Supporting Tax Reforms in Africa
- The Case of Mozambique -

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Abstract

Since 1998, Mozambique has implemented an ambitious reform agenda to improve the efficiency and equity of its tax system. The tax reform agenda is part of the overall Action Plan for the Reduction of Absolute Poverty for 2006-09 of the Government of Mozambique (PARPA II) with the ultimate goal to promote sustainable economic growth and to reduce poverty. The results achieved in the last decade sets Mozambique's performance as internationally best practice. This paper outlines the efforts of Mozambique in the area of domestic revenues, the harmonised approach by which development partners are supporting the tax reform agenda and the rationale and approach of German Financial Cooperation in the area of domestic revenues.

1. State building and growth through improved tax systems

The importance of taxation for financing public services and sustainable development is uncontroversial. The link, however, between taxation and democratisation as well as state building receives usually less attention. Improved representation through an equitable tax system, a constructive state-society engagement around taxes and the creation of modern bureaucracies, like e.g. an efficient and accountable Revenue Authority, are key elements of state building which should be emphasized more prominently in future. The International Finance Conferences in Monterrey (2002) and in Doha (2008) have highlighted the importance of increasing domestic revenues along side with the commitment of increasing funds of Overseas Development Assistance (ODA).

Interestingly, the average tax ratio in high income countries increased steadily since 1975 (currently around 37% of GDP) whereas in low income countries it has declined (with currently around 14% of GDP).[1] Therefore, when simplifying tax design and improving tax administration in low income countries, the specific conditions, like the economic structure (e.g. informal sector) and low institutional capacity, have to be taken into account in the equity and efficiency considerations of the reform discussions. A careful balance needs to be found between a simple, predictable and progressive tax system without jeopardizing economic growth of the private sector and with minimising interference with the market signals.

2. The tax reform in Mozambique

a) The tax reform agenda

The political commitment of the Government of Mozambique for implementing tax reforms is well rooted in the overall Government reform agenda. Tax issues are incorporated in 5 major sections of the PARPA II: (i) Macroeconomic and Fiscal Scenario, (ii) Economic Development, (iii) Promotion of specific sectors & job creation, (iv) Mining and (v) Assistance from Development Partners.

[1] This is among others due to substantial reduction in global trade tax revenues (Bräutigam, Fjeldstad, Moore: „Taxation and State-Building in Developing Countries", Cambridge, 2008).

Overall there are eight priority actions conforming the current tax reform agenda among which the following are highlighted:

- Gradual increase of domestic revenues (0.5% p.a. from 14.0% up to 16.2% in 2009);
- Simplification of the tax system and broadening of the tax base;
- Continuation of modernization of tax administration to achieve an efficient tax collection system which is able to curb fraud and tax evasion;
- Improved legislation which simplifies the relationship between tax payers and administration;
- Implementation of tax and customs courts;
- Refinement of legislation on local government finances.

b) **Results achieved**[2]

As a result of the reforms initiated already in 1998, Mozambique has been able to continuously increase its revenues from 10.8% of GDP in 1999 to 16.4% of GDP in 2008.[3] The Revenue Authority (RA) was established in 2006 out of a merger of the tax authority and the customs authority, to strengthening the overall fiscal regime. The new authority could more than double the number of registered taxpayers (individuals and enterprises) within two years. Furthermore, the staff of the RA was increased by 18%, 14 new collection offices were opened, new programs for public education and customer service were introduced, delays in approval of VAT-refunds reduced, the number of audits of large tax payers increased, post-clearance audits for customs introduced, the tax declaration simplified, the average time to release imported goods at the border reduced and a new training centre for the RA-staff was opened.[4] On the side of tax policy and legal framework other achievements include: the approval of a new General Tax Law clarifying the rules for tax collection and tax payer rights, rationalization of the fiscal benefits (e.g. ending special regimes for large projects), approval of a new Municipal Finance Act, reduction of the burden on small businesses by increasing the tax thresholds and enacting a Simplified Tax for Small Contributors. And in terms of future revenue yield most importantly, the tax regime for the mining and petroleum sectors was strengthened especially by removing the possibility to negotiate special arrangements for mining and petroleum investments. Most recently, the Government also initiated the procedures to qualify for the Extractive Industries Transparency Initiative (EITI).

The tax system of Mozambique corresponds today largely to the international good practice standard in developing countries. It is characterized by primary reliance on a broad-based value-added tax and a modern income tax, with excise duties for selected products and moderate import duties. Under equity considerations it is a reasonably progressive system, as there is a high threshold for entering the tax net, a low tax rate on small contributors, a progressive rate structure under the individual income tax and a structure of cero ratings and exemptions for basic needs under the VAT.

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[2] For further details see recent evaluation: „PARPA II Review – The Tax System in Mozambique“, USAID-funded study, written by B. Bolnick et al., 2009.

[3] The figure for 2009 might be below the target rate due to weak economic conditions (Bolnick et al.).

[4] „PARPA II Review – The Tax System in Mozambique“, USAID-funded study, written by B. Bolnick et al., 2009.

c) Future challenges

A recent evaluation of the tax system and the results achieved concluded that the potential for further revenue gains through changes in tax policy is limited, but that there is still huge potential for increasing revenue yields by further broadening the effective tax base, increasing the efficiency of tax administration and facilitating the taxpayer compliance through further measures of modernization. The focus of future efforts will lay on the functional integration of tax and customs operations, information technology, human resource management and development of a service culture among tax officials.

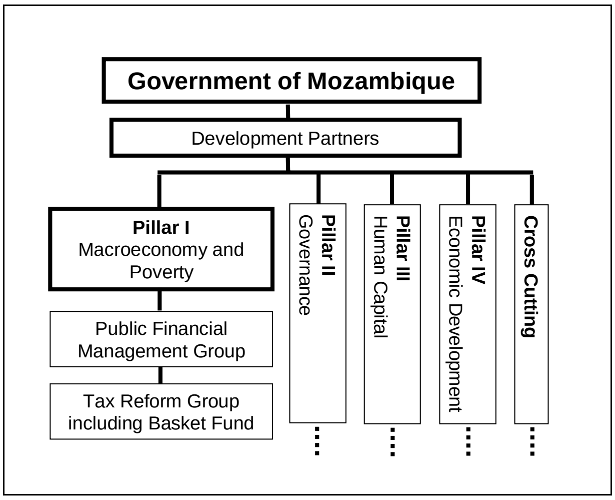
Finally, having implemented the above mentioned efficiency measures, the Government of Mozambique could consider to use some of the efficiency gain achieved to reduce tax rates and promote further economic growth instead of solely aiming for maximising the revenue ratio.

3. Development partner's approach to support the reform agenda

Since 2002, the Government of Mozambique receives considerable budget support by multiple development partners. The amount channelled through budget support has increased from 140 million USD (2002) to 459 million USD (2009) and the number of development partners amounts to currently 19 (G19). Based on this fully harmonised and aligned budget support approach, four development partners (Belgium, Switzerland, United Kingdom and Germany) decided to additionally give a specific support to the reform area of taxation and domestic revenues. A support strategy for 2007-2010 was developed and a basket financing mechanism established in order to provide the Government with special funds as well as a dialogue platform for the implementation of the revenue reforms. The International Monetary Fund (IMF) is also part of the discussions.

The planning and monitoring mechanism of the "tax basket" is fully aligned and integrated in the budget support cycle through the tax reform group and its respective policy dialogue platform. There is still some fragmented donor support in this area, but the tax reform group with its nucleus of the tax basket fund heads the direction to harmonise all tax reform donor support under one umbrella and under the leadership of the Government. This is a very positive and encouraging development, as former uncoordinated project support in the area of tax reform has not been satisfactory enough.[5] As with the other reform areas, there is a division of labour among the development partners and Germany through German Financial Cooperation (KfW) leads the tax basket and sees this approach as international best practice.

Graph: Architecture of Budget Support and Tax Basket



In view of the Paris Declaration and the objective of improving aid effectiveness, the partnership approach of the Government of Mozambique and the budget support donors with its basket financing mechanism for tax reforms can be evaluated very positively. All five criteria, ownership, harmonization, alignment, mutual accountability and managing for results, are fulfilled satisfactory and should allow to yield further positive results in future.

4. The role of tax systems in German Financial Cooperation (KfW)

The German Development Bank (KfW) manages the official Financial Cooperation (grants and loans for investments) on behalf of the German Ministry of Economic Coop-

[5] For an evaluation of the past support in the area of tax reforms see: "Donor Support for Tax Administration," Soest, German Development Institute (GDI), 2008.

eration and Development (BMZ). Strengthening tax systems and supporting developing countries' efforts to increase their domestic revenues receives growing attention within international and German development cooperation. KfW emphasizes the importance of an efficient and equitable tax system for

- state building and accountability,
- economic growth and
- poverty reduction.

These causalities and the respective role and support of development partners shall play a more prominent role in future German Development Cooperation. Furthermore, there is growing pressure on partner countries to enhance their tax systems' performance in order to justify continued increase of ODA-funds (Monterrey Consensus 2002).

The German Government supports tax reforms among others through Technical Cooperation (GTZ) and Financial Cooperation (KfW). The support to tax systems through KfW is either directly or indirectly in the following 4 areas:

- Through **General Budget Support,** where taxation is one of the reform areas of the performance assessment frameworks (PAFs) based on which funds of budget support are released.
- Through **Basket Financing** for the implementation of tax reforms (like the example of Mozambique).
- Through **Sector Budget Support** for Decentralization or fiscal transfers.
- Through **specific projects** for local government development or strengthening of Revenue Authorities through investments in infrastructure and technology with accompanying technical support.

Furthermore, the German Government has launched at the Doha Conference in 2008 the International Tax Compact against tax avoidance and evasion (ITC) which underlines the political commitment and the increased interest on the revenue side.

With the objective to move towards a stronger focus on tax systems strengthening, German Technical and Financial Cooperation (GTZ and KfW) are expanding their analytical work in the area of taxation as well as their specific support towards strengthening tax systems and enhancing domestic revenues. Efficiency and equity issues carefully balanced with economic growth requirements play a key role in the tax systems strengthening support of German Development Cooperation. Furthermore, special attention is to be given to develop harmonised and aligned approaches with partner countries which show strong ownership.

The German Ministry of Economic Cooperation and Development is currently preparing a strategy for German Development Cooperation which will outline the importance of paying more attention to the taxation area as well as the core features of the future tax systems strengthening approach of German Development Cooperation.

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