

Mozambique Public Expenditure Review

Addressing the Challenges of Today,
Seizing the Opportunities of Tomorrow

September 2014



THE WORLD BANK

Report No. 91153-MZ

Acknowledgements

This report was prepared by a World Bank team led by Enrique Blanco Armas (GMFDR, TTL) which included Natasha Sharma, Poorva Karkare, Tuan Minh Le and Giorgio Brosio (GMFDR). Dionisio Nombora (GGODR) and Carlos da Maia (GPVDR) also contributed to the preparation of the report. Sean Lothrop (consultant) edited the report. Zulfa Mulla provided logistical and administrative assistance to the team.

The team benefitted from the collaboration of many colleagues. Kirk Schmidt assisted in preparing the BOOST dataset used in this report, while the sectoral analysis chapters benefited from important contributions by Ana Ruth Menezes and Sophie Naudeau (Education), Jan Nijhoff (Agriculture), Luiz Tavares and Peter Hawkins (Water), Humberto Cossa (Health), Kulwinder Singh Rao (Transport Infrastructure), Isabel Neto (Energy) and Manuel Salazar and Ruben Villanueva (Social Protection). Uri Raich provided comments for the chapter on “Strengthening Sub-National Service Delivery.” The team benefited from comments from colleagues in other institutions, including Alfonso Cabrillo from the EU on the “Sectoral Expenditure Trends” chapter and John Barnes from the Ministry of Planning and Development on the ‘Strengthening Sub-National Service Delivery’ chapter as well as discussions with Mozambique’s external budget support partners (the ‘G19’) regarding the scope of the report.

The team would like to gratefully acknowledge the close involvement and valuable insights provided by staff at the Budget Directorate in the Ministry of Finance, in particular Chamila Idrisse Aly, Julio Dias, Gisela Sucá, Paulo Macamo, Jossy Chaise, Inacio Fuleque, Nadia Hassamo, Khopre Munapeia and Ivan Semedo. Guidance was provided by Rogerio Nkomo and Amilcar Tivane, current and former directors in the Budget Directorate respectively. The team benefitted from discussions with staff in the Autoridade Tributária de Moçambique, in particular Horácio Simão and Augusto Tacaríndua, Director General and Deputy Director General in the Directorate for Planning, Studies and Cooperation. The team would also like to thank staff in the provincial governments of Tete and Nampula, district administrators in Moatize, Changara and Moma as well as staff in the municipalities of Nampula, Tete and Maputo who generously gave their time to discuss the decentralization framework. The chapter “Improving Links between Planning and Budgeting” is based on a study prepared for this report by researchers from the Faculty of Economics at University Eduardo Mondlane, Constantino Marrengula and Eduardo Neves. Their work was supervised by Dionisio Nombora.

Excellent comments were received from three peer reviewers, Kobi Bentley (DFID), Oscar Calvo-Gonzalez (LCC2C) and Kai Kaiser (GGODR). Valuable comments were also provided by Dirk Bronselaer (AFTPE), Tawhid Nawaz (AFRVP), Giovanni Ruta (GENDR), Furqan Saleem (GGODR) and colleagues at the IMF. Julio Revilla (Program Leader for Mozambique) supervised the preparation of the report and provided useful comments and feedback during its development. Overall guidance was provided by Bernard Funck (Practice Manager, GMFDR), John Panzer (Director, GMFDR), Mark Lundell (World Bank Country Director for Mozambique) and the late Laurence Clarke (former World Bank Country Director for Mozambique).

This work was made possible by the financial support of the Mozambique Programmatic Trust Fund for Analytic and Technical Support for Inclusive Growth, financed by DFID. The team would like to express its gratitude to DFID, in particular its Senior Economic Advisor in Maputo, Kobi Bentley, as well as to the World Bank’s John Factora and Isabel Soares, who manage the Trust Fund.

Table of Contents

Acknowledgements.....	2
Abbreviations and Acronyms.....	10
Executive Summary.....	13
I. Macroeconomic and Fiscal Developments	19
1. Mozambique’s Recent Economic Performance.....	21
2. Macro-Fiscal Trends.....	23
3. Composition of Spending: Focus Areas.....	25
a. First Focus Area: Public Sector Wage Bill.....	25
b. Second Focus Area: Public Investment Spending	30
II. Tax Policy in Transition	34
1. Recent reforms.....	34
2. Revenue performance and the tax system.....	36
a. “Tax buoyancy” as an aggregate measure of efficiency in revenue policy and administration .	37
b. Corporate income tax (IRPC).....	37
c. Personal income tax (IPRS)	40
d. Value-Added Tax (VAT)	42
3. Options for Reform	43
a. Reforming the corporate income tax.....	43
b. Reforming personal income tax.....	45
c. Reforming value-added tax.....	45
III. Debt Sustainability and Fiscal Risks	48
1. Debt Dynamics in Mozambique	48
2. Debt Sustainability	50
3. Fiscal Risks.....	52
a. International Experience with fiscal risks	52
b. Fiscal risks in Mozambique	54
IV. Improving the Link between Plans and Budgets.....	60
1. A short context to public financial management reforms.....	60
2. An Overview of Planning and Budgeting Processes.....	60
3. Assessment of links between plans and budgets	62
a. Planning instruments	65
b. Role of the Cenário Fiscal de Medio Prazo	65
c. The annual plan and the annual budget.....	66
d. The role of non-government actors.....	67
4. Improving the links between plans and budgets.....	68
V. Sectoral Expenditure Trends.....	70
1. Allocation of public resources.....	70
a. Overall allocation of resources	70
b. Resource allocation to policy priorities	71
c. Allocation within policy priorities	72
2. Education	74
a. Performance on education policy objectives.....	74
b. Link between policy priorities and resource allocation	75
c. Resource allocation on services accessed by the poor.....	76
d. Resource allocation within education.....	77

e.	Composition of resource allocation	78
f.	Key areas for reform	79
3.	Health.....	80
a.	Performance on policy priorities	80
b.	Link between policy priorities and resource allocation	81
c.	Resource allocation on services accessed by the poor	82
d.	Resource allocation within health	83
e.	Composition of health spending	83
f.	Key areas for reform	84
4.	Water	85
a.	Performance on policy priorities	85
b.	Resource allocation on services accessed by the poor	86
c.	Resource allocation within water	88
d.	Composition of water spending.....	89
e.	Key areas for reform	90
5.	Agriculture	85
a.	Performance on policy priorities	91
b.	Link between policy priorities and resource allocation	92
c.	Resource allocation within agriculture	93
d.	Composition of agriculture spending.....	94
e.	Key areas for reform	94
6.	Transport and Energy Infrastructure	95
a.	Performance on policy priorities	95
b.	Link between policy priorities and resource allocation	96
c.	Resource allocation within infrastructure	97
d.	Composition of infrastructure spending.....	98
e.	Key areas for reform	99
7.	Social Protection	100
a.	Performance of the Social Protection System	100
b.	Targeting social assistance to the most vulnerable	102
c.	Resource allocation within social protection.....	103
d.	Composition of social protection spending	104
e.	Key areas for reform	105
VI.	Strengthening Sub-National Service Delivery	107
	Overview of the existing system	107
1.	The governance framework.....	107
2.	Financing service provision	109
a.	Municipalities.....	109
b.	Deconcentrated level.....	110
3.	Assignment of policy responsibilities.....	111
a.	Municipalities.....	111
b.	Deconcentrated level.....	111
4.	Planning and budgeting	112
a.	Municipalities.....	112
b.	Deconcentrated level.....	112
	Assessment of the current system.....	112
5.	Financing service provision	112
a.	Municipalities.....	112

b.	Deconcentrated level	115
6.	Policy Responsibilities and outcomes	117
a.	Municipalities	117
b.	Deconcentrated level	117
7.	Planning and budgeting	119
a.	Municipalities	119
b.	Deconcentration	119
	Options for reform	120
8.	Developing revenue sources for adequate service provision	120
a.	Municipalities	120
b.	Deconcentrated level	121
9.	Policy Responsibilities	121
a.	Municipalities	121
b.	Deconcentrated level	121
10.	Planning and budgeting	122
a.	Municipalities	122
b.	Deconcentrated level	122
VII.	Looking Ahead: Expenditure Options over the Medium Term	124
1.	The changing macro-fiscal outlook	124
2.	Factoring in external shocks	127
3.	Options for Increasing Priority Spending	128
4.	Meeting priority development needs in a fiscal consolidation scenario	130
VIII.	Conclusions	132
	Annexes	145
	Figure 1: GDP grew rapidly from a low base, and growth rates have remained high... ..	21
	Figure 2: ...led by agriculture, trade, transport and communications, and financial services	21
	Figure 3: Inflation has declined very rapidly due to sound macroeconomic and structural policies... ..	22
	Figure 4: ...but despite this declining trend significant volatility remains	22
	Figure 5: The increase in the current-account deficit reflects rising imports for large-scale FDI	22
	Figure 6: Domestic revenues have increased rapidly... ..	23
	Figure 7: ...and tax revenues are now in line with the top performers in Sub-Saharan Africa	23
	Figure 8: Compared to other countries in the region, public spending in Mozambique is high	24
	Figure 9: ...and relative to the size of Mozambique's economy, public spending is high compared with peer countries	24
	Figure 10: Overall balance fluctuates, and without windfall gains the deficit increases significantly	24
	Figure 11: Mozambique's deficit levels are relatively high compared with other countries in the region	24
	Figure 12: Both capital and current expenditures are increasing	25
	Figure 13: Public sector wages dominate current spending, while capital spending is increasingly financed domestically	25
	Figure 14: Mozambique's spending on public sector wages is high compared with its peers	26
	Figure 15: Spending on the wage bill as a proportion of revenues is also relatively high	26
	Figure 16: Changes in the wage bill are largely due to salary adjustments	27
	Figure 17: The largest share of spending on wages is in education	27
	Figure 18: Spending on wages is increasingly at the district level	27
	Figure 19: Public sector employment as a share of total employment is relatively low... ..	28
	Figure 20: ...and it is also low as a share of the population	28

Figure 21: Public sector wages in Mozambique are high compared to peer countries	29
Figure 22: Spending on wages is relatively high, but performance of the education sector is average.....	29
Figure 23: ...and while spending on health wages is relatively high, performance is below average	29
Figure 24: Public investment has grown substantially in recent years.....	30
Figure 25: ...and is relatively high compared with peer countries	30
Figure 26: Domestic revenues are higher than current expenditures.....	31
Figure 27: Financing through concessional and non-concessional loans is overtaking grants.....	31
Figure 28: Mozambique’s system to manage public investment ranks below the average for peer countries.....	31
Figure 29: Total tax rate in commercial profits in selected SADC countries.....	38
Figure 30: Taxes paid by businesses in SADC countries.....	38
Figure 31: External debt as a share of GNI	49
Figure 32: Mozambique’s deficit financing.....	49
Figure 33: Public Debt as a share of GDP.....	50
Figure 34: Contributions to debt dynamics	50
Figure 35: Present value of Debt-to-GDP levels under the baseline and most extreme shock.....	51
Figure 36: Present value of Debt-to-Revenue levels under the baseline and most extreme shock.....	51
Figure 37: Present value of Debt-to-GDP levels without fiscal consolidation	51
Figure 38: Present value of Debt-to-Revenue levels without fiscal consolidation	51
Figure 39: Impact of contingent liabilities on debt sustainability.....	58
Figure 40: The links between planning and budgeting in the education sector.....	63
Figure 41: The links between planning and budgeting in the health sector	64
Figure 42: In education, there is overspending on personnel, and under spending on capital goods.....	66
Figure 43: In health, there are considerable budget deviations, by type of expenditure and year	66
Figure 44: Spending at the deconcentrated level is always higher than planned	66
Figure 45: At the deconcentrated level, overspending varies significantly by province	66
Figure 46: The functional classification shows a steady increase in priority sector spending	72
Figure 47: Including donor resources off-government systems shows a large increase in health spending	72
Figure 48: Average consumption per quintile	73
Figure 49: Official poverty lines in IOF 2008-09.....	73
Figure 50: Annual average growth rate of per capita consumption.....	73
Figure 51: Cumulative distribution function of consumption expenditures	73
Figure 52: There are consistent and gradual improvements to net enrolment rates for the lowest grades	74
Figure 53: The primary completion rate has improved overall, although there is a recent decline in performance.....	74
Figure 54: Compared to peers, Mozambique’s primary net enrollment is around average	75
Figure 55: There are steady improvements in secondary enrollment rates	75
Figure 56: But secondary education completion rates are far below peer countries	75
Figure 57: Education spending levels in Mozambique as a proportion of GDP are one of the highest	76
Figure 58: But in per capita terms spending is on par with a number of countries in the region	76
Figure 59: For the amount that Mozambique spends on education, primary completion rates are around average.....	76
Figure 60: Access to education increases with income	77
Figure 61: Spending on primary education broadly benefits all income groups, unlike tertiary education.....	77
Figure 62: Over time, the largest share of spending is consistently allocated to primary education	77
Figure 63: Deconcentration means increasing levels of district expenditures.....	78
Figure 64: This is largely reflected in increased spending on personnel	78
Figure 65: The education budget is largely used for current spending.....	79
Figure 66: ...Which reflects high levels of spending on personnel	79

Figure 67: There are steady improvements to the pupil-teacher ratio but the ratio is still too high.....	79
Figure 68: There has been a reduction in infant and under-5 mortality rates... ..	80
Figure 69: ...But compared to peers progress is average showing improvements are still needed.....	80
Figure 70: While immunization coverage for measles is improving over time.....	80
Figure 71: The coverage is still below average compared to the region	80
Figure 72: Public spending on health in Mozambique is below regional average.....	81
Figure 73: This is also reflected in the low levels of total health expenditure per capita	81
Figure 74: Countries with lower per capita health expenditure have higher infant mortality rates.....	82
Figure 75: ...as well as higher under-5 mortality rates	82
Figure 76: As income rises, people are more likely to seek medical help when they are sick	82
Figure 77: Public health and unspecified health services receive the largest share of financing.....	83
Figure 78: Spending at the district level is increasing, but centralized spending is still high	83
Figure 79: Resources are largely spent on current costs.....	84
Figure 80: ...This reflects spending on goods and services and personnel.....	84
Figure 81: Over time the number of health workers in Mozambique are increasing	84
Figure 82: Despite these increases, Mozambique has one of the lowest health worker-to-population ratios in the world.....	84
Figure 83: Over time, there have been very gradual improvements in access to water.....	85
Figure 84: But compared to peers access to an improved water source is low	85
Figure 85: There have been very slow increases in access to sanitation facilities	86
Figure 86: And compared to peers access to sanitation facilities is low	86
Figure 87: Nation-wide, there are wide disparities on use of water facilities.....	86
Figure 88: There are also large disparities in the use of sanitation facilities.....	86
Figure 89: Access is highest for the least poor	87
Figure 90: Access to sanitation by income quintile	87
Figure 91: Public spending in water largely benefits the least poor.....	88
Figure 92: ...Reflecting a higher share of spending on urban water	88
Figure 93: There is a steady decline in water sector financing.....	89
Figure 94: Spending in the water sector is still highly centralized.....	89
Figure 95: Spending goes mainly to investment, funded through external resources.....	90
Figure 96: The largest proportion goes towards capital goods	90
Figure 97: Maize yields have been improving, but there is a recent decline	92
Figure 98: Compared to peer countries maize yields are low	92
Figure 99: Fertilizer use could significantly improve productivity, but consumption is well below peers	92
Figure 100: Mozambique's agriculture value added per worker is below peers	92
Figure 101: Spending on agriculture as a proportion of GDP is lower than average compared with peer countries ..	93
Figure 102: This is also reflected in the low levels of agriculture spending per capita	93
Figure 103: The largest share of agricultural spending has not been specified by function	94
Figure 104: Resources are executed from central and provincial levels	94
Figure 105: Resources are largely allocated towards recurrent spending.....	94
Figure 106: Which is reflected in high levels of spending on goods and services	94
Figure 107: Road density in Mozambique is one of the lowest in the region	96
Figure 108: Despite significant energy resources, Mozambique has one of the lowest electrification rates in Africa	96
Figure 109: Public Spending on infrastructure as percent of GDP (2001-06).....	97
Figure 110: Public Spending per capita on infrastructure in US\$ (2001-06)	97

Figure 111: The largest share of infrastructure resources is spent on road construction.....	98
Figure 112 Infrastructure spending through the budget is largely centralized	98
Figure 113: External investment financing is moving away from the single treasury account	99
Figure 114: Financial operations may continue to increase after 2014 - partly to finance new infrastructure developments undertaken by SoEs	99
Figure 115: Spending is largely on capital goods.....	99
Figure 116: In 2010 the largest share of social protection went to pensions and fuel subsidies.....	103
Figure 117: Over time, public spending on subsidies is decreasing and social action programs increasing	103
Figure 118: The amount MMAS and INAS spends on transfers under different social protection programs is increasing.....	105
Figure 119: Structure of territorial government in Mozambique	108
Figure 120: The largest area of deconcentrated spending is on personnel.....	111
Figure 121: Of all deconcentrated expenditures, the largest share goes to education	111
Figure 122: Compared with the region, Mozambique's urban population is higher than the average	113
Figure 123: But revenues for Mozambican municipalities are well below peer countries	113
Figure 124: Per capita resource allocation does not reflect regional differences in poverty	116
Figure 125: There are large differences in operational spending.....	117
Figure 126: And investment spending is not compensating for variations.....	117
Figure 127: There are significant differences in per capita education spending.....	118
Figure 128: ...There are large disparities in educational outcomes and per capita transfers.....	118
Figure 129: There are significant variations in per capita health spending	119
Figure 130: Higher per capita spending are associated with increased institutional birth rates.....	119
Figure 131: Baseline for expenditure trends in Mozambique	126
Figure 132: The impact of slowing growth on spending levels.....	127
Figure 133: The impact of slowing growth on budget deficits	128
Figure 134: Expenditure trends under different scenarios.....	130
Table 1: Overview of the structure for major taxes	36
Table 2: Tax buoyancy estimates (2005-2015)	37
Table 3: Tax expenditures on corporate and personal income taxes (2009-2011)	39
Table 4: Corporate income tax efficiency, selected SADC countries	40
Table 5: Personal income tax regimes in selected SADC countries	41
Table 6: Value-added tax efficiency in selected SADC countries	42
Table 7: Value-added tax structure in SADC countries	46
Table 8: Planning and budgeting process	62
Table 9: Government of Mozambique expenditure by function (billion MT)	71
Table 10: Expenditure by function via and off-CUT (billion MT)	71
Table 11: Coverage of basic social protection programs implemented by INAS (number of Households).....	101
Table 12: Changes to the subsidies under the Basic Social Subsidy Program	102
Table 13: Concentration Indices of Selected Programs, 2010	103
Table 14: Distribution of Resources by Level of Government (billion meticaï)s	108
Table 15: Structure of municipal taxes	109
Table 16: Criteria for resource allocation at the municipal level	110
Table 17: Criteria for the allocation of transfers at the deconcentrated level.....	110
Table 18: Present and potential size of total revenues: Maputo and Nampula	114
Table 19: Structure of own-revenues for provinces and districts in 2012.....	115
Table 20: Distribution of responsibilities in the education and health sectors.....	118
Table 21: Medium Term Fiscal Framework (Baseline Scenario).....	125
Table 22: Summary of priority spending levels by 2019 under different scenarios	131

Box 1: A Snapshot of the previous Public Expenditure Reviews in 2001 and 2003	20
Box 2: Small tax payers regime (ISPC)	41
Box 3: Administering value-added tax refunds, the international experience	47
Box 4: Fiscal Risks Management in Colombia	53
Box 5: A Proposed Fiscal Risks Statement for Mozambique	55
Box 6: Potential Benefits of a Medium-term Approach to Planning and Budgeting	61
Box 7: Trends reflected in the Baseline Medium Term Fiscal Framework	125

Abbreviations and Acronyms

AIAS	Water and Sanitation Infrastructure Management Company
AT	Mozambique Tax Authority
BdM	Bank of Mozambique
BNI	National Investment Bank
CDF	Democratic Republic of Congo Franc
CFM	Mozambique Railways (SOE)
CFMP	Medium-term Fiscal Framework
CGE	Audited State Accounts
CSO	Civil Society Organization
CUT	Single Treasury Account
DHS	Demographic and Health Survey
DNA	National Water Directorate
DSA	Debt Sustainability Analysis
EdM	Power and Electricity Company of Mozambique (SOE)
ENH	National Company of Hydrocarbons (SOE)
ENSBB	National Strategy for Basic Social Security
EU	European Union
FAO	Food and Agriculture Organization
FCA	Municipal Compensation Fund
FDI	Foreign Direct Investment
FID	District Investment Fund
FIIA	Investment Fund for Municipal Initiatives
FIPAG	Water Assets and Investment Fund
FMO	Budget Monitoring Reform
GCR	Gross Compliance Ratio
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GNI	Gross National Income
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
IAI	Integrated Agriculture Survey
IDA	International Development Association
IFDC	International Fertilizer Development Centre
IGEPE	Institute for the Management State Holdings
IMF	International Monetary Fund
INAS	National Institute of Social Action
INE	National Institute of Statistics
IOF	Household Budget Survey
IPA	Head Tax

IPRA	Property Tax
IRPC/CIT	Corporate Income Tax
IRPS/PIT	Personal Income Tax
VAT	Value-added Tax
LOLE	Law for Local Organs of State
MAE	Ministry of State Administration
MoE/ MINED	Ministry of Education
MMAS	Ministry of Women and Social Action
MoF	Ministry of Finance
MoH	Ministry of Health
MoPW	Ministry of Public Works and Housing
MPD	Ministry and Planning and Development
MTFF	Medium Term Fiscal Framework
MZN/MT	Mozambican Metical
NGO	Non-Governmental Organization
NPK	N-P-K is fertilizer (N for Nitrogen, P for Phosphorus and K for Potassium)
OBA	Output Based Aid
ODA	Official Development Assistance
ODAMOZ	Official Development Assistance to Mozambique
OE	State Budget
OECD	Organization for Economic Co-operation and Development
PARP	Action Plan for Poverty Reduction
PASD/PSD	Direct Social Support Program/ Direct Social Assistance
PASP	Productive Social Action
PEDD	Five Year Strategic District Development Plan
PEFA	Public Expenditure and Financial Accountability
PERPU	Strategic Program for the Reduction of Urban Poverty
PES	National Economic and Social Plan
PESOD	Annual District Operation Plan and Budget
PII	Integrated Investment Program
PNISA	National Investment Program for Agriculture
POP	Program Classification of the Budget
PPP	Public-Private Partnership
PQG	Fiver Year Government Plan
PRISE	Integrated Road Sector Program
PRONASAR	National Rural Water Supply and Sanitation Program
PSA	Food Subsidy Program
PSI	Policy Support Instrument
PSP	Public Sector Performance
PSSB	Basic Social Subsidy Program

SADC	Southern African Development Community
SISA	Tax on Transfers of Property Transaction
SOE	State-owned Enterprises
SSA	Sub-Saharan Africa
TDM	Telecommunications of Mozambique (SOE)
TIA	National Agricultural Survey
UGE	Budget Executing Unit
WB	World Bank
WDI	World Development Index
ZAR	South African Rand
ZMK	Zambian Kwacha

Executive Summary

Mozambique has enjoyed strong and sustained economic growth since the end of the civil war in 1992. The economy grew at an average rate of 7.4 percent over the last two decades, driven by sound macroeconomic management, large-scale foreign investment and ongoing donor support. In recent years Mozambique's extractive industries have begun to make a significant contribution to growth. By the end of this decade resource revenues are expected to represent a large and growing share of public revenues, where the total fiscal envelope could vary between US\$36 billion and US\$50 billion in 2032. The rise of the resource sector will bring with it both remarkable opportunities and complex challenges, and over the medium term a number of steps can be taken to ensure that Mozambique is prepared to take full advantage of the sector's enormous economic potential. Key policy objectives will include strengthening the country's fiscal stance, improving the efficiency of public spending and ensuring that sufficient resources are allocated to priority areas.

Despite robust economic growth poverty levels remain unacceptably high. Around 70 percent of the population lives and works in rural areas, mainly in agriculture or related sectors. Over half of all Mozambicans live below the official poverty line, and the 2013 Human Development Index ranks Mozambique at 178 out of 187 countries. Moreover, Mozambique's latest National Poverty Assessment (2008-09) indicates that the pace of poverty reduction has slowed in recent years, even as economic growth has continued. Mozambique has an extraordinary opportunity to achieve sustainable poverty reduction and promote inclusive growth, but exploiting this possibility will require the government to make sound policy choices in an increasingly complex fiscal and economic environment. In this context, this report addresses a number of key issues in fiscal policy and the quality of public spending. The analysis presented here is designed to inform the evolving policy debate on public spending in Mozambique.

Mozambique's strong economic growth rate has been reflected in its impressive domestic revenue performance. Domestic revenues grew at an average of 13 percent per year, in real terms, from 2000 to 2013. Recently, capital gains taxes from the extractive industries have begun to make a significant contribution to domestic revenues. In 2013 domestic revenues amounted to 23.5 percent of GDP; if capital gains taxes are included, this share increases to 27.5 percent. Rising domestic revenue has compensated for a concurrent decline in the relative size of external grants, which fell from 10-11 percent of GDP a decade ago to just 5 percent today.

Recent tax reforms have contributed to the strong growth of domestic revenues but there is still considerable scope for improvement. Tax laws have been modernized, including corporate and personal income taxes. An organizational and administrative structure has also been established to implement tax reforms. Reforms implemented have led a surge in domestic revenues. However, the tax system is still in transition. The government's overall revenue potential remains constrained by structural economic and demographic factors, including a large informal sector and a relatively small working-age population. The efficiency, equity and simplicity of major taxes could be enhanced by (i) reforming the generous fiscal incentives regime to broaden the base, (ii) abolishing the special regimes for the corporate income tax, personal income tax and VAT since there is a specific regime for small and medium enterprises, (iii) streamlining the long list of non-export zero rated items for VAT, and (iv) reforming the process for VAT refunds. Going forward, it will be important to strengthen the capacity of

tax administration to deal with taxation in the extractive industries as revenues from these sectors are projected to grow exponentially toward the end of the decade.

The pace of public spending has increased rapidly in the last few years. From 2000 to 2013 spending increased by an average of 12 percent per year in real terms. The approved 2014 budget boosts public spending to 42 percent of GDP, a considerably larger level than most countries in the region. Despite rising domestic revenues Mozambique's fiscal deficit is widening and the government is increasingly turning to commercial borrowing to finance the shortfall. The recent expansionary stance raises concerns regarding both fiscal sustainability and the effectiveness of public spending. If the current trend continues the debt burden will be unsustainable. The authorities will need to tighten the country's fiscal stance in the near future to avoid a further deterioration of the overall balance, particularly in the absence of additional capital gains taxes related to the gas developments in the north of the country.

Spending on the public sector wage bill is consistently increasing. The wage bill was 6 percent of GDP in 2000, but it is projected to increase to 11 percent by 2014. On average, between the period 2010 to 2014 annual compensation adjustments accounted for 73 percent of the increase in the wage bill (which is increasing at a rate much higher than inflation), followed by new recruitments at 21 percent, and then promotion and progression of public servants at 6 percent. Overall, the wage bill is increasing at a faster pace in priority sectors than non-priority sectors. However, this is not sufficiently addressing the need to recruit and retain quality public sector workers, to address priorities such as improving the pupil-teacher ratio or the health worker to population ratio, which are far below regional standards. Looking ahead, it will be important for the government to: (i) manage demands for salary increases through a clear government policy; (ii) reprioritize the wage bill to strengthen the existing focus on the recruitment and retention of public sector workers in priority areas (particularly education and health); and (iii) control growth in the wage bill in non-priority sectors, to ensure the increase is not higher than inflation.

Spending on public investment is also rapidly increasing. Mozambique faces a substantial infrastructure deficit, and most of its infrastructure indicators are far behind those of peer countries. The Integrated Investment Plan adopted by the government in 2013 is designed to guide public investment. By prioritizing and managing the right types of public investment, there is potential to generate significant returns. Public investments are increasingly financed through non-concessional borrowing and domestic resources, with reducing reliance on donor support. As this trend is expected to continue the government will need to strengthen its systems for managing public investment and for controlling the size and composition of the public debt. Looking ahead, if the government seeks to increase private sector participation in infrastructure investments to share financing risks and costs, e.g. through PPPs and investments by SOEs, it will be important to strengthen government systems to manage such a strategy and the risks it entails.

As Mozambique's public investment program is increasingly financed through borrowing, public debt levels are rising. Mozambique received debt relief under the Heavily Indebted Poor Countries Initiative (HIPC), which brought its debt from a high of 366 percent of GNI in 1994 to more sustainable levels by the mid-2000s. In recent years, however, debt levels have been rising by an average of 5.6 percentage points of GDP from 2012 to 2014, largely due to the use of non-concessional loans to finance public investment projects. Non-concessional financing was negligible in 2011, but in 2012 it accounted for 14 percent of total financing, and by 2017 non-concessional loans are projected to meet between 40 and 50 percent of the government's total financing needs. While debt levels currently remain sustainable,

the risk of debt distress has increased. In order to maintain debt sustainability, Mozambique will need to tighten its fiscal policy in the near term, moderate the pace of public borrowing and maximize its use of concessional financing.

Financing of public infrastructure investments through PPPs or guarantees could rapidly increase fiscal risks. Promoting private sector involvement in infrastructure investment through sovereign guarantees or public-private partnerships will generate contingent liabilities (whether explicit or implicit), which if not well managed could threaten the government's fiscal stability. The international experience suggests that the risks and costs associated with these financing instruments can be substantial. Transparency is crucial to ensuring fiscal stability, and it would be greatly enhanced by the compilation and publication of information on contingent liabilities and other fiscal risks as part of the standard budget documentation.

There is considerable scope to improve the policy orientation of public spending by establishing closer links between planning and budgeting processes. While Mozambique has made considerable progress in improving public finance management processes, there is scope for improving the link between plans and the budget. Areas for reform include: (i) strengthen the credibility of the annual budget; (ii) improve the overall macro-fiscal framework, focusing on strengthening revenue projections based on a detailed analysis of revenue estimates rather than revenue collection targets; (iii) develop capacity to improve sectoral cost estimates; and (iv) at a later stage use program-based budgeting. Donor harmonization and the use of country systems for planning and implementation are essential for avoiding parallel planning processes. In addition to these technical reforms, the nature of CSO engagement in planning and budgeting processes should be strengthened.

Spending on priority areas has increased as a share of GDP. Infrastructure investment has rapidly increased, both in absolute and relative terms, while spending on water has declined as a share of GDP. While budget allocation rates to the agriculture sector have remained consistent in real terms, poor execution rates mean that real spending has declined. Overall spending on priority areas has increased at a faster pace than total spending. And, when direct donor spending (i.e. spending that is not channeled through the government) is included, expenditures on infrastructure and healthcare have both increased significantly.

While overall levels of public spending have increased for priority areas, there is considerable scope to enhance the pro-poor orientation of public spending. Access to services improves with income, where the least poor benefit the most from public spending. The least poor are the only beneficiaries of tertiary education and also have the greatest access to water and sanitation services, particularly for urban water. These findings suggest the need to increase access to basic services for all income groups, particularly the poorest. A focus on access to public services should be accompanied by efforts to maintain quality, since investments to expand access to basic public services will raise quality challenges that will need to be addressed.

The education sector has registered substantial improvements in development outcomes, but there is still considerable scope for improvement. Primary net enrollment rates are improving, but continued progress will be required to bring Mozambique's completion rates in line with regional averages. A number of peer countries that spend a similar amount per capita on education have considerably better outcomes, suggesting scope for realizing efficiency gains. Overall, the quality of education remains a

crucial and persistent challenge. While the Ministry of Education (MoE) has engaged in several reforms to address this, such as strengthening pre-service training for teachers and school directors, the pace of implementation is too slow to have a significant impact. Looking ahead, the sector should focus on frequent in-service training and increased empowerment of school councils to monitor school related activities. Compared to the region, completion rates for secondary education are very low. However, the expansion of secondary educations needs to be carefully considered including leveraging non-state actors, as well as implementing proper incentives and addressing barriers to ensure access among the poorest.

There has been mixed progress in improving health outcomes, and there are a number of options for improving efficiency and reforming the sector. While key health outcomes such as infant and child mortality rates have improved significantly, stunting is worsening which is a cause for serious concern. Overall, compared to the region, health spending is low, both as a proportion of GDP and in per capita terms. For the amount that Mozambique spends on health, progress in outcomes is around average, where a number of countries spending a similar amount have better health outcomes. There are different opportunities for reforming the sector to improve efficiency and quality of health services, including: (i) addressing human resources for health, where Mozambique has one of the lowest health worker-to-population ratios in the world; (ii) implementing innovative financing mechanisms based on results and performance to enhance value for money; (iii) investing in community based interventions, which are relatively low cost; and (iv) improving quality and coverage of care, for example through expanding outreach interventions to increase antenatal coverage in remote areas, and strengthening facility based referral services to address complex health conditions.

In the water sector, progress in achieving objectives has been varied, particularly for rural water and sanitation, suggesting that improving coverage should be prioritized. Overall, only 53 percent of the population has access to safe drinking water (which is far lower in rural areas) and 24 percent are using improved sanitation facilities. There are significant regional inequities in access to water and sanitation services. There has been notable progress in urban water, although coverage needs to be enhanced through infrastructure expansion, which would help to address rapid urban growth and improve the quality of services. Given the need to improve coverage, it is of concern that resource allocation to water and sanitation declined from 2010 to 2012 by 35 percent in real terms, although the 2014 budget showed an increase largely due to externally financed investment. Hence the sector is subject to variable funding flows. Looking ahead, there are a number of areas for reform, including (i) increasing the urban water tariff and allowing the Fundo de Investimentos e Patrimônio de Abastecimento de Água – FIPAG to co-finance investments, which could bring in a private investor; (ii) reallocate resources from FIPAG to urban sanitation in selected municipalities; and (iii) review the institutional structure for rural water to increase operational efficiency and clarify roles and responsibilities.

In the agriculture sector, productivity is relatively low and a number of key reforms are required to implement the agriculture national strategy and investment plan. Agriculture is hugely important for the Mozambican economy, employing three quarters of the workforce and contributing to approximately 25 percent of GDP. However, compared with peer countries, both spending on agriculture and productivity levels are relatively low. Overall, it is challenging to determine how resources are allocated to strategic priorities in the agriculture sector, but the implementation of the recently launched National Investment Program of Agriculture (PNISA) should help to strengthen this

link over the medium-term. Looking ahead, the sector could undertake reforms to: (i) improve the business environment and facilitate private investment; and (ii) enhance coordination and improve management of agriculture related programs among different stakeholders.

Transport infrastructure has benefited substantially from increased investment, but a focus on capacity building and the implementation of institutional reforms are needed to realize intended objectives. Mozambique has a large infrastructure deficit where road density is among the lowest in Africa. And while the government is increasing public investment to address this gap, it is important to build capacity to manage these investments, and to rationalize procurement processes. The majority of infrastructure spending is allocated toward the construction of roads. Financing for infrastructure outside the budget has also increased, where state-owned enterprises are taking a larger role in implementation. Increasing road construction will clearly have consequences for operations and maintenance going forward. Looking ahead, there are a number of key reforms that can be implemented including: (i) improving sector coordination and integration to enhance the links between different types of transport; (ii) elaborating the transport strategic plan, to form a basis for improved planning and budgeting processes; (iii) clarifying institutional roles and responsibilities for the tertiary road network; and (iv) ensuring there is adequate regulation for PPPs.

Access to energy is low, and demand is increasing, calling for reforms to increase coverage and efficiency. Twenty percent of Mozambicans have access to electricity, which is even lower in rural areas, particularly in provinces such as Cabo Delgado and Zambézia. Demand for electricity is rapidly increasing, where Mozambique has one of the highest rates of new connections in SADC. Given high levels of energy demand, considerable investment in the transmission network is required, estimated to cost at least US\$2 billion over the next decade. By implementing a number of strategic reforms it could be possible to improve coverage and efficiency, such as: (i) revising the electricity tariff to enable proper network maintenance; (ii) investing in the transmission grid, ideally through PPPs; (iii) improve energy efficiency through the use of low-energy bulbs and implementing minimum efficiency standards for the construction of new buildings; and (iv) developing an appropriate tariff policy for natural gas as the sector is expected to significantly contribute to power generation in the medium term.

The social protection sector is in the process of being modernized, and has benefited from increased domestic financing in recent years. There have been significant improvements to program coverage and generosity of social protection programs, which are largely due to a significant effort by the government to increase spending. Also, there has been a shift in the focus of spending toward more pro-poor and progressive areas, where increasing levels of resources are spent on direct transfers, and spending on subsidies has reduced. While this progress is commendable, there are still a number of areas that the sector can improve, including: (i) deepening the social protection reforms by improving coverage and generosity further, and reducing program fragmentation; and (ii) further rationalizing fuel subsidies and relatively generous government pensions to increase resources for social protection programs that directly benefit the poor. As these reforms progress, the government could consider introducing an unconditional transfer program for poor families with children. Finally, it is important to evaluate the new programs over the medium term.

The government continues to implement its decentralization agenda, underscoring the importance of strengthening service provision at the local level. Spending at the subnational level is increasing, both in absolute and relative terms, and in 2012 38 percent of all public spending was executed at the

subnational level. District authorities are gradually assuming greater responsibilities for managing public resources, particularly public service payrolls. Meanwhile, municipal governments are expected to assume a more prominent role in the provision of primary health and primary education services.

Service delivery could be greatly enhanced by improving financing of local level service provision.

Local revenue mobilization could be expanded by enhancing incentives and building local administrative capacity. The tax administration reform of 2008 greatly increased the potential for municipal tax collection, but many of its provisions have yet to be implemented. In addition, transfers from the central government to municipalities could be subject to a formula-based allocation that could help to offset differences in municipalities' per capita revenue potential while also creating incentives to increase revenue collection. For deconcentrated governments, a formula-based transfer could be introduced that focuses on per capita allocations. These reforms would simplify current planning and budgeting procedures and enhance the ability of subnational governments to pursue locally defined priorities.

The government will be able to increase resources allocated to priority sectors even in a fiscal consolidation period.

The government's ability to expand its overall fiscal envelope by increasing tax revenues or taking on additional debt is relatively limited. A simulation exercise of alternative revenue and expenditure scenarios suggests that the authorities can increase resource allocations to priority sectors. Some of the policy options that the government could implement include: (i) limiting the growth of the wage bill, by keeping spending on compensation of employees in non-priority sectors in line with inflation, while allowing modest increases to priority sectors to focus on recruitment and retention of public sector workers, particularly in education and health sectors; (ii) limit growth in spending in non-priority sectors; (iii) implement measures to improve efficiency of spending, as discussed in the sectoral expenditure trends chapter; and (iv) seek increased private sector investment for infrastructure, sharing risks and costs with the private sector, which would require strengthening government systems to implement such a strategy. While these measures may involve difficult tradeoffs, reorienting existing fiscal resources to priority sectors will allow the government to advance key policy objectives while reinforcing its fiscal stability.

I. Macroeconomic and Fiscal Developments

Mozambique's economy has experienced strong and sustained growth since the end of the country's civil war in 1992. Driven by sound macroeconomic management, large-scale foreign investment projects and donor support, Mozambique's economy grew at an average rate of 7.4 percent over the past two decades. However, poverty levels still remain unacceptably high, where over 52 percent of the population lives below the official poverty line¹ and, nationwide, approximately 95 percent of Mozambicans live on less than US\$2 per day. The pace of poverty reduction has slowed and poverty levels vary widely by region. This suggests that the poverty incidence of public spending needs to be improved, an issue also highlighted in the 2001 Public Expenditure Management Review. With around 70 percent of the population living and working in rural areas, reducing poverty and promoting shared prosperity are of paramount concern for ensuring long-term sustainable growth and development in Mozambique.

Over time, the sources of revenues are changing, bringing both opportunities and challenges for fiscal management. Dependence on grants and other forms of donor support is slowly tapering off, from financing 44 percent of the budget in 2000, to 15 percent in 2013. Tax administration reforms have resulted in an increase in domestic revenues. While recent discoveries of coal and gas are only expected to have a significant impact on fiscal resources toward the end of the decade, windfall capital gains taxes related to gas exploration activities have already contributed to annual revenues of 3 to 4 percent of GDP. However, these revenues are assumed to be temporary and may cease in the near future. Furthermore, the onset of resource revenues has enabled Mozambique to access financing from non-concessional sources, presenting both opportunities but also increasing debt levels and potential fiscal risks that need to be managed. The importance of disclosing fiscal risks was also highlighted in the 2001 Public Expenditure Management Review, and is an issue that remains to be addressed.

The government has loosened fiscal policy in the past few years, and the current fiscal stance does not appear sustainable. Public spending is projected at almost 42 percent of GDP in 2014, and the deficit after grants is expected to widen to over 9 percent of GDP. Maintaining this trend will quickly lead to an unsustainable debt burden. Such a rapid increase in spending could also lead to absorptive capacity constraints and the possibility of inefficient spending. For the government to reinforce macroeconomic stability, public spending and debt levels need to be reduced. These fiscal consolidation efforts will require reprioritizing expenditures and increasing the efficiency of spending, to ensure sufficient resources are allocated to priority sectors. Most likely this will involve reprioritizing spending on the wage bill and public investments, which are both discussed in this chapter. Such a situation is not new to Mozambique. The 2001 Public Expenditure Management Review emphasized the importance of tightening fiscal policy to address a high budget deficit before grants. The government effectively addressed this during the mid-2000s (see Box 1), suggesting that the required reforms can be implemented and that potential institutional expertise may be available.

¹ See Alfani et al. (2012), which offers poverty estimates that differ somewhat from the official Government of Mozambique statistics.

Box 1: A Snapshot of the previous Public Expenditure Reviews in 2001 and 2003

The previous public expenditure reviews undertaken by the Bank in 2001 and 2003 highlighted a number of challenges, some of which the government successfully addressed. Relevant to today's context, the 2001 Public Expenditure Management Review emphasized the importance of Mozambique tightening fiscal policy to address a high overall budget deficit before grants to maintain macroeconomic stability and growth. The government successfully addressed this during the mid-2000s through sound macroeconomic management and prudent fiscal policy. This suggests that the Government has in the past been able to change course when an excessive expansionary fiscal stance has threatened macroeconomic stability.

The review also discussed the importance of improving public financial management, in relation to different stages of the budget cycle, public accounting and auditing, as well as budget classification through introducing the functional classification of expense. While there is still progress to be made, the government implemented successfully during the last decade an impressive set of reforms to its public financial management systems, suggesting that further advances can build upon the existing achievements.

There are however a number of recommendations from the previous reviews that have had less follow up and continue to be relevant in today's context. In particular, the 2001 Public Expenditure Management Review discussed the importance of disclosing fiscal risks, but there has been limited progress in this area to date. On the quality of spending, the report discussed the need to improve the poverty incidence of public interventions, a recommendation that remains valid today when looking at the inequality of access to basic services among the population. The report also highlights the need to improve the links between planning and budgeting in the health sector, which is an issue discussed in depth later in this report.

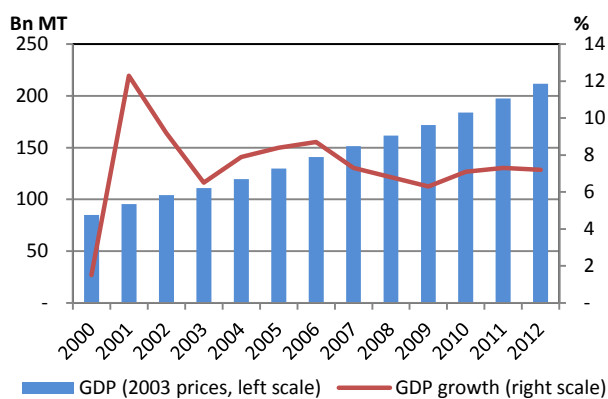
Looking ahead, substantial resource revenues expected toward the end of the decade present an unprecedented opportunity but this will need to be well managed. If the developments in the coal and gas sectors proceed as planned resource revenues could be as high as US\$9 billion by 2032, representing 7 percent of GDP and 21 percent of total government revenues.² However, these figures are subject to considerable volatility, where the total fiscal envelope could vary between US\$36 billion and US\$50 billion in 2032 (World Bank, 2014). To ensure that the government can efficiently spend a much larger resource envelope, it will be important to continue strengthening public financial management systems. The 2001 and 2003 Public Expenditure Reviews indicated that a number of financial management reforms are required, which the government successfully implemented. However, it is important to build on this progress to ensure that the government is sufficiently prepared to address the challenges ahead. Given external economic shocks and the possibility of weaker commodity prices, resource revenues could be delayed or reduced. Therefore, it will be important to adopt a prudent fiscal stance in the medium term to adequately prepare for the changes ahead.

² This revenue share is comparable to that Chile or Mongolia, but far from countries that depend from commodities for a majority of their revenue. Angola, for example, derives 78 percent of its revenue from commodities, and in many oil-rich states in the Persian Gulf commodity revenues account for 70-90 percent of total revenues.

1. Mozambique's Recent Economic Performance

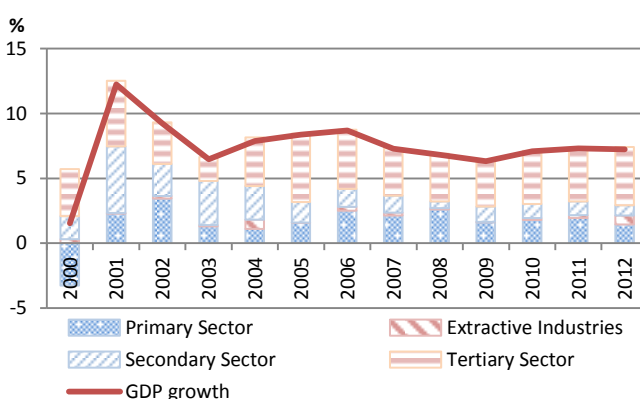
Over the last two decades Mozambique's economy has grown at an average rate of 7.4 percent per year. Strong economic growth has been driven by agriculture, commerce and trade, transport and communications, and financial services. From 2000 to 2004 manufacturing was a significant driver of growth, as large-scale aluminum producer Mozal commenced and expanded its operations, but since then growth in the sector has gradually slowed. Extractive industries have become an important source of growth in the past couple of years. Strong growth is expected to continue in the medium term, led by the extractive industries and related sectors such as transport, communications and construction.

Figure 1: GDP grew rapidly from a low base, and growth rates have remained high...



Source: INE, various years

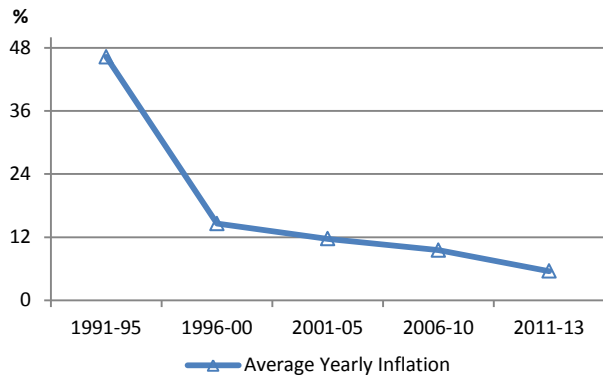
Figure 2: ...led by agriculture, trade, transport and communications, and financial services



Source: INE, various years

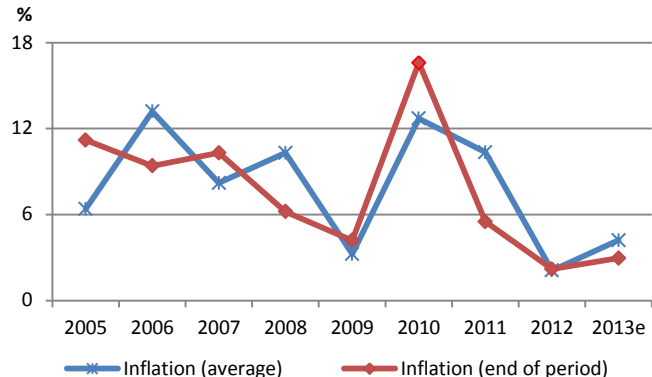
Strong growth rates have been achieved in a context of relative macroeconomic stability. Average inflation rates have declined steadily, falling from over 40 percent in the early 1990s to around 5 percent in the past few years thanks to supportive macroeconomic and structural policies. There has been some fluctuation in inflation rates in the past few years, with end-year inflation declining from almost 17 percent in 2010 to 5 percent in 2011 and reaching 2 percent in 2012. Food and energy-price volatility, environmental factors such as flooding and rising import prices have all contributed to variations in inflation rates.

Figure 3: Inflation has declined very rapidly due to sound macroeconomic and structural policies...



Source: BoM, various years

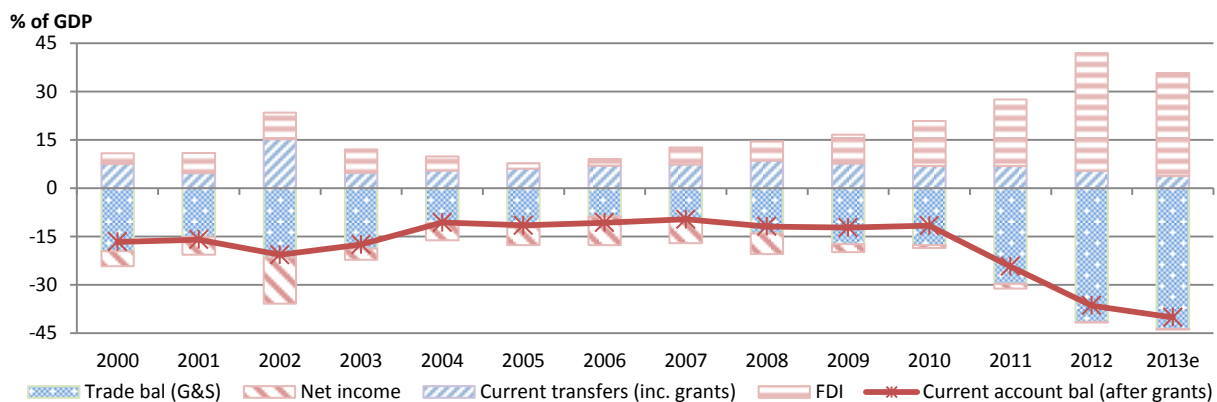
Figure 4: ...but despite this declining trend significant volatility remains



Source: BoM, various years

The current-account deficit (after grants) remained relatively stable over the past decade but increased in recent years due to large-scale investment projects. From 2004 to 2010 the current-account deficit was around 11 percent of GDP, with a large share being covered by grants from donors. In the past few years, the current-account deficit widened to 40 percent of GDP, as the trade balance increased due to large-scale capital-intensive imports demanded by the extractive industries and infrastructure sectors (see Figure 5). Although this large and widening deficit will need to be closely monitored, it does not represent a structural imbalance, as it is driven by capital investment. This import-intensive capital spending is largely financed by foreign direct investment (FDI), often focused on so-called “megaprojects.”³ This trend is expected to continue over the next 4-5 years, as most of these projects are in the construction phase. As construction is finished, and production and exports of commodities increase toward the end of the decade, the current account is expected to narrow rapidly.

Figure 5: The increase in the current-account deficit reflects rising imports for large-scale FDI



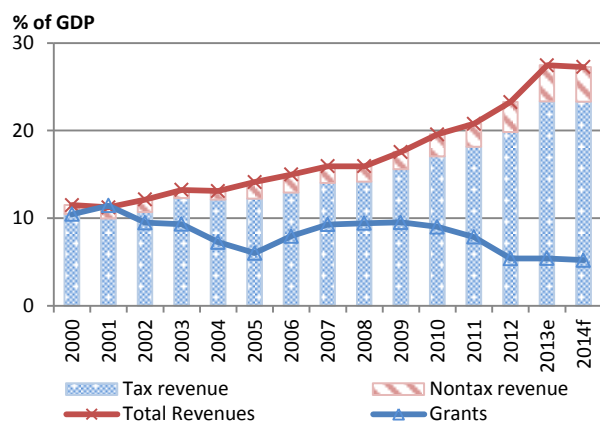
Source: IMF database

³ “Megaprojects” are very large scale investment projects that usually require heavy equipment and sophisticated technologies, which are often imported, and need huge flows of international finance capital (Gellert and Lynch, 2003). Examples of important megaprojects in Mozambique include the Mozal aluminum smelter, the Sasol natural gas pipeline and the Cahora Bassa hydroelectric facility.

2. Macro-Fiscal Trends

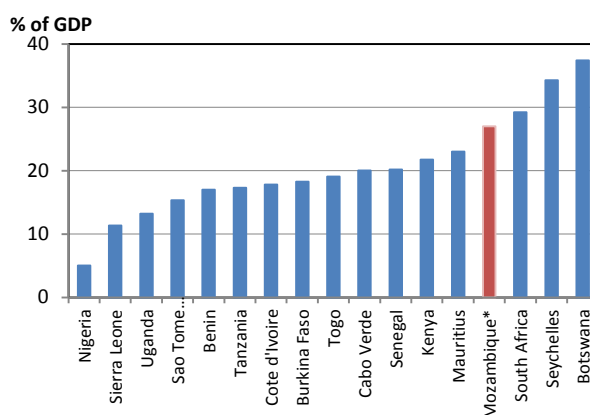
Domestic revenue collection has grown at a very rapid pace. Domestic revenue growth averaged 13 percent per year from 2000 to 2013, in real terms, and revenues increased from 11 percent of GDP to 23.5 percent in 2013, excluding capital gains taxes. If capital gains taxes are included, domestic revenues reached 27.5 percent of GDP.⁴ Meanwhile, grants from development partners are declining as a share of GDP, somewhat tempering the growth of Mozambique’s fiscal envelope.

Figure 6: Domestic revenues have increased rapidly...



Source: IMF databases

Figure 7: ...and tax revenues are now in line with the top performers in Sub-Saharan Africa



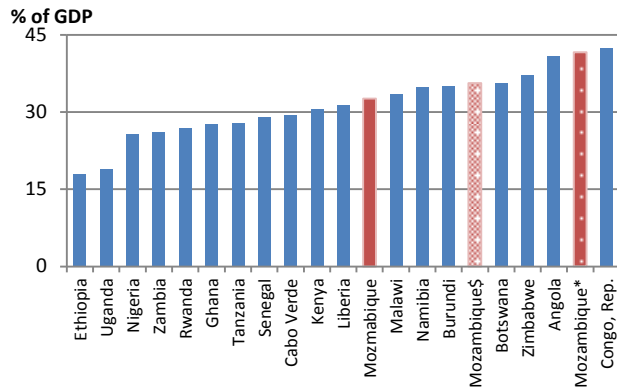
Note: Mozambique is 2013

Source: World Development Indicators, 2012

The rapid increase in public spending over the past few years raises concerns over the effectiveness of public spending. Real spending grew at an average rate of 12 percent per year from 2000 to 2013, somewhat lower than the pace of revenue growth. The approved 2014 budget increases public spending to 42 percent of GDP, which is significantly higher than other countries in the region. High spending levels and the rate at which expenditures are increasing raises concerns over the ability of the public sector to use resources effectively as well as the resulting impact on growth. Recent research (Moreno-Dodson, 2013) argues that the relationship between public expenditure and growth depends on both the composition as well as the level of spending. Excessively high public expenditure may have a negative impact on growth given the adverse effect of distortionary taxation needed to finance expenditure. Rapid increases in government spending raises domestic demand and can lead to overheating in an economy with a limited supply response capacity – which could be Mozambique’s case.

⁴ Growth in domestic revenues may slow down in the next few years. Over the past decade growth in domestic revenues was largely the result of tax administration reforms. As discussed in the next chapter, there are options for increasing tax revenues, primarily through a broadening of the base, but growth may be slower than in the past. Capital gains taxes, which have provided a boost to domestic revenue over the past few years may contribute less in the near future. These developments may slow growth or even result in a decline in tax revenues as a share of GDP in the next few years.

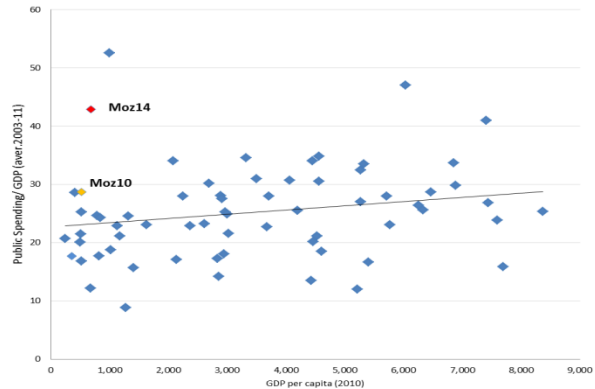
Figure 8: Compared to other countries in the region, public spending in Mozambique is high...



Mozambique\$ - 2013, Mozambique* - 2014

Source: IMF various documents, 2012

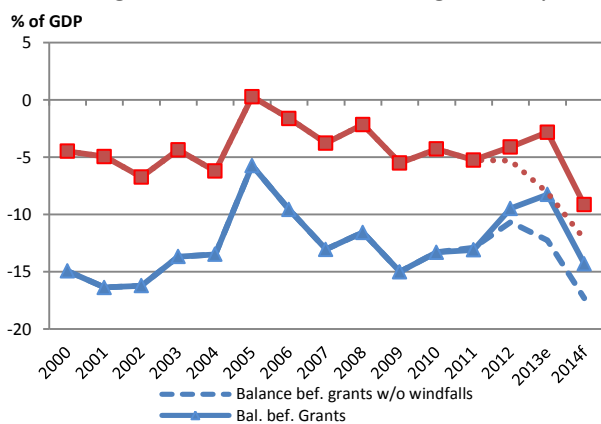
Figure 9: ...and relative to the size of Mozambique's economy, public spending is high compared with peer countries



Source: WDI and Government of Mozambique

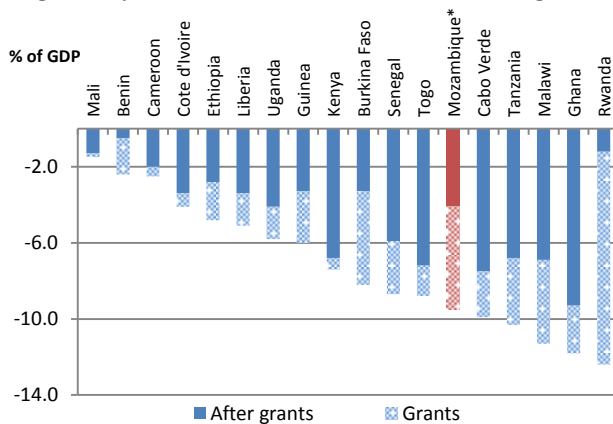
The rapid increase in spending has been matched by an increase in revenue collection, but this may be difficult to maintain over the medium term raising concerns about the sustainability of the fiscal stance. Since 2000, the overall budget balance before grants averaged 12 percent of GDP. However, there have been large year-on-year variations, with deficits in the past decade varying from close to 5 percent of GDP in 2005 to almost 15 percent in 2009. The deficit is projected to widen again in 2014, and the deterioration in the budget balance over the past few years would have been larger in the absence of significant capital gains windfalls (Figure 10). Since tax windfalls are one-off revenues, the balance may worsen again in the near future unless the government successfully reduces spending and consolidates its fiscal stance. Grants also play an important role in financing the deficit (Figure 11). At around 15 percent of GDP in 2014 (slightly below 10 percent of GDP in 2013), Mozambique's overall balance before grants is high, particularly when compared to other countries in the region.

Figure 10: Overall balance fluctuates, and without windfall gains the deficit increases significantly



Source: World Bank Staff Estimates based on IMF and IDA (2014)

Figure 11: Mozambique's deficit levels are relatively high compared with other countries in the region



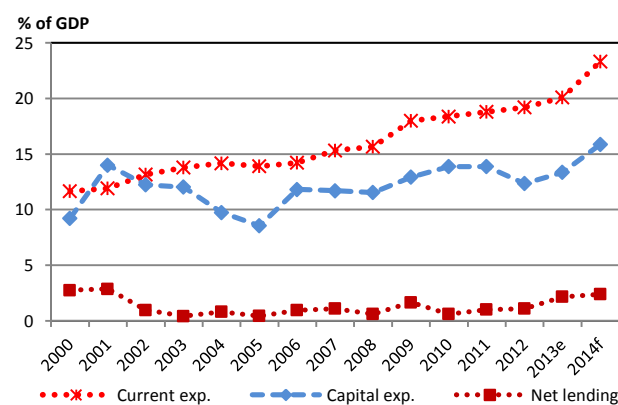
*2013

Source: IMF, various documents, 2012

3. Composition of Spending: Focus Areas

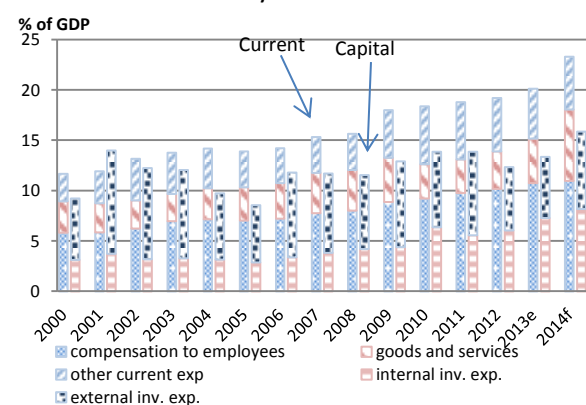
Public spending is increasing across the board, as both current and capital expenditures are rising. Between 2000 and 2012 current and capital spending grew rapidly, with current spending increasing at a somewhat faster pace. Net lending, which reflects on-lending by the government to public enterprises and other public entities, primarily for financing infrastructure investments, has increased in recent years. As shown in Figure 13 the largest share of current expenditures is allocated to personnel costs, followed by goods and services. Capital expenditures, which have historically been financed by donors, are increasingly funded through domestic resources as well as commercial borrowing.

Figure 12: Both capital and current expenditures are increasing



Source: IMF database

Figure 13: Public sector wages dominate current spending, while capital spending is increasingly financed domestically⁵



Source: IMF database

a. First Focus Area: Public Sector Wage Bill

Public spending on the wage bill is rapidly increasing, and nonwage benefits account for a large share of the wage bill. In 2000, the wage bill was equal to 6 percent of GDP, and by 2014 it is projected to increase to 11 percent. Spending on the wage bill as a share of domestic revenues is also high, averaging 49 percent between 2000 and 2013, although the proportion is declining from 51 percent in 2000 to 39 percent in 2013.⁶ A large part of the wage bill is comprised of nonwage benefits, which accounted for an average of 60 percent of all spending on compensation of employees from 2008 to 2012.

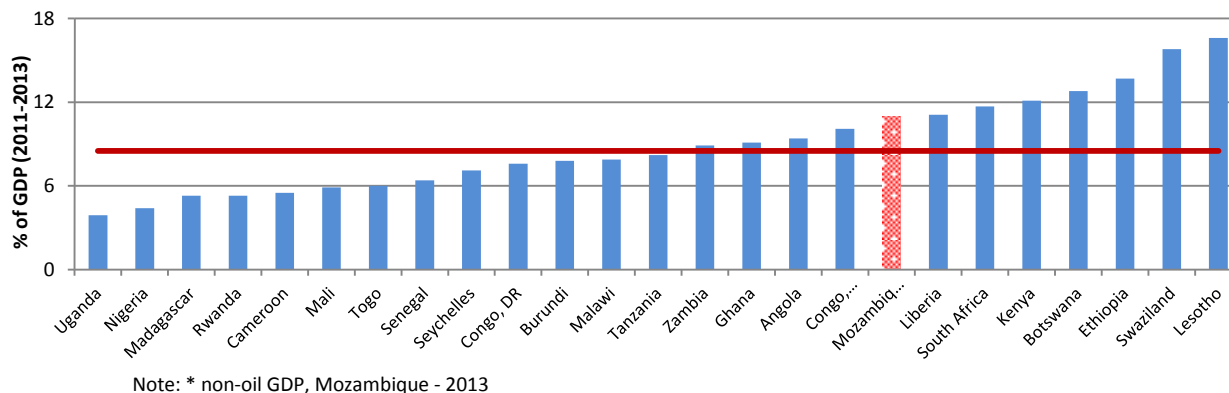
Compared with peer countries, Mozambique's wage bill is large both as a share of GDP and domestic revenues. While adequate compensation is necessary to ensure that the public sector is properly staffed and motivated, the wage bill must remain fiscally sustainable. This section discusses trends in spending on the public sector wage bill, which seems high relative to GDP and domestic revenues when compared with peer countries (Figure 14 and Figure 15). While new recruitments, promotion and progress have

⁵ Other current expenditures include current transfers, debt servicing, subsidies and other spending

⁶ It is interesting to note that while the wage bill as a share of the GDP has been increasing, as a share of domestic revenues it has been falling, suggesting that revenues have grown faster than wages during this time.

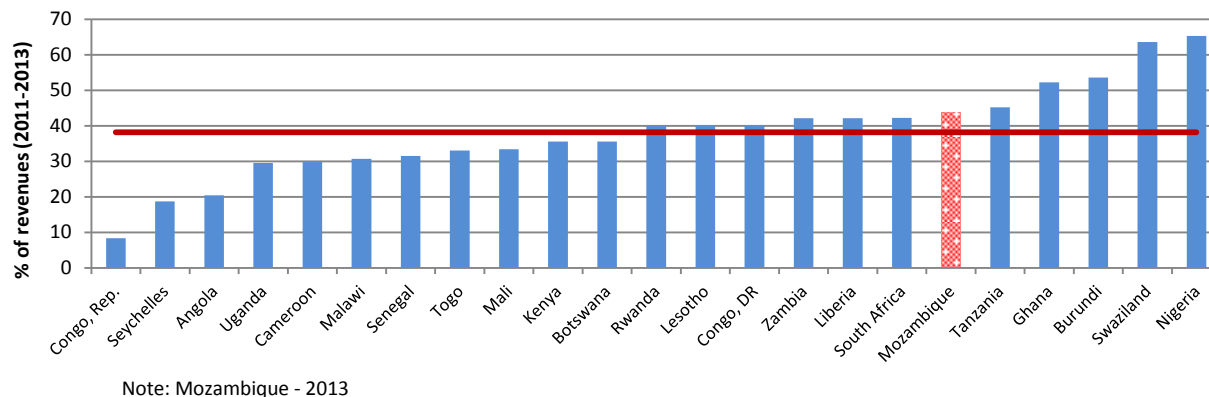
contributed to increases in the wage bill, a large proportion of the increase in the wage bill is due to annual salary adjustments. On average, between 2010 and 2014 annual compensation adjustments accounted for 73 percent of the increase in the wage bill, followed by new recruitments at 21 percent, and then promotion and progression of public servants at 6 percent.⁷

Figure 14: Mozambique’s spending on public sector wages is high compared with its peers



Source: IMF, Various documents

Figure 15: Spending on the wage bill as a proportion of revenues is also relatively high



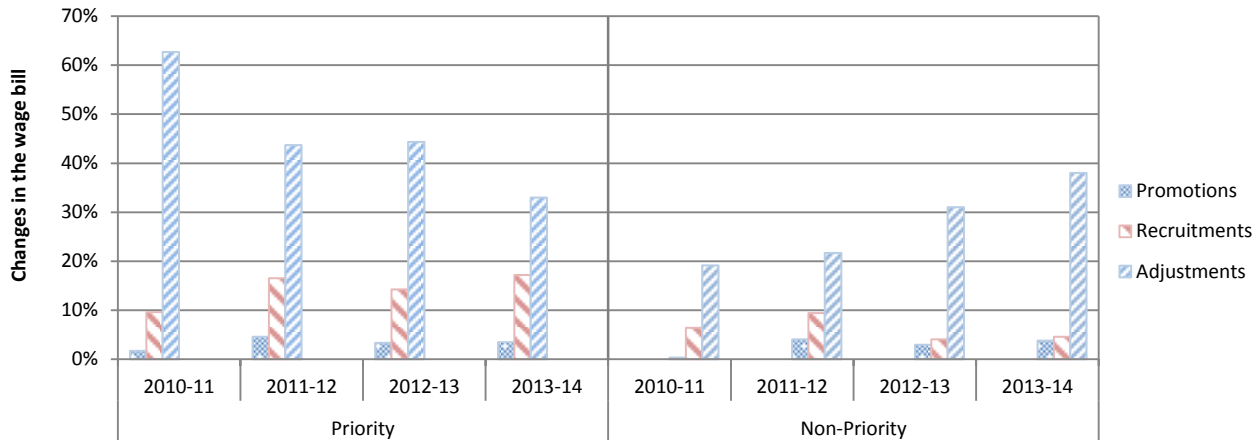
Source: Government Finance Statistics

Overall, spending on public sector wages is growing at a faster rate in priority sectors compared with non-priority sectors. Over the period 2009 to 2012 spending on wages in priority sectors increased at an annual growth rate of 18 percent, compared with 9 percent in non-priority sectors. This trend is largely because spending on the wage bill is dominated by the social sectors. In 2009, 46 percent of total spending on the wage bill was in the health and education sectors, and by 2012 this had increased to 54 percent. Within the priority sectors, on average for the period 2010 to 2014, the increase in wage bill was largely due to salary adjustments (71 percent), followed by new recruitments (23 percent) and then promotions (5 percent). This breakdown suggests that a large share of the increase in the wage bill may be important to retain a motivated work force but is not addressing the urgent need to recruit

⁷ This calculation is based on data of the budgetary impact of new recruitments, promotion and progression published by MoF

additional education and health workers. The figure below provides a breakdown of the source of increase in the total wage bill by priority and non-priority sectors.

Figure 16: Changes in the wage bill are largely due to salary adjustments



Source: Ministry of Finance

Looking ahead, it will be important to manage demands for salary increases through a clear government policy. Demands for pay rises and expansion of public sector employment are likely to increase with expectations of higher public revenues from the extraction of natural resources. The current legislation on public sector employment and remuneration (decree 54/2009) has the objective of regulating the process for recruitment, promotion and progression. However, there is arguably a case for a complementary policy to ensure the size and remuneration of the public sector takes fiscal sustainability issues into account, which would help in managing expectations and address pressures for unrealistic increases in public sector wages. Such a policy should be followed up with clear guidance at the sector level.

Figure 17: The largest share of spending on wages is in education

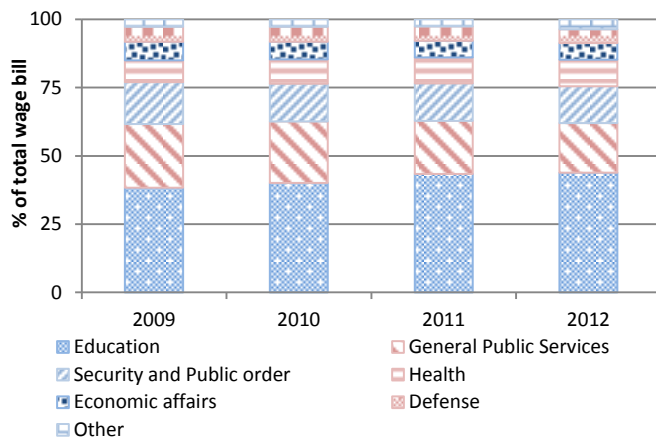
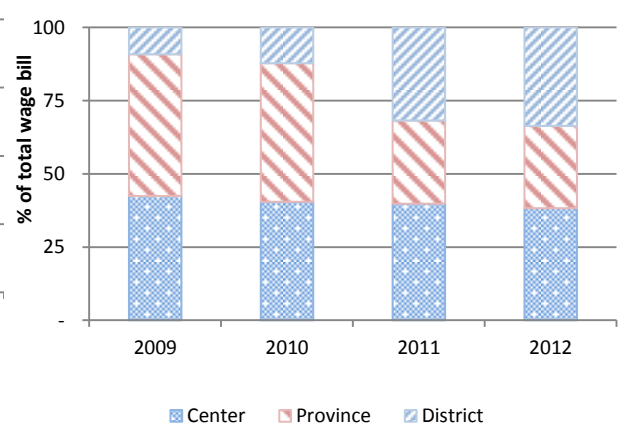


Figure 18: Spending on wages is increasingly at the district level

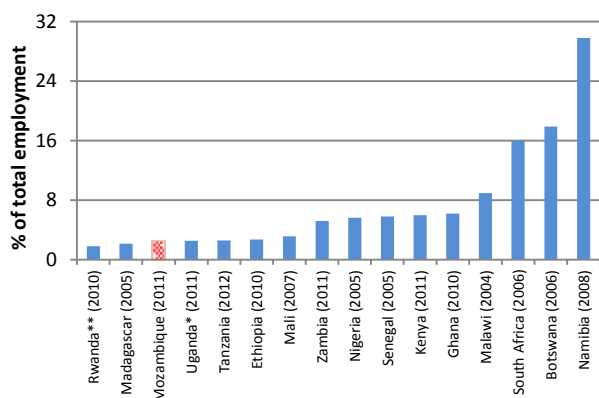


Source: Government of Mozambique and World Bank Staff Estimates

Source: Government of Mozambique and World Bank Staff Estimates

Compared with other countries, the number of public sector employees in Mozambique is relatively small, but growing rapidly. The number of public sector workers rose from 179,383 in 2009 to 296,586 in 2013, registering an annual growth rate of 13 percent (Ministry of Public Function, 2014). In comparison, spending on the wage bill has grown at a rate of 14 percent over the same period. These trends suggest that new recruitments are significantly contributing to the rapid increase in public spending on the wage bill. The number of public sector employees is still low when compared with other countries in the region, both as a share of the population and relative to total employment (Figure 19 and Figure 20).⁸

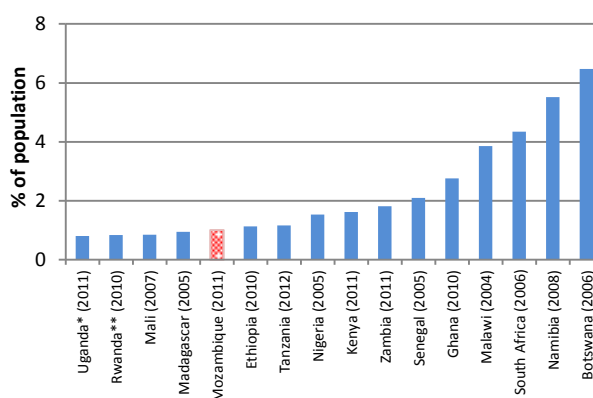
Figure 19: Public sector employment as a share of total employment is relatively low...



Note: *- does not include data on workers in SOEs, **- does not include data on military personnel

Source: Various employment surveys, Estatísticas dos Funcionários e Agentes do Estado (2012), Institute of Labour Studies (2011) and World Bank Staff Estimates

Figure 20: ...and it is also low as a share of the population.



Note: *- does not include data on workers in SOEs, **- does not include data on military personnel

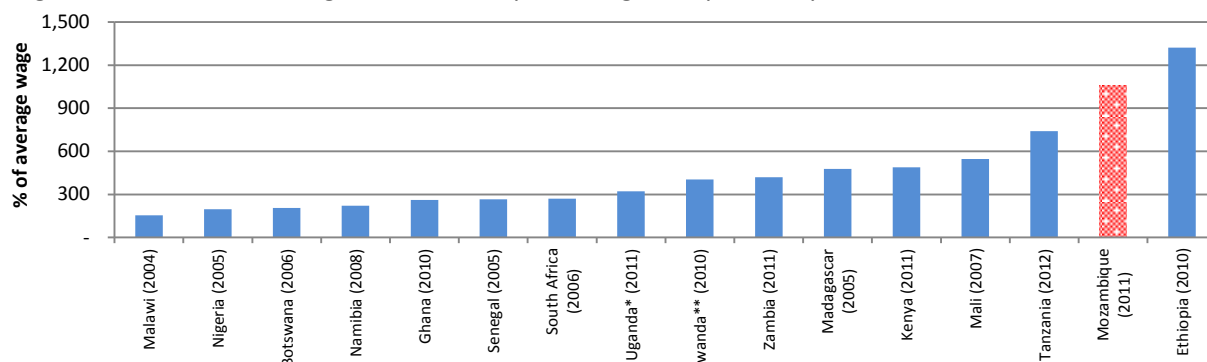
Source: Various employment surveys, Estatísticas dos Funcionários e Agentes do Estado (2012), Institute of Labour Studies (2011) and World Bank Staff Estimates

Compensation of public sector workers in Mozambique seems relatively high compared to the country's average wage. Figure 21, below, compares the relationship between the remuneration of public sector workers and average wages in a number of countries. The results suggest that public sector wages are relatively high in Mozambique, and that the overall remuneration of public sector workers is generous compared with peer countries.⁹ It is important to note that public sector compensation is only generous *relative* to the average wage level in the country, not in *absolute* terms. In addition, the comparison considers average remuneration levels in both the public sector and the overall economy, and does not take into account differences in compensation for workers at different skill levels. Remuneration levels are relatively generous compared with peer countries, largely due to regular adjustments in overall compensation levels, which is growing at a much faster pace than inflation.

⁸ Cross-country comparisons should be treated with caution since the method used to calculate public sector employment varies between countries. Moreover, due to data limitations for peer countries, comparisons are made in different years ranging from 2004 to 2011. Nevertheless, this comparison remains useful even when these caveats are taken into account.

⁹ In certain cases, the size of the public sector may be understated due to certain exclusions (thus over-stating the public average wage). In some other cases, especially in decentralized economies, the wage bill may not always include spending by local government, thus understating the wage bill (and the public average wage)

Figure 21: Public sector wages in Mozambique are high compared to peer countries

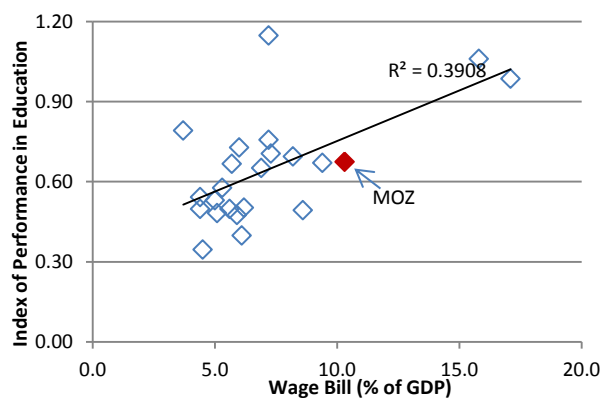


*-does not include data on workers in SOEs, **- does not include data on military personnel

Source: Various employment surveys, WDI, IMF documents and World Bank Staff Estimates

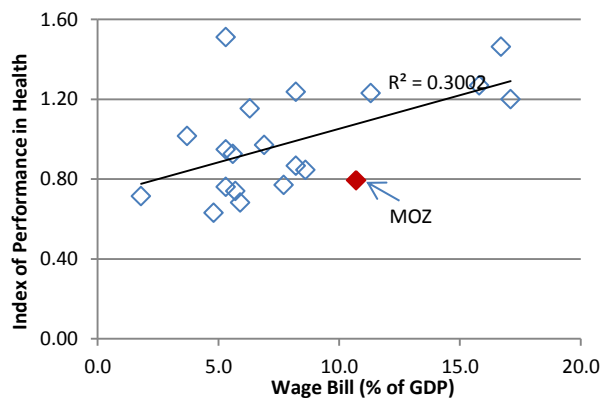
The public sector in Mozambique also appears to be less productive than that of other countries. To assess the productivity of the public administration a Public Sector Performance Index for the education and health sectors was developed for Mozambique and a number of peer countries.¹⁰ The sectoral performance indices were then compared with public spending levels in each sector. In both sectors, but particularly in health, the sectoral productivity is below what would be expected given spending on wages. This low productivity may partly be explained by the relatively high pupil-teacher ratio compared with other countries in the region (at 63 in 2012, compared with an average for sub-Saharan Africa of 41), and a low coverage of health workers to the population (at 4 doctors to 100,000 people compared with an average of 24 in low income countries). These figures suggest that there is significant room to reprioritize the wage bill within the social sectors to focus on new recruitments over annual salary adjustments that are growing at a faster pace than inflation.

Figure 22: Spending on wages is relatively high, but performance of the education sector is average...



Source: WDI, IMF various documents and World Bank Staff Estimates

Figure 23: ...and while spending on health wages is relatively high, performance is below average



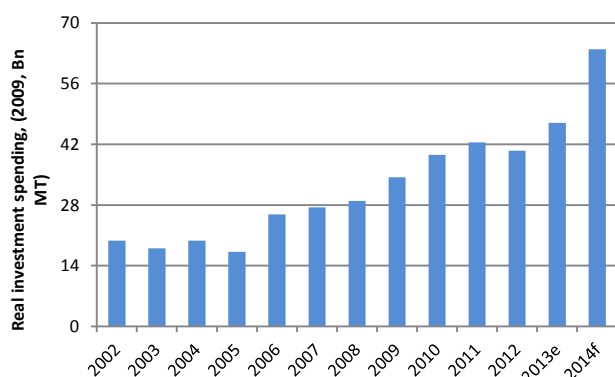
Source: WDI, IMF various documents and World Bank Staff Estimates

¹⁰ The Public Sector Performance Index is based on a methodology developed by Afonso, Schuknecht and Tanzi, 2003. The Index is based on 23 countries for the education sector and 20 countries for the health sector, where the average gap in outcomes was calculated in relation to the regional average. This index was then compared to the public wage bill to measure public sector productivity.

b. Second Focus Area: Public Investment Spending

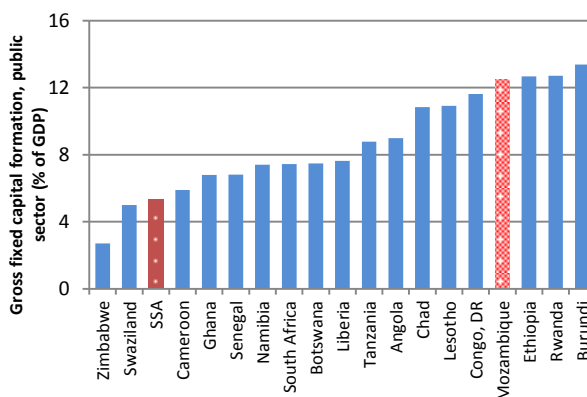
Public investment is being scaled up rapidly in Mozambique. Public investment is focused on areas such as transport, energy and irrigation, which are prioritized in the Integrated Investment Plan (*Programa Integrado de Investimento - PII*) approved in 2013 by the Council of Ministers. Mozambique has long suffered from inadequate infrastructure, but financing constraints have hindered its ability to make the investments necessary to close the infrastructure gap. Rising public investment levels, which are projected to reach 18 percent of GDP in 2014, have the potential to generate significant returns, provided that the right investments are made and that implementation is well managed.

Figure 24: Public investment has grown substantially in recent years...



Source: IMF database and World Bank Staff Estimates

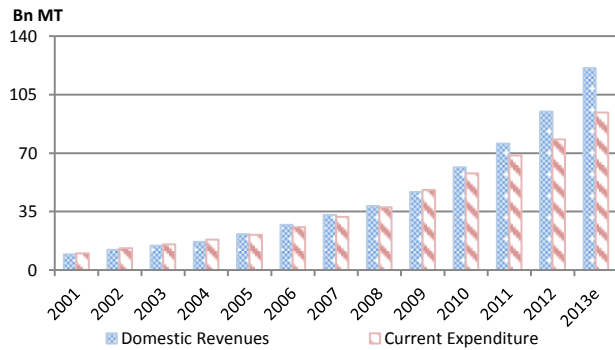
Figure 25: ...and is relatively high compared with peer countries



Source: World Development Indicators and World Bank Staff Estimates, 2012

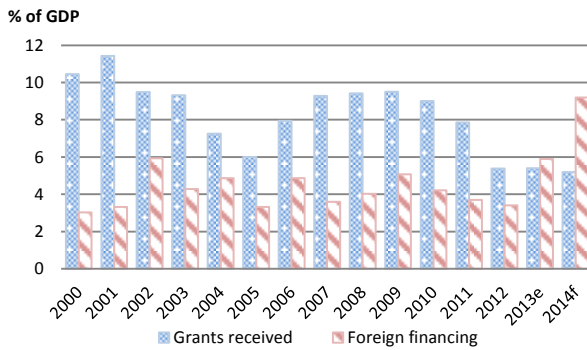
Sources of financing for public investment are gradually shifting, and both domestic revenues and external commercial financing are becoming increasingly important. For most of the past decade, domestic revenues were barely sufficient to finance recurrent spending, implying that public investments to a large extent had to rely on financing from development partners. This has changed over the past five years and now domestic revenues finance an increasing share of investment. Foreign loans (both concessional and non-concessional) are gradually increasing, and surpassed the level of grants for the first time in 2013, which have been declining steadily since 2009 as a percentage of GDP. Non-concessional borrowing, negligible in 2011, increased to 14 percent of total foreign financing in 2013 and is expected to continue rising.

Figure 26: Domestic revenues are higher than current expenditures



Source: IMF database

Figure 27: Financing through concessional and non-concessional loans is overtaking grants

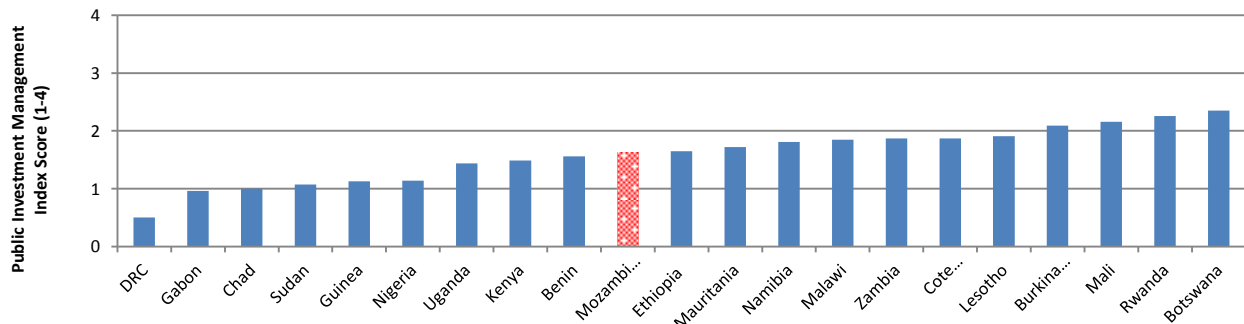


Source: IMF database

As the composition of investment spending shifts away from grants and concessional financing the government will need to assume a greater role in public investment management. Development partners frequently use their own systems to appraise and evaluate investment projects, and concessional financing poses less risk to debt sustainability than commercial borrowing. As the government increasingly turns to non-concessional financing to fund public investment it will be important for Mozambique to strengthen its own systems for managing public investments and debt. A more detailed discussion of debt sustainability is included in the chapter “Debt Sustainability and Fiscal Risks”.

To improve the quality of public investment Mozambique will need to strengthen its public investment management system. Greater attention needs to be paid to the quality of public investments, to ensure that the expected socio-economic returns are generated. Presently, the capacity of Mozambique’s public investment management processes is slightly below the regional average, leaving significant room for improvement. Enhancing public investment management will involve strengthening systems for formal project appraisal, evaluating and prioritizing public investment projects, and conducting ex-post project evaluation. These functions will become increasingly important over the short term as Mozambique allocates an increasingly large share of its income to public investment.

Figure 28: Mozambique’s system to manage public investment ranks below the average for peer countries



Source: WDI and Dabla-Norris, et.al, 2010 and World Bank Staff Estimates

The government has recognized both the weaknesses of its PIM system and the challenges that must be met in order to scale-up public investment and is already implementing reforms to improve PIM. In March 2011 the government established the Public Project Coordination and Selection Committee, an organ of the MPD that advises government on the prioritization and selection of public investment projects. The PPCSC is chaired by a representative of the MPD and includes staff from the MdF and infrastructure-related sector ministries, including the Ministries of Energy, Transportation and Public Works. It is also supported by a technical secretariat in the Directorate for Investment and Cooperation in the MPD, but capacity at all levels is limited. The Government has also prepared guidance to be used by public agencies in the preparation and appraisal of public investment projects and has made the appraisal and evaluation of investment projects for all projects above US\$5 million mandatory. These are all steps in the right direction, but much remains to be done.

To further strengthen the ability of its agencies to appropriately sequence public investments the government approved the Integrated Investment Program (*Programa Integrado de Investimentos—PII*). The PII attempts to prioritize investments over both the short and medium term based on a 3-year rolling investment program. A revised PII currently under preparation will include summary information (their expected costs and benefits, main beneficiaries, financing mechanisms and other criteria used during the appraisal and evaluation process) of all investment projects included in the PII, contributing to transparency in the system. The PII will also serve to inform medium term planning processes such as the MTFP and the debt sustainability analysis.

To strengthen its public investment management system, Mozambique should implement reforms along six pillars that are common in most public investment management systems¹¹: (i) develop the *appropriate legal framework*. The level of formalization varies across countries, but a key element in all legal frameworks is establishing that all public investments need to be evaluated before any financing is allocated or implementation started, (ii) strengthen the *Institutional Set Up*. Projects need to be evaluated independently, guaranteeing professionalism and avoiding conflicts of interest. The project evaluation should be carried out by an entity that is independent from project proponents and the entity should have sufficient decision making authority to eliminate, suspend or delay investment projects that do not seem adequately prepared or in line with the country's priorities, (iii) invest in a *continuous capacity building and training program* to strengthen the technical capacity of teams preparing and evaluating projects, (iv) prepare a *common and uniform set of norms, procedures, shadow prices and methodologies* to guide the preparation and elaboration of public investment projects. A common set of norms contributes to comparability of projects and therefore the ability to prioritize and select projects. It also contributes to the independence of project evaluators since there is a common set of norms and procedures, (v) develop an *integrated project database* to prepare, evaluate, supervise and monitor projects. Such a database would enhance the system's transparency and improve efficiency and communication between different stakeholders. The public should also have access to the database (or some of the information in it) promoting accountability, and (vi) build into the system *ex-post evaluation* of projects during project implementation and operation. The ex-post evaluation should

¹¹ World Bank, 2013, "Proposta de melhoria do sistema de investimento público em Moçambique"

analyze whether assumptions made during project appraisal were adequate, assess the quality of services being provided and permanently inform the public investment management system through the analysis and assessment of projects implemented.

To scale-up public investments while keeping overall spending levels at a sustainable level (in line with fiscal consolidation targets), the government could partner with the private sector to share costs and risks of infrastructure investments. Where infrastructure investments are likely to generate significant financial returns, the government could share costs and risks with the private sector through PPPs. An appropriate strategy would need to be designed and capacity in government agencies strengthened to be able to appropriate price and manage risks. Going further, the government could also reconsider the scope of the investment portfolio, where projects that are financially viable (e.g. in energy) could be implemented without government participation. There are already examples of the private sector taking the leadership on investment projects, such as the construction of the Nacala Railway, which is being led by Vale. The country's SOEs could also play a larger role in infrastructure investments and management, which would call for a concerted effort to boost both their financial and managerial capacity. A strategy that seeks a greater role for the private sector in infrastructure investments and operation could help in meeting the need for large infrastructure investments in a fiscal consolidation scenario, but such a strategy would need to be accompanied with efforts to strengthen government systems to manage a more complex financing mix and disclose any fiscal risks that may be generated (see chapter "Debt Sustainability and Fiscal Risks").

This chapter presents macroeconomic and fiscal developments in Mozambique over the past decade. Revenue has been growing at a very rapid pace, partly compensating for declining donor resources (as a share of GDP). The fiscal stance has been relatively conservative for most of the past decade, with deficit after grants at around 5 percent of GDP. Over the past few years, the fiscal stance has become more expansionary, with public spending as a share of GDP projected above 40 percent in 2014. Public spending has increased across the board: compensation of employees is projected at 11 percent of GDP in 2014; public investment has also increased rapidly, projected to reach 18 percent of GDP in 2014. The recent expansionary fiscal stance raises concerns regarding both sustainability and the effectiveness of public spending. Going forward, it will be necessary to tighten fiscal policy to guarantee macroeconomic stability. Limiting growth in the wage bill and an enhanced approach to public investment management should be part of this fiscal consolidation effort. For increased public investment to produce the expected returns, the government will need to strengthen its ability to manage a larger investment portfolio through improved appraisal, evaluation and selection of projects. The government could also seek to partner with the private sector to meet the country's vast infrastructure needs, but such a strategy would need to be accompanied with efforts to strengthen government systems to better manage a more complex financing mix.

II. Tax Policy in Transition

Tax policy in Mozambique has undergone major reforms since the late 1990s, and the overall tax regime remains in transition. The government has introduced significant changes in tax administration by modernizing tax laws and reforming the organizational structure governing their implementation. These reforms have generated a substantial increase in domestic revenues, but the full potential of the tax system has yet to be realized. Revenue administration remains hampered by weak audit and poor taxpayer service, the two backbone functions that support effective voluntary compliance. Revenue performance is also constrained by structural economic and demographic factors. Mozambique is a low income country with a relatively small working age population, poor youth literacy rates and a large informal economy (see Annex A1), all of which affect its revenue potential.

This chapter assesses the state of tax policy in Mozambique and argues that there is still scope to improve and simplify the tax regime. It examines the current regime for the major taxes, the corporate income tax (*Imposto sobre o Rendimento das Pessoas Colectivas – IRPC*), personal income tax (*Imposto sobre o Rendimento das Pessoas Singulares – IRPS*), and value-added tax (*Imposto sobre o Valor Acrescentado – IVA or VAT*). Together these accounted for around 70 percent of total tax revenues or 17 percent of GDP in 2012. Using international best practices as the basis for the analysis this chapter argues that there is scope to improve and simplify the tax regime. In particular, consolidating multiple schemes for small and medium taxpayers and revising the overly generous system of fiscal incentives would improve the economic and technical efficiency of tax administration. Strengthening the analytical capacity of the Mozambican Tax Authority would also help to inform sound policymaking.

1. Recent reforms

As a result of reforms in tax administration revenue collection surged during the 2000s. Total revenues to GDP rose steadily from 13.1 percent in 2004 to 23.3 percent in 2012, while tax revenues increased from 12.1 percent to more than 19.8 percent over the same period (Annex A3). Capital gains taxes related to the consolidation of ownership structures in the Rovuma basin have further contributed to increased tax revenues, at 23.3 percent in 2013, and is projected to remain constant in 2014. Even without capital gains taxes, revenues would have increased to 19.3 percent in 2014.

The largest contributors to domestic tax revenues today are the IRPC, IRPS and VAT. In 2012 these three taxes accounted for 32.6, 25.2 percent and 12.2 percent of total fiscal revenues, respectively (Annex A4). Other significant taxes include excise taxes, trade taxes and the Simplified Income Tax for Small Contributors (*Imposto Simplificado para Pequeno Contribuintes – ISPC*). From 2004 to 2012 taxes on goods and services (primarily VAT) represented the largest share of tax revenue, followed by taxes on income and profits on international trade. Over time the share of taxes on goods and services and international trade is declining, while taxes on income and profits are increasing, rising from 23 percent in 2004 to 45 percent in 2012 (Annex A3).

To increase total revenues and improve the business environment, the government launched a set of major reforms to the tax system in 1998. This process has transformed a relatively inefficient and archaic tax system into one that broadly conforms to international good practices. The government introduced the VAT in 1999, and the IRPC and IRPS in 2002. In the second half of the past decade, Mozambique passed a number of laws and regulations that overhauled the legal basis for most types of taxation. In 2006, a new General Law on Taxation revised the tax framework, including the duties and responsibilities of the tax authorities, and the obligations and rights of taxpayers.

To support the implementation of the revised tax system the government created the Mozambique Tax Authority in 2006. The objective of establishing the Tax Authority (*Autoridade Tributária – AT*) was to strengthen enforcement, improve service, curtail tax evasion, and expand the tax base. The AT combined the formerly separate tax and customs administrations and increased the number of registered taxpayers, tax staff, collection offices, and large taxpayer audits (USAID, 2009). The Tax Authority’s strategic plan for 2011-2014 identifies three major objectives: (i) sustainably increase tax collection; (ii) modernize and strengthen the tax administration; and (iii) develop communications systems and utilize new technology to improve tax administration.

The government has also introduced a number of administrative reforms designed to support improvements in the tax system. Examples include: (i) decentralizing the tax payment system by opening more tax offices, including mobile tax collection posts, allowing customs offices to accept payment of domestic taxes, and involving local administrative authorities and communities in tax collection; (ii) implementing the "single electronic window" mechanism for customs clearance; (iii) initiating the use of commercial banks for tax collection and efforts to strengthen the Large Taxpayers Division while reducing transaction costs for taxpayers; (iv) introducing electronic revenue collection and management systems via the "*e- Tributação*" ("e-taxation") system; and (v) promoting tax education, increasing public awareness of tax issues in an effort to further expand the tax base, and extending taxation authority into the informal sector. An overview of the tax structure is presented in Table 1 below, and further details are provided in Annex A2.

Table 1: Overview of the structure for major taxes

Tax	Tax base	Rate	Major exemptions
Corporate Income Tax (IRPC)	<ul style="list-style-type: none"> • Corporate entities with permanent operations in Mozambique • Capital gains • Interest income 	<ul style="list-style-type: none"> • Standard rate of 32 percent, but multiple rates are also available; e.g. agriculture, livestock, income from non-resident entities, telecoms, transport, equipment installation all taxed at 10 percent • Confidential or illicit taxes at 35 percent • Income subject to retention from source and income from non-resident entities subject to 20 percent rate 	<ul style="list-style-type: none"> • Government entities, social security institutions, cooperatives, public utilities, and activities that are cultural, recreational or sporting in nature
Personal Income Tax (IRPS)	<ul style="list-style-type: none"> • Residents taxed on worldwide income • Non-residents taxed on income originating from Mozambique • Coverage includes income and other remuneration 	<ul style="list-style-type: none"> • Individual taxable income falls into five brackets ranging from 10 percent to 32 percent depending on the level of income 	<ul style="list-style-type: none"> • N/A
Value Added Tax (VAT)	<ul style="list-style-type: none"> • Consumption-based VAT; capital expenditures and inputs netted out of the base 	<ul style="list-style-type: none"> • Standard rate of 17 percent • A zero rate is applied to exports and certain specified items • Businesses with revenues falling under the special VAT regime are subject to a rate of 5 percent 	<ul style="list-style-type: none"> • Exemption threshold of MT750,000 Businesses under this threshold can voluntarily opt for a normal VAT regime provided that they remain under this regime for at least five years

Source: World Bank Staff

A number of fiscal incentives have been established over the years in an effort to attract investment.

Examples include tax holidays, tax rate deductions, investment tax credits, accelerated depreciation, and exemptions and deductions for inflated expenses. Different incentives are offered by sector, geographical area, and type of investment. The government reports on tax expenditures in the budget documentation, in line with some of the recommendations made in the previous Public Expenditure Review (World Bank 2001).

2. Revenue performance and the tax system

While major progress has been achieved in tax reform, there are still a number of issues that need to be addressed. These include low tax productivity, high tax burdens on companies, a narrow tax base, an unevenly distributed tax burden, an excessively complex tax code and VAT refund delays. Regulatory complexity and the erosion of the tax base are major causes of revenue leakage, which effectively offsets the relatively high statutory rates in these taxes. Improvements in these aspects of the tax system could help Mozambique to enhance the efficiency, equity, simplicity, and stability of its fiscal revenues. Furthermore, the information publicly available means it is not possible to determine the

sectors from which revenues are derived. This section discusses Mozambique’s overall revenue performance and assesses each of its major taxes, with a short discussion of the ISPC included in box 1.

a. “Tax buoyancy” as an aggregate measure of efficiency in revenue policy and administration

The overall performance of the tax system is satisfactory according to the standards of tax buoyancy and elasticity. The concepts of tax buoyancy and elasticity can be used to evaluate the performance of individual taxes or the entire tax system.¹² Tax buoyancy is defined as the ratio between the real growth rate of tax revenues and the real growth rate of GDP. The data on revenue collection used in estimating tax buoyancy incorporates the impact of any changes in the tax rate, tax base or both during the reporting period. Thus, tax buoyancy measures the efficiency of the underlying tax structure as well as the impact of policy changes.¹³ In general, revenue performance is considered satisfactory if the buoyancy is greater than or equal to one, as this means that collection tends to keep up with the growth of the economy. Table 2 shows tax buoyancy in Mozambique.

Table 2: Tax buoyancy estimates (2005-2015)

	2005	2006	2007	2008	2009	2010	2011	2012	2013 (Est)
Tax growth	0.09	0.15	0.16	0.08	0.17	0.17	0.14	0.17	0.26
GDP growth	0.08	0.09	0.07	0.07	0.06	0.07	0.07	0.07	0.07
Buoyancy	1.10	1.74	2.22	1.17	2.69	2.42	1.94	2.39	3.68

Source: Government of Mozambique and World Bank Staff Estimates

b. Corporate income tax (IRPC)

In general, the corporate income tax regime in Mozambique is in line with international standards.

The regime is based on global income, and expenses incurred in earning income or maintaining assets can be deducted from taxable income. However, there are issues with the specific provisions of the IRPC and the 2009 Code of Fiscal Benefits. The fiscal incentive system tends to favor large, capital intensive projects. It also narrows the tax base and creates opportunities for tax evasions. Possibly to compensate for the erosion of the tax base, the nominal tax rate is currently very high, both by regional standards and relative to OECD countries. In addition, multiple tax rates tend to generate inefficiency, exacerbate complexity and encourage the exploitation of loopholes.

Compared to other countries in the region, Mozambique imposes a relatively high tax burden on the corporate sector. The total tax rate as a share of commercial profits in Southern African Development Community (SADC) countries is summarized in Figure 29.¹⁴ The rate in Mozambique remained constant

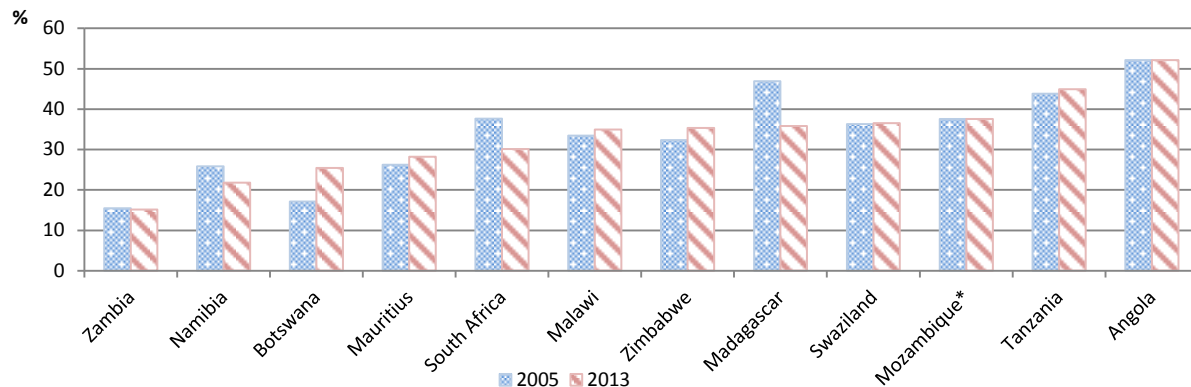
¹² For detailed discussion of tax buoyancy, tax elasticity, taxable capacity and tax efforts, see, for example, Musgrave, and Musgrave, (1989), and Le et al., (2008, 2012).

¹³ Tax elasticity and buoyancy are closely related concepts of efficiency. While tax elasticity is defined in the same way as tax buoyancy, the data on revenue collection used in estimating elasticity excludes the impact of any discretionary changes during the reporting period.

¹⁴ These data are based on the World Development Indicators, which define the total tax rate as a share of commercial profits. The indicator measures the amount of taxes and mandatory contributions payable by businesses after accounting for allowable

during 2005-13 at 37.5 percent of total commercial profits. In 2005, Mozambique ranked fifth highest among the 12 countries in the SADC sample. In 2013, however the same rate gives Mozambique the third highest tax burden in the region.

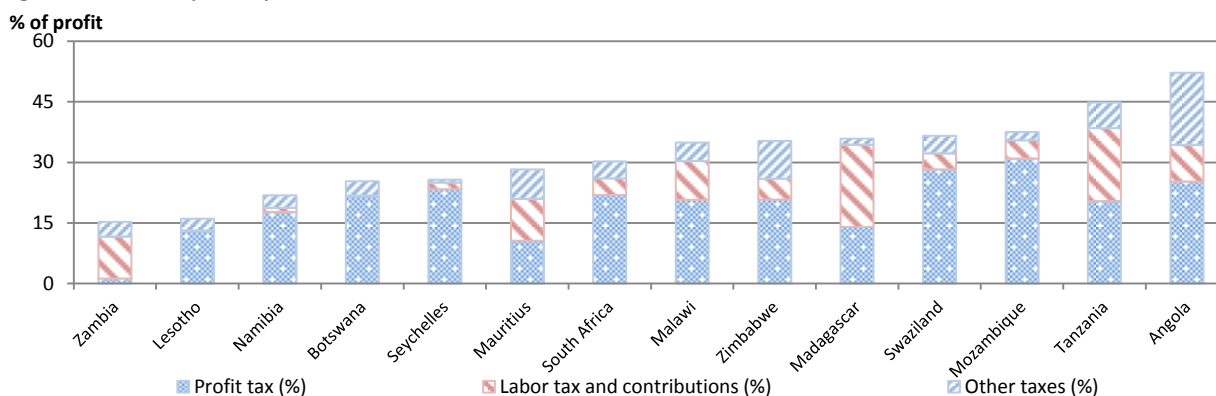
Figure 29: Total tax rate in commercial profits in selected SADC countries



*-Total tax burden on commercial profits, including labor and other taxes
 Source: IFC, Doing Business -Measuring Business Regulations, 2013

Profit taxes accounts for most of the tax burden on companies in Mozambique. Figure 30 allows further disaggregation of the tax burden on commercial profits into its various components—profit taxes, labor taxes and contributions, and other taxes. In 2012-13, of the 37.5 percent tax rate on commercial profits, profit taxes accounted for almost 31 percent, the *highest* among the SADC countries included in the sample. Although businesses often cite taxes as a barrier, improvements in tax administration seem to be paying off. The number of firms that state taxes as a constraint is declining, falling from around 50 percent in 2006 to 30 percent in 2012 (Ministry of Planning and Development, 2013). However, customs administration and customs-related corruption continues to be perceived as a serious constraint among Mozambique’s exporters.

Figure 30: Taxes paid by businesses in SADC countries



Source: IFC, Doing Business -Measuring Business Regulations, 2013

deductions and exemptions as a share of commercial profits. Taxes withheld (such as personal income tax) or collected and remitted to tax authorities (such as value added taxes, sales taxes or goods and service taxes) are excluded. These indicators are consistently estimated across countries using regular surveys by the IFC.

An assessment of the efficiency of corporate income taxes in the region suggests there is scope for further improvement. Corporate income tax productivity is calculated as the ratio between collections as a share of GDP and the standard statutory rate (see table below).¹⁵ Of the nine countries in the sample, Mozambique’s statutory rate is relatively high. Only Zambia and Namibia have higher rates, while the rate in other countries is significantly lower. However, the efficiency rate in Mozambique ranks at the low end of the regional spectrum (0.097), implying erosion of the corporate tax base.

The low efficiency of corporate taxes is due in part to fiscal incentives that favor capital-intensive production models. Foreign owned large projects often have a minor tax contribution. A recent independent study argues that large mining projects by foreign companies in Mozambique account for up to 12 percent of GDP but contribute less than 3 percent of tax revenues and represent 3 percent of employment) (Fjeldstad and Heggstad, 2011). Table 3 shows the magnitude of tax expenditures for income taxes (corporate and personal), as estimated by the Tax Authority over the three years after the introduction of the new fiscal schemes (2009-11). Tax expenditures are substantial, ranging from 16 to 23 percent of the total corporate and personal income tax collections, representing a revenue leakage of almost 19 percent on average during the period. With income taxes increasing and accounting for 12 percent of GDP in 2013, a similar leakage rate would be equivalent to approximately 2.3 percent of GDP.

Table 3: Tax expenditures on corporate and personal income taxes (2009-2011)

Year	Total F/E IRPC and IRPS (Billion MT)	Total income taxes (IRPC + IRPS), Billion MT	% tax expenditures in total income taxes
2009	3.2	13.7	23.5
2010	2.9	18.5	15.7
2011	4.7	24.9	18.8
Total	10.8	57.1	18.9

Source: AT and World Bank Staff Calculation

There is significant potential to increase revenues by improving the efficiency of corporate income taxes. If Mozambique could match the efficiency of the best performer in the sample, Botswana, it would collect an additional 3.7 percent of GDP, more than double the current amount of corporate income tax revenue. If it reached the average level of efficiency (0.14), tax collection would reach 4.6 percent of GDP, 1.5 percentage points higher than the current rate.

¹⁵ This productivity index is similar to the one applicable to evaluating the efficiency of PIT and VAT performance and widely applied in cross country assessments (see, for example, Stotsky and WoldeMariam (2002), Gallagher (2005)). While it should be treated with care as different countries have different GDP structures in terms of the share of income accruing to capital (gross operating surplus) and labor (compensation to employees), the index is useful in providing a snapshot indication to where a country tax performance stands relative to the one in referenced countries.

Table 4: Corporate income tax efficiency, selected SADC countries

Countries	Standard CIT statutory rate (%)	CIT collection (% of GDP)	CIT efficiency rate
Swaziland	30	2.7	0.09
Malawi	30	2.8	0.09
Mozambique	32	3.1	0.10
Zambia	35	4.0	0.11
Namibia	33	4.0	0.12
Zimbabwe	25.75	4.5	0.17
Mauritius	15	2.7	0.18
South Africa	28	5.6	0.20
Botswana	22	4.7	0.21
		Average	0.14

Source: PWC (2013), IMF database and World Bank Staff Estimates

c. Personal income tax (IPRS)

The legal basis for Mozambique’s personal income tax is adequate. The IRPS, by design, is broad-based and applied evenly to Mozambican citizens and foreign workers. Nevertheless, there is still scope to enhance both its efficiency and equity.

In addition to raising revenue, the IRPS is an instrument of income redistribution. However, caution is necessary to ensure that the personal income tax regime does not create undue burden or present a barrier to formalization for workers in the informal sector. This hinges on how the income threshold at which taxes are levied is determined and whether the tax is to be focused only on high and medium income earners or applied more evenly across the spectrum. Meanwhile, tax administration must be constantly improved to ensure high rates of compliance.

The IRPS regime does not allow for tax relief to be specifically given to the poor or those in low income brackets. Tax relief is instead allocated on the basis of the five different income brackets: those in higher income brackets enjoy larger tax credits, which would be contrary to equity principles underlying a standard personal income tax.

While the number of income brackets in Mozambique is in line with other countries in the region, it is still high by international standards and can lead to increased tax evasion. Table 5 shows the income thresholds and tax rates at different brackets for Mozambique and comparable countries. The fundamental justification for structuring the PIT with multiple brackets is to allow for better separation of taxpayers at different levels of income and thereby promote vertical equity. However there is no unambiguous evidence to prove this justification. Lewis (1984) models a PIT with three different hypothetical structures: the first with 7 distinct brackets with positive rates, second with 3, and third with only one marginal rate combined with higher exemption level. It is shown that all three systems are progressive but they appear to be so in different income ranges with no clearly superior alternative from a progressivity perspective. A high number of brackets on the other hand requires more complex administration, raising both collection and compliance costs and increasing possibilities for tax evasion and avoidance. Thus over the past two decades, countries, both developing and developed, strived to

reduce the number of brackets in their PIT systems and there emerged widespread interest in the new flat income tax regimes with Estonia leading the pack with its introduction in 1994.

Table 5: Personal income tax regimes in selected SADC countries

Countries	Personal Income Tax Threshold (US\$)	Personal Income Tax Threshold (% of GDP per capita)	Personal Income Tax Rates (%)
Angola	261	0.04	5; 6; 7; 8; 9; 10; 11; 12; 13; 14; 15; 16; 17
Botswana	4230	0.45	5; 12. 5; 18.75; 25
DRC	573	2.42	15; 20; 22. 5; 25; 30; 32.5; 35; 37. 5; 40
Lesotho	0	0	22; 35
Madagascar	114	0.25	20
Malawi	578	2.16	15; 30
Mauritius	8710	0.98	15
Mozambique	56	N/A	10; 15; 20; 25; 32
Namibia	4811	0.83	18; 25; 28; 30; 32; 37
Seychelles	0	0	10; 15
South Africa	6255	0.83	18; 25; 30; 35; 38; 40
Swaziland	0	0	20; 25; 30; 33
Tanzania	1246	2.05	13; 20; 25; 30
Zambia	4620	3.13	25; 30; 35
Zimbabwe	3000	3.97	20; 25; 30; 35; 40; 45

Source: IBFD, IMF

Box 2: Small tax payers regime (ISPC)

The ISPC was introduced in 2009 for small business enterprises with an annual business volume of less than MT 2,500,000. Tax payers can opt to pay 3 percent tax on the business volume or a flat fee of MT 75,000 a year. An exemption threshold has been set based on the size of the business volume, although the level is relatively low compared with the VAT threshold. Small tax payers can either decide to follow the ISPC, or instead comply with the VAT or the IRPC simplified regime for small tax payers.

In principle, the ISPC is deemed to be more advantageous for small business enterprises, but in practice migration away from the parallel simplified regimes has been low. The persistent use of the simplified regimes may be due to large differences between the normal and simplified regime which encourages underreporting of the annual business volume in order to gain favorable tax treatment. Furthermore, the tax burden under the ISPC is relatively low compared with the taxes applicable for medium and large enterprises. As a result, medium and large enterprises bear a disproportionate tax burden.

A number of measures have been proposed to improve the efficiency and equity of the ISPC, which include: (i) abolishing the parallel simplified tax regime for small tax payers to reduce potential tax leakages and tax administration costs; (ii) increasing the ad valorem rate of the ISPC; and (iii) increasing the exemption threshold under the ISPC to ensure small taxpayers are not unduly burdened.

Source: Varsano, et. al,2012

d. Value-Added Tax (VAT)

There is considerable scope to improve the efficiency of Mozambique’s value-added tax. Two measures of efficiency are used to compare the relative functioning of value-added taxes in selected SADC countries (Table 6). The Gross Compliance Ratio (GCR) is defined as the ratio between actual tax collections to the potential collections, with the latter approximated as the share of the value-added tax rate in private consumption. GCR efficiency is defined as the ratio between actual collections as a share of GDP and a standard statutory rate for value-added tax collection. In terms of GCR, South Africa is the best performer in the region (GCR of 0.8), while in terms of the overall efficiency ratio Zimbabwe is at the top (0.6). Either of these two measures indicates that Mozambique has room to improve. At the GCR level of South Africa or overall efficiency ratio of Zimbabwe, Mozambique would have been able to collect 10.8 and 10.5 percent of GDP, respectively, highlighting the significant gap in actual collections, which are the order of about 5.5 percentage points of GDP.¹⁶ Mozambique’s value-added tax performance is well below the average efficiency level of the countries in the sample: 0.4 versus 0.5 (CGR), and 0.3 versus 0.4 (overall efficiency ratio). Given Mozambique’s relatively high value-added tax rate, low collection rates imply a significant erosion of the tax base.

Table 6: Value-added tax efficiency in selected SADC countries

Countries	Household Final Consumption Expenditure (% of GDP) in 2011	VAT Collection (% of GDP)	Standard Statutory VAT rate (%)	Estimated VAT Potential (% of GDP)	Gross Compliance Rate (GCR)	VAT Efficiency Ratio
Madagascar	78.0	2.2	20.0	15.6	0.14	0.11
Zambia	45.4	3.9	16.0	7.3	0.54	0.24
Tanzania	66.1	4.5	18.0	11.9	0.38	0.25
Mozambique	78.1	5.2	17.0	13.3	0.39	0.31
Botswana	50.6	3.7	12.0	6.1	0.61	0.31
Malawi	74.5	5.6	16.5	12.3	0.46	0.34
Namibia	61.3	6.1	15.0	9.2	0.66	0.41
Mauritius	73.5	7.1	15.0	11.0	0.64	0.47
Swaziland	83.2	6.6	14.0	11.7	0.57	0.47
South Africa	61.2	6.9	14.0	8.6	0.81	0.49
Zimbabwe	91.8	9.3	15.0	13.8	0.68	0.62
Average					0.53	0.37

Source: WDI 2013, International Bureau of Fiscal Documentation, IBFD 2013, Government Finance Statistics (IMF), International Financial Statistics (IMF), World Economic Outlook (IMF), World Bank country reports, and World Bank Staff Estimates

The VAT legislation provides for an expansive list of exempt and zero-rated items. An analysis of value-added tax efficiency (Table 6) indicates that if the tax base can be expanded, the country could raise VAT collection by as much as 5.5 percentage points of GDP. However, the list of exempt and zero-rated items

¹⁶ The gap is estimated as the difference between the collection at South Africa’s GCR (10.79% of GDP) or Zimbabwe’s VAT efficiency ratio (10.54% of GDP) and the current actual collection in Mozambique (5.2% of GDP), provided that the standard rate is the same, 17%.

must be reviewed and rationalized. The VAT code should clearly specify the distinct provisions for exemptions and zero ratings, but the current legislation seems to mix the exempt and zero-rating schedules. Exemptions shrink the tax base, have an unclear impact on the poor and can lead to further requests for exemptions up and down the value chain. To effectively relieve the tax burden on the poor, it would be preferable to use a credit-invoiced based tax at the final stage, where the poor consume the taxed goods. For a zero rating, under the invoice-based credit method, tax liability would be eliminated only if the last stage is zero-rated. See Annex A7 for an illustration of the case of taxes on bread, which is typically considered to be a basic good.

While the VAT law follows standard procedures for refunds, in practice the process suffers major delays that represent a significant constraint for businesses. According to the law, the AT is supposed to review and decide on the eligibility of a proposed refund within 30 days, and any delayed refunds will be subject to interest payments. However, VAT collection is currently recorded on a gross basis in the budget, and refunds are recorded as an expenditure item. This undermines the integrity of the consumption-based VAT by causing it to mimic a turnover tax. In its final review of its Policy Support Instrument the IMF estimated that at the end of 2012 unsettled VAT refund requests had reached 1.3 percent of GDP (IMF, 2013). In some cases businesses report waiting 4 to 5 years for refunds. To address this longstanding issue, the government will start to record VAT in a net basis in budget documentation which will partly avoid further accumulation of arrears.

3. Options for Reform

There are a number of areas in which the tax system could be improved, which should consider the evolving structure of the economy. The implementation of tax reforms should consider the expected changes in the economy, which requires better informed policy making. Importantly, it would be useful to have a clearer understanding of the sectors that are important for revenue collection, which would also help to inform revenue forecasting. While the extractives sectors are expected to have a significant impact on the economy towards the end of the decade, there will be an initial production period where profits are likely to be minimal, placing additional pressures on other sectors of the economy to meet revenue targets. Also, as the extractives sectors develop it will also be important to prepare for emerging tax challenges. Production taxes are likely to become an important stream of taxes in the near future as will resource rent taxes as foreseen in the new mining and petroleum fiscal regime. The IRPC in the extractives sector will also be more complex to administer. This section discusses options for reform, such as simplifying the tax regime, consolidating multiple schemes for small and medium taxpayers and revising the overly generous post-2009 system of fiscal incentives.

a. Reforming the corporate income tax

Closing loopholes would curb the erosion of the tax base for corporate income taxes. The proliferation of fiscal incentives in the 2009 tax code runs contrary to international trends. These provisions should be reviewed and simplified. Many countries, especially in the OECD, tend to limit their fiscal incentives to a few types, such as investment tax credits or accelerated depreciation. These instruments are more

effective in attracting marginal investment, restraining fiscal losses, and preserving neutrality.¹⁷ Tax holidays and tax rate reductions are among the bluntest instruments and tend to generate ‘fly-by-night’ effects on firms’ investment decisions. It is also worth noting that the impact of a country’s fiscal incentives on FDI is dependent on the home country’s tax policy and the existence of a tax treaty between home and destination countries. If the home country allows for foreign tax credits, and if there is no “tax sparing” treaty, generous tax incentives in Mozambique amount to a pure transfer of fiscal revenues to a foreign investor’s home country without any benefits accruing to the investor.¹⁸

To expand the tax base and avoid risky investments it has become common practice for tax administrations to set a limit on the debt-equity ratio in determining taxable income of a business entity. This is known as the “thin capitalization rule.” While the ratio is set differently in different countries, it has to be specific and enshrined in the law, However, this element of good practice is absent from current Mozambique law.

The fiscal depreciation schedule should be simplified. The existing depreciation scheme is excessively complicated and involves around 20 categories. According to international good practice, tangible and intangible assets should be grouped into five categories or fewer. Such simplification tends to curb abuse and reduce both compliance costs for the firm and administrative costs for the government.

Revising the treatment of capital gains in the tax code would realign incentives. The current tax code does not allow for indexing purchase prices to determine the taxable amount from capital gains (even risk imposing a tax on real capital loss) and may act as a disincentive to long-term investment and create some type of distortionary ‘lock-in effect’ by discouraging realization of capital gains (Auten, 2005). Indexation of prices would need to take into account the prices that assets face, e.g. asset prices of extractive industries are much more likely to be affected by international commodity prices and demand dynamics than domestic inflation, which would require a differentiated treatment.

The rate structure should be consolidated to a single rate, which could then be reduced over time, in accordance with international trends, and accompanied by measures to expand the tax base. Due to ever more intense tax competition, countries are tending to reduce their corporate income tax rate. OECD countries have been reducing their statutory rates for the last 30 years; the median corporate tax rate has declined to 27 percent, with rates in countries such as Switzerland as low as 8.5 percent (see Annex A6 for further details). The existence of a special regime for corporate income taxes to deal with small tax payers seems redundant and should be abolished as there is already ISPC to deal with small and medium sized businesses.

¹⁷ Tax neutrality requires that tax incentives do not distort the before-tax ranking of different investments. To support the positive role of tax incentives in economic growth, various theoretical tax neutrality schemes such as Musgrave, Samuelson, and Harberger neutralities are designed. For concise discussion on these neutrality schemes, see Harberger (1980, pp. 303-09).

¹⁸ “Tax sparing” refers to a treaty between home and host countries, by which firms were allowed to take foreign tax credit in their home country as if the tax were paid in the host country even when the firms were granted tax holidays by the host country.

b. Reforming personal income tax

Reducing the number of tax brackets could improve the efficiency of personal income tax collection.

As highlighted, multi-bracket structure does not unambiguously improve vertical equity while raising administration and compliance costs and creating loopholes for tax evasion. Consolidating income brackets to three or four would simplify the personal income tax regime. In addition, tax thresholds and credits could be adjusted annually to account for inflation and avoid “bracket creep.” In doing so, it will be important to avoid creating too large a gap between the top marginal PIT rate and the CIT which could lead to tax evasion. The worldwide trend in tax reforms is to minimize the gap between top personal and corporate income tax rates – to reduce tax arbitrage and undesired impacts on capital and labor utilization (Hadler et al., 2006). A simplified regime for personal income taxes is redundant and should be removed in order to avoid any conflicts and duplication with the ISPC

c. Reforming value-added tax

On efficiency and practicality grounds, Mozambique should consider streamlining the long list of non-export zero-rated goods. There are a large number of non-export zero-rated items, which narrows the base for VAT collection. The international experience suggests that public investment and social programs are usually a more cost-effective pro-poor policy than value-added tax relief. Similarly, rationalizing the long list of exemptions requires distinguishing ‘regular/for profit’ suppliers of goods and services that may currently be exempted. Businesses in the agriculture and fisheries sectors should also be subject to value-added tax if their revenues exceed the established threshold. If they fall below this threshold, they should be subject to the ISPC. Currently, the AT has substantial discretion to interpret what items are to be exempt, which requires a set of analytical skills that may not be readily available (e.g. on potential competition between NGOs and VAT paying businesses in the provision of services). An accurate analysis of tax expenditures and tax gaps is essential for effective policy review and reforms. A dedicated unit within the AT should be created with sufficient capacity to collect and analyze the relevant data (see Annex A8 for an example of the type of analysis required).

The efficiency of the exemption regime is dependent on the tax threshold. There is no universally appropriate threshold, but cross country comparisons are instructive. Table 7 shows that among SADC countries value-added tax thresholds are set at vastly different levels, with a median rate of US\$32,097. The current threshold for exemptions in Mozambique is MT750,000, or US\$23,148, while the upper threshold for the special regime is MT2.5 million, or around US\$77,000. If the special regime were abolished, the exemption threshold should be revised upward to somewhere between the current exemption threshold and the upper threshold for the special regime.

Table 7: Value-added tax structure in SADC countries

Country	Date VAT Introduced	Standard Rate at Introduction	Current Standard Rate	Other Current Rates	In national currency	In US dollars ¹⁹	Remarks
Angola ²⁰		N/A	N/A	N/A	N/A	N/A	
Botswana	Jul. 2002	10.0	12.0		250,000	34,014	
DRC	Jan. 2012	16.0	16.0		79,787,000 ²¹	87,528	
Madagascar	Sept. 1994	20.0	20.0		50,000,000	25,359	
Malawi	May 1989	35.0	16.5		6,000,000	42,673	
Mauritius	Sept. 1998	10.0	15.0		2,000,000	68,291	There is no registration threshold for certain businesses and professions. e.g. domestic banks, insurance agents, lawyers, accountants.
Mozambique	Jun. 1999	17.0	17.0		750,000	23,148	A simplified scheme of taxation applies to any small company which (1) is not obliged to keep standard accounts, (2) does not elect to keep either standard accounts or simplified records and (3) had annual revenues in the previous year of no more than MT750,000
Namibia	Nov. 2000	15.0	15.0		200,000	23,026	A business is obliged to register
South Africa	Sept. 1991	10.0	14.0		20,000	2,353	Voluntary: Minimum revenue of ZAR 20,000 (certain exceptions apply)
					300,000	35,302	Compulsory: ZAR 300,000 exceeded in past 12 months, or reasonable expectation for next 12 months
Swaziland	Jan. 2013	14.0	14.0	25.0	N/A	N/A	
Tanzania	Jul. 1998	20.0	18.0		40,000,000	30,180	Taxable goods or services must equal or exceed US \$7,844 in a three month period
Zambia	Jul. 1995	20.0	16.0		200,000,000	38,596	It is a statutory requirement that suppliers making taxable supplies with a taxable turnover that exceeds or is likely to exceed K200 million (US \$38,596) in any 12 consecutive months or K50 million (US\$ 9,649) in any 3 consecutive months must register for value-added tax. As of February 7, 2004 there is no voluntary registration
Zimbabwe	Jan. 2004	15.0	15.0		6,000,000	3,221	

Source: IMF database and World Bank Staff Updates

¹⁹ The exchange rates used for calculations are in national currency per US dollar, annual moving period average for 2009, unless specified otherwise.

²⁰ There is no value-added tax (VAT) or sales tax in Angola.

²¹ As data on DRC were missing in the main reference document (i.e. Table 1: Fund Member Countries: the VAT Registration Threshold 2010), a CDF/US\$ Exchange Rate was used: US\$ 1 = CDF 911.559 on December 16, 2013 (source: <http://www.xe.com>)

Properly managed and timely VAT refunds are essential for ensuring the tax is efficient and a pure tax on consumption. Any delay in tax refunds adds a layer of “hidden costs” to registered firms and thus discourages investment. Box 3 summarizes the lessons learned from successful tax administrations.

Box 3: Administering value-added tax refunds, the international experience

Most developed countries, including New Zealand, Japan, Canada, and a number of EU member states, allow for the complete refund of all excess value-added tax credits, while developing countries often rely on a hybrid system of refunds and carry-forward arrangement for excess credits. One proven approach to administering value-added tax refunds is to establish a “gold-silver” scheme, in which refund claimants are grouped into “gold,” “silver,” and “others” categories. The criteria for the grouping, which must be simple and transparent, are generally related to the claimant’s history of exports, bookkeeping, tax compliance, and audits by tax officials. Those classified as “gold” or “silver” are typically fast-tracked, without needing preapproval for audit refunds. This system helps tax administrations focus on high-risk refund claimants

As with corporate and personal income taxes, the special regime for value-added taxes should be removed. The coexistence of the special regime with the normal and exempt regimes creates loopholes, fosters uncertainty among the business community, and increases both administrative and compliance costs. A modern tax system should have a unique, dedicated regime to deal with small and medium taxpayers, but not multiple regimes for all major tax types, corporate, personal and value-added.

This chapter discusses developments in Mozambique’s tax policy and administration over the past decade, discussing options for reforms to increase the productivity of the different types of taxes. Revenue collection increased rapidly during the past decade, primarily as a result of successful administrative reforms. The largest contributors to taxes are VAT, corporate and personal income taxes which together accounted for 70 percent of all domestic revenues in 2012. Despite strong growth, analysis suggests there is room for improving efficiency and increasing domestic revenues. Some of the reforms suggested include: (i) reforming the generous fiscal incentives regime to broaden the base, (ii) abolishing the special regimes in CIT, PIT and VAT given the existence of a specific regime to deal with small and medium enterprises, (iii) streamlining the long list of non-export zero rated items for VAT and (iv) reforming the process for VAT refunds. Going forward, it will be important to strengthen tax administration to manage revenues from natural resources which will increase exponentially toward the end of the decade.

III. Debt Sustainability and Fiscal Risks

As Mozambique has embarked on an ambitious public investment program, its debt levels have increased. Public investment in Mozambique has historically been constrained by limited access to foreign capital and relatively low domestic savings, with development partners financing the majority of public investment over the past 20 years. A projected increase in government revenues from the coal and gas sectors toward the end of the decade has opened new opportunities for debt financing and, if not carefully managed, could have implications for fiscal discipline. Increased public investment in infrastructure and human capital could generate significant returns. Non-concessional commercial financing may also be appropriate given the potential returns to increased public investments, but rising debt levels suggests that caution will be necessary when using commercial financing to fund public investments.

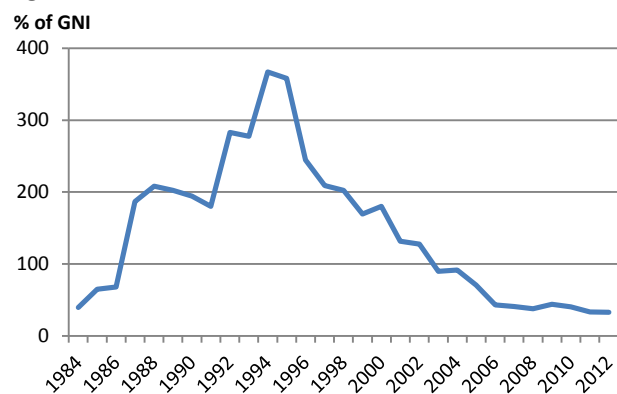
Fiscal risks also appear to be on the rise. Increasing fiscal deficits have pushed debt levels from below 40 percent in 2011 to a projected 57 percent in 2014. A more complex financing mix that uses public guarantees and public private partnerships to fund investment heightens the risk of contingent liabilities, which may threaten the government’s fiscal stance. Many countries that have experienced rapid growth embarked on ambitious infrastructure public investment programs, accumulating contingent liabilities that ultimately undermined their macroeconomic stability.²² This chapter discusses debt dynamics in Mozambique over the past decade and simulates potential shocks to debt sustainability, including risks emanating from contingent liabilities that may not be reflected in Mozambique’s current fiscal deficits. The chapter also discusses reforms that may allow Mozambique to strengthen its debt position and improve the management of fiscal risks.

1. Debt Dynamics in Mozambique

Mozambique benefitted from debt relief under the HIPC initiative, which dramatically lowered its public debt levels. External debt reached a peak of 366 percent of GNI in 1994. Debt relief helped bring the debt burden back to sustainable levels by the mid-2000s, while prudent macroeconomic policy and significant donor support helped maintain debt sustainability, contributing to macroeconomic stability and reducing financing costs (Figure 31). In recent years Mozambique has significantly increased both recurrent and investment spending. (For a more detailed discussion on fiscal policy over the past decade, see chapter “Macroeconomic and Fiscal Developments”). This increase has been partly financed by higher budget deficits and one-off revenues. Mozambique has also increasingly turned to non-concessional loans to finance public investment. In 2011 non-concessional financing was negligible, but by 2012 it accounted for 14 percent of total financing, and in 2017 it is projected to account for 40-50 percent.

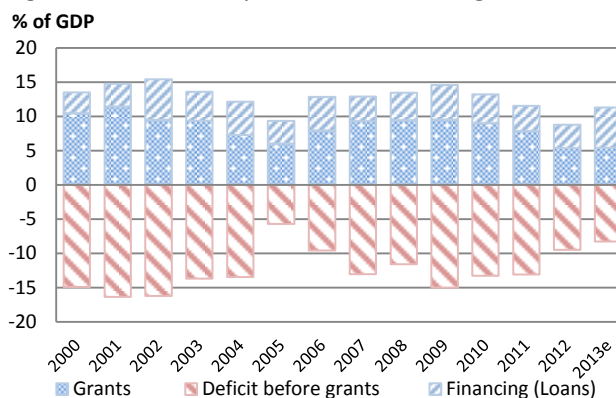
²² Contingent liabilities are liabilities that may be incurred by an entity depending on the outcome of an uncertain future event, e.g. sovereign guarantees provided to back up loans by public enterprises. In the future the public enterprise may be unable to pay back the loan, in which case the guarantee could be called and the debt would need to be assumed by the state. Contingent liabilities can be explicit, i.e. contained in a contract or legislation or implicit, i.e. there is a moral or political obligation for the state to assume the liabilities.

Figure 31: External debt as a share of GNI



Source: World Development Indicators

Figure 32: Mozambique's deficit financing



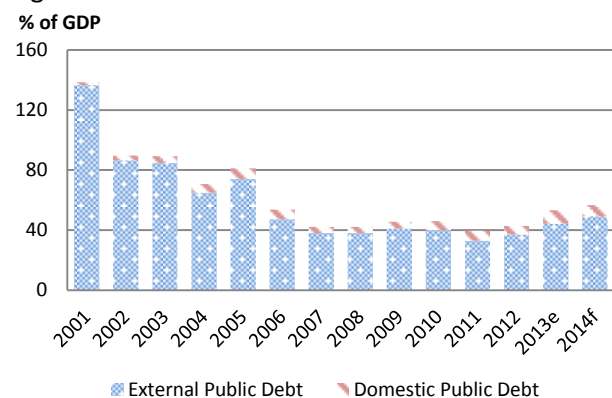
Source: IMF databases

As a result of higher budget deficits, public debt levels have increased again in recent years. Mozambique's debt burden has risen from 40 percent of GDP in 2011 to a projected 57 percent in 2014 and is estimated to remain above 55 percent for the remainder of the decade, even assuming a significant tightening of fiscal policy starting in 2015. External debt continues to dominate public debt, although in the past few years there has also been an increase in domestic public debt, partly as a result of government efforts to develop the domestic debt market (Figure 33).

Deficit levels and the interest-growth differential seem to dominate debt dynamics. During the earlier part of the past decade debt levels declined steadily, falling by 11.8 percent on average from 2004 to 2007, as the contribution of growth outpaced that of deficits (see Figure 34 below). Privatization, debt relief and an appreciation of the exchange rate also contributed to falling debt levels. From 2008 to 2011 there was little change in debt-to-GDP ratios, which remained between 40-45 percent of GDP. Debt levels as a share of GDP declined by 0.6 percentage points per year during the period, as strong growth continued to offset rising deficits. In the past 3 years, however, debt levels started increasing again, rising by an average of 5.6 percentage points per year from 2012 to 2014, as rapid growth is no longer able to counterbalance the contribution of primary deficits to increasing debt levels. A slight depreciation of the exchange rate as well as net changes in other assets have also contributed to increasing debt levels.²³

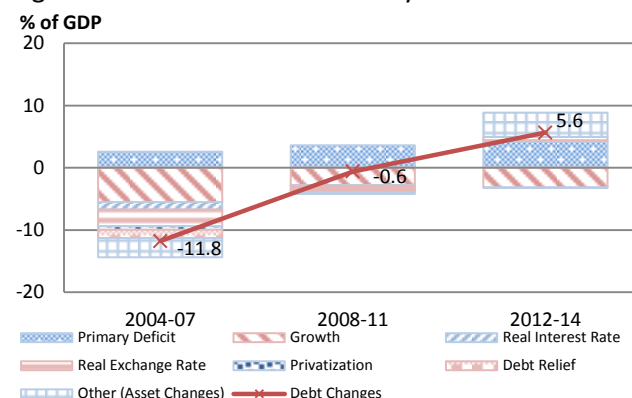
²³ "Other (asset changes)" reflect the effect of factors that are not included in debt dynamics, such as revisions in debt stocks.

Figure 33: Public Debt as a share of GDP



Source: IMF databases

Figure 34: Contributions to debt dynamics



Source: World Banks Staff Estimates

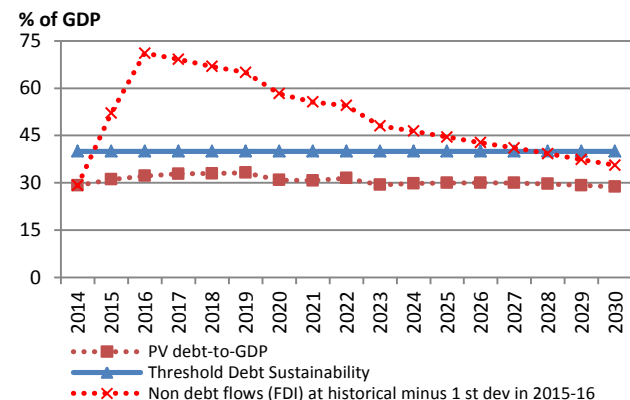
2. Debt Sustainability

Among resource-rich countries such as Mozambique, efforts to improve debt and fiscal risk management are critically important. Many resource-rich countries gain access to financing options that were not available to them before the discovery of natural resources. These financing options often imply the accumulation of contingent and implicit liabilities that need to be managed. Countries that may have been financially constrained, as is the case with Mozambique, will also seek to address longstanding development needs (e.g. in infrastructure) by frontloading investments in the expectation of a surge in government revenues in the near future. These rapid increases in spending, if financed by debt, could lead to higher risks of debt distress if the investments do not have the expected returns or if the natural resource revenues fall below expectations.

Despite a recent increase in debt levels, Mozambique’s debt remains sustainable, as suggested by the recently finalized Debt Sustainability Analysis (DSA) (IMF and IDA, 2014). The DSA shows that although debt levels are sustainable, the risk of debt distress has increased. To prepare a DSA the projected debt trajectory is subjected to a series of stress tests to assess the risk of debt distress.²⁴ In Mozambique’s case, a sudden decline in FDI or export flows would result in debt levels that breach the thresholds for debt sustainability over prolonged periods of time. Other shocks to key variables such as growth, the exchange rate or inflation would have limited impact on breaching of thresholds although it would bring debt levels closer to the threshold.

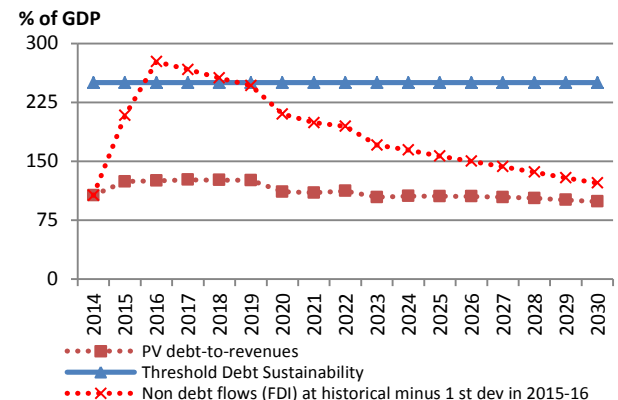
²⁴ Debt sustainability analysis is conducted by subjecting the debt baseline scenario to a series of standard stress tests to gauge the sensitivity of the baseline scenario to shocks and changes in assumptions. For more information on the DSA please consult staff guidance on the debt sustainability framework produced by both the World Bank and the IMF which is publicly available under <http://go.worldbank.org/A5VFXZCCW0>

Figure 35: Present value of Debt-to-GDP levels under the baseline and most extreme shock



Source: IMF and IDA, 2014

Figure 36: Present value of Debt-to-Revenue levels under the baseline and most extreme shock

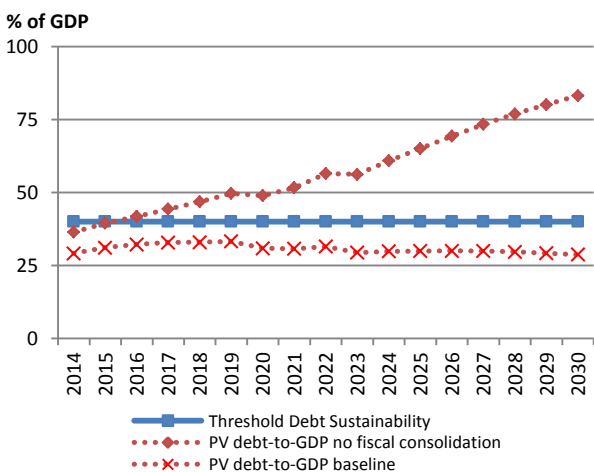


Source: IMF and IDA, 2014

Fiscal consolidation over the next few years will be necessary for debt to remain at sustainable levels.

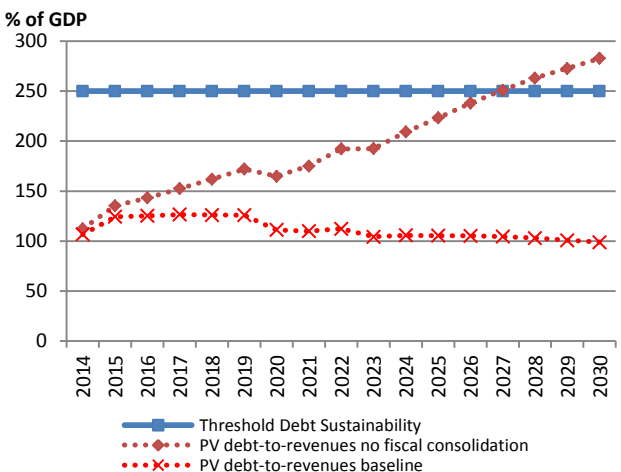
The analysis of Mozambique’s debt sustainability makes some crucial assumptions. It assumes relatively strong growth at 8 percent over the long term, partly the result of significant investments in infrastructure and growth in the mining sector as well as continued private investments to develop the gas sector. More importantly, it assumes a significant effort to tighten fiscal policy over the next 4-5 years, which would bring the public deficit to around 5 percent toward the end of the decade (from over 9 percent in 2014). This effort will be necessary for debt to remain sustainable. Failure to tighten fiscal policy over the next few years, simulated in the DSA by maintaining fiscal deficits at current high levels, would quickly lead to an unsustainable debt path as illustrated in the figures below.

Figure 37: Present value of Debt-to-GDP levels without fiscal consolidation



Source: IMF and IDA, 2014

Figure 38: Present value of Debt-to-Revenue levels without fiscal consolidation



Source: IMF and IDA, 2014

To better manage debt, the government developed and adopted in 2012 a Medium Term Debt Strategy which identifies concessional financing as the preferred option.

This strategy will help in guiding the financing of investment projects. The strategy clearly identifies concessional financing (multilateral as well as bilateral) as the preferred option for meeting any financing gap, followed by

domestic bond issuance and commercial external financing. The government sees the recourse to non-concessional credit as a way of financing public infrastructure investments in which the economic and social returns are higher than the financing costs. Issuance of domestic bonds is seen as both a way of financing the deficit as well as a means of promoting domestic savings and the growth and deepening of the local financial sector.

Current trends in external financing are not fully in line with preferences expressed in the Medium Term Debt Strategy. The preference for external concessional financing is based on the generally lower costs, larger maturity and lower interest rate risk than domestic debt. The financing mix seems to be changing quickly, as Mozambique increases access to commercial external borrowing which will both increase the costs and shorten the maturity of Mozambique's external debt. There is an apparent contradiction between the preferred financing modalities expressed in the Medium Term Debt Strategy and debt contracting since its adoption, with an increased reliance on commercial external financing, although this may be mainly reflecting limits on concessional financing available to the government.

3. Fiscal Risks

a. International Experience with fiscal risks

Fiscal risks seem to be on the rise in Mozambique. Mozambique is increasingly accessing non-concessional financing and using more sophisticated financing instruments (sovereign guarantees, international bond issuance, PPPs) to finance its ambitious public investment program. As revenues from natural resources increase, a larger share of the government's revenues will be highly volatile. These developments suggest higher fiscal risks going forward that will need to be managed.

Fiscal risks can arise from a variety of sources, such as government guarantees, PPPs or an unfunded social security system. Macroeconomic developments, e.g. sudden declines in growth, can lead to higher deficits or expenditure cut backs. Commodity producers that depend on commodity revenues are particularly exposed to commodity price cycles. Fiscal risks can also arise from contingent liabilities that countries incur. These contingent liabilities can be explicit or implicit. Explicit liabilities are obligations based on contracts or laws and they include guarantees, government insurance programs, spending related to climate-related disasters and reconstruction and indemnities. Implicit contingent liabilities are political or moral obligations, often arising from expectations of government intervention in the event of a crisis. These could include bailouts of public enterprises or the financing of their quasi-fiscal activities (like providing services below costs), bailouts of financial institutions and subnational governments. Public funding for environmental clean-up activities constitutes another contingent liability, which becomes particularly relevant for Mozambique as massive investments in the mining and gas sector take place. Social security obligations, whether explicit or implicit, has resulted in an accumulation of liabilities in many countries.

The fiscal costs of contingent liabilities can be significant once they materialize. Fiscal costs of financial system bailouts have for example averaged around 13 percent of GDP in some 40 crisis episodes from

1970-2007 (Laeven and Valencia, 2008), but have been much larger in a number of countries, such as Turkey (31 percent in 2001), Cote d'Ivoire (25 percent of GDP) or Argentina (55 percent of GDP in early 1980s). Estimates of the recapitalization of the Banco Comercial de Moçambique in Mozambique amounted to around 10 percent of GDP in the early 90s (World Bank, 2014a). Bailouts to state owned enterprises can also have significant fiscal costs, amounting to around 4 percent of GDP for an electricity utility (Indonesia), 1-5 percent of GDP for railways and metro (Colombia, Thailand) and 3 percent for water utility (Jordan).

Rapid increases in infrastructure investments often contribute to the accumulation of significant contingent liabilities. During the 1990s Colombia provided guarantees to a large number of PPPs as it embarked on a large infrastructure investment program. Many of these were triggered in a recession at the end of the decade, resulting in cumulative payments of 2 percent of GDP by 2004. Other countries that also suffered significant fiscal costs as economic crises triggered guarantees for infrastructure investments include Indonesia, Malaysia and Thailand in the aftermath of the Asian crisis in 1994/98 as well as Mexico and Pakistan (Cebotari et al., 2008, Polackova and Schick, 2002). Unfunded pension schemes can also represent significant long term fiscal risks. An assessment of Colombia's fiscal position estimated implicit pension liabilities worth 156 percent of GDP. This dwarfed an otherwise healthy fiscal stance with debt-to-GDP ratios of only 20 percent of GDP (Polackova and Schick, 2002). These developments led to a strengthening of fiscal risks management in Colombia as discussed in the box below.

Box 4: Fiscal Risks Management in Colombia

Colombia has effectively strengthened the disclosure and management of fiscal risks, following a fiscal crisis caused by the realization of some of the fiscal risks it incurred in the early nineties. In the late 1990s, fiscal risks contributed to fiscal imbalances, leading to an economic crisis and a worsening of Colombia's rating in debt markets. Following a period of instability, the authorities implemented reforms over a 15-year period to improve fiscal risk management, where Colombia is now considered to have a strong fiscal-institutional framework. The types of fiscal risks incurred, and the reforms undertaken, offer relevant lessons for Mozambique.

Sources of fiscal risks prior to the reform process

- *Contingent liabilities:* large state guarantees were granted for infrastructure related PPP projects. As demand was lower than projected, guarantees were called having a significant impact on fiscal outlays.
- *Central government fiscal balance:* public spending increased at a faster pace than revenues, resulting in a deteriorated fiscal balance. At the same time, there was increased borrowing at the subnational level, in some cases leading to insolvency.
- *Pension liabilities:* generous benefits and low contributions in a context of changing demographics contributed to an estimated unfunded pension liability of 200 percent of GDP in 2000.

Improvements to fiscal risk management after the reforms

- *Legal framework for disclosing fiscal risks:* in 2003 the Fiscal Transparency and Responsibility Law was passed, which required the medium-term fiscal framework to include an assessment of fiscal risks for the public sector. The document is public and requires parliamentary approval.
- *Integrating decisions on contingent liabilities in the budget process:* the cost of guarantees is being

internalized. Firstly, by estimating and publishing costs of guarantees, the incentive to use instruments that hide true fiscal costs compared with conventional expenditures is reduced. Secondly, the expected costs of guarantees for the forthcoming budget year are known in advance.

- *Valuation of contingent liabilities:* the Ministry of Finance (MoF) has developed a methodology for calculating contingent liabilities based on identification, assessment, management and monitoring of risks that may affect financial results of projects. This valuation includes PPPs, state guarantees, and non-explicit public debts associated with pension and severance liabilities.
- *Establishment of a contingency fund:* state entities, including SoEs and subnational governments, benefiting from guarantees must use MoF's methodology to estimate how much should be budgeted for contingent liabilities. This amount is paid into a Contingency Fund for State Entities for meeting future calls on state guarantees.

Sources: Salazar, 2014 and Cebotari, et. al, 2009

Despite the difficulty in doing so, many developing countries are estimating and publishing information on fiscal risks as a way to improve their management. It is often difficult to establish the size of the liability and quantify the likelihood that a risk materializes. Many countries publish little or no information on contingent liabilities. In some cases information may not be collected in a systematic manner, or if available countries may chose not to publish information on implicit liabilities (such as long term infrastructure contracts), since this could be seen as an assumption of the liability by the government and risk moral hazard. Despite these difficulties, some developing countries are making significant efforts to better manage fiscal risks, often driven by previous negative experiences (Chile, Colombia, South Africa, and Indonesia). Given the apparent increase in fiscal risks, it would be important for Mozambique to start monitoring fiscal risks in a comprehensive manner that facilitates its management.

b. Fiscal risks in Mozambique

Mozambique does not publish any information on fiscal risks in its budget documentation. Information that could inform a fiscal risks assessment is partly available (e.g. balance sheets for some public enterprises, infrastructure investments, state shareholdings in private companies), but it is not collected and collated in a systematic manner that would allow for a comprehensive assessment of fiscal risks. This seems to be a long standing information gap, already identified in the previous Public Expenditure Review (World Bank, 2001). To address this gap, the government could publish a fiscal risks statement, which could be added as an annex to the Cenário Fiscal de Médio Prazo and the national budget (see Box 5 below). Presently, it is very difficult to make a detailed assessment of fiscal risks in Mozambique. This section discusses briefly three potential sources of fiscal risks in Mozambique: state shareholdings in companies, public enterprises²⁵ and the current effort to scale up public infrastructure

²⁵ The Government of Mozambique owns shares in private corporations and owns 14 public enterprises. The 14 public enterprises are governed by Law 6/2012 on Public Enterprises. They are 100% owned by the state and are primarily active in the utilities sector. The Government also owns shares in private or public corporations, often holding majority ownership. These companies are governed by the same legislation as private corporations, although to improve management of its shareholdings the Government of Mozambique is preparing a law on the state's corporate sector.

investments. This is not necessarily an exhaustive list of fiscal risks in Mozambique and they may not represent the highest risks, but the discussion serves to illustrate potential risks using information readily available. For other types of fiscal risks, such as government guarantees or social security obligations, there is very limited information.

Box 5: A Proposed Fiscal Risks Statement for Mozambique

Macroeconomic Risks and Budget Sensitivity

Discussion of the macroeconomic forecasting record in recent years, and how the assumptions used in budget forecasts compare against actual outcomes. Sensitivity of aggregate revenues and expenditures to variations in each of the key economic assumptions on which the budget is based, such as the impact of exchange rates and growth estimations.

Public Debt

Sensitivity of public debt levels and debt servicing costs to variations in assumptions such as exchange rates and interest rates. A summary of the medium-term debt strategy, with projected debt in-flows, out-flows and balances. Details of loan repayments and non-performing loans should also be included.

Revenues from natural resources

Estimate revenues from natural resources, including payments from royalties. Volume and value of natural resources, as well as potential impact of price volatility.

Government Lending

Policy and institutional framework for government lending with projected inflows, outflows and balances.

Social Security Obligations

Civil service pensions: Level of government liabilities and how costs and risks will be managed. Other social security obligations: Legal framework governing relationship with the National Institute of Social Security and summary of recent financial performance.

Fiscal incentives

Main incentive schemes and foregone expenditures.

Contingent Liabilities

Guarantees: overall exposures to guarantees, e.g. for public enterprises at the central and subnational levels. Rationale and criteria for provision of guarantees; any non-repayment of guaranteed loans to be included. Public private partnerships: Summary of different PPPs, including multi-year obligations, and potential new PPPs to be undertaken. Exposure from guarantees and other contingent liabilities in PPP contracts should be included. Other contingent liabilities: A discussion on fiscal risks from climate related expenses or legal action against the government can be included.

State-Owned Enterprises

Policy framework for SoEs; financial performance of SoEs and state-owned banks.

Subnational Governments

Legal framework for intergovernmental fiscal relations. Summary of local government financial performance, particularly municipalities, which should include borrowing and other contingent liabilities related to municipal companies.

Source: Cebotari et. Al, 2009

There is little public information on the finances of companies in which the Government of Mozambique has shareholdings. The government has shares in 118 corporations. IGEPE is the government institute that manages the government's state shareholdings (except for public enterprises). In about one-fourth of these companies the state retains ownership of 50 percent or more (often 100 percent) of the shares. Shareholdings of the state in these companies are significant, amounting to 11 percent of GDP. There is no comprehensive information of the balance sheets of the companies in IGEPE's portfolio that would provide the necessary information to assess the financial health of these companies (partly) owned by the state, although some of the companies publish this information (*Telecomunicações de Moçambique, Banco Nacional de Investimento*). An annual report published by IGEPE includes information on the dividends paid to the government by these companies as well as the public expenses associated with their management. The information included in the audited state accounts (CGE) is limited to the shares that the government owns in these companies.

The exercise to clean-up the state's shareholding portfolio illustrates the potential fiscal risks of these types of operations. IGEPE has been over the past few years involved in an effort to restructure its investment portfolio, by selling shareholdings in many of the companies currently owned and retaining ownership in only a limited number of companies of strategic importance. This process often involves liquidating companies. As a shareholder, IGEPE bears a high share of the burden of liquidating companies, such as payment arrears, severance packages, etc. In some instances, these costs, assumed by the state, have represented over 100 percent of the capital of these companies. Public spending to assume the liabilities of these companies have been limited to date, amounting to US\$20 million from 2008-12. While it is not possible to assess the risk that liabilities of these companies pose to the state budget, and several of the companies in IGEPE's portfolio are highly profitable and unlikely to result in losses to the state, it would be important to have more detailed information on the financial health of the companies in which the government has majority ownership, which may pose potential future obligations to the state.

Financial information about several of the government's 14 public enterprises is difficult to access. The government fully owns 14 public enterprises, e.g. in communications, transport infrastructure, electricity or irrigation. As is the case with the companies managed by IGEPE, there is limited public information of the balance sheets of public enterprises, since the state accounts (*Conta Geral do Estado - CGE*) includes cash balances of these public enterprises, but it does not include information on their balance sheets, making an analysis of the fiscal risks they represent to the budget difficult. Some of these enterprises (*Electricidade de Moçambique, Empresa Nacional de Hidrocarbonetos, Caminhos de Ferro de Moçambique*) make their financial statements available online. Liabilities of these three companies alone amount to 10 percent of GDP, although the published information suggests that the companies are not excessively leveraged. However, many of these companies are actively seeking to mobilize additional financing and SOEs may be a key piece in the country's infrastructure investment strategy going forward, which will invariably result in increased leveraging by SOEs.

Outstanding loans of public enterprises and other public entities with the government amount to 7.5 percent of GDP, providing a sense of the type of fiscal risks that these companies could represent.

Public enterprises and other autonomous public bodies need authorization from MoF to borrow. Financing for public enterprises is often through loans to the Government of Mozambique that are then lent by MoF to the public enterprises. The CGE reports on loans by the central government to public enterprises, funds and other companies with state shareholdings. In 2012 outstanding loans by public enterprises to MoF amounted to 7.5 percent of GDP. Public enterprises often execute quasi-fiscal activities by providing services below market prices (which are partly subsidized by the state) or investing in infrastructure such as electrification, railways or roads. To better understand the type of fiscal risk that these companies' operations represent, it would be important to analyze the balance sheets of all public enterprises since the liabilities of these companies will be fully borne by the government. As importantly, to the extent they are providing essential public services, it is very unlikely that the government would let these companies fail.

The Government of Mozambique has significantly increased investments in infrastructure, resulting in a relatively high public investment level (one of the highest in Africa). Expansion of infrastructure networks is a key component of the government's growth and poverty alleviation agenda. Availability and reliability of infrastructure services are viewed as critical to private sector growth, and there are significant urban-rural disparities in access to basic infrastructure. The Council of Ministers approved in 2013 an Integrated Investment Program (*Programa Integrado de Investimento*–PII). The PII identifies some of the key development objectives to be achieved by infrastructure investments: (i) infrastructure that contributes to the country's integration and not exclusively the major infrastructure corridors that connect the hinterland countries with export markets; and (ii) infrastructure that allows Mozambique to maximize the benefits from mega projects, with particular attention paid to growth poles to be developed along development corridors.

The PII foresees an infrastructure investment program in the next few years that amounts to 130 percent of GDP, which will test Mozambique's financing capacity. The PII identifies key multi-year projects by sector that the government intends to implement in the medium term as well as a subset of projects with guaranteed financing, which are broadly ready to start implementation in the near future or have already started implementation. The projects which are already under implementation or with guaranteed financing, worth US\$20 billion, amount to 130 percent of GDP. Such a large investment portfolio would have fiscal implications for operation and maintenance going forward, with recent reports suggesting the need for O&M worth 33-50 percent of total infrastructure investment spending (World Economic Forum, 2014). The PII foresees significant financing through PPPs, which would transfer some of the risk to the private sector. The government, as a shareholder, will need to finance its portion of the multi-billion investments needed to develop the gas industry in the north. The size of the investment program will test the government's financing capacity, both in terms of investment and later on O&M. Such a large public investment portfolio has implications for the government's management capacity, as discussed in more detail in the chapter "Macroeconomic and Fiscal Developments".

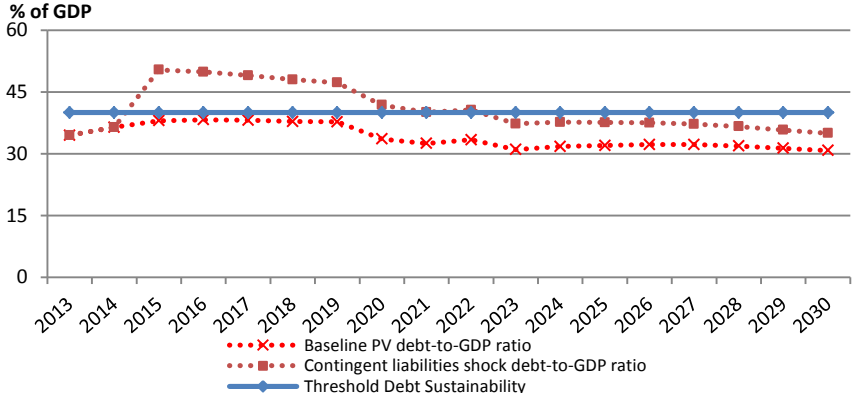
The government could seek to partner with the private sector to build and maintain infrastructures, sharing costs and risks with the private sector. As discussed in the chapter "Macroeconomic and Fiscal Developments", part of a strategy to reduce public spending while maintaining the ambitious

infrastructure investment program could be to seek a closer partnership with the private sector for investments that generate a significant financial return. This could be done through PPPs and providing a greater role for SOEs. Such a strategy would need to be accompanied with efforts to strengthen the government’s capacity to manage this, in particular any potential fiscal risks and contingent liabilities that may arise from collaboration with the private sector. An increase in fiscal risks from partnering with the private sector to implement the country’s ambitious infrastructure program could be off-set by reducing fiscal risks in other areas, for example by reconsidering the present portfolio of state participations in companies or by limiting government participation in investments that are financially viable (e.g. energy).

The realization of contingent liabilities, such as discussed in the previous paragraphs, would have a significant and long lasting impact on Mozambique’s debt levels. There is no comprehensive information on the level of contingent liabilities that Mozambique is accumulating. However, the information available suggests that fiscal risks are rising rapidly (guarantees, PPPs, long term contracts to build infrastructure and liabilities by public enterprises and state shareholdings).

An increase in debt levels by 15 percent due to the realization of contingent liabilities would bring debt to unsustainable levels for a prolonged period of time. There is limited information to allow for an accurate quantification of existing fiscal risks. The discussion in the paragraphs above, though, suggests that these are increasing and could be sizeable. It is possible to simulate the impact that contingent liabilities could have on debt sustainability in line with the discussion in the above paragraphs. The figure below simulates the impact of contingent liabilities as a 15 percent of GDP increase in debt levels in 2015. A shock of 15 percent of GDP would still be on the lower end of the type of fiscal shocks experienced by many countries. The simulation, comparing debt levels to the baseline used in the Debt Sustainability Analysis conducted in mid-2014, shows how the debt sustainability threshold would be breached and it would take almost a decade for debt levels to decline to more manageable levels again. This simulation does not take into account the likely increased financing costs of such an increase in debt levels.

Figure 39: Impact of contingent liabilities on debt sustainability



Source: World Bank Staff Estimates

This chapter discusses debt dynamics over the past decade and recommendations to better manage debt. Debt levels were declining or constant for most of the past decade. Over the past few years, however, they have increased, as a result of wider deficits caused by higher public investment and recurrent spending. Debt levels remain sustainable, although risks of debt distress have increased. Fiscal risks are also on the increase, although it is difficult to accurately estimate these given the lack of comprehensive information. The government may need to adopt a more conservative fiscal stance to lower debt levels and reduce vulnerability. An element of a more conservative fiscal stance could be to explore options for sharing risks and costs with the private sector for infrastructure investments. This would require a clear strategy to identify and manage the type of investments that could be implemented jointly with the private sector as well as efforts to strengthen government systems to manage the emerging fiscal risks. To improve the management of fiscal risks, the government should compile and analyze information on the types of contingent liabilities that the government is accumulating. This would be a first step toward a more comprehensive and systematic management of fiscal risks. Fiscal risks should also be included and discussed in budget documentation.

IV. Improving the Link between Plans and Budgets

Strong links between planning and budgeting are necessary to ensure that policy priorities are translated into government actions. The national budget is a key policy document (and some argue the most important) which details the approved allocation of public resources. Focusing on education and health sectors, this chapter argues that there is considerable scope to improve the integration of plans and the budget. Such improvements would depend on achieving a number of technical reforms, engaging a wider range of stakeholders in the reform processes, and pressure from civil society to enhance the policy focus of the budget.²⁶ Efforts to improve the links between planning and budget processes were already recommended in the previous Public Expenditure Review (World Bank, 2003), with some of the suggestions of the previous report like the adoption of the functional classification of expenses already implemented. Other recommendations, like the need to strengthen parliament's capacity to engage in budget discussions, continue to be relevant today.

1. A short context to public financial management reforms

Mozambique has made good progress on PFM reforms. The Public Expenditure and Financial Accountability (PEFA) assessments show considerable progress in public financial management reforms. In particular, progress has been achieved in the comprehensiveness of information included in the budget and improvements in tax administration. However, PEFA indicators related to policy-based budgeting show that there is significant scope for improvement. With regards to having a multi-year perspective in fiscal planning, expenditure policy and budgeting, Mozambique scores relatively low. Compared to peer-countries in Africa, Mozambique has made relatively good overall progress, forming part of the top-performing public financial management performance league (Andrews, 2010). Such progress demonstrates high-level commitment to public financial management reforms.

One of the challenges noted is that the PFM reforms have not been widely embedded across the government. Many of the good practices and laws adopted by institutional reformers at the central level, most notably in MoF and MPD, have not been broadly implemented within line ministries, SOEs, or at the provincial and district levels (Andrews, 2013). In this regard, it has been observed that scores in the PEFA assessment are higher where a few agents are responsible for making rules, and lower where multiple agents distributed across government are responsible for implementation. For example, in the PEFA assessment, the highest score is awarded for evaluating whether cash flows are forecast and monitored, but the lowest score is achieved for transparency and frequency of cash payments.

2. An Overview of Planning and Budgeting Processes

At the national level, there are a number of planning instruments, as well as sectoral strategies. Planning instruments include the 2025 Vision (a long-term plan with consensus from political parties and

²⁶ This chapter is based on work carried out in collaboration with researchers from the University of Eduardo Mondlane with the aim of promoting an informed dialogue between civil society and the government on how policies are implemented through the budget.

civil society), the National Development Strategy (a long-term plan focused on structural transformation), the five year government plan (the PQG, which is linked to the electoral cycle), the Poverty Reduction Strategy (the PARP, a medium term plan with a focus on poverty reduction largely aligned to the PQG), the Economic and Social Plan (the PES, which translates medium term priorities into annual activities), the medium term fiscal framework (the CFMP, which has medium term estimates of revenues and expenditures), and an Integrated Investment Plan (identifies key infrastructure investment projects). There are also a number of sector specific strategies and plans.

Plans are also produced at the provincial and district levels. Districts develop a five-year strategic development plan (Plano Estratégico Distrital de Desenvolvimento – PEDD). This multi-year plan is used to develop an annual operation plan and budget (Plano Económico Social e Orçamento Distrital – PESOD). The plans should have active local participation and be consistent with national planning strategies. As part of this bottom-up planning process, statistics are updated, for example on the number of new students, to assess sector needs. District annual operational plans are aggregated into a provincial level plan. These provincial and district plans are then incorporated in the PES.

Box 6: Potential Benefits of a Medium-term Approach to Planning and Budgeting

Since achieving development outcomes is a medium to long term process, many countries, including Mozambique are attempting to implement a multi-year approach to budgeting. Indeed, experience from other countries has shown that benefits of integrating plans and budgets over the medium-term can potentially enhance fiscal discipline, improve the allocation of resources to policy priorities, and promote efficiency in public spending.

The first stage in implementing a medium-term approach involves developing a medium-term fiscal framework, which specifies the aggregate resource envelope and the allocation of resources across spending agencies, providing a framework for budget decision-making. In developing countries, the ‘medium term’ aspect usually means using a three-year time horizon, with estimates for two outer years. In Mozambique, the *Cenário Fiscal de Medio Prazo – CFMP* has some elements of a medium-term fiscal framework as there is a multi-year resource envelop, but as discussed in section 3b in practice this is not well integrated with the annual budget process.

Having a robust medium-term fiscal framework is considered to be a first building block to implementing more advanced budgetary reforms, such as a medium-term budget framework, where the needs of spending agencies are considered. This stage involves spending agencies preparing budget proposals where resources are requested to meet sector objectives. There is then a process of reconciling the availability of resources (top-down estimates) with the requests of spending agencies (bottom-up needs). This process involves prioritizing the allocation of resources, and helps to strengthen the policy focus of the budget. Some countries go a step further by developing a programmatic approach to budgeting, where resources are allocated on the basis of expenditure programs. In Mozambique some aspects of the CFMP show an attempt to implement more advanced budgetary reforms, but as discussed below the budget proposals are not being effectively reconciled with resource availability.

The elaboration of the Medium-Term Fiscal Scenario paper, the *Cenário Fiscal de Medio Prazo – CFMP* effectively starts the annual budget process. Planning and budgeting is done on the basis of the territorial unit, i.e. at the provincial and district levels. The central government issues a budget limit to the provinces around February, which in practice is largely the same as the year before, as part of the elaboration of the CFMP. The province then distributes budget limits to provincial directorates and

districts based on central government guidelines (see chapter “Strengthening Sub-National Service Delivery”). Through the CFMP, budget limits are also communicated to central level spending agencies.

This territorial approach to planning and budgeting has some inputs from line ministries. In the case of education and health sectors, a national planning meeting is held where subnational sector priorities and spending needs, such as new recruitment, are discussed for each province. The line ministry is then responsible for approving these new sectoral spending needs. The sector presents these spending needs to MoF and the Ministry of Planning and Development (MPD) with the aim of influencing the budgetary limit for the province. Since the timeline for the submission of budget proposals is the same for the sector and the provincial level, in practice sectoral strategies are poorly integrated. An overview of the planning and budgeting process is presented below.

Table 8: Planning and budgeting process²⁷

Time	Process
Jan – Mar	Districts review plans and collect statistics to inform spending needs
Feb – Apr	The medium term fiscal framework (CFMP) is elaborated – initial budget limits are communicated and budget proposals are submitted for central government review
May 31st	The central government communicates the second budget limit and budget guidelines
Jun – Jul	Provincial and sectoral planning meetings are held
Aug	Budget proposals are submitted and consolidated for provinces, districts and sectors
Sept	The Economic and Social Plan (PES) and the budget (OE) are submitted to the Council of Ministers for approval by Sept 15 th , then to Parliament for approval by Sept 30 th
Dec 15	Final date for the approval of the PES and OE by Parliament

Source: World Bank Staff Compilation

CSOs have recently been engaging in planning and budgeting issues. In the post-independence period CSOs were largely engaged in direct service provision. The role of CSOs is gradually evolving and they are increasingly becoming engaged in monitoring budget implementation, expenditure tracking and conducting social audits. CSO engagement in budget processes is organized through a forum called the Budget Monitoring Forum (Forúm de Monitoria do Orçamento). When the proposed budget is presented to Parliament, the Committee of Planning and Budget seeks inputs from this CSO forum. A Development Observatory has been established, providing a platform for constructive dialogue between CSOs and the government with the objective of monitoring policy implementation.

3. Assessment of links between plans and budgets

A summary of the integration between the budget and plans is illustrated in the figures below, based on an adaptation from the analysis done by Sulemane, 2005. This section explores each of the aspects relevant for planning and budgeting with a focus on education and health.

²⁷ The budget year in Mozambique is the same as the calendar year, from January to December

Figure 40: The links between planning and budgeting in the education sector

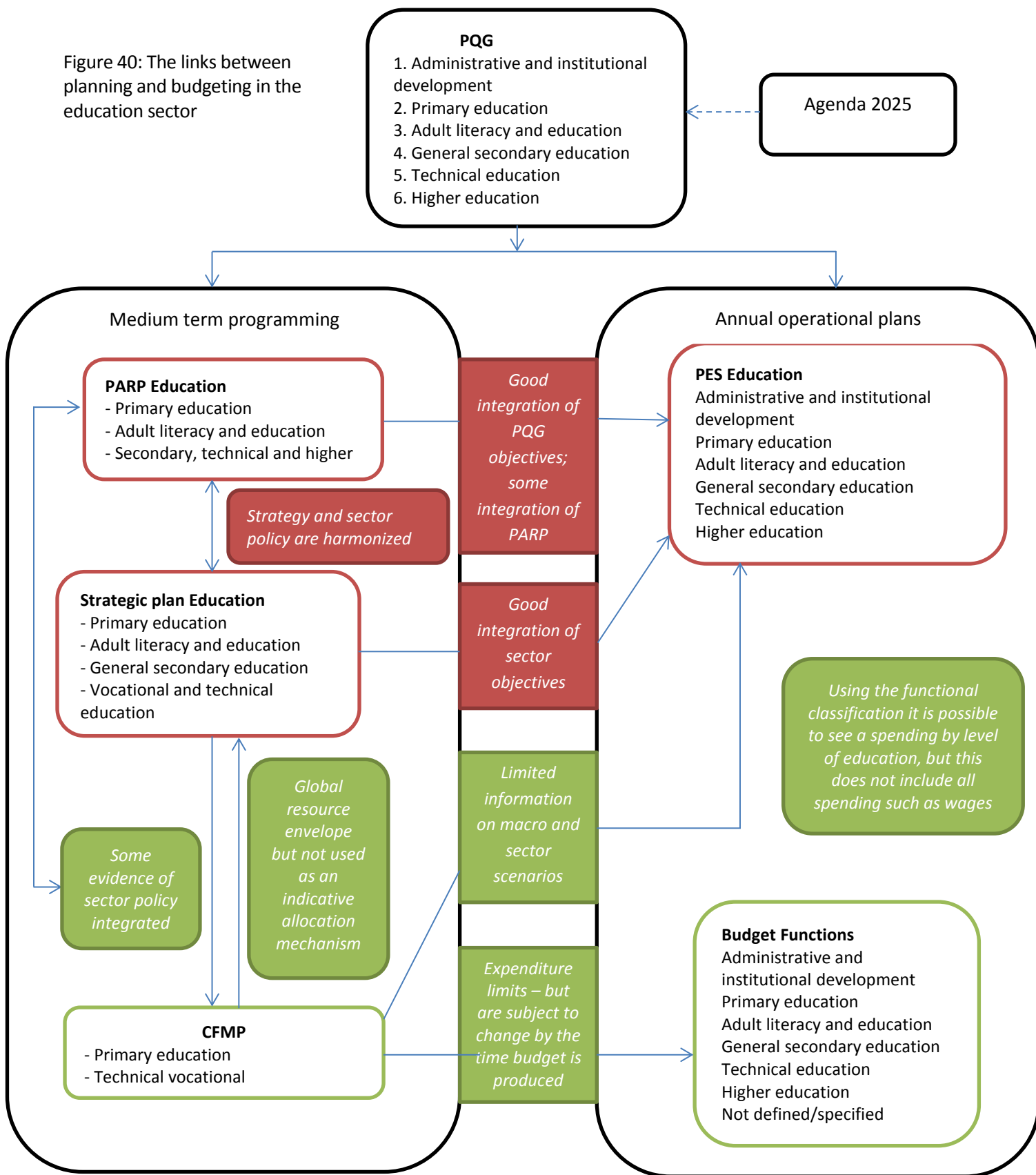
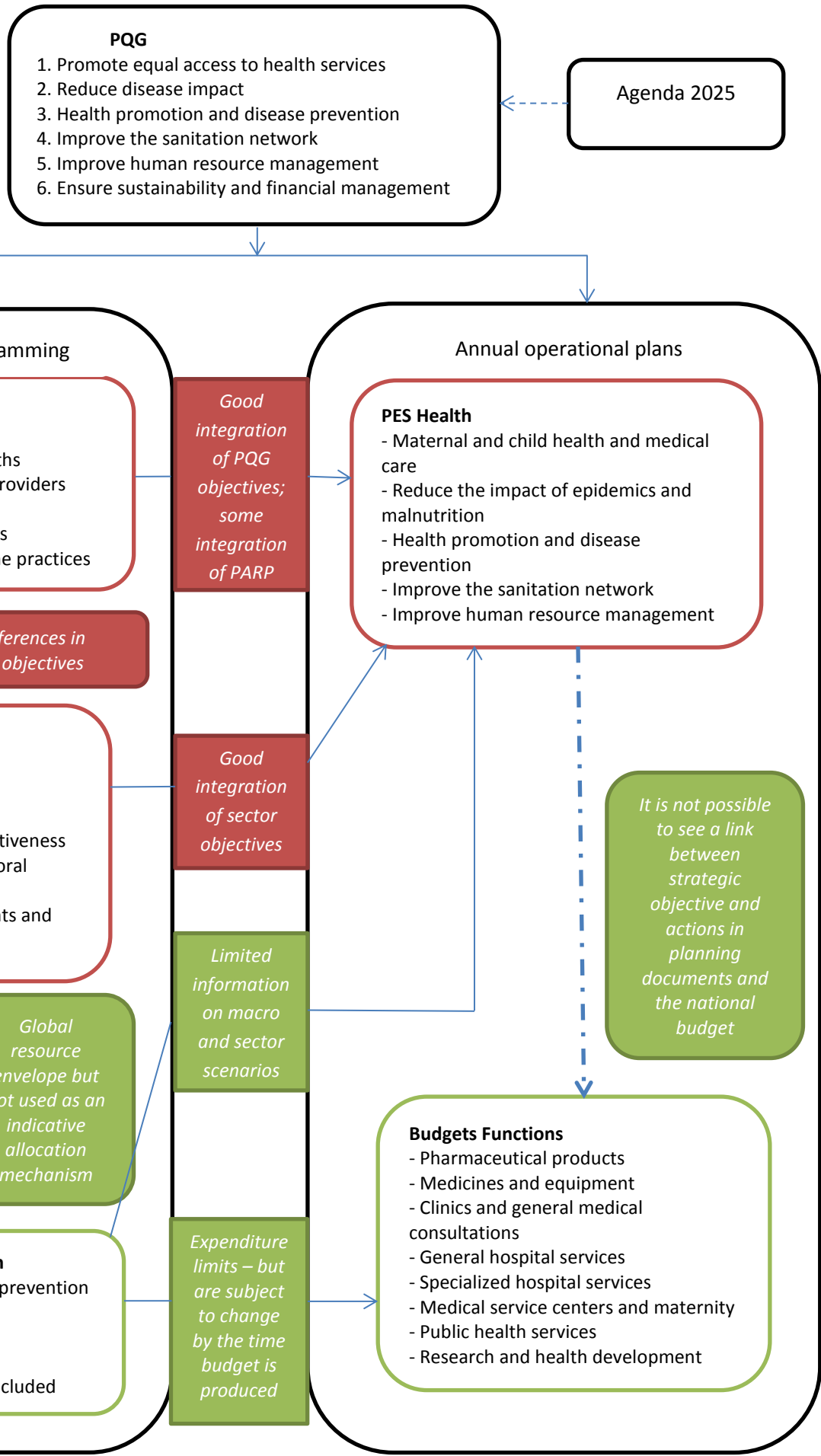


Figure 41: The links between planning and budgeting in the health sector



a. Planning instruments

In the education sector, the goals and objectives in different planning instruments are consistent and well-aligned. The PQG contains six education programs: administrative and institutional development, primary education, adult literacy and education, general secondary education, technical education and higher education. These objectives are consistent in the PARP and the education sector strategic plan. The PES goes one step further by defining the activities under each program. MoE has made a concerted effort to maintain the same program goals and objectives over different planning cycles.

In the health sector, there are multiple plans, and the alignment amongst these is slowly improving. While the terminology used in defining health programs and objectives is slightly different in the Health Sector Strategic Plan compared with multi-sectoral plans such as the PQG, the PARPA and the PES, the broad objectives are very similar. However, significant levels of resources in the health sector are channeled outside of the Single Treasury Account through donor financed projects which require separate processes. As a result, these off-budget expenditures contribute to parallel planning and coordination processes and lead to fragmentation in decision making over how resources should be allocated to priorities. In health, there are also a number of disease or intervention specific plans. In many cases implementation costs have not been estimated and funding sources have not been identified, making it difficult to prioritize different interventions. In an attempt to bridge the gap, the health sector recently completed the OneHealth Costing Tool, which estimates the total financing gap.

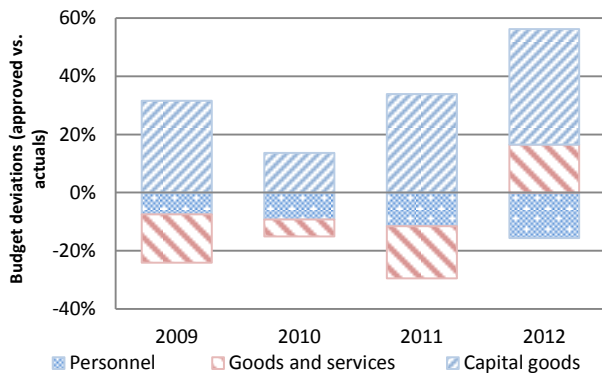
b. Role of the Cenário Fiscal de Medio Prazo

There is scope to improve how resources are estimated over the medium term. Estimations of the resource envelope are based on targets of revenue growth, rather than best estimates of collections. Experience has shown that the estimates are on the conservative side, where revenue collections actually perform better than anticipated. Information on grants is limited at the time the CFMP is prepared, meaning that the full scope of resources is not included. This situation is particularly problematic for the health sector, which receives significant support outside of the Single Treasury Account, from partners such as USAID and the Global Fund. At the deconcentrated level, the budget limits provided to the province do not indicate how much will go specifically to provincial sector directorates or district sector services. The allocation is dependent on the discretion of the Provincial Governor as opposed to clear allocation criteria.

Spending agencies submit budget proposals, but these are not being effectively reconciled with resource availability. The initial budget limits communicated are not considered as a hard budget constraint, since proposals prepared by spending agencies exceed the limits provided, and are then subjected to cuts. In the education sector, the cuts largely affect personnel costs, mostly related to overtime. The spending proposals are usually not well costed, but are rather based on a slight increase from the year before. In practice, the process of reconciling the budget proposals (the bottom up) with resources availability (top down) does not take place. As a result, there are number of adjustments to

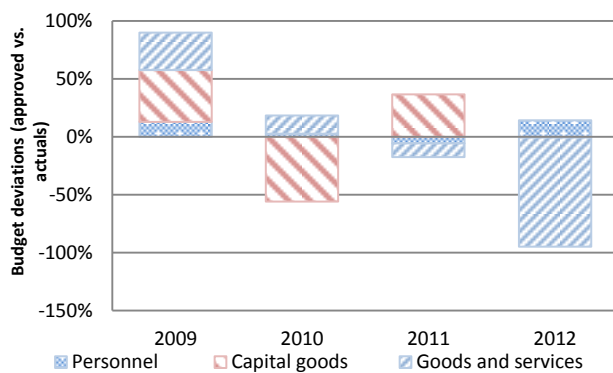
the budget during the year, which is when real prioritization of expenditure takes place. This results in significant differences between the approved and executed budget (see Figure 42 and Figure 43).

Figure 42: In education, there is overspending on personnel, and under spending on capital goods



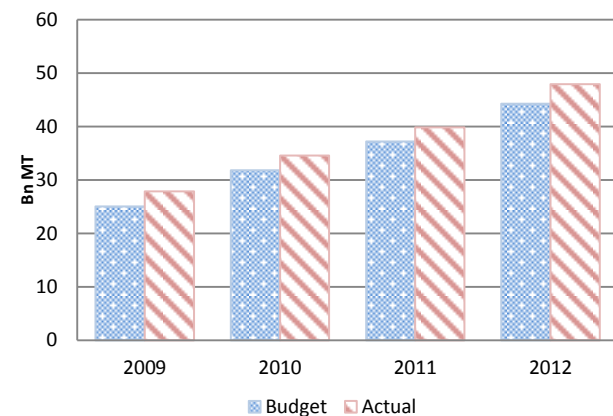
Source: Government of Mozambique

Figure 43: In health, there are considerable budget deviations, by type of expenditure and year



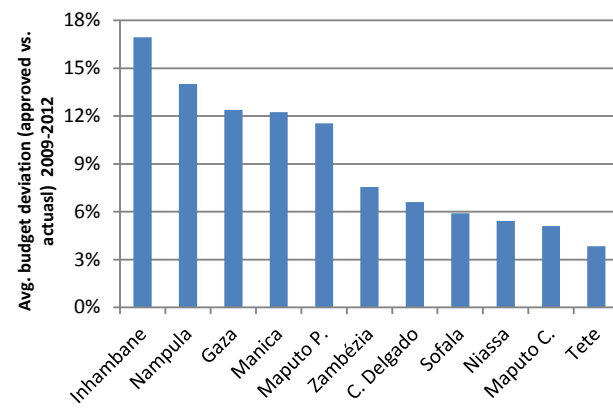
Source: Government of Mozambique

Figure 44: Spending at the deconcentrated level is always higher than planned



Source: Government of Mozambique

Figure 45: At the deconcentrated level, overspending varies significantly by province



Source: Government of Mozambique

c. The annual plan and the annual budget

While an operational plan (the PES) and the budget are both produced on an annual basis, it is challenging to assess how the budget is linked to policy objectives. The Economic and Social Plan (PES) provides an operational plan for activities to be undertaken under each program in the government's five-year plan, the PQG. However, this plan is not costed or well integrated with the budget. Reporting of the PES and the budget are done as two separate exercises. Reporting on the budget is done by the economic classification of expense, while reporting of the PES is done on the basis of activities completed under each program, making it difficult to assess how resources are allocated and spent according to policy priorities.

In the education sector, since the plan is not directly linked to the budget, a separate business plan is prepared to guide operations. Once the budget and the PES are approved, the sector prepares a business plan with detailed information on activities and costs, organized by programs and sub-programs. The business plan takes into account possible adjustments required to the PES in light of resource availability. This practice of developing a business plan fills an important gap in the disconnection between plans and budgets.

The publication of the final budget includes program-level information, but this is partial and is not reported on in budget execution reports. Following the attempts of MPD to introduce a program classification to the budget (known as POPs), information is available on how resources are allocated to expenditure programs, where the terminology is consistent with the overall objectives of the sector. However, the information does not cover the full scope of the budget and appears to be mainly for presentational purposes, as opposed to informing decisions on the allocation of resources. Information on the programmatic classification is only available in the approved budget and is not reported on during execution.

Different budget classification methods are in use, making it challenging to consistently determine how priority spending is defined, and how closely aligned the budget is with plans. For example, the government's definition of priority spending based on administrative units is evolving and there is arguably a case for improving how certain sectors are classified.²⁸ As part of the government's efforts to comply with the IMF's Government Finance Statistics standards, the functional classification of expense has been implemented (although there is scope for strengthening utilization), which shows the socioeconomic objectives that governments try to achieve through different kinds of outlays. This functional classification indicates the overall amount allocated to education and health, and specific areas within the sectors, but is not a substitute for the programmatic classification, which is related to country-specific policy objectives. As a result, it is currently challenging to accurately and consistently form an assessment of how priority spending is classified over time.

d. The role of non-government actors

There is considerable scope to strengthen non-government actors' engagement in planning and budgeting processes. Parliament approves the yearly plan (PES) and budget (OE) proposed by the government. The government is held accountable by parliament on progress both in the implementation of the PES and the OE. The Planning and Budgeting Commission in parliament is in charge of oversight of the government's plans and budgets. This commission is very active but it has limited means and capacity to carry out its duties (Umarji, 2011). The fact that parliament has seen absolute majorities by the party in government since 1994 has had implications for debates on government plans and budgets (Di Renzio, 2007). The role of CSOs in budget analysis is also limited,

²⁸ For example, in the government's methodology water is grouped with public works, and agriculture is grouped with MPD and the District Development Fund (FDD). Using this classification it would not be possible to determine that spending on water and agriculture are actually declining. This assessment is only possible using the functional classification of expense.

partly due to lack of technical capacity and reliance on external consultants to support the work. There is limited CSO representation at the provincial levels, meaning that most of the analysis is concentrated in the capital city. There is scope to improve how analysis by CSOs is used, since in practice Parliament does not usually request significant changes to the proposed budget. While the establishment of the Development Observatory is a useful initiative, this forum is largely for information sharing purposes, with minimal follow-up or discussion on how proposals from CSOs have been incorporated.

4. Improving the links between plans and budgets

To improve the policy orientation of the budget, the first step is to focus on strengthening the credibility of the annual budget, through promoting basic financial compliance. One of the key challenges observed in other countries that have introduced more advanced budgeting reforms such as a programmatic approach to budgeting is that this process helps to plan expenditures during the budget preparation phase, but is not necessarily used for managing and controlling expenditures during budget execution (Andrews, 2010). Therefore, before moving onto more advanced budgeting reforms it is important that the annual budgeting process is strengthened. This involves preparing a more realistic budget, where revenue forecasts are accurately based on a detailed analysis of tax bases and early submissions of donor commitments, as well as ensuring expenditures are fully costed. There also needs to be in-year control over spending, where commitments and cash are controlled and the budget is comprehensive with provisions for contingencies (Diamond, 2010).

The next stage would be to improve the macro framework of the CFMP. This would involve detailed analysis of revenue estimates, rather than a target based approach. Efforts should continue to encourage donors to provide information on estimates of grants that go through and off the Single Treasury Account. Currently, MPD and MoF both undertake the process of estimating medium-term resources. Instead, these efforts could be combined in an integrated macro forecasting unit. While MoF and MPD do work closely together on the development of the CFMP, there is still scope to enhance coordination. To improve the relevance of the CFMP the possibility of sending the document to Parliament as a framework for making budget decisions should be considered.

There is considerable scope to build capacity of sector's cost estimates. This would involve fully costing expenditures, including expected recurrent costs of new investments. Sectors would then submit budget proposals within the budget limit provided by MPD and MoF, based on the actual costs of service provision. Suggestions for how the planning and budgeting process can be simplified at the subnational level are discussed in the chapter "Strengthening Sub-National Service Delivery", which should be combined with efforts to build public financial management capacity at the local level.

Once the building blocks have been established, program based budgeting could be gradually phased in. Given that MPD already started program-based budgeting in 2009, further efforts could build on the existing work. The current classification structure could be simplified. Key issues in implementing program-based budgeting in Mozambique, include defining sectors and priority areas, and who the

budget holders of expenditure programs will be. These are important technical issues to address, where consensus will need to be reached among a wide range of actors involved in implementing reforms.

As an interim measure, steps could be taken to enhance the alignment of the PES and the budget, as the two operational documents guiding planning and budgeting. The PES could be submitted as an annex to the budget. At the time of preparing the PES, spending agencies are provided with templates on how to cost the different programs and activities, which could also be published in the PES.

Where significant sectoral resources from development partners are channeled off the Single Treasury Account (CUT), efforts should continue to improve how government systems and processes can be used. It is possible for projects that are off CUT to also be on-budget, because government systems and processes are used for reporting the execution of expenditures. Similarly, there could be further efforts to use government systems for planning and budgeting off-budget expenditures, where decision making processes are harmonized around the budget calendar. These efforts would help to reduce the effect of parallel processes from large projects funded outside of the CUT.

The nature of CSO engagement in planning and budgeting processes can be strengthened. Being able to actively assess whether the budget is policy focused, and to monitor its implementation largely depends on how transparent and accessible planning and budgeting documents are. One related and positive example is CSO engagement around the Extractive Industries and Transparency Process. CSOs have promoted public debate around revenues and payments from extractive industries, and have been involved in the revision of the fiscal regime for mining and petroleum. There is also further scope to improve the CSOs analytical capacity and advocacy coordination, for example through continued work with organizations experienced in this area, such as the International Budget Partnership. Ultimately, pressure from citizens to see improved service delivery and more inclusive growth, should motivate policy-makers to explain better how public resources are delivering policies.

The national budget is arguably one of the most important policy documents, but it is challenging to determine how resources are allocated to policy priorities. An analysis of the links between plans and budgets in the education and health sectors suggests that there is considerable scope to improve the integration between plans and budget. On the planning side, the formulation of strategic objectives is generally well-aligned across different policy documents in the education sector. In the health sector the alignment is improving but the significant levels of resources channeled outside of government systems contributes to parallel planning processes. The process of revenue forecasting (including donor resources) needs to be improved, and so does the estimation of costs in the preparation of budget proposals. The PES costing should be published and integrated with the budget. A number of reforms would improve the policy orientation of the budget, including capacity building to develop sectoral cost estimates, followed by expenditure planning based on programs which could be gradually phased in. Efforts should continue to improve how development partners can use government systems and processes.

V. Sectoral Expenditure Trends

This chapter assesses trends in public spending in priority sectors considered to be crucial for poverty reduction and inclusive growth. The scope of the analysis includes human development (education, health and water), as well as priorities that are important for inclusive growth and shared prosperity (agriculture, infrastructure and social protection).²⁹ Priority sector spending is measured using the functional classification of expense as this provides a detailed classification of functions or socioeconomic objectives that government units aim to achieve through different kinds of outlays.³⁰ A range of data sources are used, including existing sector public expenditure reviews, sector specific studies, or information provided directly by line ministries. Household consumption data is taken from the household budget survey 2008-09. Detailed financial data from the integrated financial management information system (known locally as e-SISTAFE) were used to construct a data tool, called BOOST.³¹ The analysis covers 2009 to 2012 as data from e-SISTAFE are available and the state accounts have been audited for this period.

The overall assessment suggests that there is room to improve the pro-poor orientation of public spending, through a focus on access to public services by the poor, as well as the efficiency of public spending. The assessment carried out suggests that the wealthier segments of the population benefit most from public spending in a number of areas (education, health, water), suggesting there is room for improving the pro-poor orientation of the budget. Comparison of spending and development outcomes with peer countries also suggests that there is considerable room to improving outcomes given spending levels. A review of previous analysis conducted by the Bank (World Bank, 2003) suggests that some progress has been made (e.g. on the need to increase domestic investment on health or the need to improve access to primary education) but also that significant challenges remain. The scope of the chapter does not aim to address in-depth questions on sector efficiency and effectiveness, but rather to provide a broad overview, which may lead to further areas of research.

1. Allocation of public resources

a. Overall allocation of resources

The largest share of public spending is allocated towards four key functions, including general public services, education, economic affairs and health. Economic affairs include areas such as agriculture, infrastructure, and energy. General public services include areas such as legislative and executive organs, basic research and public debt transactions. Table 9 below shows government spending by

²⁹ The government also identifies governance and the Millennium Challenge Corporation as being 'pro-poor' but analysis of these priorities is beyond the scope of this chapter.

³⁰ Program-based budgeting would have been the ideal type of budget classification to use for analysis in this chapter, but this has not been fully developed. MoF's methodology for calculating priority spending is not being used, as this is mainly based on administrative units, which may lead to spending towards a specific policy objective being under or over-estimated.

³¹ The BOOST has information on the approved budget and expenditure data for recurrent and investment spending (internally and externally financed), but does not have data on financial operations, which includes debt repayments and lending to SOEs. Further information on the BOOST initiative can be found on: <http://wbi.worldbank.org/boost/boost-initiative>

function, while Table 10 shows the distribution of all public spending, including resources that do not go through government systems. The inclusion of these resources shows a significant increase in financing for economic affairs (specifically to the infrastructure component) and to health.

Table 9: Government of Mozambique expenditure by function (billion MT)

	2009	2010	2011	2012
General Public Services	23.7	28.5	34.0	38.2
Defense	2.3	2.8	3.6	4.6
Security and Public Order	5.7	6.8	7.8	10.0
Economic Affairs	13.6	22.2	22.4	21.4
Environmental Protection	0.7	0.4	1.2	1.2
Collective Housing and Development	3.1	6.1	6.6	8.8
Health	7.4	8.1	9.4	15.6
Recreation, Culture and Religion	0.8	1.3	4.5	1.9
Education	16.6	20.5	23.9	26.7
Security and Social Action	5.4	6.4	8.5	8.9
Total	79.1	103.0	122.0	137.3

Source: Government of Mozambique

Table 10: Expenditure by function via and off-CUT (billion MT)

	2009	2010	2011	2012
General Public Services	31.1	34.0	39.5	43.9
Defense	2.3	2.8	3.6	4.6
Security and Public Order	5.8	6.9	7.8	10.1
Economic Affairs	18.9	27.9	27.5	32.6
Environmental Protection	0.9	0.6	1.7	1.5
Collective Housing and Development	6.8	8.9	8.4	10.2
Health	9.7	14.7	17.7	24.4
Recreation, Culture and Religion	0.9	1.4	4.6	1.9
Education	20.1	22.7	26.1	28.2
Security and Social Action	5.8	6.6	8.8	9.0
Total	102.2	126.6	145.6	166.5

Source: Government of Mozambique and ODAMOZ

b. Resource allocation to policy priorities

There has been a steady increase in priority sector spending. Sectors that have an increase in spending as a proportion of GDP include education, health and infrastructure. Notably, health spending increased significantly from 2.6 percent of GDP in 2011 to 3.9 percent of GDP in 2012. On the other hand, sectors such as agriculture and water show a slight decline in spending as a proportion of GDP. In nominal terms there are significant changes to expenditures year on year, particularly in sectors such as health, water and agriculture. Such variations are largely due to changes in donor financing. These trends have implications for consistency in levels of service provision, highlighting some of the risks of dependence

on external resources. When resources from development partners that are channeled outside of government systems are also included, health and agriculture spending increases.

Figure 46: The functional classification shows a steady increase in priority sector spending

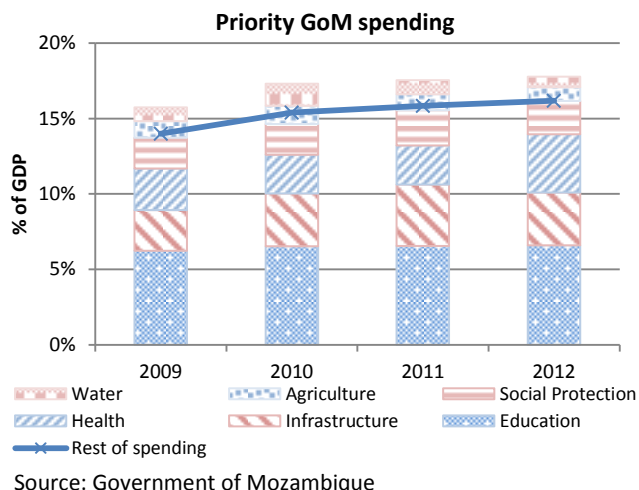
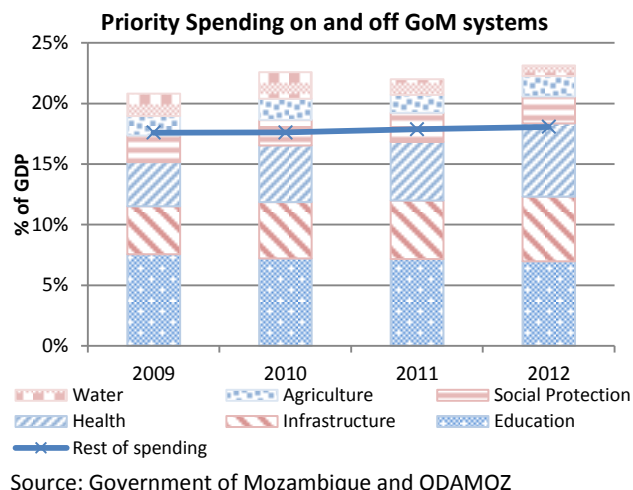


Figure 47: Including donor resources off-government systems shows a large increase in health spending



c. Allocation within policy priorities

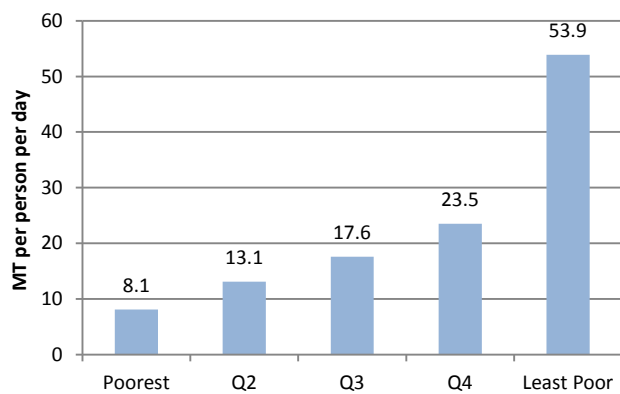
The analysis in the remainder of the chapter considers the following aspects at the sectoral level: (i) performance in relation to key policy objectives; (ii) the link between policy priorities and resource allocation; (iii) whether the poor are accessing public services and the extent to which resource allocation is pro-poor; (iv) how resources are allocated to different sectoral priorities; (v) the composition of public spending; and, finally (vi) key reforms for the sector.

To understand whether resource allocation is pro-poor, benefit incidence analysis is applied to the human development sectors. The analysis suggests that access to basic public services continues to be a constraint for the poorer sections of the population. The analysis uses household consumption data, as is commonly used in low income countries to measure poverty. Household consumption expenditure data proxy for household income and are collected in household budget surveys. This chapter uses consumption data from the Household Budget Survey (*Inquérito Orçamento Familiar - IOF*) 2008-09 to rank the population from poorest to richest. The population is then divided in five quintiles. The first quintile contains the poorest 20 percent of the population; the second quintile contains the second poorest 20 percent, and so on; the fifth quintile contains the richest (or the least poor) 20 percent of the population.

Data used for the benefit incidence analysis suggests that although there are significant income differences across quintiles, income levels remain relatively low even in the richest quintile. These data show that in the least poor quintile (quintile 5) the daily average income per person is MT53.89 , equivalent to approximately US\$ 1.78, compared with an average income of MT8.11 for the poorest quintile (Figure 48), amounting to just US\$ 0.27, while the official poverty line for Mozambique was

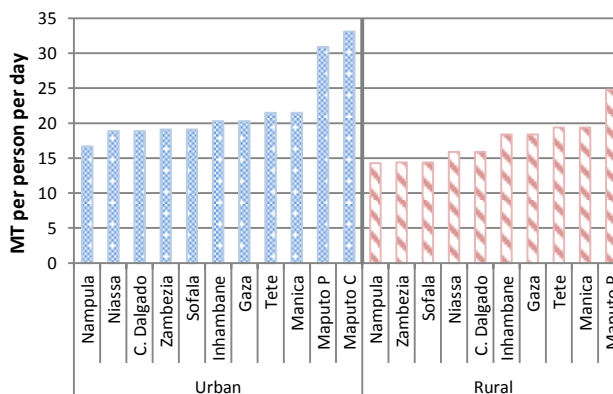
estimated at 16.4 MT in rural areas and 23.1 MT in urban areas, with considerable differences between provinces (Figure 49). This shows that while those in the top quintile earn considerably more than those in the first quintile, even the population in quintile 5 lives on less than US\$ 2 a day, on average.

Figure 48: Average consumption per quintile



Source: Government of Mozambique and World Bank Staff Estimates

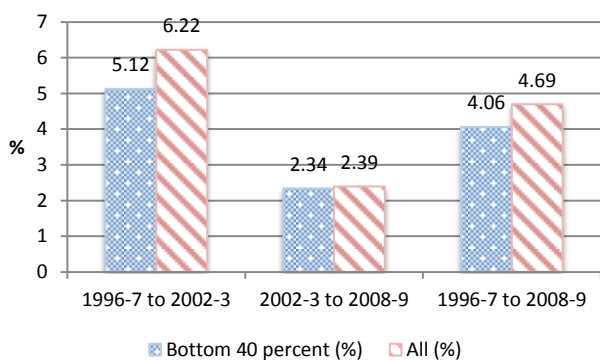
Figure 49: Official poverty lines in IOF 2008-09



Source: Government of Mozambique

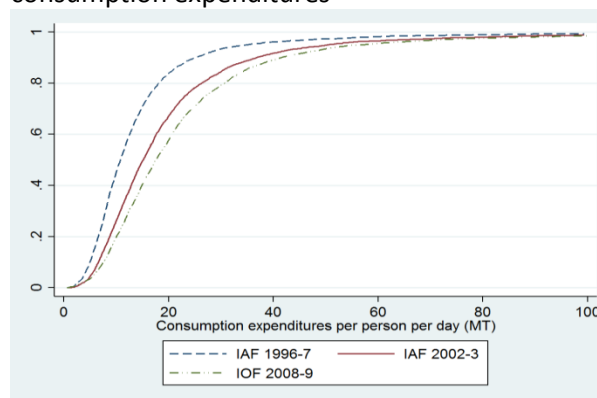
Growth in consumption patterns suggests that the bottom 40 percent of the population have benefited less from growth than the overall population. Between 1996-97 and 2008-09 average consumption of the bottom 40 percent of the population grew by 4.0 percent per year, while that of the total population grew by 4.7 per year. The gap in consumption growth between the bottom 40 percent and the total population was significantly larger between 1996-97 and 2002-03, but in the latter period consumption growth more than halved for all. The urban population has also grown. While in 1996-97 20 percent of the population lived in urban areas, the share had grown to over 30 percent by 2008-09. A better understanding of demographic and income distribution trends over time can inform expenditure analysis, e.g. whether the emergence of a large urban middle class has implications for government priorities. The trends discussed, although significant, do not suggest dramatic changes that could explain major shifts in government attention and spending patterns.

Figure 50: Annual average growth rate of per capita consumption



Source: IOF and World Bank Staff Estimates

Figure 51: Cumulative distribution function of consumption expenditures



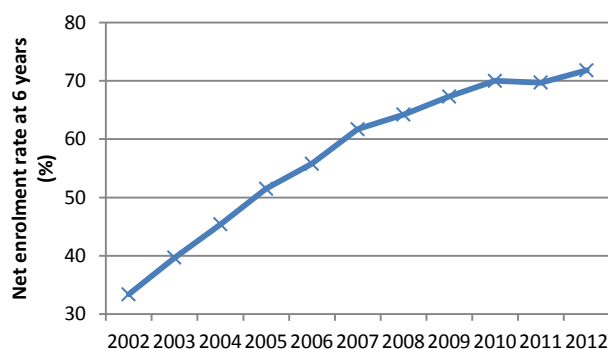
Source: IOF and World Bank Staff Estimates

2. Education

a. Performance on education policy objectives

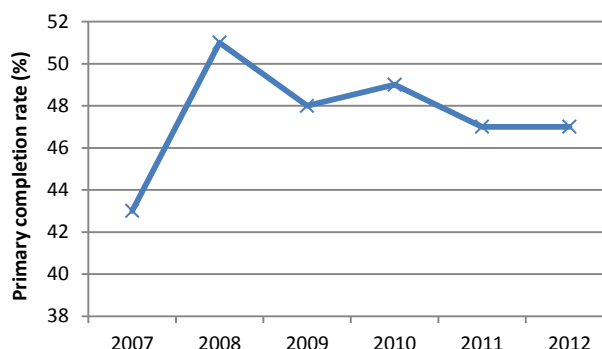
Mozambique has made progress in improving education outcomes, but this achievement needs to be sustained and improved. Sector priorities are: (i) ensuring inclusion and equity in access to and retention in school; (ii) improving student learning; and (iii) assuring good governance of the system (Education Strategic Plan 2012-2016, 2012). Within these broad priorities, special emphasis is placed on universal primary education, focusing on literacy and numeracy. Both primary and secondary enrollment rates are improving, and are notably high for primary education.³² However, more recently progress has tailed off for primary completion rates, as a result of low promotion rates during 2007-2010. Primary completion rates are expected to improve from 2016 onwards based on improvements in promotion rates since 2011.³³ There are also concerns on the overall quality of education. Compared with peer countries, performance in primary education is around average, while secondary education completion rates are well below regional peers. Assessing performance against policy objectives is largely based on intermediate outcome indicators, as publicly available data on outcomes or impact is not readily available.

Figure 52: There are consistent and gradual improvements to net enrolment rates for the lowest grades



Source: MoE

Figure 53: The primary completion rate has improved overall, although there is a recent decline in performance

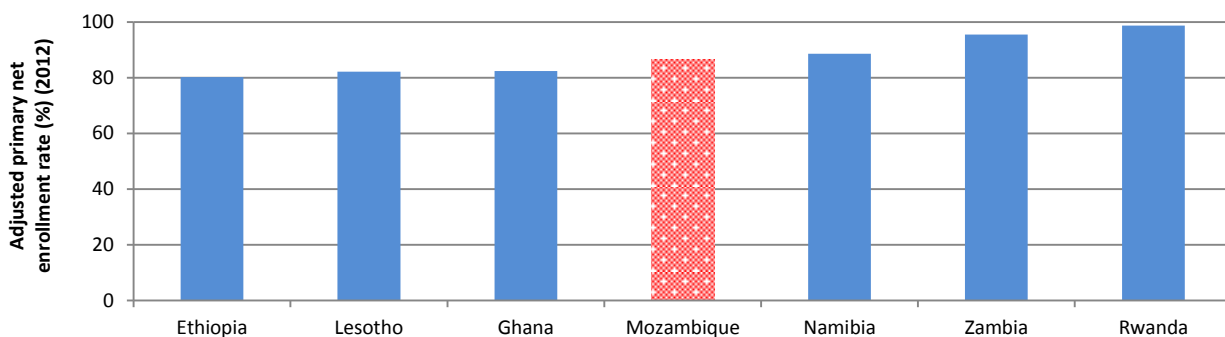


Source: MoE

³² The data in this figure comes from MoE in Mozambique and the definition used is the number of students who actually pass the exam at the end of primary schooling (7th grade)

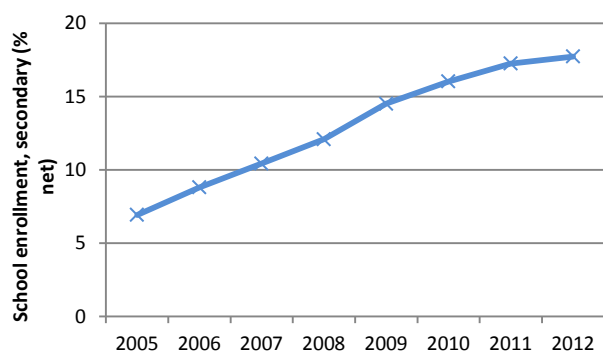
³³ When comparing Mozambique with other countries in sub-Saharan Africa the international definition for primary completion rates is used as the number of students enrolled in the last year of primary at the beginning of the school year. These differences in definition explain why the primary school enrolment rate in Figure 53 is different to Figure 59

Figure 54: Compared to peers, Mozambique’s primary net enrollment is around average



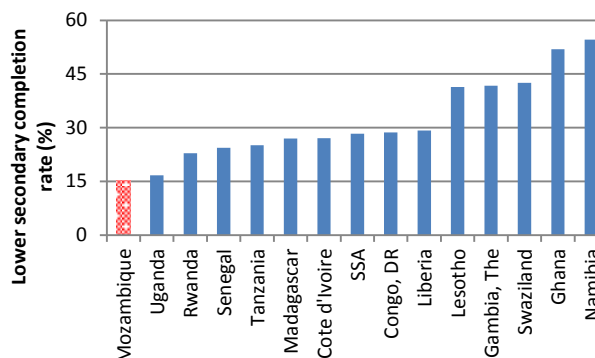
Source: World Development Indicators, 2012

Figure 55: There are steady improvements in secondary enrollment rates



Source: World Development Indicators

Figure 56: But secondary education completion rates are far below peer countries



Source: World Development Indicators, 2012

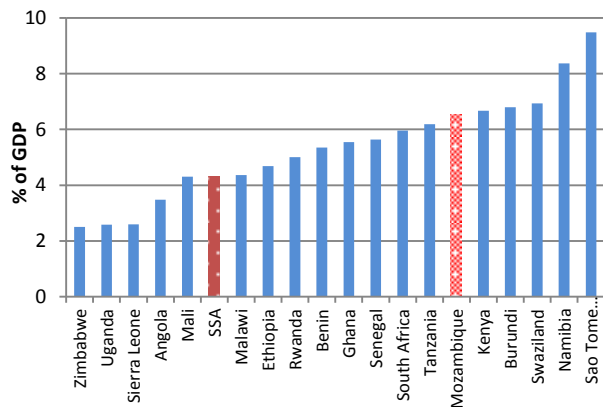
b. Link between policy priorities and resource allocation

For the amount that Mozambique spends on education, primary completion rates are around average. Mozambique’s spending on education as a share of GDP is relatively high. Spending on education in per capita terms is below the average for sub-Saharan Africa, but is still higher than a number of other countries in the region. There is significant variation in performance for a given spending level and many countries spending at levels similar to Mozambique achieve better development outcomes. This finding suggests that educational outcomes could be improved if current levels of public spending were used more efficiently. Increased funding could also improve outcomes but funding would translate into improved outcomes only over the medium to long term.

There are different options for improving the efficiency of spending. Firstly, the role of school councils and school management could be progressively strengthened to enhance governance. Presently, school councils are mostly involved in school grants, and experience has shown this is working well. The scope of intervention of school councils could be widened significantly over time and at relatively low cost to ensure monitoring of a range of school level activities, such as textbook delivery, teacher presence, and implementation of school construction and renovation projects. Secondly, there is a case for reviewing

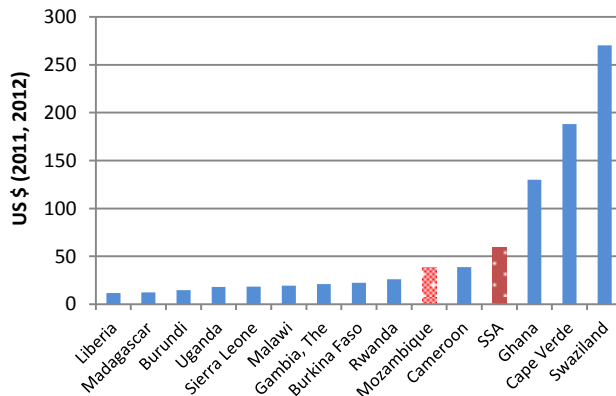
procurement mechanisms, where in some cases local procurement would be more appropriate than centralized processes, and could result in reduced costs and increased contextual relevance.

Figure 57: Education spending levels in Mozambique as a proportion of GDP are one of the highest



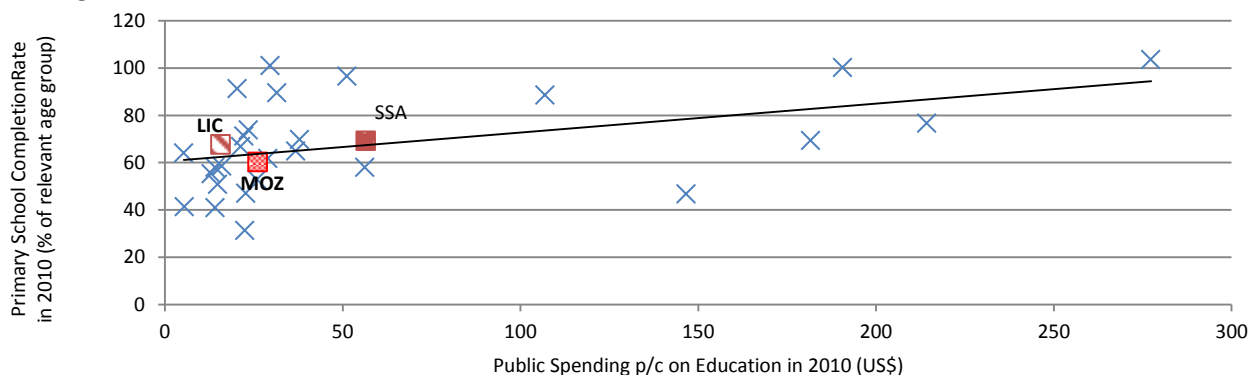
Source: World Development Indicators, 2010

Figure 58: But in per capita terms spending is on par with a number of countries in the region



Source: World Development Indicators

Figure 59: For the amount that Mozambique spends on education, primary completion rates are around average

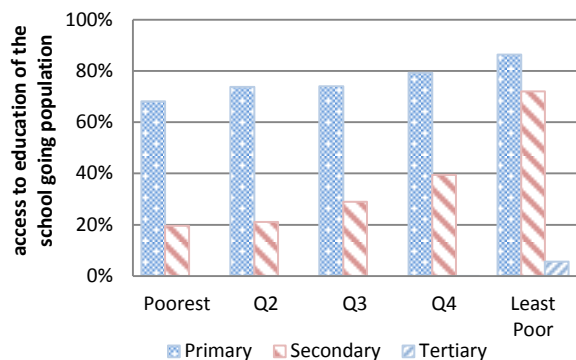


Source: World Development Indicators

c. Resource allocation on services accessed by the poor

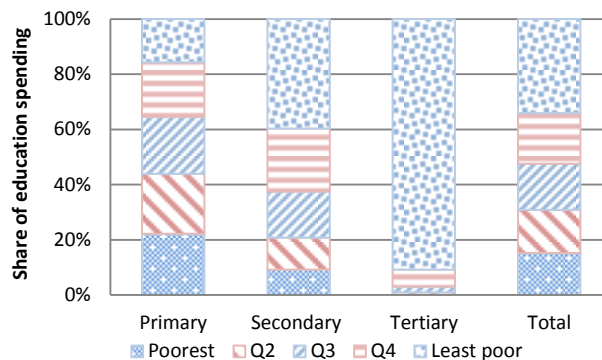
Access to education increases with income, particularly for higher education levels. For the school going population, access to education increases with income. In the poorest income category, only 68 percent of the primary school age population actually attends primary school, and only 20 percent of the poorest secondary school age population attends secondary school. In terms of actual numbers of students accessing public education services, the least poor income category has the highest number of secondary and tertiary students, and similar numbers of primary students compared with other income groups. As a result, the least poor income group benefits the most from public spending on education (which includes salaries).

Figure 60: Access to education increases with income



Source: World Bank staff calculations using data from the IOF 2008-09

Figure 61: Spending on primary education broadly benefits all income groups, unlike tertiary education...

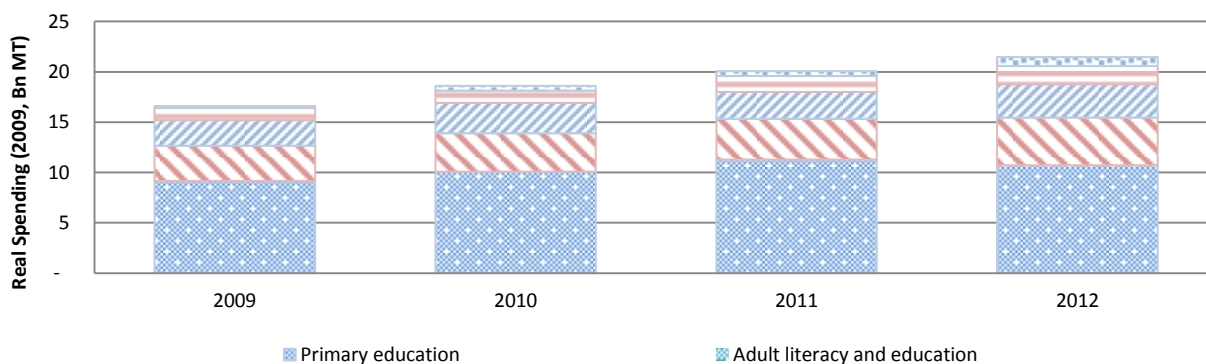


Source: World Bank staff calculations using data from the IOF 2008-09, BOOST and MoE

d. Resource allocation within education

The largest share of spending is allocated towards primary education, followed by secondary education, and this distribution is in line with policy priorities. As a result of recent reforms in the education sector it is broadly possible to see how resources are allocated to policy priorities, although a large share of resources are still ‘unspecified.’³⁴ Only nominal amounts are allocated to adult literacy, and a small share goes towards vocational and technical education. The largest share of spending goes to primary education which benefits all income groups. Increasing the number of children within the poorest quintiles accessing education, while ensuring quality services are provided remains a challenge.

Figure 62: Over time, the largest share of spending is consistently allocated to primary education

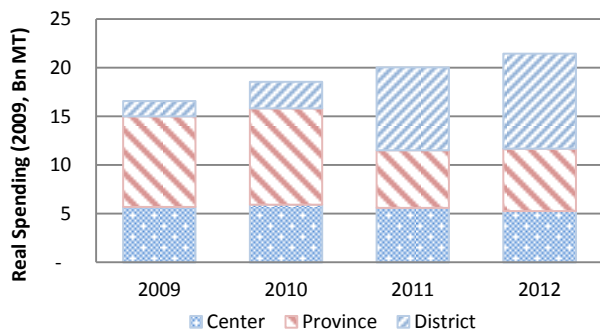


Source: World Bank staff calculations using data from MoE and the Government of Mozambique

³⁴World Bank staff estimated spending on primary education. Data in the BOOST shows that in 50.2 percent of education expenditures are ‘not defined by level or are not specified’ of which 92 percent is spent on personnel. Using data from MoE on the number of teachers by qualification and salary scales, World Bank staff has estimated distribution of ‘spending not defined by level / not specified’ by primary and secondary education. The assumptions used are that teachers with qualifications in N1 and N2 categories are teaching secondary, and N3, N4, and N5 are teaching primary, although it is recognized that some teachers in the N3 category may also be teaching secondary education.

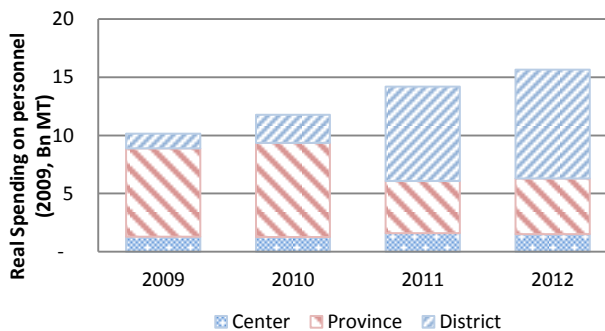
The education sector has been embarking on deconcentration reforms that are reflected in an increased proportion of spending at the district level. This increased district level spending is largely due to greater personnel payments at the district level, partly reflecting a transfer in salary payments from the provincial to district level in 2011 and 2012.

Figure 63: Deconcentration means increasing levels of district expenditures



Source: Government of Mozambique

Figure 64: This is largely reflected in increased spending on personnel



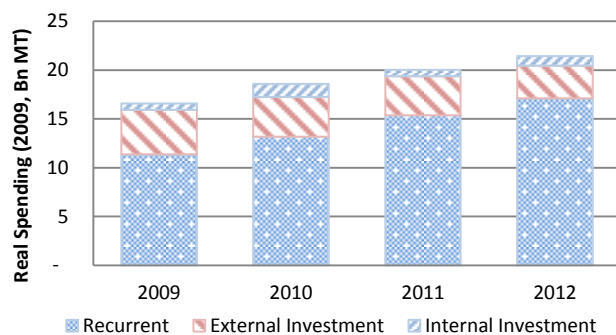
Source: Government of Mozambique

e. Composition of resource allocation

Over the past few years there has been a constant increase in current spending, led by increasing personnel costs, while investment spending has declined. This trend suggests a potential crowding out of investments, which can affect the development of social service infrastructure in provinces that are currently underserved. Spending on personnel is mainly on teaching staff to improve the student-teacher ratio, which has been steadily progressing from 72 in 2008 to 63 in 2011 (see figure below). However, an average ratio of 63 students per teacher is still too high to promote quality learning, and is significantly higher than the sub-Saharan average of 41 (WDI and MoE).

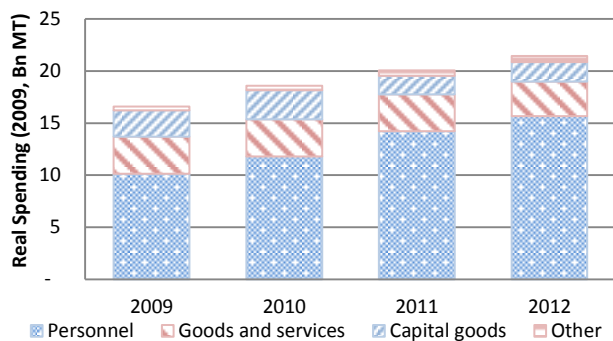
Overall, recruitment in the education sector favors teaching staff. Given the limited allocations of new civil servants each year (to reduce pressure on the overall wage bill) teaching staff are being prioritized in the education sector over non-teaching or administrative staff, but a consequence is that the lack of support staff is affecting the quality of school management. Overall, there are still large disparities in the student-teacher ratio, where Zambezia, Tete, Sofala and Nampula provinces have considerably higher student-teacher ratios compared with provinces such as Gaza and Inhambane.

Figure 65: The education budget is largely used for current spending...



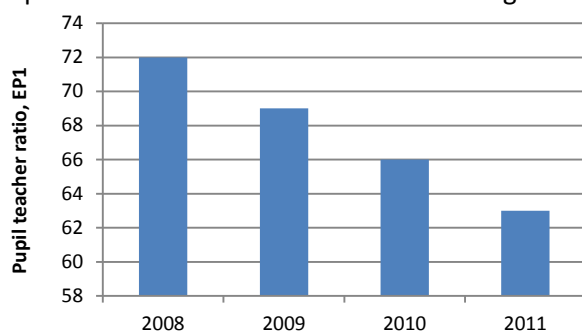
Source: Government of Mozambique

Figure 66: ...Which reflects high levels of spending on personnel



Source: Government of Mozambique

Figure 67: There are steady improvements to the pupil-teacher ratio but the ratio is still too high



Source: Ministry of Education (2012)

f. Key areas for reform

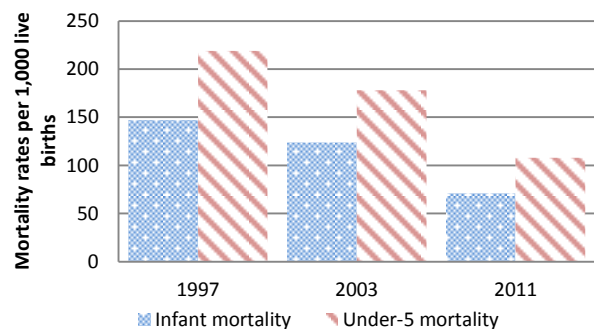
There are some important reforms that the sector can undertake to improve performance. MoE has engaged in reforms to improve the quality of education such as strengthening pre-service training for teachers and school directors, but the pace of implementation is too slow to have a significant impact in the short term. To address these capacity gaps, providing frequent and pragmatic in-service training is important. The implementation of school councils could be a low cost option for improving school governance. Low secondary completion rates are also a concern, but the expansion of secondary education needs to be carefully considered, including the leveraging of non-state actors. Alongside this, the government needs to develop its quality assurance system as well as implement incentives and address barriers to access for the poorest. For tertiary and vocational education a number of steps are needed to improve the alignment between skills produced and the demands of the labor market.

3. Health

a. Performance on policy priorities

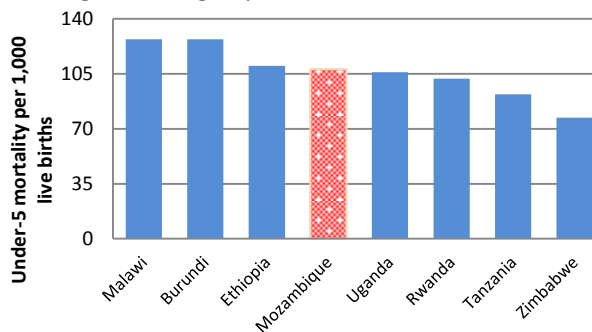
Mozambique has made mixed progress in improving health outcomes. The health sector strategic plan identifies the following priorities: (i) accelerate progress in reducing maternal mortality; (ii) accelerate progress in reducing chronic malnutrition; (iii) reduce endemic diseases, such as malaria, HIV and tuberculosis; (iv) sustain progress in reducing under-five child mortality; and (v) sustain or reduce non-transmittable diseases. For indicators such as infant and child mortality rates, Mozambique has made good progress, although it is still average compared to peer countries. For other indicators, such as stunting, the situation is worsening. In 1997, 36 percent of children were classified as being malnourished, and by 2011 this had increased to 43 percent. This situation is of concern given that nutrition contributes to productivity (as stunting impairs physical and mental development and through this pathway cognitive development), economic development and poverty reduction (World Bank, 2006). Malnutrition increases susceptibility to diseases and infections, which translates in higher morbidity and mortality, especially among children. Thus, preventing stunting not only contributes to reduce the burden of disease but also promotes economic growth (Copenhagen Consensus, 2012).

Figure 68: There has been a reduction in infant and under-5 mortality rates...



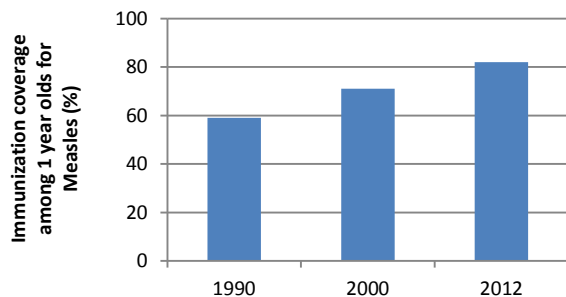
Source: Mozambique Demographic and Health Surveys, 1997, 2003, and 2011

Figure 69: ...But compared to peers progress is average showing improvements are still needed



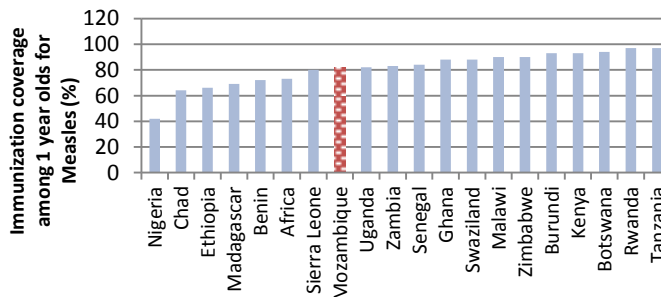
Source: Demographic and Health Surveys, various countries 2010 to 2011

Figure 70: While immunization coverage for measles is improving over time...



Source: Mozambique Demographic and Health Surveys, 1997, 2003, and 2011

Figure 71: The coverage is still below average compared to the region



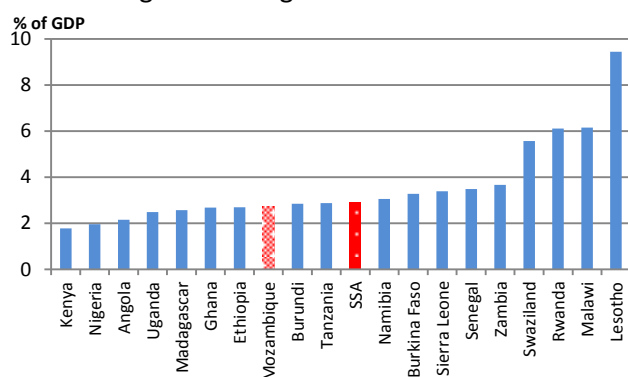
Source: World Health Statistics (2014)

b. Link between policy priorities and resource allocation

Mozambique’s spending on health is low compared to peers. Both public spending (which includes contributions from donors) and total spending (which includes donors and private spending) on a per capita basis on health is low compared to peer countries. In terms of the relationship between spending and outcomes, there is significant variation across different countries, where Mozambique’s performance is around average. A large number of countries achieve significantly better outcomes at similar levels of spending, suggesting there is room for improvement.

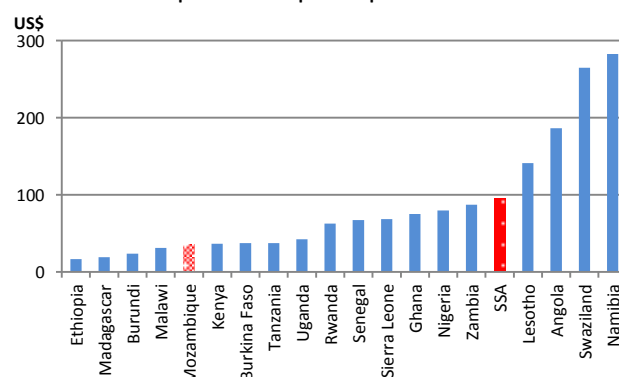
There are different opportunities for realizing efficiency gains in the health sector. Firstly, provision of community based interventions brings health prevention and promotion services and basic care closer to communities and households at low cost. This is an important consideration as individuals and households face trade-offs between receiving health prevention interventions in a distant health facility and their daily activities. Second, delivering expanded outreach population based interventions to remote areas increases the coverage of antenatal care services, immunizations and some basic clinical care to those who most need them, mainly the poor and marginalized. Reaching out to the poor and improving their health and longevity are key objectives of economic development (WHO Commission on Macroeconomics and Health, 2001). Third, strengthening facility based services could improve referral services needed to address more complex health conditions that require skilled and specialized care, including maternal health. The integration of these three service delivery models can help close the gap in accessibility and effective coverage due to geographical barriers.

Figure 72: Public spending on health in Mozambique is below regional average



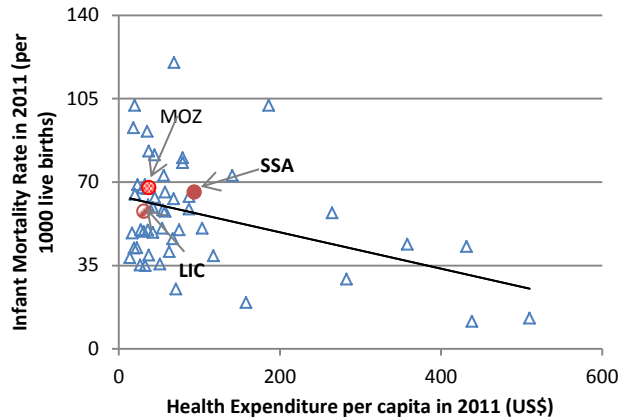
Source: World Development Indicators 2011

Figure 73: This is also reflected in the low levels of total health expenditure per capita



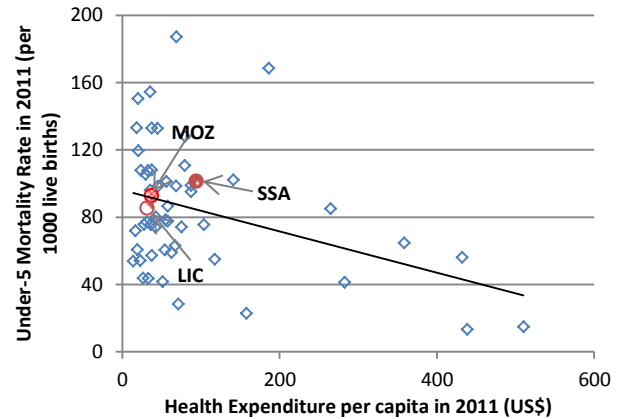
Source: World Development Indicators, 2011

Figure 74: Countries with lower per capita health expenditure have higher infant mortality rates...



Source: World Development Indicators

Figure 75: ...as well as higher under-5 mortality rates

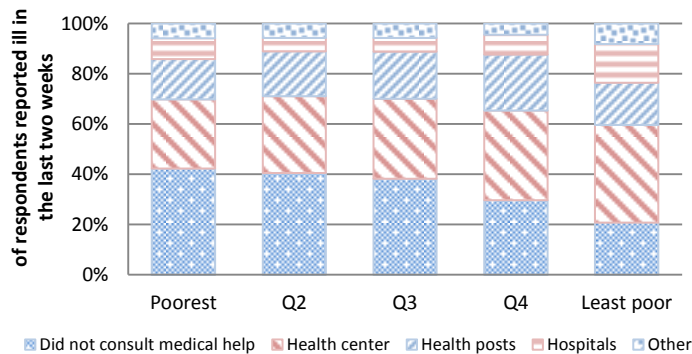


Source: World Development Indicators

c. Resource allocation on services accessed by the poor

Available data shows that the poorer people are, the less likely they are to access health services when ill. This finding is confirmed with data in the Demographic and Health Survey, 2011 which shows that the level of institutional birth rates increases by income group. For the poorest in quintiles 1 and 2, the most frequently cited reason for not seeking medical help when ill is that the health facility is too far (IOF, 2008-09). People seeking medical care are more likely to visit a health center or a health post, than a hospital. However, it is not possible to determine how government health spending benefits different income groups because detailed expenditure data is not available by type of health facility. Also, health facilities collect fees that are retained, but this information is not available by health facility level, and could therefore not be accurately netted out from government spending.

Figure 76: As income rises, people are more likely to seek medical help when they are sick³⁵



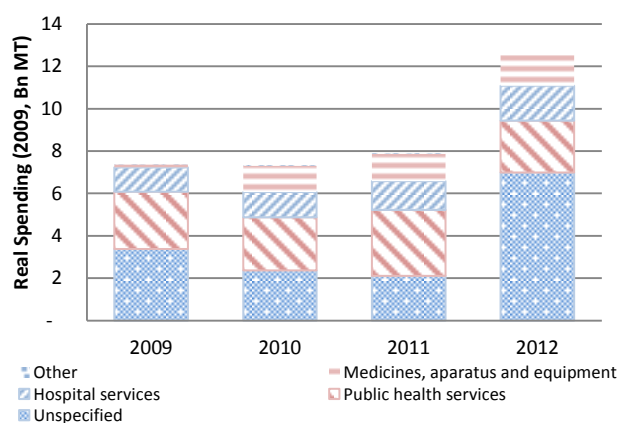
Source: World Bank staff calculations based on the IOF

³⁵ 'Other' includes private clinic, pharmacy, private doctor, traditional healer, and church.

d. Resource allocation within health

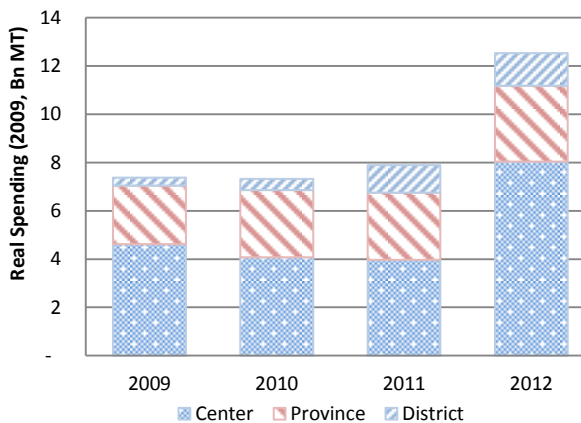
Due to large off-budget expenditures and budget classification issues, it is not straightforward to determine how key policy priorities are being financed by the budget. The health sector strategic plan and the Economic and Social Plan broadly discuss the same objectives. However, the way the budget is presented makes a comprehensive understanding of how resources are allocated to policy priorities difficult. In addition, the majority of resources spent outside of government systems (including those recorded in ODAMOZ) cannot be mapped to functions within the health sector. The weaker linkages between policy priorities and the budget are discussed in further depth in the chapter “Improving Links between Plans and Budgets.” Overall, the level of resources being deconcentrated to the district level is increasing, although centralized spending is still high.

Figure 77: Public health and unspecified health services receive the largest share of financing³⁶



Source: Government of Mozambique

Figure 78: Spending at the district level is increasing, but centralized spending is still high



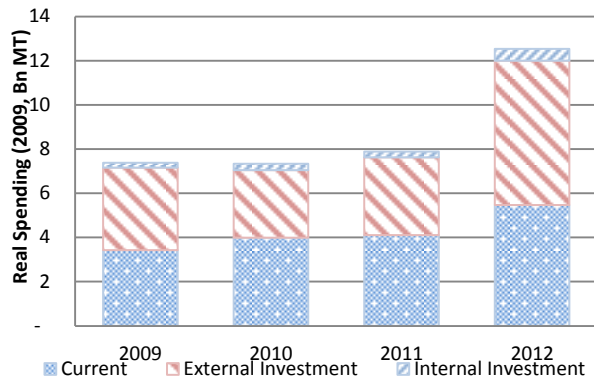
Source: Government of Mozambique

e. Composition of health spending

External investment, primarily for goods and services, continues to account for a large and increasing share of health spending. Overall, externally financed investment is increasing in the health sector, in part explaining the significant jump in spending from 2011 to 2012. Spending has increased for all expenditure categories, particularly for goods and services. Increases in personnel spending have enabled the sector to expand the number of health workers, although the equity of distributing personnel across different regions needs to be considered. Rural areas continue to face staff shortages as it is challenging to recruit and retain qualified staff in hard to reach areas where working and living conditions are relatively poor. Despite increases in personnel spending Mozambique still has one of the lowest health worker-to-population ratios in the world.

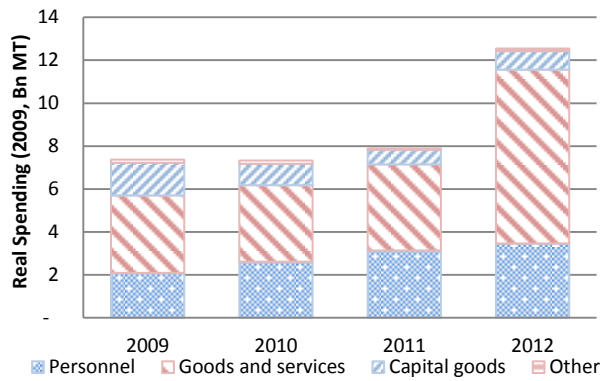
³⁶ ‘Other’ refers to medical centers and maternity, clinics and consultations, research and development in health, and pharmaceutical products. This amount is nominal and cannot be seen in the figure

Figure 79: Resources are largely spent on current costs....



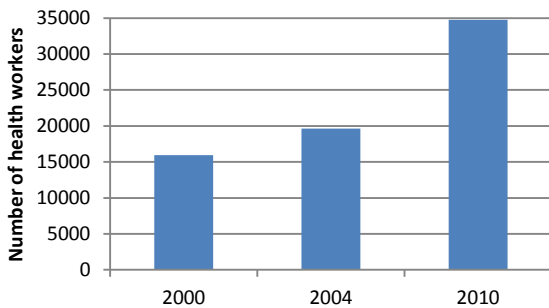
Source: Government of Mozambique

Figure 80: ...This reflects spending on goods and services and personnel³⁷



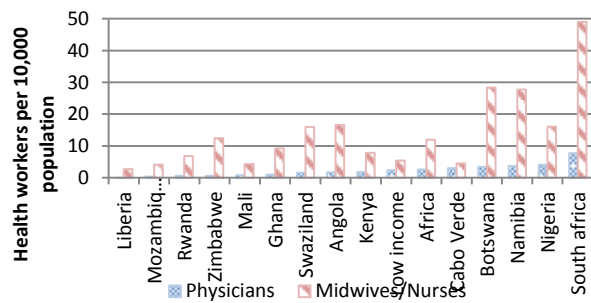
Source: Government of Mozambique

Figure 81: Over time the number of health workers in Mozambique are increasing



Source: Ministry of Health, 2012

Figure 82: Despite these increases, Mozambique has one of the lowest health worker-to-population ratios in the world



Source: World Health Statistics (2014)

f. Key areas for reform

There are a number of key areas for reform in the health sector. Firstly, it is critical to address human resources for health shortages both in quantity and quality, and improve the geographical distribution of sector staff, as well as retaining them. This entails improving training capacity especially for mid-level and university level health professionals (including in provinces); implementing a range of policies to incentivize health staff to serve in remote areas; linking performance to pay and incentives; managing better career development; and ensuring a better match between skills and positions. Secondly, increasing value-for money of resources available to the health sector is key for achieving better health outcomes. Allocating resources more efficiently will require significant changes in the overall planning system of the sector in the mid and long term. The ongoing process of developing a health financing strategy presents an opportunity for the sector to consider innovative financing mechanisms based on results and performance (on both supply and demand sides). And lastly, the quality of care constitutes a hindrance to further improve health status and generates wastage and reduces user's satisfaction.

³⁷ 'Other' refers to current transfers, other current expenses, capital transfers and financial operations

Effective coverage of services requires quality improvements to translate health interventions into improved health for a growing proportion of the population.

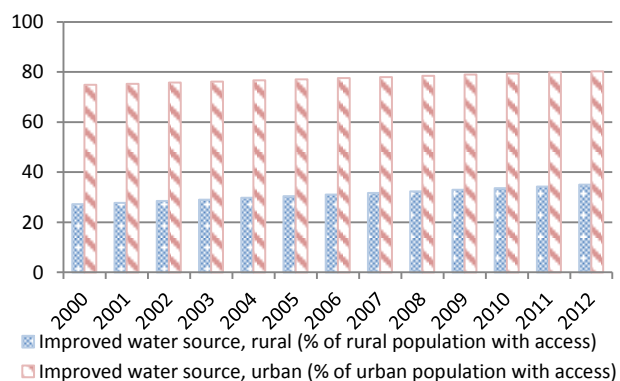
4. Water

a. Performance on policy priorities

Policy priorities in the water sector are clearly defined, although progress in achieving objectives has been varied. The objectives of the water sector include: (i) achievement of the MDGs in the rural and urban water and sanitation sector; (ii) consolidation of the process of sectoral decentralization; (iii) improve the sustainability of urban water systems in the long run (through the use of a minimum level of service in water and sanitation access and a focus on cost recovery in tariff setting, among other measures); and (iv) adoption of adequate hygiene practices in households, communities, and schools. However, progress has been slow. Nation-wide 53 percent of the population has access to safe drinking water (which is far lower in rural areas) and only 24 percent are using improved sanitation facilities (DHS, 2011). Compared to peers, access to improved water and sanitation sources are low and there are significant regional inequities.

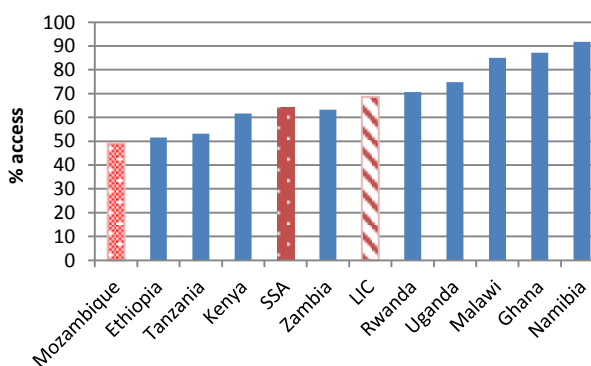
Enhancing coverage and efficiency should be prioritized. Despite recent improvements in urban water services, coverage needs to be enhanced through infrastructure expansion from below 50 to 80 percent of the population directly connected to the water systems, which would help to address rapid urban growth and improve the quality of services (particularly in relation to hours of water supply). Over time, as the level of services evolves, efficiency is also expected to improve. According to a recent Bank review of the water sector (World Bank, 2010b) there is also scope to enhance the efficiency of water services. In rural water this would involve addressing the high breakdown rates of water points, supply chain of equipment and parts, and reducing construction costs of new water points to be more in line with peer countries, as well as gradually moving towards piped systems, where cost recovery is more feasible. In urban areas the pricing of water services could be revised to allow for rehabilitation of assets and improvements of non-revenue water, which requires long term and sustained efforts.

Figure 83: Over time, there have been very gradual improvements in access to water



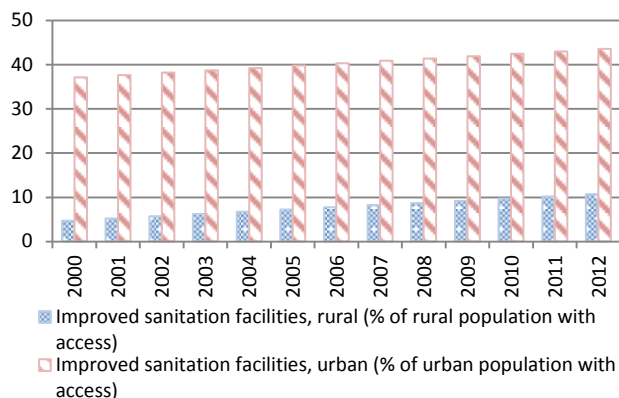
Source: World Development Indicators

Figure 84: But compared to peers access to an improved water source is low



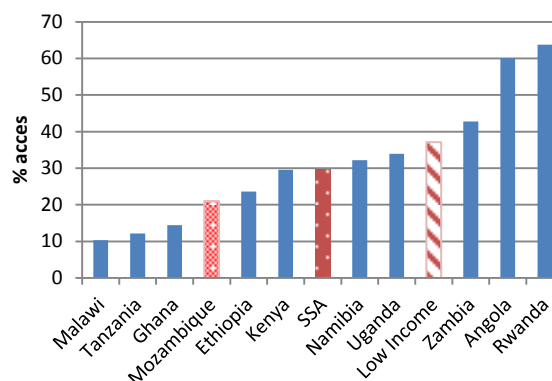
Source: World Development Indicators, 2012

Figure 85: There have been very slow increases in access to sanitation facilities



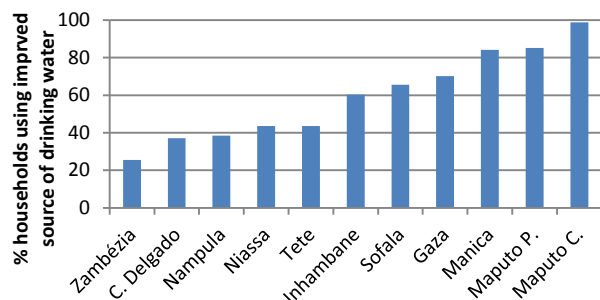
Source: World Development Indicators

Figure 86: And compared to peers access to sanitation facilities is low



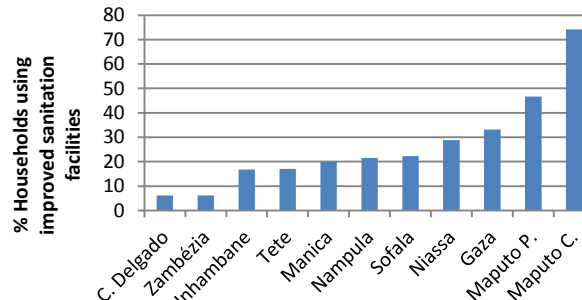
Source: World Development Indicators, 2012

Figure 87: Nation-wide, there are wide disparities on use of water facilities



Source: Mozambique Demographic and Health Survey, 2011

Figure 88: There are also large disparities in the use of sanitation facilities



Source: Mozambique Demographic and Health Survey, 2011

b. Resource allocation on services accessed by the poor

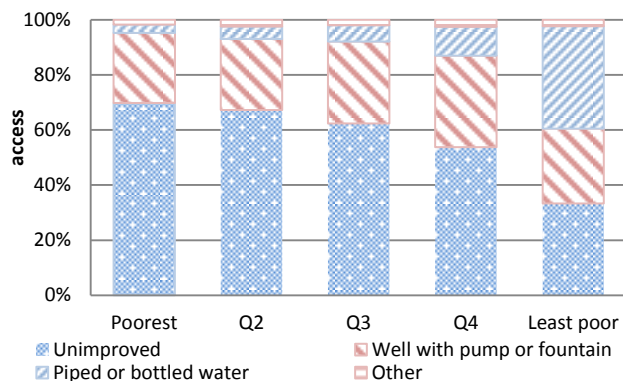
Access to water and sanitation services improves with income, although recent policy measures to increase connections in urban water are having a positive impact on access for the poorer income population. Data from the IOF 2008-09 showed that the least poor have greatest access to an improved water source.³⁸ More recently, policy measures were introduced to increase affordability and reliability of urban water, particularly for low-income households in peri-urban areas around Maputo. The policy changes include revisions to the fee structure, reducing connection fees, and legalization of water resale on an independent basis only in the FIPAG coverage area. An independent evaluation showed these policy measures had a positive impact, where between 2009 and 2012 there was a 46 percent increase in households with their own private water connection. The new connections benefited households in

³⁸Improved water source can include piped water on premises (e.g. piped household water connection), and other improved drinking water sources, such as public taps or standpipes, tube wells, boreholes, protected dug wells, protected springs, and rainwater collection.

Maputo that were significantly poorer compared with those who had a connection before 2010, although the poorest households still remain unconnected (Zuin *et al*, 2012). Increasing access to water services in small towns around Mozambique could significantly help to improve coverage, where current levels of access are very low – an average of 17 percent in 2013, with Niassa, Nampula and Sofala provinces having less than 10 percent coverage in their small towns, and with a significant number lacking any piped water at all.

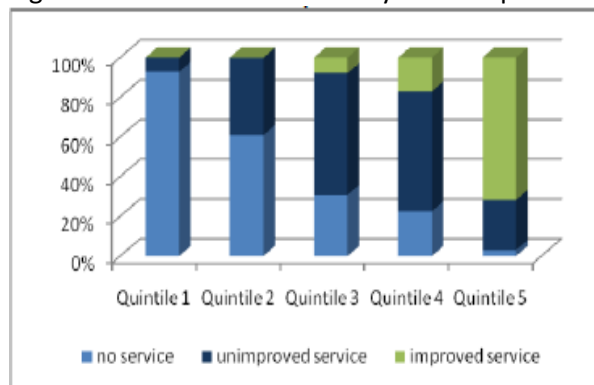
Access to sanitation services is very low and also highly unequal, with the least poor households having greater access to improved sanitation services.³⁹ There have been minimal improvements to sanitation over time, and considering significant population growth the number of people without access to sanitation is increasing over time. In 2008, only households in the three upper quintiles had access to some form of improved sanitation. Yet, even in these income groups a number of households do not have access to any toilet and have to depend on open defecation (World Bank, 2010b). Overall, it is estimated that approximately 41 percent of the population practice open defecation (UNICEF, WHO, 2012). Only 10 cities have a sewer system, and these serve only 6 percent of their residents. Whilst urban open defecation is only 12 percent (UNICEF, WHO, 2012) only a small fraction of the sludge from latrines is adequately managed. Urban and rural sanitation both need improving, to avoid spreading sanitation related diseases, which could otherwise be avoided.

Figure 89: Access is highest for the least poor



Source: World Bank staff calculations based on the IOF2008-09

Figure 90: Access to sanitation by income quintile



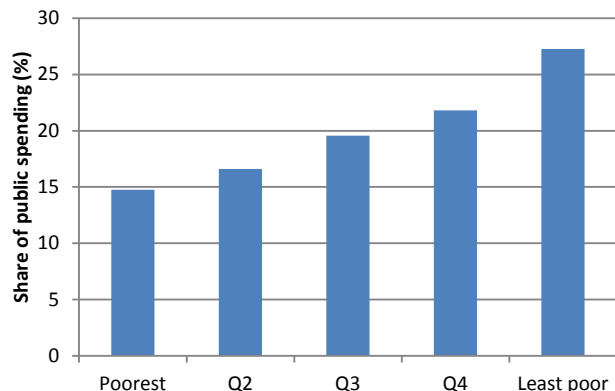
Source: World Bank, 2010b

Public spending on water is skewed towards the least poor. This disproportionate share of benefits going to wealthier segments of the population is because the majority of people in the poorest quintile and quintile 2 are based in rural areas and a larger share of spending goes towards urban water. Sanitation in general is poorly funded, and is left in large measure to individual households. The quality of on-site sanitary facilities is generally poor, and in urban areas, where periodic emptying is necessary, an unregulated private sector, including many informal manual emptiers, provides the bulk of the services. These findings suggest the need to allocate resources in a way that narrows the gap in

³⁹ Improved sanitation facilities include flush (to piped sewer system, septic tank, pit latrine), ventilated improved pit latrine, pit latrine with slab, and composting toilet (World Bank 2010b)

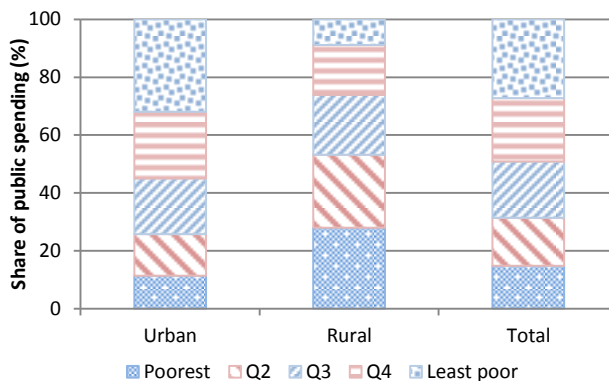
accessing water and sanitation between rural and urban areas, and between central urban and peri-urban areas, which would in all likelihood benefit the poorer segments of the population.

Figure 91: Public spending in water largely benefits the least poor...



World Bank staff calculations based on IOF data 2008-09 and Government of Mozambique

Figure 92: ...Reflecting a higher share of spending on urban water



World Bank staff calculations based on IOF data 2008-09 and Government of Mozambique

c. Resource allocation within water

Resources to the water sector declined between 2010 and 2012 by 35 percent in real terms.⁴⁰

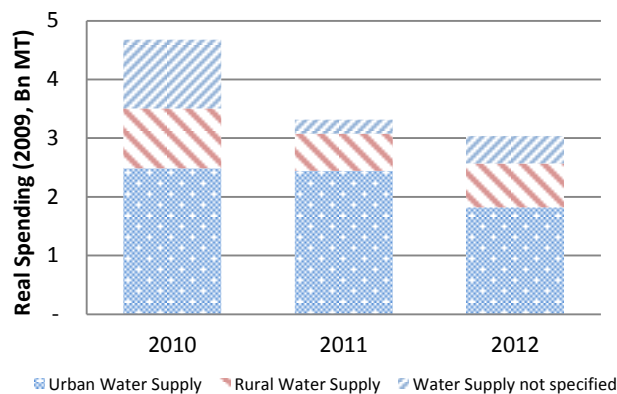
However, the 2014 budget showed a significant increase in resources allocated to the water sector, largely due to a rise in externally financed investment. The largest share of water spending goes toward urban water, which is channeled through the Ministry of Public Works and Housing (MoPW). There is also the Water Assets and Investment Fund, FIPAG, which has overall responsibility for urban water through a delegated management framework. FIPAG is a full cost recovery agency which finances investments with loans channeled through the budget, which it is required to pay back. Financing for rural water is relatively low which may partly explain the poor access to water and sanitation in rural areas. Increased investments should be accompanied with efforts to improve the institutional environment and capacity for the delivery of rural water and sanitation services.

Spending in the water sector is largely centralized, stemming partly from low population density and capacity. For rural areas, the National Water Directorate (DNA) plans investments and allocates resources to their Provincial Directorates of Water which implement and supervise investments in the provinces. Provincial and district funds are mainly deconcentrated spending from MoPW, but the continued involvement of the DNA at the center acts as a drag on investment. The Water and Sanitation Infrastructure Management Agency (AIAS) also manages its expenditure on small towns' water and sanitation from the center, but the resources cannot meet the requirements of different small water systems, which are mainly in districts, let alone the sanitation needs of all the urban areas (including

⁴⁰ This trend differs from budget data since it tries to capture only spending allocated to the water sector and does not include other spending by MoPW that is not allocated to water services

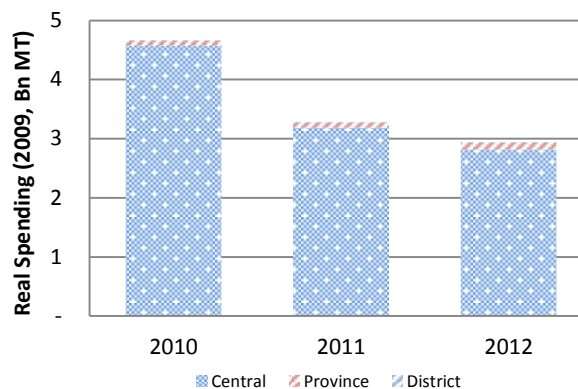
those where FIPAG supplies water, for which AIAS is also responsible). Funds from FIPAG are directed to Regional Utilities, and the vast majority of employees are based outside of Maputo. The current centralized set-up for investment in all subsectors has been justified by the relatively weak capacity and institutional presence at the subnational level, but will probably not be capable of delivering services in small towns and rural areas. A regional approach for these two sub-sectors needs to be tested before scaling up.

Figure 93: There is a steady decline in water sector financing⁴¹



Source: Government of Mozambique

Figure 94: Spending in the water sector is still highly centralized



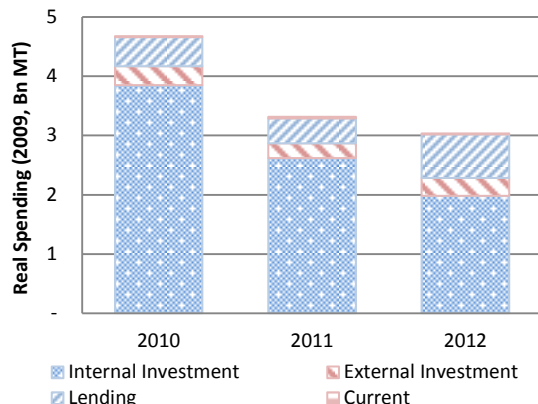
Source: Government of Mozambique

d. Composition of water spending

The largest share of resource allocation in the water sector goes towards investment costs, which is reflected in high levels of spending on capital goods. The current process for classifying expenditures means that it is not possible to determine whether sufficient resources are being allocated towards operations and maintenance of existing improved water points. However, the functionality rate of 80 percent measured in 2012 is in line with internationally acceptable levels.

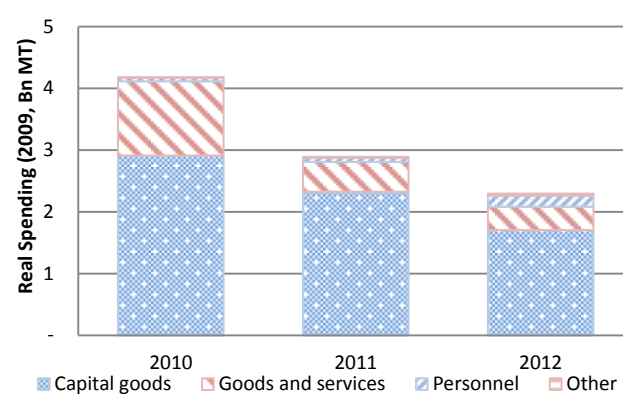
⁴¹ Figure 93 and Figure 94 cover the period 2010 to 2012, and include 'Acordos de Retrocessão' which is lending from financial institutions through the budget. This type of lending is an important source of financing for urban water, and for FIPAG in particular. This data was not available for 2009.

Figure 95: Spending goes mainly to investment, funded through external resources



Source: Government of Mozambique

Figure 96: The largest proportion goes towards capital goods⁴²



Source: Government of Mozambique

e. Key areas for reform

Looking ahead, there are a number of key areas the sector can improve.

Large Urban Water - With regard to water supply, despite good progress by FIPAG in the larger urban centers, considerable extra investment is needed to increase connection rates and develop new sources. Given FIPAG's relative strength, this could be partly funded by a tariff increase, but concessional funding will still be needed, particularly to fund new water sources.

Small Towns Water - For the smaller urban centers served by AIAS, the current low coverage rates indicate an urgent need to develop the investment fund called for under the government's Urban Water Supply and Sanitation Strategy and to strengthen AIAS's capacity at provincial level. Concessional funding and grants will be needed to develop this sub-sector, which demonstrated low economies of scale and high implementation costs in the first two pilots, Mocimboa da Praia and Ilha de Moçambique.

Rural Water - Similarly, for rural water supply, a more proactive decentralization, as envisaged in the design of government's PRONASAR program, is essential if targets are to be met. This may be facilitated and made more efficient by adopting a competitive mechanism for fund allocation. A pilot program using the OBA approach might be developed, with Provinces competing for the funds. This may help to break the cycle of supply driven funds.

Urban and Rural Sanitation - Sanitation coverage continues to lag well behind that of water. The establishment in 2014 of a multisectoral sanitation program byMPD provides for the first time a specific budget line for sanitation, but mechanisms and capacity need to be built to deliver improved services. In the larger cities there is a possibility for having FIPAG collect a sanitation tariff which is transferred to the municipality – currently done only in Beira. However, in order to regulate this, autonomous

⁴² Figure 96 does not include 'Acordos de Retrocessão' (lending through the budget) as disaggregation by economic classification is not available. 'Other' consists of current and capital transfers which are nominal.

sanitation agencies need to be established, and this represents some political and legislative challenges. The capacity of AIAS to support the municipalities technically and financially in sanitation also requires major strengthening, and specific approaches for small towns need to be developed. Throughout the sanitation sector, responsibility for sanitation needs to be mainstreamed into governance structures and sectoral programs (construction of schools, health posts etc.) and capacity for mass mobilization for sanitation, especially in the rural areas, must be ramped up.

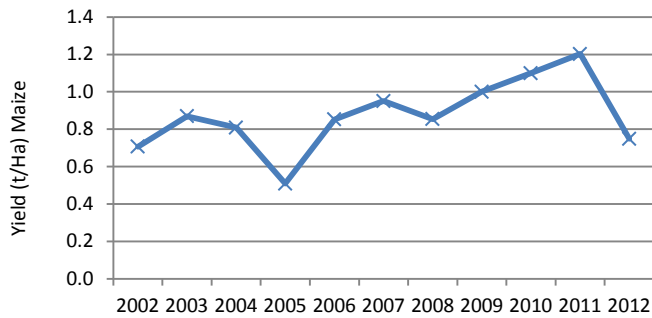
5. Agriculture

a. Performance on policy priorities

Policy priorities in agriculture are well formulated and are largely consistent across different strategic documents. Agriculture is important for the Mozambican economy, contributing to approximately 25 percent of GDP and employing above three quarters of the workforce. The agriculture sector offers scope to narrow income disparities between rural and urban areas, and reduce poverty particularly in rural areas. Policy priorities in the agriculture sector include: (i) increasing agricultural production and productivity; (ii) improving infrastructure and services for markets; (iii) the sustainable use of land, water, forest and wildlife resources; (iv) having a legal framework and policies conducive to agricultural investments in place; and (v) strengthening agricultural institutions. The agriculture strategy promotes the creation of an enabling environment for stronger private sector involvement in key value chains, and promotes public investments in areas with strong economic potential. The National Investment Program of Agriculture (PNISA) was launched in 2013 and emphasizes the need for government to facilitate private investment and proposes PPPs to develop various sub-sectors.

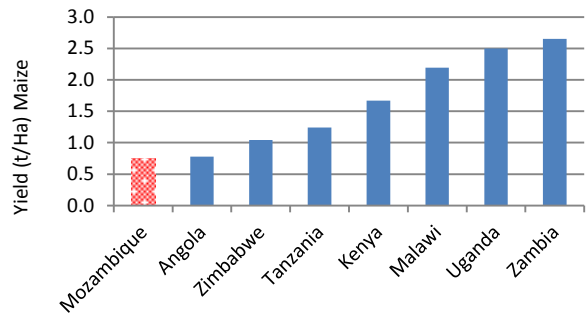
Despite modest productivity increases over the last decade, agricultural productivity remains very low when compared to peer countries. Vulnerability to adverse weather, i.e. floods and droughts, is reflected in year-on-year volatility in yields, most notably the negative impact of the 2013 floods on maize yields (Figure 97). In addition to weather risk, the use of modern input technology is low in Mozambique, resulting in relatively low yields (Figure 98). Presently, fertilizer is largely used in Mozambique for commercial tobacco and sugarcane (mainly specialized NPK compounds), and has limited use in other crops. While increased fertilizer consumption would significantly increase agricultural growth targets (IFDC, 2012), its use will need to be profitable at the farm level. Efforts to increase fertilizer use should be complemented by increasing the availability of certified seeds and improved agricultural extension services. The high cost of fertilizer, compared to other African countries, can be lowered significantly if transport costs are reduced. Initiatives to improve access to fertilizer, seeds and extension services should be led by the private sector with government facilitation. Public investment in feeder road maintenance would reduce the cost of inputs, at the same time increasing the farm-gate price of commodities, thus improving competitiveness in the value chain.

Figure 97: Maize yields have been improving, but there is a recent decline



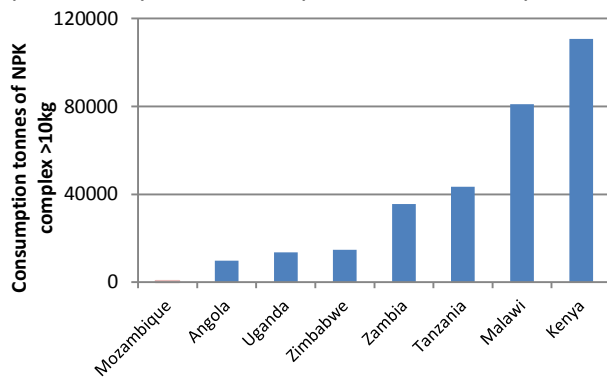
Source: FAOSTAT, 2012

Figure 98: Compared to peer countries maize yields are low



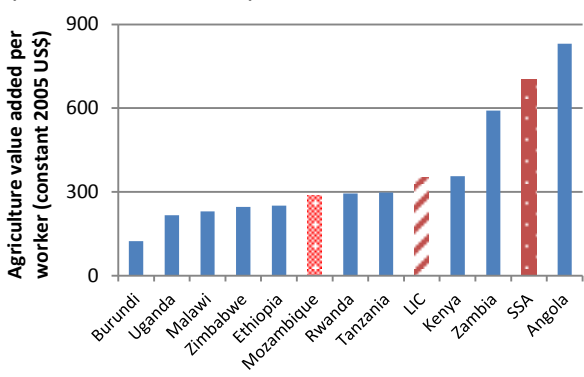
Source: FAOSTAT, 2012

Figure 99: Fertilizer use could significantly improve productivity, but consumption is well below peers



Source: FAOSTAT, 2011

Figure 100: Mozambique's agriculture value added per worker is below peers

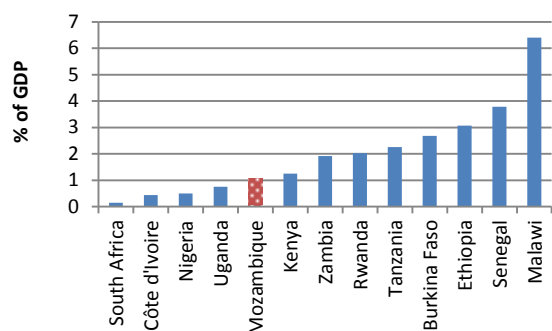


Source: World Development Indicators, 2011

b. Link between policy priorities and resource allocation

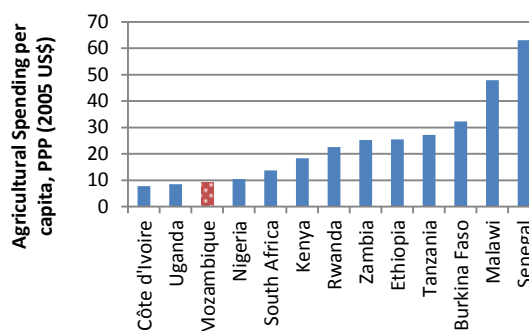
Mozambique spends relatively little on agriculture compared with peer countries and yields are lower. Spending on agriculture both as a proportion of GDP and on a per capita basis is relatively low in Mozambique compared with peer countries. There are a number of factors that contribute to agricultural productivity in addition to public spending, including the level of private investment.

Figure 101: Spending on agriculture as a proportion of GDP is lower than average compared with peer countries



Source: IFPRI, 2011

Figure 102: This is also reflected in the low levels of agriculture spending per capita



Source: IFPRI, 2011

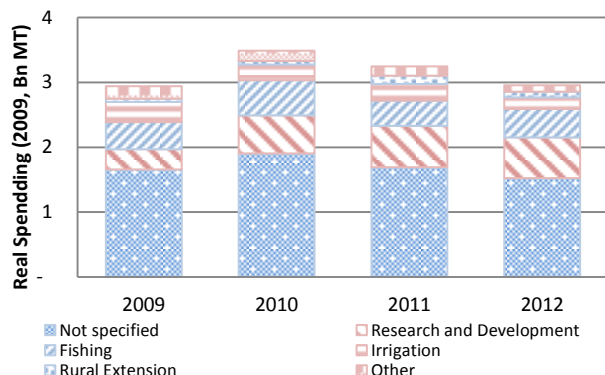
c. Resource allocation within agriculture

In real terms the budget allocation for agriculture has been relatively consistent, although there are significant variations in the execution rate.⁴³ From 2009 to 2013 budget allocations to the agriculture sector remained relatively consistent, although there is a significant increase in 2014 from external financing. In addition, the sector does benefit from core infrastructure spending to develop feeder roads. However, execution rates in the agriculture sector are low and variable, which is a cause for concern. Between 2009 and 2013 the sector only executed an average of 70 percent of all resources.

It is currently challenging to determine how resources are allocated to strategic priorities in the agriculture sector. The functional classification shows that the largest share of public spending is allocated to areas that are 'unspecified' followed by fishing and research. A significant share of resources in agriculture is spent at the central and the provincial levels. At the provincial level spending is on goods and services and personnel expenses. At the district level spending is on capital goods and capital transfers. The agriculture sector is seeking to strengthen the link between plans and the budget in the context of operationalizing the PNISA. The PNISA has information on programs that are expected to contribute to sector strategic goals and priorities. Both recurrent and capital expenditures will be aligned against these programs, providing a basis for tracking resources against results. However, this is a medium to long term initiative that requires considerable institutional change and capacity.

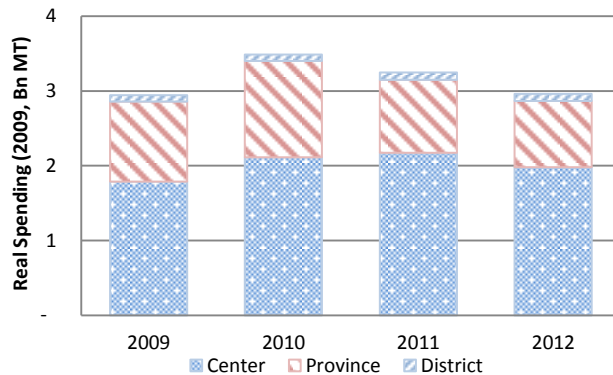
⁴³ The classification used in this chapter differs from that used by the MoF which includes a number of items that are not necessarily having a significant impact on agricultural development. The MoF priority sector classification results in significantly higher spending for agriculture.

Figure 103: The largest share of agricultural spending has not been specified by function⁴⁴



Source: Government of Mozambique

Figure 104: Resources are executed from central and provincial levels

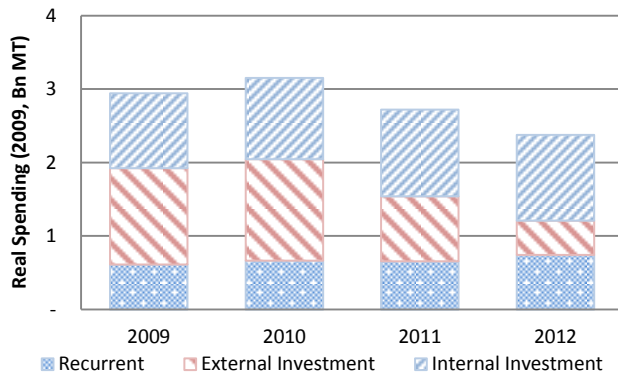


Source: Government of Mozambique

d. Composition of agriculture spending

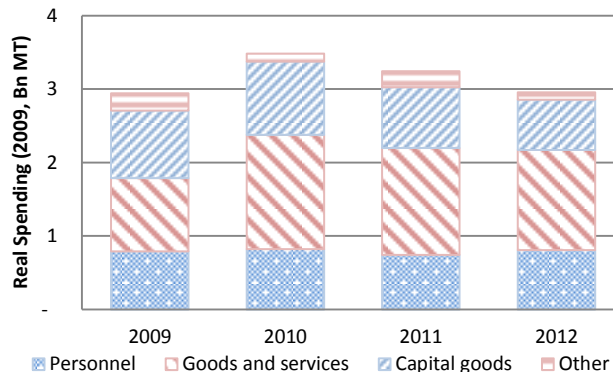
A large share of agriculture spending is classified as investment, although a closer look suggests that much spending classified as investment is recurrent spending, given the large proportion of personnel and goods and services in agriculture spending. Going forward, as the private sector becomes more prominent, the government’s role is evolving to be more focused on facilitation, regulation and service delivery, which may require a different skill set from government officials and different spending patterns.

Figure 105: Resources are largely allocated towards recurrent spending...



Source: Government of Mozambique

Figure 106: Which is reflected in high levels of spending on goods and services



Source: Government of Mozambique

e. Key areas for reform

Looking ahead, there are a number of key areas for reform in the sector. Importantly, achieving the objectives of the national agriculture strategy requires improving the business environment and

⁴⁴‘Other’ refers to a number of functions that are allocated a small share of resources, including hunting, pest control, land management, cattle, agricultural pricing, agrarian reform, forestry and veterinary

facilitating private investment in agriculture, addressing challenges related to technology, finance and factors of production. A number of policy and regulatory reforms are currently under way, and will stimulate private investment in plant breeding, seed multiplication and marketing, fertilizer market development, and a PPP approach to irrigation scheme management, leading to greater access to technology and inputs (seeds, fertilizer and water). In addition, a land reform process is slowly improving land tenure security to smallholder farmers on the one hand, and offering land use opportunities for larger producers on the other hand, thus promoting small and large investment. While these policy and regulatory reforms are significant and fundamental, their implementation will require public resources, enhanced cost recovery, and policy consistency. Linking policies with programs under the new sector investment plan (PNISA), and linking planning with funding and budget and program execution requires a new way of sector management. This includes a need for enhanced coordination and improved management of agriculture-related programs among the Ministry of Agriculture, the Ministry of Trade and Industry, the Ministry of State Administration, MPD, other ministries and various corridor development agencies.

6. Transport and Energy Infrastructure

a. Performance on policy priorities

The overall objective of the transport sector is to develop an integrated transport system over the long-term. A Transport Strategic Plan has been developed which highlights the following objectives: (i) the north-south transport system to be dominated by ship and rail transport for distances above 500km; and (ii) the east-west transport system to be dominated by road and river transport, which is virtually non-existent at present. There is already a north-south road axis connecting coastal provinces and an east-west railway, which are strategic for regional economic integration. The current east-west links are insufficiently developed to allow Mozambique to become a major transport hub by providing the hinterland countries access to Mozambique's ports.

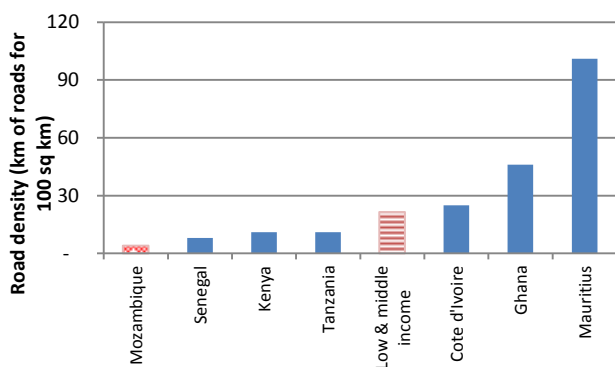
While the development of this Transport Strategic Plan is a welcomed step, there is arguably scope to elaborate the strategic plan to enhance integration of different transport modes. Such a plan should consider both the demand for different transport services and the capacity to meet these needs. Furthermore, the management of the transport sector is arguably fragmented and would benefit from greater coordination. Rail, air and maritime transport are largely managed by the Ministry of Transport, where investments are both private and public. Roads are mainly managed by MoPW. Improving the links between different types of transport modes (roads, rail and port) could help to improve coordination and is likely to result in efficiency gains as inter-sectoral activities are prioritized.

There has been some progress in achieving these objectives. On average for the period 2009 to 2012 approximately 70 percent of Mozambique's 30,000km road network was considered to be in good or fair condition, in line with sector targets (Integrated Road Sector Program – PRISE, 2009-2012). However, compared to peer countries, Mozambique is far behind, where road density is one of the

lowest in the region. To an extent, this low road density also reflects low population density in some of the rural parts of Mozambique.

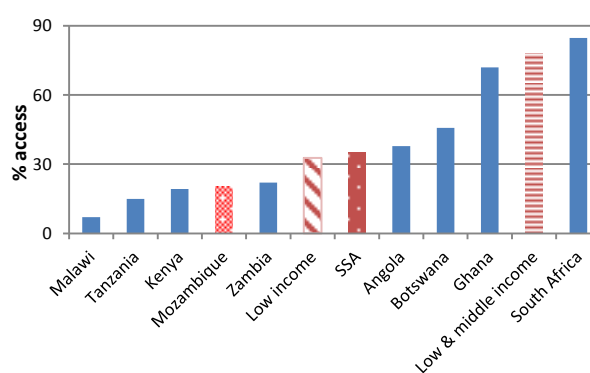
The energy sector has a number of objectives to improve current low access levels. Specifically, the objectives of the energy sector are: (i) continue the expansion of energy at the lowest possible cost; (ii) create capacity for using new and renewable energy; (iii) maximize the use of local resources in power generation; (iv) increase the capacity to supply fuel for domestic consumption; and (v) promote the effective and productive use of energy, focusing on agriculture and industry (Plano Quinquenal do Governo 2010-2014, the Government’s Five Year Plan). Access to energy is currently low, where only an estimated 20 percent of Mozambicans have access to electricity. In regions such as Cabo Delgado and Zambézia approximately 5 and 7 percent of households respectively have access to electricity (Demographic and Health Survey, 2011). Furthermore, demand for energy is rapidly increasing, where Mozambique has one of the highest rates of new connections in the SADC region (Electricidade de Moçambique, 2014). Mozambique is home to the Cahora Bassa dam, one of the largest hydropower installations in Africa, but most of this energy is exported regionally, particularly to South Africa. During times of high energy demand Mozambique has to import emergency power from South Africa at very high costs.

Figure 107: Road density in Mozambique is one of the lowest in the region



Source: World Development Indicators, 2009

Figure 108: Despite significant energy resources, Mozambique has one of the lowest electrification rates in Africa



Source: World Development Report, 2009

b. Link between policy priorities and resource allocation

To address the existing infrastructure gap, Mozambique is increasing public investments in infrastructure. Historic data shows that spending on infrastructure was broadly in line with other countries in the region. In the past few years, public infrastructure investments have increased significantly. Mozambique will have to develop its capacity for managing large infrastructure projects through strengthening public investment management processes (as discussed in some detail in the chapter “Macroeconomic and Fiscal Developments”). Local private sector capacity is also weak, where large infrastructure projects are mainly delivered by foreign firms. Furthermore, for large infrastructure

projects to be implemented according to plan and schedule there is a need to rationalize overall procurement processes, in order to ensure compliance and value for money in the delivery of contracts.

Figure 109: Public Spending on infrastructure as percent of GDP (2001-06)

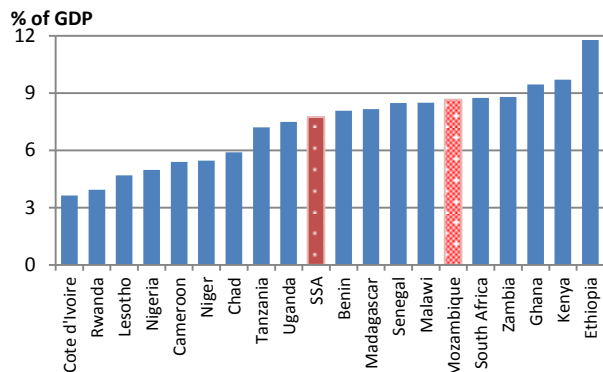
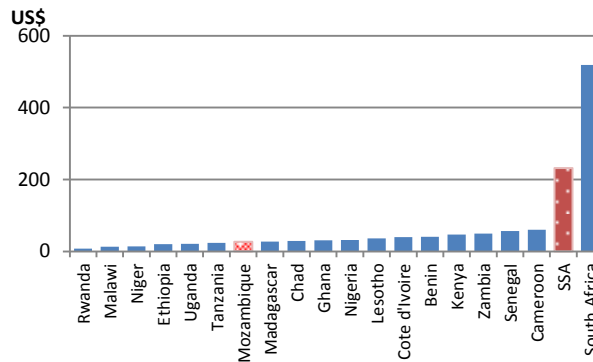


Figure 110: Public Spending per capita on infrastructure in US\$ (2001-06)

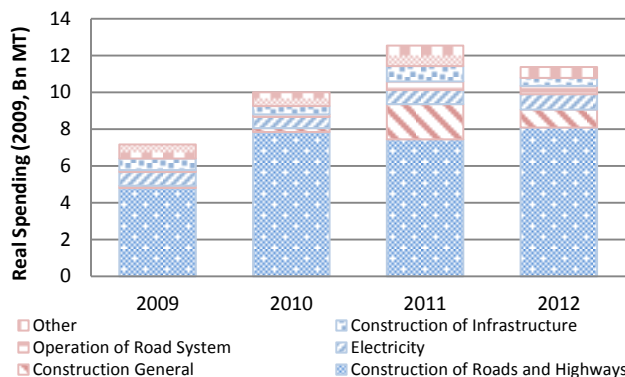


Source: Briceño-Garmendia et al, 2008

c. Resource allocation within infrastructure

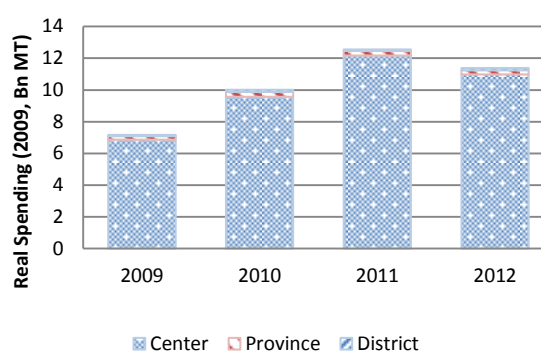
The largest share of infrastructure spending is allocated towards the development of road construction. The focus is largely on developing primary and secondary roads, where institutional roles and responsibilities are well-defined. However, there is a need to strengthen the management of tertiary roads, where for example the length of the tertiary road network is unclear. Improving the institutional responsibilities of tertiary roads would strengthen inter-sectoral linkages with the agriculture sector. Resources for infrastructure development that are channeled outside of government systems have also been steadily increasing on the development of the road system. Spending on infrastructure is largely centralized, where the amount allocated to provinces and municipalities is relatively very small. To develop the electricity transmission grid further, it is estimated that an additional US\$ 2 billion is required, which would focus on the primary network (Electricidade de Moçambique, 2014).

Figure 111: The largest share of infrastructure resources is spent on road construction⁴⁵



Source: Government of Mozambique

Figure 112 Infrastructure spending through the budget is largely centralized



Source: Government of Mozambique

d. Composition of infrastructure spending

Increasingly, infrastructure is being financed outside of the state budget. In 2012 there was a decline in infrastructure financed by partners through the budget (classified as external investment), but this was compensated with an increase in financing for infrastructure projects outside of the budget (see the figure below). SoEs are also taking a greater role in infrastructure investments, where they receive loans channeled through the budget, projected at around 3.4 percent of GDP in the 2014 state budget. For example, the SoE Maputo Sul was created in 2010 and is responsible for the development of infrastructure projects such as the Maputo-Katembe bridge, the Maputo Ring Road, and a road to Ponta d’Ouro.

The government is also engaged in a number of PPPs. In the energy sector, there are considerable gains to be realized by working with the private sector to develop PPPs for the large generation and transmission facilities. Increased collaboration with the private sector can enable the government to share costs and possible risks, although potential fiscal risks and contingent liabilities need to be better disclosed and managed. In particular, PPPs need to be better reflected in budget documentation. Improved regulation is also required for PPPs, to avoid any potential conflict of interests and ensuring that the cost of a toll is priced at the correct level to facilitate required levels of operations and maintenance. Furthermore, in order to successfully work with the private sector it will be important to develop an enabling environment to provide certainty and stability for investors and partners.

Increased road construction will have significant implications for operation and maintenance (O&M) funding needs in the future. Mozambique seems to be allocating a large share of public resources to the construction of new roads with a relatively small share being allocated for O&M, which could lead to a worsening of road conditions. Different types of roads have different O&M requirements, with paved

⁴⁵Other’ refers to a number of functions that are allocated a small share of resources, including: coal, fuel and solid mineral products, extractive industry (except fuel), infrastructure for water, railway system, air transport, and research and development

roads having relatively high O&M costs. The increase in road construction in Mozambique, many of them paved, will have fiscal implications for the future. It would also be necessary to balance new road construction with maintenance of existing roads which is often more cost effective.

Figure 113: External investment financing is moving away from the single treasury account

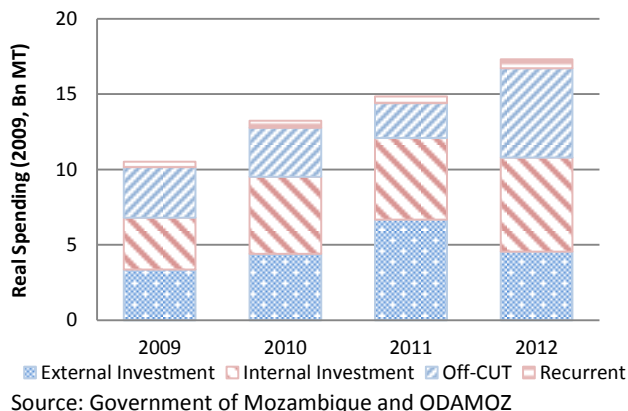


Figure 114: Financial operations may continue to increase after 2014 - partly to finance new infrastructure developments undertaken by SoEs

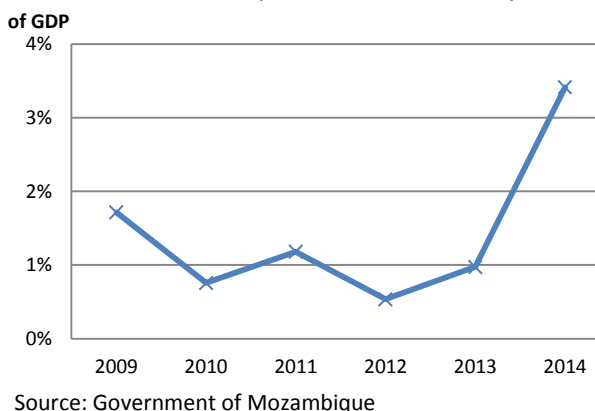


Figure 115: Spending is largely on capital goods



e. Key areas for reform

Through implementation of strategic reforms in the transport sector it would be possible to improve sector coordination and efficiency. Firstly, there is a need to improve sector coordination and integration, to enhance the links between different types of transport. These efforts should be based on an elaborated Transport Strategic Plan which is developed through a participatory process involving all the transport sub-sectors. Secondly, improved sector coordination and integration would form the basis for better linkages between the plan and budget. In particular, an elaborated strategic plan would help to guide resource allocation to improve the balance of focus between primary, secondary and tertiary road networks. While the roads sector benefits from a multi-year program, this approach needs to be extended to other sub-sectors which can be facilitated through improved planning and budgeting processes. Thirdly, institutional roles and responsibilities for the tertiary road network need to be better

defined. Fourthly, experience to date with PPPs suggests the need for further regulation to ensure tolls are adequately priced and there is sufficient attention on maintenance. The government could also explore further possibilities to partner with the private sector, through PPPs and a greater role for SOEs, to finance and operate infrastructure investments. This should be accompanied by efforts to strengthen systems to manage a more complex financing mix. Fifth, as efforts to develop the road network are underway, it will also be important to focus on road safety. To avoid road accidents, legal speed limits and improved regulation are necessary. Finally, given the significant increase in resources for the roads sector, there is arguably a need to undertake a sector specific expenditure review, which would focus on how efficiency gains can be realized, to assess the drivers in construction costs and the expected economic and social returns of ongoing and planned investments.

There are a number of reforms that can be implemented in the energy sector to enhance coverage and efficiency. Firstly, the electricity tariff needs to be revised, in order for Electricidade de Moçambique to be able to properly maintain the network. Full cost recovery tariffs were supposed to be introduced in June 2011, but this deadline was missed. Instead the government is taking a phased approach to implementation, which should differentiate increases for various consumption groups (for example industry, residential/low income) including a social tariff. Secondly, the overall transmission grid requires further investment, and the government could benefit from partnering with the private sector through a PPP arrangement. Thirdly, there is great scope to improve energy efficiency, for example through encouraging the use of low energy bulbs (which has the potential to reduce power consumption by 50 MW and generate savings of US\$ 15m in energy imports); as well as ensure the construction of new buildings that focus on energy efficiency. Looking ahead, natural gas is expected to significantly contribute to power generation, increasing from 2 percent today to 42 percent in 2020, and an appropriate policy is required to set the tariff for gas allocation.

7. Social Protection

a. Performance of the Social Protection System

Mozambique's social protection system has a comprehensive legal framework. The two legal components are: (i) the Social Protection Law (4/2007), which is organized by basic social security, obligatory social security and complementary social security; and (ii) the Basic Social Security Regulation (Decree no. 85/2009).

The National Strategy for Basic Social Security (covering 2010 to 2014) is used to organize basic social security into four areas of intervention, including: (i) Direct Social Action, which are transfer programs for the poor and vulnerable who are unable to work, in-kind transfers provided in response to temporary vulnerabilities and other social welfare services. This is managed by the Ministry of Women

and Social Action (MMAS) and the National Institute of Social Action (INAS);⁴⁶ (ii) Education Social Action, which includes school feeding programs and is managed by MoE; (iii) Health Social Action, which promotes access to basic health care and is overseen by the Ministry of Health; and (iv) Productive Social Action, a cross-sectoral approach that aims to increase access to income-generating opportunities for the poor and vulnerable who are able to work through a labor intensive public works scheme and livelihood interventions, also under INAS management.

In 2011 the Council of Ministries approved the Operational Plan for implementing the ENSSB in the areas of direct and productive social action for the period 2012-14. The document defined priority programs and the number of intended beneficiaries, focusing on three programs: (i) cash transfer intervention for extremely poor households without adults able to work (the PSSB), (ii) a labor intensive public works program for extremely poor households with adults able to work (PASP), and (iii) a temporary support program for households with adults able to work but temporarily unable to do so (PASD).

As the social protection system is being reformed and modernized, there are significant improvements in program coverage. An assessment of the social protection system conducted in 2012 shows that the system was not responsive to emerging vulnerabilities (World Bank, 2012). Since then, there have been improvements in coverage, particularly for programs under responsibility of MMAS and managed by INAS (see Table 11). This progress is expected to be underpinned by the implementation of new key operational tools, including: a common process to select beneficiaries to target the poorest households, a single register of beneficiaries integrated into a management information system to improve monitoring and integration, and a formal electronic payment system (outsourced) for all cash-based benefit programs. However, there is still scope to improve the coverage of pensions, which currently only accounts for 5 percent of the labor force, and 88 percent of the elderly have no pension.

Table 11: Coverage of basic social protection programs implemented by INAS (number of Households)

Programs	2012	2013	2014 (Planned)
Direct Social Assistance (PSD)	33,988	51,414	43,698 ⁴⁷
Basic Social Subsidy (PSSB)	274,025	304,576	341,188
Productive Social Action (PASP)	9,592	11,345	33,680
Social Services for Social Action	4,470	8,971	8,818

Source: INAS 2012 and 2013 Annual Reports and Economic and Social Plan, 2014

Over time, there have been some improvements in the generosity of social protection transfers. Major social assistance programs are not generous (World Bank, 2012).⁴⁸ For the PSSB program, the budget

⁴⁶ In 1997, the Government created the National Institute for Social Action to manage the non-contributory social assistance programs.

⁴⁷ The same goal for 2013 is being maintained for 2014.

allocation has increased over the years, and this is reflected in higher subsidies for families (see Table 12 below). While this is an important positive step, the amount allocated to PSSB beneficiaries is still not enough to cover for basic needs of poor households, suggesting there is further scope to improve generosity of social protection transfers. Furthermore, the generosity of the minimum INSS pension is also low as this only covers basic food needs of the poorest families but no other essential goods and services, suggesting that beneficiaries could be below the poverty line if the pension is the sole source of income.

Table 12: Changes to the subsidies under the Basic Social Subsidy Program

Size of the Household (number of household members)	Amount (MT) in 2012	Amount (MT) in 2013	Amount (MT) in 2014
1	130	250	280
2	190	320	350
3	260	380	420
4	320	440	480
5 or above	380	500	550

Source: INAS Economic and Social Plan, 2012, 2013 and 2014

These improvements in the coverage and generosity of social protection programs are also due to significant efforts by the government to increase spending. As seen in the earlier part of this chapter on the allocation of spending, the budget allocated to social protection programs has almost doubled. This increase is largely due to the government scaling up its own internal resources to the sector.

b. Targeting social assistance to the most vulnerable

The targeting accuracy of social assistance programs could be improved. The *targeting accuracy* of a program can be determined from the concentration index. Negative values of the concentration index indicate that a program is *pro-poor*. Two social protection programs have been designed to specifically reach the poor, the Food Subsidy Program (PSA – now the Basic Social Subsidy Program, PSSB) and the Direct Social Support Program (PASD). Only the PSA was considered to be pro-poor, although both are on the borderline between being pro-poor and not pro-poor.⁴⁹ However, there is a need to recertify current beneficiaries of the PSSB program through the newly designed targeting system given that some of the beneficiaries may have passed away and have not been removed from the lists. The table below provides more information on the extent to which social protection programs are targeting the poor and most vulnerable. Furthermore, the provinces with the highest incidence of poverty (Nampula and Zambezia) receive fewer funds per capita for social protection than other provinces with lower poverty incidence (Niassa, Cabo Delgado, Gaza). A more equitable allocation of funds according to vulnerability

⁴⁸ Program generosity is defined as the program transfer divided by average consumption expenditures of the absolute poorest households, i.e. those in quintile 1.

⁴⁹ An important caveat is that it is challenging to reach the poorest in Mozambique. Firstly, poverty across quintiles are quite flat and secondly a large share of the population is involved in the informal sector making it challenging to target based on income or consumption measures. Also, since the nature of the PSA program has changed this may affect the concentration index.

and poverty levels should be done. Poverty maps developed in coordination with the Bank can help to guide a more equitable geographical allocation of funds in the future.

Table 13: Concentration Indices of Selected Programs, 2010⁵⁰

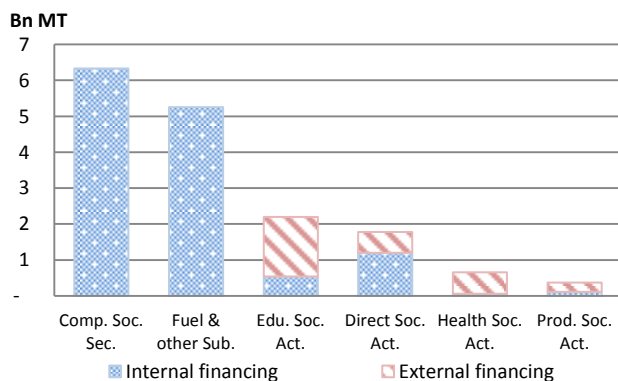
Programs	Concentration Indices	Progressivity Indices	Characterization ²⁰¹⁰
PSA (now PSSB)	-0.02	-0.38	Pro-poor
PASD	0.02	-0.34	Not pro-poor/ progressive
Old age pension	0.44	0.08	Not pro-poor/ regressive
Gasoline	0.65	0.29	Not pro-poor/ regressive
Diesel	0.73	0.37	Not pro-poor/ regressive

Source: World Bank, 2012

c. Resource allocation within social protection

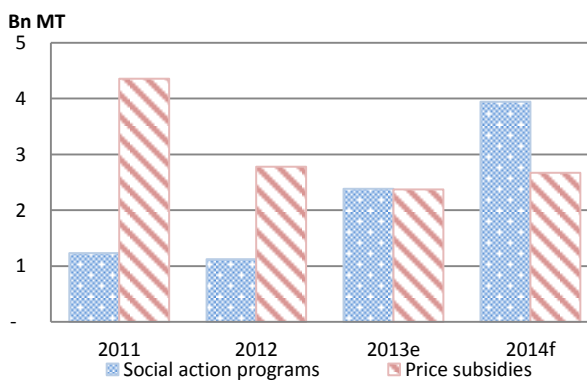
In the past few years there has been a shift in the focus of spending towards more pro-poor and progressive areas. In the past the largest share of public spending on social protection went to compulsory social security (mainly civil servant and military pensions) followed by fuel and subsidies. However, this is changing as the government has increased financing for basic social security programs that are managed by INAS, and the amount allocated to price subsidies has reduced, indicating more pro-poor and progressive spending. By continuing the trend of reprioritizing social protection spending away from subsidies and toward basic social security it could be possible to improve the allocation of inter-sectoral spending. Previously, Basic Social Security (comprising of Direct Social Action, Education Social Action, Health Social Action and Productive Social Action) was heavily dependent on external resources, but this is also changing as government internal resources for social protection are increasing.

Figure 116: In 2010 the largest share of social protection went to pensions and fuel subsidies



Source: World Bank, 2012

Figure 117: Over time, public spending on subsidies is decreasing and social action programs increasing⁵¹



Source: CGE 2010-2012, REO 2013 and Budget Law 2014

⁵⁰ Calculation of concentration indices is based on IOF data. For pensions this refers to the number of household members who had received a retirement pension the previous month.

⁵¹ Social action programs are calculated by adding expenditures for the Ministry of Women and Social Action, National Institute of Social Action, Provincial Directorate of Women and Social Action, Provincial Delegation of the National Institute of Social Action, and District Delegation of the National Institute of Social Action

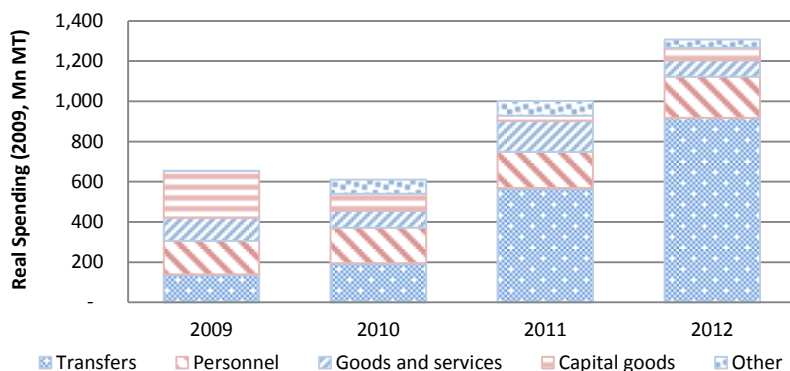
Within each of the pillars of the National Basic Social Security Strategy there is fragmentation of programs (World Bank, 2012). For example, there are many fragmented youth training programs, three different pension plans operated by INAS and MoF, and INAS is engaged in activities such as building schools and health posts, even though other institutions have a comparative advantage in this area (World Bank, 2012). By addressing fragmentation and duplication among social protection programs it could be possible to improve sector efficiency. For example, the support provided through the PASD program to target groups could be integrated under the PSSB or the PASP.

While the sector is making efforts to improve the quality of services, many of the planned activities are not currently operational. Firstly, INAS is adopting a new targeting system, outsourcing payments for beneficiaries and developing a management information system. These tools are expected to be operational by the beginning of 2015 and will improve the quality of services. Secondly, the complementary activities to support graduation out of poverty for the PASP such as savings schemes, skills transfers and on-the job training have not been designed or implemented yet. Once these activities are in place it is expected that the effectiveness of PASP programs will increase. Thirdly, there is scope to improve the case management strategy for both PSSB and PASD programs, to enable follow up on beneficiaries' progress. Therefore, over the medium term improvements to the quality of social protection services are expected as new tools and approaches are implemented.

d. Composition of social protection spending

Spending on social protection programs managed by MMAS and INAS is going increasingly towards direct transfers. The Social Protection Review (World Bank, 2012) argued that average administrative costs are high within each of the social protection programs. For example the former PSA program was evaluated as having an average administrative cost of 30 percent compared with a median of 9 percent for cash and near-cash programs in different parts of the world (World Bank, 2012). By reinforcing INAS teams at the district level there is the potential to reduce the need for INAS officials to travel to the districts which would reduce operational costs. Looking only at spending by MMAS and INAS (including provinces and districts), the level of transfers to individuals and families under different social protection programs is growing at a faster pace than other types of spending. Of total spending by MMAS and INAS, in 2009 only 21 percent was spent on transfers, compared with 70 percent in 2012. This implies that MMAS and INAS have been able to scale up the level of transfers without substantially increasing other costs.

Figure 118: The amount MMAS and INAS spends on transfers under different social protection programs is increasing⁵²



Source: Government of Mozambique

e. Key areas for reform

The Social Protection Review, 2012, recommended a phased approach to implementing the reforms, and MMAS and INAS have engaged in the first stage. This means that progress has been made by: (i) consolidating the basic social assistance system through restructuring the PSA into a new Basic Social Subsidy Program, implementing a labor-intensive public works program, and strengthening the traditional social services; and (ii) developing a new operational platform. As part of this first stage, the government could still deepen the social security reforms by improving coverage and generosity, and reducing program fragmentation. The efforts already underway by INAS to develop operational tools are expected to increase program cost-effectiveness. In addition, by undertaking further efforts to rationalize fuel subsidies and relatively generous government pensions there could be scope to increase financing for social protection expenditures that directly benefit the poor. In a second stage the government could consider introducing an unconditional transfer program for poor families with children. A third stage would focus on evaluating the new programs, tightening the links between programs and services, and strengthening coordination mechanisms with NGOs.

Total spending on priority areas as a proportion of GDP has increased. In particular, levels of resource allocations have increased for infrastructure and social protection, but have declined for water. Low execution rates in the agricultural sector are also a concern. Overall, spending on priority areas as a share of GDP has increased at a faster pace than the rest of spending. When donor resources not channeled through the government systems are also included, infrastructure and health spending increase significantly.

For certain sectors such as education and health there are some improvements in development outcomes, where progress is broadly in line with peers. Outcomes in education are improving, but this needs to be sustained and quality remains a concern. While primary net enrollment rates are

⁵² Other includes other current expenses, capital transfers and financial operations (which is nominal)

comparable to peers, secondary completion rates are well below average. In health, key outcomes such as infant and child mortality rates and child vaccination rates have progressively improved; but performance is less than average or broadly in line with peers in the region. A source of concern is that other key outcomes such as nutrition have worsened. There is much scope to improve outcomes in sectors such as water, agriculture, and infrastructure. Access to water and sanitation is low, and far below the regional average. In agriculture, yields for key crops such as maize are far below peer countries. In infrastructure, further progress is still needed, where outcomes such as road density and electrification rates are one of the lowest in Africa.

For education and health, spending has gradually increased and outcomes have improved, but efficiency gains could lead to better outcomes. Spending in health is notably low for the region. For both sectors, when Mozambique's performance is compared with peer countries that spend a similar amount on a per capita basis, progress is around average. This finding suggests that there is still scope to improve outcomes through efficiency gains. For agriculture, spending is below the regional average and so are productivity rates.

The increased allocations to infrastructure and social protection appear justified, while reduced allocations to water is a concern, particularly given low levels of access to water and sanitation. Increasing spending on infrastructure could over time help to improve outcomes, but the capacity to use increased resources effectively needs to be urgently enhanced. For social protection, the increased spending is going towards programs that are pro-poor and progressive. In agriculture there is a need to assess poor execution rates, and in water and sanitation the large gap between urban and rural sub-sectors should be reconsidered.

Access to key public services increases with income and public spending largely benefits the least poor. While there are large differences in income levels across population quintiles, even the people in the richest quintiles are relatively poor with an average income of less than \$US 2 a day. The high levels of poverty highlight the importance of focusing public spending on basic service provision that will broadly benefit all income groups. Currently, access to services improves with income and there are significant differences in access to basic services. Efforts to increase access to public services should be accompanied with efforts to improve quality.

VI. Strengthening Sub-National Service Delivery

Decentralization in Mozambique is evolving in phases with a greater degree of autonomy given to municipalities and less so to provinces and districts. The basis for decentralization can be found in the intent of the 1994 constitution to promote post-conflict economic and political stabilization. This policy led to the introduction of elected municipalities in selected parts of the country. It was initially envisaged that political decentralization would be widespread, but this was later revised. Instead, municipalities are being gradually introduced, as reaffirmed by the Decentralization Policy of 2012. More recently, there is a renewed focus on deconcentration at the level of provinces and districts.

The contribution of this chapter is to take stock of the decentralized (municipalities) and deconcentrated (provinces and districts) systems to assess how sub-national service delivery can be strengthened. The analysis in this chapter is based on interviews with the central government, and field visits to Tete and Nampula provinces, including municipalities and districts within these areas.⁵³ The chapter focuses on the financing of service provision, with some discussion on policy responsibilities and planning and budgeting.⁵⁴ Through the introduction of targeted reforms there is significant potential to increase locally collected revenues, improve the state transfer system, simplify planning and budgeting procedures, and avail more autonomy to districts in policy design and implementation.

Overview of the existing system

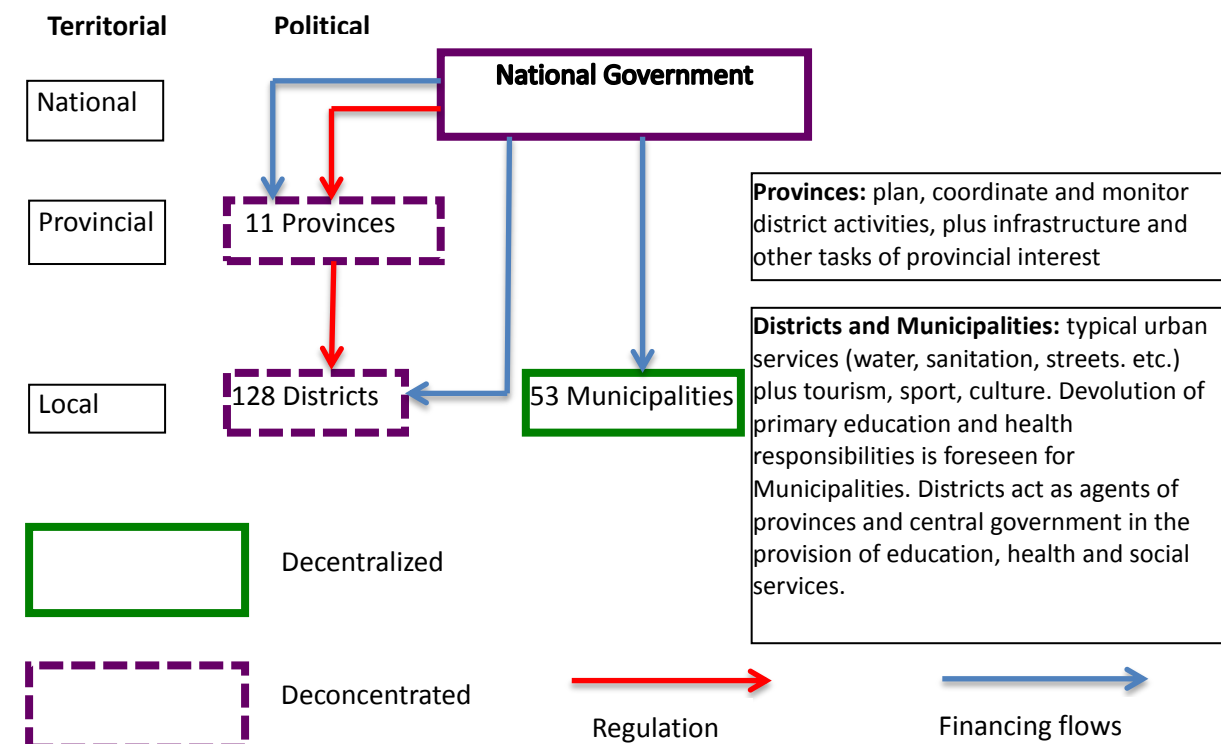
1. The governance framework

Mozambique is a unitary state with three levels of territorial governance: (i) central government; (ii) provincial governments; (iii) district governments and municipalities (see Figure 119). The legal basis for municipalities was approved in 1997, and is referred to as Pacote Autárquico (Law 2/97). Deconcentrated governance is regulated by Lei dos Órgãos Locais do Estado (LOLE), which was approved in 2003 and establishes the principles, competencies and functions of provinces, districts, administrative posts and localities. Specifically, the LOLE states that the district is the territorial unit for local administration, planning, economic, social, and cultural development.

⁵³ The municipalities include Tete, Moatize, Nampula, Matola and Maputo. The districts include Moatize, Changara and Moma

⁵⁴ A more substantial discussion on planning and budgeting can be found in the Planning and Budgeting Chapter. Borrowing by subnational governments is not discussed given the limited borrowing to date.

Figure 119: Structure of territorial government in Mozambique



Source: World Bank Staff Compilation

Resource allocation is gradually increasing at the subnational level. Table 14 shows expenditure at each level of government. Resource allocation at the sub-national level as a proportion of total resources is low, but the share is gradually increasing. Increased district level spending reflects increased responsibility for salary payments. Municipal resources remain low.

Table 14: Distribution of Resources by Level of Government (billion meticaís)⁵⁵

	2010	2011	2012
Central	67	81	87
Province	28	25	28
District	7	16	20
Municipality	3	4	5
Total	106	125	141

Source: CGE 2010-2012

⁵⁵ Total does not include 'financial operations.' Municipal revenues are grossly underestimated as the table does not include the Road Fund or ad-hoc grants received by municipalities.

2. Financing service provision

a. Municipalities

Following the 2008 finance reform, the revenue structure for municipalities was radically transformed and modernized, providing municipalities with access to potentially large sources of own revenue. With the exception of fees and tariffs, the tax rates for all other tax instruments are defined in national legislation. The municipality is responsible for its own revenue collection and administration. The definition of the tax base is always defined centrally, with municipalities being responsible for tax administration and collection. See Table 15 for the structure of municipal taxes.

Table 15: Structure of municipal taxes

	Tax base	Setting of tax rate
Property tax (Imposto Predial Autárquico - IPRA)	Value of fixed properties	Central (Residential at 0.4%, commercial at 0.7%)
Head tax (Imposto Pessoal Autárquico – IPA)	Residents between 18 and 60	Municipal (range of 1 to 4% depending on the type of municipality)
Tax on vehicles	Registered vehicles in use	Central
Tax on transfers of property transaction (SISA)	Property ownership	Central
Betterment levy (Contribuicao de Melhoria)	Increase in property values	Central
Fees, charges and betterment levies	Licenses, fees on market stalls, tariffs for service provision	Municipal (complete discretion)

Source: Boletim da Republica, 2008 no. 52

Municipalities also benefit from a limited number of transfers from the central government. Only the Municipal Compensation Fund (FCA), the Strategic Fund for Reduction of Urban Poverty (PERPU)⁵⁶ and the Road Fund are allocated on the basis of a formula. The total resource pool varies by type of transfer. The FCA was initially 3 percent of total national tax collections, but this was reduced to 1.5 percent after the tax system was modernized. The Investment Fund for Municipal Initiatives (FIIA) is 0.75 percent of national tax collections (not defined in the law), the PERPU is 140 million meticaís (approximately US\$ 4.4 million) for each year, and the Road Fund is financed from 10 percent of fuel tax revenues. The criteria used for the allocation of the municipal transfers are reported in Table 16 below.

⁵⁶ The PERPU aims to generate employment and promote social protection. Loans are provided, which need to be repaid so that funds can be lent again, as part of a 'rotating fund.'

Table 16: Criteria for resource allocation at the municipal level

Source of financing	Criteria for allocating resources
Municipal Compensation Fund (FCA)	Population (75%) and size of territory (25%).
Investment Fund for Municipal Initiatives (FIIA)	No formula.
Strategic Program for the Reduction of Urban Poverty (PERPU) for 11 municipalities.	Fixed aspect: 55% of total resources are distributed equally. Variable aspect: size of urban territory (10%), population (40%), urban food poverty (40%) and collection of local revenue (10%).
Road Fund	Density of the road network in each municipality; and typology of each municipality, e.g. city or village.
Other sector grants	Discretionary and ad-hoc basis.

Source: World Bank Staff Compilation

b. Deconcentrated level

Revenue collection potential at the provincial and district levels is much more limited. Taxes collected by provinces and districts are shared with the central government; however there is limited information about the sharing rates. There are user charges and fees, where the most important are license fees on economic and commercial activities and market fees. Provinces and districts are free to set specific and ad valorem tax rates on their fees and tariffs, as long as rate determination abides by a number of quite general criteria, such as equality and ability to pay.

There are three main types of transfers to deconcentrated governments. The main component is a block grant for financing provincial and district level expenditures. In principle, this transfer is allocated based on population and poverty. Districts receive two grants directly from the central government – a District Investment Fund and a District Development Fund. The latter is a rotating fund to private agents with a focus on employment generation, although repayment rates seem to be low.

Table 17: Criteria for the allocation of transfers at the deconcentrated level

Source of financing	Criteria for allocating resources
Block grant to provinces	Population (70%) and Multi-dimensional poverty indicator ⁵⁷ (30%).
District Investment Fund (Fundo Investimento Distrital)	The same criteria are used: Population (30%), size of territory (20%), own revenue collection (15%) and poverty levels (30%) ⁵⁸
District Development Fund (Fundo Desenvolvimento Distrital)	

Source: World Bank Staff Compilation based on Cenário Fiscal de Medio Prazo methodology 2015-17

⁵⁷ The dimensions used to calculate multi-dimensional poverty are: consumption (30%), potable water (15%), sanitation (15%), health (20%) and education (20%)

⁵⁸ The provincial poverty rate is used as district level poverty data are not available or considered to be too unreliable

3. Assignment of policy responsibilities

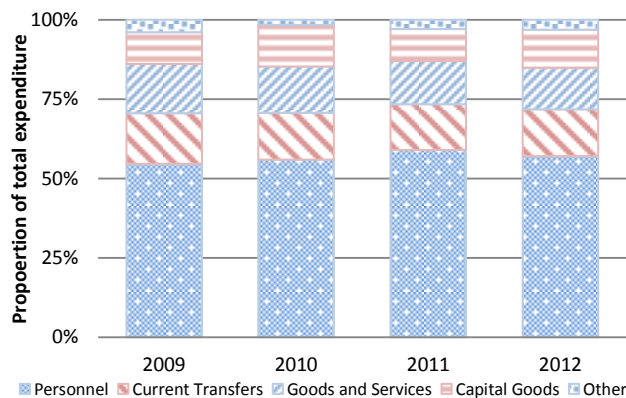
a. Municipalities

Municipalities currently provide typical urban services, but are permitted to take over responsibilities for primary education and health care. Clear municipal mandates include: local traffic, water, drainage, markets, cemeteries, parks and green spaces licensing and regulation of private transport, licensing and regulation of buildings.⁵⁹ For a municipality to deliver primary education and health services, a request must be made to the central government, after which the relevant ministry assesses capacity and is expected to provide financing for service provision. Other than Maputo the process of assuming additional responsibilities has not started. In Maputo, agreements for transferring primary health and education services were signed in 2009, but implementation was delayed.

b. Deconcentrated level

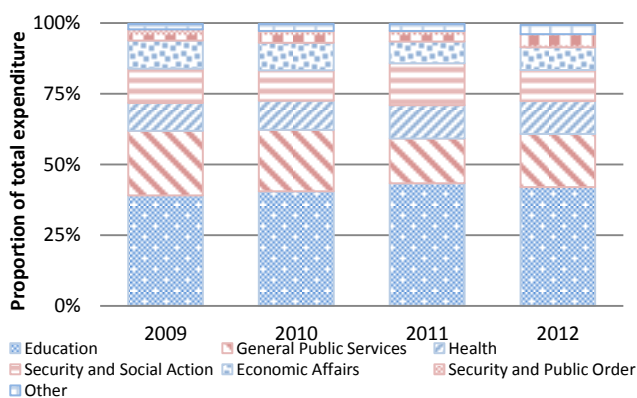
Provinces coordinate district activities, and both provinces and districts provide local services. Services provided at the provincial level are typical for intermediate levels of government, such as specific education and health functions and general infrastructure. Districts are responsible for services of local interest. Typical responsibilities would include water, sanitation and garbage disposal but these are provided at very basic levels or are almost nonexistent, because districts are mostly in rural areas and due to lack of resources. The largest proportion of deconcentrated spending is on personnel, and the largest share of sectoral spending goes towards education, reflecting deconcentration of the payroll to the district level.

Figure 120: The largest area of deconcentrated spending is on personnel



Source: Government of Mozambique

Figure 121: Of all deconcentrated expenditures, the largest share goes to education



⁵⁹ See World Bank 2009a for a detailed account of municipal functions

4. Planning and budgeting

a. Municipalities

The process of municipalities preparing plans and budgets involves interaction with the central government and with the Municipal Assembly. Each municipality has its own approach to planning, budgeting as the process has not been systemized. Municipalities prepare multi-year development plans that are approved by the Municipal Assembly. Following the communication of indicative budgetary limits from the central government, municipalities submit a budget proposal to the central government and to the Municipal Assembly. While in principle municipalities should be autonomously developing plans and budgets, the approval of the budget has to be ratified MoF, a power that can be delegated to the Provincial Governor.

b. Deconcentrated level

At the districts level, the budgeting process starts with the central government communicating a budget limit to the province, as part of the elaboration of the Cenário Fiscal de Médio Prazo (CFMP). Provinces and districts have development plans, which should be used to prioritize spending (see the chapter “Improving the Link between Plans and Budgets”). The central government also issues guidelines for the distribution of budget limits, where resources should be allocated to: (i) pro-poor priority sectors; (ii) ongoing activities (including recurrent expenses); (iii) fiscal obligations for externally financed projects; and (iv) social action programs and projects that can generate economic growth. Once the district has received the budget limit, this amount must be distributed to district services, with priority given to recurrent activities, as well as social action programs.

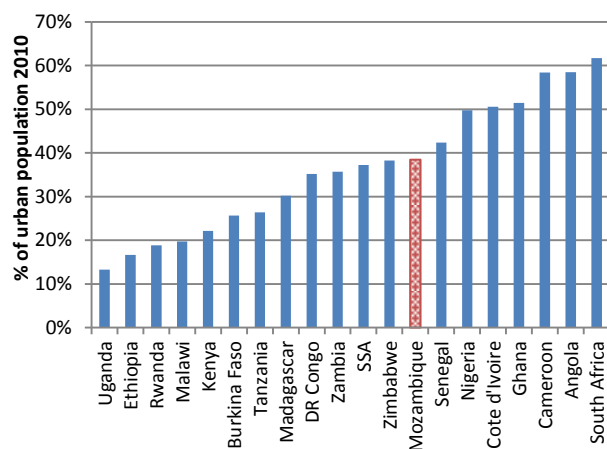
Assessment of the current system

5. Financing service provision

a. Municipalities

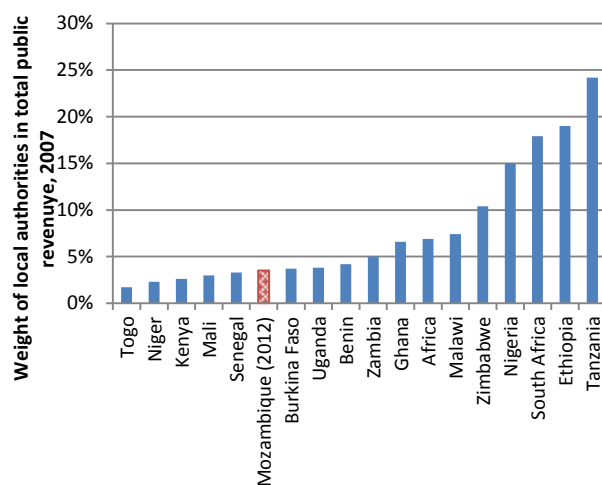
Overall, revenue levels are low for Mozambican municipalities. Revenue levels are low for the size of the urban population and compared with other countries where municipalities have similar functions. The urban population in Mozambique is higher than the sub-Saharan African average but revenues are disproportionately low. With improved tax administration it is possible to increase municipal revenues. Smaller and poorer municipalities could also increase revenues through central government support, for example through grants with an equalizing objective. This section discusses opportunities for realizing tax potential and improving the central government transfer system to facilitate this.

Figure 122: Compared with the region, Mozambique's urban population is higher than the average



Source: UNHABITAT and UNEP, 2010

Figure 123: But revenues for Mozambican municipalities are well below peer countries



Source: United Cities and Local Governments, 2010

The potential of the current system to finance local service provision is not yet fully exploited. There are two pillars to an efficient and equitable system: (i) a substantial tax autonomy, allowing the richest municipalities to finance most of their expenditure needs with their own revenue, and (ii) a grants systems with the capacity to fill the revenue disparities between the richest and the poorest municipalities, allowing every municipality to provide a similar level of service to their citizens. In the current system, the tax instruments in place are not in full use, which limits tax autonomy, and the equalizing impact of grants is still limited. Both these issues are discussed in this section.

The tax instruments available to municipalities comply with basic requirements of local taxes and have a large revenue potential. The burden of taxes such as head tax, ownership of property, property transactions and vehicles cannot be easily exported to other jurisdictions. The municipal tax base is also linked to local services. A particularly good example is the property tax, which is an ideal local tax. Since the value of a property is influenced by local public services, the provision of better infrastructure and services to a neighborhood results in property values rising, which also increases the base of the property tax.

Own taxes have a large untapped revenue potential, particularly in relation to the property tax and vehicle tax. The value of the property is the base of the property tax. However, with the exception of Maputo Council, many municipalities are still levying the previous tax, which is a poll tax on heads of households that produces almost insignificant collections. The tax on transfer of property is also non-exploited, since municipalities do not have information on property. Vehicle tax collections are made in the absence of a municipal register of vehicles and municipalities lament that centrally collected information on vehicles is not shared.

An assessment of the current tax effort in Maputo and Nampula municipalities illustrates the unrealized revenue potential. Maputo and Nampula are home to some of the largest municipalities, where income and wealth levels are higher than the national average. The analysis is likely to apply to other municipalities with very few exceptions. The assessment summarized in Table 19 shows that better exploitation of the tax base could substantially expand revenues.⁶⁰ In Maputo, the increase could potentially be from 1.3 percent of GDP to 3 percent of GDP, mainly through enhancing property tax collections. In Nampula, a similar effort could potentially increase collections from 0.9 percent of GDP to 2 percent of GDP.

Table 18: Present and potential size of total revenues: Maputo and Nampula

	Maputo		Nampula	
	<i>Present share on GDP</i>	<i>Potential share on GDP</i>	<i>Present share on GDP</i>	<i>Potential share on GDP</i>
Revenue collection	1.4	3.0	0.9	2.0
Local taxes	0.5	2.0	0.0	1.0
O/w property tax	0.2	1.0	0.0	0.6
O/w head tax	0.1	0.2	0.0	0.1
O/w vehicle tax	0.1	0.2		0.2
O/w property transaction ta:	0.1	0.7	0.0	0.3
Non tax own revenues	0.9	1.0	0.9	1.0
Transfers (including donors)	2.3	2.3	1.8	2.3
Total revenues net of donations	3.6	5.3	2.7	4.3

Source: World Bank Staff Estimates based on information provided in Annex B1

Increasing locally collected revenues would require improved tax administration. The property tax and other local taxes are quite complex to administer. For example, property tax administration requires (i) identification of properties and owners, which is difficult when property rights are not fully defined and basic requirements such as street addresses are missing; and (ii) evaluation and constant updating of property values, which is a challenging task even for sophisticated tax administrations. These challenges may exceed the capacity of most Mozambican municipalities. Municipalities also lack basic statistical data that are crucial for tax collection purposes, such as data from the civil registry and the national vehicles register.

There is considerable scope to improve incentives to realize the tax potential. Firstly, the central government has significant discretion in determining the total annual resource pool for the FIIA, which operates as a disincentive to taxing. Since there is no predictability in FIIA transfers, this reduces the

⁶⁰ The assessment is based on detailed information on revenue collection in Maputo and Nampula municipalities, revenue collection levels for the same tax instruments in other developing countries, and the characteristics of Maputo and Nampula municipalities, such as estimations of the tax base. Further details can be found in annex B2.

incentive to expand tax collections that may have high political costs. Secondly, the main grant, FCA, has no tax effort component in the allocation formula, which adversely affects the tax raising effort. Insertion of this component is not an easy task, requiring a measure of local tax capacity to be properly done. PERPU has a tax effort indicator, but it accounts for a very small share of total resources.

The system of grants does not address disparities in own revenue collection amongst municipalities. For the FCA, the formula does not include components such as wealth conditions, and fiscal capacity, which would promote equalization. Use of population in the formula means equal per capita amounts, but since the FCA only supplements own revenue, giving the same amount to each municipality maintains the existing inequities. The FCA also uses area as a criterion, which is mostly neutral in terms of redistribution. Regarding the FIIA, the equalizing impact is not discernible, as it is allocated on a discretionary basis to municipalities. In the case of the PERPU, the equalization impact is limited by its size (3 percent of total revenues) and the formula. Fifty percent of PERPU is distributed equally between municipalities. For the remaining 45 percent, the formula uses both tax effort as an indicator (which would provide positive incentives for tax collection) as well as a poverty indicator (which may act as a disincentive).

b. Deconcentrated level

For provinces and districts, own-revenues are low and central government transfers dominate as the main revenue source. Table 20 summarizes the structure of revenues for deconcentrated governments. Overall, there is limited tax collection at the provincial level, at only 2.5 percent of total revenues, and a still smaller, insignificant share of district revenues at 1.4 percent. There are different reasons for poor revenue collection. Firstly, deconcentrated governments have not been subject to the same tax reform as municipalities. Secondly, districts have to share a portion of taxes and fees with the central government which acts as a disincentive to the tax effort.

Table 19: Structure of own-revenues for provinces and districts in 2012

	in Million MT	in %
Province		
Provincial own-revenue collection (receita própria)	402	1.4
Provincial shared-revenue collection (receitas consignadas)	301	1.1
Provincial grant	27,792	97.5
Total	28,494	100.0
District		
District own-revenue collection (receita própria)	90	0.5
District grant	20,117	99.6
Total	20,208	100.0

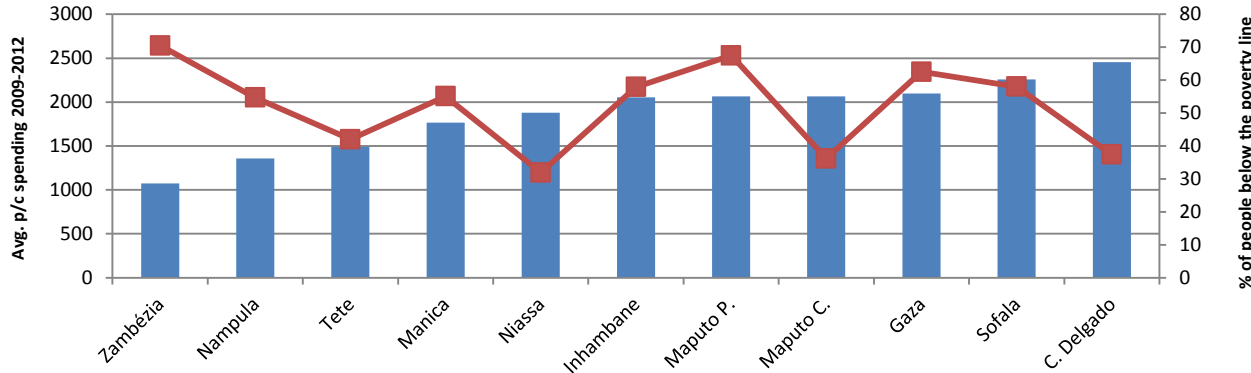
Source: CGE, 2012

Even within the current structure there is potential to increase revenues. Tariffs and fees could be productive at the district level, as they are linked to a wide range of locally managed public services, such as water supply and the use of public latrines, which districts can provide and for which the cost recovering principle should be applied. In principle, cost recovery should ensure correspondence between the value of services and the payment of fees, but this is not easy to ascertain by citizens. In some countries, to avoid abuses, lower and upper limits to tariffs and fees are introduced, which are appropriate for deconcentrated governments.

The transfer system for deconcentration should focus on ensuring equity in basic service provision. As Mozambique is a sparsely populated country with areas considered as ‘lagging’ in basic services provision, one objective of the transfer system would be to ensure a minimum level of services across the board (World Bank, 2009b). Another option would be to allocate resources based on need, where poorly performing areas receive larger transfers. A third option is to try to maximize returns to investments in the allocation of transfers, so that transfers go to the areas where the returns to investment are highest, which is appropriate for investments in economically productive areas that can stimulate growth and connect places. Over time, the proposed focus on equity of services delivery could move towards quality and performance, and a greater emphasis on efficiency.

The current system does not result in equitable transfers as there are significant differences in per capita transfers. Differences in annual average per capita transfers from the central to the provincial and district levels range from 1,073 MT in Zambézia to 2,457 MT in Cabo Delgado. Furthermore, there is minimal semblance between the amount transferred and the proportion of the population living below the poverty line. Zambézia receives on average the lowest transfer per capita, while the province has the highest proportion of people living below the poverty line. The differences in transfers may be motivated by existing recurrent commitments such as keeping existing health and education facilities running.

Figure 124: Per capita resource allocation does not reflect regional differences in poverty



Source: World Bank Staff Calculations based on Government of Mozambique, IOF 2008-09 and INE census data

Figure 125: There are large differences in operational spending...

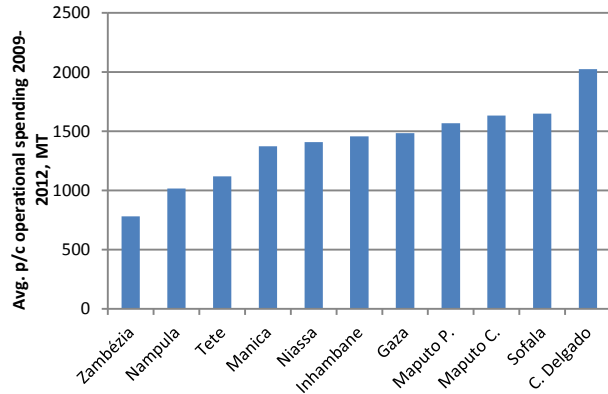
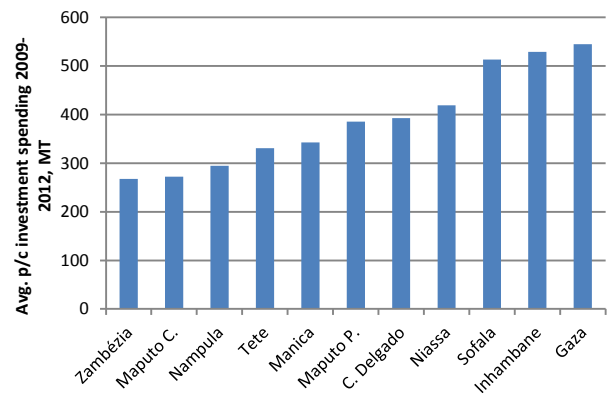


Figure 126: And investment spending is not compensating for variations...



Source: World Bank Staff Calculations based on Government of Mozambique, IOF 2008-09 and INE census data

6. Policy Responsibilities and outcomes

a. Municipalities

The process of municipalities assuming additional responsibilities has in part stalled due to lack of clarity on financing and the need to improve capacity in the smaller municipalities. Funding for transferred responsibilities is expected to come from increased transfers from the central government. In an ideal scenario, the transfers should reflect the standard cost of efficient service provision. However, detailed information on standard costs for efficient service delivery, for example in primary health centers or primary schools is not readily available. Even if such data did exist, it would be conceptually difficult to use, as standards are evaluated differently by the various stakeholders and reaching an agreement can be challenging.

Given these constraints, the current approach being used by Maputo municipality for the devolution of health services is an example of good practice. Maputo municipality health services is working with the central government to record the *existing costs* of service provision for each type of health facility, as opposed to ideal costs to reach efficient or appropriate standards. This information on the existing costs will provide the basis for the municipality requesting funds from the central government, with the expectation that there will be an increased transfer to the municipality in the 2015 budget.

b. Deconcentrated level

Spending on education and health, largely deconcentrated, is crucial for basic service delivery and poverty alleviation. From the perspective of provinces and districts, one of the most important successes of deconcentration reforms is the devolution of personnel management to the district level. In the education sector, deconcentration of the payroll is perceived to reduce teacher absenteeism, largely because of increased supervision. The existence of banking services in certain districts has also facilitated payments. However, other personnel management issues remain, such as lack of clarity about

payment of over-time. In the health sector, deconcentration is viewed to have reduced the level of bureaucracy, enabling the sector to focus more on policy making (see Table 20 below for an assignment of responsibilities in the education and health sectors among different government levels).

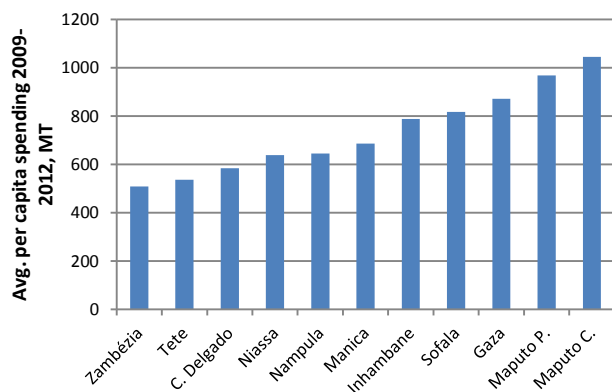
Table 20: Distribution of responsibilities in the education and health sectors

Area of responsibility	Territory with primary responsibility
National standards, policy, curricula	Central
Number of teachers or health workers recruited	Central
Personnel management and payment	District
Building and construction of schools and health facilities	In education, largely provincial but varies by type of school In health, varies by type of health facility
Implementation of standards, curricula and policies	District
Financing	Central

Source: World Bank Staff Compilation

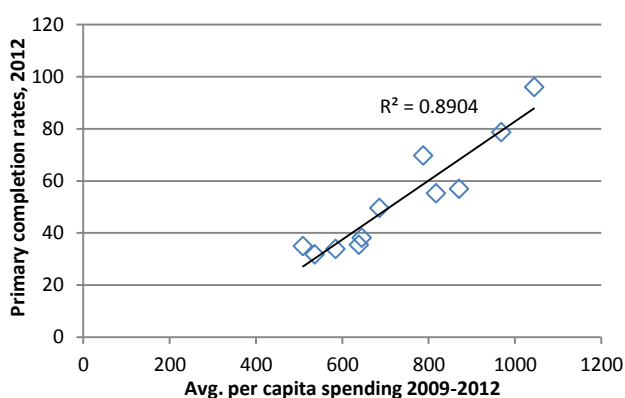
In education, there are significant differences in annual per capita spending across the country. It appears that provinces with higher per capita expenditures also have a higher primary completion rate which suggests that transfers are not allocated based primarily on equity concerns.

Figure 127: There are significant differences in per capita education spending....



Source: Government of Mozambique

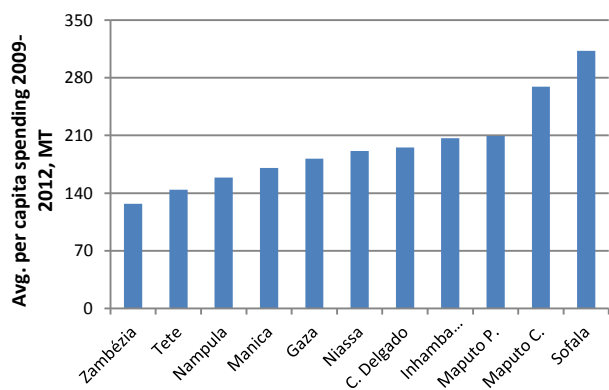
Figure 128: ...There are large disparities in educational outcomes and per capita transfers



Source: Primary completion rate data from MoE, spending data from Government of Mozambique

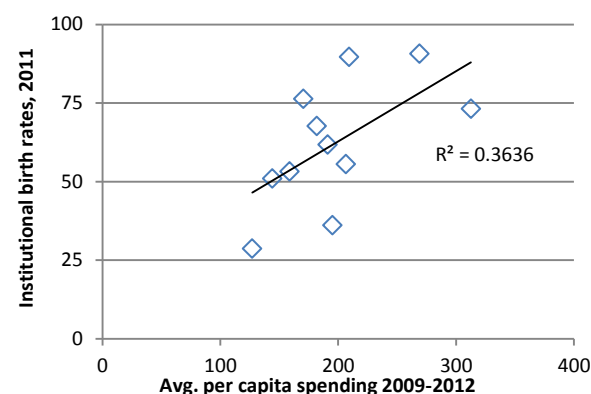
In health, per capita spending and outcomes vary significantly across the country. Provinces with higher per capita spending also appear to have higher institutional birth rates (an important indicator for the overall performance of the health system). However, it is noticeable that provinces with similar per capita spending levels have significantly different levels of institutional birth rates. Overall, the high levels of centralized health spending, as well as expenditures by donors outside of government systems, suggests that a certain degree of caution is needed in interpreting the findings.

Figure 129: There are significant variations in per capita health spending



Source: Government of Mozambique

Figure 130: Higher per capita spending are associated with increased institutional birth rates



Source: Demographic and Health Survey, 2011 and Government of Mozambique

7. Planning and budgeting

a. Municipalities

There is no detailed sectoral classification of the budget, limiting an assessment of how resources are allocated to key municipal functions. Usually, municipal budgets are limited to economic classification, with no allocation to functions, programs or activities. However, Nampula municipality is an interesting exception, where a detailed activity plan is developed, based on municipal mandates, which is costed by activity and by line item. The approach used in Nampula municipality facilitates analysis of resource allocation against activities, which helps to monitor the budget and delivery on policy priorities.

b. Deconcentration

The guidelines issued by the central government for preparing budget proposals follows good practice, but are largely geared to maintaining existing services running. Examples of good practice include ensuring non-discretionary costs and fiscal obligations are budgeted for and requiring local governments to report on projections of internally collected revenues. However, since emphasis is on running costs, there is limited scope for allocating resources to new priorities or investments that could potentially reduce inequities between provinces. There is also limited sectoral input in deconcentrated budgets, since in practice local governments and line ministries are required to submit proposals at the same time. Furthermore, with the current planning and budgeting processes, there is a lack of predictability and transparency in resource allocation, where deconcentrated units have limited understanding of the basis for transfers.

Options for reform

8. Developing revenue sources for adequate service provision

a. Municipalities

Tax administration capacity should be enhanced to realize the potential of the 2008 reform. As a starting point, there should be a national strategy for strengthening municipal tax administration. This is a longstanding issue, which was already identified as a priority in the previous Public Expenditure Review for Mozambique (World Bank, 2001). A number of practical measures can also be undertaken. Firstly, the central government should share relevant information to enhance revenue collection and monitoring of payments, such as national databases on registered vehicles, population, land and property. Secondly, substantial effort is required to build a cadaster or register of properties, and to keep the values updated. Thirdly, the system of tax collection should reflect the residence of the taxpayer. For the vehicle tax this requires using the vehicles register to allow correct administration of vehicle tax collections. For the head tax, the sums withheld by firms on account of their employees should be transferred to the municipalities of their residence. This process can be facilitated by including a municipal tax code in the firms' tax forms for each worker indicating the municipality of its residence.

Transfers should help to correct for the differences in municipalities' 'fiscal capacity', which estimates the revenues that municipalities could collect. Experience from other countries shows that this is most effectively done through having an allocation formula based on 'fiscal capacity'. Fiscal capacity is not what municipalities actually collect, but what they could collect if the average tax rate for all municipalities was applied to their tax base. This means that if a local government collects less than the potential revenue the grant will not compensate for the difference. While if a local government collects more than what corresponds to its tax capacity, the grant will not be reduced. (An illustration of the main models of equalization grants is provided in annex B2, showing how fiscal capacity is applied.)

Estimating 'fiscal capacity' is a challenging task, but there are practical options to stimulate tax effort. A first option could be to allocate a fraction of the grants according to the rate of growth of own revenues, hence remunerating those municipalities that exert a larger tax effort than the average. To reduce large fluctuations from one year to the other a moving average of the growth rate of own-revenues in the last three to four years could be envisaged. A second alternative would be implementing a 'matching principle', where revenues collected by a municipality are matched by the central government through a co-financing grant. As Mozambique has different categories of municipalities, smaller/poorer municipalities could have higher matching rates. These rates would be reviewed after a three to five year implementation period.

The municipal investment fund as well as sector and ad-hoc grants should be allocated in a transparent process. While MoF has developed a mechanism for determining the size of the overall pool of resources, it is unclear how exactly resources are allocated to each municipality, since information on allocation is not made public.

b. Deconcentrated level

There is also scope to enhance tax administration at the deconcentrated level. Firstly, the 2008 tax reform for municipalities could be extended to districts. This would expand significantly district revenue collections and eliminate disparities in tax obligations between residents of municipalities and districts. Secondly, if the tax reforms are implemented, provincial offices could take responsibility for administration. Districts are generally not well equipped to deal with complex taxes. To promote tax collection, directives could be sent from the central government to ensure all districts exert similar levels of effort. Thirdly, the system of sharing taxes and fees between the central government and the districts should be revised. The preferable option would be to abandon the system of sharing, since the current practice results in insignificant collections. The second best option is for the central government to exert renewed focus on clarifying and communicating the sharing rates.

Equalization of revenues among provinces and districts should also be enhanced. The present allocation of the provincial grant on the basis of existing levels of service provision maintains disparities that are justified only on a temporary basis. Over time, this could be corrected through the effective use of formula-based approach to allocating the transfer (see below).

9. **Policy Responsibilities**

a. Municipalities

The transfer of additional functions to municipalities has to be managed carefully. A number of steps are recommended: (i) funding provided by the central government should be based on careful calculation of present actual costs of service provision (as observed in Maputo health services) and (ii) a timeline should be developed for the transfer of responsibilities with proper sequencing, which could distinguish between different types of municipalities. Also, before new responsibilities are transferred, it is important to verify that municipalities have adequate capacity to provide the services.

b. Deconcentrated level

By implementing a formula-based approach, provinces and districts would potentially have greater autonomy to deliver public services in line with local needs. The broad assignment of responsibilities is largely in line with good practice, there is no need to devolve more responsibilities at this stage. By moving towards a formula-based transfer, provinces and districts could have increased flexibility to deliver public services in line with local priorities. This greater flexibility at the subnational level should be complemented with capacity building measures.

10. Planning and budgeting

a. Municipalities

Municipalities should adopt an integrated financial management information system, which should involve rolling out e-SISTAFE. The lack of a uniform system is widely recognized to be an issue. The e-SISTAFE system, already used by the central government and the deconcentrated levels, should be rolled out to all municipalities. This would facilitate the transfer of competencies from the central government, in the event that these are financed by increased central government grants.

It would be beneficial to improve the link between municipal budgets and functions undertaken. In particular, it would be important to focus on how discretionary resources (such as the FIIA and own-generated revenues) are allocated according to policy responsibilities and commitments in the municipal mandate. Nampula municipality is a good example of how it is possible to allocate resources against activities in a way that can be clearly understood and monitored. To ensure consistency in budget classification, efforts could start with introducing the functional classification of expense in line with IMF standards, which has been done successfully at the central and deconcentrated levels.

b. Deconcentrated level

The planning and budgeting process should be re-orientated through the introduction of a formula-based transfer allocated on a per capita basis. The introduction of a formula-based transfer would mean provinces and districts have predictability in revenues, reducing the need to negotiate with the central government as part of a lengthy planning and budgeting process. This would significantly streamline the current planning system, freeing up valuable human and financial resources.

The formula based transfer should have clear provisions for per capita allocations. The first option is to have a transfer based on equal per capita allocations. While the current allocation criteria include population, this chapter has discussed the large disparities in per capita transfers between provinces. A second option is to allocate per capita transfers for specific sectors such as education and health, ensuring a minimum share is spent on these sectors. These two options are relatively straightforward to implement.

Going further, it could be possible to implement a formula-based transfer that focuses on minimum standards. One approach could be to introduce a formula based on indicators of expenditure needs on a general basis, which would apply to the total expenditure of a province or district, e.g. a total grant that could include indicators of needs such as area and number of pupils in school. Another option which is relatively more complex is to introduce a formula based on specific indicators of need for each expenditure responsibility (for example, specific indicators for an education component, a health component and so on). A number of countries in Africa have a population based criteria in the allocation formula, as well as indicators of expenditure needs such as Ghana, Kenya, Uganda and Tanzania. For example, in Uganda there are sector specific grants (for health, education, water and so

on) which each have their own allocation formulae based on existing expenditure needs and objective expenditure needs (Steffenson, 2005). (See annex B2 for more information on how these formula-based approaches can be constructed.)

This chapter discusses options for improving service delivery at the subnational level. Subnational spending levels are reaching 38 percent of total spending in 2012. There has been a renewed focus on deconcentration where districts are assuming greater responsibility for managing public resources, largely due to deconcentration of the payroll. There is also an expectation that municipalities will take greater responsibility in delivering basic services in health and education. There is significant scope to improve the way local services are financed. There is potential to increase locally collected revenues through enhancing incentives and capacity. The tax administration reform of 2008 greatly increases the potential of municipal tax collection, but many of the provisions have not been implemented. Transfers to municipalities should be subject to a formula based allocation. Transfers should also help to correct for differences in municipalities' fiscal capacity. For deconcentrated governments, a formula-based transfer could be introduced that focuses on per capita allocations. These reforms would simplify current planning and budgeting procedures, and provide municipalities and districts with more autonomy to undertake policy responsibilities in line with local priorities.

VII. Looking Ahead: Expenditure Options over the Medium Term

The current fiscal expansion will need to be followed by a tightening of fiscal policy over the next few years, but the government will have space to increase allocation to policy priorities even in a fiscal consolidation scenario. The development of coal, natural gas and other resource industries in Mozambique is likely to significantly increase the government's fiscal resources particularly after 2020 (World Bank, 2014b). This will open policy space to allocate additional resources to priority sectors. Mozambique's fiscal situation will also change over the medium term. Growth is projected to remain strong, boosting fiscal revenues. This increase may be partially offset by declining grants and limited concessional financing. An increase in debt levels in recent years will limit the government's recourse to deficit financing over the medium term. The relatively expansionary fiscal stance of the past few years may need to be followed by a period of fiscal consolidation, but Mozambique will still have sufficient space to increase spending in priority sectors. Ensuring adequate fiscal resources are available to support poverty reduction and inclusive growth in a context of fiscal consolidation will require difficult tradeoffs and the careful prioritization of expenditures. This chapter simulates different scenarios and discusses the policy options facing Mozambique over the medium term, before the revenues from coal and gas development fundamentally alter its fiscal position.

1. The changing macro-fiscal outlook

The baseline medium-term fiscal framework (MTFF) assumes moderate revenue growth, declining grant financing and a modest fiscal consolidation effort, which together should cause deficits to fall from 9 percent of GDP in 2014 to 5 percent by 2019. The baseline MTFF in this exercise is the same one used by the IMF in its Second Review under the Policy Support Instrument (IMF, 2014).⁶¹ On the revenue side, the framework assumes no additional capital gains taxes in the future, which leads to a decline in revenues in 2015 followed by a consistent growth rate of 4 percentage points per year in subsequent years. In line with recent trends, grants are also projected to fall to 2.5 percent of GDP in 2019. Total expenditures are expected to decline from their 2014 levels as the government implements a fiscal consolidation policy. The decline in expenditures and steady revenue growth are expected to bring the deficit from 9 percent of GDP in 2014 to 5 percent by 2019. A summary of the assumptions used to develop the fiscal framework is presented in the box below while Table 21 details the baseline MTFF.

⁶¹ Assumptions are largely aligned with those of the CFMP adopted by the Government of Mozambique and the IMF PSI. There are some differences in figures between the CFMP and the IMF PSI on the one hand and the baseline MTFF on the other since documents are produced at different times. The CFMP was published most recently in June 2013.

Box 7: Trends reflected in the Baseline Medium Term Fiscal Framework

- **Revenues/GDP** will grow by about 0.4 percentage points every year in 2015-2019, with an end to capital gains taxes in 2014
- **Grants/GDP** will show a downward trend with a decline of about 0.5 percentage points per year
- **Expenditure/GDP** will decline by 6 percentage points in 2015 followed by a gradual fiscal consolidation effort of 0.4 percentage points per year
- **Deficit/GDP** would narrow to 5 percent by 2019 as a result of growing revenues and declining expenditures from 2015-19
- **The GDP deflator** would remain constant at 5.6 percent per year until 2019
- **Real growth** would remain at 8 percent per annum until 2019

Table 21: Medium Term Fiscal Framework (Baseline Scenario)

% of GDP	2013	2014	2015	2016	2017	2018	2019
Total Revenue	27.5	27.3	24.7	25.1	25.5	25.9	26.3
Tax Revenue	23.4	23.4	20.8	21.2	21.6	22.0	22.4
Regular Tax	19.4	20.4	20.8	21.2	21.6	22.0	22.4
Capital gains	4.0	3.0	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	4.1	3.9	3.9	3.9	3.9	3.9	3.9
Grants	5.4	4.9	4.4	4.0	3.5	3.0	2.5
Total Expenditure	35.6	41.6	35.6	35.2	34.7	34.3	33.9
Compensation of employees	10.7	11.0	10.4	10.0	9.7	9.3	9.0
Priority spending	13.4	16.4	13.3	13.3	13.2	13.1	13.0
Non-priority spending	10.6	12.9	10.5	10.4	10.4	10.3	10.2
Interest payments	0.9	1.3	1.4	1.5	1.5	1.6	1.7
Deficit	-8.1	-14.3	-10.9	-10.1	-9.2	-8.4	-7.6
Balance after grants	-2.7	-9.4	-6.4	-6.1	-5.8	-5.4	-5.1
Financing	2.7	9.4	6.4	6.1	5.8	5.4	5.1
Internal	-3.0	-0.1	0.5	0.0	0.0	0.2	0.2
External	5.7	9.5	5.9	6.1	5.8	5.2	4.9
GDP	461.0	526.0	600.1	684.7	781.2	891.4	1017.0
GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	225.1	243.2	262.7	283.9	306.7	331.4
GDP growth	7.1	8.0	8.0	8.0	8.0	8.0	8.0

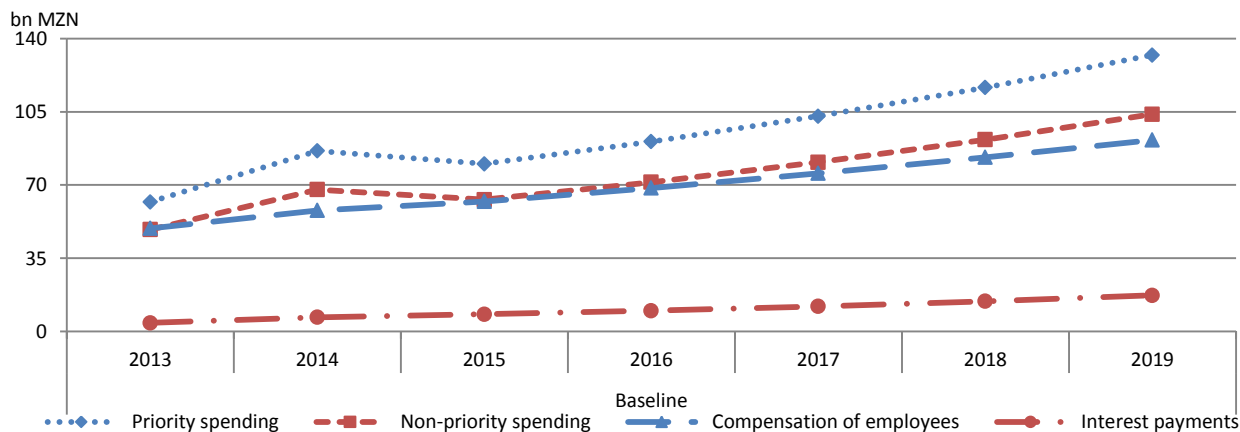
Source: World Bank Staff Estimates based on IMF (2014)

This simulation exercise evaluates a set of policy options available to the government for allocating additional spending to priority areas. Previous chapters have reviewed strategies for improving spending patterns, which could be complemented with efforts to enhance efficiency and boost allocations to priority areas. This chapter classifies spending according to four broad categories for the purpose of the discussion: (i) wages, (ii) interest payments, (iii) priority spending and (iv) non-priority spending. Interest payments are regarded as largely exogenous. The public sector wage level is one of

the key policy decisions facing the government and, as discussed in the chapter “Macroeconomic and Fiscal Developments”, comparisons with peer countries suggest that there may be room for reversing the recent trend of wage-bill increases. Priority spending includes all sectors that are likely to have a greater contribution to poverty reduction and inclusive growth. For the purposes of this analysis, priority sectors include education, health, water, agriculture, infrastructure and social protection.

Without reprioritizing public spending, priority spending would increase by a modest 8 percent per year in the medium term. As with the analysis presented in the preceding chapters, expenditure types are classified according to their functions (using the government’s functional classification).⁶² In addition, the definition of infrastructure spending has been broadened to include on-lending by the government to public enterprises to finance infrastructure investment.⁶³ Figure 131, below, illustrates expenditure patterns over the medium term, assuming no reorientation takes places between priority and non-priority spending from 2013 to 2019. The baseline shows that priority spending would increase (in nominal terms) from MT60 billion to MT132 billion over the simulation period, or around 8 percent per year in real terms, until it represents approximately 38 percent of spending in 2019. Non-priority spending would account for 30 percent of total spending in 2019, while wages would decline from 30 percent of spending in 2013 to 26 percent by 2019.

Figure 131: Baseline for expenditure trends in Mozambique



Source: World Bank Staff Estimates

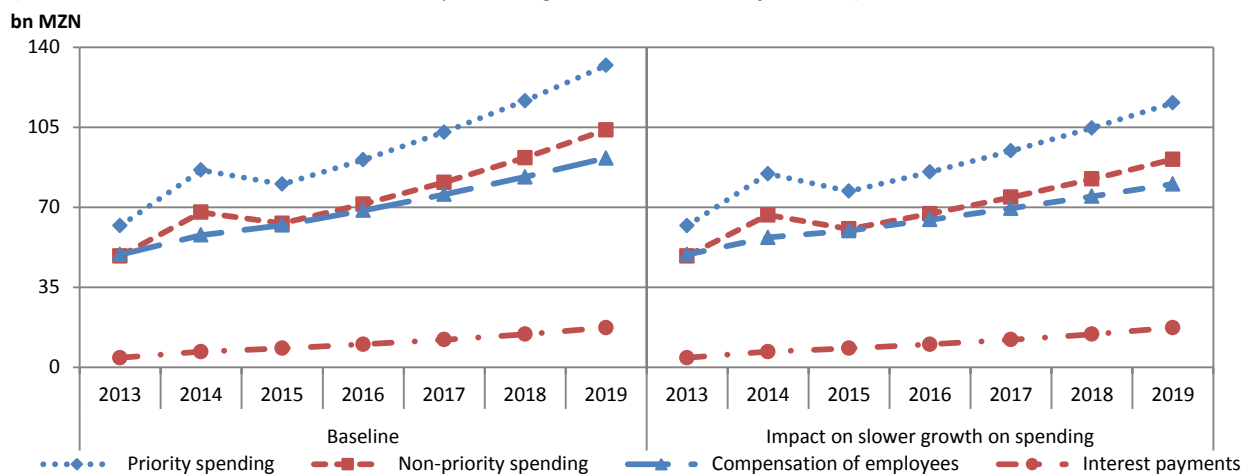
⁶² MoF’s methodology for calculating priority spending is not being used, as this is mainly based on administrative units, which may lead to spending towards a specific policy objective being under or over-estimated. The government’s functional classification of expense has been used to determine priority vs. non-priority spending. Examples of priority functions include education, health, water, agriculture, infrastructure and social protection.

⁶³ This is classified under “active financial operations” in the budget documentation.

2. Factoring in external shocks

The baseline scenario assumes a real economic growth rate of 8 percent per year, but growth is vulnerable to external shocks. GDP growth of 5 percent per year would lower priority spending growth to around 5 percent per year. While Mozambique’s recent growth has been impressive, the country remains exposed to exogenous shocks, for example related to commodity prices, global demand for its exports, short-term natural disasters and long-term climate risks. A slower growth rate of 5 percent, which is near the average for sub-Saharan Africa, would significantly reduce the fiscal resource envelope. The government could respond to lower growth and slowing public revenues by moderating expenditures, widening the deficit, or through a combination of the two. If the government reacts to lower growth by curbing expenditures across the board, with no reallocation to priority sectors, priority spending in 2019 would decline from MT132 billion in the baseline scenario to MT115 billion, a growth rate of 11 percent (in nominal terms) rather than the 13.5 percent envisioned in the baseline scenario. See Figure 132 below and Annex C for the resulting fiscal macro-fiscal framework.

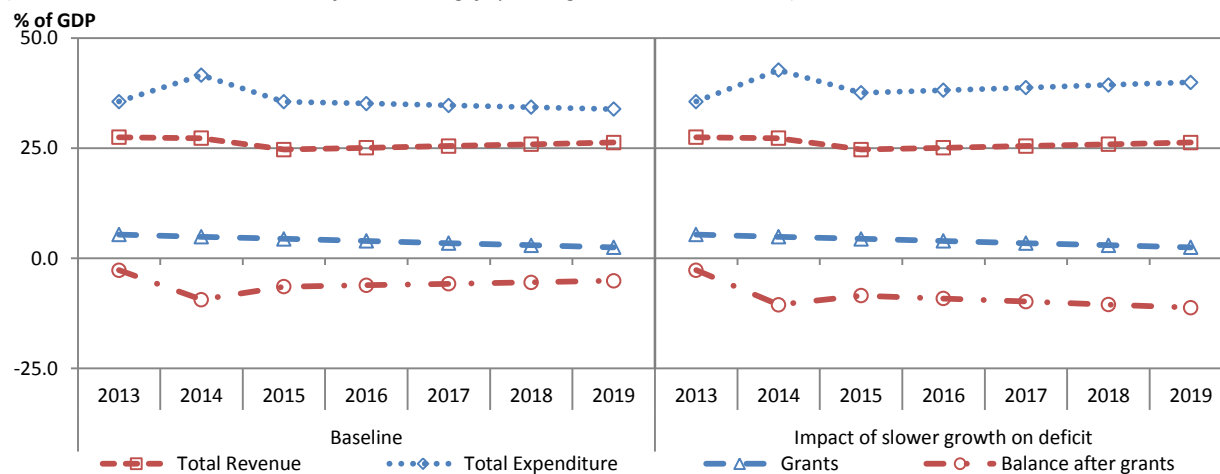
Figure 132: The impact of slowing growth on spending levels
(LHS is baseline, RHS illustrates moderate expenditure growth to maintain deficit levels)



Source: World Bank Staff Estimates

If public expenditure grows at the same rate as in the baseline scenario but GDP growth slows down to 5 percent, budget deficits would widen to 11 percent by 2019, exceeding sustainable levels. Instead of moderating expenditure growth, the government could choose to allow for larger budget deficits in the hope that more rapid growth would soon resume. If public spending is maintained at the same level as in the baseline, but resources decline as a result of lower growth, the deficit would widen to 11 percent of GDP in 2019, more than double the 5 percent envisioned in the baseline scenario (see Figure 133 below). It is unlikely that the government would maintain increasing deficits over a long period when faced with persistent moderate growth, but this simulation illustrates the sensitivity of the baseline to assumptions made on growth.

Figure 133: The impact of slowing growth on budget deficits
(LHS is baseline, RHS illustrates deficit widening if spending levels are maintained)



Source: World Bank Staff Estimates

3. Options for Increasing Priority Spending

The government has a number of policy options, each with its own benefits and costs, for increasing resource allocation to priority sectors. The level of additional resources available for priority spending will depend on how the overall resource envelope changes and on the reallocation of funds to priority sectors. None of these policy choices are necessarily easy, and there are trade-offs that will need to be taken into account. Limits on the public-sector wage bill would involve sensitive political-economic tradeoffs and would need to be implemented in a way that ensures the government can maintain a motivated public sector. Allocating additional spending to priority sectors would also need to take into account the quality of spending at the sector level to ensure additional resources are effectively utilized. This chapter simulates the impact of three different scenarios on resources for priority spending. Detailed information on the macro-fiscal framework for each of these scenarios can be found in Annex C.

Scenario I: An increasing resource envelope without expenditure prioritization

In the first scenario the government could aim for a higher resource-envelope that boosts spending across the board without prioritizing any particular sector or expenditure category. This could include: (i) an increase in public revenues, for example through reducing tax incentives and other tax administration reforms that broaden the base, though the chapter “Tax Policy in Transition” recognizes the limits to such a strategy; (ii) a slower-than-anticipated decline in grants as a share of GDP, though this would be largely exogenous and dependent on decisions by development partners; and (iii) an increase in deficit spending, taking into account debt sustainability and the need to tighten fiscal policy to ensure macroeconomic stability. The simulation assumes revenues of 29 percent of GDP by 2019, deficits narrowing to 6 percent of GDP by 2019 and grants declining to 4 percent. In a scenario where the resource envelope increases without allocating a larger share of resources to priority sectors,

priority spending by 2019 would be MT155 billion, significantly higher than the MT132 billion in the baseline scenario, or 15 percent vs. 13 percent of GDP.

Scenario II: A constant resource envelope with expenditure prioritization

The government could choose to maintain the fiscal consolidation effort assumed in the baseline scenario to lower debt levels and reduce vulnerabilities while reallocating to priority sectors. In this case, the resource envelope is assumed to remain unchanged from the baseline. The government could create fiscal space for priority spending by limiting expenditure growth in other areas. In the extreme case, zero real growth in spending on wages and non-priority sectors is assumed, which would mean compensation of employees would be 7.3 percent of GDP by 2019. Such a policy decision would enable priority sector spending to increase from MT132 billion in the baseline to MT173 billion, or from 13 percent to 17 percent as a share of GDP. Therefore, priority sector spending could increase significantly even in a period of fiscal consolidation.

To create fiscal space to increase spending in priority sectors, Mozambique could more realistically aim for a target of the wage bill as 9 percent of GDP by 2019. Such a measure would enable the government to increase overall resources to priority sectors, including to the wage bill in priority sectors while tightening fiscal policy. One option could be to limit salary adjustments for both priority and non-priority to be in line with inflation. Implementing this option in the 2015 budget could potentially create additional fiscal space of MT 548 million. A second option could be to have zero real growth of the wage bill in non-priority sectors (thereby still allowing recruitment, promotion and salary adjustments to increase in line with inflation). If this option was implemented in the 2015 budget an additional MT 272 million would be available for spending on priority areas. For both these options, the additional resources could be reallocated towards increased recruitment in priority sectors to address the need for additional health and education workers. Therefore, by reprioritizing how the total wage bill is managed it is possible to increase spending on much needed priority areas and still follow a fiscal consolidation path.

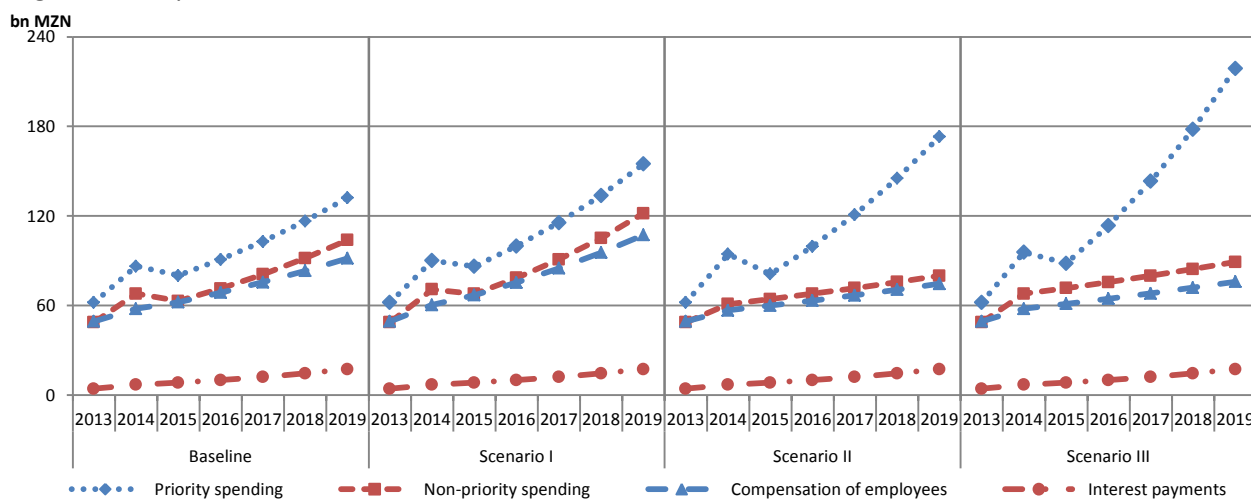
Efficiency gains in public spending and sharing the costs of infrastructure investments with the private sector could also create fiscal space to allocate to policy priorities. Analysis in this report shows that many of Mozambique's peer countries are achieving similar or better development outcomes with fewer resources, which suggests that significant efficiency gains are possible. More detailed sectoral analysis at the sectoral level and of individual programs would inform reforms to improve efficiency, but this report suggests reforms that would improve outcomes, often at relatively low costs. In the education sector, pre-service training for teachers and school directors, combined with the implementation of school councils, would improve performance of the sector. In the health sector, community based interventions and improved planning hold much promise. Improved coordination will be necessary in sectors that by nature cut across sectors, such as infrastructure investments and agriculture. Increased efforts will also be necessary to improve the pro-poor orientation of public spending, since significant differences in access remain and spending remains low in some sectors that affect the poor the most, such as rural water and sanitation. The government could also seek to partner

with the private sector to finance and operate infrastructure investments with significant financial returns, which would free up resources to invest in other areas with little private interest.

Scenario III: An increasing resource envelope with expenditure prioritization

The government could also combine a larger resource envelope (as simulated under scenario I) with a reallocation of spending to priority sectors (as simulated under scenario II), so that available resources for priority sectors increase more rapidly. In this scenario priority spending would increase from MT132 billion to almost MT220 billion by 2019. Priority spending in this scenario would be 65 percent higher by 2019 than in the baseline scenario, or 21.5 percent of GDP vs. 13 percent in the baseline scenario. Figure 134 below shows the expenditure levels of the different components under these scenarios.

Figure 134: Expenditure trends under different scenarios



Source: World Bank estimates

4. Meeting priority development needs in a fiscal consolidation scenario

These simulations show that over the medium term the government can increase spending in priority sectors, but doing so will involve important policy tradeoffs. In the baseline scenario, which assumes a moderate fiscal consolidation effort, priority spending would increase by around 8 percent per year, reaching 38 percent of all spending by 2019. The government's ability to do that depends to a large extent on the continuation of strong economic growth. A slowdown to 5 percent per year would have implications for the overall resource envelope and priority spending, which would grow by around 5 percent per year in real terms, assuming spending patterns similar to those in the baseline.

Even in a fiscal consolidation scenario, the government will have options to allocate more resources to priority spending, including limiting the growth of the wage bill and non-priority spending. Possible options to increase the overall resource envelope are discussed in chapters "Macroeconomic and Fiscal Developments" and "Tax Policy in Transition". Given how successful Mozambique has already been in increasing tax revenues through administrative reforms, and the recent rise in debt levels, there may be

limited scope for further substantial increases in the resource envelope. The government could also increase resource allocation to priority sectors by limiting the growth of the wage bill, spending on non-priority sectors, and working with the private sector to share risks for infrastructure investment. These are not easy policy choices, but they could be a key component of a strategy to allocate increased resources to priority sectors in a fiscal consolidation scenario. Efforts to allocate additional resources to priority sectors should be combined with efforts to improve spending at the sector level, as briefly discussed in chapters “Improving the Link between Plans and Budgets”, “Sectoral Expenditure Trends” and “Strengthening Sub-National Service Delivery”.

Table 22: Summary of priority spending levels by 2019 under different scenarios

(in 2019)	MT billion	Real growth 2013-19	% GDP	% total spending
Baseline	132	7.9	13.0	38.3
Scenario I	155	10.9	15.2	38.6
Scenario II	173	13.1	17.0	50.2
Scenario III	219	17.8	21.5	54.6

Source: World Bank Staff Estimates

This chapter discusses options for the government to increase priority spending in the medium term, before the surge of revenues from coal and gas toward the end of the decade. The simulation of different scenarios shows that over the medium-term it will be possible for the government to create fiscal space for increased spending in priority sectors. On the revenue side, the scope to increase the overall resource-envelope through tax revenues or debt is likely to be limited. On the expenditure side, the government will have a number of options to creating the necessary fiscal space. It could limit growth in the wage bill by limiting salary adjustments to inflation and new recruitments to priority sectors. This would allow the government to meet the needs of priority sectors for additional staff, in particular the education and health sectors, while bringing the wage bill to more sustainable levels. Public spending can also be made more efficient through reforms, often at very low cost. More detailed analysis at the sectoral and program level would be needed to inform reforms, but this report already provides a number of suggestions to improve development outcomes with the available resource envelope. In addition, the government could seek to partner with the private sector to finance and operate infrastructure with significant financial returns. This would free up resources to invest in sector with little private sector interest. These are not easy policy choices and will often require strengthening existing government systems, but should be a key component of a strategy to allocate increased resources to priority sectors in a fiscal consolidation scenario.

VIII. Conclusions

In recent years Mozambique's economic growth rate has been impressive, as has its revenue performance. On average, domestic revenues grew by 13 percent per year from 2000 to 2013, in real terms, and recent windfall capital gains taxes further boosted total government revenues. In 2013, domestic revenues reached 27 percent of GDP, comparable with South Africa, putting Mozambique in a strong position relative to its peers.

While significant progress has been achieved in improving tax administration, there are still areas for further improvement. The government has established a solid legal framework for taxation. Overall tax revenues have increased more than proportionately to economic growth. However, the tax system is still in transition. Areas for improvement include simplifying the tax regime, consolidating codes for small and medium taxpayers, and revising the current overly generous system of fiscal incentives, which favors certain types of investment. In addition, and given the likely increase in revenues from extractive industries toward the end of the decade, it would be important to strengthen tax administration to deal with this type of revenues.

The rapid increase in public spending over the past few years, projected to reach over 40 percent of GDP in 2014, needs to be followed by a fiscal consolidation period. Spending has increased in real terms by an average of 12 percent per year from 2000 to 2013. So far, the rapid rise in spending has been matched by an increase in revenue collection, but this may be difficult to maintain over the medium term. As significant advances have already been made in tax administration reform, domestic revenues may not continue growing at the same pace as in recent years. The level of grants is also expected to decline, and these developments highlight the importance of consolidating the government's fiscal stance. The recent increase in spending raises concerns regarding both fiscal sustainability and the effectiveness of public spending, suggesting the need to tighten fiscal policy in the near future.

Spending on the wage bill is consistently increasing and will reach 11 percent of GDP in 2014. Real public spending on wages increased at an average of 11 percent per year from 2000-2013. Compared with other countries, the number of public sector employees in Mozambique is relatively small, but public-sector remuneration levels are comparatively high. Public sector productivity also appears relatively low compared with other countries. There will continue to be pressures to increase public sector compensation levels, but these and the need for a sufficiently large and motivated public sector workforce in sectors such as education and health will need to be balanced with the need to reduce the wage bill to more sustainable levels. Limiting salary adjustments to inflation would allow the government to meet the demand for additional staff in priority sectors, such as education and health, while bringing the wage bill to more sustainable levels.

The government is rapidly scaling-up public investment and will need to strengthen systems to manage public investments in infrastructure. Public investments are increasingly being financed through domestic revenues and loans, with less reliance on donor support. This shift in the composition

of financing means that the government will need to play a greater role in public investment management. The government has already developed an Integrated Investment Plan, highlighting key areas such as transport, energy and irrigation. However, the success of these investment projects will depend on the quality of the public investment management system, which can still be significantly strengthened. The government could also seek to partner with the private sector to finance and operate infrastructure investments with significant financial returns (e.g. through PPPs or a greater role for SOEs). Such a strategy should be accompanied by efforts to strengthen government systems to manage the fiscal risks likely to emerge.

Debt levels have increased substantially in recent years, and fiscal risks also seem to be on the rise.

While current debt levels remain sustainable, the overall risk of debt distress has increased. To improve the debt sustainability outlook the pace of public borrowing should be moderated, and opportunities for additional concessional borrowing should be explored, in line with the medium term debt strategy. Going forward, the government should adopt a tighter fiscal stance to maintain debt sustainability. Fiscal risks also appear to have increased, though information on this topic is limited, underscoring the importance of improving reporting of fiscal risks in budget documentation and the need to enhance the government's management of fiscal risks, particularly if the private sector is to take a greater role in the financing and operation of infrastructure investments.

While Mozambique has made progress in improving public financial management reforms, there is still considerable scope to improve the link between planning and budgeting. It is not easy for citizens or other stakeholders to monitor the level of resources allocated to key public services or evaluate service delivery. Improving the link between budgeting and planning documents would require a number of technical reforms, such as widening the scope of actors involved in the reforms and, most importantly, engaging civil society so that citizens demand better information on how the budget will improve public service and promote more inclusive growth.

Overall spending on priority areas is increasing as a share of GDP. While spending has increased significantly on infrastructure and social protection, the total levels allocated to water and agriculture are declining. Starting from a very low base at the end of the civil war, sectors such as education and health have made improvements, but their current performance is only around average by the standards of comparable countries. In sectors such as water, agriculture and infrastructure, Mozambique performs particularly poorly, and regional variations are significant. These findings suggest that there is considerable room to improve development outcomes through efficiency gains in public spending, increased investment, or a combination of the two.

It is important to consider how public spending benefits different income groups, as in Mozambique the very poorest benefit the least. Access to services improves with income, where the least poor are the only beneficiaries of tertiary education. The least poor also have the greatest access to water and sanitation services, particularly for urban water. These findings suggest the need to increase access to basic services for all income groups, particularly the poorest. A focus on access to public services should

be accompanied by efforts to maintain quality, since investments to expand access to basic public services will raise quality challenges that will need to be addressed.

Strengthening local service provision will be crucial as the government continues its decentralization reforms. Resource allocation at the subnational level is gradually increasing, rising from 36 percent of total spending in 2010 to 38 percent in 2012. District governments are assuming greater responsibility for managing resources, particularly in terms of local civil service payrolls. Municipalities are also expected to take greater responsibility for delivering basic services in health and education.

There is considerable scope to improve how local services are financed, and reforms in this area could enhance service delivery. Local revenues could be increased by enhancing incentives and capacity for local tax collection. The tax administration reforms of 2008 greatly increased the potential for municipal tax collection, but many of its provisions have not yet been implemented. Moving forward, transfers to municipalities should be subject to a formula-based allocation. Transfers should also help to correct for differences in municipalities' own revenue collection and create incentives for further revenue collection. For deconcentrated governments, a formula-based block grant could be introduced that focuses on minimum standards, such as per capita allocations. These reforms would simplify current planning and budgeting procedures, providing municipalities and districts with more autonomy to undertake policy responsibilities in line with local priorities.

Even in a period of fiscal consolidation, the government can create sufficient fiscal space to increase spending in priority sectors. Based on simulations of revenue estimates over the medium term, the government could reallocate spending to priority areas, which could grow 13 percent per year in real terms. A more modest fiscal consolidation scenario coupled with expenditure reallocation could increase priority spending by 18 percent per year in real terms – but this would need to be balanced with the need for fiscal consolidation. Efficiency gains could also generate significant fiscal space to allocate additional resources to priority sectors, and more detailed analysis at the sectoral and program level would inform reforms to improve efficiency. The policy decisions necessary to create space for priority spending will not necessarily be easy, but these options should be considered if Mozambique is to be prepared to realize the significant opportunities ahead.

References

AFRODAD (African Forum and Network on Debt and Development) (2011) 'What has tax got to do with development? A critical look at Mozambique's tax system' Harare, Zimbabwe

Alfani, F., Azzarri, C., d'Errico, M. and Molini, V. (2012) 'Poverty in Mozambique – New Evidence from Recent Household Surveys', *World Bank Policy Research Working Paper. No: 6217*, World Bank, Washington DC

Andrews, M. (2010) 'How far have public financial management reforms come in Africa,' Harvard Kennedy School of Government, USA

Andrews, M. (2013) 'The Limits of Institutional Reform of Development,' Cambridge University Press, USA

Auten, E. (2005) 'Capital Gains Taxation,' in *The Encyclopedia of Taxation and Tax Policy*, eds. Cordes, Ebel, and Gravelle, The Urban Institute Press, 2005

Bahl, R. (1999) 'Implementation Rules for Fiscal Decentralization,' Georgia State University, Atlanta, Georgia

Bahl, R. (2000) 'Intergovernmental Transfers in Developing and Transition Countries: Principles and Practices,' World Bank, Washington DC.

Bartholomew, A., Takala, T., Ahmed, Z. (2010) 'Avaliação a Meio Percurso da Iniciativa 'Fast Track' da EPT Estudo Nacional,' Maputo, Moçambique

Bird, R. (2000) 'Intergovernmental Fiscal Relations: Universal Principles, Local Applications,' International Studies School of Policy Studies, Georgia State University, Atlanta, Georgia

Bird, Richard M., Martinez-Vazquez, J., and Torgler B. (2004) 'Societal Institutions and Tax Efforts in Developing Countries,' *Working Paper 04-06*, Andrew young School of Policy Studies, Georgia State University: Georgia, Atlanta

Boex J., Ilal, A., Nguenha, E. and Toneto, R. Jr. (2008) 'Intergovernmental Fiscal Relations in Mozambique, Part 1: Main Report,' World Bank, Maputo, Mozambique

Boex, J., Ilal, A., Nguenha, E., Toneto, R. Jr. (2008) 'Relações Fiscais Intergovernamentais em Moçambique,' World Bank, Washington DC

Briceño-Garmendia, C.ecilia, Karlis Smits, K. and Vivien Foster, V. (2008), 'Financing Public Infrastructure in Sub-Saharan Africa: Patterns and Emerging Issues,' *Africa Infrastructure Country Diagnostic Background Paper 15*, The World Bank, Washington DC

- Brosio, G. (2000) 'Decentralization in Africa,' International Monetary Fund, Washington DC
- Budget Analysis Group (2011) 'Breve análise das tendências nos orçamentos do sector da saúde no período 2006/11, Versão 7,' Maputo, Moçambique
- Cebotari, A.liona, Jeffrey, D.avis, Lusine L.usinyan, Amine, M.ati, Paolo, M.auro and Ricardo V.eloso, (2008), 'Fiscal Risks: Sources, Disclosure and Management,' International Monetary Fund, Washington DC
- Cheema, G. S. and Rondinelli, D. A. (2007) 'From Government Decentralization to Decentralized Governance,' in *Decentralizing Governance Emerging Concepts and Practices*, Cheema, G. S. and Rondinelli, D. A. (eds.), Washington DC. Brookings University Press
- Clements, B., Gupta, S., Karpowicz, I. and Tareq, S. (2010) 'Evaluating Government Employment and Compensation,' Fiscal Affairs Department, IMF, Washington DC
- Comité de Conselheiros (2003) 'Agenda 2025 – Visão e Estratégia da Nação,' Maputo, Moçambique
- Dabla-Norris, E., J. Brumby, A. Kyobe, Z. Mills and C. Papageorgiou (2011) 'Investing in Public Investment: An Index of Public Investment Efficiency,' *IMF Working Paper*, Washington DC
- De Renzio, P. (2007) 'Budget Reforms in Mozambique. Towards a Political Economy Approach', Conferência Inaugural do IESE, Conference Paper No. 33
- Diamond, J. (2013) 'Good Practice Note on Sequencing PFM Reforms,' PEFA Secretariat, IMF and EU, Washington DC
- Doing Business -Measuring Business Regulations, 2013
- Eaton, K., Kaiser, K., and Smoke, P. J., (2011) 'The Political Economy of Decentralization Reforms,' World Bank, Washington DC
- Ebrill et al. (2001) '*The Modern VAT*,' International Monetary Fund, Washington DC
- Fjeldstad, O. and Heggstad K. (2011) 'The Tax Systems in Mozambique, Tanzania and Zambia: Capacity and Constraints' (mimeo).
- Francisco, A (2005) 'Preparação da Metodologia do PARPA II – Papel e Funções do PARPA no Sistema de Planeamento,' Ministério do Plano e Finanças, Maputo, Moçambique
- Gellert P. and Lynch B. (2003) 'Mega-Projects as Displacements', *International Social Science Journal*, Vol. 55, No. 175, Pg. 15-25

Ghallagher, M. (2005) 'Benchmarking Tax Systems,' *Public Administration and Development Journal*, 2005

Ghana Statistical Service (2013) '2010 Population and Housing Census: Demographics, Social, Economic and Housing Characteristics,' Ghana Statistical Service, commissioned by UKAID and EU

Government of Mozambique (1997) Lei no. 2/97, 'Lei de Bases das Autarquias,' Maputo, Mozambique

Government of Mozambique (2003) 'Corporate Income Tax Code (IRPC),' as amended by Decree 61/03, Maputo, Mozambique

Government of Mozambique (2003) 'Personal Income Tax Code (IRPS),' as amended by Decree 61/03,' Maputo, Mozambique

Government of Mozambique (2005) 'BR No. 19, Resolução,' 16/2005 de 11 de Maio de 2005, Maputo, Moçambique

Government of Mozambique (2005) 'Regulamento da Lei dos Órgãos Locais do Estado,' *Boletim da República*, Maputo, Mozambique

Government of Mozambique (2005) 'Boletim da República, I série No. 19, Resolução 16/2005 – PQG 2005 – 2009,' Maputo, Moçambique

Government of Mozambique (2006) 'Estatuto Orgânico do Governo Distrital' Decreto no. 6/2006, Maputo, Moçambique

Government of Mozambique (2006a) 'Plano Estratégico de Educação e Cultura 2006 – 2010/11,' Maputo, Moçambique

Government of Mozambique (2006b) 'Plano de Acção para a Redução da Pobreza Absoluta, 2006 – 2009 (PARPA II),' Maputo, Moçambique

Government of Mozambique (2006c) 'Metodologias da Elaboração do PES/OE 2006' Maputo, Moçambique

Government of Mozambique (2007a) 'Diagnóstico Distrital – Planificação Distrital Participativa,' Maputo, Moçambique

Government of Mozambique (2008) 'Boletim da República, I série No. 3,' Maputo, Moçambique

Government of Mozambique, Ministry of Agriculture (2008) 'National Agriculture Survey,' Maputo, Mozambique

Government of Mozambique (2009) 'Law 4/2009 of 12 January: Code of Fiscal Benefits,' Maputo, Mozambique

Government of Mozambique, Ministry of Planning and Development (2010) 'Poverty and Wellbeing in Mozambique: Third National Poverty Assessment,' Maputo, Mozambique

Government of Mozambique, Ministry of Planning and Development (2011) 'Cenário Fiscal de Médio Prazo 2013-15,' Maputo, Moçambique

Government of Mozambique, Ministry of Administration, Ministry of Planning and Development, Ministry of Finance (2011) 'Critérios de Afecção e Procedimentos para o uso de Recursos no Âmbito da Redução da Pobreza Urbana,' Maputo, Moçambique

Government of Mozambique, Ministry of Health, National Statistics Institute and ICF International (2011) 'Mozambique Demographic and Health Survey,' Calverton, Maryland and Maputo, Mozambique

Government of Mozambique, Ministry of Education (2012), 'Education Strategic Plan 2012-2016,' Maputo, Mozambique

Government of Mozambique, Ministry of Public Function (2012) 'Estatísticas dos Funcionários e Agentes do Estado (2010/2011),' Maputo, Moçambique

Government of Mozambique, Ministry of Public Function (2014) 'Estatísticas dos Funcionários e Agentes do Estado (2012/2013),' Maputo, Moçambique

Government of Mozambique, Ministry of Agriculture (2012) 'Integrated Agriculture Survey,' Maputo, Mozambique

Government of Mozambique (2012) Lei no.11/2012 'Boletim da República, I Series No. 6,' Maputo, Moçambique

Government of Mozambique, Ministry of Planning and Development and Ministry of Finance (2012) 'Orientações e Metodologia para a Elaboração das Propostas de: Plano Económico e Social e Orçamento do Estado para 2013,' Maputo, Moçambique

Government of Mozambique (2012) 'Política e Estratégia de Descentralização,' Boletim da República Número 51, Maputo, Moçambique

Government of Mozambique (2012) 'Regulations of the Value Added Tax (VAT) Code' Decree Nº 7/2008, of April 16, 2008 as amended by Decree Nº 4/2012 of February 24, 2012 (Updated in August 2012), Maputo, Mozambique

Government of Mozambique (2012) 'Value Added Tax Code' Law No. 32/2007 of December 31, amended by Law No. 3/2012 of January 23 (Updated in August 2012), Maputo, Mozambique

Government of Mozambique (2013) 'Cenário Fiscal de Médio Prazo 2014 – 2017,' Maputo, Moçambique

Government of Mozambique (2013) Decreto no. 53/2013, Boletim da República, Maputo, Moçambique

Government of Mozambique, Ministry of Administration (2013) 'Relatório de Implementação: Programa Estratégico de Redução da Pobreza Urbana, Maputo, Moçambique

Government of Mozambique, Ministry of Energy (2011) 'Strategy for the Development of New and Renewable Energy 2011-2025,' Maputo, Mozambique

Government of Mozambique, Ministry of Finance (2013) 'Questionnaire for the World Bank Mission for a Public Expenditure Review in Mozambique,' Maputo, Mozambique

Government of Mozambique, Ministry of Health (2013), 'Strategic Plan for the Health Sector 2013-2017,' Maputo, Mozambique

Government of Mozambique, Ministry of Planning and Development (2013) '2012 Survey of Mozambican Manufacturing Firms' Descriptive Report, National Directorate of Studies and Policy Analysis, Maputo, Mozambique

Government of Mozambique, Ministry of Transport and Communication (2014) 'Strategy for the Integrated Development of the Transport System,' Maputo, Mozambique

Government of Mozambique, Ministry of Public Works and Housing, 'Mozambican Road Sector Program Annual Reports,' various years from 2009-2012

Government of Rwanda, Ministry of Public Service and Labour - MIFOTRA (2012) 'Rwanda Public Sector Pay and Retention Policy and Implementation Strategy,' Kigali, Rwanda

Hadler, S., Moloji, C. and Wallace. S. (2006) 'Flat or Flattened? A Review of International Trends in Tax Simplification and Reform,' Unpublished paper prepared for USAID, June 2006

Harberger, A. C. (1980) 'Tax Neutrality in Investment Incentives.' in Aaron, H, and M. Boskin, eds., *The Economics of Taxation* (Studies of Government Finance: Second Series), Washington D.C.: Brookings Institution

Instituto de Gestao das Participacoes do Estado – IGEPE, (2014), 'Relatorio e Contas 2013', Government of Mozambique

International Fertilizer Development Center (2012) 'Mozambique Fertilizer Assessment,' Alabama, US

International Monetary Fund (2008), 'Republic of Mozambique: Report on Observance of Standards and Codes—Fiscal Transparency Module,' *IMF Country Report No. 08/152*, Washington DC

International Monetary Fund (2013) 'Republic of Mozambique, IMF Country Report No. 13/200,' July 2013

International Monetary Fund, (2014), 'Second Review under the Policy Support Instrument and Request for Modification of Assessment Criteria; Staff Report; Debt Sustainability Analysis; Press Release; and Statement by the Executive Director for Republic of Mozambique', IMF Country Report No. 14/148, Washington DC: International Monetary Fund

International Monetary Fund and International Development Association, (2014), 'Mozambique Debt Sustainability Analysis,' Washington DC

Ivanya M. and Shah, A. (2012) 'How Close is your Government to its People: Worldwide Indicators on Localization and Decentralization,' World Bank, Washington DC

Kenya Institute for Public Policy Research and Analysis (2013) 'A Comparative Study of Public-Private Sector Wage Differentials in Kenya,' KIPPRA Policy Paper No. 5, Nairobi, Kenya

Laeven, L., and Fabian V., (2008), 'Systemic Banking Crises: A New Database,' International Monetary Fund, *Working Paper 08/224*, International Monetary Fund, Washington DC

Lawson, A., Umarji, M., Guilherme, J. and Chachine, C. (2008) 'Assessment of Public Finance Management in Mozambique, 2006 – Based on the PEFA Methodology,' Fiscus Public Finance Consultants and Sal and Caldeira, Maputo, Mozambique

Le, T. M., Blanca, M. D., and Rojchaichanthorn, J. (2008) 'Expanding Taxable Capacity and Reaching Revenue Potential: Cross-Country Analysis,' *World Bank Policy Research Working Paper. No: 4559*, World Bank, Washington DC

Le, T. M., Blanca, M. D., and Bayraktar, N. (2012) 'Tax Capacity and Tax Effort: Extended Cross-Country Analysis from 1994 to 2009,' *World Bank Policy Research Working Paper. No: 6252*, World Bank, Washington DC

Le, T. M. (2003) 'Value Added Taxation: Mechanism, Design, and Policy Issues,' Paper prepared for the World Bank course on Practical Issues of Tax Policy in Developing Countries, Washington DC

Lei dos Órgãos Locais do Estado, Nº8/2003, *Boletim da República*

Lewis, S. R. Jr. (1984) 'Taxation for Development: Principles and Applications,' Oxford University Press

- Moreno-Dodson, Blanca, (ed), (2013) 'Is Fiscal Policy the Answer? A Developing Country Perspective,' Directions in Development, Public Sector Governance, The World Bank: Washington DC
- Musgrave, A. R., and Musgrave P. B., (1989) '*Public Finance in Theory and Practice*,' (5th edition): Mcgraw-Hill College
- Nguenha, E., Raich U., and Weimer, B. (2012) 'Finanças Locais: Desempenho e Sustentabilidade dos Municípios Moçambicanos,' in Moçambique: Decentralizar O Centralismo, Maputo, Mozambique
- Polackova B.H., Hana, and Schick A., eds., (2002), *Government at Risk: Contingent Liabilities and Fiscal Risk*, Oxford: The World Bank and Oxford University Press
- PwC (2013) 'Worldwide Tax Summaries'
- PWC (2013) 'Worldwide Tax Summaries: Corporate Taxes 2013/14'
- Reaud, B. A. and Weimer, B. (2010) 'Comparative Assessment of Decentralization in Africa: Mozambique Desk Study,' United States Agency for Development, Washington DC.
- Republic of Namibia, Ministry of Labour and Social Welfare (2008) 'Namibia Labour Force Survey 2008,' Directorate of Labour Market Services, Ministry of Labour and social Welfare
- Republic of Zambia, Central Statistics Office (2011) '2010/2011 Quarterly Employment and Earnings Inquiry Report,' Labour Statistics Branch, Central Statistics Office, Lusaka, Zambia
- Salazar, N. (2013) 'Fiscal Risk Management for Development: The Case of Colombia,' Background Paper for the *World Development Report, 2014*
- Schneider A. (2003) 'Decentralization: Conceptualization and Measurement,' *Studies in Comparative International Development*, Vol. 338, No. 3
- Schneider, F., Buehn, A., Montenegro, C. E., (2010) 'Shadow Economies All over the World - New Estimates for 162 Countries from 1999 to 2007,' *International Economic Journal*, 24:4, 443-461
- Shah, A. and Thompson, T. (2004) 'Implementing Decentralized Local Governance: A Treacherous Road with Potholes, Detours and Road Closures,' World Bank, Washington DC
- Shah, A. (1995) 'Overview' in Shah A., eds., *Fiscal Incentives for Investment and Innovation*, New York: Oxford University Press
- Smoke, P. (2001) 'Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practice,' United Nations Research Institute for Social Development, Switzerland

Smoke, P. (2011) 'Fiscal Decentralization and Linkages to PFM,' presented at the Donor Partner Working Group on Decentralization and Local Governance, hosted by EuropeAid and Swiss Agency for Development Cooperation, Brussels 18-20 may 2011

Sousa, F. (2014) 'Mozambique's Power Supply Overview,' Electricidade de Moçambique, Maputo, Mozambique

Stampini, M., Leung, R., Diarra, S. M. and Pla L. (2011) 'How Large is the Private Sector in Africa? Evidence from National Accounts and Labour Markets,' *Discussion Paper No. 6267*, Institute for the Study of Labour, IZA, Bonn, Germany

Steffenson, J. (2005) 'Introduction to the Principles for Design of Intergovernmental Fiscal Transfer System – an International Comparison of Allocation Criteria'

Stotsky, J. and WoldeMariam A. (2002) 'Central American Tax Reform: Trends and Possibilities,' *IMF Working Paper, WP/02/227*, December 2002

Sulemane, J. (2005) 'Toward Integrated Planning and Budgeting: The Mozambican PRSP Experience,' Presentation to Tunis Workshop on Pro-Poor Growth

Suplemento, Política e Estratégia de Descentralização, *Boletim da República*, 20 de Dezembro de 2012

Tait, A., Ebel, R., and Le, T. M. (2005) 'Value-Added Tax, National,' in *The Encyclopedia of Taxation and Tax Policy*, eds. J. J. Cordes, R. D. Ebel, and J. G. Gravelle, Washington DC

Uganda Bureau of Statistics (2012) 'Statistical Abstract,' Kampala, Uganda

Umarji, M. et al, (2011), 'Avaliação de Despesa Pública e Responsabilidade Financeira (PEFA) em Moçambique 2010,' MB Consulting, Maputo, Mozambique

UNICEF and WHO (2012), 'Progress on Drinking Water and Sanitation 2012 Update', USA

United Republic of Tanzania, National Bureau of Statistics (2013) 'Employment and Earnings Survey 2012: Analytical Report,' National Bureau of Statistics, Ministry of Finance, Dar-es-Salaam, Tanzania

USAID (2009) 'PARPA II Review – The Tax System in Mozambique, Volume 1,' Washington DC

USAID (2012) 'Taxation in the Agricultural Sector in Mozambique June 2012' Draft paper prepared by DAI and Nathan Associates

USAID (2013) 'Impact Evaluation for the USAID/ *Aprender A Ler* Project in Mozambique'. Baseline Report.

Varsano, Ricardo, Coelho, I., Martins, A., and Schenone, O. (2010) 'Mozambique – Reformas da Tributacao para aprimoramento do ambiente de negocios e mobilizacao de recursos para o desenvolvimento' IMF report, Washington DC

Wallace, S. (2005) 'Fiscal Architecture' in *The Encyclopedia of Taxation and Tax Policy*, eds. J. J. Cordes, R. D. Ebel, and J. G. Gravelle, Washington DC

Weimer, B. (2012) 'Decentralization in Mozambique: Trajectory, Outcomes and Challenges. A Diagnostic Survey for Debate,' presented at the Decentralization and Local Governance Training Course, Maputo 18-20 April 2012

Weimer, B. ed. (2012) 'Moçambique: Decentralizar O Centralismo: Economia Política, Recursos e Resultados,' Instituto de Estudos Sociais e Económicos, Maputo, Mozambique

WHO (2014), 'World Health Statistics 2014', Geneva, Switzerland

Wilhelm, V. A. and Krause, P (eds.) (2008) 'Minding the gaps: integrating poverty reduction strategies and budgets for domestic accountability,' World Bank, Washington DC

World Bank, (2001) 'Mozambique Public Expenditure Management Review'

World Bank, (2003) 'Mozambique Public Expenditure Review. Phase 2: Sectoral Expenditures'

World Bank (2006) 'Why Invest in Nutrition,' in *Repositioning Nutrition as Central to Development: A Strategy for Large-Scale Action*, Washington DC

World Bank (2009a) 'Municipal Development in Mozambique: Lessons from the First Decade, Volume 1 Synthesis Report,' Washington DC

World Bank (2009b) 'World Development Report: Reshaping Economic Geography,' Washington DC

World Bank (2010a) 'How to Note: a Framework for the Assessment of Fiscal Decentralization System,' Social Development Notes, World Bank, Washington DC

World Bank (2010b) 'Mozambique Public Expenditure Review for the Water Sector,' Washington DC

World Bank (2011) 'Mozambique Analysis of Public Expenditure in Agriculture,' Washington DC

World Bank (2012) 'Mozambique Social Protection Assessment: Review of Social Assistance Programs and Social Protection Expenditures,' Washington DC

World Bank (2013a) 'Beyond the Annual Budget: Global Experience with Medium-Term Expenditure Frameworks' World Bank, Washington DC

World Bank, (2013b) 'International Development Association Program Document for Ninth Poverty Reduction Support Credit,' Maputo, Mozambique

World Bank, (2014a), 'Elements to Consider when establishing the envisaged Development Bank of Mozambique,' Washington DC

World Bank, (2014b), 'Generating Sustainable Wealth from Mozambique's Natural Resource Boom', World Bank Policy Note

World Development Indicators 2013, World Bank

World Economic Forum, (2014), 'Strategic Infrastructure Steps to Operate and Maintain Infrastructure Efficiently and Effectively' Geneva, Switzerland

Zee, H. (1995) 'Value-Added Tax.' in Shome, p., eds., *Tax Policy Handbook*, Fiscal Affairs Department, International Monetary Fund, Washington DC

Zuin, V., Nicholson M., and Davis J. (2012), 'Water Access, Poverty and Policy Changes in Peri-Urban Maputo, Mozambique,' Stanford University, US

Annexes

A. Annexes: Tax Policy in Transition

Annex A.1: Revenue collection and fiscal architecture in SADC countries

Table A1: Revenue collection and fiscal architecture in SADC countries

Country	Revenue, excl. grants (% of GDP)	Tax revenue (% of GDP)	GDP per capita (current US\$)	Imports of goods and services (% of GDP)	Exports of goods and services (% of GDP)	Agriculture, value added (% of GDP)	Population Growth (%)	Employment to population ratio, 15+ (%)	Working Age Population (% of total) [#]	Youth (15-24) Literacy Rate (%)	CPIA score [§] (1=low to 6=high)	Net ODA Received (% of GNI)	Shadow Economy (% of GDP)
Angola	40.6	19.0	5482.4	42.2	60.1	10.0	3.1	64.6	50.0	73.0 ^a	2.5	0.2	47.6 ^c
Botswana	37.4	27.2	7238.0	50.0	44.5	2.9	0.9	63.1	62.7	95.2 ^a	N/A	0.5	34.8
DRC	23.4 ^b	13.7 ^b	261.8	67.3	55.5	44.9	2.7	66.7	52.0	65.0 ^b	2.0	17.8	49.4
Madagascar	10.3 ^a	10.1 ^a	447.4	37.1 ^a	26.1 ^a	29.1 ^c	2.8	85.5	54.5	65.0 ^c	2.5	3.9	40.6
Malawi	N/A	N/A	268.1	39.5 ^a	29.6 ^a	30.2 ^a	2.9	76.7	51.4	72.1 ^b	3.0	28.4	41.1
Mauritius	23.0	19.0	8119.5	66.7	54.8	3.5	0.4	54.0	71.5	96.8 ^a	N/A	1.7	24.3
Mozambique	24.0	21.8	565.2	71.3	29.8	30.3	2.5	78.0	51.4	71.8 ^b	3.0	14.8	42 ^d
Namibia	17.7 ^a	14.9 ^a	5785.7	52.5	42.6	9.6	1.9	48.8	59.9	93.1 ^b	N/A	2.1	34.4
South Africa	29.2	26.4	7351.8	31.3	28.3	2.6	1.3	38.8	65.0	98.8 ^a	N/A	0.3	31.7
Swaziland	N/A	N/A	3041.9	74.7 ^a	66.6 ^a	7.5 ^a	1.5	44.3	58.5	93.7 ^a	N/A	2.6	43.8 ^d
Tanzania	17.3	16.1	608.7	47.3	29.6	27.6	3.0	86.1	52.0	77.3 ^b	3.0	10.1	63.0
Zambia	21.4 ^a	19.7 ^a	1462.9	43.2	46.4	19.6	3.2	69.0	50.6	74.4 ^b	3.0	4.9	54.3
Zimbabwe	N/A	N/A	714.2	76.1	44.3	14.1	2.7	82.9	55.8	99.0 ^b	1.5	10.6	56.1

Sources: WDI, 2013; Schneider, Friedrich; Buehn, Andreas; Montenegro, Claudio E. 2010. Shadow Economies All over the World - New Estimates for 162 Countries from 1999 to 2007

Note: ^{*} - Population aged 15-64; ^a - 2011 figures; ^b - 2010 figures; ^c - 2007 figures; ^d - 2006 figures;

Annex A.2: Details of the Corporate Income Tax, Personal Income Tax, VAT and Fiscal Incentives

CIT

Corporate Income Tax Code (IRPC) has been enacted by Law 34/2007 and regulated by Decrees 9/2008, 68/2009 and 2/2012.

Base: The country CIT base is rather comprehensive as it includes income from capital gains, interest income (subject to a separate withholding tax of 20 percent). Most corporate entities—those with headquarters or permanent establishment (PE) in Mozambique-- are subject to CIT based on their worldwide income. Other corporate entities (i.e. non-resident entities) are taxed on residence basis -- only income earned in Mozambique is subject to CIT. Accounting for CIT taxable income follows international standards. Specifically, taxable income equals to revenues minus costs of goods sold (COGS), fiscal depreciation, interest payments, transport/advertisement costs related to distribution and sales, research/consultancy and other costs of administrative nature (e.g., remuneration, expense allowances, pensions, and retirement supplements).

Depreciation. Fiscal depreciation is allowed according to straight line. Depreciation scheme consists of both tangible and non-tangible assets with the main depreciation rates basically in line with the ones applied in other countries in the region. However the depreciation structure is complicated, with a total of 20 categories.⁶⁴

Loss carried forward. Losses incurred by firms are allowed to be carried forward (not backward) for up to five years.

Capital gains treatment. Capital gains and capital losses consist of the difference between the realization value net of costs/acquisition value, after deduction of amounts for depreciation. Historical purchase price is accounted for and is not adjusted for inflation for the calculation of capital gains taxable income.

Transfer pricing and thin capitalization. These provisions are provided in Articles 49-53 of the CIT Code. The inclusion of such provisions in the law follows an international modern CIT code. Transfer pricing becomes increasingly critical for Mozambique as the country is embracing more FDI and mega projects in extractive industries. The box below presents some major channels for transfer pricing.

Box: Common forms of transfer pricing

Some major channels that a subsidiary in Mozambique could engage in transfer pricing through its offshore parent company or associated companies can be summarized as follows.

- Reduce selling price of outputs.
- Provide services at artificially low prices.
- Take loans at artificially high interest rates.

⁶⁴ Cross country comparison of key elements of the CIT regimes in SADC (including rate, deductible items, depreciation schedules, loss carried forward/backward, thin capitalization rules) draws on the PWC Corporate Income Tax Summaries and is on file with authors.

- Obtain/import tangible (fixed assets, materials) and intangible assets (e.g., royalty payments) at artificially high values.

Fiscal incentives. Fiscal incentives are numerous and mixed in both CIT Code and the separate 2009 Fiscal Benefit Code. Exemptions from taxable income under the CIT code are allowed for by type of organization/ownership (state, municipalities, social security institutions, cooperatives, public utilities), type of activities (cultural, recreational, and sporting activities). Further provisions for benefits provided under the Fiscal Benefits Code are analyzed in a separate section.

Rate. The CIT standard rate is 32 percent. However the rate structure is overly complex with multi-rates available. Particularly, agriculture and livestock activity as well as income from non-resident entities, telecommunications, transport, equipment installation are subject to reduced rate of 10 percent, while charges that are not properly documented or expenses considered as confidential or illicit taxed at 35 percent. In addition a rate of 20 percent is applicable to income subject to retention from the source and income from non-resident entities (in the form of withholding tax).

Simplified regime for CIT. Simplified system for determining business taxable profits is allowed in Article 54 of the CIT Code. Those entities that are not able to keep organized accounting records and earn a total annual turnover not exceeding MT 2,5 millions are eligible for this regime. Different coefficients are used for different types of incomes: taxable profit is ascertained by applying a coefficient of 0.20 to the value of sales of merchandise and products and a coefficient of 0.30 to other income.

PIT

A new Personal Income Tax Code (IRPS) has come into effect since January 1, 2003 and further changes to the law were made in 2008. In addition to PIT, other individual taxes include social security tax and local income taxes (varied by municipality).

Base: Residents are taxed on their worldwide income while non-residents are taxed on income arising from within Mozambique. The coverage is broad—including various types of income and remunerations. Income is classified into five categories as follows.

- First Category: income from employment.
- Second Category: business and professional income.
- Third Category: income from investments and capital gains.
- Fourth Category: income from real estate.
- Fifth Category: other income.

Deduction

Business income deduction. Costs for earning the incomes are typically deducted from taxable income. Such costs include staff costs, rents, depreciation of premises and equipment, fees paid to third parties for services, utilities, portion of travel expenses, and other expenses incurred during the normal run of business.

Nonbusiness expenses deduction. Gross employment income can deduct the following expenses for the purpose of calculating PIT taxable income: union contributions and pensions. Deductions are also

allowed in relation to the individual and family status of the taxpayer: MT1,800 for single or legally separated taxpayers; MT1,500 for each married or non-legally separated taxpayer; MT 600 for one dependent; MT 900 for two dependents; MT 1,200 for three dependents and MT1,800 for four or more dependents. Tax credit is available for international double taxation.

Personal allowances. None.

Rate. Individual taxable income falls into five brackets (table 5). Different levels of credits deducted from tax liability are also presented in Table 5.

Table A2: PIT rate structure

Annual income (MT)	Rate (%)	Credit (MT)
To 42,000	10	
From 42,001 to 168,000	15	2,100
From 168,001 to 504,000	20	10,500
From 504,001 to 1,512,000	25	37,500
Above 1,512,000	32	141,540

Source: Government of Mozambique (2013), PWC (2013)

Non-Mozambican residents are subject to the earned income tax, withheld and remitted by the employer or other payer at a flat rate of 20 percent. Most investment income is subject to a withholding tax at 20 percent, with exceptions of income from debit bonds and interests from bank deposits at 10 percent.

VAT (IVA)

Mozambique began administering a VAT from January 1, 1998 and since then frequent changes have been made. The new VAT code (Law No. 32/2007 of December 301) was introduced and amended by Law No. 3/2012 of January 23. Three distinct VAT schemes co-exist: A normal scheme (standard rate of 17 percent), simplified scheme (5 percent on turnover tax), and exemption scheme.

Base: The VAT is by design a consumption-based VAT in the sense that capital expenditures and inputs are netted out of the base. The tax follows destination principle whereby exports are to be zero rated and imports taxed. Credit invoice method for calculation of VAT liability is applied.

VAT threshold and exemption regime: The VAT code indicates the exemption threshold of MT 750,000 and allows for businesses under this threshold to voluntarily opt for normal VAT regime with the restrictions that if so choosing, they will be required to remain in the normal VAT regime for at least five years. This conforms to good practice in dealing with potential fraud schemes whereby those businesses may get in and out of the VAT net overnight for the sake of fraudulent refunds.

Problems lie with overly complex and long list of exempt goods and services and the co-existence of the simplified regime. The list of exemptions is provided in chapter II, article 9 (supply of exempt goods and services), covering various sectors and commodities in agriculture, forestry, livestock, and fishery, health, education (provided either by public or private establishments), banking, real estate, state assignments, gambling, culture and art, military material, and others. NGOs and goods and services supplied by the public sector (e.g., museums, art galleries, parks, botanical gardens, and zoos), social

entertainments, goods and services provided for cultural and artistic purposes are also exempt. The issue of exemption is even made more complicated when related to ‘mega projects,’ in which investors are eligible to VAT exempt certificates. As indicated in USAID (2012), different laws are de facto created to tailor different projects and create an unlevelled play field for medium and small taxpayers.

Rate. The standard rate is 17 percent. In addition, zero rate is applied to exports and multiple other items. Those businesses with revenues falling under the special VAT regime are subject to a rate of 5 percent (more detailed discussion follows).

Zero rating. The legal terms and provision for zero rating are not well specified in the VAT code. The goods and services listed in paragraph 10 of article 9 of the VAT Code are subject to zero rate (even though listed under the overall heading of exemption). These items are multiple: “Supplies of maize, maize flour, rice, bread, iodide salt, powdered milk for babies of up to one year of age, wheat, wheat flour, fresh or chilled tomato, potatoes, onions, frozen horse mackerel, lighting petroleum, jet fuel, ordinary bicycles, condoms and insecticides.”

VAT Refunds. VAT refunds are covered in Articles 21-22 of the VAT Code.

Simplified regime for VAT. This regime exists in parallel with both the normal and exemption regimes (described above). It defines that Taxable persons are subject to the simplified taxation regime, if they (1) have an annual business volume above MT 750,000 and less than MT 2,500,000, (2) do not possess and are not required to possess regularly organized accounting for income-tax purposes, and (3) do not engage in operations of imports, exports, or related activities. These businesses are subject to a tax rate of 5 percent of the turnover (this amounts to a turnover tax). Similar to the exempt regime, if they choose this special regime, they must remain for at least five years.

Fiscal Incentives

Fiscal incentives have been instituted purportedly to serve a number of objectives, including a greater ability to attract investment. The new set of incentives is provided in the Law 4/2009 of 12 January, the Code of Fiscal Benefits, and went into effect from January 1, 2009. The existence of the fiscal benefits code in parallel to the incentives provided in separate tax codes (e.g., PIT, CIT, and VAT) can lead to incoherence in the tax system and opens the door for direct negotiation with investors and discretion by tax administration.

Multiple types of fiscal incentives are available: tax holidays, tax rate deduction, investment tax credit, accelerated depreciation, exemption and inflated expenses to deduct from taxable income. Incentives are offered by sector, geographical area, and type of investments. Annex A5 summarizes the key differences between the incentive schemes prior and due to the 4/2009 Code of Fiscal Benefits. The 4/2009 Fiscal Benefits Code tends to expand fiscal benefits and be more generous. Some of the major incentives included in the code are:

- Investment credit for new investment in fixed assets—5 percent of the total investment realized in the city of Maputo and 10 percent in other provinces.
- Accelerated depreciation allowed for new immovable assets for calculating both CIT and PIT taxable income with the rate to be increased by 50 percent.

- Taxable income deduction of a maximum of 10 percent of the taxable income allowed for investment in new technology for a period of up to five years (unclear about the range of deduction and what types of technology should be allowed).
- Expenditures that are considered as fiscal costs could be inflated to 110 percent or 120 percent of the actual cost of investment in construction and rehabilitation of roads, railways, airports, telecommunication, utilities, hospitals etc. in the city of Maputo and others respectively.

Annex A.3: Central Government Revenue from 2004 to 2015

Table A3: Central Government Revenue (Billion MT)

Central Government Revenue (MT Billions)	2004	2005	2006	2007	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014	Proj. 2015
Total revenue	16.8	21.4	27.0	33.1	38.3	46.7	61.6	75.8	94.8	126.6	144.0	150.8
Tax revenue	15.6	18.5	23.3	29.1	34.0	41.5	53.7	66.2	80.9	107.6	123.1	126.6
Taxes on income and profits	3.5	4.5	6.4	9.3	11.7	13.7	18.5	24.9	36.8	55.8	57.2	49.4
Taxes on goods and services	9.4	10.9	13.0	15.5	18.1	22.9	28.8	33.0	33.3	38.3	49.4	57.9
Of which: on petroleum products	1.7	1.8	1.8	2.3	2.5	3.3	4.1	4.7	1.3	2.2	2.5	-
Taxes on international trade	2.3	2.8	3.3	3.8	3.6	4.1	5.3	6.7	7.6	10.0	10.8	12.7
Other taxes	0.4	0.4	0.6	0.5	0.7	0.8	1.1	1.5	3.2	3.5	5.7	6.6
Nontax revenue	1.2	2.9	3.7	4.0	4.3	5.3	7.9	9.6	14.0	18.6	20.8	23.5

Source: Government of Mozambique and authors' estimates

Table A4: Central Government Revenue (as % of GDP)

Central Government Revenue (% of GDP)	2004	2005	2006	2007	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014	Proj. 2015
Total revenue	13.1	14.1	15.0	15.9	15.9	17.6	19.6	20.8	23.3	27.5	27.3	25.0
Tax revenue	12.1	12.2	12.9	14.0	14.2	15.6	17.0	18.1	19.8	23.3	23.3	21.0
Taxes on income and profits	2.8	2.9	3.5	4.5	4.9	5.2	5.9	6.8	9.0	12.1	10.8	8.2
Taxes on goods and services	7.3	7.2	7.2	7.5	7.5	8.6	9.2	9.1	8.2	8.3	9.4	9.6
Of which: on petroleum products	1.3	1.2	1.0	1.1	1.0	1.2	1.3	1.3	0.3	0.5	0.4	0.4
Taxes on international trade	1.8	1.9	1.8	1.8	1.5	1.5	1.7	1.8	1.9	2.2	2.1	2.1
Other taxes	0.3	0.2	0.4	0.2	0.3	0.3	0.4	0.4	0.8	0.8	1.1	1.1
Nontax revenue	1.0	1.9	2.0	1.9	1.8	2.0	2.5	2.6	3.4	4.1	3.9	3.9

Source: Government of Mozambique and authors' estimates

Table A5: Central Government Revenue (as % of total tax revenues)

Main Taxes (% of total tax revenues)	2004	2005	2006	2007	2008	2009	2010	2011	2012	Est. 2013	Proj. 2014	Proj. 2015
Tax revenue	100	100	100	100	100	100	100	100	100	100	100	100
Taxes on income and profits	23.1	23.8	27.1	32.1	34.5	33.3	34.7	37.6	45.5	51.9	46.4	39.0
Taxes on goods and services	60.3	59.0	55.8	53.6	52.8	55.1	54.1	50.3	41.4	35.6	40.3	45.7
Of which: on petroleum products	10.7	9.8	7.8	7.9	7.0	7.7	7.6	7.2	1.5	2.1	1.7	1.9
Taxes on international trade	14.9	15.6	14.0	12.9	10.6	9.6	10.0	9.9	9.6	9.4	9.0	10.0
Other taxes	2.5	1.6	3.1	1.4	2.1	1.9	2.4	2.2	4.0	3.4	4.7	5.2

Source: Government of Mozambique and authors' estimates

Annex A4: Main tax collection (PIT, CIT, and VAT) from 2004 to 2012

Table A6: Data of collection for the main taxes as % of Total revenue collection

Data of Collection for the main taxes									
(% of Total revenue collection)	2004	2005	2006	2007	2008	2009	2010	2011	2012
PIT	14.9	13.9	13.6	14.1	15.2	13.3	13.6	13.1	12.2
CIT	6.4	7.1	9.2	12.8	14.7	15.5	15.5	17.7	25.2
VAT	36.0	32.6	33.8	32.8	33.1	35.7	38.0	36.4	32.6

Source: Government of Mozambique, December 2013

Table A7: Data of collection for the main taxes as % of GDP

Data of Collection for the main taxes									
(% of GDP)	2004	2005	2006	2007	2008	2009	2010	2011	2012
PIT	1.9	1.9	2.1	2.3	2.5	2.4	2.7	2.9	2.9
CIT	0.8	1.0	1.4	2.1	2.4	2.8	3.1	3.9	6.1
VAT	4.5	4.5	5.2	5.4	5.4	6.4	7.7	8.1	7.9

Source: Government of Mozambique, December 2013

Table A8: Expenditure-Revenue gaps from 2004 to 2015

CENTRAL GOVERNMENT										Est.	Proj.	Proj.
(% of GDP)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Total revenue	13.1	14.1	15.0	15.9	15.9	17.6	19.6	20.8	23.3	27.5	27.3	25.0
Tax revenue	12.1	12.2	12.9	14.0	14.2	15.6	17.0	18.1	19.8	23.3	23.3	21.0
Public expenditures	24.8	22.9	27.0	28.1	27.8	32.6	32.9	33.7	32.6	35.6	41.6	36.6
Public expenditures - Total Revenue	11.7	8.8	12.0	12.2	11.9	15.0	13.3	12.9	9.3	8.1	14.3	11.6
Public expenditures - Tax Revenue	12.7	10.7	14.1	14.1	13.6	17.0	15.9	15.6	12.8	12.3	18.3	15.6

Source: Government of Mozambique and World Bank Staff Estimates

Annex A.5: Incentive Schemes before and after the Law of 4/2009

Table A9: Incentive Schemes before and after the Law of 4/2009

Scheme before the 4/2009 Law	Scheme of the 4/2009 Law
<p>Agriculture</p> <ol style="list-style-type: none"> 1) 80% reduction in the corporate (IRPC) or personal (IRPS) income tax by 2012. 2) Exemption of customs duties and VAT for goods of category K. <p>Tourism and Hotel Industry</p> <ol style="list-style-type: none"> 1) Tax credit for investment and speedup amortization. 2) Exemption of import duties and VAT for goods of category K. 	<p>Agriculture and Fishery</p> <ol style="list-style-type: none"> 1) 80% reduction in the corporate (IRPC) or personal (IRPS) income tax by 2015, and 50% between 2016 and 2025. 2) Exemption of customs duties and VAT for goods of category K and their parts and accessories. <p>Tourism and Hotel Industry</p> <ol style="list-style-type: none"> 1) Reduction by 3 percentage points in the tax credit by investment and reduction in the fast-track amortization from triple to double. 2) Increase in exempted imports. 3) Elimination of the stated period of 31 December of 2007 for approval of projects in this sector. 4) Possibility to accumulate with general benefits.
<p>Large Scale Projects</p> <ol style="list-style-type: none"> 1) Reduction and exemption of tax on contractual arrangements. 2) Exemption of import duties and VAT for good of category K. 	<p>Large Scale Projects</p> <ol style="list-style-type: none"> 1) The contractual arrangement was abolished. 2) Exemption of import duties and VAT without limitation of class. 3) Possibility to accumulate with the general benefits.
<p>Rapid Development Zones (This Arrangement finishes on 31 of December of 2015)</p> <ol style="list-style-type: none"> 1) 20% tax credit by investment for a period of 5 years. 2) Exemption of import duties and VAT for goods of category K. 3) Exemption of ownership transfer tax on urban real estate. 	<p>Rapid Development Zones</p> <ol style="list-style-type: none"> 1) The time limit was abolished and the arrangement becomes of indefinite duration. 2) Possibility to accumulate with general benefits. 3) Exemption of customs duties and VAT for goods of category K and its parts and accessories.
<p>Export Processing Zones</p> <ol style="list-style-type: none"> 1) 60% reduction in the corporate income tax (IRPC) for a period of 10 years. 2) Exemption of customs duties and VAT 	<p>Export Processing Zones</p> <ol style="list-style-type: none"> 1) Exemption of corporate income tax (IRPC) for a period of up to 10 years; reduction by 50% in corporate income tax (IRPC) between the 11th and 15th year, and by 25% for all the remaining life of project (the reductions and the deadlines are lesser in the case of a single company). 2) Exemption of customs duties and VAT
<p>Manufacturing and Assembly</p> <p>This scheme was introduced by Ministerial Decree No 99/2003 when no law was required for establishment of tax benefits</p>	<p>Establishment of Basic Infrastructure</p> <p>Investment in roads, railway lines, airports, water supply, electricity, 'among others'.</p> <ol style="list-style-type: none"> 1) Reduction of corporate income tax (IRPC) by 80% in the first 5 years; by 60% from the 6th to the 10th year; and by 25% from the 11th to the 15th year. 2) Exemption of customs duties and VAT for goods of category K and its parts and accessories. <p>Manufacturing and Assembly</p> <p>Investments with the annual turnover of not less Mt 3,000,000 and not less than 20% value added.</p> <ol style="list-style-type: none"> 1) Exemption from customs duties and VAT for raw materials and materials for production process. A general limit of 5 years applies for validity of this benefit.
	<p>Science and Technology Parks</p>

1) Exemption from customs duties and VAT for material and scientific equipment, teaching aids and laboratory equipment needed for education, teaching and research. 2) Exemption from corporate income tax (IRPC) during the first 5 years; 50% reduction from the 6th to the 10th year and 25% from the 11th to 15th year.

Special Economic Zones

Zones to be defined by the government.

1) Exemption from customs duties and VAT for goods destined for the public service activities (not only of category K).

2) Exemption from corporate income tax (IRPC) for 5 years (for operators responsible for the creation of infrastructure in the Zone) or 3 years (for companies that are establishing themselves); corporate income tax (IRPC) reduction by 50% in the next 5 years, and by 25% over the entire period of life of the project (for Zone operators) or for 5 additional years (for companies).

Source: IMF

Annex A.6: Tax rates in OECD countries

Country	Average Top Statutory rate (1981-1990)	Average Top Statutory Rate (1991-2000)	Average Top Statutory Rate (2001-2010)
Australia	44.6	35.8	30.0
Austria	50.0	32.8	28.6
Belgium	44.6	40.0	35.2
Canada	34.7	29.0	22.3
Czech Republic	-	38.4	25.5
Denmark	45.0	34.0	27.6
Finland	37.2	25.8	27.2
France	47.8	34.6	35.0
Germany	55.4	42.3	23.4
Greece	46.8	37.9	30.3
Hungary	45	26.4	18.2
Iceland	n.a.	30.0	18.6
Ireland	47.8	35.4	13.6
Italy	40.0	37.0	32.1
Japan	41.7	35.7	30.0
Korea	n.a.	28.0	25.3
Luxembourg	n.a.	31.2	23.5
Mexico	40.5	34.5	31.0
Netherlands	42.6	35.0	30.2
New Zealand	41.5	33.0	32.1
Norway	29.8	22.8	27.6
Poland	n.a.	37.6	21.6
Portugal	45.9	35.0	26.7
Slovak Republic		39.3	21.2
Spain	34.4	35.0	32.3
Sweden	47.2	28.6	28.4
Switzerland	9.8	9.4	8.5
Turkey	n.a.	33.0	25.9
United Kingdom	41.3	32.0	29.4
United States	41.8	34.8	35.0

Source: OECD

Annex A7: Impact of VAT exemption and zero rate regimes on economic distortions and revenue intake (draws on Le (2003))

Some key points regarding exemptions and zero rating:

- Exemptions tend to erode the base, deplete the potential revenue intake, have unclear impact on the poor, and potentially break the chain and thereby induce cascading problems. Exemption is also likely to ratchet up and as seen from Mozambique's VAT code—exemption of food/agriculture or fishery products seemingly led to exemptions of inputs for these sectors.
- To effectively relieve tax burden on the poor through exemption it would be preferable to use credit-invoiced based VAT. The exemption would be allowed *exactly* at the final stage, where the poor consume the good. Otherwise, the tax burden is even *higher* than that in a non-exempt situation due to cascading effect.
- For zero rating, under invoice-based credit method, the tax revenues are to be eliminated only if the last stage is zero-rated (hence the poor can benefit from intended zero rating provision). Zero rating of any stage prior to the final one does not affect the total tax burden borne by the whole chain.

Let us look at the case of, say, producing bread. At the first stage, a farmer sells wheat to a miller. In stage 2, the miller makes flour and sells to the baker. At the final stage, the baker makes bread and sells it to final consumers. For simplicity, let us assume that the value added at the first stage makes up the total value of the output sold (i.e., wheat). Let P_1 , P_2 , and P_3 be the price of wheat, flour, and bread respectively. Likewise, t_1 , t_2 , and t_3 are the VAT rates on wheat, flour, and bread respectively. The mechanism of VAT collection and credit is depicted as:

$$\text{Tax liability} = t_1 * P_1 + [t_2 * P_2 - t_1 * P_1] + [t_3 * P_3 - t_2 * P_2] = t_3 * P_3$$

This indicates the effective tax revenues in the entire chain of the VAT are equivalent to the ones received under a retail sales tax system.

I. Exemption

We now introduce exemption in the tax structure and analyze its revenue implications.

1. Exemption of the first stage

Under credit invoice method: Tax liability = $t_2 * P_2 + [t_3 * P_3 - t_2 * P_2] = t_3 * P_3$

Note, under the invoice-based credit method, the tax revenues are the same in both non-exemption and first-stage exemption cases.

2. Exemption of the second (middle) stage

Under invoice-based credit method: Tax liability = $t_1 * P_1 + t_3 * P_3$

With the middle-stage exemption, the tax revenues under invoice-based credit method are higher than the ones without exemption. This is the case, because the exemption of the middle stage effectively eliminates this stage from the whole chain: the second firm (the miller) cannot claim for refund of its input tax (the tax paid by the firm on its purchase of wheat)—the tax burden hence carries on. This generates 'cascading effect,' which is typical in turnover taxation.

3. *Exemption of the third (last) stage*

Under credit invoice method: Tax liability = $t_1 * P_1 + [t_2 * P_2 - t_1 * P_1] = t_2 * P_2$

The tax revenues are less than the ones collected in the non-exemption case. As the last stage is out of the tax net, the value added in this stage escapes the tax. This indicates that the overall tax burden could be reduced by exempting the last stage.

II. **Zero rating**

1. *Zero rating of the first stage*

Under credit invoice method: Tax liability = $t_2 * P_2 + [t_3 * P_3 - t_2 * P_2] = t_3 * P_3$

Zero rating of the first stage does not change the effective tax revenues under invoice-based credit method.

2. *Zero rating of the second (middle) stage*

Under credit invoice method:

Tax liability = $t_1 * P_1 + [0 * P_2 - t_1 * P_1] + [t_3 * P_3 - 0 * P_2] = t_3 * P_3$

Under invoice-based credit method, zero rating of the second (middle) stage does not change the VAT revenues.

3. *Zero rating of the third (last) stage*

Under credit invoice method: Tax liability = $t_1 * P_1 + [t_2 * P_2 - t_1 * P_1] + [0 * P_3 - t_2 * P_2] = 0$

Under invoice-based credit method, the tax revenues for the whole chain become zero if the last stage is zero rated. This implies that to completely relieve exports from the VAT burden, zero rating, but not export exemption, must be applied.

Annex A.8: Tax expenditure analysis and tax gap analysis

In a nutshell, tax expenditures appear in the form of fiscal incentives (tax exemptions, allowances, credits, tax rate reduction etc) embedded in various provisions of a country's tax code. To measure tax expenditure, one would need to create a benchmark of the tax system, and decide if tax incentives divert from the established benchmark. Tax expenditures can be calculated either *ex post* or *ex ante* (analysis of revenue impact of a set of the new proposed tax incentives provisions). To institute tax expenditure analysis, Mozambique should start building capacity and institution for revenue forecasting – which is also essential for analyzing tax gaps in tax policy making.

Tax gap analysis: Tax gap definition, estimation methodologies, and policy implications. The basic definition of tax gap refers to the difference between tax paid/collected and the theoretical tax liability in accordance with both the letter and spirit of the law.

Tax gap = Estimated full theoretical tax liability – actual tax receipts.

Tax gap can be measured separately for each type of the tax (direct and indirect taxes) and then be aggregated to the overall size of gap or revenue leakage. Tax gap as defined is a straight forward concept but measurement is not always an easy task. In general, depending on the data available and particularly the sophistication of national statistics, advanced tax administrations apply either top down or bottom up or combined top-down/bottom-up approaches.

VAT gap analysis as starting point. Basically commonly expenditures data are available in disaggregate form would allow for the application of the top down approach to estimate the VAT gap in addition to the bottom up approach. On the other hand, as the statistics on income and other components for estimating the base of personal and corporate income taxes are not readily available in details, gap analysis for such major direct taxes follows bottom up approach which relies on tax administration internal data.

An application of the VAT gap analysis modeling. From the gross domestic product (GDP) statistics, one can derive the gross VAT base as follows:

$$C + G_c = GDP - (X - M) - I - G_w$$

Where, C	:	Final Private Consumption
I	:	Investment Expenditure
G _c	:	Government Expenditure (net of wages and salaries)
G _w	:	Government Expenditure on Wages and Salaries
X	:	Exports
M	:	Imports

As the VAT code allows for exempt and zero-rated sectors, the part of C+G_c as shown should be adjusted further. The step by step framework for estimating VAT base as shown below follows Zee (1995):

Starting with:

GDP (market price)

Adjustment A: trade balance

1. Minus exports
2. Plus imports

Adjustment B: capital formation

1. Minus gross domestic capital formation
2. Add new residential buildings
3. Add capital formation in exempt sectors

Adjustment C: exempt sectors

1. Minus value added of exempt sectors (factor costs)
2. Minus indirect taxes in exempt sectors

Adjustment D: cascading

1. Add purchases of output from exempt sectors by taxed sectors
2. Add taxed inputs in exportable agriculture

Adjustment E: government expenditure

1. Minus expenditure on wages and salaries

Adjustment F: final private expenditure

1. Minus exempt expenditures
2. Add taxed inputs in exempt expenditures
3. Add foreign expenditures in local markets
4. Minus expenditure abroad by residents

Adjustment G: Zero-rated Goods and Services

1. Minus zero-rated goods/services in Domestic Market

B. Annexes: Sub-National Service Delivery

Annex B1: A concise assessment of the potential of local taxes in Mozambique, based on Maputo and Nampula municipalities

1. Property tax

In Maputo, planned collections from property tax in 2014 amount to 0.2 percent of GDP (see Table A). This share which is much lower than the incidence of property tax on GDP observed for developing countries, which is 0.6 percent (see Table B). Considering the concentration of properties, the number of properties that are subject to the tax could increase from 15,000 to 35,000. Increasing the tax base could potentially increase the share on GDP from 0.2 to a maximum of 1.0 percent.

For Nampula, present collections from the property tax are 3 Meticaís per capita, which amount to 0.015 per cent of GDP. If Nampula was to collect property tax in line with developing country standards, the total could potentially increase to 0.6 percent of GDP. It is likely that initial collections will be substantial since the reform of the property tax has not been yet implemented in Nampula.

2. The head tax

The tax base could also provide substantial collections especially in the big cities, considering the discrimination of the tax rates (from 4 percent for Class A municipalities to 1 percent for Class D municipalities).

The tax base – the minimum wage – is small compared with the effective total income of most taxpayers. The estimates of the potential tax base for Maputo are based on following steps and assumptions:

- Active population (population in working age) is about 50 percent of total population.
- Assuming that only 50 percent of the active population is employed, the share of the total population potentially liable to the tax is 25 percent.
- The tax is levied de facto only on individuals employed in the formal sector, which covers only one fourth of total workers, lowering the proportion of taxpayers to about 6 percent of the total population.
- In the case of Maputo this simple calculation leads to an estimate of the total number of taxpayers to 65,000.
- Applying a monthly 4 percent tax rate to a 4,000 Meticaís monthly minimum wage, would bring a total annual tax payment of $4,000 \times 12 \times 0.04 = 1,920$ Meticaís per taxpayer.
- Total collections for Maputo would be $1.920 \times 65.000 = 124.800.000$ Meticaís.
- This would represent almost three times present collections, amounting only to slightly more than 0.17 percent of GDP.

In Nampula municipality a lower tax rate is applicable, and so collecting only 0.1 percent of GDP is estimated, which would more than double present collections.

3. The Motor Vehicle Tax

The motor vehicle tax could also be much more productive. The vehicle tax is also a dynamic tax base, as it can be used for environmental purposes that are relevant for municipalities.

- In Maputo its collections are 0.1 percent of GDP, while in Nampula they are only 0.045 of GDP;
- Based on the proportion of property tax collection and vehicle tax collection in other countries, it could be possible to increase collections to 0.2 percent of GDP in Maputo and 0.1 of GDP in Nampula.

4. The Property Transaction Tax

Given the complete lack of information on tax bases, the estimate of potential is very challenging. A reasonable assumption to estimate the potential collections is to maintain the presently observed proportion in collections between the property transaction tax and the property tax. More precisely, the increase in property transaction tax will parallel the increase in the property tax collections.

5. Transfers

Present transfers from central governments are roughly over 2.25 percent of municipal GDP in Maputo – half of this amount comes from block grants – specifically FCA and FIIL and the remaining part from specific grants. In Nampula the corresponding percentage is lower. The assumption made here is that Maputo will maintain its present allocation, while Nampula will be aligned to Maputo in terms of share on GDP.

Table B1: Structure of revenue in Municipalities of Maputo and Nampula 2014 (Meticais)

	Maputo			Nampula		
	Total ('000 MT)	%	Per capita	Total ('000 MT)	%	Per Capita
RECEITAS CORRENTES	1,305,159	50.5	1,064.7	201,478	72.3	332.6
Receitas Fiscais	365,506	14.1	298.2	11,788	4.23	19.5
Imposto Predial Autárquico	128,900	5	105.1	1,287	0.5	2.1
Imposto Autarquico de Veículos	65,000	2.5	53.0	4,193	1.5	6.9
Imposto Autárquico de Sisa	91,000	3.5	74.2	658	0.2	1.1
Imposto Pessoal Autárquico	44,961	1.7	36.7	1,331	0.5	2.2
Taxa por Actividade Económica	34,535	1.3	28.2	4,319	1.5	7.1
Outros Impostos	1,110	0	0.9	0		0.0
Receitas Não Fiscais	304,583	11.8	248.5	83,709	30	138.2
Taxas por Licenças Concedidas	203,988	7.9	166.4	49,410	17.7	81.6
Tarifas e Taxas pela Prestação de Serviços	64,081	2.5	52.3	15,528	5.6	25.6
Outras Receitas Não Fiscais	36,514	1.4	29.8	0		0.0
Receitas Consignadas	277,168	10.7	226.1	0		0.0
Produto de Transferencias correntes de Estado	357,901	13.8	292.0	70,032	25.1	115.6
Fundo de Compensação Autárquica	344,953	13.3	281.4	70,032		115.6
Imposto Especial sobre o Jogo	12,468	0.5	10.2	0		
Imposto de Selo Casinos	480	0	0.4	0		

RECEITAS DE CAPITAL	1,280,572	49.5	1,044.6	0		
Alienação do Património da Autarquia	1,000	0	0.8	0		
Rendimentos de bens móveis e imóveis	17,641	0.7	14.4	0		
Rendimentos de participações financeiras	10,000	0.4	8.2	0		
Transferências de Capital do Estado	342,153	13.2	279.1	105,981	38.1	175.0
Fundo de Investimento autarquico	127,089	4.9	103.7	44,678		73.8
Sector and ad hoc transfers	215,064	8.3	175.4	61,303		101.2
Transferências de Capital de Outras Entidades Públicas (Donors)	813,438	31.5	663.6	0		0.0
Donativos	96,340	3.7	78.6	7,155	2.6	11.8
Produto de empréstimos	0		0.0	0		0.0
Total Revenues	2,585,731	100	2,109.3	278,665	100	460.0
Total Revenues ('000 US\$)	83,411		68.0	8,989		14.8

Memo: GDP in 2011 in Maputo City is 67,071,000,000 and in Nampula City is 54,065,000,000 (source: INE). Estimated population figures in 2014 in Maputo City are 1225868 and in Nampula City are 605,760

Source: compilation and calculations by the Authors, on the basis of information provided by the municipalities and by INE

Table B2: The property tax as a share of GDP in representative groups of countries (percent)

	1970s	1980s	1990s	2000s*
All countries	0.77	0.73	0.75	1.04
(number of countries)	37	49	59	65
OECD countries	1.24	1.31	1.44	2.12
(number of countries)	16	18	16	18
Transition countries	0.34	0.59	0.54	0.68
(number of countries)	1	4	20	18
Developing countries	0.42	0.36	0.42	0.6
(number of countries)	20	27	23	29
Latin American countries	0.36	0.37
(number of countries)	8	10

* The data for 2000s is for five years from 2000 to 2004

Source: Bahl, Roy, Jorge Martinez-Vazquez, The Property Tax in Practice in Bahl, Roy, Jorge Martinez-Vazquez and Joan Youngman (Eds.). 2008a. Making the Property Tax Work: Experiences in Developing and Transitional Countries; Lincoln Institute of Land Policies, Cambridge, Massachusetts

Annex B2: Formula-based General Purpose/equalization transfers

There are five types of formulas currently used around the world for general transfers. They are listed according to their increasing complexity and potential for efficient equalization

1. Transfers based on equal per capita allocations

This is the simplest system for allocation of grants requiring only information on population. It is used in a number of countries, such as Germany for the allocation of a share of VAT and Canada for the allocation of the block grant for health and social services. It assumes that population is a suitable indicator of local expenditure needs. It also has some non-minimal equity content since it gives the same per capita amount to poor and rich areas, although it does not consider revenues. The formula would be as follows:

$$TR_i = (P_i/P) \times TR$$

where TR is the transfer; P is population; i stands for local unit i. Variables without i refer to the country total.

2. Formulae based on general indicators of expenditure needs

These formulae are very popular and derive from the previous one by adding other indicators of needs such as area, number of pupils in schools. The indicators are not related to distinct expenditure responsibilities assigned to local governments, but to their total expenditure.

An illustration of a simple formula follows, with three equally weighted indicators—for example, geographic area and the number of pupils in schools, in addition to population:

$$TR_i = P_i/P \times 1/3 TR + P_{up_i}/P_{up} \times 1/3 TR + A_i/A \times 1/3 TR$$

where in addition to previous symbols Pup is the number of pupils in schools and A is area (km²).

3. Formulae based on specific indicators of expenditure needs

These formulae are more complex since they use distinct indicators of need for each local expenditure responsibility. They represent a considerable improvement over the previous system but require more information and may be subject to obfuscation if not managed in a transparent way. An example is provided by South Africa, where the general purpose transfer to the provinces is allocated according to a system that has six components: (i) an education component, representing 51 percent of the total transfer allocated according to population in school age and to school enrolment; (ii) a health component, representing 26 percent of the total transfer allocated according to population with and without medical aid; (iii) a basic component, representing 14 percent of the total transfer allocated according to population; (iv) a poverty component, representing 3 percent of the total transfer allocated according to the number of poor persons (quintiles 1 and 2); (v) an economic activity component, representing 1 percent of the total transfer allocated according to GDP; and (vi) an institutional component, representing the remaining 5 percent equally distributed as a lump sum among provinces.

The formula for the education component would be the following:

$$ETR_i = SAPI/SAP \times 0,5 ETR + P_{up_i}/P_{up} \times 0,5 ETR$$

where, in addition to previous symbols, ETR is the education component of the transfer; SAP is school-age population; and Pup is the number of pupils enrolled in schools. Similar formulas would apply to other expenditure functions.

4. Formulae based only on fiscal capacity

In this case, the transfer does not take account of expenditure needs, but only differences in fiscal capacity. An example is provided by the Canadian system of general-purpose transfers to provinces that consider only differences in tax capacity and assume, correspondingly, that each province has the same per capita expenditure needs. It has to be noted that the Canadian provinces are very large in terms of area, which reduces the variance in expenditure needs. Furthermore, the general-purpose transfers to provinces are supplemented with specific transfers that consider needs. The formula would be as follows:

$$TR_i = t \times (B/P - B_i/P_i) \times P_i$$

where, in addition to the previous symbols, B is the effective tax base (not the assessed tax base, but the base that potentially can be assessed; and t is the average effective tax rate on the concerned tax base).

It has to be noted that since $B/P - B_i/P_i$ measures the difference between the per capita national average tax base and that of region i, the formula brings the fiscal capacity of those sub-national governments that are below the national average up to the national average, i.e., it provides 100 percent equalization with reference to the national average. Equalization can obviously be less intense, being eminently a political choice.

5. Formulae that consider both expenditure needs and fiscal capacity

These formulas are a combination of the third and fourth formulas. Expenditure needs are estimated for each local expenditure responsibility and aggregated; the transfer will result from the difference between total expenditure needs and fiscal capacity, as in the following formula:

$$TR_i = \sum N_{ij} - FC_i$$

where, in addition to previous symbols, N is expenditure need; FC is fiscal capacity; and j stands for expenditure responsibility.

Such formulas are used in an increasing number of countries such as Australia, Denmark, Japan, Korea, and the United Kingdom. They are very complex and require a considerable amount of information, thus requiring considerable length of time for their complete implementation. If properly built and implemented, they can be both efficient and equitable.

C. Annexes: Looking ahead: Expenditure Options over the Medium Term

Table C1: Sensitivity Analysis: GDP declines, spending reduces, and the deficit is constant

	2013	2014	2015	2016	2017	2018	2019
(% of GDP)							
Total Revenue	27.5	27.3	24.7	25.1	25.5	25.9	26.3
Tax Revenue	23.4	23.4	20.8	21.2	21.6	22.0	22.4
Normal Tax	19.4	20.4	20.8	21.2	21.6	22.0	22.4
Capital gains	4.0	3.0	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	4.1	3.9	3.9	3.9	3.9	3.9	3.9
Grants	5.4	4.9	4.4	4.0	3.5	3.0	2.5
Total Expenditure	35.6	42.0	36.2	36.0	35.8	35.6	35.3
Compensation of employees	10.7	11.1	10.5	10.2	9.9	9.6	9.3
Priority spending	13.4	16.6	13.6	13.5	13.5	13.5	13.4
Non-priority spending	10.6	13.0	10.7	10.7	10.6	10.6	10.6
Interest payments	0.9	1.3	1.5	1.6	1.7	1.9	2.0
Deficit	-8.1	-14.7	-11.5	-10.9	-10.3	-9.7	-9.0
Balance after grants	-2.7	-9.6	-6.8	-6.6	-6.4	-6.2	-6.0
Financing	2.7	9.6	6.8	6.6	6.4	6.2	6.0
External	5.7	9.7	6.3	6.6	6.4	6.0	5.8
Internal	-3.0	-0.1	0.5	0.0	0.0	0.2	0.2
GDP	461.0	511.7	568.0	630.5	699.8	776.8	862.3
CPI/GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	219.0	230.2	241.9	254.3	267.3	281.0
GDP growth	7.1	5.1	5.1	5.1	5.1	5.1	5.1
in Billion MT							
Total Revenue	126.8	139.7	140.3	158.2	178.5	201.2	226.8
Tax Revenue	107.9	119.7	118.1	133.7	151.2	170.9	193.1
Normal Tax	89.4	104.4	118.1	133.7	151.2	170.9	193.1
Capital gains	18.4	15.4	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	18.9	20.0	22.2	24.6	27.3	30.3	33.6
Grants	24.9	25.2	25.2	24.9	24.3	23.2	21.6
Total Expenditure	164.1	214.9	205.6	227.1	250.6	276.2	304.1
Compensation of employees	49.3	56.8	59.8	64.6	69.6	74.8	80.2
Priority spending	61.9	84.7	77.0	85.4	94.7	104.7	115.7
Non-priority spending	48.7	66.6	60.5	67.2	74.4	82.3	91.0
Interest payments	4.1	6.8	8.3	10.0	12.0	14.4	17.3
Deficit	-37.3	-75.2	-65.3	-68.9	-72.2	-75.1	-77.3
Balance after grants	-12.4	-49.4	-38.7	-41.8	-45.1	-48.5	-51.9
Financing	12.4	49.4	38.7	41.8	45.1	48.5	51.9
External	26.3	49.9	35.7	41.8	45.1	46.7	49.8
Internal	-13.8	-0.5	3.0	0.0	0.0	1.8	2.0

Source: World Bank Staff Estimates

Table C2: Sensitivity Analysis: GDP declines, spending is the same and the deficit widens

	2013	2014	2015	2016	2017	2018	2019
(% of GDP)							
Total Revenue	27.5	27.3	24.7	25.1	25.5	25.9	26.3
Tax Revenue	23.4	23.4	20.8	21.2	21.6	22.0	22.4
Normal Tax	19.4	20.4	20.8	21.2	21.6	22.0	22.4
Capital gains	4.0	3.0	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	4.1	3.9	3.9	3.9	3.9	3.9	3.9
Grants	5.4	4.9	4.4	4.0	3.5	3.0	2.5
Total Expenditure	35.6	42.8	37.6	38.2	38.8	39.4	40.0
Compensation of employees	10.7	11.3	10.9	10.9	10.8	10.7	10.6
Priority spending	13.4	16.9	14.1	14.4	14.7	15.0	15.3
Non-priority spending	10.6	13.3	11.1	11.3	11.6	11.8	12.0
Interest payments	0.9	1.3	1.5	1.6	1.7	1.9	2.0
Deficit	-8.1	-15.5	-12.9	-13.1	-13.3	-13.5	-13.7
Balance after grants	-2.7	-10.5	-8.5	-9.1	-9.8	-10.5	-11.2
Financing	2.7	10.5	8.5	9.1	9.8	10.5	11.2
External	5.7	10.6	8.0	9.1	9.8	10.3	11.0
Internal	-3.0	-0.1	0.5	0.0	0.0	0.2	0.2
GDP	461.0	511.7	568.0	630.5	699.8	776.8	862.3
CPI/GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	219.0	230.2	241.9	254.3	267.3	281.0
GDP growth	7.1	5.1	5.1	5.1	5.1	5.1	5.1
in Billion MT							
Total Revenue	126.8	139.7	140.3	158.2	178.5	201.2	226.8
Tax Revenue	107.9	119.7	118.1	133.7	151.2	170.9	193.1
Normal Tax	89.4	104.4	118.1	133.7	151.2	170.9	193.1
Capital gains	18.4	15.4	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	18.9	20.0	22.2	24.6	27.3	30.3	33.6
Grants	24.9	25.2	25.2	24.9	24.3	23.2	21.6
Total Expenditure	164.1	218.8	213.5	240.7	271.4	305.9	344.8
Compensation of employees	49.3	57.9	62.2	68.6	75.6	83.3	91.5
Priority spending	61.9	86.3	80.1	90.8	102.9	116.6	132.1
Non-priority spending	48.7	67.8	63.0	71.4	80.9	91.6	103.8
Interest payments	4.1	6.8	8.3	10.0	12.0	14.4	17.3
Deficit	-37.3	-79.1	-73.2	-82.5	-92.9	-104.7	-118.0
Balance after grants	-12.4	-54.0	-48.0	-57.6	-68.7	-81.5	-96.4
Financing	12.4	54.0	48.0	57.6	68.7	81.5	96.4
External	26.3	54.5	45.2	57.6	68.7	80.0	94.7
Internal	-13.8	-0.5	2.8	0.0	0.0	1.6	1.7
	2013	2014	2015	2016	2017	2018	2019
(% of GDP)							
Total Revenue	27.5	27.3	24.7	25.1	25.5	25.9	26.3
Tax Revenue	23.4	23.4	20.8	21.2	21.6	22.0	22.4
Normal Tax	19.4	20.4	20.8	21.2	21.6	22.0	22.4
Capital gains	4.0	3.0	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	4.1	3.9	3.9	3.9	3.9	3.9	3.9
Grants	5.4	4.9	4.4	4.0	3.5	3.0	2.5

Total Expenditure	35.6	42.8	37.6	38.2	38.8	39.4	40.0
Compensation of employees	10.7	11.3	10.9	10.9	10.8	10.7	10.6
Priority spending	13.4	16.9	14.1	14.4	14.7	15.0	15.3
Non-priority spending	10.6	13.3	11.1	11.3	11.6	11.8	12.0
Interest payments	0.9	1.3	1.5	1.6	1.7	1.9	2.0
Deficit	-8.1	-15.5	-12.9	-13.1	-13.3	-13.5	-13.7
Balance after grants	-2.7	-10.5	-8.5	-9.1	-9.8	-10.5	-11.2
Financing	2.7	10.5	8.5	9.1	9.8	10.5	11.2
External	5.7	10.6	8.0	9.1	9.8	10.3	11.0
Internal	-3.0	-0.1	0.5	0.0	0.0	0.2	0.2
GDP	461.0	511.7	568.0	630.5	699.8	776.8	862.3
CPI/GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	219.0	230.2	241.9	254.3	267.3	281.0
GDP growth	7.1	5.1	5.1	5.1	5.1	5.1	5.1
in Billion MT							
Total Revenue	126.8	139.7	140.3	158.2	178.5	201.2	226.8
Tax Revenue	107.9	119.7	118.1	133.7	151.2	170.9	193.1
Normal Tax	89.4	104.4	118.1	133.7	151.2	170.9	193.1
Capital gains	18.4	15.4	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	18.9	20.0	22.2	24.6	27.3	30.3	33.6
Grants	24.9	25.2	25.2	24.9	24.3	23.2	21.6
Total Expenditure	164.1	218.8	213.5	240.7	271.4	305.9	344.8
Compensation of employees	49.3	57.9	62.2	68.6	75.6	83.3	91.5
Priority spending	61.9	86.3	80.1	90.8	102.9	116.6	132.1
Non-priority spending	48.7	67.8	63.0	71.4	80.9	91.6	103.8
Interest payments	4.1	6.8	8.3	10.0	12.0	14.4	17.3
Deficit	-37.3	-79.1	-73.2	-82.5	-92.9	-104.7	-118.0
Balance after grants	-12.4	-54.0	-48.0	-57.6	-68.7	-81.5	-96.4
Financing	12.4	54.0	48.0	57.6	68.7	81.5	96.4
External	26.3	54.5	45.2	57.6	68.7	80.0	94.7
Internal	-13.8	-0.5	2.8	0.0	0.0	1.6	1.7

Source: World Bank Staff Estimates

Table C3: Scenario I – increasing resource envelope without prioritization

	2013	2014	2015	2016	2017	2018	2019
	% of GDP						
Total Revenue	27.5	27.8	25.8	26.6	27.5	28.3	29.2
Tax Revenue	23.4	23.8	21.6	22.3	23.0	23.7	24.4
Normal Tax	19.4	20.8	21.5	22.2	22.9	23.6	24.3
Capital gains	4.0	3.0	0.1	0.1	0.1	0.1	0.1
Non-Tax Revenue	4.1	4.0	4.2	4.3	4.5	4.6	4.8
Grants	5.4	5.2	5.0	4.8	4.6	4.4	4.2
Total Expenditure	35.6	43.4	38.2	38.5	38.8	39.1	39.4
Compensation of employees	10.7	11.5	11.2	11.0	10.9	10.7	10.5
Priority spending	13.4	17.1	14.4	14.6	14.8	15.0	15.2
Non-priority spending	10.6	13.5	11.3	11.5	11.6	11.8	12.0
Interest payments	0.9	1.3	1.4	1.5	1.5	1.6	1.7
Deficit	-8.1	-15.6	-12.4	-11.9	-11.4	-10.8	-10.3
Balance after grants	-2.7	-10.4	-7.4	-7.1	-6.8	-6.4	-6.1
Financing	2.7	10.4	7.4	7.1	6.8	6.4	6.1
External	5.7	10.2	6.6	6.8	6.5	5.9	5.6
Internal	-3.0	0.2	0.8	0.3	0.3	0.5	0.5
GDP	461.0	526.0	600.1	684.7	781.2	891.4	1017.0
CPI/GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	225.1	243.2	262.7	283.9	306.7	331.4
GDP growth	7.1	8.0	8.0	8.0	8.0	8.0	8.0
	in Billion MT						
Total Revenue	126.8	146.2	154.5	182.1	214.4	252.3	296.5
Tax Revenue	107.9	125.2	129.6	152.7	179.7	211.3	248.1
Normal Tax	89.4	109.4	129.0	152.0	178.9	210.4	247.1
Capital gains	18.4	15.8	0.6	0.7	0.8	0.9	1.0
Non-Tax Revenue	18.9	21.0	24.9	29.4	34.8	41.0	48.3
Grants	24.9	27.4	30.0	32.9	35.9	39.2	42.7
Total Expenditure	164.1	228.2	229.2	263.7	303.3	348.8	401.2
Compensation of employees	49.3	60.4	66.9	75.4	84.9	95.5	107.3
Priority spending	61.9	90.1	86.2	99.8	115.5	133.7	154.8
Non-priority spending	48.7	70.8	67.8	78.4	90.8	105.1	121.7
Interest payments	4.1	6.8	8.3	10.0	12.0	14.4	17.3
Deficit	-37.3	-82.0	-74.7	-81.5	-88.9	-96.6	-104.8
Balance after grants	-12.4	-54.6	-44.7	-48.7	-52.9	-57.4	-62.0
Financing	12.4	54.6	44.7	48.7	52.9	57.4	62.0
External	26.3	53.6	39.9	46.6	50.6	52.9	57.0
Internal	-13.8	1.1	4.8	2.1	2.3	4.5	5.1

Source: World Bank Staff Estimates

Table C4: Scenario II – constant resource envelope with prioritization

	2013	2014	2015	2016	2017	2018	2019
	% of GDP						
Total Revenue	27.5	27.3	24.7	25.1	25.5	25.9	26.3
Tax Revenue	23.4	23.4	20.8	21.2	21.6	22.0	22.4
Normal Tax	19.4	20.4	20.8	21.2	21.6	22.0	22.4
Capital gains	4.0	3.0	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	4.1	3.9	3.9	3.9	3.9	3.9	3.9
Grants	5.4	4.9	4.4	4.0	3.5	3.0	2.5
Total Expenditure	35.6	41.6	35.6	35.2	34.7	34.3	33.9
Compensation of employees	10.7	10.8	10.0	9.2	8.6	7.9	7.3
Priority spending	13.4	17.9	13.5	14.5	15.5	16.3	17.0
Non-priority spending	10.6	11.6	10.7	9.9	9.2	8.5	7.9
Interest payments	0.9	1.3	1.4	1.5	1.5	1.6	1.7
Deficit	-8.1	-14.3	-10.9	-10.1	-9.2	-8.4	-7.6
Balance after grants	-2.7	-9.4	-6.4	-6.1	-5.8	-5.4	-5.1
Financing	2.7	9.4	6.4	6.1	5.8	5.4	5.1
External	5.7	9.5	5.9	6.1	5.8	5.2	4.9
Internal	-3.0	-0.1	0.5	0.0	0.0	0.2	0.2
GDP	461.0	526.0	600.1	684.7	781.2	891.4	1017.0
CPI/GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	225.1	243.2	262.7	283.9	306.7	331.4
GDP growth	7.1	8.0	8.0	8.0	8.0	8.0	8.0
	in Billion MT						
Total Revenue	126.8	143.6	148.2	171.9	199.2	230.9	267.5
Tax Revenue	107.9	123.1	124.8	145.2	168.7	196.1	227.8
Normal Tax	89.4	107.3	124.8	145.2	168.7	196.1	227.8
Capital gains	18.4	15.8	0.0	0.0	0.0	0.0	0.0
Non-Tax Revenue	18.9	20.5	23.4	26.7	30.5	34.8	39.7
Grants	24.9	25.9	26.6	27.0	27.1	26.6	25.4
Total Expenditure	164.1	218.8	213.5	240.7	271.4	305.9	344.8
Compensation of employees	49.3	56.7	59.9	63.3	66.8	70.5	74.5
Priority spending	61.9	94.4	81.1	99.6	120.9	145.2	173.0
Non-priority spending	48.7	60.9	64.3	67.9	71.7	75.7	79.9
Interest payments	4.1	6.8	8.3	10.0	12.0	14.4	17.3
Deficit	-37.3	-75.2	-65.3	-68.9	-72.2	-75.1	-77.3
Balance after grants	-12.4	-49.4	-38.7	-41.8	-45.1	-48.5	-51.9
Financing	12.4	49.4	38.7	41.8	45.1	48.5	51.9
External	26.3	49.9	35.7	41.8	45.1	46.7	49.8
Internal	-13.8	-0.5	3.0	0.0	0.0	1.8	2.0

Source: World Bank Staff Estimates

Table C5: Scenario III – increasing resource envelope with prioritization

	2013	2014	2015	2016	2017	2018	2019
(% of GDP)							
Total Revenue	27.5	27.8	25.8	26.6	27.5	28.3	29.2
Tax Revenue	23.4	23.8	21.6	22.3	23.0	23.7	24.4
Normal Tax	19.4	20.8	21.5	22.2	22.9	23.6	24.3
Capital gains	4.0	3.0	0.1	0.1	0.1	0.1	0.1
Non-Tax Revenue	4.1	4.0	4.2	4.3	4.5	4.6	4.8
Grants	5.4	5.2	5.0	4.8	4.6	4.4	4.2
Total Expenditure	35.6	43.4	38.2	38.5	38.8	39.1	39.4
Compensation of employees	10.7	11.0	10.2	9.4	8.7	8.1	7.5
Priority spending	13.4	18.2	14.7	16.6	18.3	20.0	21.5
Non-priority spending	10.6	12.9	11.9	11.0	10.2	9.5	8.8
Interest payments	0.9	1.3	1.4	1.5	1.5	1.6	1.7
Deficit	-8.1	-15.6	-12.4	-11.9	-11.4	-10.8	-10.3
Balance after grants	-2.7	-10.4	-7.4	-7.1	-6.8	-6.4	-6.1
Financing	2.7	10.4	7.4	7.1	6.8	6.4	6.1
External	5.7	10.2	6.6	6.8	6.5	5.9	5.6
Internal	-3.0	0.2	0.8	0.3	0.3	0.5	0.5
GDP	461.0	526.0	600.1	684.7	781.2	891.4	1017.0
CPI/GDP Deflator	221.3	233.7	246.8	260.6	275.2	290.6	306.9
Inflation	5.5	5.6	5.6	5.6	5.6	5.6	5.6
GDP Real	208.3	225.1	243.2	262.7	283.9	306.7	331.4
GDP growth	7.1	8.0	8.0	8.0	8.0	8.0	8.0
in Billion MT							
Total Revenue	126.8	146.2	154.5	182.1	214.4	252.3	296.5
Tax Revenue	107.9	125.2	129.6	152.7	179.7	211.3	248.1
Normal Tax	89.4	109.4	129.0	152.0	178.9	210.4	247.1
Capital gains	18.4	15.8	0.6	0.7	0.8	0.9	1.0
Non-Tax Revenue	18.9	21.0	24.9	29.4	34.8	41.0	48.3
Grants	24.9	27.4	30.0	32.9	35.9	39.2	42.7
Total Expenditure	164.1	228.2	229.2	263.7	303.3	348.8	401.2
Compensation of employees	49.3	57.9	61.1	64.5	68.1	71.9	76.0
Priority spending	61.9	95.7	88.2	113.5	143.3	178.1	218.9
Non-priority spending	48.7	67.8	71.6	75.6	79.9	84.4	89.1
Interest payments	4.1	6.8	8.3	10.0	12.0	14.4	17.3
Deficit	-37.3	-82.0	-74.7	-81.5	-88.9	-96.6	-104.8
Balance after grants	-12.4	-54.6	-44.7	-48.7	-52.9	-57.4	-62.0
Financing	12.4	54.6	44.7	48.7	52.9	57.4	62.0
External	26.3	53.6	39.9	46.6	50.6	52.9	57.0
Internal	-13.8	1.1	4.8	2.1	2.3	4.5	5.1

Source: World Bank Staff Estimates