CDD Centro para Democracia e Direitos Humanos

GOVERNAÇÃO ECONÓMICA

SCUT SCALING UP TAX JUSTICE

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Tuesday, October 8, 2024 | Year VI, Number 50 | **Director:** Prof. Adriano Nuvunga | **English**

TAX INCENTIVES IN THE EXTRACTIVE INDUSTRY:

A Long-standing Debate Resurfacing as Political Rhetoric Among Mozambican Presidential Candidates

- As Mozambique approaches the presidential elections scheduled for 9 October, the topic of tax incentives in the extractive industry has taken center stage, with candidates promising to revisit and renegotiate the contracts of megaprojects. However, while these promises may resonate with the public, the specifics of what this renegotiation entails remain largely unclear.

Credits: Carta de Moçambique

The truth is that the actual context calls for bold and decisive action. The upcoming elections present a critical opportunity for leaders to commit to concrete, transparent reforms in the extractive industry. Not only in addressing the gaps in already signed contracts but also reinforcing the extractives tax incentives governance in general by ensuring that they are only provided fairly and transparently, with the publication of disaggregated data on the amount of total revenue lost and undergoing regular cost-benefit analysis of such public expenditure.

All major candidates — ranging from the ruling Frelimo party to the opposition[1] — have highlighted the need to reassess the contracts governing the country's megaprojects. They point to the imbalance between the profits accrued by foreign companies and the benefits reaching ordinary Mozambicans.

Renegotiating contracts with multinational companies is no easy feat. While candidates have been vocal about the need for change, specific plans, or mechanisms for how this will be accomplished are notably absent. None of the candidates have outlined the legal, economic, or diplomatic steps they would take to renegotiate these contracts without risking investor confidence or economic stability.

This article delves into the continued significance of this debate and highlights why the stakes involved demand more than mere political rhetoric, calling for concrete actions to address it.

1. Extractives Tax incentives in retrospect: A very onerous learning curve?

After independence, Mozambique engaged in meaningful economic reforms, including investment and tax laws to attract investment in strategic sectors such as export-oriented industries and extractive industries. The investment promotion tools relied on granting tax incentives to Multinational Enterprises (MNEs), resulting in several billions of Dollars flowing in the form of Foreign Direct Investment (FDI) to the extractive industry.

Tax incentives were perceived for a long time as the panacea in the competition for foreign investment.[2] In addition to the tax incentives granted by the Code of Tax Benefits under the Investment Law, major projects have benefited from specific incentives resulting from negotiations with the government. The incentives in question take the form of exemptions, deductions from tax and taxable income, tax credits for investment, accelerated depreciation and reintegration, reduced tax rates, and deferred tax payments.

Starting in the early 2000s, Mozambique attracted its largest influx of foreign direct investment (FDI) since independence, primarily focused on the extractive industry aimed at exporting raw materials. These investments offered minimal local value addition, contributed relatively little to job creation, and retained limited economic benefits within the country[3].

Key projects during this period included the Mozal's aluminum production project, the Kenmare Heavy Sands project in Nampula Province, SASOL's natural gas exploration in Inhambane, and Vale do Rio Doce's coal mining ventures in Tete province, with contracts signed in the early 2000s. In the early 2010s, the discovery of vast natural gas reserves in the Rovuma Basin further fueled FDI inflows. All enjoying wasteful tax incentives that have been costing money to the state to this day.

The capital Inflow had a significant impact on economic growth, rising to around 7% per year. However, the same cannot be said about the revenue collection. In fact, the contribution of the extractive industry has been consistently low, averaging 4.5% of the total tax Revenue.

As a result, the Tax Incentives Strategy proved ineffective, raising doubts about its overall efficiency. Policymakers, including those involved in investment law and policy frameworks, responded by tightening the governance of tax incentives. These measures included shortening the duration of incentives and requiring investors to meet additional performance criteria.

In the extractive industry, reforms focused on reducing the duration of incentives, ensuring tax progressivity by eliminating tax holidays, reduc-

[1] Voice of America. (2023, October 2). Moçambique: Candidatos prometem renegociar megaprojetos, mas não dizem de que forma. https://www.voaportugues.com/a/mo%C3%A7ambique-candidatos-prometem-renegociar-megaprojetos-mas-n%C3%A3o-dizem-de-que-forma/7801775.html

[2] Nova, Y., & Mosca, J. (2022). Investimento directo estrangeiro: "Extractivisando" a economia moçambicana. Observatório do Meio Rural. Destaque Rural Nº 169. https://omrmz.org/wp-content/uploads/DR-169-Investimento-Directo-Estrangeiro.pdf

[3] Castel-Branco, C. N. (2002). Mega projectos e estratégia de desenvolvimento: Notas para um debate. https://www.iese.ac.mz/lib/cncb/Mega_projectos_Moz_texto.pdf

tions, and exemptions and clarifying fiscal stability and capital gains taxation mechanisms. The aim was to continue encouraging investments while also increasing tax revenue to fund public infrastructure, education, and healthcare improvements. However, these changes did not apply to already signed contracts with multinational enterprises (MNEs) in the extractive sector.

1.1. The case of the mining industry

Just to elucidate the generous deals that mining companies have secured with the Mozambican government, we refer below to four of the pioneering megaprojects in the country.

Let's start with Mozal. Operating since 1998 in Maputo province, the aluminum smelter was the first major Foreign Direct Investment project in independent Mozambique. This megaproject received several benefits, including a reduced Corporate Income Tax (IRPC) of 15 percent for the mine over a period of 10 operational years. It also enjoyed exemptions for the manufacturing sector, including Excise Duty (ICE), CP, Value-added tax VAT and SISA, customs duties, along with a personal Income Tax (IRPS) exemption for expatriates during the construction phase and additional exemptions for the first five years of operation, among others.

In 2002, the Mozambique Government and Kenmare Moma Mining Limited (KMML)[4] signed a contract for prospecting, research, development, and production of Heavy Sands in the areas of Moma, Congolone and Quinga in Nampula Province.[5] KMML is a 20 years contract, benefits from both profit-based and cost-based tax incentives, ranging from 50% of the IRPC rate for a period of 10 years, after the start of production, exemption from customs duties, VAT, and ICE on the import of equipment, machines, and class K material for a period of 5 years. The royalty rate is reduced by 50% compared to actual of 6%. Meanwhile, the complementary part of the project, KMPL, has a specific fiscal regime, that exempts all the taxes and only tax 1% of the financial year turnover.

In 2007 the Government signed a Concession contract[6] with actual Companhia Vale do Rio Doce (later on VALE Moçambique[7]), actual Vulcan Minerals Mozambique (VMM) for exploration of two types of mineral coal, Thermal coal, and coking coal, in Moatize District, Tete province. This 25-year contract includes several benefits[8], such as exemptions from customs duties, VAT, and ICE on the import of class K equipment, machinery, and other materials. Additionally, it offers a 25% reduction in the IRPC rate during the first five years of profit and a 50% reduction in SISA. The contract also allows for tax allowances on losses for 15 years after the start of production, along with investment uplifts and special conditions for withholding tax on services provided by non-resident entities. However, the royalty rate was not included in any incentives and remains fixed at 3%, in accordance with existing legislation.

There is also the Montepuez Ruby Mining (MRM) project. This was not established under a concession contract; instead, it was granted concession license no. 4703 on November 11, 2011, which is valid until November 11, 2036. This license allows for the exploration of aquamarine, garnet, ruby, and tourmaline in Nhamanhubir, Montepuez District, Cabo Delgado Province.

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[4] The contract signed under Law No. 2/86 of April 16 (Mining Law), establishes that KMML has the exclusive right to carry out heavy mineral operations in these areas for 25 years, with the possibility of extension as long as exceeds 15 years. https://www.inami.gov.mz/images/Contratos/KENMARE%20MOMA%20MINING%20LTD.pdf.

[5] The project is divided in two parts, Mining and Processing. The KMML is responsible only for mining activities and Kenmare Moma Processing Limited (KMPL) is the complementary project responsible for processing and separating the heavy sands into zircon, ilmenite and rutile, classified as an industrial project located in the Special Economic Zone (SEZ) an Industrial Free Zone (IFZ). These tax incentives were established under Law 5/94, dated September 3, along with decrees 53/94 and 3/87 from January 30.

[6] The contract for coal exploration was signed in 2007 between the Government of Mozambique and the company Rio Doce Moçambique (RDMZ) under Law no 14/2002 of 26 June (Mining Law). The contract provides for a term of 25 years, renewable for the same period. https://cipmoz.org/wp-content/uploads/2021/01/Vale-decide-Desinvestir-em-Moc%CC%A7ambique-2.pdf

[7] Vale entered into a binding agreement with Vulcan to sell the Moatize coal mine and the Nacala Logistics Corridor for a total of US$270 million, comprising US$80 million after the transaction and US$190 million from existing business to completion; plus a 10-year Royalty Agreement subject to certain mine production conditions and coal price. https://vale.com/pt/w/vale-announces-the-sale-of-its-coal-assets-1

[8] The VMM profit-based and cost-based tax incentives were granted under the Law 3/2001, of February 21 and Decree 16/2002, of June 2.

While MRM did not enter into a formal contract with the Government, it fulfills its tax obligations under Law 11/2007, dated July 27, along with other general tax regulations. Although MRM does not benefit from any profit-based or cost--based tax incentives, it is eligible for general tax incentives on investment, which include exemptions from customs duties, VAT, and ICE on the import of equipment, machinery, and class K materials for a period of 5 years as outlined in the tax law. However, the current tax regime, established by Law 15/2017, dated December 28, does not apply to MRM due to the stability clause, as the company opted to continue complying with tax obligations under Law 11/2007. Consequently, the applicable royalty rate is set at 10%, and the Mining Resource Income Tax (IRRM) is not levied on the project's extraordinary cash flows.

1.2. The case of the hydrocarbon industry

The Mozambican government approved in 2000, the first Natural Gas project in Pande and Temane, located in Inhambane province, with the South African petrochemical company Sasol[9]. This project was granted a mix of profit-based and cost-based tax incentives, since provides a 50% reduction in IRPC rate to 17.5% (from 35% industrial contribution rate which later became 32% IRPC), in the first 6 years of commercial production, a 5% Royalty rate, and exemptions on customs duties, VAT and ICE, on income and goods of the Expatriates and accelerated. Also benefits from fiscal stability under the Contract.

Following the Pande and Temane project, more two projects for exploration and production of Natural Gas contracts were signed in 2006, the Rovuma Basin Areas 1 and 4 Liquified Natural Gas projects. The first one was signed with Anadarko Mozambique Area 1 (whose participation in the project was ceded to TotalEnergies Rovuma Area 1 in 2019). The second was signed with ENI EAST AFRICA, in the form of EPCC (Exploration and Production Concession Contract), now Mozambique Rovuma Venture (MRV). For both the tax incentives were granted under the EPCC and Law 3/2001, of February 21, and Decree 16/2002, de June 27.

The Area 1 and 4 Rovuma Basin projects, also have a mix of cost-based and profit-based tax incentives, their fiscal and contractual regime are quite similar, except the rates of the cost recovery mechanism. In practice, they are exempted from customs duties, VAT, and ICE on the importation of the petroleum operations equipment, have an accelerated depreciation mechanism for Exploration and Operational Capital Costs. A 75% reduction in IRPC for 8 years after the start of commercial production and exemption and 50% reduction on SISA. For both the royalty rates depends on the depth level of the oil or natural gas deposits, however due to the greater depth, which is between 1500 and 2600 meters, the applicable royalty rate is minimum 2% on Liquified Natural Gas.

Hydrocarbon contracts in Mozambique generally focus on three main sources of state revenue: (1) royalties, which are a fixed payment per ton of gas or oil produced; (2) corporate income tax, calculated based on annual profits; and (3) the largest source of revenue, known as "profit oil," which represents the state's share of total production.[10]

The first steady revenue stream for the state comes from royalties, which are paid based on the value of the gas or oil produced. These payments are not tied to profits and begin as soon as production starts, guaranteeing income for the state in the early stages of production. It is generally assumed that the royalty rate for natural gas production in Mozambique is around 6%. However, contracts signed before the introduction of Law No. 12/2007 of June 27 benefit from lower royalty rates, with some as low as 2%, reducing the amount of revenue the state collects from this source.

[9] The Production Agreement of Petroleum (PPA) Contract was signed under Law 3/81 of 3 October

[10] Other sources of state revenue include Production Bonuses and commitments from the companies regarding Institutional Support, Training, and Social Investment. I2A Consultoria e Serviços. (2023). Independent Report of the Extractive. Industry Transparency Initiative: Year 2020. http://www.itie.org.mz/download/decimo-relatorio-itie-mocambique-english/?wpdmdl=3385&refresh=63fa77d20135b1677359058

The second key revenue source is Corporate Income Tax (CIT), which is set at 32% in Mozambique. For oil operations, taxable income is calculated by deducting eligible exploration, capital, and operating expenses from total income. Starting in 2007, the government introduced generous tax incentives, including reduced CIT rates for the initial years of production. Because of the wide range of deductible expenses, CIT contributes relatively little to state revenue during the initial years of production.

The final and most significant revenue source is the production-sharing mechanism, but this revenue comes later in the production cycle and initially benefits multinational corporations (MNCs). This system is influenced by cost recovery, with profit-sharing percentages changing based on the ratio of cumulative income to cumulative expenses, known as the R-factor. For instance, in the early years of production, 90% of the "gas profit" from TotalEnergies' concession will go to the company, with only 10% going to the state. Over time, the state's share of the gas profit increases, with a more equitable distribution occurring in the later stages of production.

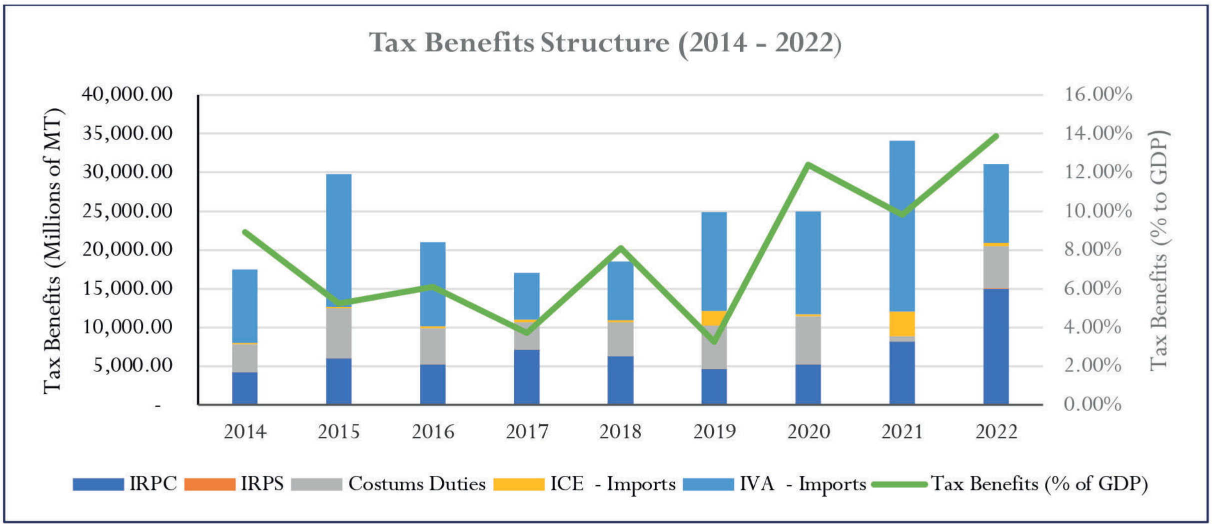
In short, in conclusion, while Mozambique's hydrocarbon projects offer significant potential for state revenue, the structure of contracts and tax incentives largely benefits multinational corporations.

2. What price are Mozambicans paying for past sins?

The volume of tax revenue losses derived from tax benefits in Mozambique has been increasing consistently over time. A recent study conducted by CDD estimates that between 2013 – 2022, the State accounts recorded cumulative tax expenses of around 218,8 billion meticais – an average share of 7.9% of GDP per year.

As can be noted from the graph below, the tax expenses of the Mozambican government on incentives for the extractive industry from 2014 to 2022 show a fluctuating but generally increasing trend. In 2014, tax benefits reached the amount of 17,5 billion meticais, around 8.9% of GDP, and in 2022, amounted to 31,1 billion meticais, around 13.9% of the GDP.

Graph 1. Trends in Mozambique's Tax Benefits Structure

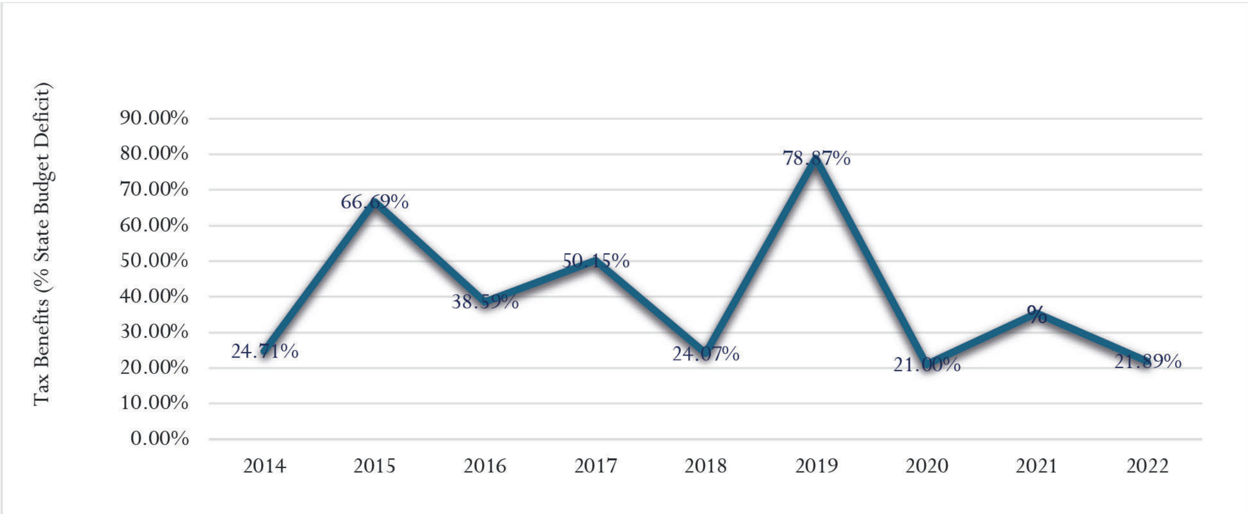


Source: General State Budget Account (https://www.mef.gov.mz/)

Looking closer to the tax benefits structure, the VAT exemptions on the imports of goods and services, especially K Class goods averaged 50%, while withholding IRPC on services provided by non-resident entities, has averaged 28%, in third place comes the customs duties[11] with an average contribution of 19.05%. ICE and IRPS have shared around 2.88% and 0.01%, respectively. The VAT exemption, especially on the import of equipment and other materials from K class, make the biggest revenue loss, with a record value of 22,070.09 million MT in 2021, the IRPC reached the peak in 2022, with a total amount of 15,008.8 million MT.

The trade-off is onerous. On average over the period under analysis (2014 to 2022), the tax benefits granted would been sufficient to cover around 40% of the government budget deficit. The Tax benefits, in 2014 shared 24.1% of the overall Government Budget deficit before Donations and Loans (External or Internal), in 2015 it increased to 66% and peaked at 78.87% in 2019, after that in 2022 dropped to 21.09%, as illustrated in Figure 3. Therefore, the tax benefits would have played a significant impact in reducing the fiscal deficit and internal debt, ensuring sound macroeconomic stability by allowing less exposure to debt shocks.

Graph 2. Share of Tax Benefits on State Budget Deficit

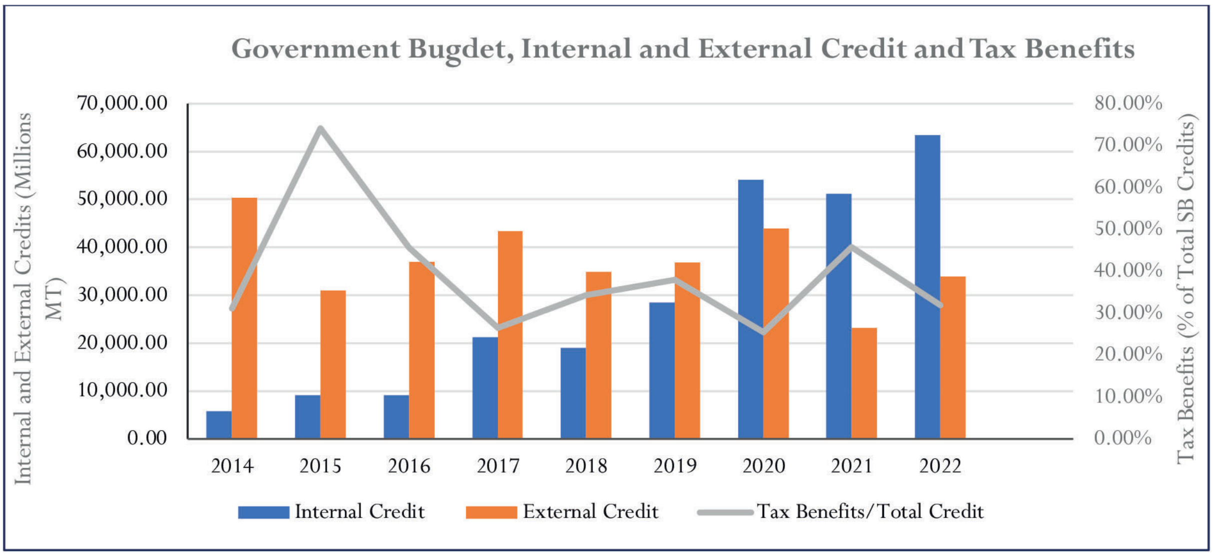


Source: General State Budget Account (https://www.mef.gov.mz/)

While the country loses billions with tax incentives, the Mozambican government increasingly resorts to public debt to finance its needs. Between 2014 and 2022, according to Figure 4, internal credits grew faster than external credits, with on average rate of 42.58%, while external debt was only 0.28%. The rise of internal debt to fund the government budget deficit recently is related to limited access to international markets, therefore the Government relied more on the domestic market, specifically the national banking system, to fund the deficit. The tax benefits in 2014 would have been enough to cover around 75% of the total State Budget (SB) loans and in 2022 around 30%, and from 2014 to 2022 would have been enough to cover around 40% of the total credits taken out by the government. Therefore, the tax benefits would have contributed to reduce the government debt by 40%.

[11] According to article 12 of Law 32/2007, VAT Code, the VAT and ICE are exempted on Costums duties exemption on imports of equipment class K as classified in Costums tariffs and Investment Code.

Graph 3. Trends in Internal and External Budget Credits and Tax Benefits



Going beyond demagoguery

In the lead-up to Mozambique's 9 October presidential elections, the manifestos of the main candidates[12] converge on one populist yet vague promise: renegotiating contracts for megaprojects. This pledge taps into widespread public sentiment around foreign exploitation of natural resources and the perception that the country is not receiving its fair share of the benefits. However, the striking lack of detail and the timing of their proposals is cause for concern.

None of the candidates provide clear information on which specific contracts they aim to renegotiate or outline how they would achieve better terms. This omission reveals either a superficial understanding of the complexities surrounding these massive deals, or an intentional evasion of the challenges involved just to get the support of the voters. These contracts often include long-term agreements with multinational corporations, and changing their terms could lead to lengthy legal battles and potential investor flight.

The omission of details raises questions about the feasibility and sincerity of these promises. Are these candidates truly prepared to challenge global corporations and navigate the technicalities of international law? Or are they offering hollow rhetoric, designed to win votes but ultimately unworkable in practice? Only time will tell. However, looking at the realities of the last three decades, the latter seems more likely.

The truth is that the actual context calls for bold and decisive action. The upcoming elections present a critical opportunity for leaders to commit to concrete, transparent reforms in the extractive industry. Not only in addressing the gaps in already signed contracts but also reinforcing the extractives tax incentives governance in general by ensuring that they are only provided fairly and transparently, with the publication of disaggregated data on the amount of total revenue lost and undergoing regular cost-benefit analysis of such public expenditure.

[12] Lutero Simango, supported by the Democratic Movement Party of Mozambique (MDM), Daniel Chapo, supported by the Front for the Liberation of Mozambique Party (FRELIMO), Venâncio Mondlane supported by the Optimistic People for the Development of Mozambique Party (PODEMOS) and Ossufo Momade supported by the National Resistance Party of Mozambique (RENAMO).

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