

THE COST OF TAX INCENTIVES AND EXEMPTIONS IN UGANDA

1. Introduction

In the recent past, most governments have been actively promoting their countries as investment destinations to attract scarce private capital, associated technology and managerial skills in order to help achieve their development goals. As such, they offer preferential tax treatments in form of exemptions, tax holidays, credits, investment allowances, preferential tax rates and import tariffs (or customs duties) and deferral of tax liability.¹ In Uganda, tax incentives are granted to mainly foreign investors targeting sectors government considers strategic to the growth of the economy. For example, sectors such as tourism, construction and those setting businesses in the industrial parks among others. On the other hand, Foreign Direct Investments is expected to provide jobs and contribute to future revenues in addition to technological and skills development.

However, when extravagantly and arbitrarily awarded, such tax incentives could be costly to the country in terms of revenues foregone. Besides, there is a debate as to whether tax incentives are a major component that foreign investors consider when deciding on an investment destination. Other factors such as market characteristics, relative production costs, political stability and resource availability are preferred.² The relative value of tax incentives and exemptions granted to companies in Uganda has never been established because the country lacks a framework for monitoring such strategic interventions. In addition to tax incentives and exemptions granted to companies, there are exemptions granted to listed institutions and individuals under the various tax laws.

This policy brief presents key findings of a study conducted by SEATINI Uganda and Democratic Governance Facility on **“The Impact of Harmful Tax Incentives and Exemptions in Uganda”**. The study examined the legal and policy framework for tax incentives and exemptions in Uganda; exemptions granted during the financial year 2017/18 and makes recommendations for policy improvement and practice.

¹<http://www.un.org/esa/ffd/publications/design-and-assessment-of-tax-incentives-in-developing-countries.html>

² United Nations Conference on Trade and Development (2000), Global Survey on Tax Incentive and Foreign Direct Investment

UGX
1,420.29 Bns

Amount estimated to have been lost due to tax exemptions in 2017/18

UGX 1trn

Amount lost every year in tax exemptions

2. The Legal Framework for Granting Tax Incentives and Exemptions in Uganda.

Tax incentives and exemptions in Uganda are granted under two categories. First, tax exemptions are provided for under the various tax laws like Income Tax, Value Added Tax, Excise Duty, Local Service Tax and Customs External Tariff. Tax Exemptions in the Income Tax Act are provided under section 21 including; Employees earning UGX. 235,000 monthly and below; Employment Income of the police and armed forces; Allowances for members of parliament; 10-year tax holiday to interest income of Savings and Credit Cooperative Organizations (SACCOs), among others.

The VAT Act provides for exempt supplies, exempt imports and exempt import of services under sections 19, 20 and 20A respectively.

The second category of tax incentives and exemptions are granted by the Executive. In the past, the law granted the minister of finance considerable discretion to declare any class of income to be exempt from tax³ but this was abolished except those under bilateral agreements with foreign countries and accredited international institutions.

However, despite the abolition of statutory ministerial discretion in tax matters, we still see

³ Income Tax Decree of 1974

government issuing tax waivers in recent years similar to the abolished ministerial discretion. These exemptions, which are not provided for by statute, primarily take the form of the government paying taxes on behalf of taxpayers or simply waiving off the tax.

Whereas tax incentives can be used to attract investment, it can also be repulsive where provisions are difficult to track, understand or comply with and/or invited corrupt behaviour on the part of tax officials which tends to increase project costs and uncertainty⁴.

Particularly discouraging are non-transparent incentive regimes, including those subject to frequent change and involving excessive administrative discretion. Investors would prefer a stable and sound tax system that does not deviate significantly from international norms. Considering that there are no clear guidelines for granting tax incentives to some of the beneficiary companies in Uganda, there is a risk of abuse. The selective award of incentives is also unfair and promotes inequality among sector players in the economy.

⁴ OECD (2017), Tax Incentives for Investment – A Global Perspective: Experiences in MENA and non-MENA countries

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3. Harmful Tax Exemptions Granted by Government

In FY 2017/18 alone, the government of Uganda is estimated to have lost UGX 1,402.29 billion in revenue foregone in various tax incentives and exemptions granted to individuals. These were captured under VAT exempt supplies, VAT zero rated supplies, Deemed VAT, international trade

tax exemptions, Savings and Credit Cooperative Organizations (SACCOs), Government undertakings, policy reversals, allowances for members of parliament, and Restrictions to URA. These are summarized in the table below;

Fig. 1: Estimated revenue losses in FY 2017/18

Exemption category	Estimated revenue loss (UGX Bns)	% share
VAT Exempt	111.01	7.8%
VAT Zero rated	30.11	2.1%
Deemed VAT	202.59	14.3%
International trade tax exemption	513.97	36.2%
SACCOs	10	0.7%
MP's allowances	33	2.3%
Other Income tax	14	1.0%
Government undertakings	102.81	7.2%
Restriction of URA enforcements	195.8	13.8%
Policy Reversals	207	14.6%
Total	1,420.29	100.0%

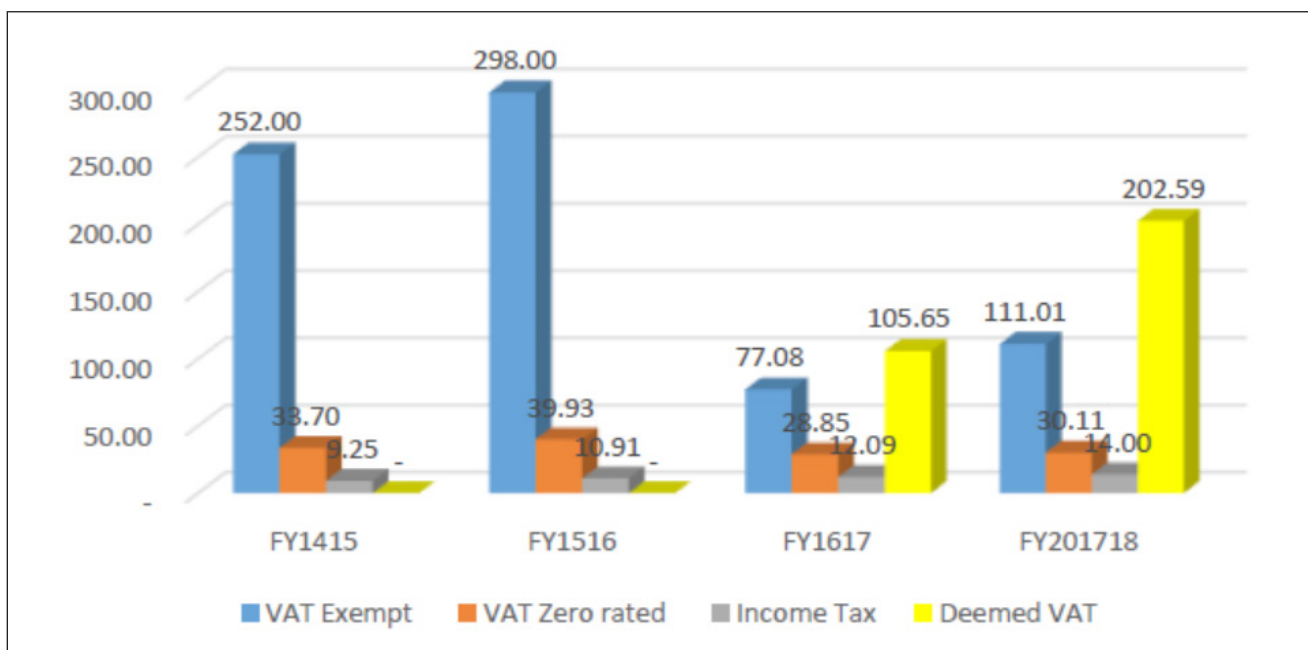
Source: Authors' computations and URA reports

3.1. VAT Exemptions

These are granted under the exempt supplies, zero rated and deemed VAT. The total revenue lost in VAT in FY2017/18 is estimated to be **343.71 bn**. VAT exemption supplies accounted for **111.01 bn**, zero rated goods **30.11 bn** while deemed VAT was the highest with **202.59 bn**. Deemed VAT is granted to a taxable supply made to a Government ministry, department or agency by a contractor executing an aid-funded project. It is deemed to have been paid by that ministry, department or agency if the supply is for use solely and exclusively for the aid-funded project. In this case, the suppliers invoice government VAT inclusive but this is deemed to have been paid and they can successfully claim their input VAT from URA.

UGX 1,402.29 billion
Revenue foregone in various
tax incentives and exemptions
granted to individuals
in FY2017/18.

Fig. 2: Revenue foregone in VAT exemptions



Source: Authors’ computations from URA reports

3.2. Government Undertakings

This incentive is usually provided to sectors that government considers strategic to the development of the country, however, in some instances, some tax heads that do not even directly relate to the companies such as PAYE are also exempted. In this case, Government agencies are instructed to pay PAYE taxes for contractors/ employees for some of these companies. For instance, in FY 2017/18, government exempted two big companies from almost all tax heads including corporation tax, VAT, Stamp duty, import duty and withholding taxes. In most cases, government is unable to pay for these undertakings leading to revenue loss in form of uncollected taxes. In FY2017/18, government committed to pay UGX 29 billion on behalf of Quality Chemicals for corporation tax, UGX 25 billion for Uganda Electricity Generation Company Ltd (UEGCL) for stamp duty, UGX 6 billion for Southern Range Nyanza in import taxes, UGX 5 billion for BIDCO (corporation tax), UGX 3 billion in import taxes for Aya Investments (import taxes) and UGX 1.5 billion in corporation tax for Steel and Tube industries, (Parliament Hansards). It has been reported that between the financial years 2009/10 and 2016/17, the Government paid UGX 198 billion in respect of tax expenditure on behalf of hotels, hospitals, textile companies, manufacturers of steel, milk, palm oil and tertiary institutions.

In FY 2017/18, government undertakings were UGX 102.81 Bns, (MoFPED 2017).

For FY 2019/10, there is a proposal before parliament to authorize government to write off Shs 500bns worth of tax waivers for at least 34 private companies and government agencies.

These payments were either not grounded in the law or lacked supporting evidence.

3.3. Exemption of SACCOs

In the tax amendment 2017/18, SACCOs were exempted from paying tax on their interest income for 10 years up to 2027 in order to facilitate their growth, financial inclusion especially for the unbanked population and enhance access to cheaper credit facilities. While the spirit for exemption is commendable, the beneficiaries of this exemption are actually not the poor people but middle income earners of government ministries and agencies. For instance, Uganda Revenue Authority runs a SACCO with a portfolio of over 20.5 billion while the Wazalendo SACCO of the Army is worth 270.57 billion. SACCOs in Uganda are perceived as an alternative for the poor. However, not all SACCOs are small in turn-over and for the rural poor as stated above. The implication of this exemption is that employees of big organizations are keeping their savings

and use them to access credit for which the institution will not pay taxes on interest earned, thus costing government the much needed revenues for development. In addition, the banks that have mainly relied on government and corporate employees as customers for loan products have lost business. It is estimated that Approximately UGX 10Bns were lost in 2017/18 due to this exemption.

3.4. Exempt Employment Income

According to Section 21(q) of the Income Tax Act, the official employment income of a person employed in the Uganda People's Defence Forces, the Uganda Police Force, the External Security Organisation, the Internal Security Organisation or the Uganda Prisons Service, other than a person employed in a civil capacity is exempted from tax. An amendment in 2016, included the employment income of a person employed as a member of parliament except salary. A member of parliament receives a consolidated pay between 20-25 million per month including a basic salary of 11 million shillings monthly. The members of parliament only pay tax on their salary according to the employment Act, unless exempt all allowances paid to an employees are consolidated and subjected to tax at rate specified on the PAYE schedule. The exclusion of emoluments of members of parliament from tax is not only discriminatory, unfair and promotes inequality but also costs the country billions in taxes. The country on average loses about 33 billion annually from this exemption. Regarding employment income tax exemptions for the members of armed forces, there is no clear justification for favouring them over other public employees. In addition to exemptions on their employment income, the army through the

defence forces shop Ltd launched in 2010 provides duty free items to its members.

The army shop had been closed in 1990s due to mismanagement. Currently, the shop provides construction materials at about 38% subsidy on quota basis. Officers from the rank of brigadier to the general get 385 bags of cement annually and 143 iron sheets, while major to colonel receive 350 bags and 130 iron sheets. Junior officers get 310 bags and 100 iron sheets.

3.5. Environmental Tax

In FY 2017/18, government banned the importation of cars older 15 years to protect the environment from automobile pollutant emissions. In the same spirit, the age of cars exempted from environmental levy was extended to eight years from the original five years to encourage Ugandans to import newer cars. An environmental levy for all vehicles between 8 and 15 years old was increased to 50%. Whereas the motive is well intended, this policy may not achieve its intended purpose. The revenues generated from it are not directly linked to any environmental protection measures but rather channeled into the consolidated fund which is later allocated according to government priorities. Similarly, the extension of 0% levy for new cars will not benefit many Ugandans since only a small proportion of the population can afford new cars.

3.6. Impact on the Economy

The rationale for granting tax incentives to certain sectors besides increasing Uganda's competitiveness is to accelerate job creation for Uganda. For instance, several tax incentives and exemptions are provided to developers of industrial parks to boost investment and create

The country on average loses about 33 billion annually from Employment Income exemptions

jobs⁵. It is estimated that 47,000 jobs have been created in the industrial parks.⁶ Whereas the economy is progressing steadily, presently a significant proportion of the country's population are not benefiting optimally from this growth. The vast majority of Uganda's labor force remains employed in low productivity activities. According to UBOS (2014), 58 percent of the population aged between 14-64 (productive age) was unemployed. World Bank (2018) notes that the rapidly expanding economic sectors are often more capital intensive than labor

intensive and employ only a small proportion of the workforce. The vast majority of the population continues to work in the agricultural sector, often engaged in subsistence activities, with only a small proportion of agricultural workers engaged in the cultivation of high-value, commercialized crops. Yet allocation to the sector is still deplorable. In financial year 2018/19, the government allocated 893 billion (3%) to agriculture.

⁵ Uganda Budget, 2018

⁶ Daily Monitor September 21st 2018

4. Recommendations

Government

- Government should reduce the use of tax incentives to drive investment but rather focus on improving the core drivers of investment like infrastructure development, political stability, and sound macroeconomic environment. Where exemptions are granted, government should focus on Sector targeted rather than individual/company specific.
- The executive should encourage Statutory exemptions other than arbitrary executive exemptions because they are less distortionary as they usually apply to entire sectors not specific entities and are more transparent.
- Government should develop clear guidelines for implementing tax exemptions. At the moment, there are no clear guidelines for granting exemptions neither are there routine reviews of the impact or benefits accruing from tax incentives, exemptions and holidays that justifies their continued existence.⁷
- The Ministry of Finance Planning and Economic Development should develop a framework for evaluating the performance of Tax exemptions granted against its objectives. This may be hard but government can evaluate in terms of revenue foregone and/or direct financial subsidies for each job created.

Parliament

- Parliament should exercise its oversight role in monitoring tax incentives granted to investors.
- The exemption of SACCOs from tax should be tagged to the turnover. Big SACCOs with turnovers in excess of the presumptive upper threshold (UGX 150M) should not be exempted.

Uganda Revenue Authority

- Uganda Revenue Authority should pay close attention on monitoring of exempt taxpayers to ensure that they do not overlap they do not abuse. This may involve imposing harsh penalties on exempt insertions which don't file returns. It is observed that URA is usually relaxes to pursue tax exempt institutions.

Civil Society Organizations

- Civil society organizations should sensitize the public on tax exemptions to make use of the available exemptions within the law.
- Civil society should undertake continuous research on the impact of tax incentives to support evidence based policy making.

⁷ Auditor General Report, 2017

Conclusion

SEATINI Uganda recognizes that some tax incentives and exemptions when implemented well may result into increased capital transfers, skills and technology and increased employment. However, attention should be focused the cost-effectiveness of the tax incentives and exemptions. Sometimes even where tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefit derived from the new investment. These tax incentives and exemptions should be followed up with clear monitoring of achievement of objectives for granting them.

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