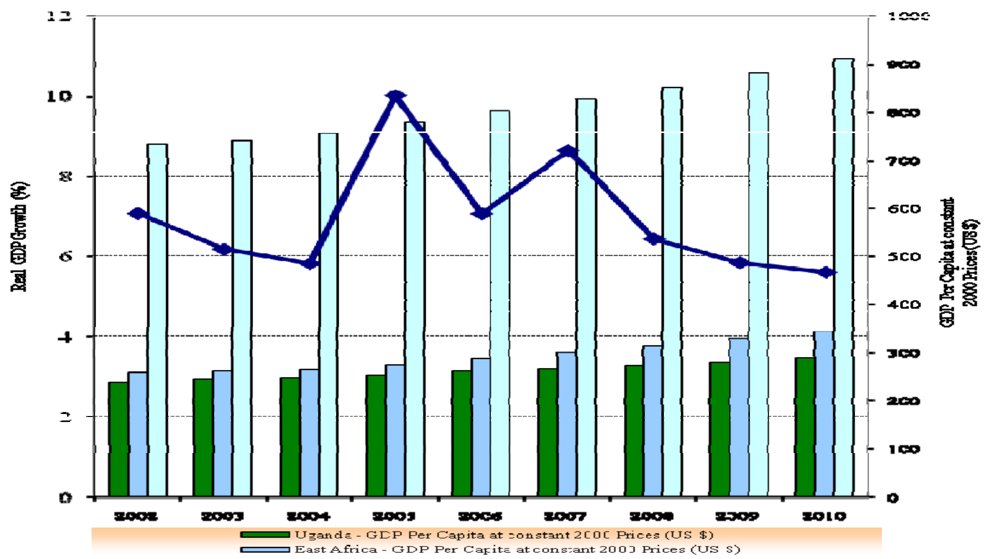
Domestic Resource Mobilization in Uganda
Policy Note

Intoduction

During the period 2000-2008, Uganda's growth rate has been very impressive. Estimates show that average GDP growth rate (at factor prices) for the five years(2003/04-2007/2008) was as high as 7.9 per cent, with the economy posting a growth rate of 8.9 per cent for the year 2007/2008. However, growth decelerated owing to the financial crisis during the period 2008/09 to 7.1 percent. The global recession impacted the economy through (i) reduction in foreign financial inflows including aid, grants, foreign direct investment and remittances; (ii) depreciation of the exchange rate, and; (iv) reduction in commodity prices of major exports of goods that are exported beyond the region.

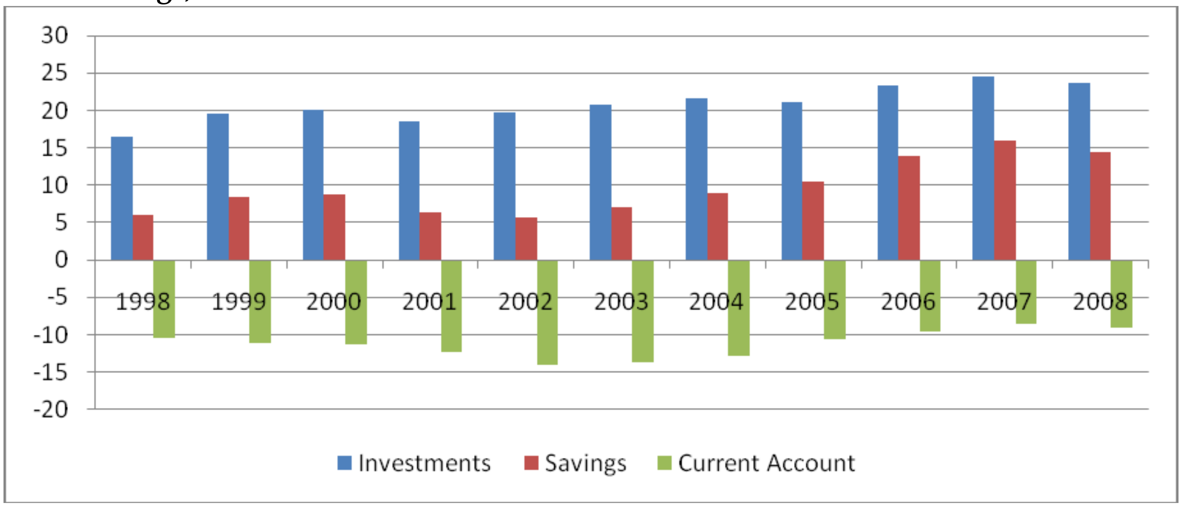
Fig.1: Uganda's Recent Economic Trends



Source: Uganda Bureau of Statistics

Albeit the unprecedented growth, Uganda like many Sub-Saharan African (SSA) countries has the lowest savings rate of any developing region. In 2005, gross domestic savings in the SSA region averaged 18.0 percent of GDP, compared with 26.0% in South Asia, 24.0% in Latin America and the Caribbean, and nearly 42 percent in East Asia and Pacific countries (World Bank, 2007a). Savings in Uganda have remained generally low compared to other regions. While savings have remained low, they have been on an increasing trend growing from 5 to 15 percent of GDP during the period 1998-2008.

Total Savings, Investments and the Current Account



Why Domestic Resource Mobilization in Uganda?

There are compelling reasons to make a case for enhancing domestic resource mobilization in Uganda:

- Domestic resources would help the country to mitigate the adverse impact of volatility and uncertainty in aid flows. Volatility and uncertainty in aid flows make budget management difficult (Bulir and Hamann, 2007).
- Increasing domestic resources creates additional fiscal space for supporting high-priority spending which allows a country to maintain spending consistent with its policy priorities when aid is reduced or phased out.
- For the case of Uganda, dependency on trade taxes will continue to reduce with globalization (and the associated liberalization of trade regimes), formation of free trade areas and customs unions, and agreements with other regional blocks like the European Union. This means that strengthening the domestic revenue base is required to cover the losses from trade taxes.
- Similarly, as countries compete more aggressively to attract foreign investment, Uganda will be forced to reduce corporate income tax rates to remain competitive. This implies that the tax base needs to be broadened to minimize impact on tax revenue.
- Finally, taxation increases incentives for public participation in the political process and creates pressure for more accountability, better governance, and improved efficiency of government spending.

Notwithstanding the strong case for domestic resource mobilization, there are binding constraints for both the financial and public sector being the key players in mobilization of resources:

Binding Constraints to Revenue Mobilization in Uganda

Low income levels, high unemployment and widespread poverty: Uganda like most other developing countries has a challenge to widen its tax base largely because of the low income levels of its citizens and high unemployment level.
Corruption: The level of corruption is still considered as a serious problem within the URA. Revenue corruption manifests itself in the form of smuggling, undervaluation and under-declaration of income and taxable goods and misclassification of goods.
Structure of Uganda's economy: Uganda's low revenue performance has been attributed to the structure of the economy. Uganda has a significantly large agriculture sector, accounting for 21.4% of GDP in 2007/08 and 70 percent of the population is employed in the agriculture sector.
Large informal sector and inadequate tax education: The Uganda National Household Survey (UNHS) 2002/03 showed that Uganda's labor force stood at 9.8 million persons, of whom 2.6 million were in non-agriculture informal sector. The informal sector is hard to tax.
Unregulated Small to Medium Enterprises (SMEs): constitutes 75% of all companies in Uganda. The direct tax these enterprises can appropriately pay is presumptive tax which amounted to only Shs 3.6 billion in 2005/6. Enforcement of this tax has been a challenge due to limited registration of these companies.
***Tax evasion and avoidance remains a serious constraint to Uganda's ability to raise resources*:** While the URA has made significant improvement in administration, this has not particularly been reflected in the improvement in tax collection.
***Tax incentives and holidays*:** In an effort to attract investors, Uganda instituted several tax incentives and holidays. However, although some effort has been done to streamline and in some cases abolish them, these incentives still remain. They are largely arbitrarily given with no clear expiration and coverage.
Regional Integration: Uganda and five other East African Countries are in the process of implementing the East African Customs Union. The key objective for this Union is to widen the market for goods produced within the region. However, this also comes with challenges since all tariffs between the countries in the Union have been abolished.

Constraints to Savings Mobilization and Financial Intermediation

***Concentration of Banks*:** Most banks still remain a preserve of the urban areas. In addition, they are largely dominated by a few banks, few large depositors and loans largely concentrated among the few borrowers.
***Risk sharing of Banks across sectors*:** Banks still mainly focus on lending to specific sectors due to their low risk tolerance. Agriculture which is a major sector in Uganda has had problems attracting bank financing given its risky nature.
***The maturity structure and range of products is a constraint*:** Only 12 percent of total loans, 35 percent of loan volume, 17 percent of total deposits, and less than 0.4 percent of time deposits have a maturity of more than one year.
***Undeveloped Financial Markets*:** The undiversified financial market has limits the availability of hedging instruments and thereby increasing the liquidity premium attached to the available instruments which has resulted into high interest rates.
***High interest rate spreads explained by overhead costs, credit risk, and weak competition remains a major constraint*:** Interest rate spread, which is the difference between the weighted average lending rate and the weighted average deposit rate—is about 20 percentage points at present.

Key Major Measures to Enhance Savings Mobilization

Tapping on the informal sector. The URA should make an effort of targeting businesses and commodities that are under-taxed especially in the informal sector. Increasing domestic tax collection amongst the informal sector would also result into less overreliance on taxing a few commodities especially fuel which is interlinked with a lot of other sectors and could indeed harm growth in the long-run. This would be done in two specific ways: First, a presumptive tax can be fully implemented to capture informal business activities which are not fully captured under current system. Second, VAT should be extended to the retail stage. The bulk of this tax is collected on imports and large whole sellers and manufacturers. To identify the small informal businesses, it would require implementation of the National Identity Card where an individual or business (small or big) can easily be tracked. In addition, URA would need to undertake a special survey to establish the potential revenue that is not currently paid by small enterprises. By undertaking these measures, this would greatly widen the tax base especially in the informal sector.

Streamlining of tax incentives: Tax incentives are politically much more difficult to completely abolish. Given the cost of tax incentives to the ability to collect taxes, the government should make an effort to streamline these incentives in its quest for attracting investors. This should be done by undertaking due diligence on the benefits and costs of the investments vis-à-vis the revenue foregone. While the revenue foregone and benefits (including growth and employment creation) by providing these incentives is not clearly known, it would be very beneficial to the tax collection effort to

Introduction of new tax handles including property Tax: With the abolition of graduated income tax in Uganda, local governments are totally dependent on transfers from the central government. With the emergence of the middle class that owns properties, there is need to explore introducing new tax handles with equity considerations taken into account. One of the tax that could bring considerable revenues to the URA is the property tax which would largely be paid by the middle class to finance key service deliveries.