic economic activity is sufficient to utilise the productive potential of the economy. *Internal imbalance* is characterised by either unutilised capacity (unemployment) – a case of excess domestic supply – or rising prices (inflation) – a case of excess domestic demand. External balance relates to trade and financial relations with the rest of the world. *External imbalance* implies either a current account surplus above the sustainable level – an excess supply of foreign exchange (balance-of-payments surplus) – or a deficit below the sustainable level – an excess demand of foreign exchange (balance-of-payments deficit). In order to achieve overall balance, policy-makers have to consider both the internal and external imbalances.

In Figure 1 we can see the level of economic activity on the horizontal axis and a measure of external competitiveness on the vertical axis. The *II-line* plots combinations of domestic expenditures and competitiveness that give *internal balance*. The line slopes downwards to the right, since with higher domestic activity, expenditure will rise above the level required for internal balance, unless there is a decline in the economy that diverts expenditure outside the economy. Any point not on II is one of internal imbalance. Points above, like a, represent excess domestic demand, since for a given competitiveness, activity is too high to

achieve internal balance. Points below II, like c, represent excess domestic supply, since for a given competitiveness, expenditure is too low for internal balance.

Figure 1: Internal and External Balance



Source: Weiss, 1995, p.18.

The *BB-line* plots combinations of activity and competitiveness that give *external balance*. Points above BB, like d, represent excess supply of foreign exchange (a trade surplus), since for a given competitiveness, activity is below the level that achieves external balance. Points below BB, like b, represent excess demand of foreign exchange (a trade deficit), since for a given competitiveness, expenditure is too high for external balance.

Different economic states are depicted in the four segments of Figure 1: Segment 1 has an excess domestic demand/trade surplus; segment 2 has an excess domestic demand/trade deficit; segment 3 has an excess domestic supply/trade deficit; segment 4 has an excess domestic supply/trade surplus. Only at point e – where the two lines intersect – will internal and external balance be achieved. In

this framework macroeconomic stabilisation programs can be seen as attempts to move developing countries to point e.[3]

2.2 IMF Stabilisation Programs

Due to the close economic cooperation between the governments of many developing countries and the IMF, examining macroeconomic stabilisation is to a large extent a question of understanding how the IMF's structural reform programs respond to macroeconomic imbalances.[4] Many developing economies can be found in segment 2, with excess domestic demand and excess demand for foreign exchange. IMF stabilisation programs aim at reducing domestic demand and the demand for foreign exchange (a move towards e), through tight fiscal and monetary policy – also known as expenditure-reducing policies – in combination with exchange-rate adjustments – also known as expenditure-switching policies. The general idea is to reduce aggregate demand – also known as absorption – by controlling the supply of domestic credit and through a depreciation of the real exchange-rate.

2.2.1 Fiscal Policy

The balance-of-payments can be viewed as a fiscal phenomenon. The key issue is the correlation between the fiscal deficit and the current account deficit, also known as the current account of the balance-of-payments. Reducing the fiscal deficit is seen as the most direct means of reducing absorption. The national income (Y) corresponds to the value of output produced. Absorption (A) can

[3] Weiss, 1995, pp.17-19.
[4] Even though there is a clash of opinions about the design of these programs (e.g. the speed and quality of adjustment), most economists agree that macroeconomic stability is a prerequisite for sustainable economic growth. See Easterly and Schmidt-Hebbel, 1993; Mussa and Savastano, 1999.

exceed or fall short of national income, and the difference between them can be referred to as the current account balance or exports minus imports:

$$(1.1) \qquad (Y - A) = (X - M)$$

This equation can be disaggregated further, since by definition absorption is composed of private consumption (C_p), private investment (I_p), and government expenditure (G):

$$(1.2) \qquad A = C_p + I_p + G$$

National income in turn is composed of private consumption (C_p), private savings (S_p) and taxes (T):

$$(1.3) \qquad Y = C_p + S_p + T$$

By putting equations (1.2) and (1.3) into (1.1) we obtain:

$(Y - A) = (C_p + S_p + T) - (C_p + I_p + G) = (X - M)$ and after rearranging we get:

$$(1.4) \qquad (S_p - I_p) + (T - G) = (X - M)$$

Here we have the relation between the fiscal deficit and the current account deficit. For simplicity the fiscal deficit is taken as the difference between tax revenues (T) – which are assumed to be the only source of revenue – and government expenditures (G). Equation (1.4) indicates that the counterpart to the current account deficit is the government fiscal deficit and the saving-investment balance of the private sector.[5] As long as $(S_p - I_p)$ remains stable, changes in the fiscal deficit will be closely associated with movements in the current account deficit. The fiscal deficit is a key cause of excess absorption over national income and

[5] Note that non-tax revenues and foreign capital flows are ignored in order to clearly demonstrate the role of the fiscal deficit.

thus of the current account deficit. Measures to reduce the fiscal deficit should therefore directly reduce the current account deficit as well.[6]

2.2.2 Monetary Policy

The balance-of-payments can also be viewed as a monetary phenomenon. Money in the economy can be of external (foreign exchange reserves) or domestic origin (domestic credit). A change in domestic money supply (ΔM_s) is the sum of changes in foreign exchange reserves (ΔR) and in domestic credit (ΔDC):

$$\Delta M_s = \Delta R + \Delta DC \quad (2.1)$$

A change in money demand (ΔM_d), is a function of change in nominal income (ΔY):

$$\Delta M_d = k \cdot \Delta Y \quad (2.2)$$

where k is 1/v, and v is the velocity of circulation of money. In this model k is either constant or relatively stable and independent of changes in domestic credit. Where the money market is in equilibrium money demand equals money supply, $\Delta M_s = \Delta M_d$. Combining equations (2.1) and (2.2) gives:

$$\Delta R = k \cdot \Delta Y - \Delta DC \quad (2.3)$$

Equation (2.3) states that a change in foreign exchange reserves is determined by the difference between the change in money demand and the change in domestic credit. The implication is that excess monetary expansion leads firms and households to spend their excess money balances; if this expenditure goes on non-traded goods it will raise the price level (and thus Y); and if it goes on traded goods it will lower foreign exchange reserves.

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[6] Weiss, 1995, pp.19-20.

The model can be broadened by linking domestic credit expansion and absorption. In equation (1.1) we saw that the current account equals the difference between national income and absorption. The current account must be balanced by changes in international reserves and foreign capital flows (F):

$$(2.4) \qquad (X - M) = (\Delta R - \Delta F)$$

By using equation (2.3) $\Delta R = k \cdot \Delta Y - \Delta DC$ and equation (2.2) $\Delta M_d = k \cdot \Delta Y$ we get:

$$(2.5) \qquad (X - M) = (\Delta M_d - \Delta DC - \Delta F)$$

Combining equation (2.5) with equation (1.1) gives:

$$(2.6) \qquad (Y - A) + \Delta F = \Delta M_d - \Delta DC$$

Thus, excess domestic absorption over income (A>Y) requires either additional foreign capital (ΔF), or a growth of domestic credit in excess of money demand. The focus on the fiscal deficit requires that ΔDC be disaggregated into credit to the private (ΔDC_p) and to the public sector (ΔDC_g). Similarly, foreign capital inflows can be disaggregated into ΔF_p and ΔF_g. Different sources of financing the fiscal deficit can now be illustrated. If a fiscal deficit exists it can be financed by running down foreign reserves (ΔR); by foreign borrowing (ΔF_g); by domestic credit expansion (ΔDC_g); or by borrowing from the private (non-bank) sector (ΔB). Putting these possibilities together gives:

$$(2.7) \qquad (T - G) = \Delta R + \Delta F_g + \Delta DC_g + \Delta B$$

Where the scope for foreign and domestic borrowing is limited, the main source of financing is domestic credit expansion (ΔDC_g). The central thrust of the IMF's stabilisation programs is to restrict this source of money growth. By keeping the growth of credit below the growth of money demand, the current account deficit

and the rate of inflation will be reduced.[7] A reduction of the fiscal deficit reduces the need for domestic credit expansion. Measures to reduce the fiscal deficit should therefore indirectly reduce the rate of inflation as well.[8]

2.2.3 Exchange-rate Policy

Tight monetary and fiscal policies are often combined with exchange-rate adjustments – such as devaluations – in order to achieve external balance. A devaluation that boosts exports improves the current account. The inflationary impulse of the devaluation – causing relative prices to rise – in combination with tight fiscal and monetary policies, will reduce absorption as well.[9]

2.3 The Role of Tax Reforms in Stabilisation

In table 1 we can clearly see the role of the fiscal deficit in the stabilisation process by recalling the two balance-of-payments definitions – equations 1.4 and 2.1 – derived in the previous section. As mentioned in the section on fiscal policy, the fiscal deficit is a key cause of excess absorption over national income and thus of the current account deficit. Measures to reduce the fiscal deficit should therefore directly reduce the current account deficit as well. As mentioned in the section on monetary policy, a reduction of the fiscal deficit reduces the need for domestic credit expansion. Measures to reduce the fiscal deficit should therefore indirectly reduce the rate of inflation as well. Thus, measures to reduce the fiscal deficit directly affect the overall balance-of-payments, since they decrease the current account deficit, and indirectly since they reduce the rate of inflation.

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[7] Note that this theoretical model ignores the negative effects on output and employment, although this has been acknowledged, even in IMF reports (e.g. IMF, 1987), as an unrealistic assumption.
[8] Weiss, 1995, pp.27-29.
[9] World Bank, 1994, p.52; Weiss, 1995, p.50.

Table 1: Stabilisation Equations

Sector:	Foreign		Private		Government	Equation
1.Fiscal Policy	X - M	=	$S_p - I_p$	+	T - G	1.4
2.Monetary Policy	ΔR	=	ΔM_S	-	ΔDC	2.1

Source: Sections 2.2.1 and 2.2.2.

The advantages of reducing the fiscal deficit through an increase in tax revenues become evident when the potential costs of alternative ways to cover the deficit are considered: (i) money creation, (ii) domestic borrowing, (iii) foreign borrowing, and (iv) running down foreign exchange reserves.[10]

(i) Money creation is revenue obtained from central bank money printing, resulting in increased money supply. This action does not automatically translate into higher inflation but is likely to do so in the long run. When the increased money supply accommodates a higher money demand, is transitory or if there are lags in the transmission of increases in the money supply to prices, this form of money creation will be non-inflationary, also known as seigniorage. One interpretation is to view inflation as a tax, which is determined by the government to maximise seigniorage revenue. Beyond a certain point though, further increases in inflation will reduce rather than increase revenue, also known as the seigniorage Laffer curve. Higher domestic inflation could harm economic growth since it distorts relative prices and increases uncertainty. The inflation-tax can be seen as an inefficient and inequitable form of taxation.[11]

(ii) Domestic borrowing or the issuing of domestic bonds is not always an option in developing countries, as a result of insufficiently developed capital markets. Where it is an option, it runs the risk of crowding out private investments, due to insufficient available credit or increased interest rates.[12]

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[10] Weiss, 1995, pp.8-10; pp.20-25.
[11] World Bank, 1994, p.49; Agénor, 2000, p.472.
[12] Agénor, 2000, p.86.

(iii) Excessive foreign borrowing could create an unsustainable foreign debt that has to be paid with hard-to-collect foreign currency. If the government can borrow abroad and use the money efficiently and productively, this can be a rational option, but when it is used for low-return activities it is a costly alternative. A large foreign debt is difficult to service with scarce resources and the economy becomes vulnerable to fluctuations in international interest rates. Increased foreign debt also increases the tax pressure on future budgets.[13]

(iv) Running down foreign exchange reserves can only be a temporary solution since the stock of foreign exchange reserves is clearly limited in developing countries. Further, if maintained for a long time, such a policy could provoke a speculative pressure on the exchange-rate and capital flight, where there are no foreign exchange controls imposed.[14]

The key point here is that all feasible means of covering the fiscal deficit have potential costs: monetisation of the deficit can be inflationary; domestic borrowing can raise interest rates and crowd out the private sector; foreign borrowing may create unsustainable levels of foreign debt; and running down foreign exchange reserves is a short-range plan that may provoke capital flight. A cut in government expenditures would have an immediate impact on the fiscal deficit, but since many developing countries have cut expenditures as far as prudently possible, the revenue-side of the fiscal deficit has received increased attention. If additional tax revenues can be raised through improvements of the tax system, this would be the preferable alternative for decreasing the fiscal deficit and stabilising the economy.

[13] Weiss, 1995, p.23.
[14] Ibid.

Chapter 3 Theoretical Framework Part II – Tax Reforms

This chapter is structured as follows; section 3.1 discusses tax policy design and sections 3.2-3.4 review important theoretical aspects of the recommendations of uniform taxation. The theoretical framework in this chapter will serve as our instrument when assessing the revenue effects of the Mozambican tax reforms in chapter 6.

3.1 Tax Policy Design

Although tax reform recipes must consist of country-specific ingredients, the similar characteristics of tax systems in developing countries make it possible to draw some general conclusions about the substance of tax reforms. As theoretically illustrated in the previous chapter, tax revenues play an essential role in the stabilisation process. But increasing tax revenues is not an easy task and common structural characteristics of developing economies – large informal sector, weak tax administration and widespread poverty – make taxation difficult. Since taxation is not only about raising revenue but also a matter of efficiency in resource allocation, equity of income distribution and the administrative capacity, it is easy to understand the complexity involved in the design of a tax system. Raising revenue while considering the indirect costs of inefficiency and inequity, and the direct cost of administration is the main challenge of tax reforms.[15]

The two influential schools for tax policy design are the optimal taxation and uniform taxation literature. The principle of optimal taxation is to minimise the excess burden of taxation, i.e. the loss in private welfare over and above the amount of revenue collected from a tax. Lower tax rates for goods with elastic demand and higher rates for goods with inelastic demand – also known as the

[15] Shome, 1995, p.3; Weiss, 1995, p.175.

Ramsey rule or inverse elasticity rule – lead to the smallest loss in economic efficiency.[16] Optimal taxation requires large amounts of information, efficient tax administration and a highly differentiated structure of tax rates. The outcomes of optimal taxation – under the socio-economic circumstances mentioned above – will be uncertain and difficult to carry out under administrative constraints. Optimal taxation literature has therefore had little impact on the design of tax systems in developing countries, where tax policy is often the art of the possible rather than the pursuit of the optimal.[17]

The principles of uniform taxation with: wide tax bases; low neutral and uniform taxes; and simple administrative procedures, are more likely to increase tax revenues in developing countries, even though optimality will not be fulfilled. The gains in economic efficiency, horizontal equity, and administrative simplicity that stem from uniform taxation are intended to outweigh the vertical equity (i.e. progressivity) losses that might occur.[18] In order to increase tax revenues, uniform taxation recommends:[19] (i) broadening the tax base; (ii) simplifying the rate structure; and (iii) improving tax administration. Table 2 provides an overview of the general and specific revenue-generating tax reforms that uniform taxation literature recommends. The specific aspects concerning the particular categories of taxes and tax administration are discussed in sections 3.2-3.4.

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[16] Gillis et al., 1996, pp.356-357.

[17] For further reading about optimal taxation see Newbery and Stern, 1987.

[18] Horizontal equity: people in equal economic circumstances are treated equally by the tax system. Vertical equity: people in different economic circumstances are treated differently by the tax system. Bird, 1992, pp.10-14.

[19] Thirsk, 1991, p.58; Weiss, 1995, p.184.

Table 2: Overview – Recommendations of Uniform Taxation

Tax	Recommendations of Uniform Taxation		
	Broadening the Tax Base	**Simplifying the Rate Structure**	**Tax Administration**
In General	- Minimise exemptions and fiscal incentives, in order to reduce the scope for tax planning, avoidance and evasion. - Lower tax rates and improve tax administration, in order to increase the number of taxpayers especially from the informal sector.	- Eliminate taxes yielding low revenues, streamline the rate structure and reduce high marginal tax rates, in order to simplify the tax system, lower the administrative costs and reduce the scope for tax evasion.	- Increase taxpayer compliance and administrative efficiency, in order to increase the collecting capacity and reduce the direct costs. - Increase taxpayer compliance by: simplifying legislation, increasing self-assessment, improving auditing procedures, introducing self-enforcing taxes, increased use of withholding at the source (such as PAYE) and establishing tough penalties for tax evasion. - Increase administrative efficiency by: increasing computerisation, increasing the use of the banking system to collect taxes, introducing a unique identification number and a master tax file to improve auditing procedures, establishing tough penalties for corruption and improving staff skills. Drastic changes might be the best alternative.
Direct Taxes	- Reduce exemptions from personal income taxes. - Reduce the role of fiscal incentives. - Increase self-assessment through presumptive indicators of income.	- Introduce global income taxation with 2-4 brackets, and a threshold rate. - Reduce top marginal rates: 30-50%. - Lower the rates in coordination with tax base expansion. - Unify multiple company tax rates, single-rate. - 3-4 depreciation categories to 3-4, single-rate. - Level the top marginal rate for the personal and company income taxes.	
Indirect Taxes	- Introduce an efficient broad-based value-added tax. - Introduce an excise tax on few luxury goods.	- Introduce a single-rate VAT, 10-20%. - Exemptions for essential commodities - Introduce an excise tax on 3-4 categories of luxury goods.	
Trade Taxes	- Reduce import tariffs (see Simplifying the rate structure as well). - Improve customs administration. - Evaluate the export tax benefits.	- Reduce nominal tariff rates equally. - Tariff reduction in coordination with VAT tax base expansion, in order not to lose revenues. - Remove inefficient export taxes.	

Source: Section 3.2-3.4.

3.2 Broadening the Tax Base

The general idea is that a broad tax base with low tax rates can collect a larger amount of tax revenue with fewer distortions. The two ways of broadening the tax base is to identify new bases to tax or expand the bases of the existing tax instruments. Both options are associated with higher direct costs, due to increased administrative pressure, but expanding the existing tax bases is generally the preferable option, at least in the short run until tax administration has developed.[20] Important tax instruments among direct taxes are the personal and company income taxes; among indirect taxes the sales/consumption and excise taxes; and among trade taxes import tariffs and export taxes.[21]

Due to the large informal sector and the low per capita income, few people are subject to personal income tax, which yields little revenue in most developing countries. Personal income tax is largely paid by the urban formal sector, but since the urban elite is often also the strongest political voice in society, tax exemptions are common, leaving the tax burden on a narrow tax base far smaller than its potential. The tax base can therefore be broadened by eliminating or reducing exemptions. The equitable argument for this reform is obvious, even though it might be politically difficult to implement. When it comes to including parts of the informal sector at reasonable administrative costs, increased self-assessment with, for instance, presumptive indicators of income, can be introduced. If implemented fairly and on a realistic criterion, this would lower the costs of tax administration, with improved auditing ability and reduced tax evasion.[22]

Companies are easier to monitor than individuals, but company income tax yields little revenue as well. The main reason for this is the prevalence of various fiscal incentives such as profit-linked exemptions; tax holidays; and investment-

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[20] World Bank, 1991, pp.29-30.
[21] Note that indirect taxes and trade taxes are treated as different tax categories.
[22] World Bank, 1991, pp.31-39; Gillis et al., 1996, pp.333-337; Tanzi and Zee, 2001, pp.2-7.

linked deductions, frequently used to attract foreign direct investments. These incentives have a negative effect on the tax base and, since they contribute to an increased GDP, they have a double negative effect on the tax ratio.[23] In order to broaden the tax base of company income tax, to expand coverage to include more firms and to create an equal playing field, the role of fiscal incentives should be reduced.[24] If these measures continue to exist, the government must make sure that the beneficiaries fulfil the contracts, so that the potential positive effects such as increased job opportunities or use of local sub-contractors can be maximised.[25]

Indirect taxes are the most important category of taxes in developing countries, since commodities are easier to tax than income. Almost all countries have some kind of tax on commodities, but due to differences in administrative capacity it is applied differently. The broad-based value-added tax (VAT) levied on consumption, has become the favourite tax on commodities, over alternatives such as turnover and sales taxes. The basic argument in favour of the VAT is that it has a self-enforcing mechanism with refunds for taxes paid on inputs at all intermediate stages, increasing incentives to belong to the formal sector. Even if final retailers evade the tax net – which is common when the informal sector of the economy is large – the VAT will have raised some revenue by the taxation of earlier transactions. This makes the VAT a reliable revenue generator with few distortions that incurs relatively small efficiency losses, even though it demands higher administrative capacity. A common alternative is the turnover tax imposed on gross value of transactions, which has a cascading effect.[26] This gives producers incentives to integrate vertically to avoid taxation, which creates distortions. Common problems where the VAT has been implemented is that its actual tax base is narrower than its potential and that the credit mechanism is

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[23] Tax ratio: tax revenues as a share of GDP (in %).
[24] World Bank, 1991, pp.31-39; Gillis et al., 1996, pp.333-337; Tanzi and Zee, 2001, pp.2-7.
[25] Shah, 1995.
[26] Cascading effect: the tax content in the final price will vary with the number of intermediate stages, i.e. higher price with larger amount of intermediate stages.

inefficient. The tax base can be broadened – if the administrative capacity allows – by including all important wholesale and retail sectors into the VAT net. The credit mechanism should be made as efficient as possible by minimising the delays in refunds on inputs. When expanding the tax base it is important to introduce selected VAT exemptions for necessities – in order to avoid regressive effects – since the VAT consumes a larger share of the income of the poor.[27]

The economic rationale for imposing an excise tax is different from that for other taxes. The excise tax should be highly selective, targeting just a few goods with inelastic demand, such as luxury goods or goods with negative externalities for instance fuel, tobacco and alcohol products. A common problem with the excise tax is that it covers too many products, often because of revenue reasons, but with high administrative costs. A good excise system does generate revenues – but as a by-product – from a narrow base and with low administrative costs.[28]

Many developing countries rely heavily on trade taxes since the foreign trade sector is easy to tax and monitor. Import tariffs are important revenue sources and are also applied for protectionist reasons. Export taxes are employed to promote non-revenue goals such as increased processing of raw materials, by imposing high rates of taxes on unprocessed exports and lower on processed items. When it comes to broadening the tax base in the short run it is important to reduce tariff exemptions and to improve border controls to reduce tax evasion. In the long run – since tariff reduction is usually a part of an overall program of trade liberalisation – revenue may decrease if complementary measures are not implemented. Such measures include the implementation of a fully functioning VAT that will switch the dependency from trade taxes towards indirect taxes. Finally, the benefits from export taxes should be carefully evaluated.[29]

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[27] World Bank, 1991, pp.31-39; Gillis et al., 1996, pp.333-337; Tanzi and Zee, 2001, pp.2-7.
[28] Ibid.
[29] Ibid.

3.3 Simplifying the Rate Structure

When the tax bases have been defined as broadly as administratively possible, the rate structure has to be simplified. The general idea is that lower rates and fewer rate brackets, simplify the rate structure, reduce tax evasion and lower the administrative costs, and thus increase revenues.[30]

With a narrow tax base, an increase in personal income tax is unlikely to increase revenues. Common problems for those subject to personal income tax are the separate schedules and different rates, which treat different sources of income differently and complicate administrative procedures. A switch to global income taxation, that – unlike schedular taxation – treats all sources of income alike, would simplify this procedure. The number of rate brackets should be reduced and the recommended number is 2-4. It is also important not to set the top marginal tax rate at a level that will be counterproductive, i.e. result in widespread evasion and/or a reduction in work effort. The recommended rate is between 30-50%. A threshold rate must be implemented – if not already in place – to avoid taxing the poor.[31]

A reduction of company income tax must be accompanied with an expansion of the tax base if a situation of decreased revenues is to be avoided. Common problems concerning company income tax is the use of multiple rates based on sectoral differentiation and the incoherent design of the depreciation system. Multiple rates along sectoral lines – with preferential treatment for selected sectors – distort the allocation of resources and are indefensible if a government is truly committed to market economy. Measures to unify multiple company income taxes are therefore important, and a single rate is preferred. The depreciation systems often include too many asset categories and rates, which makes it difficult to estimate the cost of capital and profitability of investment. The number of

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[30] World Bank, 1991, pp.41-43.
[31] World Bank, 1991, pp.39-43; Bird, 1992, pp.88-90; Gillis et al., 1996, pp.335-337.

categories should be reduced to 3-4 and a single depreciation rate is recommended. In order to avoid incentives for tax arbitrage – where companies treat profits/wages as whichever is the more favourable at the point of taxation – a principle of good tax policy is to ensure that the top marginal rates for personal and company income taxes do not differ materially from each other.[32]

When it comes to indirect taxes, a broadly-based VAT stands out as the most effective method of taxing commodities yet, as mentioned in the previous section. The VAT should be given a moderate flat rate of 10-20%, since levels below 10% usually generate too low revenue relative to the administrative costs. A single rate is preferred to the politically attractive but administrative costly multiple rate systems, and exemptions should be granted for necessities. In order not to complicate the VAT rate structure it is better to introduce a separate instrument – such as an excise tax – to tax luxury goods. The categories of commodities subject to the higher excise tax rates should not be more than 3-4.[33]

Most attempts to raise further revenue through higher import tariffs will probably lead to the opposite effects, since higher rates would increase incentives for smuggling. When reducing import tariffs it is important to implement a simultaneous adjustment in the consumption tax rate in order not to reduce total revenue collected. A fully functioning and effective VAT that does not differentiate by source of production is the best alternative to meet the revenue needs. It is also important that all nominal tariffs rates are reduced by the same proportion in order to avoid unintended changes in the relative rates of effective protection across sectors. Export taxes, imposing high rates on unprocessed exports and lower on processed items, could result in lower revenues and should be carefully examined.[34]

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[32] World Bank, 1991, pp.42-46; Tanzi and Zee, 2001, pp.6-7.
[33] Ibid.
[34] Gillis et al., 1996, pp.332-333; Tanzi and Zee, 2001, p.7.

3.4 Improving Tax Administration

A weak tax administration with low collecting capacity is a common constraint shared by many developing countries and contributes to the inefficiency and direct costs of the tax system. Changes in tax administration are one of the most important reforms for increasing revenues, since they would permit more revenue to be collected at existing or reduced tax rates. Lack of well-trained staff, excessively complex tax laws, light penalties for tax evasion, corruption and old administrative techniques, make tax evasion one of the most serious problems of economic policy in developing countries.[35] In some developing countries it is estimated that over half of the potential revenue is lost due to tax evasion.[36]

In the short run, taking the existing administrative capacity as given and designing tax options within those constraints might be the best approach. In the long run though, tax administration must be improved and developed as a part of the adjustment process. Tax administration reforms should aim to improve taxpayer compliance and administrative efficiency.

In order to improve compliance, tax legislation should be simplified, since complex tax laws make it easier for tax auditors to engage in side deals. Simpler tax laws would also make the administrative job easier and more efficient, decreasing the costs for auditing. Tax collection can be shifted to a system with increased self-assessment, in which taxpayers are required to calculate their own liability. This could increase the number of persons who identify themselves as tax payers and allow tax officials to focus on improving compliance and auditing. The reduced interaction between the taxpayer and the tax official would also reduce the opportunity for collusion. For this reform to be effective and to reduce the risk of underassessment, auditing procedures have to be improved and followed through

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[35] Gillis et al., 1996, p.338; Agénor, 2000, pp.83-86.

[36] For India see Goswami, Sanyal and Gang, 1991, pp.201-213; for Bolivia and Uruguay see Silvani and Radano, 1992, pp.19-59.

in cases of suspected tax evasion. The introduction of self-enforcing taxes such as the VAT will also increase compliance, since it increases the incentives to belong to the formal sector. Another effective method is to increase the use of withholding at the source – such as the Pay-As-You-Earn system (PAYE) – an effective method for collecting taxes, which is levied directly on salaries and capital income. Tough penalties can also be introduced in order to decrease the incentives to evade tax.

In order to improve administrative efficiency, technical means of assistance such as: the mechanisation of manual procedures; increased use of tax collection through the banking system; increased computerisation; and the creation of a master tax file and a taxpayer identification number to improve data storage, should be introduced. The increased use of technical means will also require an improvement of staff skills, which can be attained through training and/or replacement of staff. When it comes to corruption and poor morale among tax officials, higher salaries in order to attract better staff is a common, but rarely sufficient measure. The lack of resources usually excludes this possibility as well. Another alternative is to impose tougher penalties for rent-seeking activities among public employees. Sometimes drastic changes – such as a privatisation or a complete restructuring of administrative arrangements – might be the only antidote to the plague of corruption. These are costly measures but might be worth the investment if revenue collection is radically improved.[37]

[37] World Bank, 1991, pp.51-53.

Chapter 4 The Pre-reform Tax System

This chapter describes the evolution of the Mozambican tax system in 4.1, and describes the major problems in the pre-reform tax system in 4.2.[38]

4.1 The Evolution of the Tax System

Mozambique is a country that has undergone several transitions in the last 30 years: from Portuguese colonisation to independence (1975); from a centralised socialist planned economy to market economy (1987); from civil-war to peace (1992); and from single-party Marxism-Leninism to political pluralism with multi-party elections (1994). These drastic changes affected the development of the economy as well as the design and structure of the tax system.

At the time of independence in 1975, the Soviet Union was an important military and economic partner and Mozambique adopted a socialist economic system. Large-scale public enterprises were identified as the engine of economic growth and the development plans prioritised the expansion of the health and education sector, and the national defence. With an increase in expenditures the need for sustainable tax revenues increased as well. The fact that Mozambique was unable to explore its numerous natural resources at the time, made the need for revenues even greater. Due to inadequacies in the prevailing tax system, tax revenues had started to decline. Revenues collected from the important industrial sector decreased since many industries had been abandoned and sabotaged by fleeing settlers. The efficiency and collecting ability of the tax administration was reduced due to the lack of educated staff.[39] It was difficult for the tax

[38] All historical material from Ibraimo, 1998, pp.111-119, and Vasques, 1998, pp.1-26 unless otherwise indicated.
[39] At the time of independence only about 40 Mozambicans had acquired a university degree, Nkomo, 1986, pp.319-342.

administration staff to carry out audits since the few private companies that still produced profits had superior accounting competence.

In order to adjust the tax system to the budgetary needs and the political objectives of the government a tax reform was carried out in 1978 – Resolution No.5/77. The objectives of the reform were obviously to increase revenues, but with a change in the composition of total tax revenues, increasing the importance of direct taxes, while prioritising the principle of social justice, i.e. progressivity. Measures were taken to improve collection procedures and overall tax legislation; company profits were taxed harder; and seven different income taxes were introduced to fulfil the objective of progressive taxation. The principle of social justice could clearly be seen in the different categories of taxes: among the direct taxes, company profits were taxed harder than personal incomes; and among indirect taxes, superfluous goods were taxed harder than necessities. The reform was successful and tax revenues increased from below 10% of GDP in the late 1970s up to 12.3% in 1983 and direct taxes increased from 15% of total tax revenues in the late 1970s to 26.9% in 1983.[40]

In 1983 the tax system deteriorated as the civil-war was intensified and the economy was degraded. The growth strategy of the planned economy had failed. The tax base was reduced since the informal sector grew rapidly. Soon the majority of private sector profits were made in the informal sector, which reduced the efficiency of the tax system. Studies conducted in 1986 estimated that the tax system missed out on 70% of the actual flow of goods. In the same year tax revenues were down to 6.9% of GDP, an all time low.[41]

In 1987 the path towards a market economy began when the first World Bank/IMF induced economic reform program – the Economic Rehabilitation Program (ERP) – was launched. The ERP was a comprehensive reform programme and focused on: promoting private investment; liberalisation of prices;

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[40] WBAD, 2004.

privatisation of state-owned enterprises; reforming the financial sector; reforming the foreign exchange market; and improvement of fiscal policy.[42] In this program tax reforms became a part of the overall goal to create a fully functioning market economy. In the tax reform of 1987 – Law No.3/87 – the former socialist priorities were given less attention in favour of the necessary adjustments that had to be made for the creation of a market economy tax system. The objectives were to increase elasticity of tax revenues relative to GDP growth and to broaden the tax base. This was going to be done by increasing the relative importance of indirect and trade taxes. A turnover tax was introduced in order to collect a larger share of commercial sector profits; trade liberalisations were carried out; personal profits were taxed harder through the implementation of a surtax; and public corporations became subject to taxes. Some of the prevailing problems were corrected: the new turnover tax reduced the large number of intermediate stages that had appeared logical during the time of socialism; trade liberalisations in combination with an intensified trade flow increased trade tax revenues, and tax revenues increased once again to 11.4% of GDP in 1991. The indirect and trade taxes increased in relative importance and accounted for over 75% of total tax revenues in 1991.[43]

4.2 Major Problems in the Pre-reform Tax System in 1996

As the country and the economy went through major transitions in the following decade – with the peace-agreement of 1992 and the first democratic elections of 1994 bringing political and economic stability – the tax system was only fragmentarily modified and new problems emerged. Numerous tax laws and decrees – leftovers from the colonial period, the days of planned economy and the tax reform of 1987 – were out-of-date and in need of profound updating. The

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[41] Ibid.
[42] Sulemane and Kayizzi-Mugerwa, 2001, p.2.
[43] WBAD, 2004.

Mozambican pre-reform tax system in 1996 fits well into the developing country profile described in the previous chapter with a large informal sector, inefficient tax administration and rampant poverty, which made taxation difficult. The tax system was generating low revenues (<10% of GDP) and with high direct and indirect costs. In table 3 we can see the structure of the pre-reform tax system in 1996.[44]

Table 3: The Pre-reform Tax Structure – 1996

Tax	**Explanation**	**Level**
Direct Taxes		
Contribuição Industrial	Business profits tax (for companies and individuals; commercial and industrial activities)	15-45% (special case 50%)
Imposto sobre Rendimento do Trabalho (IRT-A, IRT-B)	Income tax A (for individuals) Income tax B (for production and service cooperatives; agricultural, forestry or livestock activities)	IRT-A: 0-30% (0-20% in 1998) IRT-B: 1-30%
Imposto Complementar	Complementary tax (progressive surtax for companies and individuals)	0-40% (special case 55%)
Contribuição Predial	Urban property tax	12-45%
Indirect Taxes		
Imposto de Circulação	Turnover tax	1-20%
Imposto de Consumo	Consumption tax (on domestic and imported goods)	20-75%
Imposto Especial sobre Combustivies	Fuel tax	Fixed tax per unit of fuel
Trade Taxes		
Direitos de Importação	Customs duties	0-35%
Taxa de Servicos Audaneiros	Customs fee	1%
Direitos de Exportação	Export duties	14%
Other Taxes		
Imposto de Reconstrução Nacional, Imposto do Selo, Imposto de Turismo, Imposto de Compensação	Poll tax, stamp tax, tourism tax, motor vehicle tax	

Source: IMF, 1998; BM, 2000; MPF, 2001

Table 4 provides an overview of the major problems for different categories of taxes and tax administration. The problems are discussed in sections 4.2.1-4.2.4.

[44] IMF, 1998; WBAD, 2004.

Table 4: Overview – Major Problems

Category of Taxes	Major Problems
Direct Taxes	- Narrow tax base due to the large informal sector. - Complex rate structure for the income tax. - Common exemptions and fiscal incentives. - Complex legislation.
Indirect Taxes	- Narrow tax base due to the large informal sector. - Inefficient turnover tax with a complex rate structure - Consumption tax with complex rate structure and common exemptions. - Fuel tax sensitive to inflation changes.
Trade Taxes	- Common exemptions. - High rates increasing incentives for evasion. - Customs administration suffering from rent-seeking activities.
Tax Administration	- The administrative climate: complex administrative procedures; complex legislation; lack of transparency; low morale among public servants; centralised administrative structure; and rent-seeking activities. - Lack of modern techniques. - Lack of qualified staff.

Source: Sections 4.2.1-4.2.4.

4.2.1 Direct Taxes

The direct taxes had not undergone any significant modifications since the reform of 1978, which had eroded the tax base and decreased the efficiency and equity of the tax system.[45] The direct taxes were producing very little revenue (1.9% of GDP) due to several reasons: (i) The informal sector was very large with few people and companies subject to the direct taxes. Over 80% of the labour force was employed in agriculture, forestry and fishing, and the majority worked in small-scale businesses in the informal sector or simply for subsistence. A large share of the population was not paying any direct taxes at all since regular incomes were rare and most cash payments were never accounted for. (ii) The problematic income tax legislation with five different income taxes (see table 3) was an inheritance from the 1978 reform, where progressive taxation was given high priority. Especially the complementary tax, originally created as a surtax, was

[45] CEM, 2001, introduction.

limited in practice to certain kinds of income from capital and increased the complexity of the direct tax structure. The list of depreciation and amortisation rates for companies was also complex and had not been revised since 1968. (iii) Exemptions and fiscal incentives were common and contributed to the narrow tax base. Public sector employees were exempt from income tax, with the motivation that the public sector in general paid lower salaries than the private sector and therefore the tax exemptions should contribute to keep competent staff. A perfect example of inequitable exemptions in the tax system was the 1998 reduction of the top layer income tax for individuals from 30% to 20%, favouring the high-income minority and reducing direct taxes as a share of total tax revenue from 19.5% to 15.1%. Middle-size enterprises were carrying the largest tax burden since small enterprises were escaping the business profits tax in the informal sector and the larger ones could benefit from tax exemptions. Fiscal incentives were commonly used to attract investments. Since the legislation concerning the benefits from fiscal incentives was excessively complex and difficult to construe, contracts were not monitored to a satisfactory level, making the actual tax base for the business profits tax much smaller than its potential.[46]

4.2.2 Indirect Taxes

Since direct taxes were difficult to collect, indirect taxes had increased in importance (5.3% of GDP) and were the most important category of taxes. But indirect taxes were also suffering from problems: (i) The tax base was smaller than its potential since a large share of consumption was carried out in the informal sector. (ii) The efficiency of the major indirect tax – the initially successful turnover tax – was questioned in the mid 1990s. The tax had cascading effects, which raised prices and increased the burden for the final user. This also increased the difference between the prices of the formal and informal sector, which

[46] CEM, 2001, pp.48-49; WBAD, 2004.

increased incentives for tax evasion, contributing to the large informal sector. The rate structure was excessively complex as well, with eight rate categories and many exemptions. (iii) The consumption tax had a complex rate structure and exemptions were common. (iv) The fuel tax was collected with a fixed tax per unit of fuel, making it sensitive to changes in inflation. If the tax was not revised and updated with the rate of inflation, it would lose its real value in local currency.[47]

4.2.3 Trade Taxes

The trade taxes were low (2.1% of GDP) since the tax base was smaller than its potential due to: (i) The governments increased use of exemptions, causing distortions and inequity. A study conducted by the IMF showed that the tax revenues collected from imports were 20% below their potential value in 1998, and 12% in 1999, due to exemptions from import duties for certain companies and members of parliament during these years.[48] (ii) The high import tariffs and export taxes increased incentives for tax evasion through smuggling. (iii) The problems with customs administration (see tax administration below).[49]

4.2.4 Tax Administration

Tax administration was highly inefficient due to several reasons such as: (i) The administrative climate. A study of red-tape in Mozambique carried out in 1996 described complex administrative procedures; out-of-date and unpredictable alteration in legislation; lack of transparency; and low morale among public servants.[50] Another study points out the centralised administrative structure – another inheritance from the planned economy – as the main cause of

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[47] IMF, 1998, pp.112-113.
[48] Gorman, Sab och Ramos, 2000, introduction.
[49] CEM, 2001, p.15.
[50] World Bank, 1997, introduction.

inefficiency.[51] Customs administration was suffering from serious deficiencies in all aspects of customs management and controls due to rent-seeking activities that contributed to the low levels of trade taxes being collected. (ii) The lack of modern techniques. Modern means of assistance for the tax administration such as a tax identification number or computerised storage of information was yet to be introduced. Deposits and transfers were checked by visual examination of statements provided by the bank. The entire checking procedure was manual and the risk of fraud obviously high. Unprocessed payments were highly unlikely to be detected. (iii) The lack of qualified staff. Only about 3% of the public servants had attained a university degree and nepotism was common in the employment process. Only 13% had been appointed through a competitive process. The lack of resources made improvements difficult.[52]

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[51] CAS, 2000, p.15.
[52] IMF, 2001, p.8; PSR, 2001, pp.1-5.

Chapter 5 The Tax Reforms

This chapter will sequentially describe each reform – including administrative measures – in sections 5.1-5.3. The reforms are then summarised in section 5.4, which also includes table 6 with the structure of the post-reform tax system. References will be made to this table in the text.

By the mid 1990s Mozambique was still facing serious internal and external imbalances, and was highly dependent on external financing. With a large fiscal deficit, large current account deficit and high rate of inflation, Mozambique could be characterised as a typical segment 2 economy (see figure 1). In order to gradually reduce the fiscal deficit and to correct the macroeconomic imbalances, measures were taken to: improve the effectiveness and transparency of public expenditure; improve the external balance; and increase tax revenues.[53] As described in the previous chapter the tax system was generating low revenues – even when compared to sub-Saharan standards – with high direct and indirect costs.[54] The outdated tax system was in need of profound updating and the first measures were taken in 1997 to create a modern, efficient, wide, fair, simple and predictable tax system, with a more efficient tax administration.[55] The reforms that were introduced between 1997 and 2003 were comprehensive and affected all categories of taxes (see table 5).

Table 5: Tax Reforms – Date of Introduction

Tax Reform	Date of Introduction
Reform of Customs Administration and Trade Taxation (5.1)	1997
Reform of Indirect Taxation (5.2)	1999
Reform of Direct Taxation (5.3)	2002/2003

Source: MPF, 2001; AIM, 2002.

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[53] CEM, 2001, introduction.
[54] When measured in tax revenues as a share of GDP, the ratio for Mozambique in 1996 was 9.8% compared to the sub-Saharan average of 19.5%. WBAD, 2004.
[55] PARPA, 2001, p.77.

5.1 Reform of Customs Administration and Trade Taxation – 1997

The customs and trade tax reform included the following elements:[56]

- Even though the actual customs reform was initiated in 1997, the preparations for the reform had already begun in 1995 with the creation of a special unit in charge of the overall customs reform (*Unidade Técnica para Reestructuração das Alfandegas – UTRA*).
- A new Customs Code – Decree No.42/96 – published in October 1996 reduced exemptions, tariff rates and the dispersion of rates. Administrative requirements, such as the need for an import registration permit (*Boletim de Registo de Importação*), were abolished in 1998. The top tariff rate was further reduced from 35% to 30% in 1999, and then again from 30% to 25% in 2003 (see table 6), as a part of the cooperation with the Southern African Development Community (SADC), making Mozambique one of the most open trade policy regimes in sub-Saharan Africa.
- The hiring of a foreign private firm – Crown Agents – in 1997 to manage customs in a three-year process of training and restructuring. This led to: the modernisation of customs legislation and the integration into one coherent body of laws and regulations; the simplification of declaration forms; a re-evaluation and replacement of customs staff; a simplification of the pay structure linking it to performance; and increased computerisation of customs procedures. New policies were introduced as well, such as publicising and penalising disclosures of fraud and corruption. Another three-year contract was signed in 2000, with the objective of gradually returning customs management to Mozambican authorities.

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[56] CEM, 2001, pp.15-19; MPF, 2001; IMF, 2001, pp.8-9; PER, 2003, p.19.

5.2 Reform of Indirect Taxation – 1999

The reform of indirect taxation was initiated in 1998 – with the passing of Law No.3/98 – but was not taken into practice until 1st of June 1999 due to a prolonged preparation time. The reform included the following elements:[57]

- The creation of the value-added tax (*Imposto sobre Valor Acresentado – IVA*) and the selective excise taxes (*Imposto sobre Consumos Especificos – ICE*) (see table 6). These taxes replaced the turnover tax and the consumption tax as the major indirect taxes.
- The VAT was given a single positive rate of 17%, with exemptions granted for particular products including essential food items, medicines and inputs into agricultural production (see table 6). Both domestic transactions and imported goods became subject to the VAT.
- A simplified VAT feature was also introduced. Companies with a low yearly turnover (< MZM 250 000 000), that were not involved in trade activities, could apply for an exemption from maintaining full accounts and were taxed at a 5% rate on turnover instead. This alternative made it impossible to apply for deductions for tax paid on inputs.
- A central VAT unit was created and fully integrated into the national tax administration (*Direcção Nacional de Impostos e Auditoria – DNIA*).
- A unique taxpayer identification number (*Número Único de Identificação Tributária– NUIT*) was also introduced for each firm subject to the VAT, with a simultaneous implementation of computerised systems for registration and control, to ensure greater coordination of information between the tax administration and customs. Special monitoring procedures were introduced for the 100 largest VAT payers.

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[57] Soguel and Schoenenberger, 1999, pp.1-34; BM, 2000; MPF, 2001; IMF, 2001, p.7.

- VAT collection through the banking system was introduced.
- The selective excise taxes were given a lower rate interval, compared to the previous consumption tax, and were set between 15-65% (see table 6). The same goods and items (domestic and imported goods considered as luxury items, superfluous or unhealthy, such as tobacco and alcohol) became subject to the selected excise taxes. Coverage was expanded and came to include musical instruments, games and certain sports equipment as well.
- The fuel tax was increased in 2003 in order to restore its original value (see table 6). Since the tax had not been revised since 1997, the revenue in real terms had declined due to inflation. The decision to raise the tax was preceded by a comprehensive analysis of the impact of a higher fuel tax, called the Poverty and Social and Impact Analysis (PSIA). A decision was also made to earmark the fuel tax revenue for the road maintenance fund.[58]

5.3 Reform of Direct Taxation – 2002/2003

The reform of direct taxation started in 2002 with the reform of fiscal incentives for investments, but the major changes came about in 2003 with the reform of income taxes. The reforms included the following elements:[59]

- A new code on fiscal incentives for investments – Decree No.16/2002 – was passed in June 2002 and introduced transparent rules and standard concessions for foreign investors. The purpose was to ensure the control of tax exemptions given to investments and to clarify the circumstances concerning these, by minimising overlapping and securing that the beneficiaries fulfilled their part of the deal.

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[58] Nicholson et al., 2003.
[59] AIM, 2002; KPMG, 2002; PER, 2003, p.19.

- The implementation of an internal tax reform unit (*Unidade de Reformas Tributária dos Impostos internos – URTI*) in 2001, in order to assist the launching of the reform of direct taxation.
- A new income tax law was passed in 2002, and was officially introduced in January 2003. The five existing taxes on company profits and personal incomes were replaced by just two, one for all company profits (*Imposto sobre Rendimento das Pessoas Collectivas – IRPC*) and one for all income earned by individuals (*Imposto sobre Rendimento das Pessoas Singulares – IRPS*) even when earned from illicit sources (see table 6).
- Efforts were carried out to bring the large number of informal operators into the tax system. Some of the activities in the informal sector were believed to be carried out by registered companies from the formal sector deliberately trading goods in the informal sector. To avoid this leakage, administrative controls were tightened. In order to bring a larger part of the "real" informal sector into the tax net, the tax system was made more user-friendly with simplified licensing procedures and increased self-assessment by taxpayers.
- The top marginal rates for the company income tax were kept at 35% and the legislation that made it possible to charge up to 50% was abolished.
- The personal and company income tax rate was set between 10-35%, for income higher than the introduced threshold rate of MZM 24 000 000 per year. The previous personal income tax had a ceiling of 30%, but the top rate of income tax actually collected was just 20%, due to a generous diploma passed in May 1998, also mentioned in the previous chapter. The rate was reduced once again from 35% to 32% in late 2003 (see table 6).
- Income from capital or rents would be taxed at a higher rate than the income earned by a factory worker. The taxpayer's family situation would also be taken into account, where people with large families would be entitled to a deduction (a form of child allowance).

- The reform eliminated the tax exemptions enjoyed by public servants. It was no longer considered acceptable that public servants in the tax office should demand taxes from business people when not paying any taxes themselves. This reform was accompanied by a general rise in public sector wages, leaving the net wage unchanged.

5.4 A Summary of the Tax Reforms

As we can see in table 6 the tax reforms carried out in Mozambique between 1997 and 2003 changed the tax structure a lot.

Table 6: Post-reform Tax Structure – 2004

Tax	**Explanation**	**Level**
Direct Taxes		
Imposto sobre Rendimento das Pessoas Singulares (IRPS)	Personal income tax	10-32%
Imposto sobre Rendimento das Pessoas Collectivas (IRPC)	Company income tax	10-32%
Indirect Taxes		
Imposto sobre Valor Acresentado (IVA)	Value-added tax	17%
Imposto sobre Consumos Especificos (ICE)	Selective excise tax	15-65%
Imposto Especial sobre Combustivies	Fuel tax	Gradually adjusted for inflation, aim is to restore the 1997 value of the tax
Trade Taxes		
Direitos de Importação	Customs duties	0-25%
Taxa de Servicos Audaneiros	Customs fee	1%
Direitos de Exportação	Export duties	14%
Other Taxes		
Imposto de Reconstrução Nacional, Imposto do Selo, Imposto de Turismo, Imposto de Compensação	Poll tax, stamp tax, tourism tax, motor vehicle tax	

Source: IMF, 1998; BM, 2000; MPF, 2001; AIM, 2002; KPMG, 2002.

Among the direct taxes the number of income taxes was reduced from five to two and the rates were reduced even though the actual top rate was increased slightly

from 20% to 32%, compared to the pre-reform tax structure. Among the indirect taxes the replacement of the turnover tax and the consumption tax, with the VAT and the selective excise tax constitute the major changes. Since the turnover tax and the VAT have different functions it is no use comparing their rates. The interval for the selective excise rates was lowered compared to the pre-reform tax structure from 20-75% to 15-65%. The fuel tax was gradually adjusted as well in order to restore its 1997 value. Among the trade taxes there was a major reduction of the top import tariff from 35% to 25%, while the export taxes remained unchanged.

Chapter 6 The Revenue Effects

This chapter is the first step in the analysing procedure and evaluates the revenue effects of the Mozambican tax reforms in 1997-2003. In section 6.1 the implemented tax reforms will be analysed through comparison with the recommendations of uniform taxation outlined in the theoretical framework in chapter 3. In section 6.2 the revenue effects on each category of taxes will be analysed through the change in the level of tax revenues as a share of GDP, and in section 6.3 through the change in the composition of tax revenues. A summary of the revenue effects can be found in section 6.4.

6.1 The Mozambican Tax Reforms and Uniform Taxation

As we can see in table 7 the Mozambican tax reforms included many measures in accordance with the recommendations of uniform taxation, but also some that were not. Even though it is hard to point out the most important reforms, international experience suggests that the replacement of the turnover tax in favour of the VAT; the simplification of the income tax rate structure; and the tariff reduction complemented with the reform of customs, have been the most important revenue-generating reforms so far.[60] Each category of taxes will be discussed in sections 6.1.1-6.1.3 and a summary follows in section 6.1.4.

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[60] The implementation of the VAT raised additional revenue in Indonesia, Colombia and Malawi. Khalilzadeh-Shirazi and Shah, 1991, introduction;
The simplification of the rate structure raised additional revenue in Bolivia, Colombia, Indonesia, Jamaica and Malawi. Gillis, 1989;
The privatisation of tax administration raised additional revenue in various countries in Latin America. Acuña, 1992, pp.377-403.

Table 7: The Mozambican Tax Reforms and Uniform Taxation

Tax	Major Problems	Measures to Broaden the Tax Base and to Simplify the Rate Structure	Measures to Improve Administrative Efficiency	Not in Accordance with Recommendations
Direct Taxes	- Narrow tax base due to the large informal sector. - Complex rate structure. - Common exemptions and fiscal incentives. - Complex legislation	- Simplification and improvement of legislation on fiscal incentives. - Reduction of exemptions. - Abolition of inefficient taxes and reduced number of income taxes. - Efforts to include the informal sector. - Reduction of top marginal rates. - Levelling of the top personal and company income tax rate at 32%. - Elimination of income tax exemption for public servants.	- Tightened administrative controls. - Simplification of licensing procedures for companies. - Increased use of self-assessment. - The creation of a reform unit. - Simultaneous increase in the salary of public servants.	- Reforms to increase vertical equity (i.e. progressivity) such as the harder taxation on capital and the deductions for taxpayers with many dependants.
Indirect Taxes	- Narrow tax base due to the large informal sector. - Inefficient turnover tax with a complex rate structure - Consumption tax with complex rate structure and common exemptions. - Fuel tax sensitive to inflation changes.	- Replacement of the turnover tax with the VAT. - Single-rate of 17% for the VAT introduced. - Separate excise tax introduced on luxury goods. - Adjustment of the fuel tax.	- The creation of a VAT unit and its integration into the general tax administration. - Enhanced cooperation with customs office. - Taxpayer identification number. - VAT collection through the banking system. - The introduction of the simplified VAT feature.	- Legislation can be easily modified. - Reduced excise taxes. - Too many goods subject to the excise tax.
Trade Taxes	- Common exemptions. - High rates increasing incentives for evasion. - Customs administration suffering from rent-seeking activities.	- Reduction of tariff exemptions. - Reduction of top tariff rate to 25%. - Reduced number of rates. - Simplification of legislation.	- Abolition of unnecessary administrative procedures. - The reform of the customs office with: - Efforts to improve transparency. - Training of customs staff. - Modification of the pay-structure. - Tougher penalties. - Increased computer use	- Unchanged export tax. - The first tariff rate reduction in late 1996 without a simultaneous adjustment in the consumption tax.

Source: Information from table 4 and chapter 5.

6.1.1 Direct Taxes

With the reform of legislation on fiscal benefits from investments; the reduction of the number of income taxes and rates; the efforts to include the informal sector; the reduction of exemptions; and the tightened administrative controls and simplified licensing procedures; we can see the efforts to broaden the tax base, simplify the rate structure and improve administrative efficiency. Attention has been paid to all the major problems identified in the pre-reform tax system. The simplification of the excessively complex income tax rate structure and the efforts to reduce fiscal incentives were important measures to increase tax revenues.

The harder taxation on capital income and the deductions for taxpayers with many dependants – measures to increase vertical equity (i.e. progressivity) – were not in accordance with the recommendations and ought to increase the complexity of the tax system. Uniform taxation suggests that progressivity is dealt with through the expenditure side of the budget. In this case the global income taxation that does not differentiate between sources of income and an introduction of a proper child allowance might have been preferable alternatives.

6.1.2 Indirect Taxes

With the replacement of the cascading turnover tax with the VAT; the introduction of a separate excise tax; the creation of a VAT unit; the creation of a tax identification number and the VAT collection through the banking system and the introduction of a simplified VAT feature for small-scale businesses; we can see the efforts to broaden the tax base, simplify the rate structure and improve administrative efficiency. Attention has been paid to all the major problems identified in the pre-reform tax system. The implementation of the VAT was an important measure to increase tax revenues and its design complies almost perfectly with the recommendations.

A problem that might appear is the fact that the legal rules governing the VAT can be easily adapted – a feature that was desirable in the implementation period of the tax – but might contribute to uncertainty for future investors. Another problem with the VAT has been the delays of refund payments, causing inefficiency. When it comes to the excise tax – the only tax where increases were recommended – the new rates were actually decreased from 20-75% to 15-65%. Yet another problem with the excise tax is that coverage was expanded instead of decreased, and that an excessive number of items are now subject to the tax.

6.1.3 Trade Taxes

With the reduction of tariff exemptions; the reduction and dispersion of rates; the simplified administrative procedures; and the reform of the customs administration; we can see the efforts to broaden the tax base, simplify the rate structure and improve administrative efficiency. Attention has been paid to all the major problems identified in the pre-reform tax system. The tariff reductions in combination with the reforms of customs administration were important measures to increase revenues.

The export tax has remained unchanged though. Trade liberalisations have always been a matter of discussion and subject to disagreements between the government – that wants to keep import tariffs and export taxes for protectionist reasons – and the World Bank/IMF – wanting to liberalise. Without penetrating deeper into the discussion about the existence of export taxes, it can be understood that precautions will be taken before further liberalisations. In the mid 1990s the cashew nut industry – an important export sector at the time – was ruined through the abolition of the export tax on cashews, which resulted in decreased revenues.[61] The tariff reduction at the end of 1996 and the gap until 1999 – when the VAT

[61] McMillan, Rodrik and Welsh, 2002.

was implemented – suggests that lower total tax revenues were collected during this period.

6.1.4 Summary

Most reforms of the Mozambican tax system in 1997-2003 were in accordance with the recommendations of uniform taxation, suggesting that a positive result for the level of tax revenues is expected. A positive result does not necessarily mean an immediate revenue effect in the short run. The revenue effects can lag behind due to, for instance, sequencing issues and an acclimatisation period for taxpayers and tax administration, leading to unchanged or even decreased levels of tax revenues. An immediate increase in tax revenues usually indicates that exemptions have been reduced successfully and that the tax base has been broadened.

Even though minor administrative modifications have been carried out, the absence of a comprehensive reform of tax administration is a source of unrest. Even though a reform is on its way with plans to introduce an autonomous Central Revenue Authority (CRA) by 2006, it might be problematic to introduce a tax administration reform as the last part of a comprehensive tax reform. The importance of the tax administration and its tendency to impose a constraint on all tax reform efforts might be an explanation for the potential negative effects of the measures taken in 1997-2003 as well.

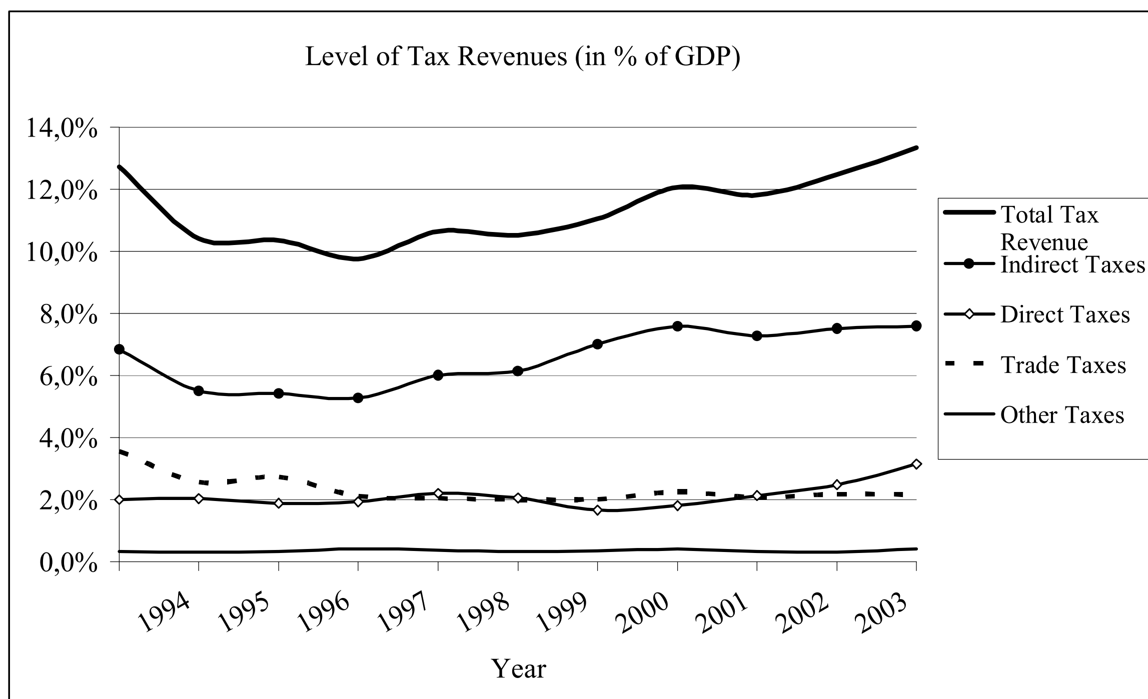
When it comes to the composition of tax revenues, the reduction of the trade taxes and the efforts to make indirect and direct taxes more efficient and broad-based demonstrate the governments' intentions to decrease the dependence on trade taxes and to increase the dependence on indirect and direct taxes.

6.2 Level of Tax Revenues

As we can see in figure 2 there was a significant increase in the level of tax revenues as a share GDP between 1997 and 2003. This increase can be explained

partially by the substance of the tax reforms – adopting the recommendations of uniform taxation to a large extent – but these positive effects would have been impossible without an increased economic activity leading to: increased number of incomes; an increased consumption level; and an increased trade flow. The slight reduction in 2001 was the effect of the sharp increase in GDP in that year due to the implementation of the first mega-project, the Mozal aluminium smelter.[62]

Figure 2: Level of Tax Revenues



Source: Data for 1994-2002 from WBAD, 2004; Data for 2003 from INE, 2004.

From 1997 – when the reform of customs began – until 2003 the revenues collected from trade taxes increased slightly from 2.0% to 2.2% of GDP. From 1997 until 1999 the trade tax revenues remained unchanged, and in 2000 they increased to 2.2% where they remained. The unchanged revenues until 1999

[62] The mega-projects are seven large capital-intensive investments that will have a major impact on GDP, but not on the level of tax revenues since they benefit from tax exemptions. Andersson, 2001, p.16.

suggest that the expected decrease from the tariff rate reduction was compensated for by the improvements in customs administration. The slight increase in 2000 indicates further improvements in customs procedures and/or an increased trade flow. The slight increase in trade tax revenues during this period implies that the expected reduction of revenues due to tariff reductions was offset by an improvement in customs administration, with a successful broadening of the tax base. Even though reports from 2001 suggest that the trade tax base did not increase as fast as expected – since smuggling and illegal imports continued to be a problem – the government and the private sector seemed satisfied with the results.[63] The private firm in charge of the customs reform was contracted for an additional three year period and the private sector representatives characterised the reform as: "far-reaching and innovative, setting a good example for other African countries".[64]

The indirect taxes increased from 6.0% in 1997 to 7.6% in 2003. From 1997 to 1998 there was no increase in indirect taxes, since the consumption tax was not simultaneously adjusted with the tariff rate reductions of late 1996. From 1998 to 1999 – the implementation year of the VAT – there was a jump from 6.1% to 7.0%. In 2000, the first complete VAT year, there was yet another jump up to 7.6%, suggesting a successful implementation of the VAT.[65] There were many reasons for these short run positive revenue effects. Since the price level was left pretty much unaffected when the VAT was introduced, the consumption level was unaffected as well.[66] With the same level of consumption and the self-enforcing mechanism of the VAT – increasing the incentives to register in the formal sector for the refunds on inputs – the tax base was broadened. The simplified VAT

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[63] CEM, 2001, p.20.
[64] Ibid, p.48.
[65] Even though the excise tax and the fuel tax – which account for around 20 % of indirect taxes – have increased as well, most of the changes in the indirect taxes can be derived from the changes in the VAT, the single largest tax instrument in Mozambique.
[66] Cruz, 1999, p.9.

feature was also an enticement for the informal sector to become part of the formal sector. Another reason was the decision to monitor the 100 largest VAT taxpayers since they account for almost 64% of Mozambique's domestic VAT receipts. Finally, the sequencing of introducing the VAT after initiating the reform of customs was a successful decision – even though it may have been unintentional – since the bulk of the VAT is collected at customs on imports. The implementation of the VAT ought to enhance fiscal sustainability in the long run as well.

The direct taxes increased from 2.1% in 2001 to 3.1% in 2003. From 2001 to 2002 – the year for the implementation of the new legislation on fiscal incentives – there was a jump in direct taxes from 2.1% to 2.5%. From 2002 to 2003 – the first year with the new income taxes – there was yet another increase to 3.1%, reaching its highest level since 1983, suggesting a successful reform of direct taxation. Even though the initially very low levels of revenue should be recognised, the short run positive revenue effect indicates that exemptions were cut in a successful manner. A contributing factor to this development was the improved legislation on fiscal incentives that eliminated loop-holes in tandem with the enforcement of tax collection, control and tracking. The fast growth of the tax base through the simplified rate structure and the eased burden on administration are other explanatory factors.

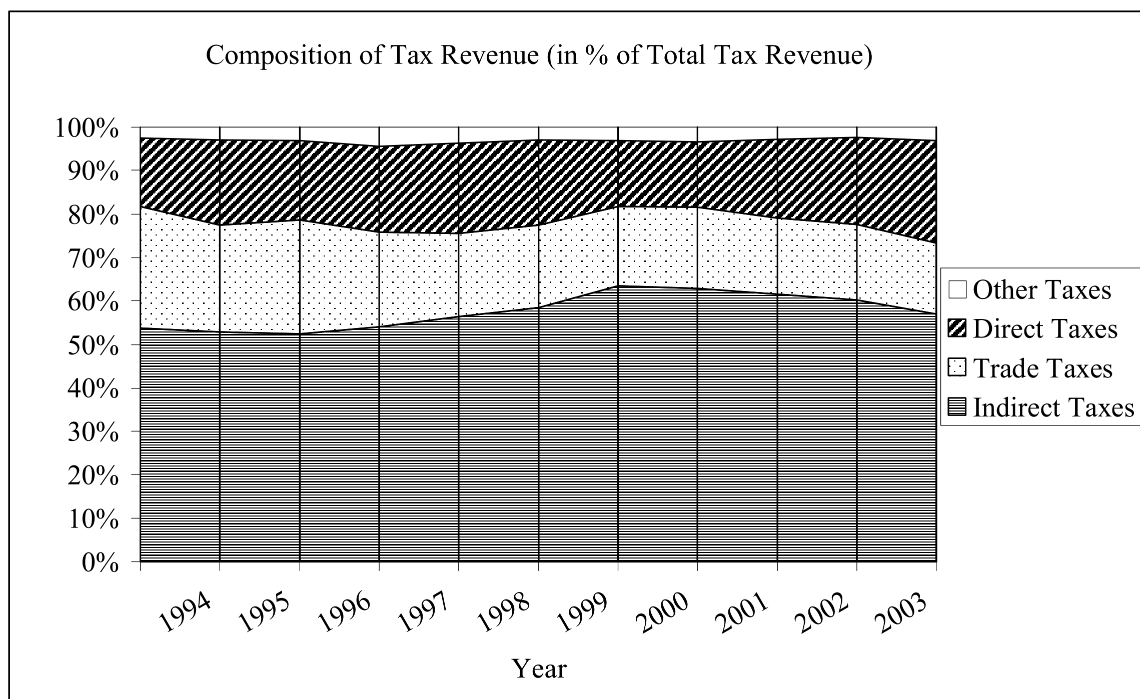
Other taxes play a diminished role in the tax system, fluctuating between 0.3-0.4%.

6.3 Composition of Tax Revenues

During the last decade there has been a gradual shift in the composition of tax revenues (see figure 3). There has been a declining trend in trade taxes as a share of total tax revenue, from 24.6% in 1994 to 16.3% in 2003. The indirect tax revenues increased gradually from 52.9% in 1994 to 63.5% in 1999. Since then there has been a gradual decline to 56.9% in 2003. There has been no clear trend

in the direct tax revenues but in 2000 they reached their all time low with 15.1%. Since then there has been fast increase and in 2003 they reached 23.6%, the highest level since 1988, making direct taxes the second largest category of taxes after indirect taxes. As was observed in the previous table other taxes play a diminished role in the tax system, which is confirmed by its 2-4% share of total tax revenues during the last decade.

Figure 3: Composition of Tax Revenue



Source: Data for 1994-2002 from WBAD, 2004; Data for 2003 from INE, 2004.

The overall trend seems to be a decreased importance of trade taxes, while indirect taxes increased in importance during the introduction of the VAT and since then have decreased slightly in favour of the direct taxes. These can all be seen as positive trends: the increased reliance on VAT and income taxes will make tax revenues less sensitive to fluctuations in trade flow, even though the bulk of the VAT still falls on imported goods; the reduced reliance on trade taxes is a common condition in World Bank/IMF programs, that has to be fulfilled; and the

increased importance of direct taxes is an important step towards the creation of a modern tax system and the future enhancement of total tax revenues.

6.4 Summary – Revenue Effects

The implemented reforms were to a large extent in accordance with the recommendations of uniform taxation. The tax reforms significantly increased the level of tax revenues and shifted the composition towards a more modern structure. The immediate positive revenue effects observed can be explained by a successful broadening of the tax base, through a reduction of exemptions, increased efficiency in indirect taxation and a positive overall development of the economy. The lack of a comprehensive reform of tax administration does not seem to have imposed a constraint on the tax reforms, but revenues might have increased even more if such a reform had been implemented prior to the separate tax reforms.

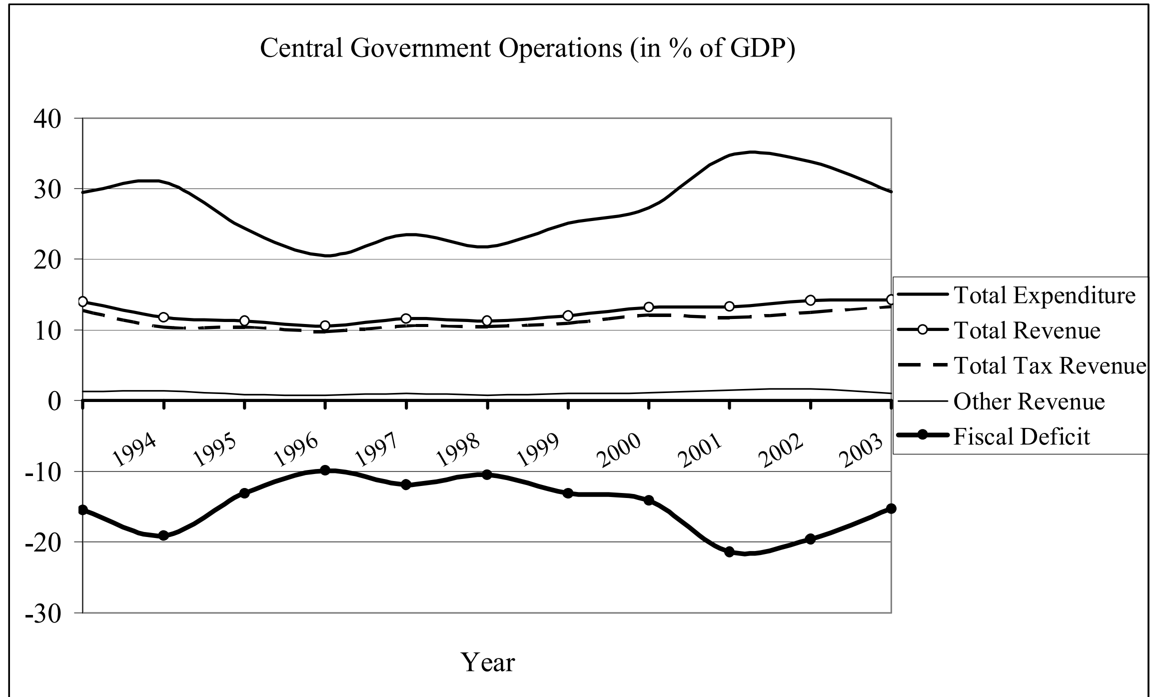
Chapter 7 The Stabilisation Effects

This chapter is the second step in the analysing procedure and evaluates the stabilisation effects of the tax reforms. In section 7.1 the changes in total tax revenues will be compared with the changes in the fiscal deficit. The general idea is to examine whether the changes in tax revenues have contributed to a decrease of the fiscal deficit. In section 7.2 the changes in the fiscal deficit will be compared to the changes in the current account deficit and in the rate of inflation. The general idea is to examine whether the change in the fiscal deficit has also changed the current account deficit and the rate of inflation as suggested by the theoretical framework in chapter 2. A summary of the stabilisation effects can be found in section 7.3.

7.1 Total Tax Revenues and the Fiscal Deficit

As we saw in the previous chapter there has been an significant increase in total tax revenues as a share of GDP in the last couple of years, from 9.8% in 1996 to 13.3% in 2003. In order to see if this increase in total tax revenues has affected the fiscal deficit, the changes in total expenditures and other revenues have to be taken into account since they also affect the fiscal deficit. Then we can evaluate if the changes in the fiscal deficit can be traced to changes in tax revenues or expenditures or, as is most likely, a combination of both. Figure 4 gives us a complete view of the central government operations in the last decade.

Figure 4: Central Government Operations



Notes: Total expenditure: total expenditure and net lending, excluding residual; Total revenue: total tax revenue and other revenue; Other revenue: non-tax revenue; Fiscal deficit: overall balance, excluding all grants. Source: Data for 1994-2002 from WBAD, 2004; Data for 2003 from INE, 2004.

In figure 4 we can see that Mozambique has had a fiscal deficit for the whole last decade, which emphasises the importance of external financing for the economy. We can also see that the changes in total revenues to a large extent can be traced to the changes in total tax revenues, since other revenues (i.e. non-tax revenues) play a minor role for total revenues. Total revenues have been gradually increasing from 10.6% of GDP in 1994 to 14.3% in 2003, a similar pattern to the one for total tax revenues.

The most striking observation is the correlation between the change in total expenditures and the change in the fiscal deficit. This "mirror image-reflection" of total expenditures in the fiscal deficit can be explained by the two essential characteristics of the Mozambican budget: the large and fluctuating total expenditures; and the low – even though they have increased slowly in the last

couple of years – but steady total revenues. There have been large alterations in the level of total expenditures from the lowest level of 20.5% in 1996 to the highest level in 2001 with 34.7%, the highest level since 1983. The increasing trend in total expenditure in the beginning of the decade can be explained by the severe floods that the country suffered in year 2000 and the recovery that followed, and problems in the financial sector with the recapitalisation of a state-owned bank absorbing valuable resources.

Even though the fiscal deficit in the Mozambican economy is far more dependent on the changes in total expenditures, the fact cannot be neglected that the increase in total tax revenues since 1997 has contributed to a slight reduction of the fiscal deficit, compared to a situation where tax revenues would have remained unchanged.

7.2 The Fiscal Deficit and Stabilisation

The theoretical framework in chapter 2 demonstrated how a decreased fiscal deficit contributes to macroeconomic stabilisation: directly through a decreased current account deficit; and indirectly through a reduction of the rate of inflation. If a similar pattern can be found in the change of the fiscal deficit and the changes of the current account deficit and the rate of inflation, it can be concluded that the fiscal deficit does affect these variables, and that measures to decrease the fiscal deficit (i.e. revenue-generating tax reforms) do contribute to macroeconomic stabilisation in Mozambique.

First of all we must establish if our calculated figures for the current account from equation (1.4): $(X - M) = (S_p - I_p) + (T - G)$, differ from the given figures for the current account.[67]

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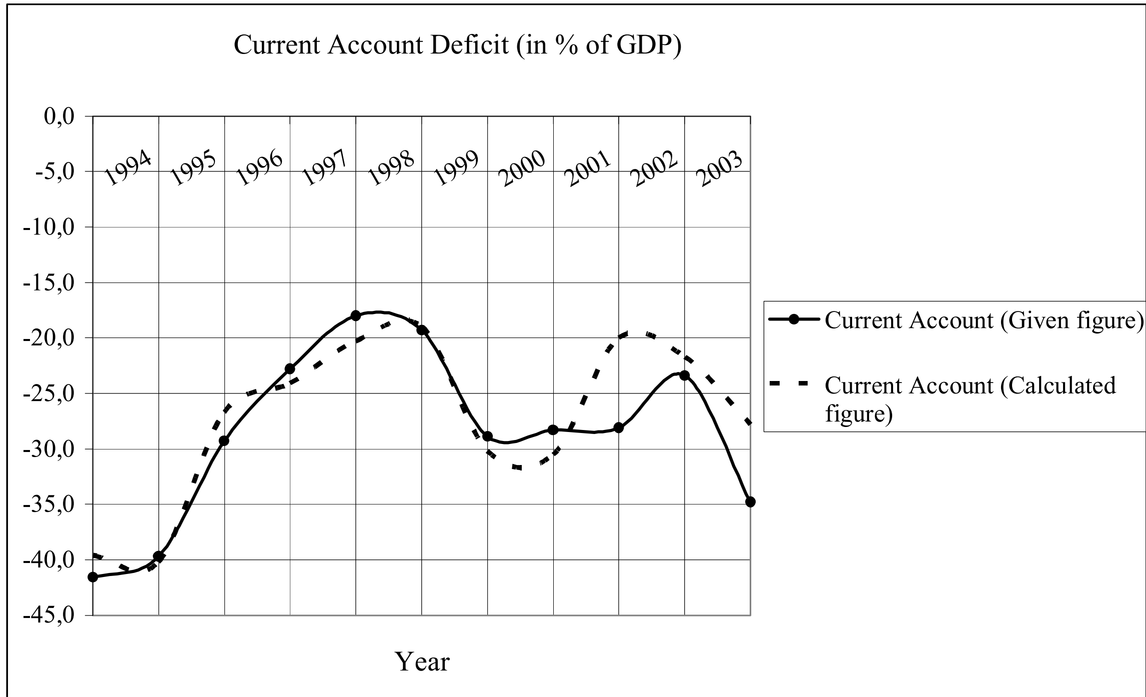
[67] Since there were no given figures for private savings in Mozambique during the past decade, gross domestic savings was used instead. Other sources (PER, 2003) indicate that these figures have not differed significantly in the last decade since the public sector cannot afford to save.

Figure 5: The Current Account Deficit

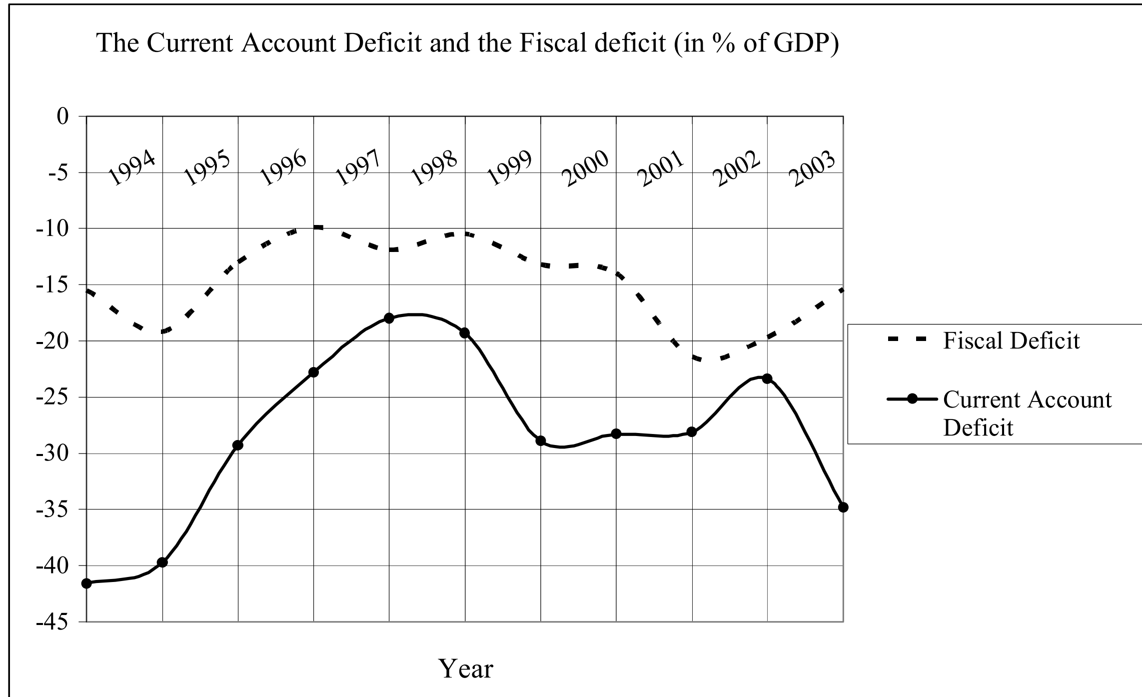


Notes: Current account (given figure): current account balance, excluding net official capital grants; Current account (calculated figure) through equation (1.4) from chapter 2. Source: Data for 1994-2002 from WBAD, 2004; Data for 2003 from INE, 2004.

In figure 5 we can see that the calculated figures from equation (1.4) provide a fairly good explanation of the current account. The difference that exists between the given figure and the calculated figure can be explained by the paucity of data, rounding errors and the fact that the (S_p - I_p) does not remain stable.

In order to establish if the changes in the fiscal deficit have affected the changes in the current account deficit, we need to examine whether these two variables have moved in the same direction.

Figure 6: The Current Account Deficit and the Fiscal Deficit



Notes: Fiscal deficit: overall balance excluding all grants; Current account deficit (given figure): current account balance, excluding net official capital grants. Source: Data for 1994-2002 from WBAD, 2004; Data for 2003 from INE, 2004.

Figure 6 tells us that the current account deficit and the fiscal deficit tend to move in the same direction, even though the patterns do not match perfectly. The major exception is for 2003 where we can see a slight decrease of the fiscal deficit and a sharp increase of the current account deficit, due to a sharp increase in imports and unchanged exports.[68] In spite of this, the changes in the current account deficit seem to correspond quite well with the changes in the fiscal deficit, suggesting that the measures to decrease the fiscal deficit to some extent have contributed to a decreased current account deficit in Mozambique.

As we can see in figure 7, the fiscal deficit and the rate of inflation tend to follow a similar pattern, at least since 1997. The source of unrest is the steady fiscal deficit from 1996 to 1998, with a simultaneous sharp decrease in inflation.

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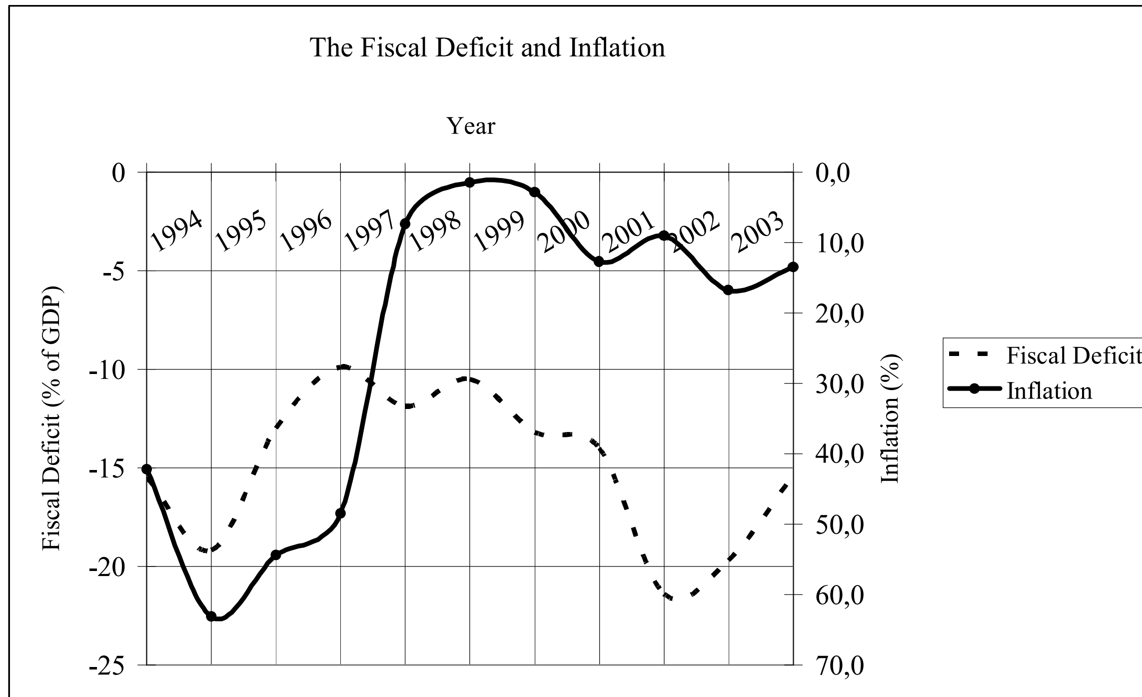
[68] INE, 2004.

The reason for this sharp decrease in inflation was the tightening of monetary policy in 1996 through the creation of a central bank, the privatisation of other banks and reforms in the financial sector. This also helped stabilise the Metical, contributing twice to containment of inflation.[69]

Figure 7: The Fiscal Deficit and Inflation



Notes: Fiscal deficit: overall balance excluding all grants; Inflation: Consumer Price Index, annual average change. Source: Data for 1994-2002 from WBAD, 2004; Data for 2003 from INE, 2004.

These changes suggest that the rate of inflation might be affected by the changes in the fiscal deficit in Mozambique, but that other variables seem to affect the rate of inflation to a larger extent.

[69] Ubide, 1997.

7.3 Summary – Stabilisation Effects

The increased level of tax revenues contributed to a slight reduction of the fiscal deficit, even though the fiscal deficit seems to be far more dependent on the fluctuations of total expenditures. The changes in the fiscal deficit tend to move in the same direction as the changes in the current account deficit and the rate of inflation, but not to the extent suggested by the stabilisation equations. Both the current account deficit and the rate of inflation seem to be affected by other variables to a larger extent than the fiscal deficit.

Chapter 8 Conclusions and Policy Implications

The purpose of this study was to evaluate the revenue and stabilisation effects of the tax reforms carried out in Mozambique between 1997 and 2003. Questions of particular interest were if the implemented tax reforms increased tax revenues and if the revenue effects contributed to macroeconomic stabilisation. The results of this study suggest that:

- The implemented tax reforms were to a large extent in accordance with the recommendations of uniform taxation. There was a significant increase in the level of tax revenues and a shift in the composition towards a more modern structure.
- The increased level of tax revenues contributed to a slight reduction of the fiscal deficit, even though it was established that the fiscal deficit is far more dependent on the fluctuations of total expenditures.
- The changes in the fiscal deficit tend to move in the same direction as the changes in the current account deficit and the rate of inflation, but not to the extent suggested by the stabilisation equations. Both the current account deficit and the rate of inflation seem to be affected by other variables to a larger extent than the fiscal deficit.
- The conclusion drawn is hence that: *the implemented tax reforms increased tax revenues significantly and contributed to a slight reduction of the fiscal deficit, which in turn has contributed to macroeconomic stabilisation to some extent*.

Even though the efforts to increase tax revenues so far have been quite impressive and have contributed to stabilisation through a reduced fiscal deficit, the large imbalances remain. The persistent fiscal deficit in Mozambique has to be cut at some point, since the country cannot depend on external financing for ever. Future

measures to decrease the fiscal deficit have to include policies both to increase tax revenues and to decrease total expenditures. Since the fiscal deficit is far more dependent on the level of total expenditures, it is important to make these as efficient as possible. This could therefore be an interesting area for future research.

When it comes to tax revenues – even though the level of tax revenues has already been raised – there are still improvements to be made and these are my suggestions for future reforms:

- Carry out the introduction of a Central Revenue Authority in order to improve the overall efficiency of tax administration. The successful customs reform could serve as a reform role model. The reform should include: technical training of current staff; the hiring of new skilled staff; increased computerisation and computerised storage of taxpayer information; development of the technical means, introduced with the VAT (such as the NUIT and tax collection through the banking system), should be extended to other taxes as well; and an expansion of the self-assessment system.
- Increase the excise tax rate back to its previous interval (20-75%) and reduce the number of goods subject to the tax. The excise tax should only be levied on goods with inelastic demand and an increase of the rate could both raise revenues and enhance equity.
- Increase the efficiency of the VAT, through improvements of the refund payments.
- Identify new sources to tax. Mozambique is rich in natural resources and countries with a large share of natural resources usually have a higher tax ratio. If the resources can be successfully exploited without the use of fiscal incentives, there is revenue to be gained. As administrative capacity increases there will be possibilities for an expansion into new tax bases.

- Continue the efforts to reduce fiscal incentives. Fiscal incentives are revenue forgone and the reduction of these kinds of measures has an immediate positive impact on tax revenues. Mozambique should try other means to attract investments such as: improved infrastructure; reliability and predictability of the legal system; the existence of well-defined laws of ownership and flexible labour market laws, since these matter just as much for the profitability of investments.
- Continue the efforts to reduce the informal sector. Expand self-enforcing mechanisms with increased incentives to belong to the formal sector. A thorough investigation of the informal sector and more prohibitive legal consequences for informal activities could broaden the tax base.
- Efforts to increase economic growth will also have a positive impact on tax revenues: an increased per capita income will increase the number of formal incomes and the personal income tax will increase in importance; an increased level of formal consumption will increase the revenues from indirect taxes; and an increased trade flow will increase the revenues from trade taxes.

If expenditures can be held at a constant level – or at least not increase faster than revenues – and if the suggested measures can contribute to additional revenues collected, tax revenues could contribute to stabilisation to a larger extent in the coming years than they have done until 2003.

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Consulted people in Maputo (April-May 2004)

Altvall Hans-Erik, Consultant/Team Leader, Programa Escandinavo, National Statistics Institute/INE, personal interview.

Canell Eleanor, Member of the staff, National Directorate of Taxes and Audit/DNIA, personal interview and assistance.

Cipriano Claudio, Member of the staff, National Statistics Institute/INE, data providing and assistance.

Cruz Antonio F T S, Member of the staff, Gabinete de Estudos and Ministry of Planning and Finance/MPF, data providing and assistance.

Dade Saide, Director, Dirrecção das Contas Nacionais e Indicadores Globais, National Statistics Institute/INE, personal interview, data providing and assisstance.

Johnston Anton, Development Counsellor at the Swedish Embassy, personal interview, data providing and assistance.

Loforte Telma, Program Official, Oficial de Programa, Swiss Development Cooperation/SDC, personal interview, data providing and assistance.

Sulemane José, National Director for planning and budget at the Ministry of Planning and Finance/MPF, PhD at the University of Eduardo Modlane, personal interview and assistance.