

**Donors' principles and resulting stress:
Indirect taxes and donor-funded public works**

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Abstract:

In the context of financial aid, most donors do not pay for indirect taxes levied by recipient governments on projects otherwise financed by external funds. Since governments want to avoid exemptions, many countries pay the taxes from domestic resources to their own revenue authority. Although this is in theory equivalent to exemption, it raises many difficulties in practice leading to underbudgeting of tax votes and growing arrears with contractors. The paper proposes to solve the issue via budgeting procedures rather than via tax exemptions, and suggests that donors may want to reconsider their “no tax” rules.

1. Introduction

Many donors that provide funds for infrastructure projects in developing countries do not accept the payment of fiscal charges which recipient governments would impose under normal circumstances. Since recipient governments are trying to limit exemptions in the fiscal regime in order to broaden the tax base and reduce the scope for fraud and tax avoidance, many countries apply the normal fiscal rules and regulations to donor-funded investment projects and pay these taxes out of general government funds in order to comply with the donors' rule. Mozambique has also adopted that approach.

In theory, and assuming that donors would not disburse and execute projects unless there is a sufficient provision for the payment of the tax-related part of contractors' invoices in the budget, the full amount of these indirect taxes paid by state flows back to the revenue authorities swiftly as revenues, which would provide the funds for the payment of these project-related charges. Thus, the availability of funds for other areas of public expenditure would not be affected. In effect, from the fiscal point of view, it makes no difference whether government spends more on taxes and thereby collects more revenues, or whether it exempts the respective projects and contracts from tax.

Due to the mechanisms and phasing of the budget process and widespread incomplete understanding of the VAT mechanism, however, provisions for the payment of taxes in the budget tend to be grossly inadequate. The shortfall is dramatic in Mozambique. Instead of scaling down project execution and disbursements, however, most donors continue to disburse. The projects go on, while the state is accumulating arrears. Various special rules and partial exemptions have been put into place in order to alleviate the effects on contractors' liquidity and profits. This temporary solution is not sustainable, but can actually go on for a considerable period of time.

A solution is actually not too difficult. If the administration would pay fiscal charges on donor-funded public works swiftly and in full, most of the additional payments would flow back to revenue authorities. If government would exempt, in the sense of zero-rating, such projects from taxes similar to how exports are treated, the revenue loss would be small. It is important to assess the potential revenue loss, which has not been done so far. The author's best guess is that the net effect on the availability of funds for other purposes will be quite small.

This paper, after an analysis of mechanisms and scenarios, argues that most of the VAT which the State is not paying is also not received by the revenue office. The part that is received is essentially stemming from involuntary credits of contractors to government – and thus domestic financing –, or is born by donors via inflated prices.

The paper looks at alternative solutions, such as zero-rating of contracts and invoices of which donors finance the non-tax part or an improvement of the budget process which would ensure that the State's obligations to pay the VAT and import charges receives the funding that it reserves.

In the final section, the wisdom of the current practice of many donors under which they insist in not paying taxes is questioned. After all, the principles and rules were instituted at a time when public finance in recipient countries was generally intransparent and where the focus of aid organisations was on balance-of-payment gaps rather than budgetary constraints. It is proposed that in addition to government changing its budgeting procedures, donors start paying taxes for the infrastructure projects which they support. This would speed up implementation, avoid special rules and their potential for abuse, and probably also reduce the cost of public works in those

cases where contractors make bids which include a safety margin for the event that payments of the tax part of their invoices to public-sector clients may take a long time to materialise.

2. Background

In project-related financial aid, most donors and financial institutions decline payment of indirect fiscal charges, such as value-added tax and import duties, on public works which they finance.¹ The rationale is straight-forward: donors fund the full resource cost of an investment. If they were to pay taxes on top, which do not constitute resource costs, they would be providing additional and non-earmarked funds to the treasury, over and above the economic resource cost of the project. Consequently, project donors as well as staff in donor offices and beneficiary sectors would see such taxes as illegitimate fines on donations or soft loans.

As long as the donor bears the full resource cost of the project, domestic revenues and expenditures are indeed not negatively affected. If, for example, a donor pays the full C.I.F. cost of an imported piece of machinery and also for the transport and labour to bring it to its destination, but no taxes, all other activities would go on as before, and tax revenue of the State would remain at the same level as before. Exempting donor-funded projects does not appear to be harmful.

However, the idea of exempting project-related activities from indirect taxes conflicts with governments' efforts to cut down on exemptions and limit discretion of tax collectors. Since administrations tend to be weak and corruption endemic, this seems to be an adequate approach. Therefore, tax legislation of Mozambique, similar to that of many other countries, does not allow tax exemptions for donor-funded projects. Instead, indirect taxes and import duties are paid from general budgetary resources. As a result, donors' requirements are met.

From a theoretical point of view, this mechanism should not have negative effects on the availability of budgetary funds for other purposes because the additional taxes paid by the State would translate into additional revenue which the State collects. Other expenditures would not be squeezed out. Both solutions, the exemption path or the option where the State pays the taxes to itself and thereby increases revenues by an equal amount, are virtually equivalent with regard to the amount of revenue that is available for other purposes.

3. Underbudgeting for fiscal charges

In practice, however, budget allocations for payment of indirect taxes relating to donor-funded projects tend to be extremely inadequate in Mozambique. This is due to two factors.

First, many of the players (on both sides, donors as well as government) have an incomplete understanding of how the value-added tax works. A common yet false argument is that a contractor surrenders only part of the tax which he receives from his government client because he is allowed to deduct the VAT paid on his suppliers' invoices. The fact that the suppliers themselves, and their suppliers, each surrender VAT on the basis of their respective value-added is often not taken into account. Therefore, the argument that the full amount of tax paid from budget resources would flow back to the revenue authorities is frequently questioned.

¹ Actually, the rule applies to all financial aid and some aid-in-kind as well. But public works are the most visible practical case.

Secondly, the budget process disguises the impact which the failure to settle obligations relating to the payments of the VAT part of suppliers' invoices would have on revenues. Budget preparation starts with an estimate of domestic revenue and an assessment of general budget support to be expected. Expected yields of the various taxes are projected on the basis of historic results, adjusted for expected growth and the presumable impact of any planned policy changes. Of course, growth rates of an industry's output and of its value added depend in part on demand from donor-funded public works. However, the percentage of estimated tax yields that depends on such projects and works is not identified explicitly. Due to the cascaded nature of the value-added tax, it would indeed be difficult to assess the impact, since the industry that surrenders the tax to the revenue authority is often not the one where the change in final demand occurs.

At some point, the revenue estimate is closed, and the budget preparation process proceeds to the allocation of funds to spending units. As a first step, ceilings are issued for recurrent expenditure and, separately, for domestically funded investment expenditure which includes the payment of indirect taxes for donor-funded public works. In practice, the ceilings allocated for investment tend to be a residual after recurrent requirements have been taken into account. Quite frequently, the amounts that are "left" for investment expenditures are already insufficient to cover the tax payments required for externally funded investment projects at this stage already.

When the sectors then prepare their respective detailed spending proposals within the allocated ceilings, tax payments related to externally funded projects appear to conflict with other investment expenditures many of which are, in fact, current and even recurrent in nature. As a result, the overall amount allocated to payments of indirect fiscal charges relating to donor-funded projects tends to be insufficient. Long discussions often take place, but typically, no consensus can be reached on either cancelling projects or allocating more funds to tax-related expenditure items. It is claimed that other internal investment expenditure and in particular the recurrent expenditure cannot be reduced. Since the overall expenditure ceilings had been fixed before, there appears to be a trade-off between the payment of taxes that relate to donor-funded projects and other expenditures.

Yet, virtually no attention is paid to the fact that the allocation for tax payments has repercussions on the validity of the revenue estimate. If the revenue estimate implicitly assumed that taxes on donor-funded projects would be paid out of internal budget resources, that revenue will be less if the budget does not pay the taxes. This mechanism, however, is not considered. There is no feedback loop in the process.

In essence, the budget process suggests a trade-off which does not exist. Attempts to allocate expected revenues that depend on the State paying the tax in the first place to other uses is futile since that revenue would no longer be available if it is to be spent on something else.

4. Reactions and work-arounds

In principle, donors should stop disbursing when the provision for tax payments from domestic, general budget resources is insufficient. Furthermore, the Ministry of Finance should even insist in a reduction of donor spending when it thinks, rightly or wrongly, that it is unable to provide internal funds for the payment of project-related fiscal charges. In practice, neither of these reactions occur. No ministry wants lose external funds, and a consensus about which project to eliminate can generally not be reached. Ministries and ministers want the job done and results achieved. Donors want to see the funds which they have made available actually spent. And contractors want to stay in business and are not inclined to walk away just because the tax part of their invoices is not being paid. Thus, there is an unholy alliance to "muddle through".

Under a normal VAT regime, the obligation to surrender value-added tax to the revenue authorities sets in when the company issues an invoice. It does not matter when payment is actually received. This general principle is also enshrined in the Mozambican VAT law and regulations. If the rules were adhered to, contractors and their suppliers would be required to surrender the full amount of the VAT invoiced, irrespective of whether or not they have actually received the payment relating to that part of the invoice. Obviously, a huge drain of companies' financial resources and a severe reduction of profitability would be the result if payments are delayed or do not occur due to systematic underbudgeting for fiscal charges.

But since "the show must go on", various special mechanisms have been put into place which mitigate the effects of systematic underbudgeting for tax payments. The first mechanism is a general budget line for the payment of import-related charges denominated "encargos aduaneiros". This budget line, which is not attributed to specific spending units, can be used for the payment of customs duties and VAT levied at the border if the project is supported by external funds and inscribed in the budget. In order to utilise that budget line, the spending unit requests a payment order from the Ministry of Finance and deposits it with the customs administration *in lieu* of actual payments. Customs account for the payment order as revenue. No actual flow of funds is involved.

This facility is also available to suppliers that are executing work for government agencies. For example, if a contractor builds class rooms for the Ministry of Education on the basis of donor funds, the Ministry of Education can request the payment order against this budget line for import duties and taxes on behalf of the contractor. As a result, the construction company does not have to pay the import-related charges – duties as well as VAT – on, say, steel or cement.

A second work-around is a clause which exempts major pieces of equipment like construction equipment from import duties as well as VAT.² This is particularly important for local companies which need to import heavy earth-moving equipment.

Third, a decree was issued in 2000 which allows contractors for public works to request assessment of tax liability on the basis of payments received rather than invoices issued.³ This facility can be extended to subcontractors, but not to normal suppliers. Although this facility mitigates the effects of late payments, it does not specifically address the fact that the pre-tax part of the invoices tends to get paid normally while the VAT-related part remains outstanding for a long period of time. A creative interpretation of that decree, however, provides more relief. This interpretation allows contractors to defer the entire VAT payment to the revenue authorities as long as they haven't received the payment from government which relates to the tax portion of the invoice. Thus, when the contractor receives payment relating to the pre-VAT part of the invoice from the account which holds the external project funds, no VAT at all is surrendered to the revenue authorities. Only later, when the payment relating to the VAT element of the contractor's invoice is received, the full amount of the VAT, minus the VAT paid on invoices of suppliers' and subcontractors' invoices, is due. The peculiarity of this decree is that it allows contractors to allocate payments to the tax and the non-tax part of the invoice. The normal rule would be that VAT is considered to be included proportionally in all payments.

² Decree no. 55/2004 (see República de Moçambique, 2004) changes the VAT code to the effect that equipment of the class "K" (heavy equipment) that is exempted from import duty on the basis of the Investment Law is also exempted from VAT.

³ See República de Moçambique (2000); this approves the "Regime Especial de exigibilidade do imposto sobre o valor acrescentado nas empreitadas e subempreitadas de obras públicas".

Another work-around should also be mentioned. In Mozambique, a large portion of the fuel tax yield is earmarked for road routine maintenance. But since the allocated funds for payment of fiscal charges in the context of donor-funded road construction and rehabilitation are insufficient, the Road Fund uses part of the receipts from the fuel tax to pay VAT relating to donor-funded construction work. In essence, earmarked tax revenues are transformed into non-earmarked tax revenue, while spending on road routine maintenance remains lower than it should be.

As a result, the show can indeed go on in spite of inadequate budgets for tax payments on donor-funded public works. But the State keeps accumulating debts with construction companies, construction companies with their subcontractors, and the latter two with the revenue authorities.

5. Fiscal and other effects

Obviously, the State is collecting less revenue when it is accumulating arrears with its own tax payments and deferring tax liability. But is the amount that the State could collect equal or near-equal to the amount that it would have to budget and pay? This is actually difficult to assess without some empirical research. At the same time, it is amazing that this question does not appear to be addressed in on-going studies.⁴

The difference between tax which the State pays and the resulting revenue which the State would collect depends on the following factors and mechanisms:

- a) The amount of VAT which contractors and sub-contractors pay to local suppliers who are not subcontractors. There is no exemption or deferment for these transaction, the contractor has to support the VAT until he can off-set it against VAT received.
- b) The incidence of the facility that fiscal charges on imports are paid for against the general allocation for import-related charges, with the effect that the contractor would not have VAT claims to off-set against VAT received.
- c) The amount of work which these contractors and sub-contractors do for non-government clients. If the non-government portion is big enough, they are able to off-set the VAT paid to suppliers against the VAT received from non-government clients. But if the non-government portion is very low or non-existing, they would be sitting on large amounts of claimable VAT paid to suppliers which they cannot off-set because they have no VAT revenue.
- d) The percentage of contractors to which the 2000 decree is applied; it appears that not all of them use that facility.
- e) The number and amounts of donor-funded projects which are delayed or cancelled due of the fact that allocations for tax payments in the budget are insufficient.

Given the fact that VAT relating to big contracts is probably deferred and that the smaller contracts are being executed by companies which also have non-State clients, and that VAT on imports does not become a claimable item because it is paid for by a payment order on behalf of the

⁴ The European Union has recently financed a study on the problem of the non-payment of VAT and other indirect charges in the Roads sector. The study tried to take stock of the arrears in VAT payment from the Roads Fund to contractors, but did not address the decisive question of how much would flow back to the revenue authorities if the State would actually start paying taxes in full.

importer, it could well be that the State would collect more than 90% of additional VAT payments as revenues, with very little or even no delay. The part that would not flow back is composed of the following:

- VAT which contractors or subcontractors surrender in spite of not having being paid, because the rules of the Decree 27/2000 do not apply,
- VAT paid to suppliers who are not subcontractors, to the extent that the contractor and subcontractor have so few other contracts that they cannot off-set the respective amounts against VAT received on these other contracts in their monthly tax declarations.

Although VAT transactions relating to donor-funded public works are effectively suspended, and although most of our contacts in the donor community think that the volume of externally funded investment is not affected, there are real repercussions. The discussion of the VAT issue consumes considerable time and effort of staff at donor offices, ministries and suppliers. Administration of the deferment scheme is cumbersome and prone to abuse. The State, and often enough the donors as well, end up paying considerable contractual penalties because of the delays which occur in the process of in payment of VAT from budget resources; there is the suspicion that these penalties actually represent a windfall profit for the contractors because they do not pay fees, penalties or interest for the deferment of their obligation to pay to the revenue authorities.

It is also likely that contractors are bidding at higher prices because they know from experience that the VAT part of their invoices will be paid at best with long delays. Therefore, they might increase their pre-tax bid prices in such a way that this covers not only the real cost and profit, but also the VAT which they may have to pay to the revenue authorities in spite of not having received the equivalent amount from the government client. The irony is that this would result in the donors effectively paying indirect taxes through inflated prices, even though they are formally refusing to do exactly that.

Thus, a resolution of the issue is urgent, which is also reflected in repeated statements in IMF and joint donor-government reviews of general budget support.

6. Defining a lasting solution

Short of donors changing their policy, there are three alternative solutions to consider:

- a) Proper and adequate budgeting for payment of the VAT and import duty-related fiscal charges,
- b) Zero-rating of invoices, or
- c) Full exemption of the contractors from the VAT regime.

For the **proper budgeting approach** to work, the budget process must become more sophisticated. Knowing that most of the additional tax which the budget would pay as counterpart financing would flow back as revenues at almost the same time, the budget lines relating to such payments have to be given the highest priority in the budget preparation process. In defining budget ceilings, it is necessary to specify the amount which is meant for tax payments and distinguish it clearly from ceilings for other types of expenditure. When sectors present their budget proposals, it has to be verified that they respect that split. No reallocation between the items should be possible. But if a sector needs more funds for tax payment purposes, it should be possible to go beyond the initial ceilings.

In addition, a feedback loop to revenue estimates needs to be established. After the ceilings for tax payments are established, it needs to be checked whether this is compatible with the revenue estimate. Upward or downward adjustments of the revenue estimate must be made if this is necessary in order to achieve full compatibility. However, this calculation cannot be scientific since it is not evident from tax receipts and declarations to what extent the revenue relates to government-paid or other forms of tax. A trial-and-error approach is required which might start with the assumption that maybe some 80% of additional budget allocations for tax purposes would flow back as additional revenue.

Measures need to be taken which prevent spending units from reallocating funds from votes for taxes to other types of expenditure within the fiscal year. In the beginning, the best approach would probably be to create a centralised budget line for taxes related to donor-funded investment projects against which sectors can draw for this purpose. With this simple measure, it is evident that those funds cannot be reallocated to other uses because they are not part of a sector's budget allocation.

In order to prevent insufficient cash allocations to that budget line, spending units can be given the option to apply for a credit certificate in favour of the contractor which he, in turn, can present to the revenue authorities *in lieu* of VAT payment. At the same time, one has to be aware that the main contractor generally deducts VAT paid to his subcontractors and suppliers and will therefore not owe the full amount to the tax office. The amount of actual reimbursements of VAT from the tax authorities to the contractor will increase, and prompt settlement is required.

The **zero-rating approach** is totally equivalent from a fiscal point of view. To implement it, the Budget Directorate or the Budget Execution Directorate of the Ministry of Finance must be authorised to allow specified contracts to receive the same treatment as exports. In practical terms, the contract would need to be approved and certified, and the contractors would need to keep a record of zero-rated invoices which they issue under each contract.

To the extent that the contractors have paid VAT on their suppliers' and subcontractors' invoices, they would have the right to claim the respective amounts back from the revenue authorities unless they have collected VAT through other work for private clients against which they can offset the VAT which they paid to their suppliers. Still, the number of continuous refund cases will increase, particularly in the roads sector where the government is the main or even exclusive client for most contractors.

Although all exemptions and wavers open doors to abuse, we assume that this can be controlled. The number of companies that execute infrastructure works for government is limited, and can probably be inspected more closely. The procedures for approving tax-exempt works contracts must be watertight.

The zero-rating approach comes with two problems, though. First, it does not easily accommodate those cases where the donor refuses to pay import duties. This aspect needs to be handled either by way of a continuation of the existing budget line for import-related fiscal charges or through a budgetary allocation to cater for such charges if the contractor presents proof and a corresponding invoice. Second, the solution is difficult to implement in those cases where financing agreements with donors require a counterpart contribution from government which is defined as a percentage and where this percentage has been calculated to reflect the typical fiscal charge in different types of expenditure.

Third, government and in particular the Ministry of Finance need to be prepared to fend off requests from other spending units to be treated in the same manner, i.e. get a waiver on value-added tax, although the contracts and payments do not relate to projects for which a donor finances the

full economic, non-fiscal cost. Very likely, spending units which do not fully understand the rationale for the tax waiver will point out the economic, social and political importance of what they are doing, refer to the severe funding constraints under which they are operating, and request relief through a waiver on value-added tax. If this request is made through the right channels, the waiver could easily be granted even against the opinion and recommendation of the Ministry of Finance. The danger of this type of abuse is fairly high.

The third option would consist in taking the contractor fully out of the tax regime. It would consist of the contractor neither charging VAT on the invoices nor being able to claim a refund for VAT paid to suppliers and subcontractors. This solution is sometimes brought into discussion because of alleged lower impact on revenues compared to full zero-rating.

However, we reject this solution. First of all, it would require the creation of virtual companies or subsidiaries in those industries where companies tend to work for private sector clients as well as for government. It would make it difficult to distinguish between normal work for government and those special cases of donor-funded projects where the donors insist on not covering fiscal charges. The solution would also favour companies with a high degree of vertical integration against those who subcontract parts of their work and buy supplies locally. Finally, the partial tax exemption which this solution brings is not in line with the spirit of the donor policy under which they do not accept to pay any fiscal charges, irrespective of whether they are direct or indirect.

One may also be tempted to propose a full VAT exemption (in the sense of zero-rating) of all public works contracts for public entities, irrespective of whether or not the project is funded by a donor. However, this approach would be difficult to control in practice and would result in high claims against the revenue authorities for refund of VAT paid to suppliers. Therefore, we do not consider this option further.

7. Managing the transition

As we have seen, tax revenues relating to donor-funded projects is currently low because the State is not paying the full amount of tax that it should. But the shortfall may be less than the amount not paid by the State. Although this is not a sustainable situation, it still implies that all suggested solutions could result in some reduction of the amount of funds that are currently available for other purposes.

Estimating the amount of revenue which government would lose under a zero-rating approach or the (equivalent) amount of additional payments of taxes from budget resources that would not flow back would not be excessively difficult, though. One would essentially need to know the VAT amount due but not budgeted in one year in the main affected sectors (roads, water, education), and then look at a sample of contractors and their sub-contractors and assess how much more they would surrender to the revenue authorities if the public clients would pay according to contractual obligations. Our guess is that some 80-90% of additional payments would in fact become additional revenues as well, maybe even more.

The transition can even be managed gradually. The budget could give priority to tax payments relating to donor-funded public works, and the allocation of liquid resources for that purpose could get high priority. Then, the effect on VAT yields can be monitored. It would be useful to carry out a study about the likely percentage of additional VAT paid by the State which would not flow back as revenue. The study would take a sample of companies and assess the amount of pre-tax that these companies have been unable to off-set against tax liabilities. The potential shortfall

of additional revenue compared to additional tax paid by the State depends critically on that amount.

A practical solution might also include a provision whereby the state issues certificates which contractors can deposit at the revenue offices *in lieu* of payments which relate to that part of the arrears which the contractors would have to surrender directly, and a phased amortisation of the remaining debt in actual payments.

To what extent interest and penalties on arrears have to be paid needs to be negotiated with each contractor. A fair compensation for the delays depends on whether the debt is denominated in local or foreign currency, whether the contractor has to pay penalties for late and possibly also for deferred payment to the revenue office and whether he has actually surrendered the tax which was due but not paid by the government client.

8. The donor perspective

One conclusion from the previous discussion is that some indirect taxes on donor-funded investment projects are being received by the revenue authorities even when government does not live up to its obligation to settle the VAT-related part of contractors' invoices. Who is, in the end, supporting these revenues?

At first sight, it may look as if the contractors suffer a reduction of revenues and therefore see their financing requirements increase and their profits lower than expected. But since the situation has been on-going for several years, it is probably safe to assume that this was already factored into the bid and contract prices. Since the donors pay for the lion's share of the contractors' invoices, it is the donors and financing agencies who, in the end, do not get the value for money which they would otherwise get. In effect, the donors probably bear the cost of those taxes that are being surrendered to the revenue office even though, officially, they refuse to cover fiscal charges. Maybe this should make donors re-think their policy.

There is another reason why donors might want to reconsider their stand. The "no tax payment" rule originates from a period when governments in developing countries were not elected, public finance systems intransparent and dialogue about spending policies and priorities virtually inexistent. Under these circumstances, the donors' refusal to provide non-earmarked funds to governments made some sense.

The origins of the rules also go back to a period where most developing countries' currencies were severely overvalued and shortages of foreign exchange were addressed by administrative rather than market mechanisms. Consequently, the donors' and governments' main focus was on the balance of payment constraint. In this period, it was thought that the donors' main role should be to relieve foreign exchange constraints. Consequently, it was thought that not only indirect taxes but also other local costs such as clearing costs at harbours or domestic transport should be supported by recipient governments' own resources.

These days, however, many of the donors who insist on not paying taxes on project support also provide general budget support. Where market mechanisms are used to allocate foreign exchange, donors and governments look at budget constraints much more than balance-of-payment constraints. Donors nowadays analyse budgets and financial reports of recipient countries and have an on-going and often fruitful dialogue on policy and spending patterns with the governments of the countries which they support. Wouldn't it therefore be appropriate to simply accept the payment of indirect taxes and consider them as indirect budget support?

Abandoning the no-tax clause would have several advantages:

- It would alleviate a considerable burden on the administration because it would make all these special rules and arrangements obsolete and lower the potential for abuse.
- It would lower the pre-tax price level for infrastructure work.
- It would do away with most of the time-consuming and therefore costly discussions about outstanding VAT-related invoices and allow donor and sector staff to move on to more productive uses of their time.
- Government budgeting and public finance management would become more straight-forward. The impact of spending on tax for revenues does not have to be taken into account (which is difficult to do in the first place) and the issue of the impact of reallocations from tax to other purposes on revenues does not need to be considered. Reallocations across votes within a spending unit become less critical than they are at the moment.

On the negative side, two aspects should be mentioned, though. Such shift of donor policy would require a re-negotiation of the balance between project and programme aid between the various departments in the donor agency,. When donors accept to pay taxes, it is possible that less roads, boreholes and schools can be built with the current budget. Expected reductions in bid prices would compensate for part, but not for all of this. Thus, sector departments may start claiming additional funds from the macro departments as a compensation, arguing that the tax which they would now have to pay represents budget support and reduces their impact. However, in a period when several donors are scaling up their aid to Africa and to Mozambique, the re-balancing of the aid portfolio can probably be managed without too many controversies.

The other potentially problematic aspect relates to the reliability of governments' estimates of internal revenues. Donor funds spent on projects would now make a real and probably significant contribution to domestic revenues. Consequently, delays in project implementation would have a negative impact on government revenues. However, this being said, we would question whether this uncertainty is bigger than the current vagaries related to taxes paid from the expenditure side of the budget.

The World Bank has made a step in the suggested direction recently and for new contracts. Common funds for sector support are becoming ever more popular. It is noteworthy that no-one has insisted that construction work financed against the funds' resources should be exempted from tax. Apparently, and rightly so, donors have no problem with that. Peer pressure among donors to follow that example might be reinforced if the Mozambican government made a strong statement to the effect that it urges donors to abandon the no-tax policy and reserves the right to refuse funding with the non-tax principle in financial project aid in the medium run.

Donors who are engaged in policy dialogue with government would be well advised to make a strong point that a lasting solution, be it by way of proper budgeting or by way of zero-rating of relevant contracts, needs to be adopted quickly. The current muddle-through-situation inflates prices for infrastructure work and absorbs too much managerial time. And donors who insist on tax exemption because they want their projects to get the same treatment as others might consider that most-favoured fiscal treatment might imply that their projects become the most cumbersome to execute.

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