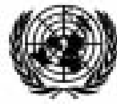

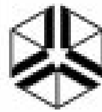

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Fiscal Policy, Growth and Poverty Reduction in Uganda

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Abstract

After more than a decade of economic decline and civil war, Uganda was able to return to economic growth thanks to the policies pursued by Museveni's National Resistance Movement which elicited considerable donor support. They include macroeconomic reforms, public sector restructuring, privatisation and decentralization, all with emphasis on poverty reduction. The government recognises that fiscal policy is the key to success and much effort has, in the past decade, gone towards fiscal reforms and the improvement of institutional capacities. Still, in a country with limited finances and a thin tax base the competition for resources has been stiff. While the government has been able to embark on initiatives such as universal primary education, thanks to an improved revenue base and donor support, the decentralization drive is hindered by serious fiscal constraints at the local level.

Keywords: fiscal policy, growth, poverty reduction, Uganda, Africa

JEL classification: 023, H30, O55

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1 Introduction

Uganda is one of the few countries in Africa to have reversed economic decline and to have begun implementing measures for poverty reduction. For example, the government declared universal primary education in 1997, which saw primary school enrolments rise by 160 per cent to over 6 million. The government has also undertaken far-reaching political decentralization, seeing it as the best means of meeting the development and service demands of the countryside. In achieving these goals, fiscal reforms are a pre-requisite. They are important in the creation of a stable economic environment, with low inflation, a stable currency, increasing investment, and a high level of economic growth. Fiscal reforms have helped the government to streamline its budget, improve revenue collections and prioritise expenditures. However, fiscal reforms have not been easy in a country with a past of political and economic chaos. Thus a major portion of the discussion in this chapter focuses on the trade-offs, which have characterised the government's fiscal and budgetary reform efforts.

This study focuses on three areas that illustrate well the challenge of fiscal policy in Uganda a country newly emerged from economic crisis, and with few resources, that is trying to recreate an environment for poverty-reducing growth and security. The first issue relates to fiscal policies and decentralization, currently underway in Uganda. The devolution of power to districts and counties has been a key goal of Museveni's National Resistance Movement, since its assumption of power in the mid-1980s. It is seen as the basis on which to establish sustainable poverty reduction policies that ensure broad participation. To what extent has the government been able to reconcile demands from powerful groups for central control and the need to empower the rural population? The second relates to the impact of fiscal reforms on the private sector. The government wants to cede economic activities to the private sector, only retaining a regulatory role. How does this reconcile with the government's development stance, which is based on the extension of services to the population? Third, the study looks at the issue of aid dependence. While donors have been crucial in funding both the recurrent and capital budgets of the government in the past decade, it has been argued that Uganda needs to rely more on own resources if it is to sustain development. To what extent is the government able to achieve this? The study is concluded with a summary of the impact of fiscal policies on growth and poverty reduction.

2 Fiscal policies in perspective

Uganda – both before and during the reform period – was, in a number of respects, quite far from a typical African economy. A decade of economic mismanagement and civil war, during the 1970s and part of the 1980s, had destroyed most of its physical infrastructure, while its international trade links were likewise decimated. By the beginning of the 1980s, agriculture had largely reverted to subsistence, with a substantial portion of the coffee crop smuggled to neighbouring countries (Bigsten and Kayizzi-Mugerwa 1992, 1999). Manufacturing had failed to recover from the expulsion of Asian business families by Idi Amin in the early 1970s. Since the Africans that had taken over the Asian businesses had resisted taxation, the tax base was seriously eroded (Jamal 1976). On the other hand, parastatals became wholly dependent on government for their daily operations. Moreover, the military government that ruled in the 1970s

was incapable of pursuing consistent macroeconomic policies. In efforts at creating employment, it maintained a large, low productivity, public sector and army.

Thus when Museveni's National Resistance Movement (NRM) took power in Uganda in the mid-1980s, the tax base was quite thin, while the expenditure demands were large. Since the budget deficit was financed largely via state-owned banks, inflation remained high. When the government embarked on economic reforms in 1987, the challenge was how to increase tax revenue, while also controlling expenditure. This proved quite difficult, explaining the unsteady course of the initial reforms.

In the 1980s, the most important source of tax revenue was coffee. Coffee processing and export were managed by the Coffee Marketing Board (CMB), a major parastatal. However, CMB was poorly run and its privileged position in the enchashment of coffee was abused (Henstridge 1995). It owed farmers vast sums of money, had become heavily indebted to the government, and had huge overhead costs. In the 1980s the coffee sector had two other direct impacts on the fiscal position of the government. First, to maximise supplies of imported consumer goods, the government had embarked on 'barter trade' of its 'excess' coffee that is that which was outside the quota system of the International Coffee Organisation, mostly with countries of Eastern Europe. In anticipation of returns from barter trade, the ministries increased their commitments. But since barter goods were in the form of machinery and generally difficult to liquidate, ministerial deficits piled up. The financing of coffee purchases also led to fiscal distress for the government. With the failure of CMB to meet the credit needs of the co-operative unions and primary societies in their purchases of coffee the government, via the Bank of Uganda, undertook to provide the financing of coffee purchases from the farmers. This open-ended commitment led to much abuse and to a burgeoning budget crisis.

Table 1 shows that government revenues remained fairly low for much of the second half of the 1980s and early 1990s. They improved gradually after the mid-1990s, rising above 11 per cent of GDP, but remaining well below the African average of 20 per cent of GDP. Neighbouring Kenya had, for example, revenues of over 20 per cent of GDP during this period, while Tanzania's were 15 per cent of GDP. When public sector efficiency is low, rapid increases in revenues might give rise to serious problems of absorption, however. This happened in Uganda towards the end of the 1980s as aid increased but without sufficient matching funds and other capacities to absorb it. Some donors then diverted their aid to debt servicing. In the 1990s, however, the government sought to articulate a broad social agenda, one, which to be realised demanded an increase in revenue.

Table 1

Uganda: Revenue, expenditure and grants, 1985–99

(Averages in % of GDP)

	1985–90	1990–95	1995–99	2000	2001
Recurrent revenue	5.8	8	11.4	11.7	11.8
Recurrent expenditure	10.7	18.1	18.3	11.2	11.8
Development expenditure	3.9	8.8	7.7	9	10
Grants	1.2	6	5.5	7	9

Source: Uganda (various issues), Background to the budget.

This in turn necessitated tax reforms as well as the expansion of the tax base. While the latter was achievement partly via the growth of the economy, it was necessary to find new sources of revenue. Table 2 shows that trade taxes comprised the bulk of total revenue, in the form of export duties, customs and sales tax on imports. While the incidence of trade taxation falls heavily on the rural sector, trade taxes meet the requirement of simplicity of tax collection. Imports are fairly bulky and visible and usually enter the country through verifiable entry points. On the other hand in an economy with a huge informal sector, which is by definition invisible since participants are poorly recorded as well as their incomes, increasing income taxes without over taxing the visible part of the economy has been very difficult. Recent years have seen a switch to more neutral taxation (VAT).

Improvements in revenue collection in the 1990s are thanks to the creation of the Uganda Revenue Authority (URA). It is an independent agency established in the early 1990s, with terms of service that are much better than in the rest of the civil service. Although on its establishment there was a remarkable increase in tax collection, the URA has not been insulated from the lethargy and corruption that pervades the civil service. The management of the URA has changed frequently, while employees have been dismissed in large numbers in recent years as a means of 'unclogging' the system. Part of the problem is that the URA has to work in an economy, which has had a poor tax culture for the past two decades. Moreover, the rapid expansion of the economy, following reforms, overwhelmed the capacities of the fledgling URA. Serious declines in revenues in the mid-1990s forced the government to introduce an armed Anti-Smuggling Unit (ASU) to patrol the borders.[1] Subsequent problems with revenue collection forced the government to establish a Revenue Protection Unit, attached to the office of the President. It is significant that normal security organs could not provide the services needed to stop embezzlement, collusion and smuggling, which have afflicted the tax administration.

Table 2

Uganda: Sources of recurrent revenue, 1988–99

(% of total)

	1988–90	1990–95	1995–99	1988–99	2000/01
Income tax	10.5	13.2	14.7	12.7	20
Export duties	13.4	2.6	0.6	3.9	-
Customs	22.4	39.1	33	34	10
Excise duty	9.4	8.9	12.9	10.6	30
Sales tax/VAT*	35	25.3	30	28.9	34
Other revenue	9.3	10.9	8.8	9.9	6

*VAT replaced sales tax in the 1996/97 financial year

Source: Ministry of Finance, Planning and Economic Development (various issues)

1 ASU patrolled the borders and helped minimise smuggling activities. However, its work was halted during the presidential elections of 1996, leading once again to increased smuggling and loss of revenue.

Table 3
Uganda: Major recurrent expenditure items 1988–99
(% of total expenditure)

	1988–90	1990–95	1995–99
General government	16.5	24.2	21.2
Defence and security	36	27.2	33.1
Education	16.5	12.8	9.1
Health	4.5	4.6	4.4
Debt service	14.5	23.4	23.3
Other*	12	7.8	8.9

* ‘Other’ includes economic services, mainly co-ordination costs in the Ministry of Finance
Source: Ministry of Finance, Planning and Economic Development (various issues)

In terms of tax reforms, the goals have been fourfold: broaden tax base, increase efficiency of collection, create incentives for the private sector and ensure equity of taxation. With respect to customs and tariffs, the schedules have been simplified, while import licensing was replaced by a negative list. The government has also replaced sales tax with value added tax (VAT). Although the latter is a more equitable tax, it was initially resisted by the business community notably participants in the informal sector. VAT administration pre-supposes the keeping of proper records, which had not been the case in Uganda for decades. There was fear that record keeping might increase tax liabilities. There were also complaints that VAT of 20 per cent would make Ugandan products non-competitive in regional markets, especially since neighbouring Kenya, which was not landlocked and had better infrastructure had a lower VAT. Uganda’s VAT was subsequently reduced to 17 per cent.

In policy terms, the targets of public expenditure have been declared to be the following: first, increasing the income of the poor via provision of roads to improve access to markets and modernisation of agriculture to enhance rural incomes. Second, improving the quality of life of the poor via adequate provision of health, education, water and sanitation services, and last to ensure that expenditure practices are subject to high levels of transparency and accountability. Related to this is the need to develop the government’s ability to scrutinise the public sector investment programme, with a view to reducing it to manageable size. In reality, paucity of resources and the political economy of resource allocation have tended to make the achievement of these overall ambitions very difficult.

Government expenditure has been characterised over the past decade by the dichotomy between defence and security related expenditure and that on social services, including health and education. The Uganda government argued that security was crucial for development and that it should not be reduced too drastically if the relative peace that Uganda has enjoyed is to be maintained. Although defence and related expenditures had been reduced in the early 1990s, they had shot up again in the second half of the decade, reaching 30 per cent by fiscal 1996/97 (see Table 3). The military insurrections in the north had escalated while the crisis in DRC and Uganda’s active involvement had

pushed up military expenditure.[2] Since Uganda was working within a cash budget framework, increased expenditures on the military meant reduced outlays on areas such as health and education. Moreover, the government ministries sometimes circumvented the cash budget restrictions by issuing promissory notes to suppliers. This became a source of domestic debt accumulation and continued indiscipline. Government expenditure has exceeded revenue since the mid-1980s (see Table 1), with the gap financed mainly by donor aid.

In conclusion, Uganda had pretty much used up its peace premium by the end of the 1990s. While the government had managed to eradicate the discretionary element in the allocation of resources, the tax base was expanding very slowly, with fear that it would not be adequate to meet the government's ambitious social agenda. The World Bank concluded in its overview of the fiscal challenge that 'the government needed to transcend the revenue maximisation phase and embark on long-term strategies for a tax system based on an optimal level of taxation'. Further progress demanded improvements in the economic environment. There was need for serious policy initiatives in privatisation,[3] human capacity development, development of the budget system and the rationalisation of public expenditures. There was also need to address corruption.

3 The fiscal challenge of decentralization and poverty reduction

Decentralization has seen a major revival in most of Africa. It is seen as a means of restoring democracy and of involving the population in the decision-making process and in production. Moreover, Collins and Green (1994) have even argued that it has market surrogate properties and thus augurs well with the recent emphasis on market-based reforms in Uganda. Above all, decentralization would help foster local ownership of development programmes.[4]

However, decentralization would have little meaning if not accompanied by financial decentralization. In this regard, the Ugandan experience provides interesting examples. How was this to be done in a country where finances had been tightly steered from the centre since independence? A block grant system was devised with the government allocating resources (unconditional grants) according to the level of programmes of the line ministries in each district. However, since these projects were overwhelmingly in the better off parts of the country, this system was abandoned for 'a needs based formula' – with a weighting of 10 per cent for the area size, 10 for the population, 40 per cent for the school-age going population and 40 per cent for child mortality (i.e. for children aged 0–59 months). Still, since the weighting did not take into consideration

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[2] The government claimed, at least initially, that its soldiers were not costing it much more than if they were based at home, since they were surviving on very simple rations. The DRC problem has since become more intractable.

[3] In spite of its privatisation drive, the country continued to promote the activities of the National Enterprise Corporation (NEC) an enterprise belonging to the military, but losing money since inception.

[4] The Local Government Commission was established in 1993 and its provisions were enshrined in the Uganda Constitution of 1995 (see also Uganda 1997a).

the potential tax base, a degree of inequality in resource distribution still remained. Moreover, employees need incentives to work in the remoter regions of the country.

Already in fiscal 1996/97, the government could provide budgetary votes to 13 districts. The government also suggested conditional grants: one demand-driven, for example by initiatives that the local government wishes to undertake and the other is the equalisation grant. Conditional grants are meant to be the instruments through which local authorities implement national priority programmes. On the other hand, equalisation grants are subsidies to local governments in areas 'lagging behind the national average for a particular service' (Uganda 2000, Local Finance Commission 1997). However, since the level of access to services is not known nationally allocation of equalisation grants has so far been arbitrary.

However, so far the bulk of the transfers from the centre to the local governments has gone towards salaries, for example in primary schools and the civil service. To collect supplementary resources for development, a graduated personal tax is imposed at the local level. This tax is, however, arbitrary and regressive. It has recently been attacked by Members of Parliament as archaic and undemocratic. Still, it is an important source of revenue for many local governments.

A high level of accountability is a prerequisite for the success of decentralization. For example, transparency and accountability demand the setting up of district service commissions, tender boards as well as local government public accounts committees (Semakula 1996). However, records are generally poorly kept, while in many cases not at all, partly owing to serious lack of capacities at the local level but also to outright corruption. This has hampered planning as well as budgeting procedures. Many ambitious initiatives that would ensure uniformity and comparability and the flow of funds from the Poverty Action Fund, such as the Local Government Budget Framework, have not been adopted fully.

At the centre, the government has not been able to follow-up and monitor the extent to which the various reforms at the local level have been internalised and to devise the means to assist those areas where implementation has been slow and intransigent. The government thus introduced a 'district monitoring and accountability grant' in fiscal 2000/01, to help assess the extent to which the objectives of the PAF are being met as well as the level of accountability at the local governments. Funds will also be made available to line ministries and the Auditor General for independent assessment.[5]

Still, in the more successful districts, decentralization of services and transfer of responsibilities to the local level seem to have had a positive impact on the population. Responses to local needs are quicker, while financial decentralization has helped to introduce prioritisation at the local level. It also seems plausible that the rampant corruption at the centre is reduced somewhat, given the proximity of the local leadership to the population.

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[5] Ablo and Reinikka (1998), using a survey of 250 government aided primary schools and 100 public clinics, for the period 1991–95, found that fewer resources than actually despatched reach the local level. This is partly because a per cent of the money is used up as overhead etc at the various levels.

With respect to poverty reduction, Uganda has registered a sharp fall in the number of its poor in the past decade (Appleton 1998). The extent to which this can be ascribed to specific improvements in fiscal policies is doubtful, however. What we have is an economy, which had returned to growth after decades of poor management and accumulated external shocks. The initial reductions in poverty levels were due to the return of peace, which enabled peasants to return to their farms, while also improving markets for their produce. The more peaceful conditions also encouraged the return of the donor community, while improving economy enabled the government to raise its revenues. These developments had positive impacts on the government's capacity for service provision, also in the countryside. Further reduction in poverty for Uganda as whole, while still based on the preservation of peace, will also depend on the government's fiscal policies, especially how the resources from the centre are shared by the districts. The southern districts of Uganda, besides proximity to the capital and thus access to markets and modern employment, have also enjoyed more peaceful conditions. The remoter districts have less resources and also suffer from political destabilisation, partly caused by poverty and lack of income generating opportunities. How the government devises its resource-sharing strategies might well determine the speed at which these outlying districts are incorporated in the modern economy and their relative poverty reduced.

4 Fiscal reforms and the private sector

In a major policy statement related to the reform of the public service, the government has emphasised the importance of its being perceived as 'a partner and facilitator, not as a bureaucratic hindrance' (Uganda 1999). For much of the 1990s, the government has sought to extract itself from areas where the private sector has a comparative advantage and to increasingly focus on the provision of public goods, in the areas of regulation, promotion and provision of security, legal and other services. A major hindrance to these reforms has been the government's rather limited capacity to generate revenue. Ideally, it should tax the budding manufacturing sector lightly, in order to encourage its expansion and compensate the cost disadvantages related to the country's landlocked status.

However, the private sector in Uganda sees tax policy and administration as among the most serious impediments to doing business in the country. A combination of inadequate administration, poor or calcified legislation, and a general lack of precedent in dealing with tax matters has generated unnecessarily cumbersome procedures, and led to high costs of production. The Uganda Manufacturing Association (UMA) has been vocal in pointing out these shortcomings (Uganda Manufacturers Association, 1995). However, marking a departure from the past, and as an example of the new partnership between the state and the private sector, UMA is actively involved in the debate and is consulted on major economic issues. It drafts a commentary on the government's budget before its presentation. However, UMA's own message to the government is often mixed, bringing protectionist pressure to bear as well as advocating further liberalisation. UMA argues that taxes are too high and need to be lowered progressively in order to encourage the entry of new business. However, UMA also argues that the country's liberalisation of its trade regime has superseded that of its neighbours, leading to dumping. In this regard, infant industry as well as employment

protection arguments have also been put forward. Notably, industrialists have decried the impact on the textile industry of the importation of second-hand clothing.

Although, given its small tax base, the government has had little room for manoeuvre; it has made a number of concessions to the private sector, including the creation of a Commercial Court as well as a Tax Tribunal. Procedures for the administration of VAT, including refunds have also improved. In turn there have been attempts to minimise tax evasion and to improve the country's tax culture, if necessary by using military solutions, notably the heavily armed Revenue Protection Service to intercept smugglers.

5 The issue of aid dependency

Donor aid has been crucial for Uganda's economic recovery. However, the difference between Uganda and its neighbours, who have performed less well is that the leadership was able to meet the bulk of the conditionalities attached to the aid programmes and loans while other countries failed to do so. Thus the combination of Uganda's dire economic need, but also willingness to implement reforms, endeared it to Western donors (see for example Kayizzi-Mugerwa 1997, 1998).

Besides injecting money into programmes and projects, donors also supported recurrent expenditure via balance of payments support. However, the government became heavily dependent on loans and aid for its budget and overall development. In a number of budget speeches, the government expressed a desire to lower this dependency. Other donors even pointed at the low level of aid absorption, which made it necessary in the late 1980s and 1990s for some donors to devise ways of reducing the country's indebtedness instead via the fifth dimension.[6] However, it can be argued that Uganda is not yet at a level where donor aid is unnecessary for its development. The problem is more in the use to which aid is put. It has been argued by Collier (1996) for example that aid should partly be used to lower corporate taxes, and thus contribute directly to the development of the private sector and thus lead to a bigger tax base in the future (Bevan 1994).

It can also be argued that aid flows for poor countries are necessary to cushion them from the shocks inherent in globalisation. They help provide bridging finances and alleviate the political tensions arising from adjustment and retrenchment by increasing the provision of social services.

However, donor-government relations have not been smooth all the time. Authorities in Uganda have, for example, argued that development cannot take place in an insecure environment and that a strong military is indispensable to social development. Given the serious military and political tensions in the Great Lakes region, the government's argument has found sympathy among donors and multilateral aid agencies. Still, the government cannot simultaneously increase social expenditure and maintain a well-financed military. There is bound to be a trade-off. Donors are averse to funding

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6 The fifth dimension was a mechanism devised by Nordic donors, as well as Holland, to alleviate Uganda's debt servicing difficulties by paying money directly into a debt-servicing fund at the Bank of Uganda, and thereby keeping Uganda current in its obligations to the IDA. This then ensured a continued flow of concessional resources from the World Bank's soft window.

regimes that are involved in military adventures or that seem to be expanding their armies.[7] Donors have also threatened to reduce their aid programmes, or indeed to end development cooperation altogether, if corruption was not dealt with decisively, that is from the highest level. It is somewhat ironical, however, that donors see Museveni's personal engagement in economic management as demonstrating a high level of domestic ownership, when it could simply indicate lower levels of ownership and engagement at the lower levels of the administration.

Still, in spite of the problems listed above. Uganda has performed relatively well. It was the first country to qualify for the HIPC programme, and the first to benefit from the enhanced HIPC package. In quick succession, the government has devised a Poverty Action Plan and instituted a Poverty Action Fund to which the funds liberated by the HIPC initiative as well as fresh funds from donors are now channelled (Uganda 1997b, 2000, IMF 1999, World Bank 1996, 2000).

6 Conclusion

With support from the donor community, the Uganda government has sought to improve public sector management and raising the efficiency of public expenditures as the best means of addressing poverty in the country. A major feature of this effort relates not only to the fiscal consolidation of the budget but also to the government's prioritisation of expenditures. In recent years, there has been a focus on healthcare, education, especially at the primary level, agricultural extension services, road maintenance, demand-driven water development (as well as sufficient resources for the public sector investment programme).

However, the implementation of fiscal reforms has been difficult. On the one hand, the government has had to satisfy donor conditionalities while, on the other, it needs to preserve the support of domestic sectors and groups by maintaining some subsidies and expenditures. The military is a good example. Given Uganda's fractious and violent history, a strong army and thus high military expenditures are deemed necessary by the government. The government argues that without security there can be no development. Donors have conceded as much, though there is clearly a trade-off between expenditures on security and those on social sectors.

The budget's financing options have also implied trade-offs of their own. Earlier, trade taxes, notably those on coffee exports, were popular, mostly for their ease of collection. Commodity taxation has a high incidence on the poor, however, with the countryside in effect subsidising the cities. There was then a switch to fuel taxation, which on the face of it seemed more equitable, since cities are transport-intensive. However, fuel enters directly into the cost of transporting exports to the sea as well as the price of the 'wage goods' to producers in the countryside, including the remotest regions. Thus equitable taxation continues to be a subject of intense debate and political rivalry.

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[7] Ironically, though the military assumes a good share of national resources, few attempts have been made to put it under the same scrutiny with respect to efficiency as the civil service, for example. Issues of national security are always used to justify this laxity. Still, how military resources are used will continue to be very important to resource-poor economies like Uganda.

In a country intent on private sector development, such as Uganda, tax policies have assumed a central place in the economic debate not least since the level of taxation ultimately defines the business environment. Pressure groups representing the manufacturing sector have argued that taxes are among the most important obstacles to the expansion of industrial activities. The government has argued, however, that at only 11.5 of GDP total taxation is much lower than in many other African countries. The problem is that the tax base is still quite shallow.

With Uganda recently embarked on an ambitious decentralization and poverty reduction drive, local taxation, local expenditure and administrative efficiency at the local level have become key concerns. Local leaders have argued, however, that the reform process has been too slow and lopsided. They point out that the government seems to have decentralised the problems such as poverty reduction to the districts but kept the human and financial resources at the centre. However, although Uganda's tax base is small, making it difficult to embark on any explicit targeting strategies, the government's focus on the provision of universal primary education has won it much domestic as well as donor support. It incorporates many features of concern to populations and the donor community. There is a focus on the majority of the people, including the poor, while education provision has a positive spillover in many other areas of social and economic development.

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