Expanding the tax base in Uganda. What could be considered?

OVERVIEW

The Government of Uganda (GoU) is committed to narrowing the gap between the current and potential revenue performance. This commitment builds on the government's existing policy of seeking to increase tax revenues as a share of Gross Domestic Product (GDP) by at least 0.5% per annum, requiring them to grow at a rate in excess of the rate of growth in GDP (commonly referred to as buoyancy). Nevertheless, the current revenue yield remains below expectations for a country at Uganda's stage of development. This hinders economic growth and development by limiting the government's ability to provide the education and welfare programmes that would act as drivers of higher achievement. The tax system should be "competitive", but also yield enough revenue to address these issues consistently and sustainably.

This briefing paper provides insights into who is currently excluded from the tax bracket and what measures can be adopted to ensure that the domestic tax base is widened.

KEY ISSUES

1. Weaknesses in major taxes: These were identified in the poor performance of Value Added Tax (VAT), Corporate Income Tax (CIT), and Personal Income Tax (PIT).
2. Over generous tax expenditures that erode the tax yield.
3. A growing untaxed economy.

INTRODUCTION

The tax base is the total amount of income, property, assets, consumption, transactions, or other economic activity subject to taxation by a tax authority. A narrow tax base is non-neutral and inefficient. A broad tax base reduces tax administration costs and allows more revenue to be raised at lower rates.

Taxes are important for economic development. Uganda's tax system comprises several tax instruments, including direct taxes (i.e. personal and corporate income taxes) and indirect taxes (such as excise duties and value-added tax). The revenues that the tax system generates reflect a broad balance between taxes on consumption, income, and international trade. Although an improvement in revenue collection is of fundamental importance to financing the third National Development Plan (NDPIII) and Vision 2040 Agenda, a good tax system is one where revenue generation is not pursued at all costs.

A. WEAKNESSES IN MAJOR TAXES

While the fundamental design of the tax system is sound and appropriate for an economy at this stage of its development, both the tax yield and its rate of growth appear to be well below potential, with weaknesses apparent in most of the major tax heads, including VAT, CIT, and PIT as discussed hereafter:

Value Added Tax

Value Added Tax is normally a buoyant source of revenue, with growth expected to at least match that of GDP. However, yields are below potential due to:

1) Unnecessary VAT exemptions

In FY 2021/22, the list of exempt supplies in the Second Schedule of the VAT Act was expanded to include; (i) the supply of liquefied gas; (ii) supply of denatured fuel ethanol from cassava; (iii) supply of feasibility, design and construction services to a manufacturer newly investing at least US$ 30 million (or US$ 5 million for a local investor), subject to using at least 70% locally sourced raw materials and with the capacity to employ at least 70% citizens. The VAT exemptions have continued to grow over the last three FYs, from Ug shs 110.56bn in FY 2019/20 to Ug shs 124.65bn in FY 2021/22. In some instances, these are no longer relevant, thus eroding the tax base.

2) The deeming provisions to special circumstances.

In FY 2021/22, the proportion of the value of deemed[1] supplies to total supplies to the government was 66%, an increase from 60% registered in FY 2020/21. In addition, the value of VAT

[1] Deemed VAT is a relief mechanism which requires no payment of the VAT charged by a company or individual to its customers.

foregone on account of deeming increased from Ug shs 777.223bn in FY 2020/21 to Ug shs 1,218.949bn in FY 2021/22, representing a 56% increase.

This continued expansion of the deeming provisions has eroded the revenue base. Narrowing the deemed provisions would be budget-neutral, although, to the extent that this prevents abuse of the provisions, it would be revenue-positive.

Corporate Income Tax

Revenue yield from CIT as a percentage of GDP in Uganda is lower than in other East African Countries (EAC), despite having the same CIT rate. Uganda also records CIT productivity[2] of around 10%, considerably lower than the Kenyan productivity of 14% (World Bank, 2017). The disparity between the high nominal CIT rate and the low effective rate suggests that yields have been distorted by a high number of allowable deductions (beyond the normal costs of doing business) and the treatment of losses carried forward.

In FY 2019/20, the total deductions were Ug shs 13,470bn and have since increased to Ug shs 19,063bn in FY 2021/22. Similarly, the allowable deductions as a percentage of gross income increased from 13% to 18% in FY 2021/22. The allowable deductions have continued to increase at a higher rate over time compared to the gross income declared, which minimizes the tax base.

Additionally, the CIT-Effective Tax Rate (ETR) for foreign firms is significantly low. The proportion of tax from income earned by foreign firms in FY 2019/20 was 2.18% and increased to 3.02% in FY2020/2, then reduced to 2.65% in FY 2021/22. When compared to the CIT-ETR for local firms, it reveals that local firms are being taxed more than foreign firms. In FY 2021/11, the CIT-ETR for local firms was 25%, whereas that of foreign firms was 2.7%. The ETR for foreign firms (multinationals) therefore is over 20 percentage points lower than that for the local firms, which is attributed to profit shifting by the foreign firms. When the effective tax rate for foreign firms /multinationals is enhanced, the tax base will expand.

Personal Income Tax

The productivity of PIT is undermined by widespread under- and non-declaration. For taxation to have a positive effect on accountability, taxes should be felt by most citizens, including government servants. Certain classes of employees, by the nature of either their work or their residence, are not taxed, affecting perceptions of fairness and equity. The use of tax reliefs and exemptions by certain groups, for instance, exemptions applied to Judges, Members of Parliament (MPs), expatriates and employees under donor-funded programmes undermines the progressiveness of the tax system. Exempt incomes applied to certain streams of incomes of MPs increased from Ug shs 126.64bn in FY2019/20 to Ug shs 128.83bn in FY 2021/22. Additionally, the value of exempt incomes for the Judiciary increased from Ug shs 5.64bn in FY 2019/20 to Ug shs 7.53bn in FY 2020/21 and FY2021/22. Reviewing the exempt incomes would expand the tax base.

B. OVERGENEROUS TAX EXPENDITURES

Tax Expenditures

Uganda's current tax structure provides for several generous exemptions, beyond the exemptions under VAT. Tax expenditures include (i) tax exemptions, which are incomes that are excluded from the tax base; (ii) tax deductions or allowances which refer to amounts that reduce taxable income; (iii) tax deferrals, which are amounts that are not included in the calculation of income for a given year but are included in the calculation of a future year; (iv) tax rate reliefs/reductions, which occur by allowing some taxpayers to benefit from reduced tax rates on specific goods or services; and (v) tax credits, which are amounts deducted from a taxpayer's liability (e.g. tax refunds). The estimated value and share of total tax expenditures to total revenue increased over the three FYs. In FY 2019/20, the estimated revenue foregone/lost was Ug shs 1,891.47bn (11.29%), which increased to Ug shs 2,478bn (14.79%) in FY2021/22.

Donor-Funded Projects

Globally, Official Development Assistance (ODA) has generally been exempted from taxation in developing countries. Such exemptions are often stipulated in international treaties, as well as in project agreements between donors and recipients, which would be negotiated for each project and apply only to that project. Many of the largest infrastructure projects are donor-funded, meaning that, at least in part, they are exempt from

2 CIT productivity reflects how well the tax performs in terms of revenue collection, given the tax rate. It is given as the portion of GDP in revenue that is mobilised for each point of CIT rate.

taxation. Exempting aid sets, a bad example and creates a precedent for more exemptions. The discretionary agreements used to secure ODA exemptions potentially legitimize a practice that, when applied to investors could facilitate corruption and harm perceptions of fairness in the tax system, undermining compliance.

In FYs 2020/21 and 2021/22, donor-funded projects were not taxed. Consequently, an estimated Ug shs 517.788bn in FY 2020/21 and Ug shs 485.243bn in FY 2021/22, in the form of import duties, was foregone. Additionally, the incomes of expatriates working with donor-funded projects were not taxed exacerbating a lower tax yield. Non-resident employees and contractors are exempt from tax, while resident counterparts are taxed, favouring non-residents over residents

C. THE UNTAXED ECONOMY

Informal Economic Activity

Widespread informality, which accounts for almost half of all economic activity in Uganda, is a major structural constraint to revenue growth. The informal sector is not only large; it is the fastest-growing sector in Uganda. Many Ugandans conduct business wholly or partially in the informal sector, beyond the sight of the tax system (MFPED, 2019).

The size of Uganda's informal economy is estimated to be 34.4% which represents approximately US$58 billion of GDP. The businesses are typically unregistered and thus not captured by the tax system. While estimates of the size of the informal economy vary, there is a substantial amount of economic activity that goes untaxed. Understanding the nature of informality in Uganda is key to designing appropriate policy measures

The Digital Economy

E-commerce broadly refers to conducting business over the internet, including the sale of products and services online, such as Jumia, Uber, Facebook etc. Unlike in traditional businesses, it is difficult to assess where e-commerce creates value, what it is, and how it should be measured. While digital companies operate virtually, their profits are often taxed only in the state where they have a physical establishment. For instance, web-based businesses such as Facebook have a significant presence in the country, from which they profit, but do not qualify as a resident under the current law.

In FY 2021/22, Ug shs 0.6bn was collected from two web-based businesses representing 0.0027% of the total revenue collected. This was the first time revenue was collected from web-based businesses as the law governing the revenues became effective in FY 2021/22. While this is a significant step towards limiting revenue losses for the digital economy, it would be useful to have all other companies with online transactions get on board for VAT and income tax.

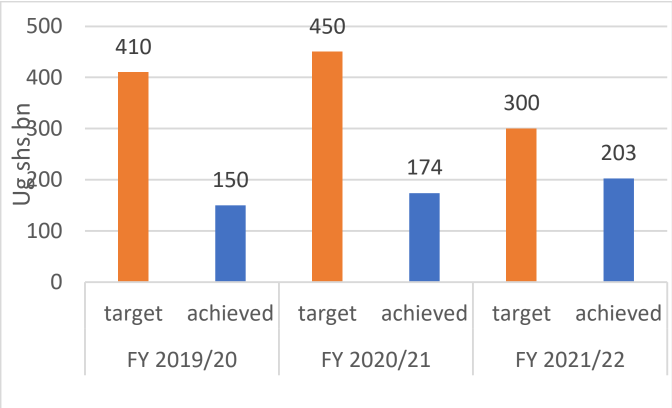
The Extractives Industry

Uganda is projected to receive oil revenue in FY2024/25 and these deposits have the potential to supply domestic needs, as well as export a significant surplus. However, given that natural resources are by nature exhaustible, it is in the interest of the Government to have a prudent fiscal policy that attracts investment while retaining a reasonable share of revenues. The Government should balance the objective of attracting foreign investment while ensuring its share of revenues.

The current fiscal regimes for oil, gas, and mining are generally sound. However, the appropriateness of the regime for taxing the full value chain, including mid-stream and downstream businesses, as well as the related transactions, is limited. When the fiscal regime is adjusted to fully capture revenue streams and the full value chain of the extractive and mining sector, the government will be ready to fully tap into revenue yields from the extractives sector.

Specifically, concerning the mining sector, there was a notable increase in the value of minerals produced per year which was majorly due to an increase in the number of artisanal miners (figure 1). The value of minerals achieved increased from Ug shs 150 bn to Ug shs 203bn (%). However, the targets over the years were not achieved due to poor regulation of artisanal miners. For instance, more than 75% of the Artisanal Small Scale Miners (ASMs) are unlicensed yet they contribute over 80% of minerals mined in the sector. Additionally, the Ministry of Energy and Mineral Development (MEMD) does not have mechanisms to verify the number of minerals mined by ASMs and mining companies, as such, they depend on quantities declared by the miners which may be misleading or inaccurate. This potentially accounts for the large variance between what was targeted each year and what was achieved.

Figure 1: Value of mineral production (Ug shs bn)



Source: MEMD Q4 Reports

Challenges

1. The increasing values of tax exemptions, incentives and reliefs have continued to erode the government's tax yield.
2. The imported duty-free supplies for donor-funded projects implicitly incentivize imports rather than promoting local suppliers. Local producers are disadvantaged when competing to supply donor projects.
3. Non-resident employees and contractors are exempt from tax, while resident counterparts are taxed, favouring non-residents over residents. Thus, Uganda is effectively allowing donated money to flow out of Uganda.
4. Difficulties in formalizing the large and ever-growing informal sector which limits the income tax yield.

Conclusion

The Government could expand its tax base by tapping into different areas in the tax regime to attain its development goals. Despite a robust tax legal framework, some legal regimes such as tax exemptions on supplies to donor-funded projects or incomes earned locally by non-residents working with donor-funded projects and the wide-ranging deeming provisions on externally-funded projects have led to low tax revenue performance. To address the weaknesses, mitigation measures including a review of legal regimes to streamline the tax system, eliminate system inefficiencies, and systematically formalise the informal sector to widen the tax base are proposed.

Recommendations

1. The Ministry of Finance, Planning and Economic Development Tax Policy Department (MFPED/TPD) should review the list of exempt supplies (Second Schedule) and zero rate supplies (Third Schedule) of the VAT Act to ensure continued effectiveness and relevancy of the supplies, especially regarding social welfare and equity objectives.

2. The MFPED/TPD should consider reviewing the policy to either end or streamline the deeming of supplies to the government to minimize abuse and potential revenue leakages.

3. The Uganda Revenue Authority (URA) should strengthen its compliance initiatives, for example, its return examinations and international tax unit to capture the right values. Ensure adequate information to support the carry forward of losses.

4. The MFPED/TPD should remove the unwarranted tax exemptions to streams of income of selected citizens as they damage perceptions of fairness in the tax regime and narrow the tax base.

5. The MFPED/TPD should rationalize tax exemptions to only investments that are underperforming and fairly distribute tax exemptions to both local and foreign investors. This shall create equity and confidence in tax contributions.

6. The Government should encourage the formation of small and medium enterprise (SME) cooperatives for tax purposes and collaborate with the Ministry of Trade, and that of Local Government, plus the Registrar General to formalize the SMEs for tax purposes. By forming cooperatives, a largely-unorganized informal sector can be transformed into a formal one, making it easy for the government to track their income performance for tax collection purposes.

7. The MEMD should fast-track registration and formalization of artisanal small-scale miners.

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