Tax Expenditures: What are the options for sustainable investment attraction?

Overview

When citizens are able to take advantage of investment and business opportunities in the economy and internationally they earn an income, which in turn enables them contribute to government revenue in form of taxes. These are a premise for government provision of social services and public investments.

In the quest to guarantee growth and sustainability, the Government of Uganda (GoU) developed a Domestic Revenue Mobilization Strategy (DRMS, 2019-2024), and one of its core objectives is to encourage a healthy flow of investments. One of the vehicles the government applies to attract investments is the tax system in form of tax reliefs. The value of revenue foregone from the reliefs is described as 'tax expenditure'. Tax Expenditures exist as well for other reasons, that include: a social purpose, to provide relief to certain sectors of the economy, providing investment incentives, to redistribute income on equitable grounds, or simply due to administrative complexity with collecting tax from a certain activity, person or sector.

However, tax expenditures may yield various indirect costs to the economy as a whole. The tax expenditure in one area or sector may mean that taxes may be higher – or public spending lower – in other areas. Accordingly, the benefit provided by the tax expenditure may affect a smaller group of firms or individuals than the forgone public spending. (MFPED, 2022).

Increasingly, in the face of elevated debt, global conflict, climate change, COVID-19 and Ebola, trying to rely on tax expenditures to compete for investors and rebuild resilience in the economy undermines domestic resource mobilization. This is exacerbated where tax expenditures disproportionately benefit foreign firms, while reducing local morale.

This policy brief proposes alternative options geared towards harnessing a healthy flow of investment and businesses.

Key Issues

1. Gradual rise in tax expenditures over the years which impacts negatively on public spending.
2. Inequitable distribution of tax expenditures which accords preferential treatment to foreign investors, thus reducing local investors' morale.
3. Credibility concerns arising from the limited empirical evidence of the impact of tax expenditures on investment.
4. Loss of neutrality of the taxation system.

Introduction

The Government of Uganda in the third National Development Plan (NDP III) committed to supporting and strengthening the private sector as the main engine for growth and addressing the challenges constraining private sector growth. These include: slow bureaucratic decision-making by the public service, corruption, case backlog in the judiciary, and inadequate access to patient capital. In addition, the government will continue to provide an enabling environment for private sector growth through maintaining macroeconomic stability, and provision of long-term finance at affordable rates. Increasingly, over the years the most preferred investment attraction offered has been tax incentives, especially targeting foreign direct investments. In the last three financial years, tax expenditures have consistently increased representing on average of 11.5% of total taxes collected. According to the Tax Justice Alliance Uganda, the continued reliance on tax expenditures, which rank least on investors' priority considerations for investment decisions, is partly responsible for the perennial fiscal deficit challenges. As well, tax exemptions increase the complexity of tax administration and mainly benefit those who are better off rather than the poor and vulnerable (IMF, 2022). Consequently, with a tax-to-GDP ratio of 13%, Uganda is still grappling with mobilizing adequate domestic resources to finance direct public expenditure.

The DRMS seeks to provide a business-friendly tax environment to support investment. Additionally, it envisages a reduction of unproductive revenue leakages from exemptions by publishing a full tax expenditure framework to better understand the fiscal cost of supporting investment and social welfare.

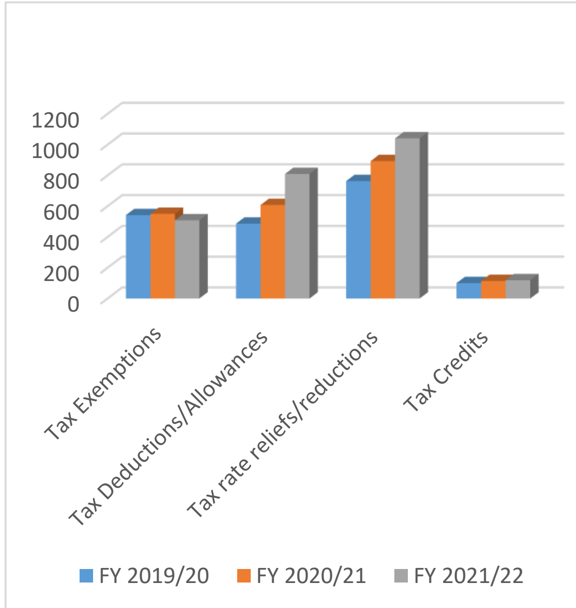
Trends in tax expenditures

Tax expenditures comprise tax exemptions, tax deductions or allowances, tax rate reliefs/reductions and tax credits. These are effected through the tax heads: Value Added Tax (VAT), income tax, customs and excise duty. Tax expenditures escalated notwithstanding the difficulties to estimate the real impact created by them.

In FY 2019/20, the estimated revenue foregone was Ug shs 1,891.47 billion (bn) (11.29%), which increased to Ug shs 2,164.83bn (12.92%) in FY 2020/21 and finally to Ug shs 2,478bn (14.79%) in FY 2021/22.

Whereas the total revenue foregone due to tax exemptions as a percentage of GDP reduced from 1.65% in FY 2019/20 to 1.33% in FY 202/22, the other components of tax expenditure increased over the same period for instance; tax deductions/allowances increased from 2.9% in 2019/20 to 4.83% in FY2021/22, tax reliefs/reductions from 4.56% (FY2019/20) to 6.2% (FY2021/22), and tax credits from 0.6% in FY 2019/20 to 0.71% in FY2021/22. This translates into an average of 11.5% foregone in terms of respective total taxes collected (Figure 1).

Figure 1: Tax Expenditures by Composition FYs 2019/20 to FY2021/22 (Ug shs Bn)



Source: URA Database

Although, it is of strategic intent by the government to encourage priority industries that bring productive investment and employment opportunities, using tax expenditures as a vehicle for spurring investments is affected by the following constraints:

1. Inability to reliably estimate the costs arising from the Tax Expenditures (TE). Over the FYs 2019/20-22, TEs increased, however efforts to establish the costs and benefits have proven complex despite the allocation of resources to monitor the effectiveness of tax expenditures.
2. Inequitable distribution of tax expenditures. Preferential treatment is given to foreign investors which affects the morale of local investors. There is limited awareness about incentives for local investors.
3. Tax expenditures tend to induce distortions to economic behaviour, as they influence the behaviour of firms and individuals. Where they are inappropriately targeted, their presence could lead to inefficient allocation

of resources across the economy. These further discourage compliance and heighten the clamour by others for similar treatment, leading to exemption creep.

4. High administrative and compliance costs for firms and individuals, who may need to prepare application documentation for tax exemption.

Options to harness investments

The private sector, being the primary engine of growth, there are other plausible options to boost investments as opposed to tax expenditures.

1. ***Predictable tax regime:*** Investments especially in manufacturing tend to be long-term and thus the creation of a conducive operating environment is essential. This entails limiting frequent changes to excise duty and VAT and harmonizing export taxes. This makes the tax regime predictable.

2. ***Lowering the cost of financial transactions***: Access to affordable financial services is essential for poverty reduction and economic growth. Evidence from the World Bank suggests that at the macro level, more developed financial systems can allocate capital and risks more efficiently which should result in larger reductions in poverty and income inequality. At the micro level, financial inclusion[1] can reduce poverty, increase resilience and improve the lives of the poor, women in particular.

3. ***Equitable taxation system***

This entails balancing economic and societal objectives, which would enhance the distribution of the tax burden. This should be accompanied by spending the revenue to benefit all citizens fairly.

4. ***Improved infrastructure***

Well-developed infrastructure lowers the cost of doing business. For example, quality logistics services play an important role in facilitating the transportation of domestic, regional and international goods. This increases the competitiveness of a country's exports by reducing the costs involved in transporting goods. In road, rail corridors and transboundary river basins., collaborative management of these regional public goods would reduce the costs. Additionally, investment in green infrastructure would be useful in the medium term to boost growth and protect against climate shocks thus boosting agricultural productivity and securing livelihoods.

5. ***Inter-governmental collaboration***

The effective implementation of the African Continental Free Trade Area (AFCFTA), is an opportunity to attract more investors. The continental free trade pact can catalyze direct foreign investments by lowering barriers to entry and harmonizing regulation across countries. Reducing barriers to trade and investment, enhancing competition and ensuring markets function fairly and efficiently through clear and predictable rules would increase intra-African exports. Export sectors to benefit the most are textiles and apparel, chemical, rubber and plastic products and processed foods.

These options are complemented by the following existing opportunities:

- Growing population leading to increased demand and hence the need for the availability of high-quality products of superior varieties.
- Changing attitudes towards locally produced products resulting in growing demand.

[1] Access to and use of basic financial services

- Vast unexploited areas with high potential for investment and value addition in agriculture, mineral resources and tourism.
- Increasing collaborations through groups and associations such as the Uganda Manufacturers Association. This supports the promotion of members' products and services, which improves marketability.

Conclusion

Tax expenditures are the obvious enticement for foreign investment, these are increasingly becoming unsustainable given the associated problems. Many opportunities can support investment sustainability that would spur growth. For these opportunities to be exploited, there is a need for an integrated approach to addressing local constraints while stepping up inter-government collaboration. Thus, it is imperative to have a policy shift from a greater emphasis on tax expenditures as the first call for investment attraction. The new options would achieve inflows, bring jobs and expertise, build local capacity, and forge connections that would help local companies join regional and global value chains.

Recommendations

1. The Ministry of Finance, Planning and Economic Development's Tax Policy Department should hasten the process of developing policies to limit the use of tax expenditures through rationalization in favour of a conducive investment climate.
2. The TPD should provide regular updates on tax expenditures and conduct feasibility studies of proposed tax expenditures and the related costs and benefits.
3. The MFPED should hasten the implementation of existing policies that support investment growth which should result in increased outputs to serve potential regional markets.
4. The Ministry of East African Community Affairs (MEACA) and the Ministry of Trade, Industry and Cooperatives (MoTIC) should enhance awareness of the benefits and services that can be obtained from regional collaborations.

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