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POLICY BRIEF

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Improving Tax Revenue Performance in Uganda

Executive summary

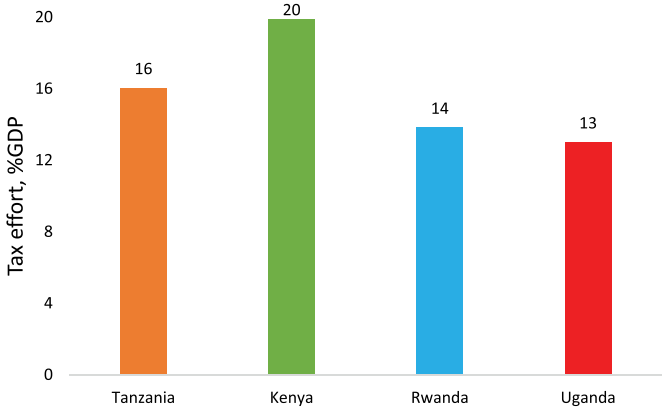
Despite efforts to improve tax revenue performance, tax revenues have not been responsive to overall GDP growth. This has resulted in a tax-to-GDP ratio that has stagnated at about 13% for some time. The stagnant tax effort has constrained government in its quest to expand public expenditure to support improved service delivery. This policy brief, based on a research paper[1] that examined the principal determinants of tax revenue performance in Uganda, discusses how Uganda's tax revenue performance can be improved. Bases on auto regressive distributed lag econometric methods, our analysis shows that dominance of the agricultural and informal sectors pose the largest impediments to tax revenue performance in Uganda. In addition trade openness, industrial sector growth and development expenditures are positively associated with tax revenue performance. We propose policies to support the development of value added linkages between agricultural and industrial sectors while emphasizing the need to unlock the potentially large contributions of the informal sector with a view of widening the tax base.

Introduction

Despite major reforms in tax policy and administration, Uganda's tax revenue performance, as a percentage of GDP, has made only modest improvements over time. The major reforms included the institution of the Uganda Revenue authority – meant to improve tax administration; the introduction of VAT; the new income tax act; and the abolition of graduated tax. These reforms were largely successful and helped to improve the tax revenue performance from 6.8 percent of GDP in 1991/92 to 12.7 percent in 2006/07 (Cawley & Zake 2010)[2]. However, the early momentum in tax revenue performance improvements has not been sustained. Over the last decade tax revenues have not been responsive to overall GDP growth with the result being that tax revenue performance measured as the tax-to-GDP ratio has stagnated at about 12-13%

Indeed Uganda's tax effort, measured as the ratio of tax revenue – to – GDP, is low even when compared to neighbours in the East African region. For example, while tax effort has averaged between 19 - 20 percent in Kenya, 16 percent in Tanzania and 13.8 in Rwanda, it has barely averaged 13 percent in Uganda over the last five years (Figure 1).

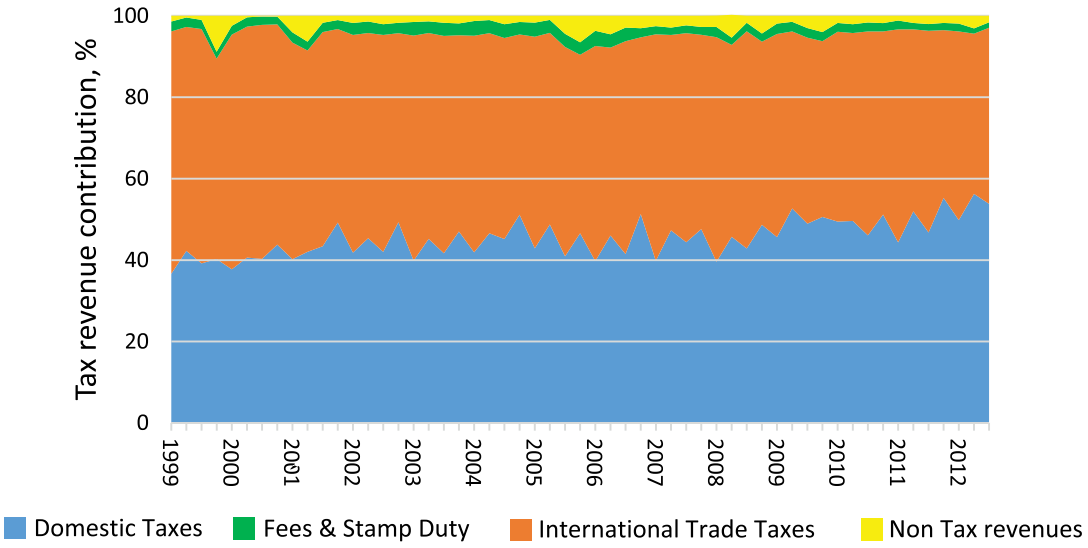
Figure 1: Tax effort in selected EAC countries



Data source: World Bank development indicators

The composition of the domestic tax revenues is characterized by a gradual shift away from international trade taxes towards domestic indirect taxes. For example the share of international trade taxes has declined to 46 percent in 2012 from 59 percent in 1999 while the importance of domestic taxes has increased from 37 percent to 50 percent during the same time period (Figure 2).

Figure 2: Distribution of Uganda's tax revenues

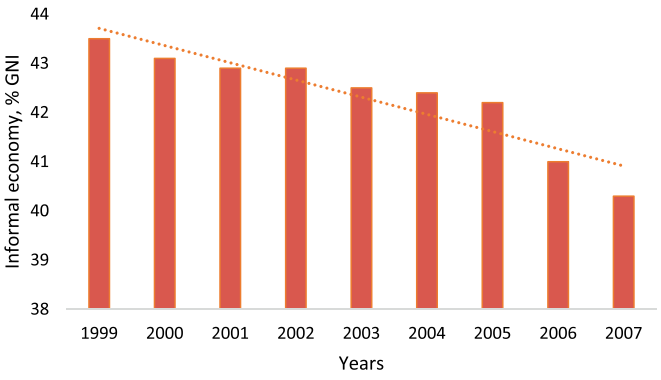


Source: Ministry of Finance, Planning and Economic Development

In some ways, the shift of domestic revenue from international trade reflects the effects of trade liberalization characterized by a systematic decline in tariff rates, particularly for products originating from within Uganda's regional trading blocs. Such reductions in tariff rates have been shown to negatively affect trade tax collections, particularly from imports. The declining contribution of trade taxes indicates that domestic consumptive taxes will have to play an important role in Uganda's tax revenue efforts.

The informal sector in Uganda is large and is one of the major hindrances to improvements in tax revenue performance. Recent estimates by Buehn & Schneider (2012)[3] indicate that the size of the informal sector or "the shadow economy" expressed as a percentage of gross national income stands at 40.3 percent.

Figure 3: The informal sector in Uganda



Data source: Buehn & Schneider (2012)

Although the informal sector in Uganda, expressed as a percentage of gross national income (GNI) is declining it is still higher than Kenya (29.5 percent), Rwanda (40.1 percent) and Burundi (39.6 percent) and only less than Tanzania (53.7 percent) among the East African Community (EAC) states (for details see Buehn & Schneider 2012). A study by Muwonge et al. (2007)[4] estimates that 87 percent of all business establishments in Uganda; 80 percent of Uganda's economic total active labour force and 88 percent of Ugandan women workers are all categorised within the informal sector. This evidence points to the ubiquitous nature of informality in Uganda.

Response of tax revenue performance to Sector growth

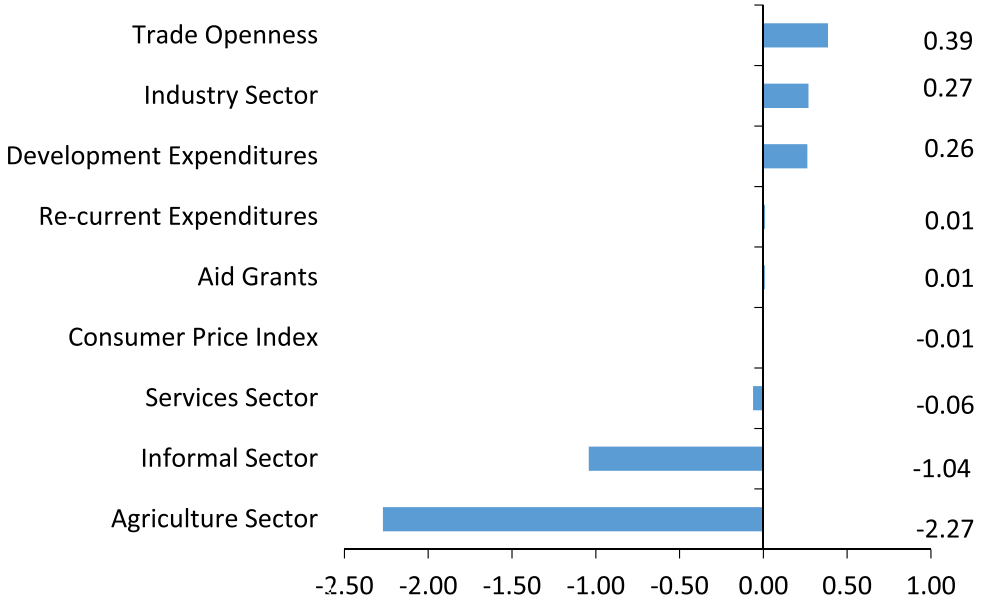
There are observable mismatches in the contributions of economic sectors to overall tax revenue performance (Figure 4). The agricultural and informal sectors pose the largest impediments to tax revenue performance in Uganda. The industrial sector exhibits a positive long run relationship with tax performance. However, the services sector, which has been the major driver of growth in Uganda, has not demonstrated a negative but significant long-run relationship with tax revenue performance.

Why the differences in sector contributions to tax revenues?

There are several possible explanations for the observed mismatches between sector contributions to tax revenue performance.

Agriculture sector: Our results show that dominance of the agricultural sector poses the largest impediment to tax revenue

Figure 4: The long run determinants of tax revenue performance



performance in Uganda: a one percentage increase in agricultural GDP is associated with a 2.270 percent decrease in the tax-to-GDP ratio. One possible explanation for this large negative effect of agriculture on tax revenue performance is that Uganda's agricultural sector is largely small holder and informal and therefore potentially difficult to tax. Up to two-thirds of Uganda's labour force is directly employed in the agricultural sector, but majority of these people engage in low productivity subsistence farming. In addition, the Uganda agricultural sector has been a major beneficiary of targeted tax exemptions (Kasirye 2015)[6]. Improving the contribution of the agricultural sector to tax revenues, therefore, will require support geared towards improving productivity, growth, formalization and commercialisation in the sector.

Industrial sector: With regard to the industrial sector, a one percentage point increase in industrial GDP results in a 0.269 percentage increase in tax-to-GDP ratio. One possible explanation is that industry has both forward and backward linkages: it can support value addition in agriculture through agro-processing and yet ably link to the services sector, for example, through trade in manufactured products, support to banking, telecoms, and other trade-support services. Indeed industrial growth can lead to structural transformation from low productivity jobs in agriculture to higher productivity jobs in industry and manufacturing. This shift to higher productivity jobs widens the tax base as wages improve and taxes become easier to collect. These results suggest that growth in agriculture should be linked to value addition in industry.

Services sector: The services sector does not seem to influence tax-GDP ratio growth and this should be of policy concern because it has been a major driver of growth in Uganda A one percentage point growth in services GDP is associated with a 0.06 percentage reduction in tax effort although this effect is statistically insignificant. We attribute this non-response to tax evasion, the high informality in services sector, revenue losses arising from tax exemptions, and illicit financial flows through networks of double taxation treaties.

Other determinants of tax-revenue performance

Trade openness: Trade openness has the largest positive effect on tax revenue performance. A one point increment in the trade openness as a percentage of GDP results in a 0.39 percentage increase in tax-to-GDP ratio. These results indicate the importance of trade in improving tax effort and could be interpreted as reflecting the ease of collecting international trade taxes (IMF 2011)[5].

The informal sector: The informal sector in Uganda has a large negative effect on tax revenue performance. The coefficient on our proxy for the informal sector – the logarithm of the percentage share of currency outside banks (COB) in broad money (M2) is negative and statistically significant. A one percentage point growth in the percentage share of the informal sector is associated with a 1.042 percent reduction in tax effort in the long-run. A large informal sector makes tax collection difficult and therefore affects tax effort. This result implies possible gains accruing from formalizing the informal sector in order to widen the tax base.

Development expenditures: Development expenditures have significant positive effects on tax effort. A one percentage increase in the share of development expenditures in GDP results in a

0.26 increase in the tax-GDP ratio. This results highlights the productivity effects of development expenditures. However, the positive effect of development expenditures could be strengthened through prudent use of funds. Despite the fact that development projects might take longer periods to mature and ultimately to enlist productivity gains, there are valid concerns that such expenditures are not usually implemented prudently. For example there are serious absorptive capacity constraints that usually delay project implementation. In addition, projects are usually patterned with corruption scandals leading to delays and delivery of sub-standard works which compromise quality. Corruption is likely to affect project selection, execution and quality. In such circumstances, there is scope to improve the productivity of development expenditures.

Conclusions and policy implications

In conclusion our estimates indicate that in the long run tax revenues are positively influenced by trade openness, development expenditures and growth in the industrial sectors, and negatively influences by the agricultural and informal sectors. These results suggest that: 1) Improving the responsiveness of tax revenue to GDP growth requires the pursuit of broad-based growth policies as a first step. 2) Improving the productivity of agriculture, agricultural formalization and linking agricultural production to value added agro-processing in the industrial sector can unlock the structural constraints to tax revenue growth. 3) Policy makers should focus on working with the informal sector to improve tax revenue performance. Unlocking the informal sector requires careful policy design to widen the tax base and ensure that the informal activities are brought into the tax net. In addition strengthening the tax body's institutional autonomy, dealing with political interferences and strengthening institutional capacities for tax administration will improve efficiency in tax collection. 4) The positive effect of development expenditures could be strengthened through prudent use of funds, ensuring value for money and guarding against corruption in project implementation. 5) International trade continues to be an important source of tax revenues and continued efforts in fostering regional integration, trade facilitation and removing trade barriers will strengthen the contribution of trade taxes.

Endnotes

1 Mawejje, J. and Munyambonera, E.F (2016), "Tax Revenue effects of sectoral growth and public expenditure", Economic Policy Research Centre, Research Series No. 125
2 Cawley, G. and Zake, J. (2010), "Tax Reform", in Kuteesa, F., Tumusiime-Mutebile, E., Whitworth, A., and Williamson, T. (2010) "Uganda's Economic Reforms: Insider Accounts". Oxford University Press
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The Economic Policy Research Centre (EPRC) is an autonomous not-for-profit organization established in 1993 with a mission to foster sustainable growth and development in Uganda through advancement of research –based knowledge and policy analysis.

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