Financing a just and inclusive recovery, interview with Ms. Izabela Karpowicz – International Monetary Fund (IMF) Resident Representative for Uganda

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Question: Considering current shocks, what do you think should be the priorities in terms of pursuing a just recovery?

Answer: Speaking of recovery, we have a complex situation. On one side, Uganda is recovering from the Covid-19, a shock that has persisted much longer than we thought it would. In addition, we have a new global shock that has manifested itself through high inflation. We hoped that the latter would resolve quickly, but inflation is more now widespread and persistent and is hurting the poor most who have already been negatively affected by the pandemic-related lockdowns. The situation is further complicated by the higher borrowing cost, which is a reflection, again, of the global response to inflation with many advanced and developing countries' central banks forced to hike the policy rates to combat inflation. This has left the government with a narrower fiscal space for its everyday operations and for the developmental initiatives to support a just recovery.

Within this narrower fiscal and monetary space, priorities for interventions remain the same, though they may be more difficult to achieve. One of the main areas of actions for is strengthening the social safety nets to enable scaling up support to the vulnerable in times like these, so that financial support can be channeled where it is most needed quickly and effectively. Education and health are also utmost priorities. Uganda has a very young population in need of strong fundamentals to prosper. The right time for education starts at early age, if we miss the opportunity to school children and youth, we will not be given this chance later in their lives. The Covid-19 lockdown has made this priority even more urgent because the education gaps have widened. This is one of the priorities where strong focus in the short term is a precondition for stronger growth and job creating in the long term. There is also scope for reforms to enhance the efficiency of public spending, including on infrastructure which is a complement to human capital development.

Question: Where in your opinion could government get the money to invest in some of these priorities given the limited fiscal?

Answer: The first sphere of action is revenue mobilization. Uganda lags its pears in collecting tax revenues. Moreover, the revenue base is low which means that the government must knock at the same door more if it wants to raise more revenues raising also issues of fairness and sustainability, to go back to your question on the just recovery. The Fund has in various occasions pointed to the high cost of tax expenditures in terms of foregone revenues, their negative impact on the tax system's perception of fairness and on the functionality of the tax system. Also, research has shown that tax expenditures do not contribute to attracting foreign direct investment (FDI) in the long term whereas strong institutions, good infrastructure and human capital are the main determinants of FDI. Second, a just adjustment, by lowering government's deficits has the potential of containing borrowing costs. This will free the space for other priority spending and help crowd in the private sector that could contribute more to supporting developmental priorities and create jobs. Finally, persistent recourse to concessional external financing is key for ensuring a steady flow of cheap finance and foreign exchange access. This type of financing comes with conditions that are meant to improve government's processes and has beneficial long-term effects.

Question: Thinking of the IMF's role in Uganda, what are the objectives under the government's program supported by the Extended Credit Facility (ECF) arrangement and how does the IMF help the authorities achieve them?

Answer: The ECF loan is a budget support disbursed in bi-annual tranches over three years against reforms that are pre-agreed with the government in our periodic consultations. The program aims at a revenue-based fiscal consolidation, improved spending composition to finance priority sectors, as discussed, and at strengthening the governance and anticorruption frameworks. The IMF is supporting these priorities not only financially but also through capacity building and research. We have recently provided technical assistance on evaluating the public investment management, estimating the cost of tax expenditures, and strengthening anti-money laundering risk-based supervision at the Bank of Uganda (BoU). Recommendations arising from these interactions are summarized in reports that provide a range of options for addressing the challenges facing the government and form the basis for future reforms.

Question: What are your views about using Special Drawing Rights (SDRs) to finance the budget, especially considering the narrowing fiscal space?

Answer: SDRs are government resources that can be used to finance the budget. It is a cheap resource because the use of it gives rise the payment of interest that is lower than the cost of other external borrowing though subject to fluctuation as it is linked to the interest on short - term instruments in currencies that constitute the SDR basket. The alternative of using this resource for the budget is keeping it in Bank of Uganda's reserves. This is an important consideration as the government faces a trade-off between cheap financing and sufficient reserves to finance imports. The BOU should also continue to build reserves gradually over time to meet the EAC target of 4.5 months import cover as circumstances in the market permit.

Question: What are your thoughts on government's reliance on monetary financing measures to fund the budget?

Answer: Uganda has borrowed from the central bank exceptionally during Covid - 19 and many other countries have done the same. The Uganda government has committed to repaying the advances provided by the BOU over the course of the ECF arrangement. It is important to meet these obligations to ensure BOU's independence The government pays a market interest rate on these advances, so this is not truly a free resource or cheap financing.

Question: In your view, how should the government protect the vulnerable households from rising prices?

Answer: We have advised countries to allow domestic prices to follow international prices. Price signals are crucial to induce demand responses. Higher prices on energy should encourage more efficient use of energy and investments in renewables, while higher food prices more agricultural production. Measures aiming at preventing domestic prices to adjust are costly, crowd out productive spending and reduce producer incentives. Revenues generated through higher prices can be more productively used to target support to those most in need.

However, the ability of countries to effectively protect vulnerable households from energy and food price shocks depends on the strength of their social safety net, in other words programs that allow the government to identify eligible households and efficiently deliver such assistance. Countries with strong social safety nets can use targeted and temporary cash transfers to mitigate the impact for low - income and vulnerable groups. Tax systems can also be used to provide relief to vulnerable households, for example, using refundable tax credits. Notably, the immediate relief should be temporary.

Countries where social safety nets that are not strong can expand existing programs (e.g., school feeding programs) by increasing benefit levels and coverage as needed. Ad hoc measures, such as those introduced in response to Covid - 19, can be considered.

Reducing taxes on energy and food is generally not advisable. However, in countries with weak social safety nets where the expansion of existing programs does not provide sufficient protection and where food security concerns are particularly severe, governments can consider temporary reductions in taxes with clear sunset clauses for staple foods and import tariff cuts on necessities, which are less distortionary.

Question: The IMF has been often accused of imposing austerity in times of crisis. Will Uganda be spared and if not, how will you ensure that the poor are cushioned from its perils?

Answer: Fiscal consolidation is unavoidable. Public debt has increased substantially in the last 5 - 6 years and the borrowing cost is high and crowds out developmental spending and private sector investment. Fiscal consolidation cannot be postponed into the future. How it is done will determine the impact on long term growth and living standards. The IMF is of the view that there is much scope for broadening the tax base to raise more revenues to ensure debt remains sustainable and financing sufficient to meet growing developmental needs. Spending should be strictly prioritized and increased in social areas which will ultimately create better preconditions for growth. As population is affected by shrinking services in other areas, social protection should come into play to protect the most vulnerable as needed.