

Banco Mundial

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March 13, 2007

H. E. António Fernando
Minister of Industry and Commerce
Ministry of Industry and Commerce
Maputo
Mozambique

Excellency:

Mozambique: Comments on the Strategy for Improving the Investment Climate in Mozambique

I would like to introduce myself. I recently joined the World Bank's office in Maputo and will be involved in the overall management of the program. I look forward to soon meeting you personally. In the meantime, I would like to take this opportunity to share with you our comments on the Government's Strategy for Improving the Investment Climate in Mozambique.

We have reviewed the Strategy with interest and are pleased to note the recent progress in reforms, especially in the area of business registration and start-up. We also note that the document presents a good diagnosis and identification of the main obstacles that need to be addressed if Mozambique is to succeed in creating an enabling environment that is conducive to private-sector led growth.

We are pleased to attach for your review and consideration our detailed comments on the Strategy. As you will note, we concur that the 11 areas of investment climate improvement that are included in the Strategy are relevant and critical to improve the investment climate in Mozambique. We also agree with the identification of the main issues that need to be addressed within those areas. We would suggest, however, that the Strategy can be further strengthened with the elaboration of specific measures and timelines to address the issues identified. Similarly, we would emphasize that the general approach to improve the business environment should be to streamline and reduce existing regulatory burdens, and to simplify and strengthen existing government delivery mechanisms, so as to be more customer-focused.

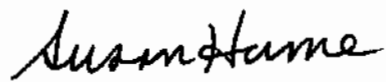
To assist your Government in implementing its Strategy and key reforms, we would like to reiterate our offer to provide technical assistance through the World Bank Group's Foreign Investment Advisory Services (FIAS), which specialize in investment climate issues.

Finally, we look forward to working with you and the IMF in the coming few weeks in finalizing agreed upon benchmarks for improving the investment climate for the next three years (2007-2009), as part of the overall goal of your stated goal of achieving the best investment climate in SADC by 2015.

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I look forward to our continued collaboration in this important agenda. I also look forward to meeting you soon.

Sincerely,

A handwritten signature in black ink that reads "Susan Hume". The signature is written in a cursive, flowing style.

Susan Hume
Country Program Manager for Mozambique
Africa Region

I.E. António Fernando

Felipe



March 13, 2007

- cc: H.E. Manuel Chang, Minister of Finance
- H.E. Aiuba Cuereneia, Minister of Planning and Development
- H.F. Pedro Couto, Deputy Minister of Finance
- H.E. Ernesto Gove, Governor of Central Bank
- Mr. Jean Clement, Africa Region, International Monetary Fund
- Mr. Gregor Binkert, World Bank

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F. B. L. Silva 13.03.07



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Bcc: Messrs/Mmes: M. Baxter, A. Bila, S. Hume, L. Malate, S. Chande (AFCS2); G. Binkert, A. Nucifora (AFTP1); P. Nicholas, M. McCue, P. Ridolfi, N. Walima (AFCMZ), D. Wagle, W. Drum, M. Bouri, (AFTPS); IRIS4.

Attachment: World Bank Comments on Strategy to Improve the Business Environment

The adoption of a strategy to improve the investment climate in Mozambique, with the aim of being the best in SADC by 2015, is an important step in the process of creating an enabling environment that is conducive to a private sector-led growth. If adopted and successfully implemented this strategy can be instrumental to increased private investment and productivity, which would lead to growth and employment creation. We would like to take this opportunity to provide several general and specific comments (elaborated below) for you to consider in order to further sharpen and improve the strategy.

General comments

The 11 areas of investment climate improvement that are included in the strategy are relevant and critical to improve the investment climate in Mozambique. The strategy emphasizes the importance of focusing on delivering the basic foundations of a good investment climate.

While the improvement of the investment climate is a broad agenda, the proposed strategy will help establish a framework for addressing the key constraints. However, it is important to note that no country has a perfect investment climate. Even in industrialized countries achieving a good investment climate is a process, which requires continued and focused implementation. As such, it is important that the strategy establishes some priorities and sequencing for the alleviation of key constraints. Experience shows that even modest initial improvements can unleash a strong response when they target important constraints and are implemented in ways that give firms the confidence to invest (an example is enhancing property rights in China, another example is trade and regulatory reforms in India).

The strategy would gain by adopting a monitoring and evaluation system that would use measurable performance indicators for each of the indicators, within a time bound framework.

Given the cross-cutting nature of the investment climate reforms that are included in the draft strategy, we would emphasize that the institutional arrangements for implementation need to be clarified. Several ministries, directorates and institutions are going to be involved in this investment climate reform. As such, it is important that the strategy establishes how these ministries are going to interact. For example, will the coordination of the reform effort be handled under an inter-ministerial commission? What are the advantages and disadvantages of adopting such an arrangement? Are there alternative arrangements? Which Ministry will lead the coordination and what would be its relative strengths and weaknesses in such a role? These arrangements will be critical in sustaining an ongoing investment climate improvement.

It is worth noting that while the strategy proposed to improve the investment climate is necessary and critical, it is not sufficient in itself to guarantee additional private investment and productivity. To be able to secure an increase in investment and productivity, the proposed strategy would need to be coupled with additional improvements in security, especially related to property rights (title to land and other property); as well as the establishment of the appropriate legal and institutional framework for the delivery of infrastructure services.

One general comment is that we do not see the need for creating additional institutions or structures to improving the investment climate. Rather, our suggestion would be to focus on streamlining and reducing existing regulatory burdens, and to rationalize and strengthen existing government delivery mechanisms, so as to be more customer-focused.

Specific comments

Starting up a business (time and cost)

Under this indicator, Mozambique has in fact made some significant improvements. The exact impact of the computerization of the registration and the electronic publication of the by-laws will be reflected in the next *Doing Business* Report. As for reducing further the cost to start up a firm, the proposed reduction of the minimum capital requirement will help address this aspect. The next challenge that would need to be addressed would then be to extend and complete the computerization of the registration process in all of the provinces.

Licensing

Regarding licensing, we would generally agree with the diagnosis. However, we would have several concerns regarding the recommendations to reduce the time and cost to obtain a license. While a One Stop Shop could be useful in easing the burden of having an investor move from one institution to another one, this approach will not resolve the problem. Instead, this appears to be a problem that really requires the abolition of as many licenses as possible, in addition to a simplification of process. One way of reducing the number of licenses is to adopt a "guillotine" approach which has been successfully pioneered in other countries. This approach entails a systematic review of all licenses and asking relevant ministries/departments to justify the reason for each license and why it should continue to exist. In Kenya, recently, this approach has resulted in plans to eliminate or streamline more than 1,000 of the original 1,300 licenses identified, with the result that the only licenses remaining would be those that are essential for health, safety, and the environment. The World Bank would be pleased to assist the Government in this process, through Technical Assistance and with help from the Foreign Investment Advisory Service (FIAS).

Paying taxes

The Mozambican VAT refund policy "*Código do Imposto sobre o Valor Acrescentado (Código IVA)*" is established and governed by a set of laws, including the Law 3/98, Decrees 51/98, 12/99, 44/99, 82/99 and 30/2001. This tax refund policy was established to provide tax relief and stimulate activities for eligible private sector firms and activities which fall under the value-added tax refund structure.

However, delays in VAT refunds to private firms have become a significant constraint to private sector development in Mozambique. In the sample of 194 firms surveyed for the preparation of the "2003 Mozambique Investment Climate Assessment", 24 firms reported being owed refunds; and, the average amount owed was more than 13 percent of their annual sales.

The issue is not the tax regime itself. Instead, it is the implementation of the tax regime that brings about a significant cost and time to businesses. In particular, the reimbursement of value added tax is far too slow and causes significant cash flow difficulties to firms. We would suggest that the strategy state the results obtained by the Commission established in the context of the Joint Review, which comprises the Ministry of Finance, the Confederation of Business Associates, and private firms. Based on the results achieved, it will be possible to best determine the way forward. As you know, an effective VAT system requires sufficient institutional capacity and resources to properly manage the system and make it fully functional. Given that there are delays in VAT refunds due to a lack of funds, it will be important that the Directorate of Taxes and Audits find a way to improve collection, including through the prosecution of non-compliant institutions and expediently channeling these funds back to those firms that are in compliance with the VAT system. Another potential solution to

reducing the delays in VAT refunds is to offset these refunds against upcoming VAT payments, in particular, where large VAT refunds are involved (though this would be only possible for VAT payments related to sales made within Mozambique).

Labor law

Attached to these comments is a table showing the constraints to labor market flexibility versus desirable outcomes resulting from an improvement in the investment climate. The measures proposed in the draft strategy are basically sound but we would suggest that they be accompanied by specific timelines and steps for implementation.

Access to finance

We would recommend that the strategy for this component be better developed. Based on substantial experience in other countries, development banks (already tried in Mozambique) have been unsuccessful. More importantly, the Government's role is to facilitate the enabling environment for the financial sector to allow for further competition, innovation, and new financial products. The FSAP has provided specific recommendations in this area and provides a good roadmap to implement such an approach.

Time and cost for import and export

The proposed strategy does not contain any specific proposals for what would be done. As such, we have no comments.

Workers' productivity

The proposed strategy does not offer data that would show that productivity is low. Accordingly, we would discourage consideration of a study or any other initiative that would seek to establish an institute for productivity. Rather, we would recommend that a more specific skills development strategy be developed (for which the World Bank could assist the Government).

Closing a business

It would be important to reflect in the proposed strategy that a draft law to simplify the process for closing a business and improving the recovery rate is currently under way and is expected to be completed in April 2007. Similarly, a timetable of actions would need to be developed.

Protecting Investors

It is not clear what the role of the Business Information Center would be, how it is related to the existing CPI offices, and how creating a new enterprise databank would attract foreign investment. We would suggest that the proposed strategy reflect the fact that a new commercial code has already been adopted (end-2005), and that the next step would be for the modernization of the Companies Act, in line with international best practice, to provide greater transparency of information and disclosure.

SUMMARY TABLE ON KEY ASPECTS OF THE LABOR LAW WHICH REQUIRE CHANGE

| Aspects of the Law | Current Status as per draft labor law | Desired outcome |
|--|--|--|
| Overtime hours | Upper limit of 96 hours per trimester. No worker may work overtime in two consecutive trimesters nor work more than 8 hours per week. | No upper limit. There is no rationale for a limit. Moreover, the limit stifles productivity and quality standards. |
| Night work and weekly holidays | Workers can only work 7 of the 9 hours between 8:00 PM and 5:00 AM the next day. Weekly holiday is a period of 24 consecutive hours which must be a Sunday | No limit is necessary. There is no rationale for one. It is a matter to be agreed upon by the employees and employers. Could create operation disruption. No set day is necessary. Moreover, no minimum number of hours of rest is necessary. |
| Tolerância de ponto | The approval of a <i>tolerância de ponto</i> gives the employee the right to <u>suspend work with pay</u> . | A 48 hours notice is necessary to avoid disrupting the business operations. No payment can be made by firms. |
| Paid Annual Leave | 12 days following a year of work 24 days following a second year of work 30 days starting from the third year of work | 10 days following a year of work 20 days for those between two and five years of work 28 days for those with more than five and less than 21 years 30 days for those with more than 21 years |
| Additional paid leave | 5 days for an employee's own wedding 5 days for death of spouse, parents, children, uncles, aunts, step father and step mother. 2 days | 2 days for an employee's own wedding 5 days for death of spouse, parents, children No paid leave for others. |
| Fines | Fine is imposed following the first occurrence of a violation with no attempt to educate the firms. | Emphasize educative approach as opposed to punitive one. No fine should be issued on the first observation of a non compliance. Instead a warning could first be given and then a fine if the issue is not addressed. |
| Hiring of foreign experts without approval from the Ministry of Labor | Hiring possible without an approval based on the following percentages of employees: <ul style="list-style-type: none"> • Small enterprises: 10%¹ • Medium enterprises: 8 % • Large enterprises: 5 % The law is unclear as to whether this percentage includes the management. | If the percentage does not include the management the respective percentages are satisfactory. If they do, then the percentage is too low for the small enterprises. |
| Retrenchment cost | 45 days of salary for each year of work. This represents 170 weeks of salary (for an employee working 20 years) Retrenchment cost for economic reason was not agreed and is unknown Labor union would like 30 days of salary/year of work Employers would like 12 days of salary/year of work | 80 weeks of salary 15 days of salary/year of work |

¹ Small size enterprises are considered to be those with up to 10 employees. Medium size enterprises are those with a number of employees between 11 and 100 while the large enterprises are those that have more than 100 employees.