

TAX REFORM GROUP

Input for preparing Joint Review 2006

I. Executive summary

The performance in 2005 in the area of tax reform was **positive**. In the context of strengthening tax administration and the process of preparation for the establishment of the Central Revenue Authority (ATM) in 2006, the target defined in the PES/PAF was partially met: the Parliament approved the Law for the creation of the ATM by the end 2005; the regulations and procedures necessary for its implementation (mainly the Organic Structure of the ATM and the Statute of the Employee) had been finished and approved (at the level of the Ministry of the Finances). Its formal approval by the Cabinet did not happen during 2005.

The target of 13.9% for the PES/PAF indicator of total revenue collection in percentage of GDP was met, with effective total revenue of 14.1% of the GDP. The revenue had a real growth of 24.1% in comparison to 2004, representing an important recovery after the reduction in 2004, but it was only at 97,3% of the value budgeted for 2005. The tax revenues, which represent about 80% of the total revenues, had a level of budgetary execution of 94.7%, in which the best performance in real growth was in income taxes, in particular on the corporate tax. The lowest growth levels in the taxes on goods and services were observed in the VAT on internal operations and in the excises on tobacco.

In the process of consolidation of the tax reform and preparation for the establishment of the ATM, there had been also progress in the process of internal reforms of the Tax Directorate, the statutes for the functioning of the Fiscal Courts were approved and there was further expansion of the computerization of services to some provinces. Aiming at improving the efficiency in revenue collection, it was increased the identification and collection of tax arrears, audits on large tax payers, customs inspections and smuggling control, simplification of customs clearance procedures, better information to the tax payers and training for administration staff. Progress was also observed in the process of VAT reimbursements, with reduction of the processing time from 90 to 30 days, also a result of better performance of the tax payers.

The publication of 2004 General State Account and the opinion of the Administrative Court on this account, raised questions and recommendations for the improvement and greater transparency in the revenues records and performance of the administration services, which had been in part corrected during 2005 (to confirm), but still needs follow up attention and improvement.

Main challenges for 2006:

The Tax Administration has in 2006 the challenge to sustain the increase and efficiency of revenue collection, consolidation of the reform while proceeding with the transition to the ATM. Despite the recovery in 2005, the level of tax revenues is still one of lowest in Sub-Saharan Africa. Higher effort must be done for increasing efficiency and reducing tax evasion. A more rigorous management of the tax benefits is also necessary, as well as higher rationalization in its concession.

It is also necessary a comprehensive policy and management domestic revenues mobilization, including the revenues resulting from exploration of natural resources (mines, fauna, forests, etc) and higher transparency in its management and record.

| Tax Reform | Indicator QAD 2005 | Target 2005 | Achievement | Evaluation at JR 2006 |
|---|---|--|---|------------------------------|
| Simpler and more comprehensive, fair and balanced tax system | Strengthening tax administration and establishment of ATM in 2006 | Approve regulations and procedures for ATM | Approved at ministerial level but not by cabinet, due to delayed approval by Parliament | Partially met |
| | Total revenue in percentage of GDP | 13.9% | 14.0% | Met |

II. Performance in tax reform process

The process of tax reform and its administration observed progress during 2005, focusing essentially in the processes of preparation for the establishment of the Central Revenue Authority (ATM) in 2006 and the strengthening of administration for consolidation of the tax system.

The law for the creation of the ATM and the general tax were submitted to Parliament already in 2004, but due to enforcement of new Constitution they were returned to Government for revision, submitted once more to Parliament in March 2005 and only approved by the Parliament by December 2005. The process of finishing the regulations and procedures for its implementation was carried through within the foreseen schedule, in particular the two ministerial diplomas on the Organic Structure of the ATM and the Statute of the Employee. These regulations were approved by the Minister of Finance but still require formal approval by the Cabinet (submission for approval not later than one month after the promulgation of the Law by the President of the Republic (early February of 2006). The achievement of this indicator was then conditional on the Parliament approval, and this only happened in the end 2005. It is considered that the Government undertook the work under its competence for its approval. Thus the performance indicator for 2005 - approval of the regulation and procedures of the ATM - is considered as partially met.

In the process of preparation for the establishment of the ATM, progress was also made in the internal administration reforms process, with the transformation of the Tax and Audit Directorate into the General Tax Directorate and expansion of the computerization of services for some provinces. The statute for the functioning of the Fiscal Courts was approved. Under the PAF matrix objective of strengthening the tax administration, efforts for the improvement of the efficiency in revenue collection were made, with more activity in the identification and collection of tax arrears, audits on large tax payers (targeting mainly the direct taxes), customs inspections and smuggling control, simplification of customs clearance procedures and reduction in customs clearing times, more information for the tax payers and administration staff training in general. Progress also observed in the process of VAT reimbursements, with reduction of the processing time from 90 days to 30 days (Decree 55/2004 of 10th December), resulting also from better performance of the taxpayers. These efforts may have contributed to the improvement of collected revenues, but they are still below the programmed value for 2005.

III. Performance in the domestic revenue mobilization¹

The total collected revenue in 2005, amounting to 21'418.5 billions MTs, corresponding to 14.0% of GDP, represented a real increase in 24.1% compared with values in 2004², but it is still at 97.3% of the value budgeted for 2005. About 80% of the total collected revenues are tax revenues, corresponding to an execution rate of 94.7% in relation to the budgeted value. Amongst tax revenues, the best performance (real growth) was in the income tax, in particular in the corporate tax. Despite this higher growth rate, the relative weight of the income taxes in the total revenue (slightly above 20%) was practically the same of 2004. The lowest growth levels in the taxes on goods and services were observed in the VAT on the internal operations and in the excises on tobacco, mainly due to still high levels of evasion on these taxes. The taxes on the external trade grew in real terms slightly over 23%. Of the other taxes, the most significant it is the tax on fuels, where a reduction of 20.8% in real terms is observed, due to non adjustment made on the tax on a quarterly basis, in face oil price increase.

INTERNAL REVENUES (billion MTs)

| Indicadores | Budget 2005 | Collection 2005 (BER) | Effective collection value | Collection in % of GDP |
|-----------------|-------------|-----------------------|----------------------------|------------------------|
| Total revenue | 22'225.9 | 20'932.1 | 21'418.5 | 14.1% |
| Tax revenue | 19'777.1 | 18'024.9 | 17'406.0 | 11.4% |
| Capital revenue | 681'8 | 1'123.7 | 923.7 | 0.6% |
| Nominal GDP | 152'894.0 | n.a. | 153'041.0 | - |

Regarding the other taxes and recurrent revenues in general, it is observed a reduction in real terms in 2005. Particular growth is verified in capital revenues, but these represent only 5.2% of the total revenue. It is also important to highlighted the progress made in the wider inclusion in 2005 of own revenues of the some ministries (3,3% of the total revenues) and districts, but there is still work to be done to increase the coverage of these revenues in the budget and execution (district level only with 17.8% budget execution - apparently non-realistic estimate - and central level with 157% execution).

In general it can be considered that there was a satisfactory progress in the recovery of the revenues collection, in 14.1% of the GDP, achieving the PAF target of 13,9%. However, the level of tax revenues is still one of lowest in Sub-Saharan Africa and in comparison with countries with similar economic structure. Higher effort must be carried out to increase the efficiency of the administration, including better inspections and better control at the borders, for reduction of tax evasion. In particular, it is also necessary a more rigorous management of the tax benefits and higher rationalization in its concession in accordance with the established benefits regime³.

IV. Other Questions:

¹ All figures mentioned in this text are from the *Mapa Fiscal* agreed with the IMF mission of March 2006.

² Note however, that this recovery takes place after a significant reduction in revenues in 2004.

³ According with CGE 2003 and 2004, tax benefits granted in those years grew from 5.8% to 7.2% of total revenues in 2003 and 2004 respectively, being in 2004 more than 65% of those benefits on VAT on imports and import duties.

a) General State Account 2004 and Opinion of the Administrative Court

According to data from the General State Account (CGE) 2004, the total revenue in 2004 was of 15'977'446 millions of Meticaís (97% of the value reported in BER 2004 and of the value reported by the DGI for JR 2005), corresponding to a real growth in relation to 2003 of -2.8%. The reduction of the revenues is basically attributed to the reduction of the taxes on the external trade and of the VAT.

The differences observed between the values of the total revenues in the several government reports, seem to be attributed to the different treatment given to the VAT reimbursements in the different reports. For higher transparency and easier reading of the data, it is suggested that the source of these differences is explained and explicit in the government annual execution reports (BER, BdPES).

The report and opinion of the Administrative Court (TA) raises the following main questions on the state revenues:

- The CGE does non-tax revenues in accordance with the law (between capital revenues and reimbursements from loans granted by the State). Government diverges from TA, by classifying these non-tax revenues as deficit financing.
- Important revenue amounts are not recorded in the budget (own and capital revenues, profits from state assets, state shares in companies and dividends).
- Regarding the tax collection offices of Maputo and Matola, the general observation is made on bad recording of tax processes, problems with the application of accounting norms and information flows, that affect the quality of the tax administration performance.
- The recording of VAT reimbursements as treasury operations, contrary to the recommendation of TA to consider them as tax expenditure according with the law for higher transparency.

Aiming at addressing some of these concerns during 2005, the collection offices were restructured, staff with better training was increased and was introduced the computerization of revenues. Additionally, the coverage of capital revenues in the budget was increased, but still needs to be agreed with DNO a solution on the classification of some components of this revenue category.

b) Budget and PES 2006

The state revenue is projected to grow to 26'503.4 billion MTs, corresponding to 15% of GDP, being the tax revenue 12.4% of GDP. This forecast corresponds to a real growth of 17% in the total revenue. It is expected that these results are achieved with higher fiscal efficiency and widening of the base tax. The PAF goal for 2006, agreed in September 2005 (MYR) is 14.8% of the GDP.

The nominal increase in the last years has been significant, but it has also been difficult to reach the goals and forecasts. The Tax Administration faces a particular challenge during 2006, to keep the increase and efficiency in revenue collection, consolidate the reform while proceeding with the transition to the ATM, re-integrating all the employees of the Customs and Tax Directorates in the new ATM and creating a new General Directorate of Common Services. These efforts should not contribute to lose sight of the commitment to increase performance in revenue collection. A Strategy for Information Technology for the new ATM, with emphasis in the integration and modernization of

computerized systems for the several general directorates (Customs, Internal Taxes and Common Services) is also foreseen.

Some of the foreseen measures to improve the efficiency in revenue collection are: efforts directed specifically to the large taxpayers, enlarged number of taxpayers, with the roll-out of NUIT to more collection offices, the increase in the number of audits and inspections, the implementation of the program for incentives to tax compliance. Regarding trade facilitation, it is expected the implementation of the legislation on customs clearance at all border posts, collection via bank system, development of the computerization system and the introduction of non-intrusive control equipment for containers.

In the context of the biggest effort to increase of domestic revenue, to make cover higher expenditure needs and reduction of the level of external dependency, it becomes more imperative the need for a comprehensive policy and management on domestic revenue mobilization, with the inclusion of the potential revenue generation from the exploration of natural resources (mines, fauna, forests, etc) and better transparency in the results of this process.

c) Agreement on indicator for 2006 PAF on improvement of efficiency in the tax administration

Once satisfactorily completed the process of preparing for the establishment of the ATM in 2006, and taking in consideration the main challenges to the administration to sustain the increase of the state revenue, it was agreed that the focus in the process of PAF monitoring in this area would be moved towards the improvement of administration efficiency, to ensure the achievement of the priority objective of developing a simpler, comprehensive, fair and balanced taxation system.

In this context, it was proposed the consideration of indicators more oriented to results and specific to tax administration performance and/or trade facilitation. A working group was created, including representatives of tax administration and the private sector, to intensify the dialogue on the private sector concerns on tax policy and administration, and in particular on the delays in processing VAT reimbursements.

As a resulted of this process of dialogue and consultation, the agreed indicator and target are:

Indicator: Establishment of CRA (Revenue Authority)

Target: Elaboration and approval of PDTI (Information Technology Development Plan).

According with the main objective in this area, it will also be continued the dialogue on tax policy in the context of established working groups.