



# UGANDA

## SELECTED ISSUES

July 2017

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## SELECTED ISSUES

June 26, 2017

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<sup>1</sup> Prepared to provide the background for Uganda's 2017 Article IV Consultation and the Eighth Review under the Policy Support Instrument.

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# UGANDA'S EXPERIENCE UNDER THE 2013 PSI<sup>1</sup>

- Overall, performance under the current Policy Support Instrument (PSI) has been assessed to be satisfactory. Most quantitative assessment criteria were met, and macroeconomic stability maintained.
- However, the pace of structural reforms slowed down compared with the past, and only about half of the structural benchmarks were ultimately met.
- The experience shows the importance of ensuring commitment to the reforms, explaining them better, and getting broad-based buy-in to achieve progress.

## A. Introduction

**1. Uganda's program relation with the Fund dates to the 1980s.** After several Poverty Reduction and Growth Facility arrangements, Uganda was the first country to request the just created PSI in 2006.<sup>2</sup> Since then, Uganda has had four successive PSIs (with the fourth one expiring in July 2017). The PSIs have been instrumental in supporting Uganda's growth agenda. Technical assistance has complemented the objectives of the PSIs, and focused on tax policy and administration, public finance management, monetary policy, financial sector supervision and macroeconomic statistics.

**2. Uganda has been assessed to perform well under successive PSIs.**<sup>3</sup> Growth remained strong during the PSI periods, though since 2010 trend growth has slowed.<sup>4</sup> Inflation was maintained within reasonable bands—except for the 2011 inflationary spike—and reserves within adequate levels, while the fiscal deficit has been generally low. Despite the good performance, there were some weaknesses related to public financial management, including persistent use of supplementary budgets, under-execution of development budgets, *"procurement problems, inability to enforce contracts, and limited implementation capacity"*.<sup>5</sup> The structural agenda also suffered some *"technical and political limitations as well as 'reform fatigue'."*<sup>6</sup>

<sup>1</sup> Prepared by Clara Mira, Adam Mugume (Executive Director, Research, Bank of Uganda), Lawrence Kiiza (Director Economic Affairs, Ministry of Finance during the period of the 2013 PSI), and Axel Schimmelpfennig. Tunc Gursoy provided valuable research assistance. The authors thank Ari Aisen, Roger Nord, and Jonathan Swanepoel for helpful comments.

<sup>2</sup> The PSI is a non-borrowing instrument for low income countries which do not need Fund financial assistance. The PSI helps countries design and implement effective economic programs to maintain or consolidate macroeconomic stability and debt sustainability and deepen structural reforms. In addition, a PSI can be a useful signaling device to donors, investors, and markets. The PSI is designed to promote a close policy dialogue between the IMF and a member country, normally through semiannual assessments of the member's economic and financial policies.

<sup>3</sup> The key exception was a review in 2011 which could not be completed due to a significant fiscal slippage.

<sup>4</sup> Selected Issues Paper, "Growth diagnostics."

<sup>5</sup> 2006 Article IV Consultation and Staff Report, First Review of the PSI, Request for Waiver of Assessment Criteria, and Request for a Three-Year PSI. <https://www.imf.org/external/pubs/ft/scr/2007/cr0729.pdf>

<sup>6</sup> Seventh Review Under the Policy Support Instrument, Request for a New Policy Support Instrument and Cancellation of Current Policy Support Instrument. May 2010. IMF Country Report No. 10/132.

### Box 1: Key Elements of Uganda's Past PSIs

**February 2006 PSI.** The PSI focused on maintaining macroeconomic stability and structural reforms under way. Priorities on the fiscal side included addressing domestic arrears and ensuring adequate fiscal space for critical infrastructure spending. Monetary policies targeted nonfood inflation of 5 percent or less, and aimed at ensuring deepening and developing the financial sector.<sup>1</sup>

**December 2006 PSI.** The PSI focus was to create fiscal space to allow for the scaling up of infrastructure investment; enhance financial intermediation; debt management; lower business costs and improve Uganda's competitiveness; and deal with unfinished items, including arrears. A strategy paper for avoiding domestic arrears was submitted to Cabinet.

**May 2010 PSI.** The priorities continued to focus on infrastructure development. The enhancement of revenue mobilization became more pressing as aid was expected to slow down. This PSI started addressing issues related to the preparation for the exploitation of oil and the establishment of the East African Monetary Union (EAMU) by strengthening of the legal, regulatory, and institutional frameworks. The move to inflation targeting also happened during this PSI (2011).

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Sources: IMF (2006, 2010).

1/ [Press Release](#): "IMF Executive Board Completes Final Review of Uganda's PRGF Arrangement and Approves 16-month Policy Support Instrument, January 24, 2006."

## B. The Current PSI

**3. The current PSI was approved by the IMF's Executive Board in June 2013 with an initial duration of three years.** Following a one-year extension in 2016, it was set to expire in June 2017, before being extended again through end-July 2017. The overarching objective of the 2013 PSI was to support inclusive growth through macroeconomic stability and structural reforms. Specific priorities included (i) enhancing revenue through measures to broaden and deepen the tax base and improve tax administration; (ii) improving the effectiveness of PFM; (iii) preparing the economy for oil production and management of petroleum revenues; (iv) moving from inflation targeting 'lite' to full-fledged inflation targeting; and (v) improving the business environment, supporting the development of the financial sector, and continuing to maintain financial sector stability.<sup>7</sup> In practice, a critical objective was to ensure that the scaling-up of infrastructure investment was properly implemented, while safeguarding the debt sustainability low risk of distress rating.

<sup>7</sup> Memorandum of Economic and Financial Policies, June 2013.

**4. The external environment influenced Uganda significantly, as a small open economy with a freely-floating exchange rate.** In FY2014/15, the Ugandan shilling declined by 27 percent vis-à-vis the US dollar year-on-year (with the depreciation reaching nearly 40 percent in August 2015), as the economy was affected by global liquidity concerns, negative shocks in neighboring countries and trading partners, and election-related nervousness.<sup>8</sup> As a commodity importer, Ugandan imports benefited from the oil price shock, even if in the medium run it represents a risk which could have delayed investment decisions in the domestic oil sector.<sup>9</sup> Uganda was however also negatively affected by the commodity price decline, including for coffee, Uganda's largest export commodity. Security concerns in the region have also impacted sentiment, and more recently, the South Sudan crisis has led to a decline in Ugandan exports and remittances, and an exponential increase in refugee arrivals. Droughts have affected the economy and triggered a spike in food prices in 2013 and more recently in 2016-17. Reduced development partners' aid budgets as the 2013 PSI started also spurred domestic borrowing requirements.<sup>10</sup>

**5. Rebasing led to an upwards revision in GDP in November 2014.** Improved methodologies and coverage showed a FY2009/10 GDP that was 17 percent larger than previously believed. Thus, some indicators experienced significant change, including the debt-to-GDP ratio, (almost 4 percentage points lower, and the tax-to GDP ratio (about 1 percentage point lower).<sup>11</sup>

## C. Performance Under the Current PSI

### Quantitative conditionality

**6. Performance under the quantitative assessment criteria was generally assessed to be sound, with most quantitative assessment criteria met.** However, projections consistently overestimated infrastructure investment and underestimated current expenditure (and thus domestic financing), which contributed to an overestimation of growth.

**7. Growth performance was consistently overestimated.** The Ugandan economy was projected to grow on average by 6.3 percent in the initial three years covered by the 2013 PSI, based on projections in June 2013, June 2014, and June 2015. However, the actual growth was on average 5 percent, while the FY2016/17 growth is projected at about 3.9 percent. Such performance confirms the decline in trend growth recorded since 2010.<sup>12</sup> Over the same period, IMF's global and Sub-Saharan Africa forecasts was also repeatedly revised down,

<sup>8</sup> Annex 1, 5<sup>th</sup> PSI review.

<sup>9</sup> Box 3, 2015 Article IV explains why Uganda benefited less than other countries in the region from the oil price decline, with reasons including the shilling depreciation; the taxation modality; the oligopolistic nature of suppliers; and the lags between purchases and distribution.

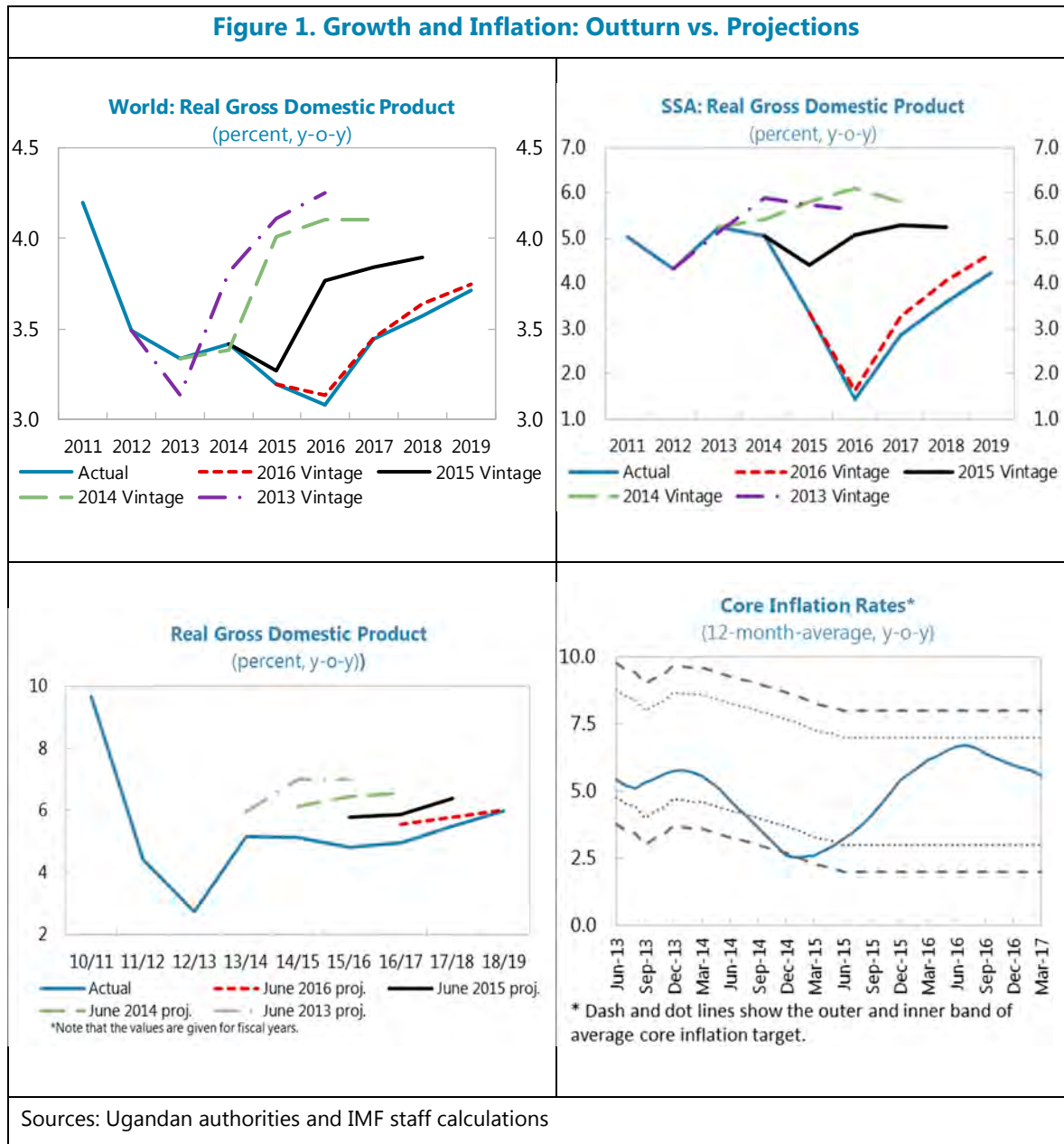
<sup>10</sup> The economy is however able to withstand the impact of shocks relatively well (Annex III. Uganda: Economic Resilience Analysis, 2015 Article IV consultation).

<sup>11</sup> See Box 2 of IMF (2015).

<sup>12</sup> Selected Issues Paper, "Growth diagnostics."



suggesting that some of the growth optimism reflected expectations over an improved external environment.



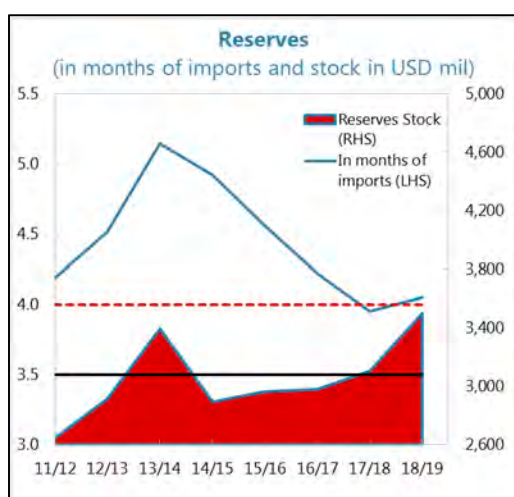
**8. Inflation during the period was kept close to the 5 percent core inflation target.** BoU transitioned to an inflation targeting regime in July 2011, initially referred to as “lite”. The 2013 PSI introduced an inflation consultation clause (ICC), which during the first year of the PSI co-existed with the previous base money target.<sup>13</sup> Performance under the PSI in this area was good, with only one breach of the inner (lower) band of the ICC in December 2014, when the

<sup>13</sup> The consultation clause establishes a 5 percent core inflation target with an inner and an outer band, with the target defined as the 12-month average of the y-o-y percent change of core CPI.

12-month average core inflation recorded 3.1 percent, well below the target of 5.7 percent. This was driven by subdued food crop prices and low import prices. Such a breach triggered consultations with staff in line with the ICC. During the consultations, BoU explained that the prospects for loosening earlier had been constrained by “(i) the start of a shilling depreciation trend; (ii) an expected increase of food prices; and (iii) unclear fiscal prospects.”<sup>14</sup>

**9. Inflation targeting has served Uganda well.** The system has continued to strengthen, with better forecasting, clear arrangements for monetary policy formulation, and revamped policy instruments. Despite the shallowness of the financial markets, the monetary transmission has worked reasonably well, though faster when rates increase.<sup>15</sup>

**10. International reserves have been built up and properly managed.** The



authorities’ needs for foreign exchange during the period have been important as they prepared for the rise in government imports and made large payments in USD related to the repayment of loans for large infrastructure projects. This resulted in BoU having to carefully plan a reserve accumulation policy. BoU generally met PSI reserve targets and kept reserves within the adequacy range. Foreign exchange interventions have been limited to smoothing excessive volatility. Furthermore, the modalities of foreign exchange purchases in the market have been generally sound and evolved throughout the duration of the

PSI, initially with pre-announced daily auctions, moving to a pilot whereby BoU agreed to buy a fixed amount from each of seven banks in 2015, moving to the current, more discretionary system.<sup>16</sup>

**11. The key objective of increasing the tax to GDP ratio by at least ½ percent of GDP per year was not consistently met annually, though it was met on cumulative terms over the PSI period.** Shortfalls in the tax-to-GDP ratio target for FY2013/2014<sup>17</sup> were compensated by significant improvements in FY2014/15, which contributed to an aggregated increase in the tax-to-GDP ratio of around 2.2 percentage points of GDP between FY2012/13 and FY2015/16.

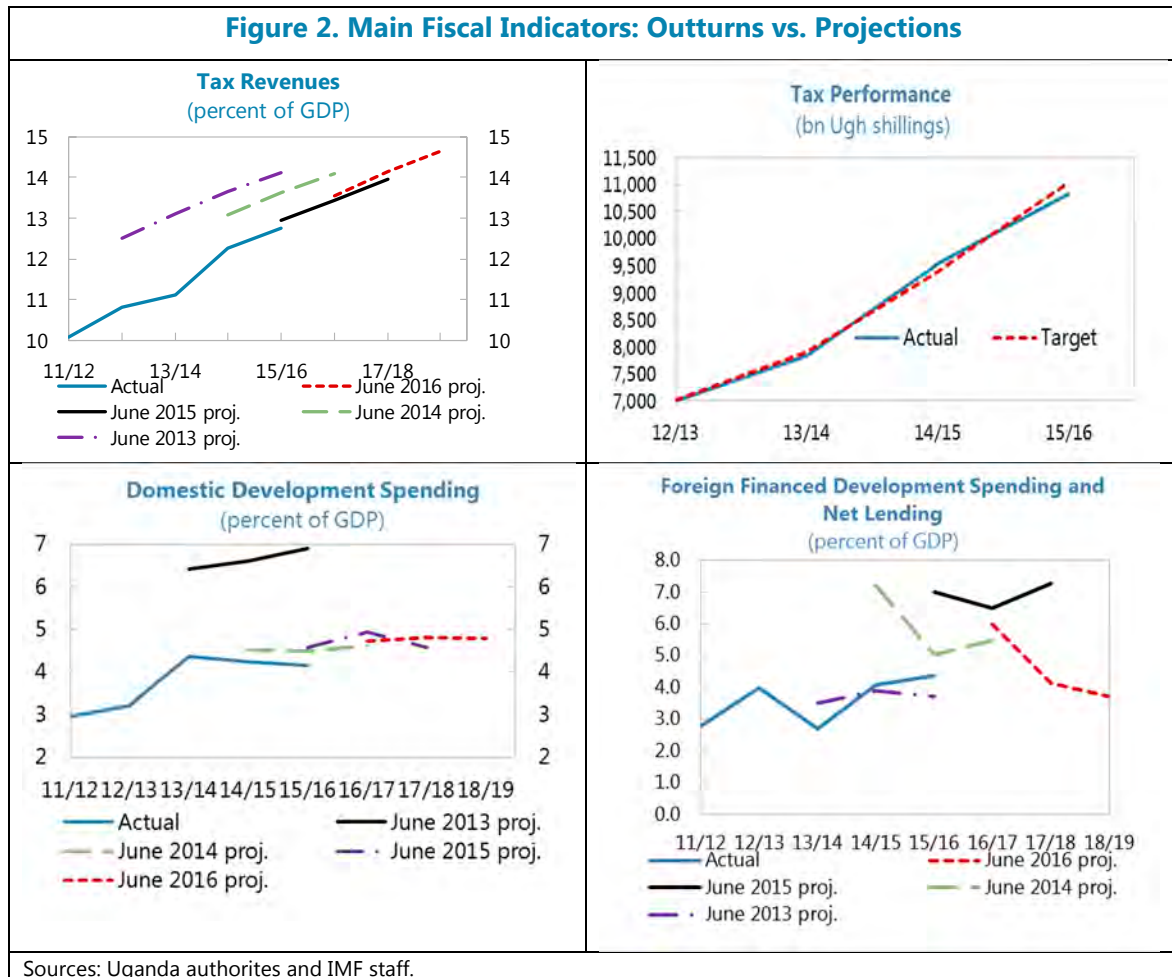
<sup>14</sup> 4<sup>th</sup> PSI review and 2015 Article IV consultation.

<sup>15</sup> Appendix VI, 2015 Article IV consultation.

<sup>16</sup> Only in the context of the 5<sup>th</sup> PSI review, in 2015 the PSI acknowledged a period of disconnect between reserve buildup and foreign exchange interventions, as at the time reserve accumulation was ongoing while the shilling was depreciating and BoU was intervening to smooth excessive volatility in the exchange rate market, thus sending conflicting signals.

<sup>17</sup> As discussed in the 1<sup>st</sup> PSI review, the FY2013/14 approved budget omitted measures for about ¼ percent of GDP, including the dismantling of income tax exemptions for agro-processing and some value-added tax (VAT) exemptions and the strengthening of capital gains tax policies. The second review elaborated that this had been compounded by the impact of lower-than-anticipated growth, policy slippages and compliance issues.

Both tax policy and administrative measures played a role, with initiatives being supported by technical assistance, including in preparing a VAT-gap analysis.

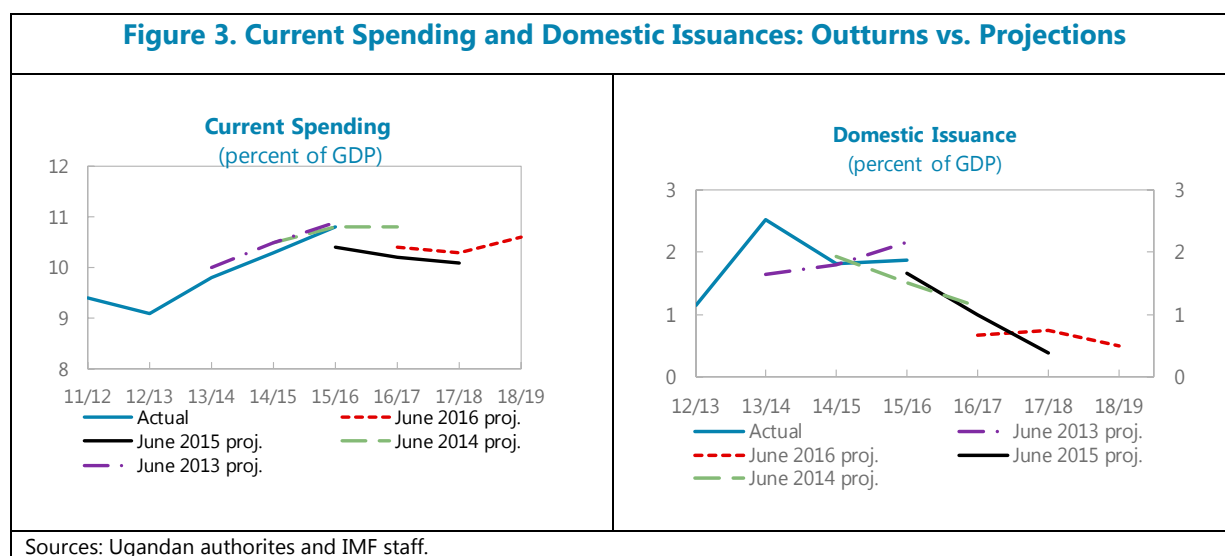


**12. The fiscal strategy was based on the decision to prioritize infrastructure investment to remove key bottlenecks to growth.**

- *Development spending and net lending<sup>18</sup> increased by 2.1 percentage points, from 6.5 percent of GDP in 2012/13, to 8.6 percent in 2015/16. Despite the increase, such amount was significantly lower than originally projected, particularly in the externally-financed part. The forecast error on the foreign financed and net lending projections was, on average for the three years, about 1.1 percent of GDP.*

<sup>18</sup> The large HPP projects, Karuma and Isimba, are being captured under “net lending” in the framework, as the loans are taken by the government but then on lent to the electricity company.

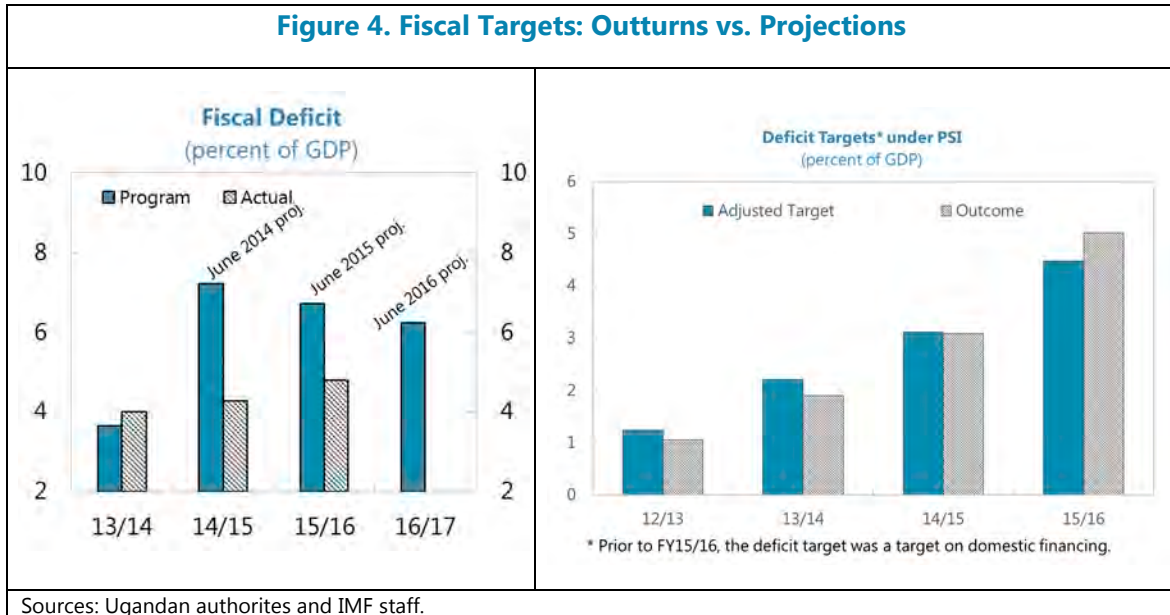
- The main reasons behind the lower-than projected infrastructure expenditure include capacity issues—in the areas of procurement, contract management, compensation—and in some cases poor design of projects. As the low implementation and execution rate became more apparent, the projections under the PSI started to discount accordingly the infrastructure investment budget releases, resulting in more accurate projections. The delays in the absorption of funds and project implementation were among the key reasons behind the World Bank’s decision to temporarily withhold new lending effective August 22, 2016 (which lasted until May 2017, when it was decided to resume new lending). Given the relevance of this area, the PSI included benchmarks in this area since the third review, and technical assistance was provided to improve procedures and strengthen capacity and controls. Recent work has been undertaken to support the design and implementation of the Action Plan to improve Public Investment Management.



- *In parallel, current expenditures increased by 1.9 percentage points of GDP.* In most cases (particularly towards the end of the period) such expenditures were higher than originally projected, and led to higher-than-projected domestic issuances. The average underestimation of domestic issuances was about 0.3 percent of GDP over the three-year period. Higher domestic issuances could generate crowding out effects on the private sector and raise lending rates.<sup>19</sup>
- *The overall deficit was lower than projected, though the target was not always met.* The under-execution of development spending offset occasional revenue shortfalls and current expenditures overruns, leading to a lower-than-projected deficit most of the

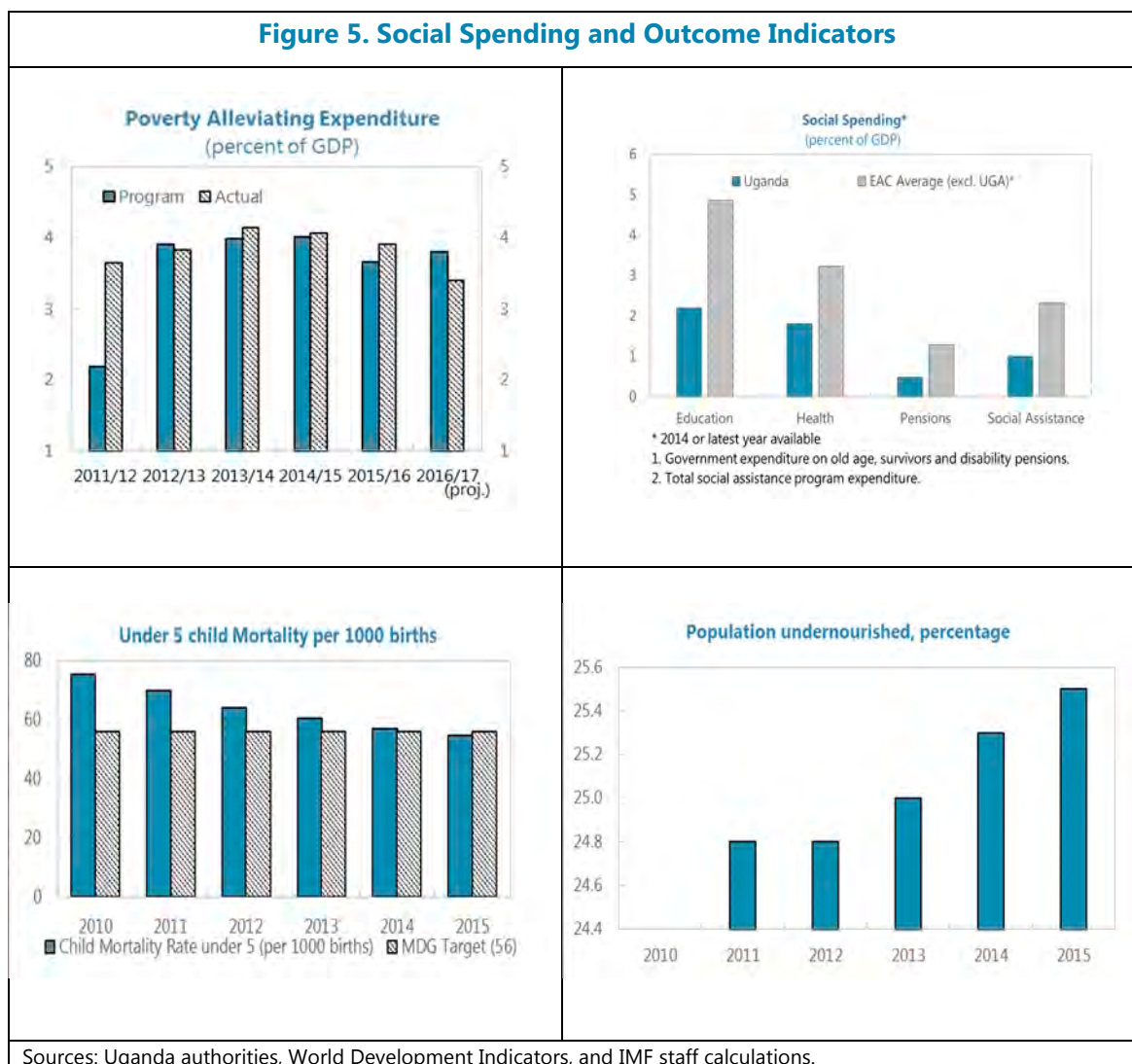
<sup>19</sup> See Box 1. "Uganda: Government Domestic Debt and Private Sector Crowding Out". 2<sup>nd</sup> review of the PSI, <http://www.imf.org/external/pubs/cat/longres.aspx?sk=41737.0>

PSI period. For purposes of the PSI<sup>20</sup>, the deficit definition was narrower, as it excluded externally-financed development spending and other one-off flows like oil-related revenue. With this definition, the deficit target ceiling was respected during the first two years of the PSI, but missed for FY2015/16 in the context of softer-than-anticipated nominal growth and higher-than-anticipated election-related spending.



**13. The PSI addressed government advances from the BoU.** In the context of higher than anticipated domestic financing needs and tight liquidity conditions (particularly in the first part of the year), the authorities used a temporary advance from the BoU to finance operations, which was not repaid within the year. The PFM Act requires that advances from BoU be repaid within the fiscal year. Furthermore, the PSI included a new indicator to monitor the repayments of these advances in the 5<sup>th</sup> PSI review (November 2015), in the context of a higher-than-usual recourse to advances which were complicating monetary policy implementation within the inflation targeting framework. The PSI’s definition of advance is more precise and stringent than that of the PFM Act. To further address this issue, the PSI also introduced a structural benchmark in the 5<sup>th</sup> review on the “*introduction of specific rules and controls on the intra-year use and balances of the Uganda Consolidated Fund (UCF) and UCF/TSA and institutionalize these rules in a framework agreement with the BoU and in the charter of fiscal responsibility*”, which was, however, not met.

<sup>20</sup> The Fund’s debt limits policy changed during the period of the 2013 PSI. As a result, in November 2015 the numerical nonconcessional borrowing (NCB) ceiling was dropped, and program monitoring changed from the monitoring of net domestic financing to monitoring the overall deficit.



**14. The PSI also included a social spending floor.** The floor was defined as the sum of the domestic expenditures inclusive of salaries and wages for the Health, Education, Water and Environment, and Agriculture sectors. The program targets were exceeded. However, the overall social spending level has remained stable, at around 4 percent of GDP, since FY12/13. This level is significantly lower than the EAC average for related social categories (Health, Education, Pensions and Social Assistance). While it is difficult to measure improvements in social indicators in such a short period, some progress was achieved in terms of poverty reduction during the period of the PSI, and some social indicators also improved. However, other social indicators, such as malnourishment, deteriorated.

**15. The PSI also put emphasis on the need to strengthen social protection.** Though not part of the formal conditionality, staff and authorities engaged in frequent discussions about the merits of social protection in a country like Uganda, its affordability and likely positive impact reducing poverty, improving social indicators and enhancing growth and productivity. In the course of the PSI, a Social Protection Policy was approved in November

2015, and Government committed to deepening the existing social assistance programs as well as expanding new ones gradually.

**16. Public debt increased over the period from 26.2 percent of GDP in FY12/13 to 34½ percent in FY15/16.** Projections were biased towards higher debt in the first years of the PSI—in line with the originally expected higher development expenditure and higher deficits, but also as a result of a purely statistical effect from GDP-rebasing prior to the fourth review.<sup>21</sup> On average in the three-year period, public debt was about 4.2 percentage points lower than the average PSI projections. While in principle the lower-than-projected infrastructure investment should have resulted in an even lower debt-to-GDP ratio, considering the rebasing, some factors played in the opposite direction. This include lower-than-projected growth a more depreciated exchange rate, and higher-than-projected domestic borrowing.<sup>22</sup> Furthermore, delays in the execution rates of projects resulted in a divergence between the contracted and effective loans (“debt” was considered contracted or guaranteed following the approval by a resolution of Parliament under the PSI’s definition during most of the PSI period) and the executed capital expenditure recorded in the fiscal accounts.<sup>23</sup>

**17. Uganda has remained at low risk of distress through the duration of the PSI.** Debt is expected to remain sustainable over the medium term, provided the key assumptions behind the macroeconomic framework –mostly in terms of revenue increases, fiscal consolidation as projects are completed, and projects yielding the expected growth dividend. However, vulnerabilities have recently increased.<sup>24</sup>

**18. The PSI included a criterion establishing that all oil-related resources had to be placed under the Oil Fund, which was consistently met.** The Oil Fund was ring-fenced for the financing of infrastructure projects. Furthermore, the PSI followed closely all the use and movements of the oil fund, with the MEFP explaining in detail the stock of the Oil Fund and its currency composition over time. However, when the Oil Fund was closed to open a Petroleum Fund in line with the new PFM Act, the resources from the Oil Fund were not moved to the Petroleum Fund as originally agreed, but were pooled into the Consolidated Fund. Thus, the ringfencing of the Oil Fund resources for infrastructure was lost. Preparations for oil revenue management and taxation also started and benefited from technical assistance to support the design and improvement in the fiscal regime for extractive industries; the Income Tax and the Valued Added Tax were updated with IMF TA.

<sup>21</sup> Before the rebasing, the public debt to GDP ratio in 2012/13 was 30.1 percent.

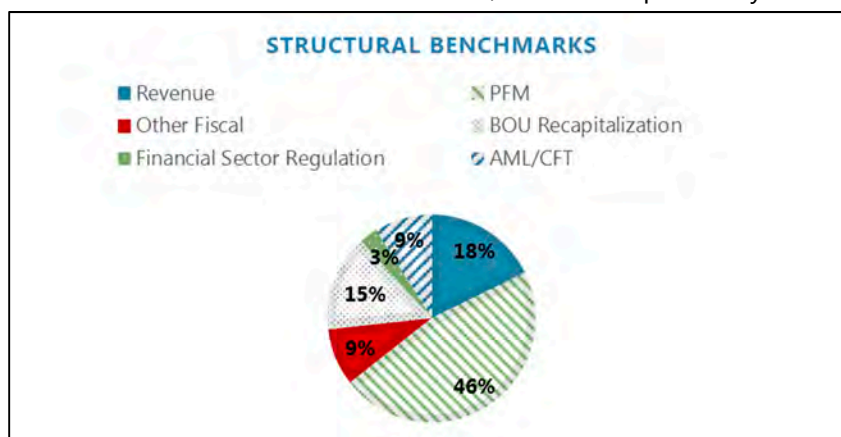
<sup>22</sup> Selected Issues Paper, “A Medium-Term Fiscal Anchor: Managing Debt as Public Investment is Scaled up.”

<sup>23</sup> The World Bank 2016 Country Economic Update shows how execution rates of public investment projects in the areas where investments have grown the most (energy and transport) has deteriorated the most; both the energy and transport infrastructure sectors have not been able to realize over two percentage points of GDP due to issues related to execution, with Energy’s execution rates below 60 percent over the period 2009/10-2014/15.

<sup>24</sup> See the DSA conducted at the time of the 7<sup>th</sup> PSI review.

## Structural reforms

**19. The emphasis of the structural reform PSI under the program fell on the fiscal side.** 74 percent of all structural benchmarks were of fiscal nature, and more specifically related to public financial management (about half of the benchmarks). Since the 2013 PSI started just after the end-2012 scandal of the theft of donor funds in the Office of the Prime Minister, many reform areas were focused on strengthening accountability and closing the loopholes that contributed to the problem.

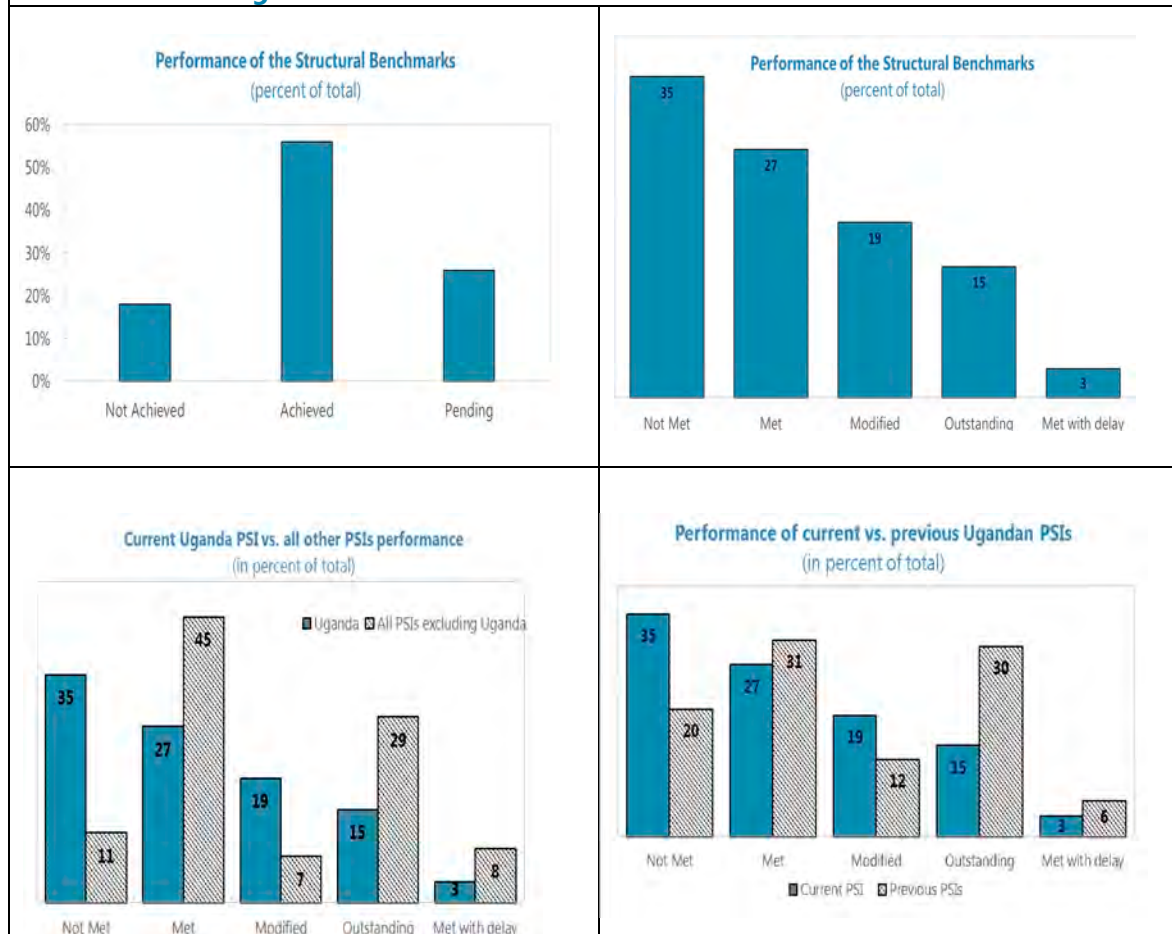


**20. Structural benchmarks were partly met.** The IMF's database for Monitoring of Fund Arrangements (MONA)—which tracks the performance of countries in terms of reviews, quantitative and structural conditionality—shows that less than a third of the structural benchmarks were met, even when including the ones implemented with a delay. Nearly 1/5 of the SB had to be modified. However, performance is better when looking at the ultimate outcome: 56 percent of structural reforms were ultimately achieved.<sup>25</sup> Potential reasons behind the declining performance in the structural side could include insufficient buy-in resulting from insufficient elaboration between the benchmark and its ultimate objective, or insufficient attention and commitment to the implementation of the agreed agenda, together with technical lapses or failures. The number of structural benchmarks remained relatively constant at around 12 structural benchmarks per PSI review on average, and do not seem to have become more complicated or ambitious.

<sup>25</sup> MONA database counts as "Not met" the benchmarks that have not been accomplished by its due date. However, a more flexible definition considers as "Met" those benchmarks whose objectives were finally achieved, even if late.



**Figure 6. Indicators on Structural Reform Performance\***



Sources: IMF staff.

\*All PSIs refer to all PSI programs since the creation of the instrument. Also, one structural benchmark can be counted multiple times if it is included in multiple reviews.

**21. Performance of some of the key structural benchmarks are the following:**

- Publication of the stock or arrears and unpaid bills.** In the initial version of the PSI, the requirement was to submit to cabinet regular quarterly reports on unpaid bills on nine ministries based on data in the Commitment Control System for the previous quarter. Such benchmark was not met. In the second PSI review, it was agreed to expand the requirement to all ministries and require publication in the context of efforts to streamline “institutional arrangements to deal with reporting mechanisms” (second review, para. 23 MEFP). Capacity issues were mentioned as key reasons behind the inability to deliver. To try to simply reporting requirements, the reporting frequency under the benchmark was reduced from quarterly to semi-annually. Furthermore, a technical MoU was prepared clarifying the definitions, which had been blamed as a factor of confusion (second review). A new indicative target was included in the context of the first review of the PSI on the reduction of the stock of arrears; this scaling up of conditionality was useful to place prominence to the problem. In 2016, a reconciliation and verification exercise was undertaken that provided a clear basis to

understand the magnitude and sources of the problem. The reconciliation was followed by TA support, and a strategy is expected to be prepared in line with its recommendations to prevent future accumulation of arrears, and deal with the existing stock.

- **The presentation of the BoU Act amendments to Parliament was delayed.** The amendments are aimed at further strengthening the independence of the BoU and facilitate operations. They include provisions for automatic recapitalization to ensure a level of BoU's capital as a share of its monetary liabilities. Extensive consultations and discussions explain part of the delays.
- **Benchmarks also addressed the need to recapitalize BoU with marketable securities, while the BoU Act amendmenst came into effect.** These benchmarks were met, and addressed the most pressing need, which could have removed the sense of urgency about the need for reform for the BoU Act. However, the temporary recapitalizations were meant to go hand in hand with a streamlining of the operational and administrative costs of the BoU. Progress is still ongoing in this front.
- **Consistent with the assessment that the financial sector was generally sound, the PSI's structural benchmarks in the financial sector field focused on assuring a prompt exit of the FATF grey list.** Though progress took longer than anticipated, the required legislation has been just passed.
- **Although not a structural benchmark in itself, the PSI called for improved fiscal-monetary coordination, with better communication to ensure better policy alignment.** The central bank would benefit from better certainty about the extent and timing of issuances of securities for fiscal purposes; and of limits in the overdrafts in the main government account or use of government deposits. Progress is still ongoing in this area.
- **PFM experienced significant progress.** Key areas include the adoption of the new PFM Act, the enactment of a Charter of Fiscal Responsibility; the upgrading of payment and payroll systems (with the electronic integrated financial management system (IFMS) and the integrated personnel and payroll system (IPPS), which helped identify ghost workers and pensioners); the introduction of a Treasury Single Account (preceeded by the closing of many dormant accounts, which were instrumental in the 2012 financial impropriety event); the removal of some tax exemptions; the publication of a VAT-gap analysis. More recently, benchmarks on enhancing public investment management were introduced, and generally complied with, though sometimes with delays.

## D. Conclusions

**22. Successive PSIs have contributed to growth by maintaining macroeconomic stability and implementing reforms in the fiscal, monetary, and financial sectors.**

Furthermore, focusing on the current PSI, most of the quantitative targets have been achieved, and some structural ones. However, the under-execution in infrastructure development and over-execution of current spending contributed to lower growth than originally projected, expenditure composition shifts, and generally lower deficits. While the public debt-to-GDP ratio declined, the reduction was partly due to GDP-rebasing.

**23. Key achievements under the PSI include** (i) domestic revenue mobilization improved significantly, and progress is ongoing to continue moving in this direction; (ii) PFM experienced significant progress, with the adoption of the PFM Act and the introduction of the TSA, that is allowing for more efficient and transparent cash management; (iii) debt remained at low risk of distress, even if vulnerabilities increased; (iv) the transition to inflation targeting was conducted smoothly, and the capabilities and procedures at the central bank continue to be strengthened and become more sophisticated, with inflation having been kept in check.

**24. However, some areas continue to suffer from delays and require further strengthening.** These including PIM (particularly to address weak implementation capacity); budgeting processes, arrears and fiscal rules; the business environment; deepening and expanding access to the financial sector, which remains shallow<sup>26</sup>; and further improving fiscal-monetary policy coordination.

**25. In terms of processes, the experience shows that it is essential to get sufficient commitment to implement the agreed structural agenda.** Explaining more clearly what is the economic rationale behind each benchmark and their relevance could help. The support with TA when necessary (ensuring regular follow up of the implementation of the TA reports), could also contribute to enhancing implementation, and a more serious analysis and demand for accountability in case of delays. Ensuring buy-in from the key players at the highest level can also make a significant difference; when reforms have been supported by a champion, progress has been faster and more constant. A broader commitment to the PSI beyond MoFPED and BoU could also help ensure smoother implementation, so bringing on board more actively other key stakeholders could be useful, including Parliament, or the Prime Minister.

**26. The fact that debt has increased without fully reflecting the expected increase in capital spending due to partly low execution rates confirms the importance of ensuring further progress in public investment management.** While work is in progress, it is important to consider these limitations to ensure forecast errors are minimized and projections better reflective of realities.

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<sup>26</sup> Selected Issues Paper, "Financial Inclusion and Development."

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## GROWTH DIAGNOSTICS <sup>1</sup>

- Trend growth slowed since around 2010, associated with challenges in productivity growth, physical and human capital accumulation, and business environment.
- Cyclical factors also contributed to the growth slowdown in the last few years, including the conflict in neighboring South Sudan and a recent drought.
- Reinvigorating growth requires balancing infrastructure investment with human capital investment and improving the business environment to better support the private sector and economic diversification.

### A. Introduction

**1. Uganda has achieved strong growth in the previous two decades.** Real GDP growth averaged 8 percent per year in 1995-2010, raising per capita GDP by about 4 percent per year.<sup>2</sup> The peace dividend since the post-conflict stabilization in the mid-1990s stimulated strong agricultural production and investments for reconstruction (e.g., DFID 2015, World Bank 2016b). Substantial aid flows during the post-conflict recovery also supported investments and public service delivery. More low-skill jobs became accessible during the reconstruction, further boosting income of the poor. In addition, a wave of structural reforms in the 1990s, including abolishing marketing boards, liberalizing the financial sector, and privatizing public enterprises significantly improved productivity (World Bank 2016a). However, some of the productivity gains could represent a one-off move toward the production possibility frontier.

**2. The growth record contributed to Uganda's strong progress in poverty reduction.** Extreme poverty was more than halved from about 87 percent in 1990 to 34.6 percent in 2013 under the international poverty line (Figure 1), 6 percentage points lower than the Sub-Saharan Africa average. Uganda met the respective Millennium Development Goal early.<sup>3</sup> Nevertheless, further progress in reducing poverty is needed. The poverty elasticity of growth in Uganda is estimated about 0.8 (Figure 2), which means that each percentage of per capita

<sup>1</sup> Prepared by Martin Brownbridge (Bank of Uganda) and Larry Qiang Cui. Bertrand Gruss provided valuable inputs, and Tunc GURSOY provided excellent research assistance.

<sup>2</sup> Uganda Bureau of Statistics (UBOS) rebased GDP data from FY2009/10 onward in 2014, but not on historical series, and thus the results should be taken with caution. Recent BoU analysis suggest the average real GDP growth rates could be one percentage point lower if measured on the new base.

<sup>3</sup> Based on the World Bank's 2016 Uganda Poverty Assessment Report. The poverty rate refers to poverty headcount ratios measured by the international poverty line of 2011 international PPP\$1.9 per day. Under the national poverty line, the poverty ratio declined from 56.4 percent in 1993 to 19.7 percent in 2013, but the national poverty line was set two decades ago.

GDP growth is associated with a reduction of extreme poverty by 0.8 percentage points. The elasticity estimate is below the SSA average of 1.1. This suggests that raising the growth rate is important, while more can also be done to make growth more inclusive.

**3. Trend growth has slowed since 2010 (Figure 3).** In 1995-2010, average annual trend growth in Uganda was higher than that of SSA average and of EAC peers. Since 2010, however, trend growth has declined from about 7½ percent to 4 percent.<sup>4</sup> While this decline is largely in sync with the Sub-Sahara Africa average, it decoupled from the growth momentum of EAC peers—Kenya, Rwanda, and Tanzania, which have continued strong trend growth of 6½ percent.

<p><b>Figure 1. Progress in Reducing Poverty: Uganda vs. Peers</b></p> <p>Sources: World Development Indicators database and IMF staff calculations.</p>	<p><b>Figure 2. Elasticity of Poverty Reduction of Growth: Uganda vs. SSA*</b></p> <p>Sources: R. Ram (2013), World Bank Povnet database, and IMF staff calculations. * Calculations for Uganda were based on the international extreme poverty line of PPP\$1.99 per day.</p>
<p><b>Figure 3. Trend Growth: Uganda vs. Peers *</b></p> <p>Source: IMF staff estimates. *Based on HP filter applied to calendar year annual growth; EAC-3 refers to simple averages for Kenya, Rwanda, and Tanzania.</p>	<p><b>Figure 4. External Factors' Impact on Growth</b></p> <p>Source: IMF staff estimates based on Chapter 2 in IMF (2017b).</p>

<sup>4</sup> The literature indicates that such HP filter estimates are subject to potential bias of end-year observations. Nevertheless, an alternative multivariate Kalman filter approach finds a similar decline of the estimated trend growth from about 7 percent to 4 percent in the same period.

## B. External Factors

**4. External factors have been largely supportive to growth (Figure 4).** An analysis based on IMF (2017b) showed that external factors<sup>5</sup> have positively supported Uganda's per capita GDP growth in 2000-2014, when the trend slowdown started. Three main external factors are external demand, external financing conditions, and terms of trade changes. The external financial condition has had a positive and rising impact in the last decade. The estimated impact on Uganda's per capita GDP growth was about  $\frac{3}{4}$  percentage point (ppt) in 1995-99, increasing to about  $1\frac{1}{4}$  ppts in 2010-14. Second, the external demand is also estimated to have had a positive impact. The estimate was  $1\frac{1}{2}$  ppts in 1995-99, declined to about 1 ppt in 2000-04, and remained at about  $1\frac{3}{4}$  ppts throughout 2005-14. Third, the terms of trade have had a negative but marginal impact, and the size of the negative impact has become smaller in the last five years than in 2000-04. Thus, external factors cannot explain the trend growth decline in 2010-14. The following analyses further examine what other factors could explain the slowdown of the trend growth, starting from productivity growth and then continuing with factor contributions.

## C. Productivity Trends

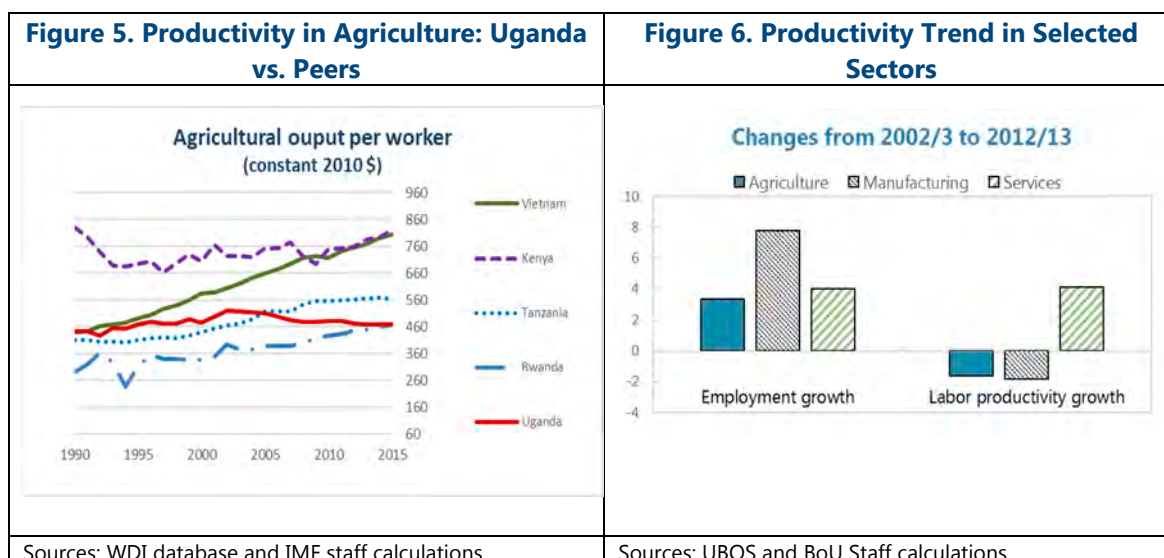
**5. Uganda's agricultural productivity has declined since the early 2000s, while that of fast-growing peer countries continued to rise.** Agriculture employed about 70 percent of the labor force, and thus it has a significant impact on overall productivity and poverty reduction. Uganda's agricultural output per worker recorded a steady rise between 1990s and early 2000s, but then started to decline (Figure 5). In contrast, the average agricultural output per worker in other major EAC countries has largely continued to rise. Uganda's Ministry of Finance, Planning and Economic Development (MoFPED) (2014) find that the dominance of small-holder farms coupled with weak agricultural extension services likely contributed to the decline in agricultural productivity.

**6. More recent survey data also indicate productivity decline in agriculture and manufacturing sectors.** A recent Bank of Uganda (BoU) analysis finds that productivity in agriculture and manufacturing sectors declined by about 2 percentage points between 2002/03 and 2012/13 even though both sectors experienced positive employment growth (Figure 6).<sup>6</sup> In addition, the MoFPED (2014) finds that sub-sectors that experienced employment growth were those with low productivity, such as retail trade and agriculture, while high productivity sectors (e.g., manufacturing, transport and communication) had lower

<sup>5</sup> The estimates on the impact of the external factors are based on cross-country panel regressions and applied to Uganda. External demand conditions are measured by the export-weighted growth rate of domestic absorption of Uganda's trading partners. External financing conditions are proxied by a quantity-based measure of capital flows to peer developing economies in Africa. The terms of trade refer to commodity price changes weighted by their shares in a country's total trade. See chapter 2 of IMF (2017b) for details.

<sup>6</sup> The sectoral productivity growth rates need to be treated with caution because the classification of occupations in the labor force modules of the household surveys may not have been consistent with GDP classifications to support consistent estimates over time.

employment growth. Such a pattern of higher employment growth in lower productivity sectors would further reduce the economy-wide productivity. The shift of more labor to less productive sectors also undermines structural transformation as documented in some African countries (e.g., McMillan and others, 2014). In contrast, during the high growth period of the 1990s, about 90 percent of Uganda's growth could be attributed to productivity growth (e.g., Kasekende and others, 2004), benefiting from the initial market-liberating reforms. Therefore, productivity decline is likely a major domestic contributor to the growth slowdown.



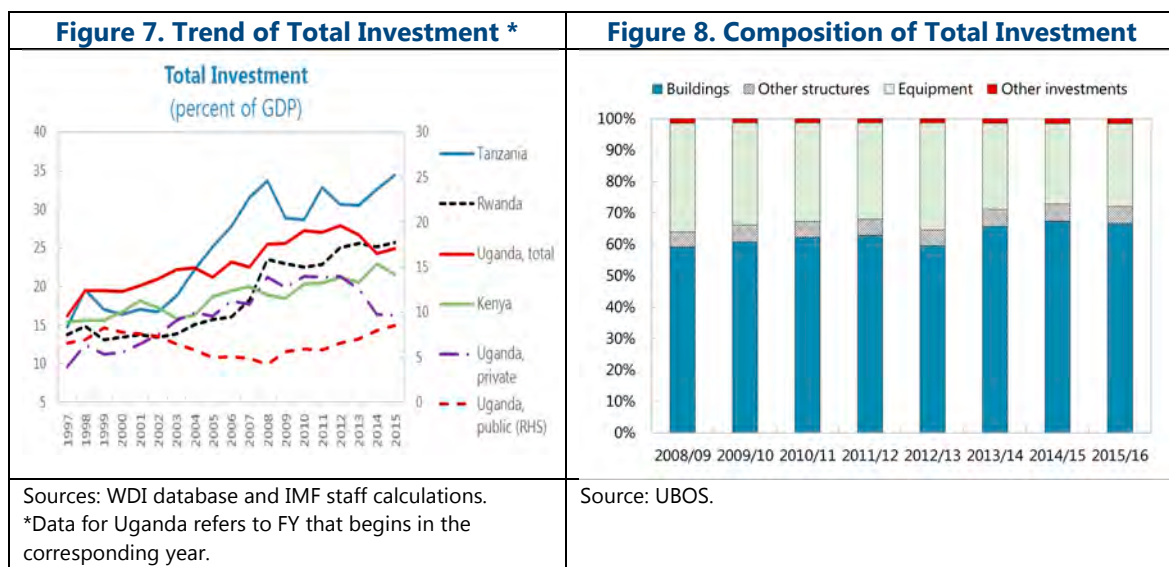
## D. Physical Capital Contribution

**7. Uganda's physical capital accumulation has slowed in recent years despite rising public investment (Figure 7).** Productivity growth typically requires more intensive use of capital. Also, Uganda is a low-income country where capital is relatively scarce, and therefore capital accumulation can also directly contribute to growth. However, the economy-wide capital accumulation in Uganda has shown some signs of weaknesses. Total investment has risen since late 1990s—mostly driven by private investment—until around FY2012. Private investment plateaued by FY2010/11 and then declined since FY2012 despite rising public investment. The poor quality of the public investment likely reduced the expected catalytic effect on private investment, as reflected in weak project selection and execution (World Bank 2016c). The declining overall investment driven by lower private investment likely contributed to the de-coupling of Uganda's growth from the continued strong growth momentum in Kenya, Rwanda, and Tanzania.

**8. The composition of investment showed some shift away from most growth-enhancing areas (Figure 8).** Recent studies (e.g. IMF, 2014, and McMillan and others, 2014) find that developing countries that achieved sustained growth need to move from low-productivity agricultural to modern tradable sectors, particularly in manufacturing. Such sectors require more investment in equipment and other productive assets. Using UBOS data, a recent Bank of Uganda analysis finds that among major types of investment, the share of equipment investment has declined from about 35 percent to about 30 percent between



FY2008/09 and FY2015/16. In contrast, the share of buildings rose by a similar amount, associated with investment in the non-tradable real estate sector, although such investment is less used in productive activities and hence less growth-enhancing.

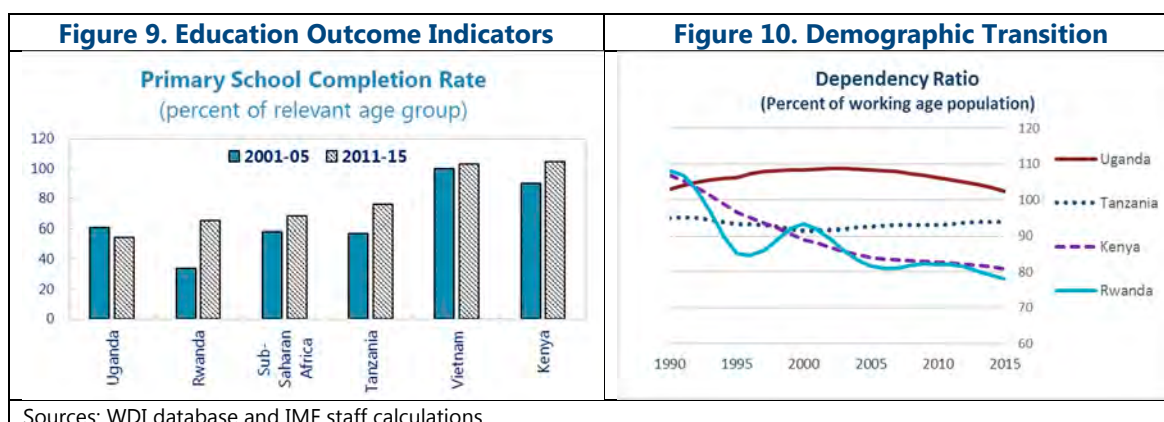


## E. Human Capital Contribution

**9. Recent indicators suggest challenges in human capital accumulation due to poor quality of education.** Uganda has a young and fast-growing population and thus both quality of the human capital and changes in labor force participation and affect its trend growth. One proxy of human capital formation is the average primary completion rate. Uganda's primary complete rate declined from 60 percent in 2001-05 to about 55 percent in 2011-15. This decline is in sharp contrast of the improving rate in EAC peer countries (Figure 9). In addition, MoFPED (2014) reported that the lack of quality vocational education, such as those on practical skills and management practices, resulted in mismatches between labor skills and business needs, particularly in the skill-intensive manufacturing and service sectors. Meanwhile, the needs for skill formation in Uganda is rising rapidly with a young labor force (Figure 13). An estimated 700,000 individuals enter the labor market each year, and they need quality education to gain competency for high wage jobs and become competitive in regional and global markets. The emergence of the oil sector gives more urgency for quality education to equip the young labor force with the required skills in new jobs being created in the sector.

**10. In addition, the demographic changes also affected the contribution of human capital to trend growth.** First, changes in labor force participation likely contributed to the slowdown. Brownbridge and Bwire (2016) find that a one-off increase in labor force participation could explain some of the trend growth slowdown. In late 2000s, about 1.6 to 2 million internally displaced people returned into the labor force from the camps. This change led to an increase of the working age population by about 6 percent. Second, the high dependency ratio also affects growth. About 49 percent of Uganda's population is younger than 15, well above the Sub-Saharan Africa average of 43 percent; the high dependency ratio in

Uganda is also found to have held back consumption growth, particularly for the poorest (World Bank 2016a). Educating and empowering women would help support Uganda's demographic transition toward the level of regional peers (Figure 10), and such a transition in turn would support higher growth based on cross-country experiences (Fox and others, 2017).



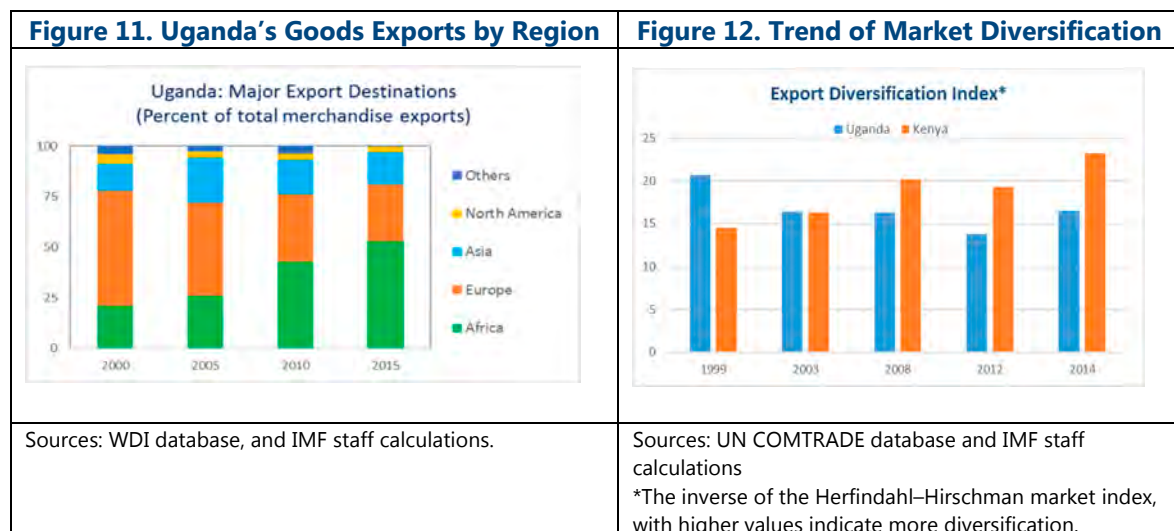
## F. Structural Transformation and Diversification

**11. In addition to the employment and productivity patterns discussed earlier, this section further analyzes structural transformation and diversification.** Drawing on cross-country evidence, IMF (2014) find that such transformation and diversification boosts growth and reduces its volatility. The following analysis benchmarks Uganda's performance with those of the EAC peers that continue to show a strong growth momentum.

**12. Uganda has improved export performance, although primary products still dominate.** World Bank (2015) finds that Uganda's exports have included about 60 new products, while the traditional concentration in coffee and cotton exports has declined. The share of the top five products has declined from about 86 percent in the 1990s to about 55 percent in early 2010s. Several new exports (e.g., flowers, wood, and minerals) and some manufactured products (processed leather and construction materials) have emerged, although top export products continue to be primary goods. Meanwhile, Uganda's exports have become more diversified by some measures. The share of total export to African countries has increased from about 20 percent in 2000 to more than 50 percent in 2015, while the share of exports to Europe has declined from over 50 percent to about 30 percent (Figure 11). Rising exports to EAC are also found to lead to more new products (World Bank, 2015).

**13. Many indicators on export diversification and the composition of GDP still indicate scope for improvements.** Despite progress in new export products and some diversification, overall export performance is below those of well-performing EAC peers. Total export of goods of Uganda has remained at about 10 percent of GDP since the mid-1990s, although service export increased. In addition, country-level market diversification has declined (Figure 12), indicating rising export concentration in a few countries, while, for example, Kenya recorded a steady rise in market diversification in the same period. With limited market diversification, export performance is more vulnerable to changes in a few

countries, as evidenced by the recent adverse impact from South Sudan and DRC. Furthermore, while the industrial sector increased from about 15 percent of GDP in mid-1990s to about 25 percent in FY2006/07-FY2007/08, this sector’s share has since declined and leveled off at about 20 percent of GDP over the last decade, indicating limited structural transformation and risk of premature de-industrialization.



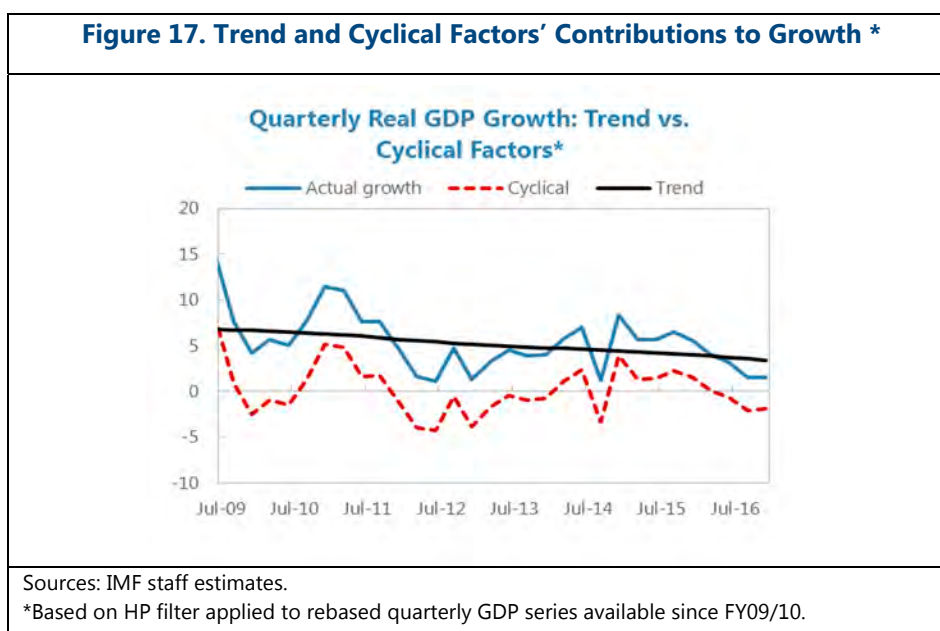
## G. Structural Constraints

**14. What are the structural issues that could explain the constraints on growth as discussed earlier?** IMF (2014) find that structural constraints, such as infrastructure and regulatory barriers, strongly affect a low-income country’s progress in structural transformation. This section draws on cross-country comparison of a range of indicators to zoom in on the potential constraints, which likely affected productivity growth as well as the accumulation of physical and human capital in Uganda.

**15. While Uganda’s business environment has improved, progress is less rapid than in peer countries (Figure 13).** Measured by the distance to the frontier of best global performance in Doing Business, Uganda’s score increased from about 50 in early 2000s to about 70 in 2016. In comparison, the progress achieved in EAC peers over the same period (proxied by the median score) is faster than in Uganda, and thus the ratio of Uganda’s score to the median EAC score has declined toward late 2000s and then remained at about 90 percent throughout the 2010s. For example, Uganda ranks 115 in Doing Business Indicators, compared with Kenya at 92 and Rwanda at 56. Access to electricity ranks 184, also low compared with peers in East Africa. This would put Uganda at a disadvantage in attracting investment and business creation that in turn affects trend growth.

<p><b>Figure 13. Doing Business Distance to Frontier</b></p>	<p><b>Figure 14. Doing Business Component Indicators</b></p>
<p><b>Relative Scores of Doing Business</b> (higher value indicates better business environment)</p>	<p><b>Doing Business Indicators</b> (Rankings, center is the best)</p>
<p>Sources: World Bank Doing Business database and IMF staff calculations. The years refer to the publication time.</p>	<p>Sources: World Bank Doing Business database and IMF staff calculations.</p>
<p><b>Figure 15. Firm Survey Results on Business Constraints</b></p>	<p><b>Figure 16. Global Competitiveness Indicators</b></p>
<p><b>Business Constraints: Uganda and Peers</b> (Scores: center is the best)</p>	<p><b>Global Competitiveness Index</b> (Scores: center is the best)</p>
<p>Sources: World Bank Enterprise Survey database and IMF staff calculations.</p>	<p>Sources: WEF Global Competitiveness database and IMF staff calculations.</p>

**16. A wide range of business environment indicators point to a common set of weaknesses in infrastructure, governance, business regulations, and labor skills (Figures 14, 15, 16).** In recent surveys, firms and investors find persistent constraints in Uganda’s infrastructure bottlenecks (particularly electricity) and the ease of starting a new business and trading across borders. In addition, the 2016-17 Global Competitiveness Report find that investors consider corruption as a top constraint, which contributed to Uganda’s low ranking at 113, compared unfavorably with Rwanda (52) or Kenya (96). Also, Uganda ranked 151 out of 176 countries in the 2016 Transparency International Corruption Perception Index; and the World Bank’s 2015 Governance Indicators ranked Uganda below its EAC peers Rwanda, Tanzania, and Kenya. Moreover, the skill shortage or mismatches between existing education with the required practical skills and management practices are becoming more of a concern in recent surveys, particularly for manufacturing firms (MoFPED 2014).

**Figure 17. Trend and Cyclical Factors' Contributions to Growth \***

## H. Cyclical Factors

**17. The most recent slowdown since FY15/16 was also affected by cyclical factors (Figure 17).** A decomposition of the contributions of trend and cyclical factors based on quarterly GDP data shows that cyclical factors also affected growth significantly at times. In FY15/16, cyclical factors are estimated to have contributed to about half of the decline of the annualized growth rate from the previous year. These factors include the recent drought since late 2015, as well as the deterioration of the conflicts in South Sudan, which had been a major export market for Uganda in recent years. Some factors discussed in earlier sections also explain Uganda's vulnerability to these cyclical factors. For example, weak agricultural extension support makes small-holder agriculture more vulnerable to cyclical changes of weather conditions. In addition, insufficient export diversification and regional integration exposes Uganda to risks in individual trading partners.

## I. Policy Implications

**18. The authorities' focus on infrastructure remains appropriate to support growth, but improving public investment efficiency and complementary measures are key to maximize the growth impact.** While the focus on electricity and transportation does address the binding business constraints, recurring under-execution suggests the better prioritization and sequencing of projects can help select the right projects within the constraint of absorptive capacity. More focused but better managed public investment could generate more salutary impact through improved quality and efficiency.

**19. Strengthening human capital is also important to achieve higher and more inclusive growth.** Providing the young labor force with sufficient practical skills demanded by business is essential for youth employment and Uganda's competitiveness. For example, enhancing agricultural extension service would likely boost labor productivity in the sector that

employs about 70 percent of the labor force. The government's recent efforts for strengthening vocational education are steps in the right direction, while private sector participation in curriculum design, skill certification, and practical training as recommended in MoFPED (2014) would improve the delivery. In addition, quality public education and health services can support a healthy and productive labor force and provide better opportunities for the poor. Emphasis on empowering women to be economically active is equally important (IMF 2017a). This includes addressing obstacles to women in accessing land or inheriting assets and improving fertility choices. Furthermore, IMF (2015) also finds that boosting targeted social protection can help efficiently build human capital of the poor and enhance the inclusivity of growth.

**20. Accelerating business environment reforms would support productivity growth of the private sector.** Enhancing Uganda's competitiveness requires faster progress in reforms to support business creation and growth, trading across borders, and more effective fight against corruption. Improving financial market infrastructure (e.g., credit bureau and collateral registry) and liberalizing financial market to support long-term finance would help enhance credit to the private sector.<sup>7</sup> Meanwhile, some targeted government interventions in key sectors could help. For example, MoFPED (2014) finds that agricultural extension services are key to boost agricultural productivity, while supports to specific firms are largely ineffective. Hausmann and others (2015) and World Bank (2016b) find that government can more actively support core infrastructure, reduce regulatory barriers, and coordinate firm clusters in labor-intensive agro-industry that fully utilize Uganda's comparative advantages, as well as manufacturing industries around transport corridors to capitalize on the improved infrastructure. Furthermore, a strong monitoring and evaluation system is critical to learn from experiences and improve the focus and efficiency of government interventions in supporting structural transformation. Finally, the authorities' focus on fighting corruption would also ease the burden on private business while boosting investor confidence. Policy measures include increasing public contract and regulatory transparency and establishing mechanisms for independent public scrutiny, including direct monitoring by the public or via non-government organizations. The anti-corruption hotline introduced by the Uganda Investment Authority recently is a step in the right direction.

**21. Advancing EAC integration could further support Uganda's export diversification and structural transformation.** EAC integration can provide land-locked Uganda with a much larger market, expand Uganda's investment and job opportunities, and offer opportunities for pooling resources in regional infrastructure and financial sector development. These opportunities in turn can further boost exports and strengthen Uganda's growth. Potential measures include educating farmers about export standards and accelerating inter-governmental agreements on regulatory harmonization.

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<sup>7</sup> Selected Issues Paper, "Financial Inclusion and Development."

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## A MEDIUM-TERM FISCAL ANCHOR: MANAGING DEBT AS PUBLIC INVESTMENT IS SCALED UP<sup>1</sup>

- Uganda's central government debt has risen by 9 percentage points of GDP since 2013 as public investment scaled up and is projected to peak at 42 percent of GDP in FY19/20.
- Fan-chart analysis illustrates the risks that debt can deviate from the projected trajectory, if the country is hit by shocks as in the past.
- Risks around the baseline debt projection are largely unchanged when comparing projections made at the beginning of the PSI with those made today.
- However, with the debt level now being higher, the probability of crossing the debt ceiling in Uganda's Chart of Fiscal Responsibility has increased.
- Focusing on baseline debt projections as a medium-term anchor can guide the appropriate size of deficits to keep debt on a manageable path, providing a buffer below the authorities' debt ceiling.

### A. Recent Developments

- 1. The Policy Support Instrument (PSI) began in mid-2013 in a relatively low risk environment.** Central government debt was assessed to be approximately 26 percent of GDP. Following receipt of debt relief in the mid-2000s, debt had risen around 7 percentage points of GDP to this level, but all external debt was on concessional terms.
- 2. The program involved ambitious public investment, with new infrastructure expected to be accompanied by robust growth.** Public investment was projected to be 10 percent of GDP each year of the program period, roughly the same as recurrent expenditure. Major hydro power projects would involve non-concessional borrowing, raising the interest bill, but the impact on debt was expected to be offset by robust growth, projected to increase from 5 percent in FY2012/13 to 7 percent by FY2014/15.
- 3. Growth, domestic interest rates and the exchange rate were subject to adverse shocks over the program period, but these shocks were offset by better than expected external borrowing rates.** Growth fell short of expectations, reflecting drought, election-related disturbances and rigidities in the banking system which constrained credit (Figure 1).<sup>2</sup> Growth averaged around 5 percent over FY2013/14-FY2015/16. There was a significant exchange rate depreciation in 2015 (Figure 2) and effective interest rates on domestic government debt were higher than expected (Figure 3). By contrast, effective interest rates on external debt were slightly lower than expected (Figure 4).

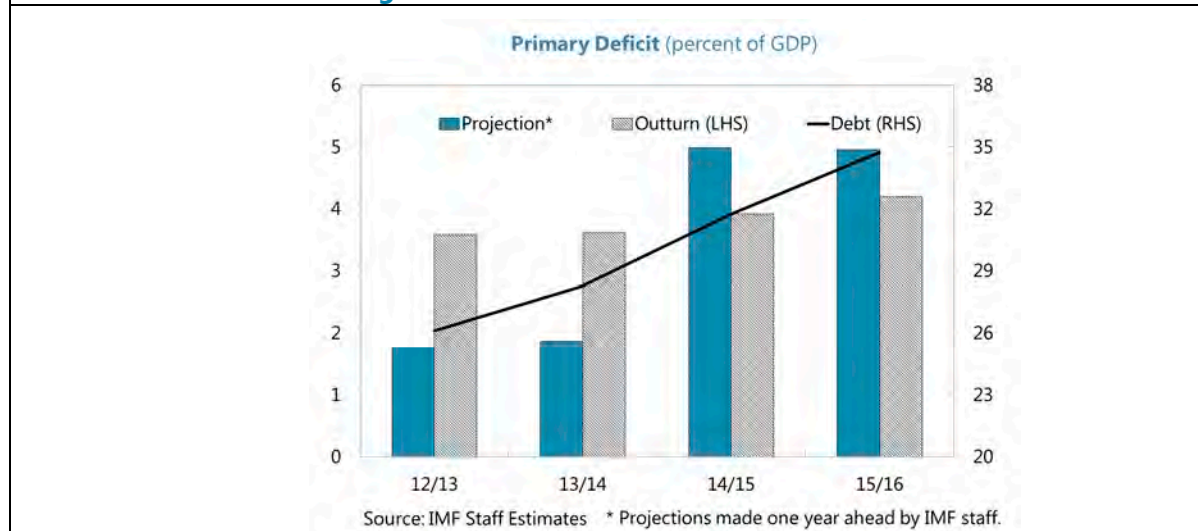
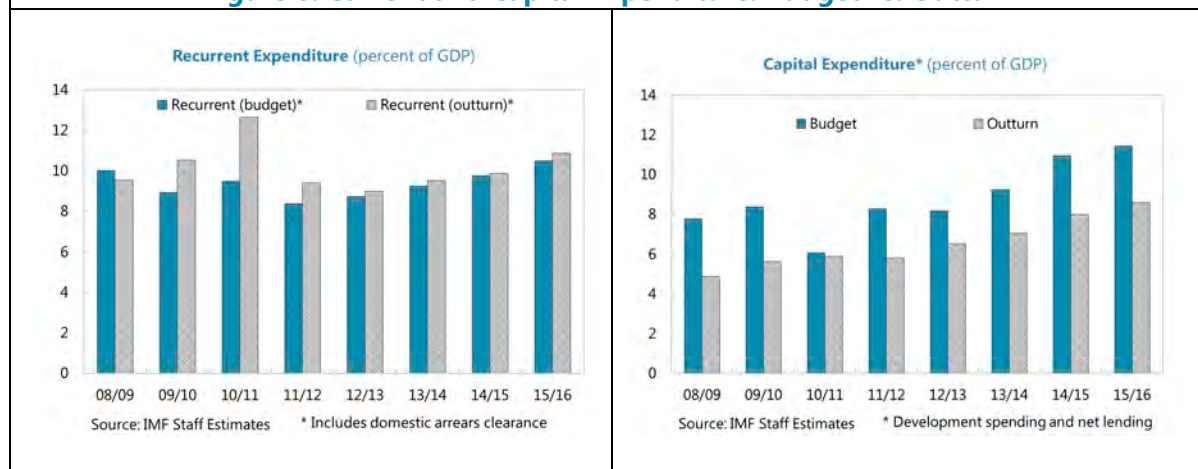
<sup>1</sup> Prepared by Andrew Hodge.

<sup>2</sup> Selected Issues Paper, "Growth Diagnostics."



**4. Overall, government debt rose by 9 percentage points to 35.7 percent of GDP in FY2015/16 as projected.** Primary deficits increased over the program period and were somewhat worse than expected over 2013-2014, but under-execution of the development budget resulted in smaller than expected deficits in 2015-2016 (Figure 5). Recurrent expenditure exceeded projections over the period, particularly in the election year of FY2015/16 (Figure 6). However, this was outweighed more recently by under-execution of the development budget. Development expenditure over FY2012/13-FY2015/16 was 85 percent of what was projected when the program began. This reflected weak execution of the externally financed development budget.



**Figure 5. Government Debt and Deficit****Figure 6. Current and Capital Expenditure: Budget vs. Outturn**

## B. Authorities' Medium Term Strategy

**5. The authorities seek to balance risks to debt sustainability with the need for debt-financed public investment to fill large infrastructure gaps.** The overarching aim is to ensure public debt remains sustainable, ideally retaining an overall rating of low risk of debt distress under the IMF-World Bank Debt Sustainability Framework (LIC DSA). In order to achieve these objectives, the authorities are committed to adhering to Uganda's Charter of Fiscal Responsibility adopted in 2015, which embodies a ceiling on public debt of 50 percent of GDP (in net present value terms) and requires the overall deficit to be reduced to 3 percent of GDP by FY2020/21.

**6. Debt is expected to rise from 35.7 percent of GDP to around 42 percent of GDP over the medium term.** Public investment is expected to peak at around 11 percent of GDP in the near term before declining in order to meet the 3 percent of GDP deficit target by FY2020/21.<sup>3</sup> Deficit reduction will also be supported by annual ½ percent of GDP increases in revenue, due to ongoing

<sup>3</sup> One quarter of projected investment is to be financed externally on non-concessional terms.

tax policy and administration reforms. Non-interest recurrent expenditure is assumed to remain approximately unchanged (as a percentage of GDP).

**7. Risks to the baseline debt projection are likely tilted to the downside.** Debt will be higher than expected if growth fails to recover as projected (perhaps due to poor quality project execution)<sup>4</sup> and if interest rates are higher than expected (due to greater reliance on non-concessional borrowing). Unexpected exchange rate depreciation can also increase the domestic currency value of debt. Under-execution of the externally financed development budget can imply lower than expected borrowing, but this may come at the expense of lower growth.

### C. Fan Charts: Capturing Uncertainty around Forecasts

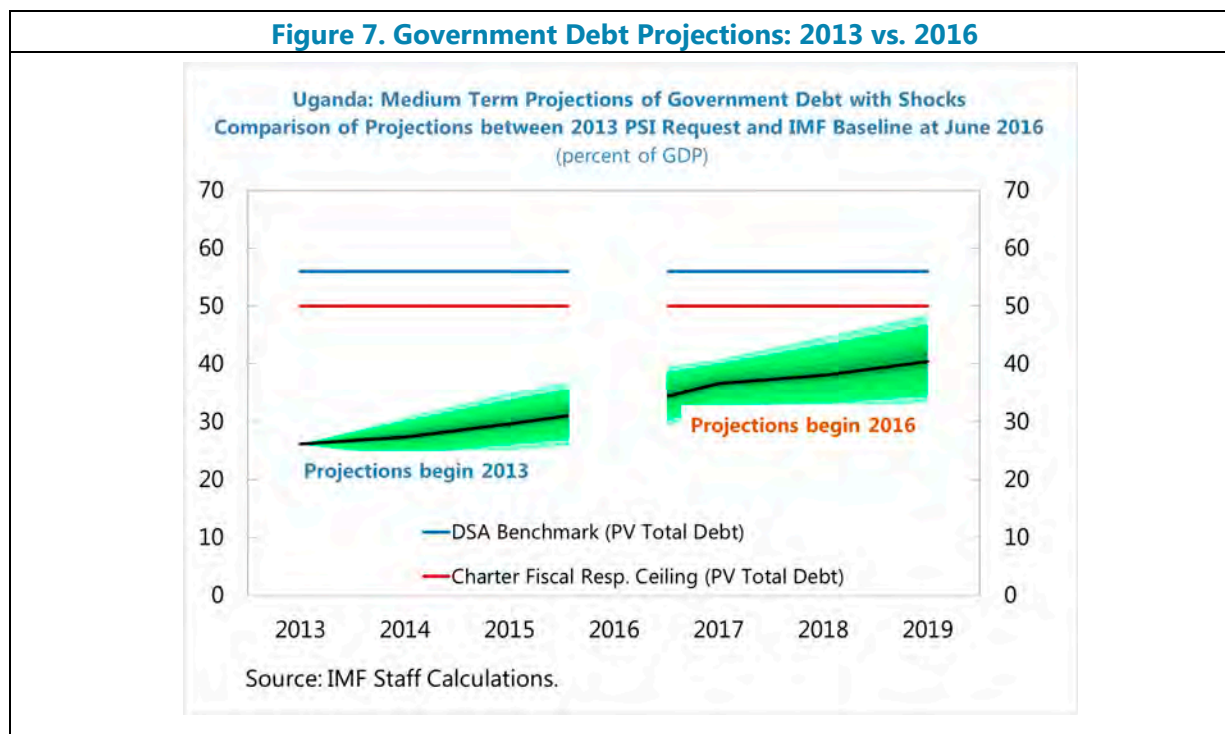
**8. Fan charts can capture uncertainty around baseline debt forecasts.** They represent potential trajectories for debt, corresponding to different possibilities for growth, exchange rates and interest rates, that may differ from the baseline forecast. These different possibilities are obtained by drawing shocks from a joint normal distribution of macroeconomic and fiscal variables, calibrated based on historical volatility of these variables. These shocks are added to the baseline forecasts.

**9. Fan charts indicate that the risk of debt deviating from its projected path are approximately the same as at the commencement of the PSI in 2013<sup>5</sup>.** This can be seen by comparing the two 'fans' in Figure 7. The left-hand side fan is constructed as of end FY2012/13, based on data up to that point and also initial PSI projections. The right-hand side fan is constructed using data up to end FY2015/16, along with current baseline projections. The upward sloping black line in the middle of each fan corresponds approximately to the PSI projection (for the left fan) and the baseline IMF projection (for the right fan). The width of the right-hand side fan after three years (i.e. 2019) is only slightly larger than the width of the left-hand side fan in 2016. The probability of debt deviating from its projected path by any given amount over the next three years is assessed to be approximately the same as it was in FY2012/13 when the PSI commenced. This indicates that the fiscal slippages and shocks to growth, interest rates and the exchange rate experienced since 2013, while not trivial, have not been significantly different to pre-2013 shocks to increase the likelihood that debt deviates from its projected path.

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<sup>4</sup> See IMF (2017) for further details.

<sup>5</sup> Baum and others (2017) describes the methodology used to produce the fan charts.

**Figure 7. Government Debt Projections: 2013 vs. 2016**

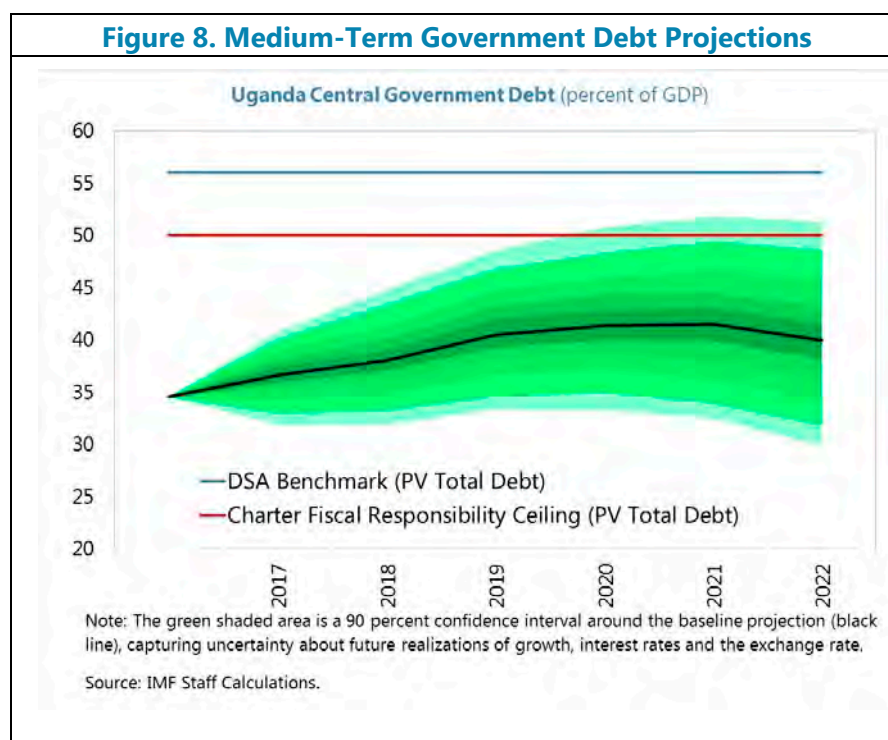
**10. Despite no significant increase in uncertainty about future debt outcomes around a projected path, there is now a greater risk of debt reaching levels above 50 percent of GDP because of shocks or slippages, given that debt is now at a higher level than when the PSI commenced.** In Figure 7, the left-hand side chart indicated that in FY2012/13 there was effectively zero probability over the PSI period of debt reaching 50 percent of GDP. However, the fan chart constructed using data up to FY2015/16 begins at a higher debt level and is centered around a baseline debt projection that reflects rising debt due to continued public investment scaling up. Figure 8 extends this fan chart to FY2021/22. This reveals that there is now a small probability that debt will reach levels of around 50 percent of GDP by the end of the medium term. Scaling up of public investment has brought debt closer to the 50 percent level, so that adverse shocks have the potential to drive debt closer to this level over the medium term.

#### D. Policy Recommendations

**11. The authorities have committed to a Charter of Fiscal Responsibility to anchor fiscal policy.** The Charter requires keeping government debt below 50 percent of GDP in net present value terms and achieving an overall fiscal deficit of no more than 3 percent of GDP in FY20/21—consistent with the EAC convergence criteria for monetary union<sup>6</sup>.

<sup>6</sup> The East African Monetary Union (EAMU) convergence criteria include a ceiling on debt of 50 percent of GDP in net present value terms, as well as a ceiling on overall deficits of 3 percent of GDP.

**12. Adopting the baseline debt projection shown in Figure 8 (curved black line) as a debt ceiling will help the authorities adhere to the Charter of Fiscal Responsibility (CFR), by providing a buffer in the event of adverse shocks.** Under the baseline, debt remains below 43 percent of GDP over the medium term, well below the ceiling in the CFR and also the DSA benchmark for total public debt<sup>7</sup>, helping to ensure that Uganda remains at low overall risk of debt distress. If debt deviates from the projected path because of over-budget spending, or exchange rate shocks / realization of contingent liabilities etc., higher fiscal balances will likely be required to bring debt back to manageable levels.



**13. The baseline debt projection is consistent with scaling up public investment in the near term, but also reflects a projected reduction in the size of deficits to 3 percent of GDP by FY20/21, requiring ongoing improvements in revenue collection.** Non-interest current expenditure is projected to remain unchanged over the medium term (as a percentage of GDP), while conservative assumptions are made about interest rates. Reducing the deficit to 3 percent of GDP by FY2020/21 will require annual revenue increases of ½ percent of GDP per year, as well as reduction of public investment from the near-term peak of 11 percent of GDP to 9 percent of GDP as major infrastructure projects (e.g. in hydro power) are completed.

<sup>7</sup> The DSA benchmark for total public debt is in present value terms.

## References

Baum, A., A. Hodge, A. Mineshima, M. Moreno Badia and R. Tapsoba, 2017, "Can They Do It All?" Fiscal Space in Low Income Countries." IMF Working Paper No. 17/110 (Washington).

International Monetary Fund, 2017, "Uganda: Staff Report for the 2017 Article IV Consultation and the 8<sup>th</sup> PSI Review" (Washington).

## FINANCIAL INCLUSION AND DEVELOPMENT <sup>1</sup>

- Traditional indices suggest that Uganda’s financial development is low relative to regional peers, with significant scope to enhance the sector’s contribution to growth.
- Financial development also underperforms benchmarks based on fundamentals.
- Measures to raise the credit-to-GDP ratio include addressing high interest rate spreads, strengthening the credit infrastructure, and developing additional products through the mobile money platform.
- There is scope to enhance financial development more broadly through initiatives to liberalize the insurance sector and further develop capital markets.

### A. Financial Access in Uganda

**1. A well-developed financial sector is important for economic growth.** International evidence supports the existence of strong linkages between financial development and growth and reduced inequality (Levine 1997; Beck et. al, 2007). Financial development can help lift a country’s growth potential by mobilizing savings, promoting a more efficient allocation of capital, facilitating economic diversification and risk management, and can reduce income inequality by easing credit constraints on the poor. Enhanced financial development initially promotes financial stability and greater economic resilience, by strengthening financial buffers and broadening the range of instruments available for responding to adverse shocks. Box I shows that Uganda stands to benefit from enhanced financial development.

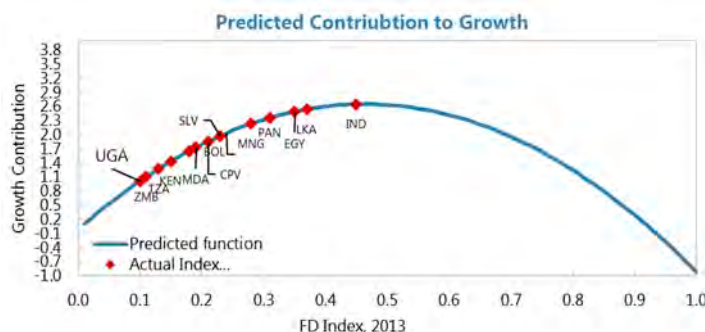
**2. The introduction of mobile money technologies has helped Uganda and its regional peers achieve the twin goals of developing their financial markets efficiently and expanding financial inclusion.** New cost-saving financial products include mobile money products and transactions and banking services and technologies. Although Kenya has been at the forefront of this mobile money technology, Uganda, Tanzania and Rwanda have also been successful in using this technology<sup>2</sup>, with over 80 percent of all mobile money transactions in 2011 reportedly processed in East Africa (Davidson and Pénicaud’s, 2012). While the range of mobile money financial products continues to grow, ensuring that the supervisory framework keeps pace with financial innovation in the sector will be important.

<sup>1</sup> Prepared by Ruby Randall (IMF) and Elizabeth Kasekende (BoU).

<sup>2</sup> It is important to note that mobile money differs from mobile banking. While individuals can now easily send money to their mobile money account from their bank accounts using a cell phone, several unbanked mobile money users do not own a bank account but are able to use mobile banking facilities.

### Box 1. Financial Development's Contribution to Growth, the Reduction in Growth Volatility, and Financial Stability

**Enhancing financial development can help boost Uganda's growth.** Regression results from Heng, Ivanova, et al. (2015 & 2016) show a growth contribution of financial development of 1.03 percentage point in 2013 holding all other variables constant, while in Kenya and Tanzania the growth contribution is estimated at 1.44 and 1.28 percentage points, respectively. The average index in SSA was 0.12, with an estimated growth impact of 1.20 pp. The diminishing marginal contribution of financial development to growth suggests a larger growth impact for countries at a lower level of financial development than for the more financially developed. For instance, increasing Uganda's development index from 0.10 to that of Cape Verde's (0.21) while holding all other variables constant, increases the growth impact by 0.86 percentage points to 1.86 pp, whereas a further increase in the index from Cape Verde to Panama (0.31) would result in an increase in the impact of 0.50 percentage points to 2.37 pp. Some lower middle-income countries (e.g. India and Sri Lanka) are closer to the inflection point, beyond which the marginal contribution becomes negative.

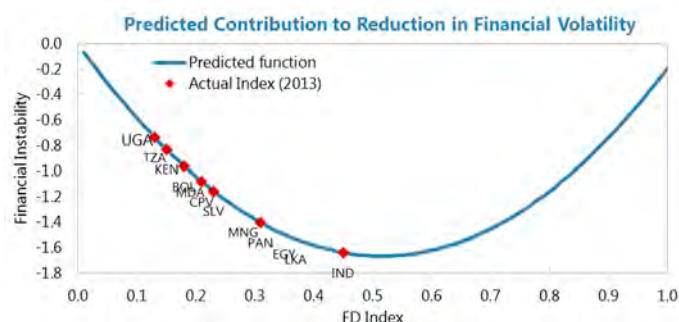
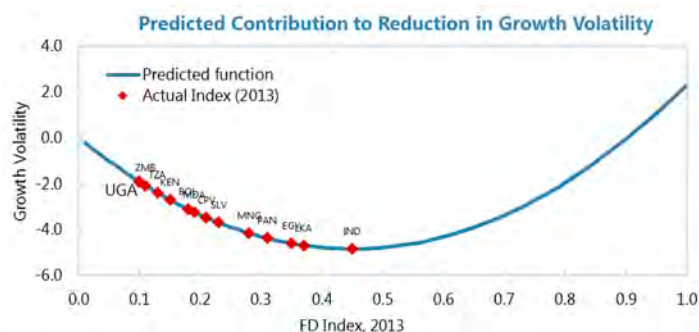


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For instance, increasing Uganda's development index from 0.10 to that of Cape Verde's (0.21) while holding all other variables constant, increases the growth impact by 0.86 percentage points to 1.86 pp, whereas a further increase in the index from Cape Verde to Panama (0.31) would result in an increase in the impact of 0.50 percentage points to 2.37 pp. Some lower middle-income countries (e.g. India and Sri Lanka) are closer to the inflection point, beyond which the marginal contribution becomes negative.

#### Financial development can also help to reduce growth volatility and financial instability.

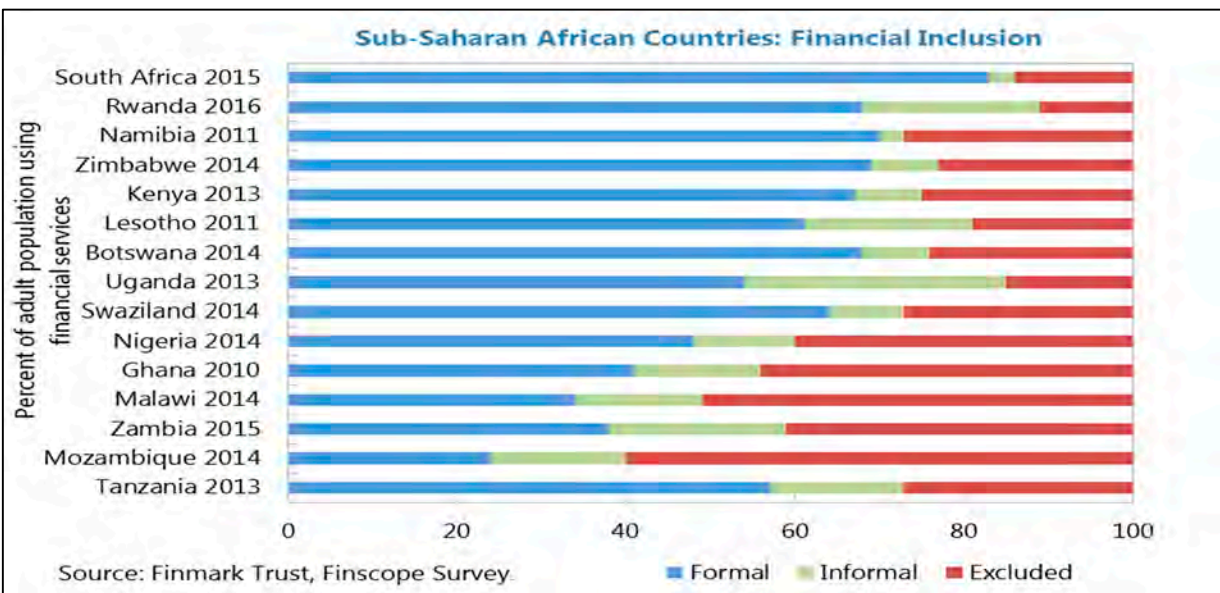
Financial development strengthens resilience to shocks by providing tools for risk mitigation and pooling. The contribution of financial development to the reduction in growth volatility is measured by the standard deviation of GDP growth, and is estimated at -1.9 pp in Uganda in 2013. The contribution to reduced financial instability is measured as the inverse to the Z-score— which compares the banking system's capitalization and returns with the volatility of those returns—and is estimated at -0.58 pp in 2013. Uganda and other peers are in the range of the curves where additional financial development reduces growth volatility and financial instability, respectively. Beyond the inflection point, increasing financial development adds to volatility and instability, particularly if it gives rise to a higher incidence of risk-taking and costly speculation. Thus, as with the contribution to growth, Uganda stands to benefit from further financial development, in terms of reducing growth volatility and financial stability.



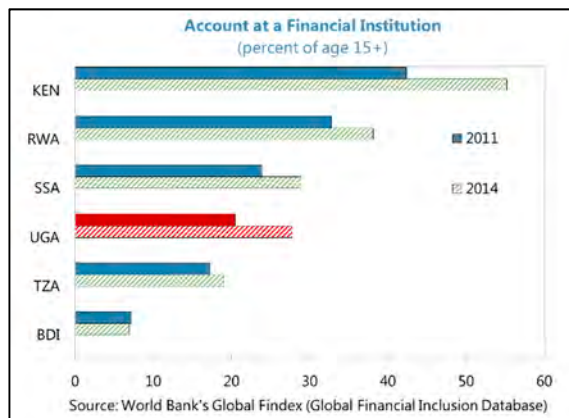


**3. Uganda has achieved significant gains in expanding both the number and range of financial service providers and products.**

It achieved among the lowest share of the population excluded from access to financial services among the SSA countries reviewed by FINSCOPE, after accounting for nonbank formal and informal credit channels<sup>3</sup>. The rapid growth in utilization rates achieved between 2010 and 2015 has established Uganda as an emerging industry leader, with over 21 million registered users and mobile money transactions valued at 44 percent of GDP.



- In addition to progress with respect to mobile money transactions, data from the World Bank’s Global Financial Inclusion Database show a significant rise in the percentage of individuals aged 15 and older holding an account at a bank or another type of financial institution from 20.5 percent in 2011 to 27.8 percent in 2014, bringing Uganda closer to the average for Sub-Saharan Africa.



<sup>3</sup> Formally financially included represents individuals 16 years or older who have/use financial products/services provided by a financial service provider that is regulated or officially supervised; Informally included represents individuals 16 years or older who use financial mechanisms not provided by a regulated or supervised financial institution; and “Financially excluded” represent individuals 16 years or older who have no financial mechanisms and rely on informal channels for saving, borrowing, and remitting; their transactions are cash-based or in-kind.

- FINDEX data also show a reduction in the gender gap in account ownership between 2010 and 2015, in contrast to several regional peers.



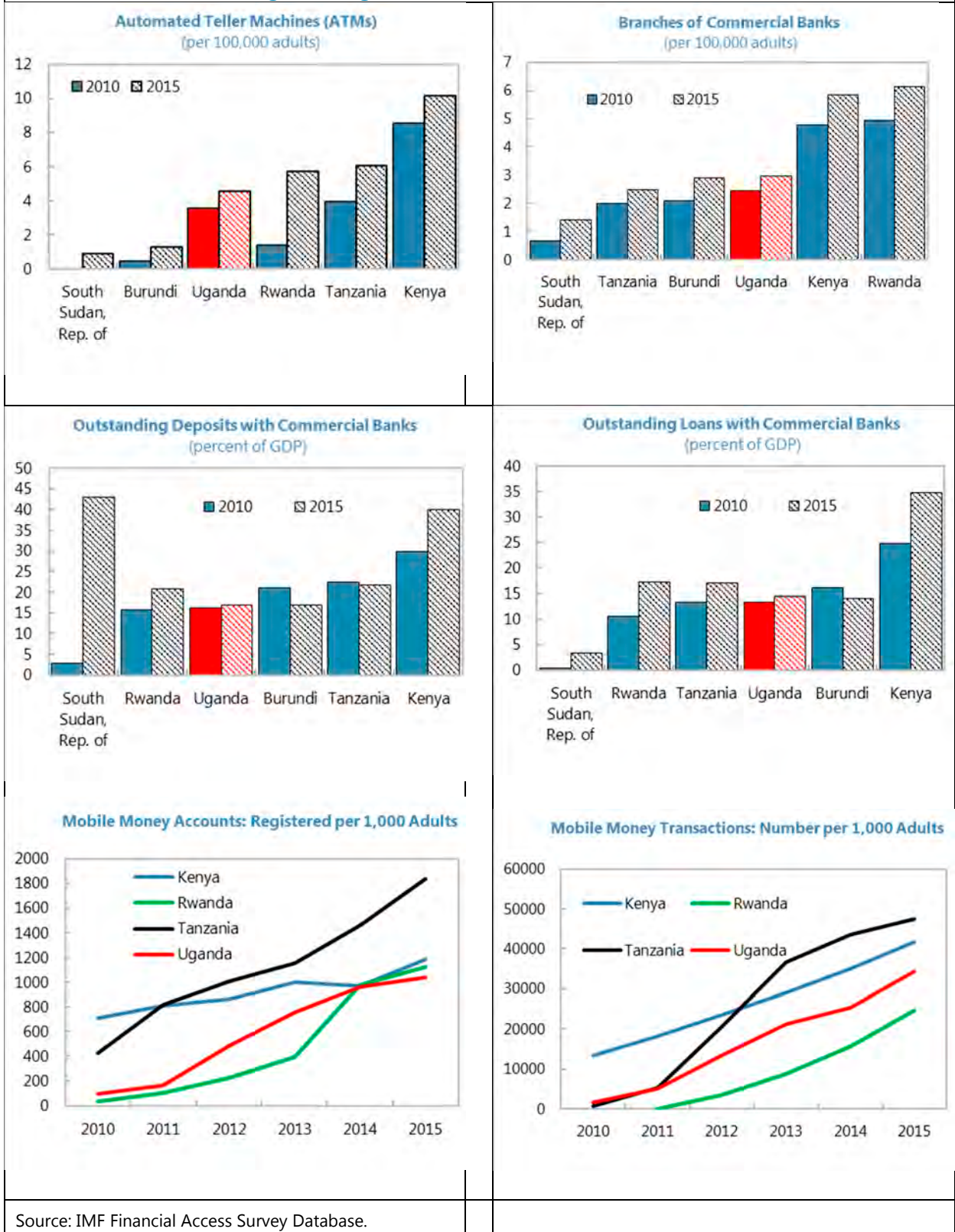
**4. These gains notwithstanding, more needs to be done to enhance access to financial services in Uganda, to boost Uganda's growth potential (Figure 1).**

- Commercial bank penetration rates in Uganda (2.5 commercial bank branches per 100,000 adults in 2010), were below rates in Rwanda (4.8) and Kenya (4.9), and registered smaller increases than both Kenya and Rwanda over the five-year period.
- Commercial bank deposits and loans rose to 16.9 percent and 14.5 percent, respectively in 2015—but these were among the lowest increases observed within the EAC.
- Data from the IMF's Financial Access Survey show that although access to automated teller machines (ATMs) increased from 3.5 to 4.6 per 100,000 adults between 2010 and 2015, several East African Community (EAC) countries achieved higher access levels and registered bigger gains than Uganda over the five-year period.

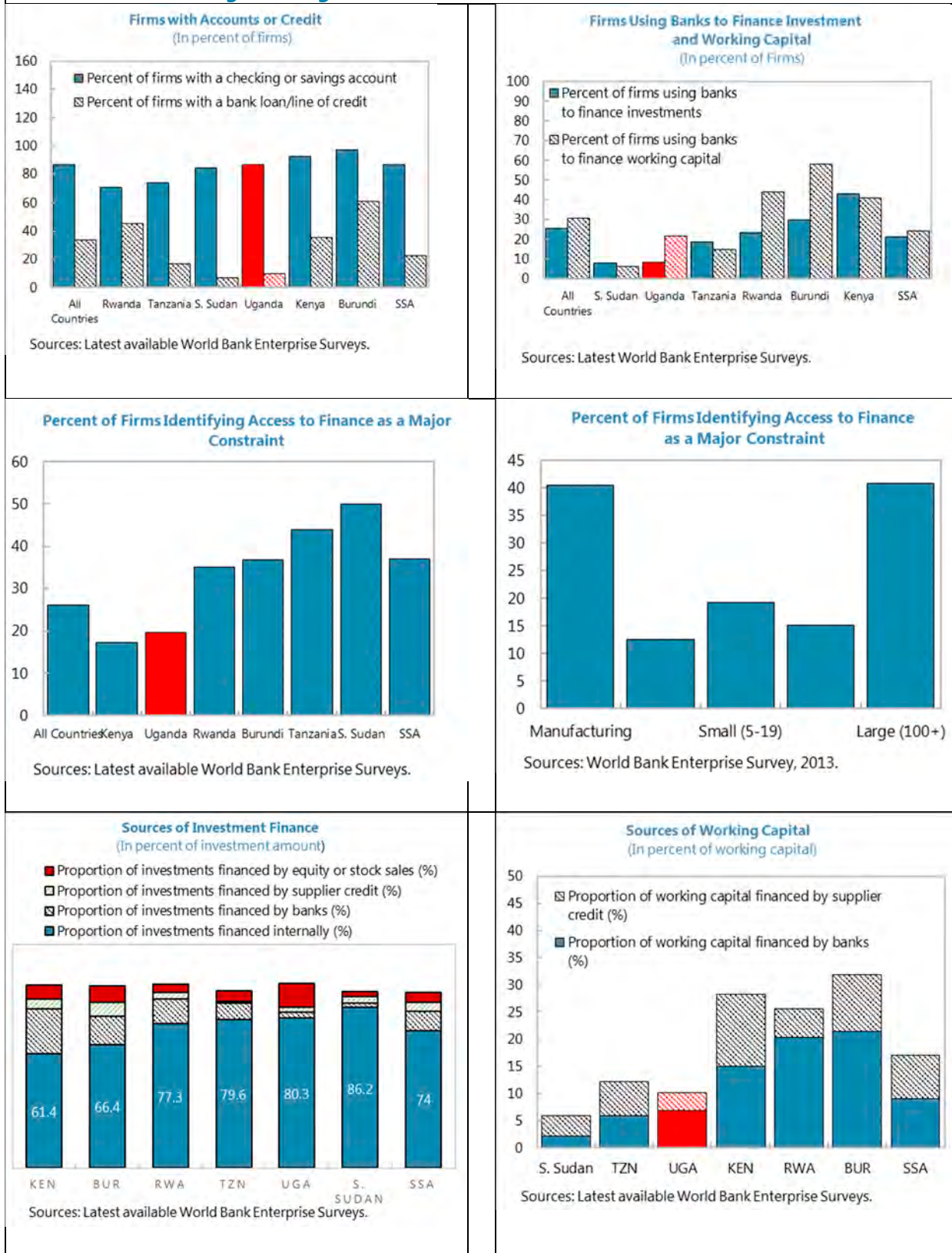
**5. World Bank Enterprise Survey data indicate the presence of gaps in firms' financial access levels vis-a-vis regional peers, with potentially adverse consequences for productivity (Figure 2).**

- Although 87 percent of Ugandan firms surveyed reported having access to either a checking or savings account, consistent with the SSA average, only 10 percent of firms reported having access to a bank loan or line of credit—less than half of the average for SSA and the lowest level of access reported after South Sudan.
- Surveyed firms in Uganda report that over 80 percent of their investments are financed internally—higher than the average for SSA (74 percent) —while only 3 percent of their investments are financed by banks, in contrast to the SSA average of 10 percent.
- Although just 20 percent of Ugandan firms surveyed identified access to finance as a major constraint, on par with Kenya, this percentage was much higher among manufacturing firms (40 percent) and large firms numbering 100 or more employees (41 percent).

**Figure 1. Uganda: Access to Financial Services**



**Figure 2. Uganda: Access of Firms to Financial Services**



- Equity participation, however, was reportedly the highest in Uganda (12.6), and more than double the share in SSA (5.4 percent). However, only eight domestic companies are listed on the Uganda Stock Exchange, and the last IPO took place in 2012.
- The proportion of Working Capital financed by supplier's credit in Uganda (3.3 percent) was the lowest within the EAC and lower than the SSA average (7.9 percent). The proportion of working capital financed by banks was also low relative to several EAC peers and 30 percent below the SSA average.

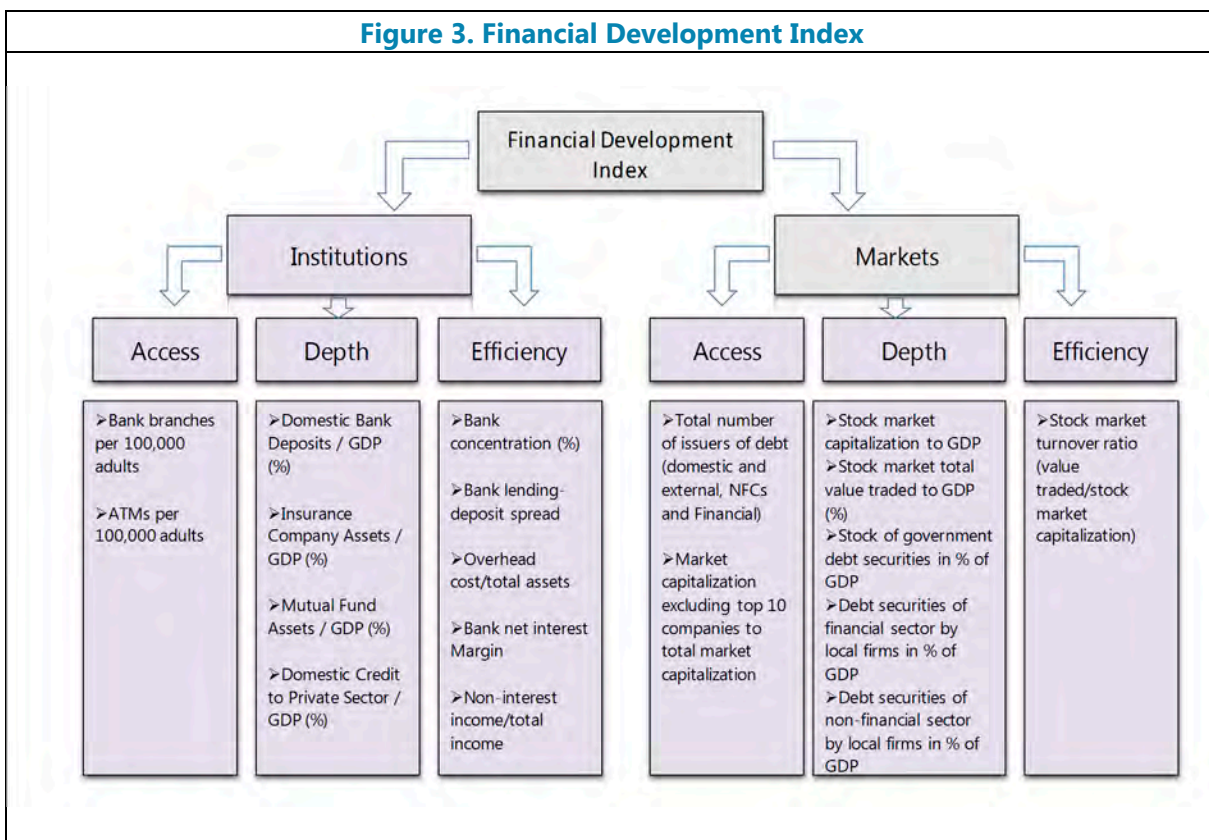
## B. The Financial Development Index

**6. Uganda's financial system is dominated by its banking sector, which accounted for 79 percent of financial system assets in 2012.** Deposit-taking institutions licensed by the Bank of Uganda comprise commercial banks (Tier I), credit institutions (Tier II), and microfinance deposit-taking institutions (Tier III). There were 31 regulated financial institutions in Uganda as of 2014—25 banks and 3 credit institutions and 3 microfinance deposit-taking institutions. However, with the failure of Crane Bank in October 2015, the number of banks has fallen to 24. Parliamentary approval of the Tier IV Microfinance Institutions Act in July 2016 supported the establishment of a Microfinance Regulatory Authority to complement the BoU's supervision of the sector.

**7. The adoption of a comprehensive financial index facilitates a more systematic benchmarking of Uganda's overall financial development and analysis of the impact of financial development on growth and financial stability.** In this regard, this paper utilizes the index of financial development adapted by Heng, Ivanova, et. al. (2015 & 2016), based on the analytical framework developed by Sahay et. al. (2015), to benchmark Uganda's progress over time and relative to its peers. It also examines financial development gaps, computed as the deviation of the financial development index from a prediction based on economic fundamentals—such as per capita income, government size, and macroeconomic stability—both over time and relative to a peer group comprised of other members of the EAC and Lower Middle-Income countries, given Uganda's objective of achieving middle-income status.

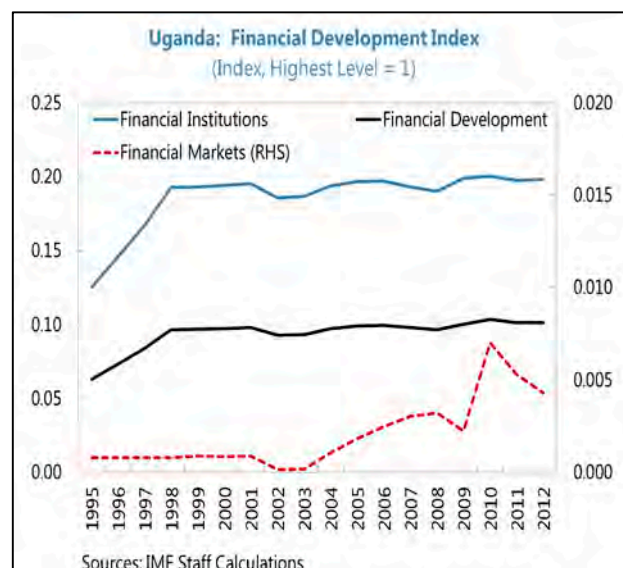
**8. The Financial Development Index (FDI) is comprised of two components: financial institutions and financial markets, with each component disaggregated into access, depth, and efficiency subcomponents.** Each sub-component is in turn constructed based on several underlying variables that measure development in each subcategory (see Text Table below). The series used to compute the index are as shown in Figure 3. The database is comprised of 122 countries for the period 1995-2014, based on data availability. All data listed in Figure 1 were normalized into an index ranging between zero and 1. Indices for each subcomponent—Financial Institutions Access (FIA), Financial Institutions Depth (FID), Financial Institutions Efficiency (FIE), Financial Markets Access (FMA), Financial Markets Depth (FMD), and Financial Markets Efficiency (FME)—were created by aggregating the underlying indicators shown below using equal weights within subcomponents of each index. The indicators were selected to maximize country coverage

and comparability across the sample, since a balanced dataset was needed for the analytical computations. However, the trade-off is that many of the indicators that capture the latest financial innovations, particularly in the Mobile Money industry are not included—thereby understating the degree of financial development in Uganda and elsewhere in the EAC.

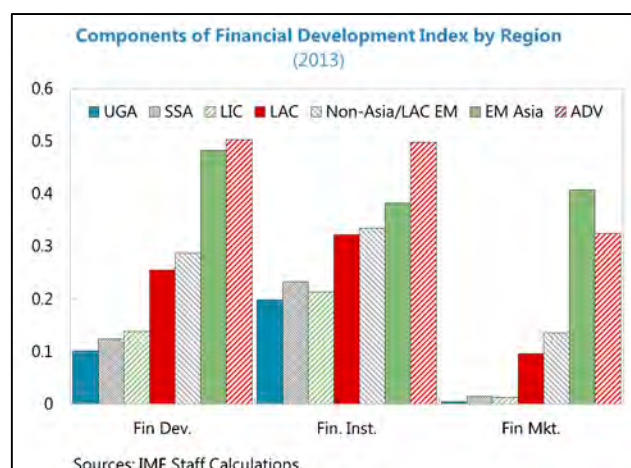


## C. Trends in Financial Development Indices

**9. Uganda’s composite financial development (FD) index rose sharply at the start of the review period, but moderated thereafter.** The data show a sharp increase in the index in the mid-1990s, stemming from the rise in the financial institutions (FI) index, as the authorities liberalized financial policies within the context of successive Fund-supported programs. During this period, the Bank of Uganda (BoU) liberalized interest rates, restructured weak banks, and strengthened financial supervisory oversight—the latter culminating in the introduction of risk-based supervision and the enactment of the new Financial Institutions Act in 2004.



**10. Uganda’s financial development score was lower than the average for Sub-Saharan Africa.** A comparison of Uganda’s relative performance vis-à-vis regional comparator groups in 2013<sup>4</sup> shows that Uganda’s overall financial development index rating (0.10) was below the average index for SSA<sup>5</sup> (0.12) and for low-income countries (LICs) (0.13), and that weaker performance was attributable to both the financial institutions and markets indices.



**11. Uganda’s financial development also fell short of other EAC and lower middle-income peer countries.**<sup>6</sup> This reference group is of interest given the Uganda’s aspirations of reaching middle-income status. Uganda began the review period with a low overall composite index and was outpaced by other similarly ranked during the review period—namely, Zambia, Armenia, and Cameroon, each now classified as lower middle-income countries. Each of these countries experienced a significant increase in their financial institutions index relative to the

<sup>4</sup> 2013 was latest available data period.

<sup>5</sup> Index excludes South Africa.

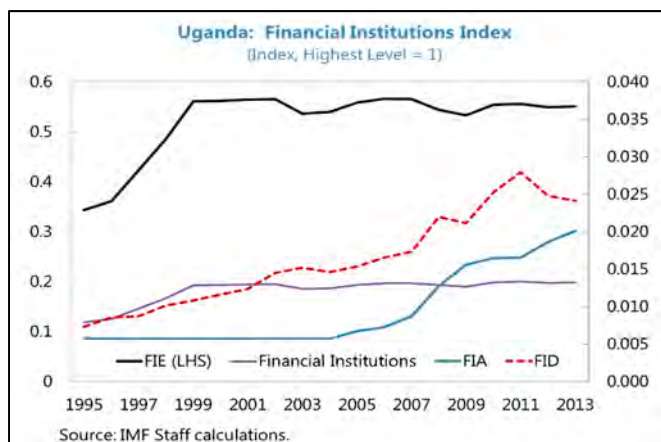
<sup>6</sup> Current country income classifications as listed by the World Bank, <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>. Sub-sample includes all EAC and lower middle-income countries included in the Heng, Ivanova dataset.

benchmark during the review period in contrast to deteriorating gaps observed in Uganda (see below). The median composite FDI for this reference group was 0.15, and the FDI score was 0.13 in Kenya and 0.12 in Tanzania, relative to 0.10 in Uganda. It is noteworthy, however, that the relative performance of Uganda’s Financial Market Development (FMD) index was stronger than that of its Financial Institutions Development Index. Uganda’s FMD ranking exceeded that of seven lower middle-income countries, and increased by over 400 percent during the review period, albeit from a very low base.



**12. During the 1990s, the BoU was proactive in encouraging competition by licensing new banks.**

As a result, the subsequent rise in the Financial Institutions Access Index (FIA) largely reflects the expansion of bank branch networks and ATMs. However, growth in the financial institutions index was much more muted after the initial surge of reforms in the 1990s, as the increase in competition and contestability in retail banking failed to translate into further gains in cost efficiency and reductions in interest rate spreads. In 2009, the BoU also facilitated the launching of innovative mobile payments products,, which helped to expand financial access—initially through mobile phone technology enabling customers to send and receive

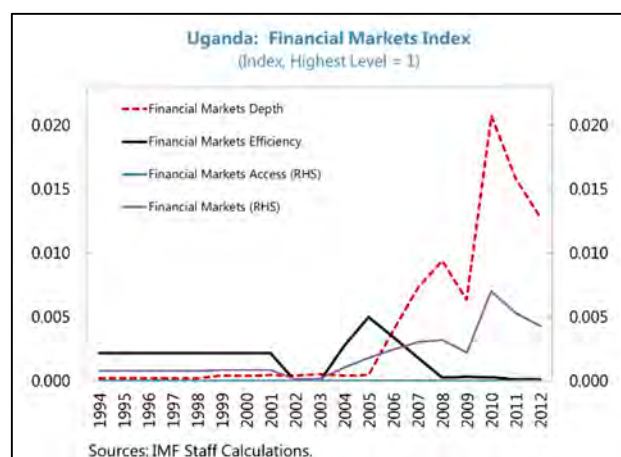




money without a bank account.<sup>7</sup> Mobile money services have since evolved, as individuals can now: save and obtain loans through their mobile money accounts; send and/or receive money to and from their mobile bank accounts; and engage in cross-border money transfers to selected East African countries using mobile money.<sup>8</sup> However, mobile money transactions that are not linked to bank accounts are not captured by the index due to existing data limitations.

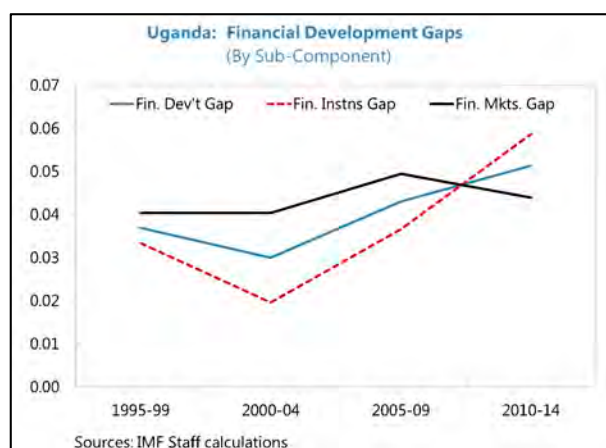
**13. The financial markets index stagnated at the start of the review period and then experienced rapid growth (from a very low base) between 2002 and 2010.**

It then declined in 2011-13 during the political electoral cycle, which weighed on economic activity and on the equity counters. In general, the performance of the financial markets index was dominated by the financial markets depth index, which experienced a sharp increase from 2005 onwards, reflecting the growth of the stock market following its inception in January 1998. However, its operations still remains on very small scale, with only eight local listings, limited corporate bond issuance, and very low capitalization (about 4.6 percent of GDP in 2016).



## D. Financial Gaps

**14. Throughout the review period, actual financial development in Uganda was below potential.** Financial gaps were computed for each of the indices and sub-indices—namely, the difference between the estimated values/benchmarks based on underlying fundamentals and actual financial development indices<sup>9</sup>. The data show that Uganda's financial development gaps were positive, meaning below potential, throughout



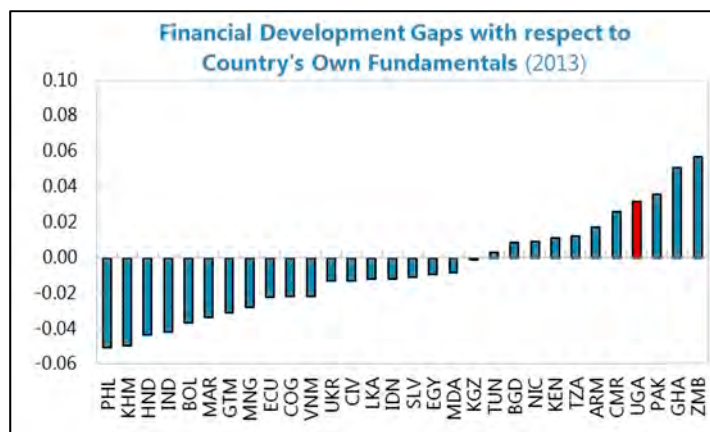
<sup>7</sup> In Uganda, one is required to register for mobile money using a national ID card. A process that is much easier than opening a bank account. Several unbanked mobile money users do not own a bank account to use mobile banking facilities

<sup>8</sup> The transfer of transactions across selected East African countries started in 2015 with Kenya's Safaricom partnering with Tanzania's Vodacom, Rwanda's MTN, and, Uganda's MTN to introduce cross border transactions with uniform prices across countries (Kariuki and Gicobi, 2015; Ochieng, 2015).

<sup>9</sup> Fundamentals included: initial GDP per capita, government consumption, population growth, the inflation rate, trade to GDP, average years of schooling, size of the shadow economy ranking), Financial Openness Index, Rule of Law Index, and Legal Origins.

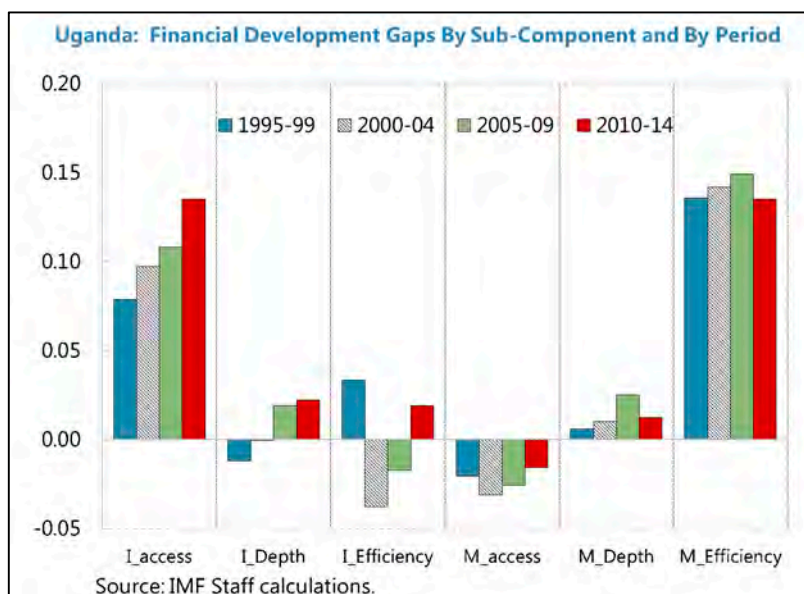
the review period, and that the gaps increased throughout much of the review period.

**15. Uganda’s financial development gaps also exceeded those of other EAC countries and many lower middle-income peer countries.** Uganda’s gaps were largely attributable to underperformance in financial institutions efficiency and depth, and financial market access.



**16. An analysis of the financial gaps by subcomponent over time reveals uneven development across the sub-indices and the impact of policy reforms.** For instance, the reduction of the Financial Development (FD) gap during 2000-04 reflected stronger financial institutions development (FI), after the progressive policy reforms of the late 1990s.

- The BoU’s pro-market reforms in the mid-1990s and encouragement of bank entry and nonbank competition contributed to financial institutions’ efficiency relative to potential, but did not improve financial institutions access relative to potential. More specifically, strengthened financial oversight resulted in a significant reduction of credit risk, as the NPL ratio declined from close to 50 percent in 1994 to just 2.6 percent in 2004, contributing to an improvement in the Financial Institutions Efficiency (FIE) index relative to its benchmark. At this time, the FIE gap swung from a positive gap (an average of 0.03 in 1995-99) to a negative 0.04 in 2000-04— representing overperformance relative to the benchmark. However, failure to sustain the reform momentum and translate enhanced competition (from the increase in bank entry in the 1990s) into reduced cost-to-income ratios meant that these efficiency gains were not durable. Thus, the FIE gap further deteriorated and turned positive again in 2010-14.

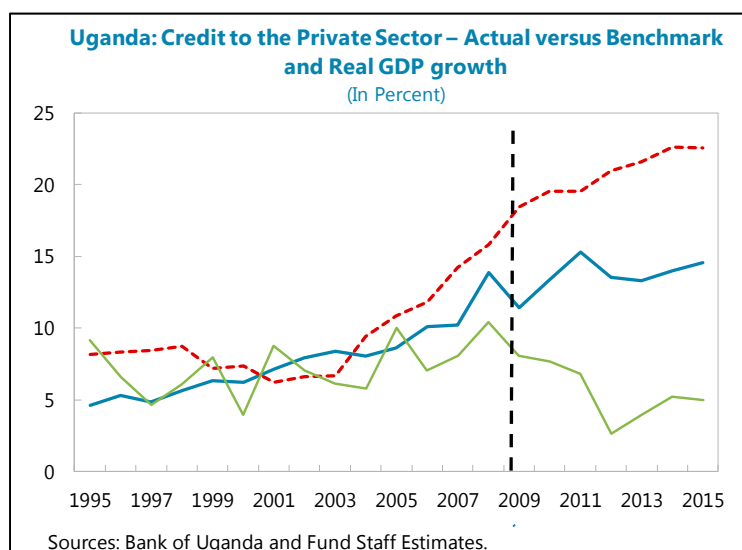


- Notwithstanding the growth in the Financial Institutions Access (FIA) index in the 1990s, the data show that the positive FIA gap steadily widened. The worsening gap reflected the failure of bank branches and ATMs to keep pace with the rapidly growing adult population and other fundamentals.
- By contrast, the Financial Markets Access (FMA) index outperformed the benchmark throughout the entire review period, reflecting the rapid growth in Uganda's government bond market and the growth in equities' market capitalization—albeit from a low base—with most locally-listed companies the result of divestitures of government-held shares in companies. Consistent with the rest of the EAC, the corporate bond market was less dynamic, as the development of corporate securities markets typically becomes more relevant at higher income levels (Redifer, forthcoming). In Uganda, many private businesses are mainly family-owned and shy away from the disclosures that are necessary for a listing.
- The Financial Market Efficiency (FME) gaps were significantly pronounced throughout the review period, reflecting a low turnover ratio and low liquidity stemming from a narrow investor base and a limited number of listings.

## E. Enhancing Private Credit Deepening in Uganda

### 17. The data suggest that the widening gap between the private sector credit-to-GDP benchmark relative to the actual credit-to-GDP ratio could be a key factor contributing to the recent economic slowdown.

The private sector credit-to-GDP ratio is one of the indicators used to construct the financial institutions depth index, and is of particular relevance in the case of Uganda since its credit depth (14.6 percent in 2015) is below EAC and SSA averages (23.3 and 29.0 percent, respectively, in 2015). Using a similar approach as Al Hussainy (2011), Barajas (2013), and IMF Country Report 15/195, a panel data set comprised of 138 emerging and low-income countries for the period from 1995–2015, was used to estimate the benchmark ratio of private sector credit to GDP. The fitted values from a first-stage regression of private sector credit depth on underlying fundamentals<sup>10</sup> were taken as the underlying credit depth benchmark. The specific

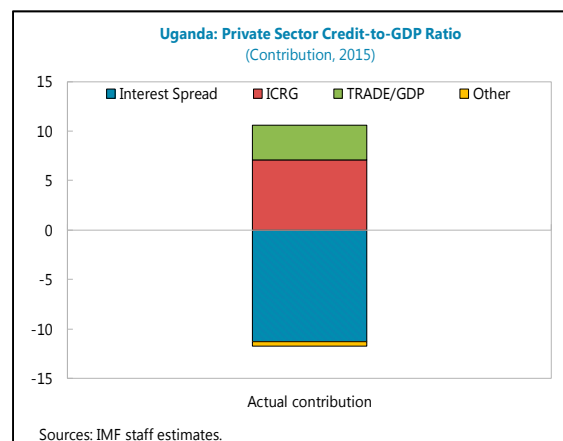


<sup>10</sup> Fundamentals included: (i) the log of GDP per capita and its square; (ii) the log of the population as a proxy for market size; (iii) the log of population density, proxying for ease of service provision; and (iv) the log of the age dependency ratio.

results from this exercise were consistent with the findings of Heng, Ivanova et.al. (2015) noted above, and confirm a gap in the ratio of credit to the private sector-to-GDP in Uganda, from about 2003, which intensified from about 2009 until the end of the review period. The latter period from 2009-15 coincides with the sharp break in trend growth in Uganda, stemming in part from negative productivity growth in agriculture and industry, as well as unproductive real estate investment<sup>52</sup>.

**18. Following (Al Hussainy (2011), Barajas (2013), and IMF Country Report 15/195), the credit depth and gap were modeled as a function of policy variables and exogenous factors<sup>53</sup>.** Equation (4) is representative and the variation captured by the model is sufficient to nearly close the private sector credit gap observed in 2015—the latter estimated at 8.0 percent (Table 1).<sup>54</sup> Financial stability factors, external flows and international country risk were found to be the main determinants of the variation in credit depth. The text chart illustrates the contribution of the variables with the largest impact, and the remaining significant variables are included in the category “other”.

- The effect of interest rate spreads stands out as particularly relevant, with high spreads contributing to a significant reduction in credit depth. The NPL ratio also had the expected sign but a much smaller impact (included in “other”), based on the panel dataset, and could differ for Uganda-specific data.
- Also, significant were the International Country Risk Guide (ICRG) composite variable (a barometer of sovereign and financial risks potentially impacting bankers’ willingness to lend—with a higher score connoting lower risk) and trade openness—the latter suggesting that trade credits are an important component of private credit demand.
- Macroeconomic stability (included in “other”) also helped to underpin improvements in credit depth<sup>55</sup>.



<sup>52</sup> Selected Issues Paper, “Growth diagnostics.”

<sup>53</sup> See Barajas (2013) for an exposition of the full model. The equation used in this paper is in line with this paper and presented in Table 1.

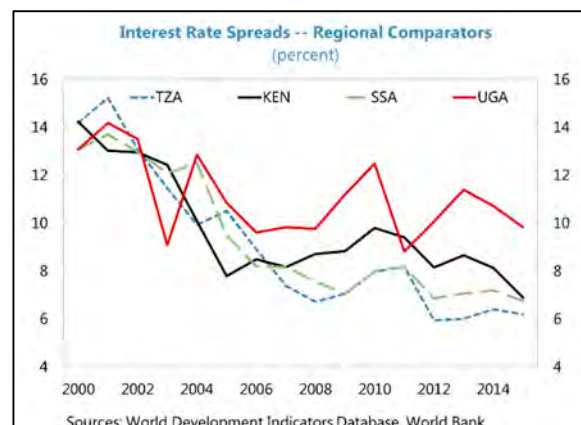
<sup>54</sup> The coefficients in each of the estimated private sector credit equations all yielded the expected signs and most were significant at better than the 5 percent significance level. In 2015, Uganda’s private credit-to-GDP ratio was 14.6 percent, and the model generated a fitted value of 13.2 percent.

<sup>55</sup> These contributions are part of a comparative static exercise that holds constant the influence of all other factors, and is therefore meant to be only illustrative.

## F. Conclusion

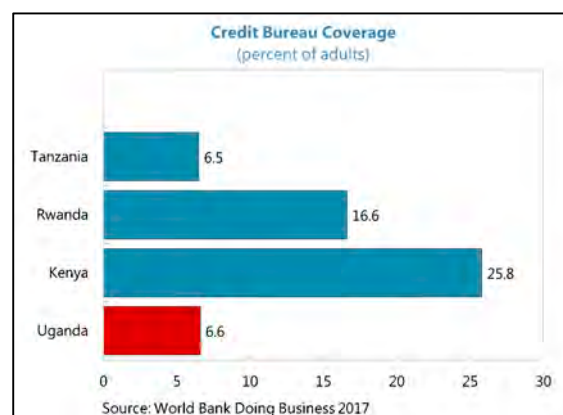
### 19. Raising the credit-to-GDP ratio will require addressing the root causes of high interest rate spreads and high cost of finance—the subject of forthcoming joint research with the Bank of Uganda.

Average lending rates have exceeded 20 percent since mid-2011 and were 23.1 percent at end-February 2017, while implicit deposit rates averaged 13 percent. Lending rates are high in both real and nominal terms, even by regional standards. According to the Economic Forum for Global Competitiveness Report (2016-17), Uganda ranks 120<sup>th</sup> out of 138 countries in terms of affordability of financial services. Moreover, household and enterprise surveys suggest that the high cost of finance and high collateral requirements serve as a binding constraint on credit growth.



### 20. Strengthening the credit infrastructure will help to reduce credit risk and enhance banks' willingness to lend.

Credit reporting systems could be enhanced by increasing the number of users and contributors and expanding credit profiles. In addition, creditor rights should be strengthened, including through reducing the cost of collateral recovery; and expanding collateral access through an enlargement of the collateral and land registries. Finally, the scope and coverage of credit bureaus should be expanded to include other nonbank credit-related transactions, and review collateral enforcement.



### 21. Credit growth will also be enhanced through financial innovations in mobile money and banking, agency banking, and micro-banking.

Notwithstanding the important contribution of mobile money to financial inclusion, it will be important to increase the contribution of both mobile money and banking to both savings mobilization and credit extension. In addition, the implementation of agency banking and growth of micro banking will help to extend financial access to rural areas. It would also be important to strengthen the regulatory framework to ensure that regulation of these industries keeps pace with financial innovation, and in this regard, the adoption of an appropriate mobile money policy would be helpful. Approval of the regulations for agency banking should also be fast-tracked.

**22. Liberalization of the insurance sector can help to increase the scope for long-term finance and capital market development can make a bigger contribution to financial development.** Passage of the Retirements Benefits Sector Liberalization Bill, currently before Parliament, could enhance the availability of long-term finance for lending to MSMEs by increasing the number of participants and insurance products. Uganda’s insurance penetration rate is among the lowest in the EAC, and is one of the factors causing the low financial institutions depth observed earlier. There is significant scope to boost financial development by introducing products that can help individuals and businesses to mitigate financial risks—such as the provision of insurance for farmers, which can help to contain the economic impact of drought. However, given the likely correlation of in-country risk, a viable pooling of risk may necessitate the adoption of regional and/or international insurance solutions. Finally, there is scope to broaden capital markets development through greater corporate bond issuance. In this regard, staff recommends further review of the newly launched Capital Markets Development Master Plan, with a view to formulating an appropriate strategy for addressing the challenges that have constrained Uganda’s capital market development. Such proposals include: enhanced sensitization to boost the public’s awareness of the potential benefits of capital market development; addressing high transaction costs; and improvements in the capital market infrastructure—by further strengthening the legal, regulatory and supervisory framework and improving the overarching policy framework for capital markets development.

Table 1. Uganda: Estimated Equations

Private Sector Credit to GDP Ratio and Private Sector Credit Gap					
	(1)	(2)	(3)	(4)	(5)
Dependent variable	PSC_GD P	PSC_GD P	PSC_GD P	PSC_GD P	PSC_GA P
<b>Economic Environment</b>					
US Fed. Funds. Rate	-1.487 *** 0.318	-1.419 *** 0.121	-1.408 *** 0.133	-0.866 *** 0.104	
GDP deflator	-0.157 *** 0.060	-0.088 *** 0.027	-0.055 ** 0.029	0.324 *** 0.118	
GDP growth (-1)					-0.247 *** 0.065
Inverse of GDP deflator (-1)					-0.054 0.077
<b>Financial stability</b>					
Int. spread (-1)	-0.348 *** 0.060		-0.657 *** 0.076	-1.053 *** 0.089	
Chng in Int. spread					0.179 * 0.089
NPL ratio (-1)	-0.219 *** 0.058			-0.152 *** 0.028	
NPL ratio					0.129 *** 0.064
<b>External flows</b>					
FDI/GDP (-1)		0.176 *** 0.048	0.140 *** 0.048	0.080 * 0.042	
TRADE/GDP (-1)		0.120 *** 0.016	0.090 *** 0.016	0.077 *** 0.018	0.059 *** 0.026
Remittances		0.251 ** 0.101	0.310 *** 0.105	0.324 ** 0.118	
<b>Policies</b>					
Gen. Gov. Balance/GDP					-0.284 *** 0.052
Gen. Gov. Balance/GDP (-3)		0.144 *** 0.057		0.016 0.055	
Gen. Gov. Balance/GDP (-4)			0.133 *** 0.060		
<b>Institutions and Infrastructure</b>					
ICRG composite index		10.813 * 6.349	13.699 ** 7.175	14.189 *** 5.772	26.949 *** 9.231
Fixed Tele. Subscriptions					##### *** 1.85E-08
Constant	51.275 *** 1.136	21.816 *** 3.694	28.992 *** 4.263	39.121 *** 3.668	-17.040 *** 5.604
Observations	1007	1481	1212		839
Adjusted R-squared	0.909	0.907	0.920	0.945	0.951
F-statistic	115.243 ***	132.224 ***	139.677 ***	177.273 ***	210.505 ***
Method: Panel Least Squares					
Sample (adjusted): 2000 2015					
Source: IMF Staff calculations.					
Standard errors underneath coefficients.					
*** p<0.01, ** p<0.05, * p<0.1					

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# ISSUES IN INTERNATIONAL TAXATION<sup>1</sup>

## A. Executive Summary

**1. The Uganda Ministry of Finance, Planning and Economic Development requested that the IMF Fiscal Affairs Department analyze issues in cross border corporate income taxation that may be contributing to the relatively low revenue performance of the Uganda corporate income tax.** Although Uganda's statutory corporate tax rate is the same as that of Kenya and Tanzania, for example, the percent of GDP raised by the tax is only about half of that in Tanzania, and less than a third of that in Kenya. Nearly 45 percent of corporate tax revenue in Uganda comes from fewer than thirty major corporations in the main economic sectors receiving the most foreign direct investment, other than mining and extractive industries<sup>2</sup>—and the great majority of those companies are subsidiaries of multi-national enterprises. Thus, the structure of the Ugandan economy lends itself to revenue loss through cross-border tax planning and avoidance techniques.

**2. The report focuses on three broad potential sources of corporate tax revenue leakage.** These include: (i) the widespread use of tax incentives and exemptions granted in an attempt to increase foreign direct investment; (ii) aspects of the domestic tax code (ITA) that can facilitate cross border tax planning; and (iii) tax avoidance using Uganda's network of double tax treaties (DTTs).

**3. Uganda—in common with most developing countries—faces strong pressures to grant tax incentives and exemptions to attract investment, which should be resisted.** These pressures arise from requests from potential investors, but are exacerbated by competition for investment among countries. Much evidence supports a view that such incentives are largely unnecessary—in that taxes are not among the most important factors in attracting foreign investment—and often are entirely redundant—that is, companies report that the investments would have been made without these tax incentives. Redundancy is particularly likely when the investment in question is made to produce for the local domestic market, or when the investment entails exploiting other location specific economic rents—as in the case of extractive industries, or telecommunications. And some types of investment tax incentives are more effective than others: tax holidays and reduced rates on ex post profits counterproductively reward most the most profitable (successful) firms, which likely need this benefit least, and do not incentivize actual new investments. Incentives for new investment are much better achieved by accelerated depreciation, and/or initial allowances that are specific to new investment. Uganda already has these latter, more effective, types of incentives in its basic tax system.

<sup>1</sup> This report was produced by Prepared by Victoria Perry, Li Liu and Stephen Shay.

<sup>2</sup> This report does not address issues specific to the extractives sector, as there has been much specialized technical assistance to the Ugandan authorities in that area.

#### 4. **Cross-border tax avoidance possibilities arise through several means, including interest stripping, payment of management and service fees, and abusive transfer pricing:**

- *The Ugandan ITA includes a “thin-capitalization” rule, restricting the deduction of interest payments where a company’s debt to equity ratio exceeds 1.5:1. The rule is seriously undermined, however, by a provision that provides that the restriction will not apply if the loans in question are on terms that would have been set between unrelated parties; and analysis in this report finds that for most large companies the ratio is not binding. The report recommends that Uganda replace or supplement this rule with a so-called “interest stripping rule,” which restricts the amount of interest payments that can be deducted relative to a before-tax, depreciation and interest measure of gross profits.*
- *Payment of management and service fees to parent companies—a common tax planning device—is reportedly a major source of tax base leakage in Uganda. The ITA appropriately provides that such fees are subject to withholding in Uganda. However, this rule is largely rendered ineffective by the fact that most of Uganda’s existing DTTs do not include a provision permitting this withholding. Uganda should try to include a withholding provision for such services in its existing treaties—when and if these can be renegotiated—and insist on its inclusion in any new treaties.*
- *Uganda has taken steps to reduce revenue loss through abusive transfer pricing, including by the introduction of rules based upon the OECD transfer pricing guidelines, the undertaking of training for staff of the URA, and the commencement of several complex transfer pricing cases. Going forward, Uganda should seek additional information to allow it to improve risk assessment for transfer pricing audits, through (i) requiring mandatory routine production of the documentation now available only on request; and (ii) ensuring that Uganda satisfies all the criteria (discussed in the report) which will allow it to obtain information newly required under the country-by-country reporting requirements of the BEPS project.*

**5. Uganda’s double taxation treaty network presents the opportunity for tax reduction by foreign investors.** While any DTT will—by design, though it is advisable to minimize this—lead to some reduction in a claim on the tax base by the source country, treaties are also frequently used in tax planning by multi-national corporations to achieve “double non-taxation.” This is done by routing investments into source countries through intermediate companies in treaty countries that permit no, or very low, taxation on the income of those intermediary companies. Best practice anti-abuse provisions in treaties can help to minimize—if not eliminate—this, and should be adopted by Uganda in all of its treaties to the extent possible. The Ugandan Cabinet has recently approved a model treaty and treaty policy, which largely represent modern best practice for source countries seeking to enter into DTTs. *It will be highly advisable for the Ugandan government to follow the model provisions in negotiating all new treaties.* To the extent that treaty partners can be induced to enter into re-negotiation of some treaty provisions, this too should be undertaken. Uganda will also want to consider whether to enter into the new Multi-lateral Instrument (MLI) to adjust the provisions of its existing treaties. Whether this will be helpful—and not all desirable changes are covered in the MLI—will depend upon the positions already taken in the MLI by all of Uganda’s separate treaty partners. This needs to be carefully assessed in each case.

**6. Finally, the report addresses an important issue that crosses over Uganda’s domestic tax law, and its DTTs: indirect transfers of interest in Ugandan assets that take place offshore.** Recent amendments to the ITA include provisions that would tax in Uganda capital gains arising on such transfers where the underlying assets constitute “immovable property,” including mineral and petroleum rights. However, these provisions are not effective where transfers take place in a treaty country—as Uganda’s treaties do not now include a provision that would permit Uganda to assert the right to tax this base. *Where possible, these provisions should be renegotiated, as any important such transfer would be structured through a country with such a treaty. Further, it would be advisable to extend in domestic law and in treaties the meaning of “immovable property,” to encompass other rights that give rise to economic rents based on a location in Uganda—for example, licenses and rights to domestic telecommunication assets.*

## B. Introduction

**1. The Uganda Ministry of Finance, Planning and Economic Development requested that the IMF Fiscal Affairs Department analyze issues in cross border corporate income taxation that may be contributing to the relatively poor performance of the corporate income tax.** At 13.3 percent of GDP in FY15/16,<sup>3</sup> Uganda’s overall tax revenue collection remains at the lower end of regional peers—albeit representing a considerable improvement from the 10.8 percent tax ratio in 2013/14—and the authorities remain committed to increasing the tax-to-GDP ratio by ½ percent of GDP per year over the medium term, an objective that is supported by the IMF policy support instrument (PSI) and technical assistance (TA). As of 2015, the performance of the corporate income tax was still low by regional standards, shown in Table 1.

**Table 1. Uganda: Regional Corporate Income Taxes (Uganda 2015)**

Country	Standard CIT Rate	CIT Revenue as Percentage of GDP	Efficiency Ratio
<b>Uganda</b>	<b>30</b>	<b>1.06%</b>	<b>0.04</b>
<i>Other EAC Countries:*</i>			
Burundi	30	2.40%	0.08
Kenya	30	3.68%	0.12
Rwanda	30	1.12%	0.04
Tanzania	30	2.01%	0.07

\*: Data refers to the latest year available. Efficiency ratio is defined as the CIT revenue ratio divided by the standard CIT Rate.

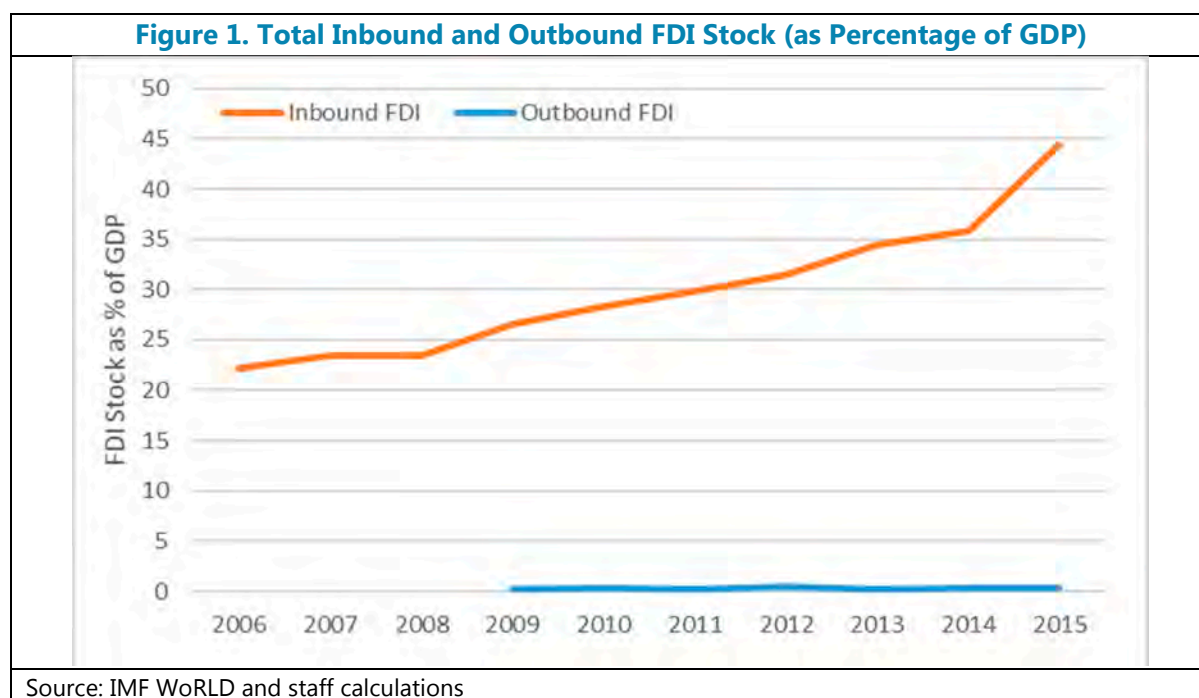
Source: IMF World and staff calculations

<sup>3</sup> Uganda’s overall tax-to-GDP ratio is estimated to be 14 percent of GDP in FY 16/17 using GDP projected in the main IMF staff report.

**2. The analysis in this report points to three broad areas that potentially contribute to this deficiency: widespread use of tax incentives/exemptions for many sectors and firms; tax base leakage through tax planning using various cross-border income stripping techniques by multi-national enterprises (MNEs); and weaknesses in the Uganda double tax treaty (DTT) network.**

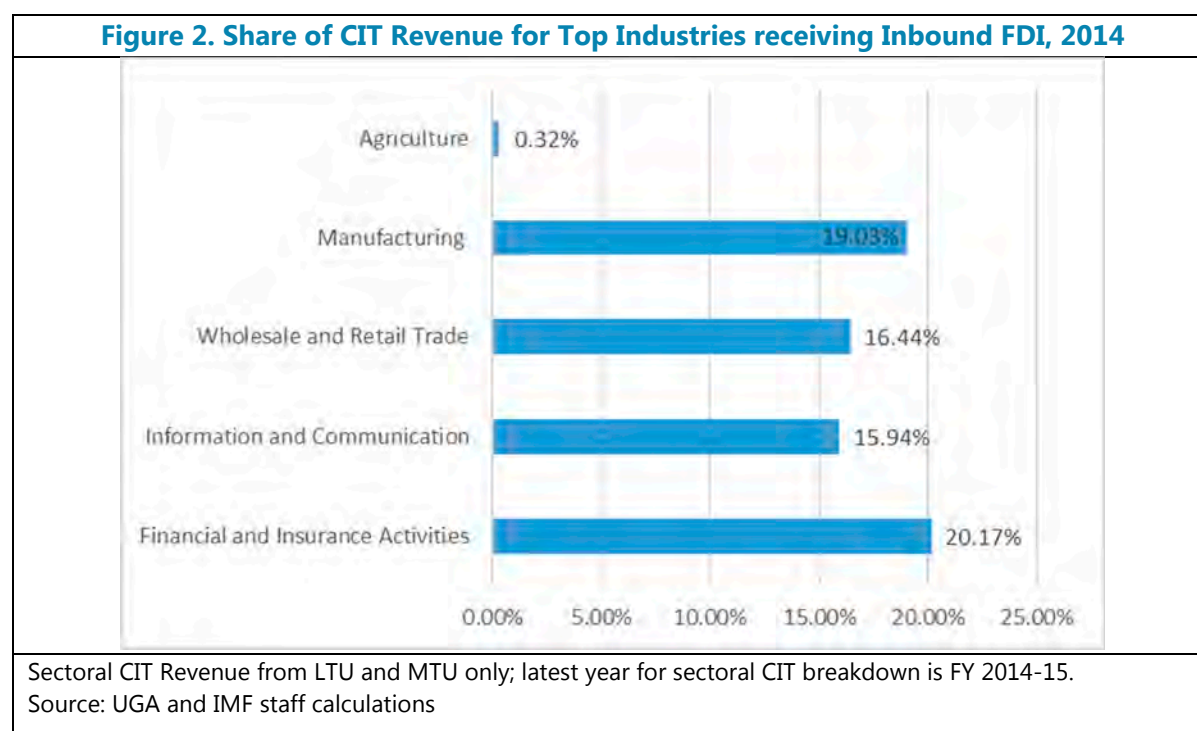
The URA recently estimated revenue foregone through certain tax expenditures—a positive step—but has thus far been unable to estimate the amount of revenue being lost as a result of cross border international tax planning. Given the limitations on data and time, it is also not possible for the mission team to estimate with reasonable accuracy the potential tax losses arising from tax avoidance through weaknesses in the provisions of the Income Tax Act (ITA), or through the use and abuse of tax treaties. However, the structure of investment and sources of tax revenue make clear that ample opportunity for cross border tax planning exists.

**3. Uganda remains a “source” country for international tax purposes.** Data provided from the URA with regard to the activities of large taxpayers across the major foreign direct investment (FDI) receiving sectors of the economy indicate that the vast majority of the largest taxpayers in those sectors (finance, agriculture, manufacturing, information and telecommunications, and wholesale and retail trade) are subsidiaries of MNEs—thus giving rise to considerable opportunity for cross border tax planning. And the stock of inbound FDI as a percentage of GDP has increased markedly over the past 10 years, as shown in Figure 1, indicating that Uganda’s economy is becoming more open to cross border capital flows.<sup>4</sup> Uganda still has very little outbound FDI. Uganda is not unique among EAC countries as being a large net capital importer. For example, Kenya has also attracted increasing net FDI in recent years, and the growth in its total inbound FDI stock is still outpacing that of its outbound FDI.



<sup>4</sup> Table 5 further provides a breakdown of inbound FDI stocks by source country during 2012-2015.

4. Nearly three-fourths of CIT revenue is derived from the five sectors that are the largest recipients of FDI,<sup>5</sup> as shown in Figure 2.

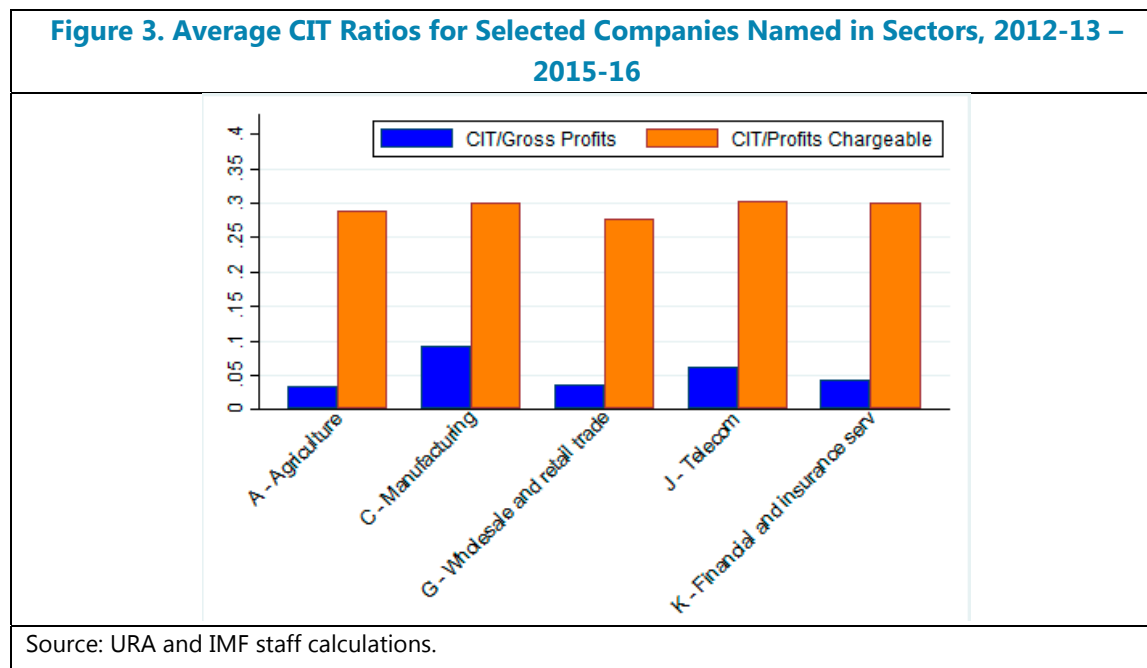


The average tax rate relative to gross profits (ATR) for the largest companies in these five principal economic sectors (29 unique companies, 89 separate observations) was less than 10 percent during FY 2012/13 – 2015/16.<sup>6</sup> Figure 3 summarizes the ATR as a percentage of gross profits for this group of companies by industry (left blue bar). The ATR ranged from 3.4 percent in Agriculture to 9.1 percent in Manufacturing during the sample period.<sup>7</sup>

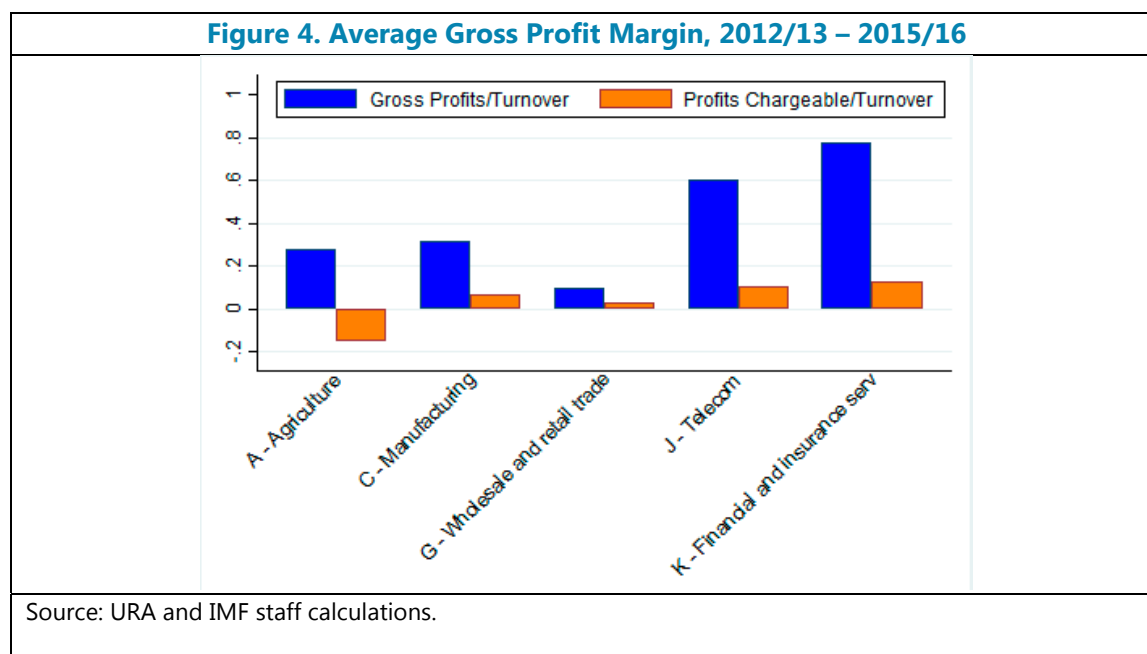
<sup>5</sup> Other than Mining and Construction; this report does not address specifically issues relating to fiscal regimes for natural resources, which have been extensively addressed by specialized IMF missions.

<sup>6</sup> The analysis is based on anonymized detailed CIT tax records for a selected sample that include the largest 29 companies based on annual turnover in five key economic sectors in Uganda, including Agriculture, Forestry, Fishing; Manufacturing; Wholesale and Retail Trade; Information and Communication; and Financial and Insurance Services between financial years 2012-13 and 2015-16. Total CIT contribution from these companies accounted for approximately 45 percent of total CIT revenue in Uganda in 2014-15.

<sup>7</sup> The average ATR was substantially lower than the average corporate tax paid as a percentage of pre-tax chargeable profits (right orange bar), which is very close to the statutory tax rate of 30 percent; the issue is the reduction in chargeable profits.



As shown another way in Figure 4, there is a considerable gap between the gross and chargeable profits in all five of these key economic sectors in Uganda. While it is to be expected that gross profit would exceed taxable income, given normal deductible expenses, variations and such large differences can also reflect earnings stripping through tax avoidance. Wholesale and retail trade and agriculture exhibit lower gross profit margins compared to other industries. Other industries in the data reviewed also demonstrate on an aggregate basis a considerable gap between their average gross profit and the taxable profit.



**5. The Uganda authorities are well aware of the potential tax leakage that can result from cross border activity, and have taken several positive steps to try to combat this.** Major improvements in this regard in the last few years include introduction of more detailed transfer pricing rules (and on the administrative side, the bringing of several major transfer pricing cases); the very recent adoption by cabinet of a new model DTT for Uganda, along with treaty policy guidance for government; and the adoption of new provisions governing the taxation of mineral and petroleum extraction.

**6. This report identifies several areas where the law could be further tightened to better protect Uganda’s tax base from cross border base erosion and profit shifting.** These include interest stripping provisions, tighter protections against excessive revenue loss from nonresident management and service fee charges, provisions to protect against transfers of interest in Ugandan assets without the payment of tax to Uganda, and ways to reduce inappropriate treaty reliefs and treaty abuse.

**7. Given the current broad tax exemptions and holidays, and the low effective tax rates on inbound foreign investment even aside from these holidays, it would be unwise to consider reducing the statutory corporate tax rate at this time.** The 30 percent statutory rate is in line with that of all neighboring EAC countries. Reducing it under these circumstances would result in a windfall to existing investment, both domestic and foreign, giving up much needed tax revenue for little or no spur to economic growth. Further, such a move would likely give rise to yet more damaging regional tax competition, at a time when tax revenue is sorely needed for investment in human capital and infrastructure.

### C. Tax Incentives and Exemptions

**8. The Ugandan Government faces a tradeoff between increasing the ratio of tax revenues to GDP and giving tax exemptions and incentives to potential investors in an attempt to create economic growth and, especially, to create new jobs.** Pressure to award such tax exemptions seems, if anything, to be growing—yet based upon the government’s own estimates, the revenue cost of such incentives across all taxes and types constitutes 8-10 percent of tax revenue. Uganda’s tax ratio now stands at just over 13 percent, still below the regional average of 14 percent and clearly insufficient to meet the country’s needs for investment in human capital and physical infrastructure. Recent Fiscal Affairs Department analytic work finds that revenue ratios of less than about 15 percent of GDP are adversely correlated with economic growth<sup>8</sup>.

**9. Uganda is not alone in facing these pressures.** While all countries face them to some degree, they are particularly acute in developing countries. They generally seek to attract foreign investment to contribute (it is hoped) to economic growth—and they tend to suffer from a

<sup>8</sup> International Monetary Fund, 2016, “Tax Capacity and Growth: Is there a Tipping Point? Working Paper”, November (Washington).



perceived lack of bargaining power relative to the MNEs by whom they are implored to grant exemptions. The problem is sufficiently widespread that the IMF, together with the World Bank, OECD and UN, were asked by the G20 to write a report on how such tax incentives could be made more “efficient and effective” (and less damaging to the revenue base) in lower income countries.<sup>9</sup>

**10. Several lessons can be drawn from this report, and from the sources on which it in turn draws.** These concern (i) what type of incentives are more effective and less damaging to the revenue base; (ii) how much are the tax benefits really needed in order to obtain investment in any given case; (iii) the need to measure the benefits hoped for, in a coherent way—and to assure that they will actually be produced; and (iv) the potential benefits of regional coordination.

***Are tax incentives really needed?***

**11. Considerable evidence from surveys of MNEs themselves, including for Uganda, make clear that—whatever may be said in any specific instance—taxes are not generally a decisive factor in deciding whether to invest in a given location.** As cited in the report referred to above: *“In 2010, the United Nations Industrial Development Organization conducted a business survey of 7,000 companies in 19 sub-Saharan African countries active in agriculture, mining, manufacturing, utilities, construction, and services sectors. Investors were asked to rank the importance of twelve location factors and to assess how they might have changed, improved and worsened, in the last three years. The results suggest that tax incentives packages ranked 11th out of 12 in importance.”*

**12. Tax incentives are often found to be redundant in attracting investment in developing countries; that is, the same investments would have been undertaken even if no incentives had been provided.** Table 2 (drawn from the cited report) shows redundancy ratios, based on investor surveys in various countries, measured by the percentage of investors who claim that they would have invested even without tax incentives. Redundancy levels thus obtained—subject to well-known caveats, such as a discrepancy between answers and actual behaviors under a counterfactual scenario—are high in most countries. For example, redundancy rates exceed 70 percent in 10 out of the 14 surveys listed in Table 2. The redundancy ratio for Uganda was found in this particular study to be 93 percent.

**13. The ability of MNEs to avoid source country taxation may blunt the impact of tax incentives.** Thus the base protection measures discussed in the other sections of this report cannot be fully divorced from the issue of the granting of exemptions and incentives. As discussed later in this report, foreign-controlled groups have structural tax advantages in most CIT systems, even before considering avoidance opportunities, and Uganda’s is no exception. A MNE that can readily reduce Uganda taxes (by, for instance, using related party interest deductions to shift profits to a low tax jurisdiction) is in little need of additional benefit from corporate tax incentives such as holidays and exemptions.

<sup>9</sup> See “Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment,” REPORT PREPARED FOR THE G-20 DEVELOPMENT WORKING GROUP BY THE IMF, OECD, UN AND WORLD BANK, October, 2015. <http://www.imf.org/external/np/g20/pdf/101515.pdf>

**Table 2. Uganda: Redundancy of Tax Incentives Based on Investor Surveys 1/**

Burundi (2011)	77	Rwanda (2011)	98
El Salvador (2013)	37	Serbia (2009)	71
Guinea (2012)	92	Tanzania (2011)	91
Jordan (2009)	70	Tunisia (2012)	58
Kenya (2012)	61	Uganda (2011)	93
Nicaragua (2009)	15 or 51 /2	Vietnam (2004)	85
Mozambique (2009)	78	Thailand (1999)	81

1/ Percent of affirmative answers to the question if an incentive was redundant;

2/ 51 percent for non-exporting firms outside free zones

### ***Types of incentives***

**14. Many low-income countries—like Uganda—use costly tax holidays and income tax exemptions to attract investment, but investment tax credits and accelerated depreciation yield more investment per dollar spent.** Uganda already has—appropriately—generous initial allowances and favorable depreciation schedules—as well as unlimited income tax loss carryforwards. These factors reward new investment. Tax holidays and exemptions provide the greatest benefit to the most profitable enterprises—which need them the least. Further, their benefit is derived only after the investment begins to make positive taxable returns. The holiday incentives are much less well targeted to attract actual new investment at the margin.

**15. Tax incentives targeted at sectors producing for domestic markets or extractive industries generally have little impact.** If companies' goals are to produce for the Uganda market, or to extract Uganda natural resources, those markets and resources include location specific rents that themselves are a key attraction for the investors to come to Uganda.

***The real social benefits to be derived from, and the costs of, the incentives should be carefully measured***

**16. A tax incentive serves a useful social purpose if the social benefits it actually generates exceed the associated social costs.** Investment tax incentives ultimately aim to contribute to a country's development and improved living conditions for its citizens. A number of elements are critical to determining the social benefits of an incentive. These include: (i) *size of the net investment effect*—the rise in investment should be corrected for the redundancy effects mentioned above, and displacement effects—the reduction in any other investments—to infer the net incremental increase in capital due to the incentive; (ii) *net impact of higher investment on jobs and wages*—new jobs can yield significant social gains if they reduce unemployment. However, if new jobs displace existing jobs, the social benefits depend on the productivity (and wage) differential between the new and old jobs; (iii) *productivity spillovers*—to the extent that new investment boosts productivity elsewhere in

the domestic economy, such as in supplying or competing firms this magnifies social benefits by raising income levels more widely.

**17. The social costs of tax incentives depend on various factors, and must be offset against the benefits as measured above.** These include: (i) *net public revenue losses*—public revenue falls if tax incentives are redundant or create leakage and abuse. Taxes generated by additional *net* investment and jobs can be offset against this; (ii) *administrative and compliance costs*, which can rise due to tax incentives, especially if they are complex or create opportunities for rent seeking and corruption; (iii) *scarcity of public funds*. Often overlooked is the fact that \$1 of tax revenue has a higher social value than \$1 of private income, because it is the greater value of the public expenditure it finances that justifies transferring resources from private to public sectors through taxes. To compare changes in private income and tax revenue, the latter thus need to be weighted by the “marginal cost of public funds”, which will be greater than one; (iv) *distorted resource allocation*. Discrimination in favor of some and against other investment implies that taxes, rather than productivity differences, determine resource allocation.

#### ***Tax competition and regional cooperation***

**18. Demands for tax exemptions and incentives by potential investors lead to harmful tax competition among the countries targeted, particularly within regions.** This “race to the bottom” has become more acute in sub-Saharan Africa over the past few decades. Uganda, like many other countries, understandably feels pressure to match the tax incentives granted by neighbors Kenya and Tanzania. Where the investments in question are mobile—such as investments in manufacturing facilities for export, as opposed to the extraction of local minerals, or production for the domestic market—this competition is particularly intense. The best approach to minimize this loss of revenue is to achieve a degree of harmonization and coordination among relevant neighboring countries in regard to the grant of these tax benefits. The EAC provides a vehicle for this coordination, which it would be advisable to further utilize.

**19. Tax treaties should not be used as a form of tax incentive.** This is discussed further in section IV of the report, below.

## **D. Three Sources of Tax Base Leakage**

### **Structural Tax Advantages for Foreign-Controlled Businesses**

**20. It is challenging for every country to tax foreign-controlled groups or nonresident companies carrying on business within their borders.** It is generally the case that some value is contributed to the local business of an MNE group from outside as well as inside the country. Capturing the appropriate share of the total value for the source country requires well-tuned cross-border tax rules. Further, as MNEs continuously find new innovative ways of reducing their tax burden, anti-avoidance rules are in constant need of being monitored and strengthened.

**21. Statutory-based structural advantages exist for foreign controlled groups.** There are clear tax advantages for MNEs to making deductible payments, including interest, royalties, and management fees, to low-taxed nonresident affiliates. This reduces the Ugandan tax base by benefitting from the deduction at a 30 percent rate, while (in the absence of even lower reduced treaty rates) paying tax to Uganda on the transfer at 15 percent withholding. This advantage for foreign-controlled business constitutes an integral part of the current international tax architecture, and is found in almost every country's tax system. Thus, it would not be recommended to change this (other than to control abusive earnings stripping, as discussed below). However, this structure provides natural tax advantages to MNEs as compared to purely domestic enterprises, and serves to highlight the potential redundancy of providing additional tax exemptions and incentives to FDI. In an otherwise well designed tax system with fair recovery of expenses allowed to businesses, tax incentives to attract foreign investment *generally are unnecessary and inappropriate*.

**22. Countering structural advantages of foreign-controlled groups.** These structural tax advantages of foreign-controlled groups in avoiding source (host) country taxation may be mitigated in part only if the foreign-controlled business's income is fully taxed, within the parameters of this architecture, by the source country, including by *taxing capital gains on the exit from the business*. They also are a reason why it is important to include in the law robust measures to prevent abuse of intercompany deductible payments for interest and management and service fees and to tax indirect offshore transfers of businesses realizing their value from economic activity in the source country. These issues are discussed in succeeding parts of this report.

### **Interest stripping and thin capitalization**

**23. The ITA includes an anti-avoidance rule designed to prevent reduction of the tax base through artificially inflating interest deductions.** The present restriction is in the form of a "thin-capitalization" rule (ITA Section 89, as amended in 2015), which restricts interest deductibility based upon the ratio of debt to equity in a foreign controlled company's capitalization. To the extent that the Ugandan subsidiary has a debt to equity ratio of more than 1.5:1, interest payable with respect to the excess is disallowed as a deduction. The exact form of this rule has varied over the past several years. The allowable ratio has gone from 1:1, to 2:1, and now to 1.5:1—along with changes in the definition of what debt and equity are involved in calculating the ratios.

**24. A positive aspect of the current rule is that, in the case of corporations to which it applies (those which are owned more than 50 percent by a non-resident person), the ratio is to be calculated with regard to all debt and equity, not restricted to related party debt.** While it is common to apply such rules only to related party borrowing, the current Ugandan approach is much preferable, and represents a more modern view. Such rules targeting all debt are more effective in restricting excessive corporate borrowing; from an administrative standpoint, anti-abuse rules restricted to related party borrowing are easier to avoid through use of related party guarantees of third party debt and back-to-back loan arrangements. Further, the approach of

targeting all debt also focuses more generally on the risks for macroeconomic stability that excessive real leverage can cause, regardless of the source of the loans.<sup>10</sup>

**25. An important problem with Uganda’s rule as presently drafted, however, is that it includes an exception for “arm’s length debt” which can easily undercut the protection afforded by the anti-abuse rule.** Section 89(2) provides that the 1.5:1 ratio will not be binding if the debt ratio of the company does not exceed the “arm’s length debt” amount—defined as the amount of debt that an unrelated financial institution would be willing to lend to the Ugandan subsidiary. *This exemption should be removed.* It will be very difficult for the URA to prove that an unrelated party would have lent any specific amount to such an MNE subsidiary—it simply provides a way for the parent MNE group to avoid the binding rule.

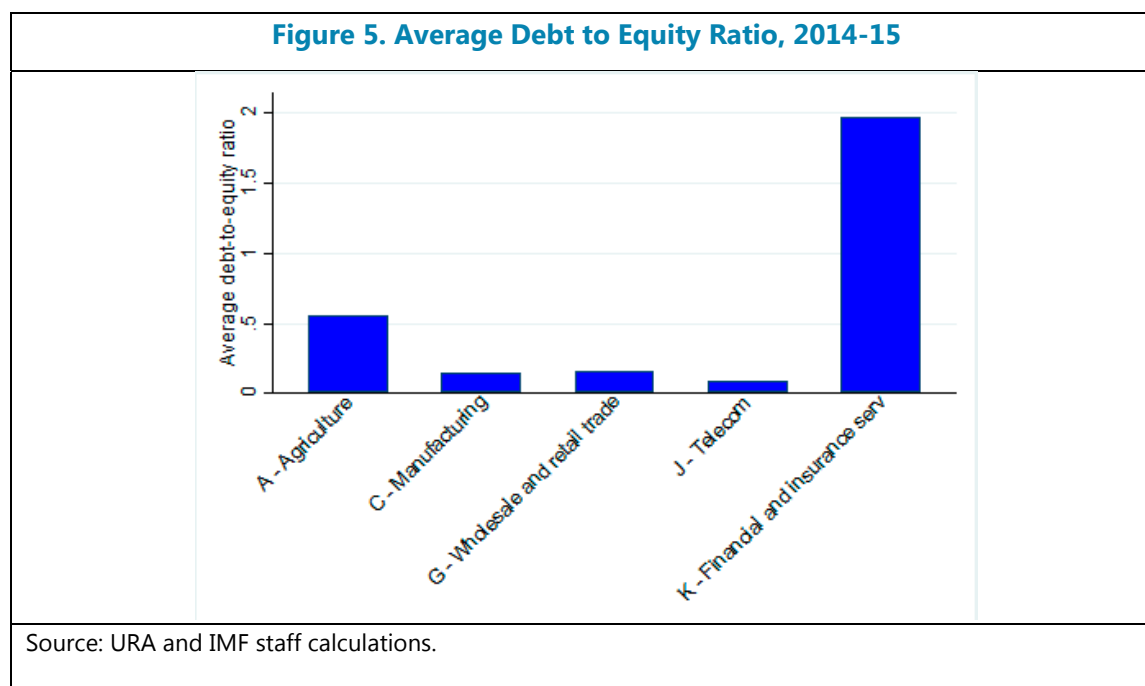
**26. Uganda’s provision against profit shifting by means of abusive interest deductions should be augmented (or replaced) by adopting an “earnings stripping” rule.** This is the more modern approach—utilized for example by Germany, and recommended under the G20/OECD base erosion and profit shifting (BEPS) Action 4. This approach implements a “fixed ratio” rule that, regardless of the debt to equity ratio, limits net interest deductions claimed by a corporation to a fixed percentage of earnings before interest, taxes and depreciation (EBITDA).<sup>11</sup> Interest deductions so restricted are allowed to be carried forward. The ratio is normally set at around 30 percent of applicable EBITDA, although recommendations for such a rule, including in the BEPS Action 4, propose a range of possible ratios from 10-30 percent. This type of rule avoids problems such as the need to define what constitutes debt (in a world with complex hybrid financing instruments), and serves as a backup in combatting the charging of an excessively high interest rate on related party debt. Thin capitalization rules such as that in Section 89 are subject to both those problems.

**27. A very rough analysis of the possible effect of adopting such an “EBITDA” interest-stripping rule indicates that it could be more effective at restricting profit shifting than the existing 1.5:1 thin capitalization ratio, as well as better addressing the problems referred to just above.** Table 3 and Figure 5 below compare the revenue impact of these two rules for the major MNE subsidiaries for which data was available, by sector. As shown in the figure, under the existing thin capitalization ratio test of 1.5:1 debt to equity, no company in this data set other than in the financial sector reaches the restrictive debt ratio. It is important to note that the structure of the financial sector – based upon borrowing and lending in various forms – naturally involves high debt ratios. For this reason, financial institutions are normally not subject to the same debt/equity/earnings stripping rules as non-financial enterprises. But even in the largest companies in the four non-financial sectors examined here, some would fall within the restriction of an earnings

<sup>10</sup> International Monetary Fund, 2016, “Tax Policy, Leverage and Macroeconomic Stability, Policy Paper”, December (Washington).

<sup>11</sup> EBITDA is a cash flow measure that is viewed as representing a reasonable commercial measure of an enterprise’s ability to borrow money and service debt. To this end, earnings stripping rules’ reliance on allowing interest deductions up to a fixed ratio of EBITDA creates link between allowable interest deduction and economic activity generated by the firm.

stripping rule measuring deductible interest against EBITDA. This of course varies depending on the level chosen—10 to 30 percent—as shown in the Table 3.



**Table 3. Uganda: Estimated Revenue Impact of the EBITDA Rule, 2014-15**

With Interest Expense Ratio Above:	Share of Companies	Share of Interest Expenses	Estimated CIT Revenue Gain (as % of Tax Revenue)
(1)	(2)	(3)	(4)
<b>Excluding Banks:</b>			
10%	47%	39.00%	0.22%
20%	27%	17.84%	0.10%
30%	20%	10.25%	0.05%

Source: URA and IMF staff calculations.

**28. As shown in Table 3, using a limit on interest deductibility of 20 percent of EBITDA, and not including financial sector companies in this limit, about one-quarter of the companies in the test data would be subject to restriction on interest deduction, resulting in the disallowance of about 18 percent of their deducted interest, for an increase in tax revenue from these companies alone of about 0.1 percent of overall tax revenues. This should not be taken as exactly correct, or as extendable in a linear way to all companies. It is just a very rough example of the potential impact of such a change on a single small sample of companies for a single year.**

### Service and management fees

**29. It is common for multi-national groups to centralize charges for management overhead costs and general service fees (commonly through a centralized services company in a favorable tax jurisdiction) to charge out to members of the group.** This practice raises numerous issues, including classification of the charges (as services, royalties or embedded in cost of goods), transfer pricing (including whether the charges sufficiently benefit the associated Ugandan company that they would be paid by an independent enterprise and, if there is a mark-up on the charge, whether the mark-up is appropriate), and whether the payment is eligible for relief from withholding tax by treaty. The income will be subject to a 15 percent withholding tax in Uganda.<sup>12</sup> Where the fees are so subject to withholding, the result is (as in the case of interest payments) lowering the Uganda effective tax rate—since these fees are deductible at 30 percent. The same effect can be achieved with charges for royalties. And these benefits can be further increased through use of treaties and transfer pricing.

**30. Excessive relief for management fees under existing DTTs.** The withholding tax called for under Uganda’s statutory law is easily avoided by routing management and service fee charges through treaty jurisdictions. A number of treaties allow Uganda to impose withholding tax on technical services only if they are provided to a person in Uganda for a period or periods of 6 months or more in a 12 month period (or 183 days in a period of 365 days).<sup>13</sup> If that provision does not apply, or if the treaty does not include such a provision, then services generally would be classified as business profits and would not be permitted to be taxed by Uganda if the service provider does not have a permanent establishment in Uganda. As a practical matter, this means that very few services provided from outside of Uganda will be taxed at all, which advantages non-local services over local services.<sup>14</sup>

**31. Adoption of Uganda Model DTT technical services article.** Uganda should seek to amend *all* of its existing treaties to add the technical services article set out in the model treaty approved by Cabinet. (Such an article will be added to the UN Model DTT in the near future).

## Transfer pricing

**32. There is broad scope for engaging in abusive transfer pricing.** Transfer pricing refers to the prices that are charged for transfers of goods, services, property or other items of value in transactions between associates. The term “associates” is defined broadly in ITA Section 3 to reach a range of related persons that can include persons within a family, corporations or businesses that

<sup>12</sup> This is the case unless the management fees and constitute Uganda source income for the recipient carrying on business in Uganda through a permanent establishment.

<sup>13</sup> See e.g., Convention Between the Republic of Mauritius and the Republic of Uganda for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income (“Uganda–Mauritius Treaty”) Art. 13. Uganda’s existing treaties, other than those with The Netherlands and Zambia (and the signed treaty with China) have provisions with effects similar to the Mauritius treaty.

<sup>14</sup> A recent change to the Ugandan VAT law attempts to generally advantage local services by imposing reverse charged VAT on imported services but not allowing businesses to take a VAT credit for that tax. This would offset the income tax advantage described here. However, it is an extremely blunt instrument to achieve local content requirements and distorts the operation of the VAT.

have a common owner(s), and also includes unrelated persons where one person can direct the action of another person in the context of the transaction in question. The term used in the Ugandan transfer pricing regulations for transactions among associates that are subject to transfer pricing rules is “controlled transactions.”

**33. The revenue risk from transfer pricing is high.** Transfer pricing can occur even in the context of transactions occurring solely within one country, where the parties to the transaction will be taxed differently. For example, this can happen where one company is subject to full income tax and the associated company enjoys a tax exemption. Where more than one country is involved transfer pricing is particularly important. In even the simplest two-country case it is likely that there are disparities in tax rates, and hence opportunities to derive advantage from abusive transfer pricing. And increasingly *transactions and ownership of operations are structured through intermediary legal entities that do not bear a meaningful corporate tax* because they are located in countries that either do not tax income or that facilitate very low effective tax rates on the income. These countries include a number of Uganda’s important trading and treaty partners, such as The Netherlands and Mauritius as well as prospective treaty (and trading) partners such as the United Arab Emirates (UAE) and Qatar. The benefit from income-shifting in these cases goes almost exclusively to the taxpayer while the revenue loss is suffered by Uganda. Moreover, local Ugandan businesses suffer the economic disadvantage relative to MNE subsidiaries of being unable to take the same advantage of income shifting to a lower tax jurisdiction.

**34. The arm’s length standard is the measuring principle for determining whether a controlled transaction gives rise to inappropriate income shifting.** Under the Ugandan transfer pricing regulations, the arm’s length standard is satisfied when the results of a controlled transaction are consistent with the results that would have been realized in a transaction between independent persons dealing under the same conditions. This is the internationally accepted standard.

**35. URA has made progress in enforcing arm’s length transfer pricing.** Transfer pricing compliance improves when rules are reasonably clear, incentives for aggressive transfer pricing are reduced, and enforcement is focused, tough and fair. Uganda has taken important steps in promulgating transfer pricing regulations and in putting resources into a large taxpayer office and advanced transfer pricing training for personnel. Moreover, the URA’s large taxpayer office is now pursuing transfer pricing cases through complex audits. The payoff from these steps is already starting to emerge in terms of staff understanding and capacity, and should bring in increasing revenues.

**36. Continuing the progress made.** Important elements of a robust transfer pricing enforcement strategy include obtaining relevant information and engaging in rigorous risk evaluation to target cases with a high enough payoff to justify the resource-intensive effort to support a transfer pricing adjustment. An initial starting point is to develop metrics for evaluating information currently reported on tax returns of Ugandan associates to identify transfer pricing risks.



**37. Information and documentation.** It is important to identify substantial controlled transactions and to obtain all the information relating to a controlled transaction, including information regarding the income from the transaction that is realized in the rest of the group. This is a key element in being able to fully evaluate transfer pricing risk. The transfer pricing documentation that has been required under the transfer pricing regulations' practice note is fulsome and complete, but is only provided to URA on request. The penalties added to ITA for failure to provide this information are an important addition to the law. Sufficient information should be required to be provided with the tax return with respect to material controlled transactions to allow URA to screen for transfer pricing risk and thereby make more efficient use of its resources. In addition, the URA should be authorized to require the taxpayer to provide "see-through" profit information, and test the price in the controlled transaction against the reasonableness of the resulting profit split among relevant associates in relation to the actual activity carried on by those associates. Identification should be made easier by adoption of country-by-country (CbC) reporting called for by the OECD's BEPS project.

**38. The advent of multilateral CbC reporting is a signally important international tax development and Uganda should take full advantage of it.** Under the G20/OECD BEPS Action 13, a MNE with substantial revenues (generally consolidated group revenue in excess of EUR 750 million annually for a prior year) would be required to engage in the three-tier CbC reporting. This means that it would have to make and maintain a Master file, a local file and a country-by-country report which would be exchanged by its home jurisdiction tax authorities with those of the jurisdictions where the multi-national group has activities—though, importantly only if such jurisdictions meet standards required to maintain confidentiality. Countries that require such reports by multi-national subsidiaries under their local law, that enter into appropriate information exchange agreements (described below), and which meet those standards are eligible to exchange and receive CbC reports.

**39. The potential of CbC reporting for Uganda is considerable.** A significant number of the MNEs that have investments in Uganda (including for example major MNEs such as AB Inbev, Barclays, Bhata Airtel, British American Tobacco, Diageo, Ericsson, Heinekens, LaFargeHolcim, MTN, Sabco, Standard Chartered Bank, Total)<sup>15</sup> likely will be required by their home country or by a country in which they have a substantial operation to participate in CbC reporting. Moreover, a brief review of the current list of CbC information exchange relationships on the OECD website (<http://www.oecd.org/tax/beps/country-by-country-exchange-relationships.htm>) shows, for example, that both The Netherlands and Mauritius are engaging in CbC reporting exchanges. Accordingly, it is recommended that:

- a. MOF pursue adoption of legislation that would require a Uganda reporting entity of an MNE Group to annually file a CbC Report; and

<sup>15</sup> The structure of foreign investment in Uganda is readily available through publicly reported sources, including by using Orbis.

- b. URA continue its progress in taking steps to be able to execute the Multilateral Competent Authority Agreement on the Exchange of Country-By-Country Reports (CbC MCAA, found at <http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/cbc-mcaa.pdf>) that will authorize such exchanges.

## E. Source Rules

**40. The source rules in section 79 of the ITA should be reviewed and modernized.** The source rules were drafted over 20 years ago and have not fully kept pace with modern cross-border trade and investment. The Ministry has this on the agenda, but is waiting for pending legal cases to be resolved before changing the rules. The revenue implication of these rules may be quite large.

**41. Services income is an example of problems with the existing rules.** There are four possible bases under Section 79 upon which services income may be characterized as Ugandan-source income: (i) the income is derived from services rendered in Uganda (Section 79(c)); (ii) the services are rendered under a contract with the Government of Uganda (Section 79(d)); (iii) Uganda is permitted to tax the income under a tax treaty (Section 79(r)); and the income is attributable to “any other activity” occurring in Uganda, including an activity conducted through a Ugandan branch (Section 79(s)). As noted in prior advice,<sup>16</sup> countries are increasingly aligning the source rule for services income with that applicable to royalties; looking to the place of utilization rather than the place of performance (see Sections 79(j)(i) and (ii)). Thus, services income should have a Uganda source when paid by: (i) a Ugandan resident (other than as an expense of a business carried outside Uganda through a branch); or (ii) a non-resident as an expenditure of a Ugandan branch. This also would align the statutory source rule under the ITA with the taxing right under the technical service article in Uganda’s model tax treaty (Art. 13(5)). The source rule should apply regardless of whether the service fee is paid directly to the non-resident service provider, or through a recharge arrangement with a related nonresident company.

**42. Source rules that look to the place of contract are also subject to manipulation and should be reviewed.** The rule for sourcing income from sales of goods purchased by the seller under ITA section 79(a)(ii) looks to where the agreement of sale was made. This kind of rule is readily manipulated and should be reconsidered, in order to associate the sale with where the selling activity is carried on, rather than where the contract is executed.

## F. Uganda’s Tax Treaties

### Introduction

**43. Double tax treaties (DTTs) are concluded to eliminate double taxation and—to a lesser extent—to protect against the avoidance of taxation.** Double taxation arises if both

<sup>16</sup> See *Uganda Fiscal Regimes for Extractive Industries: Next Phase* (Technical Assistance Report, IMF Fiscal Affairs Department), P. Daniel, L. Burns, D. Mesa Puyo, E. Sunley, June 2015

residence country and source country claim taxing rights over the same income. DTTs contain provisions that allocate income between the contracting countries, whereby the source country typically gives up (part of) its taxing rights in exchange, it is hoped, for more FDI, lower investment costs, better access to patents and knowledge-based capital with positive spillovers, or nontax benefits. In addition, a treaty should improve cooperation between taxing authorities in carrying out their functions, including by the exchange of information with a view to preventing or detecting avoidance or evasion of taxes.

**Table 4. Uganda: Withholding Tax Rates**

Residence Countries	Dividends		Interest	Royalties	Management Fees	Effective since:
	Individuals, Companies	Qualifying Companies				
Statutory withholding rates, Uganda ITA						
	15	15	15	15	15	
Reduced rates under treaties in effect:						
1 Belgium	15	5	10	10	10	2007
2 Denmark	15	10	10	10	10	2000
3 India	10	10	10	10	10	2004
4 Italy	15	15	15	10	10	2000
5 Mauritius	10	10	10	10	10	2003
6 Netherlands	15	0/5	10	10	NA	2004
7 Norway	15	10	10	10	10	1999
8 South Africa	15	10	10	10	10	1997
9 United Kingdom	15	15	15	15	15	1992
10 Zambia	0	0	0	0	NA	1968

Source: IBFD and Uganda ITA

**44. Risks of double taxation only exist where there is a significant level of existing or clearly intended cross-border trade and investment between two States.** In the circumstances of Uganda, which is only a source country in connection with all its current treaty partners, it is especially important to balance the revenue loss from reducing withholding tax rates and restricting source taxation of business income against evidence of concrete benefits that Uganda as the source country will receive in return. It is highly risky for a country to adopt a treaty in the hope of future investment that it is believed would not be made without the treaty, without engaging in a disciplined analysis to ensure with some confidence that this is true, and that, if so, the benefits outweigh the potential costs.

**45. In all countries, a government policy and process regarding choice of treaty partners should preserve a central decision-making and negotiating role for the Ministry of Finance.** Further, there should be a government policy addressing the factors described in the next paragraphs of this section of the report. Uganda has recently adopted guidance at the Cabinet level

regarding such a treaty policy, which very well addresses these issues. *Following that guidance consistently in negotiation and implementation of DTTs will serve Uganda well.*

**46. This section of the report addresses the following issues.** (i) Best practices in entering into treaties; (ii) the existing Uganda treaty network, including treaties that are in the process of adoption or negotiation, examining specific issues which expose the tax base to revenue loss or which should be modified to conform to current best practices including withholding tax rates, limitation of benefits provisions, source taxation of technical services, and offshore sales of interests in immovable property entities; (iii) issues raised by the EAC treaty; and (iv) opportunities and challenges presented by the opening for signature of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the Multilateral Legal Instrument, or “MLI”).

### **Importance of a Tax Treaty Policy**

#### ***Maintaining a transparent treaty policy***

**47. Uganda’s international tax policy is manifested in its tax law provisions (generally, the Income Tax Act (ITA)) governing taxation of non-residents (including international investors) on income derived from Uganda and of Ugandan residents on their foreign income.** Under ITA Section 88, a Ugandan DTT modifies domestic tax law. Accordingly, once entered into, Ugandan DTTs become an integral element of Uganda’s international tax policy. Negotiating DTTs effectively requires the development of a tax treaty policy that aligns DTTs with Uganda’s international tax policy; it is this that is now embodied in Uganda’s recent protocol providing guidance on negotiating DTTs, and the accompanying model DTT for Uganda that is discussed below. These have not yet been made public, and we recommend that at least the model DTT and a summary of the treaty policy be made public. A country should not negotiate a DTT in isolation from other DTTs; each treaty negotiation should be understood as part of a country’s overall tax treaty program.

**48. The new Uganda DTT model is based on the UN Model.** That model is now being amended to take account of recent changes in best practice, including modifications recommended in the G20/OECD Base Erosion and Profit Shifting (BEPS) project, and provisions embodied in the text of the MLI discussed further below. This report includes comments on the Ugandan model treaty below, including the recommendation of updates to keep it in line with this current best practice.

#### ***Using cost-benefit analysis to assess the need for a treaty***

**49. Recent thinking about treaties in developing countries has begun to focus on the inefficiency of bilateral treaties generally.** These are time consuming to negotiate, they absorb resources to administer (including processes for refunding treaty-based reclaims of withholding taxes), they tend to be based on one-sided investment flows—as in Uganda’s case—and therefore result in revenue loss. Treaties are hard to terminate as a diplomatic matter, even when the formal

termination provisions only require a customary six-month notice. Treaties also are hard to change and can stifle tax law reform in the international context. A statutory reform affecting cross-border business can be effectively negated by a provision in a single treaty. The inflexibility of treaties once adopted is particularly significant currently as the OECD and UN have proposed the most significant changes in international tax rules in decades and changes may be expected to continue in coming years.

**50. A dramatic expansion of Uganda’s tax treaty program may not be the highest and best use of government (especially Ministry of Finance and URA) resources.** Policymakers should consider whether it is possible to achieve the same objectives as a DTT through a mix of (i) unilateral measures in the Uganda laws governing taxation, (ii) agreements governing specific investments or concessions,<sup>17</sup> (iii) bilateral or multilateral tax information exchange agreements (TIEAs), and (iv) bilateral or multilateral investment protection agreements, including sector specific instruments such as shipping and aircraft agreements.

**51. The decision to enter into each specific DTT should be based on an overall cost benefit analysis.** This requires balancing the tax revenue loss from treaty source taxation concessions against gains in the form of increased investment (i) that would not be made absent the DTT, and (ii) that leads to job creation and increased incomes for residents. The latter point is critical; increased investment is beneficial to Uganda only to the extent it improves the quality of life of Uganda’s residents, so that its benefits do not accrue only to a nonresident investor.

**52. The cost of administering a DTT program should not be underestimated.** In addition to the time and cost of treaty negotiations, there are substantial ongoing costs. Implementation of a tax treaty network may require adjustment at several levels, including changing forms and filing requirements for non-residents who claim treaty benefits (it is critical to vet non-resident claims for treaty eligibility). Further, to avoid inadvertent treaty disputes with taxpayers, internal treaty coordination mechanisms are required from local office level up to central policy administration. Finally, ongoing monitoring is required to uncover tax avoidance schemes and enforcement is required to attack schemes that are uncovered (whether by URA or as often is the case from information shared by other governments).

**53. Ugandan revenue loss is likely to be substantial from DTTs.** For a country such as Uganda that principally is a recipient of foreign investment, each DTT results in revenue loss relative to the same investment without the treaty. The extent of the revenue loss depends on the specific terms of the DTT. In general, two broad factors affect the amount of revenue loss from a DTT. First, is the extent to which Uganda’s right to tax nonresidents is reduced by a DTT. The key source taxation issues affected by treaties are (i) withholding tax reductions on interest, dividends, rents and royalties, (ii) restricted net-based source taxation of business profits, including under many DTTs fees for technical, professional and management services, and (iii) limits on taxation of capital gains,

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<sup>17</sup> While specific arrangements or investment incentives are generally not advisable, they may (if unavoidable) cause less revenue damage than a treaty with provisions that open the opportunity for tax avoidance to the world.

including from offshore sales of stock in companies (especially those holding resource and telecom assets).

**54. Taking the concession of source taxation just described as a given in the nature of DTTs, the second—and critical—factor affecting revenue loss is the extent that the treaty is susceptible to “treaty shopping” use by investors from a country other than the treaty partner.** While it is possible to employ anti-treaty shopping (e.g., so-called limitation on benefit or principal purpose) provisions, it often is possible to circumvent these limitations with sophisticated planning or as a result of limited enforcement capacity. As a practical matter, each treaty should be viewed as a potential “treaty with the world”. It is therefore critical to preserve the right for Uganda in each tax treaty to prevent the abuse or misuse of the treaty.

**55. Revenue loss can increase over a long period of time as investors shift investments to the weakest treaty in a country’s tax treaty network.** It is difficult to measure the exact amounts of revenue loss that result from a treaty program, but the magnitude can be material. It is critical to understand that a country’s network of DTTs is only as strong as the DTT that permits the greatest reduction of source taxation and/or the greatest abuse. Adopting a treaty with the wrong treaty partner without adequate protections becomes a loophole for all inbound FDI affecting the country’s entire tax base. The data on Uganda’s FDI already shows that it is substantially funneled through the Netherlands and Mauritius (Table 4).

**Table 5. FDI Stocks by Source Country, 2012-2015 (Values in US\$ million)**

FDI Stock from:	Treaty?	2012	2013	2014	2015
Netherlands	Yes	1,065.50	1,559.38	2,050.74	5,726.51
UK	Yes	2,003.58	2,083.29	2,333.59	1,154.58
Kenya	No	976.99	1,021.89	1,131.49	773.04
Mauritius	Yes	498.51	570.00	637.10	708.05
India	Yes	234.94	253.73	201.24	187.13
Bermuda	No	381.63	382.29	392.60	169.07
South Africa	Yes	388.47	400.03	328.64	163.33
France	No	150.35	196.64	202.95	93.70
USA	No	515.99	524.70	145.78	89.09
Singapore	No	32.07	34.18	14.27	38.33
Belgium	Yes	(61.85)	94.64	95.62	21.59
Sweden	No	87.02	87.32	86.41	(3.50)
Others		1,401.73	1,562.82	2,209.03	1,247.05
Total		7,674.92	8,770.92	9,829.49	10,367.97

Source: Statistics Department, Bank of Uganda

**56. Ugandan gains from entering DTTs need to be carefully evaluated against the costs of doing so.** Balancing against inevitable revenue loss from a DTT are potential gains in the form of investment. Importantly, the gains that should be counted are from investment that would not be

made in the absence of a DTT. Before entering into a DTT it is best practice for a country to assess: (i) what investment would come from the treaty partner country, (ii) whether the investment would occur without the presence of a DTT, and (iii) whether the investment could be encouraged by an instrument that does not involve the revenue loss of a DTT. It must be recognized that, if asked, investors routinely claim that a DTT is necessary for investment, but such claims should be carefully scrutinized. Comments from the private sector indicate that treaties are not necessarily a material factor.

**57. The tax administration advantages of a DTT (such as exchange of tax information, resolution of tax disputes and assistance in collection) generally can be accomplished under other agreements**, such as the Convention on Mutual Administrative Assistance in Tax Matters, recently adopted in Uganda, or by entering into other bilateral agreements (such as a tax information exchange agreement or a shipping and aircraft agreement) without the revenue loss accompanying a DTT. Moreover, it is possible in theory to enter into a limited treaty that includes information exchange and a mutual agreement procedure to address investor concerns about resolving tax disputes.

### **Issues in Existing Ugandan DTTs**

**58. Uganda has 10 DTTs in force, with: Belgium, Denmark, India, Italy, Mauritius, The Netherlands, Norway, South Africa, the United Kingdom, and Zambia.** None of these treaties conforms to the Uganda model treaty or to current international best practices, highlighting the observation made above regarding the rigidity of DTTs as an instrument and difficulties of maintaining an up to date DTT network.

**59. Uganda also has a number of treaties that have been signed, but for which notice has not been given or the treaty partner has not completed the formalities for the treaty to enter into force, as well as some under negotiation.** The jurisdictions with which Uganda has signed a DTT but for which the DTT is not in force include China, Egypt and the UAE. The texts of the Egyptian and UAE DTTs have not been made public nor has the IMF mission team reviewed these documents. Uganda also has ongoing negotiations with several countries, including Qatar, Serbia, and Turkey. Succeeding sections consider areas of potential revenue leakage in the current and proposed Ugandan treaty network specifically.

### ***Withholding tax rate reductions***

**60. In general, and except for the DTT with Zambia and the dividend rate with The Netherlands, Uganda's DTTs provide only modest reductions in withholding tax rates from the statutory rates.** While broadly speaking, there is limited risk of revenue loss from these withholding rates, even isolated reduced rates, if in a treaty with a country such as The Netherlands whose law facilitates its use as an intermediary country, can result in revenue loss. The DTT with The

Netherlands limits dividend withholding<sup>18</sup> to 5 percent for companies holding at least 50 percent of the capital of a company. The FDI data show disproportionate FDI from The Netherlands, strongly suggesting that Dutch companies are used as an intermediate treaty shopping vehicle.

**61. Viewed from a different perspective, however, even a reduction from a 15 percent to a 10 percent withholding rate is a substantial percentage reduction.** The signed DTT with China (not yet in force) has a 7.5 percent rate on dividends and an effective 7 percent rate on equipment royalties (and under the Protocol to the DTT only 70 percent of equipment royalties (rents) are subject to the withholding). The very old treaty with Zambia includes a zero rate of withholding on dividends, interest and royalties if the item of income is taxed in Zambia.

**62. The laws of Mauritius and The Netherlands present clear potential for treaty shopping advantage to be taken of lower withholding tax rates and other treaty benefits.** A Mauritius or a Dutch company has potential to be used as a conduit company. The DTT withholding rates from Uganda are reduced (dividends 10 or 5 percent, interest 10 percent and royalties 10 percent) thus offering clear advantages over direct investment from a non-treaty country and even other treaty countries. These treaties do not have limitation on benefits provisions. There is no experience yet with the revised statutory treaty anti-abuse rule of ITA Section 88 and how its beneficial ownership and economic substance conditions to use of a DTT might apply to limit treaty shopping.

#### ***Fees for technical, management and professional services***

**63. Under ITA Sections 83 and 85, the Uganda withholding rate on management or professional fees paid to a non-resident company is 15 percent.** It is common practice for global groups to consolidate group service expenses and to charge them out to the group, often with a mark-up (that sometimes is “parked” in a low-tax intermediary jurisdiction). In discussions with URA and private advisors, there appeared to be a consensus that use of management or technical services fees paid to nonresidents is one of the most substantial source of cross-border revenue leakage.<sup>19</sup> Even where a reduced withholding rate does not apply on such payments, from the company’s point of view the reduction of the effective tax rate by virtue of paying the deductible service fee at 30 percent Uganda corporate tax, and being subject only to the 15 percent statutory withholding rate, saves 15 percentage points of tax. If a DTT can be used to further reduce the effective tax rate on management fees to a 10 percent withholding rate or even a zero rate, this base erosion tax planning can achieve 20 or even 30 percentage points of tax savings.

<sup>18</sup> It can be argued that reduced rates for dividends are less problematic than for interest (and other deductible payments) since dividends come from income that has already been taxed by the source country (in theory).

<sup>19</sup> The mission was not able to verify this quantitatively given an absence of sufficiently reliable data specific to these kinds of charges.



**64. There will be circumstances in which treaties may be used to avoid withholding on management and technical service fees altogether.** As an example, under the DTT with The Netherlands, a company that does not pay material tax in each of those jurisdictions (through features of their respective laws) could be used to charge out services fees. Because this existing treaty does not have the advisable technical services article found in the Uganda Model DTT, the fees would be classified as business profits and therefore exempt from Ugandan withholding tax under the business profits article of the treaties.<sup>20</sup>

**65. To address the technical services issue, it is advisable to include a separate technical services article such as that in the Uganda model DTT in all future treaties.** The Uganda model DTT Article 13 is a good model. This approach is increasingly accepted internationally.

**66. The MLI—discussed further below—does *not* provide an avenue to cure the DTT technical services issues.** It does not include options to add technical services provisions to DTTs. The G20/OECD BEPS project did not reach an agreement on technical services, and these have been addressed almost exclusively through the UN.

#### ***Offshore indirect transfers of interest***

**67. “Offshore indirect transfers of interest” (OITIs) have become of increasing concern for the tax base of developing countries.** These are discussed in the following section VI of the report, as they involve both domestic law and treaty issues. In short, analysis strongly favors a primary right to tax of the country in which the underlying immovable assets are located, with respect to capital gains realized by their indirect transfer offshore.

#### ***Limitation on benefits provisions***

**68. It now is recognized as a best practice for a DTT to include a limitation of benefits (LOB) provision that restricts use of a DTT to entities that have a sufficient economic nexus with the residence country to justify the source country tax concessions given under the DTT.** This is particularly important for DTTs with countries whose tax systems either do not impose material income tax, such as Mauritius, Qatar and the UAE, or whose tax systems offer a tax-efficient conduit for income from Uganda to a third country investor, such as the Netherlands and the United Kingdom. The Uganda model DTT, with one significant modification, presents a good start on this problem, though it also would be advisable to *add* a principal purpose test as well.

**69. Uganda recently revised a domestic law statutory anti-abuse provision.** ITA Section 88 has been amended to provide that a nonresident entity (other than a publicly listed company) seeking to benefit from a DTT would not be eligible for benefits if: (i) it is not the beneficial owner of the income; (ii) it does not have unrestricted ability to enjoy the income and determine its uses; and (iii) it does not have economic substance in its country of residence. This is a shift from the earlier limitation of treaty benefit rules that restricted the application of treaty benefits to where 50 percent

<sup>20</sup> In the absence of a Ugandan permanent establishment of the investing company.

or more of the underlying ownership of the nonresident was held by resident individual or individuals of that other contracting state for purposes of that DTT. The effect of this new rule in practice remains open at this point, as does the legal status of the ITA provision in relation to treaties. *For these reasons, it is important for Uganda to include limitation of benefits provisions in all its treaties.*

**70. The MLI may be used to add limitation on benefits provisions to DTTs.** The MLI has options that could include needed limitation on benefits language in all treaties where both bilateral parties agree to do so; *Uganda should make sure that when the time comes, this step is taken—which only can be effective, however, to the extent that its treaty partners will agree.*

### ***EAC treaties***

**71. The EAC multilateral DTT (MDTT) signed in 2010 is intended to promote intra EAC trade and investment.** Because it does not include any LOB provision, the EAC MDTT could be used in theory by any third country investor that establishes a company in one of the EAC countries. In general, it appears that the laws of the EAC states would require payment of reasonably material tax in the event of conduit use of a member country entity, and therefore at this point this is not too much of a danger. Nonetheless, internal laws can change quickly, so it would be advisable that the EAC MDTT be updated with suitable LOB provisions before it is brought into force. Other provisions which would conform the treaty to current best practices, such as including authorization for source country taxation of direct and indirect sales of immovable property, also should be added. This would seem to be a reasonable path to propose, since the treaty was now drafted some time ago, and best practices in these regards have—particularly within the last two years—moved forward. It would be good to bring the EAC treaty into force in line with current best practice.<sup>21</sup>

### ***Multilateral legal instrument (MLI)***

**72. The MLI was made public at the end of November, 2016 and opened for signature as of December 31, 2016.** It includes 18 articles that each would permit a party to the MLI to modify existing in force bilateral DTTs, provided that the DTT partner agrees in each case to make the same modification.<sup>22</sup> Uganda has not signed the MLI, as of this time.

**73. The treaty modifications provided in the MLI range from the highly technical rules affecting hybrid mismatches in Part III, to the relatively less important change to treaty preambles in Article 6, to the much more important LOB provisions of Article 7, offshore sale of immovable property entities provision of Article 9 and mandatory binding arbitration rules of Articles 18 - 26.** A signatory to the MLI must determine its position in respect of all the provisions in relation to each of the signatories of in-force DTTs. The MLI is open for signature and the OECD held an initial signing ceremony on June 7, 2017. The convention will remain open for additional signatories after that date. Of Uganda's treaty partners, only Mauritius, Norway and

<sup>21</sup> Recent IMF technical assistance to the EAC Secretariat focuses on these issues.

<sup>22</sup> A handful of the provisions may be applied to one and not both of the DTT parties.

Zambia did not sign the MLI and both Mauritius and Norway have sent letters to the OECD saying they intend to do so as soon as possible. The countries must indicate to which treaties they intend for their MLI positions to apply. Thus, for example, The Netherlands has identified its treaty with Uganda as one to which it would apply the MLI. Its proposed provisions include a “principal purpose test” type of anti-abuse rule. Where a partner has signed the MLI adopting this position, it will apparently not be possible for Uganda to have included in its MLI changes an LOB provision, as the principle purpose test is the default position in the MLI.

**74. The MLI offers Uganda an opportunity to add important provisions to in force treaties, particularly with respect to LOB provisions and taxation of offshore sales of immovable property entities.** These, and other changes, will only be effective, as described just above, with the agreement of DTT partners to accept the changes—so the MLI cannot be viewed as a complete panacea for dealing with DTT revenue leakage. Further, some of the issues discussed herein, most importantly the payment of technical services, are not covered under the MLI in any case.

**75. It appears that the process under the MLI for determining a country’s positions involves at least the following steps:**

- Determine Uganda’s position in respect of each substantive article of the MLI. Is the position proposed one that Uganda would like to adopt as part of its treaty policy?
- With respect to each in force DTT, determine
- Whether Uganda would want to include the DTT within the ambit of the MLI as a Covered Agreement,
- If so, how each substantive article would interact with the DTT in question so as to determine whether to accept application of the MLI rule or opt in to the MLI rule (as appropriate for that article) and what reservations if any are needed in relation to the article,
- Determine whether the treaty partner has signed the MLI and what provisions it has notified that it is willing to accept, and
- Make notifications are necessary for each MLI article in relation to the DTT in question.

**76. In general, the substantive articles of the MLI (omitting the procedural dispute resolution provisions), would be favorable to Uganda, or at worst would do no harm.** The LOB and offshore immovable property entity provisions in particular would improve existing treaties—to the extent that treaty partners will agree to include those.

## G. Indirect Transfers of Interest

**77. The Ugandan authorities have identified as a substantial concern the taxation, or lack thereof, of gain on offshore indirect transfers of interest (OITIs) in Ugandan assets.** This is an issue that has become increasingly important to the tax bases of developing countries. The problem is the ability to sell interests in important domestic assets, without being subject to capital gains taxation in the country where those underlying assets are located. This is achieved by selling interests in foreign entities that own the assets (outside the location country) rather than selling the

assets themselves. The central conceptual question raised by OITIs is that of how taxing rights should be allocated between the country where the underlying asset is located and other jurisdictions involved in the transaction.

**78. Current understanding of best practice—as embodied in both the OECD and UN model DTTs—is to permit source country taxation of offshore transfers where the underlying asset is immovable property located in the source country.** This is generally defined to include real estate, and, importantly, mineral deposits, licenses relating to them, and rights thereto.<sup>23</sup> In order for such taxation to be effectuated, *both* domestic income tax law and relevant provisions of any tax treaties governing relations between the source country and the country in which the indirect transfer takes place must explicitly extend the reach of taxation to such transfers. The Uganda ITA includes a provision defining as sourced in Uganda income from indirect transfers of shares in a company the assets of which consist directly or indirectly primarily of interests in immovable property, where the interest or share constitutes a business asset.<sup>24</sup> Amendments in 2015<sup>25</sup> provide a mechanism to ensure that tax can be collected where an indirect transfer of an underlying mineral license occurs, by requiring notification of the transfer by the licensee, making the licensee the liable agent for the income tax incurred by the non-resident transferor, and defining such a license as a business asset for source rule purposes.<sup>26</sup>

**79. These provisions of the ITA could be extended and strengthened.** It would be desirable to extend taxation of offshore transfers to indirect holdings beyond the resource sector. This can be done without going as far as to tax all indirect transfers of shares in any Ugandan company.

**80. There is good economic justification for extending the definition of immovable property to reach assets embodying location specific rents that are clearly linked to national assets**—e.g., telecommunication licenses; rights to operate public power grids or water systems; forests and fish. These types of assets derive their value from economic rents specific to the location country, and have been at the heart of some of the major disputes over such offshore taxation in a number of jurisdictions, including in Uganda.

**81. It is also necessary to provide in any applicable double taxation treaty that such gains on indirect transfer of (immovable) assets are to be taxed in the source country (Uganda).** The practice is embodied in the OECD and UN model tax conventions in Article 13(4). When more than 50 percent of the value of the asset being directly transferred is derived from immovable property in the source country, the right to tax capital gains (or losses) is, under treaties based on these models, allocated in full to that country; where between 20 and 50 percent of the value is so derived, the taxation is proportionate. It is critically important to note that *this important provision will only apply*

<sup>23</sup> Some countries have extended the reach of taxation of indirect transfers offshore to include interests represented by any interests in domestic companies (e.g., Peru; India), but this is not common.

<sup>24</sup> ITA Section 79(g)

<sup>25</sup> ITA Section 89GF

<sup>26</sup> This is necessary in Uganda as only business assets are subject to capital gains taxation on transfer.

*if the right to so tax indirect transfers is not limited in applicable tax treaties to the residence country (as opposed to allowed to Uganda, the source country). Uganda's treaty with India (and the treaty signed with China) does allow the source country (Uganda) to impose tax on these offshore sales. In considering whether and how to apply the provisions of the MLI, this is one of the items that the MLI could be used for to add to existing treaties. The proposed revisions would include the needed language in all treaties where both bi-lateral parties agree to do so; Uganda should make sure that when the time comes, this step is taken—which only can be effective, however, to the extent that its treaty partners will agree. Moreover, if any treaty does not have such a rule, it will attract use solely for that reason.*

**82. The new Uganda model DTT should be amended** (i) in order to capture in Uganda gains on *indirect* transfers of immovable property as defined (presently) to include mineral rights –at present only direct transfers are included within the scope of the treaty; and (ii) to extend the reach of immovable property by defining it more broadly to include all instances of value derived from location specific rents arising in Uganda.

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## Glossary

ATR	-	Average tax rate
BEPS	-	Base erosion and profit shifting
CbC	-	Country-by-Country
CIT	-	Corporate Income Tax
DTT	-	Double Tax Treaty
EAC	-	East African Community
EBITDA	-	Earnings before interest, tax, depreciation and amortization
FDI	-	Foreign direct investment
GDP	-	Gross domestic product
IBFD	-	International Bureau of Fiscal Documentation
IMF	-	International Monetary Fund
IMF WoRLD	-	IMF Worldwide Revenue Longitudinal Database
ITA	-	Income Tax Act
LTU	-	Large taxpayer unit
LOB	-	Limitation of Benefits
MCAA	-	Multilateral Competent Authority Agreement
MLI	-	Multilateral Legal Instrument
MNEs	-	Multi-National Enterprises
MOF	-	Ministry of Finance
MTU	-	Medium taxpayer unit
OECD	-	Organisation for Economic Co-operation and Development
OITI	-	Offshore Indirect Transfers of Interest
PSI	-	Policy support instrument
TA	-	Technical assistance
TIEA	-	Tax Information Exchange Agreement
TP	-	Transfer pricing
UAE	-	United Arab Emirates
UN	-	United Nations
URA	-	Ugandan Revenue Authority
WHT	-	Withholding tax