

31 August 2022 – Economic Growth Forum VI



# Analysing the Effectiveness of Uganda's Income Tax Incentives

---

Are Uganda's investment incentives achieving their goals?

Liam Carson: IGC - Country Economist

Dr Kyle McNabb: TaxDev - Uganda Tax Policy Advisor

Dr Silver Namunane: REAP - DRM Specialist

**IGC**

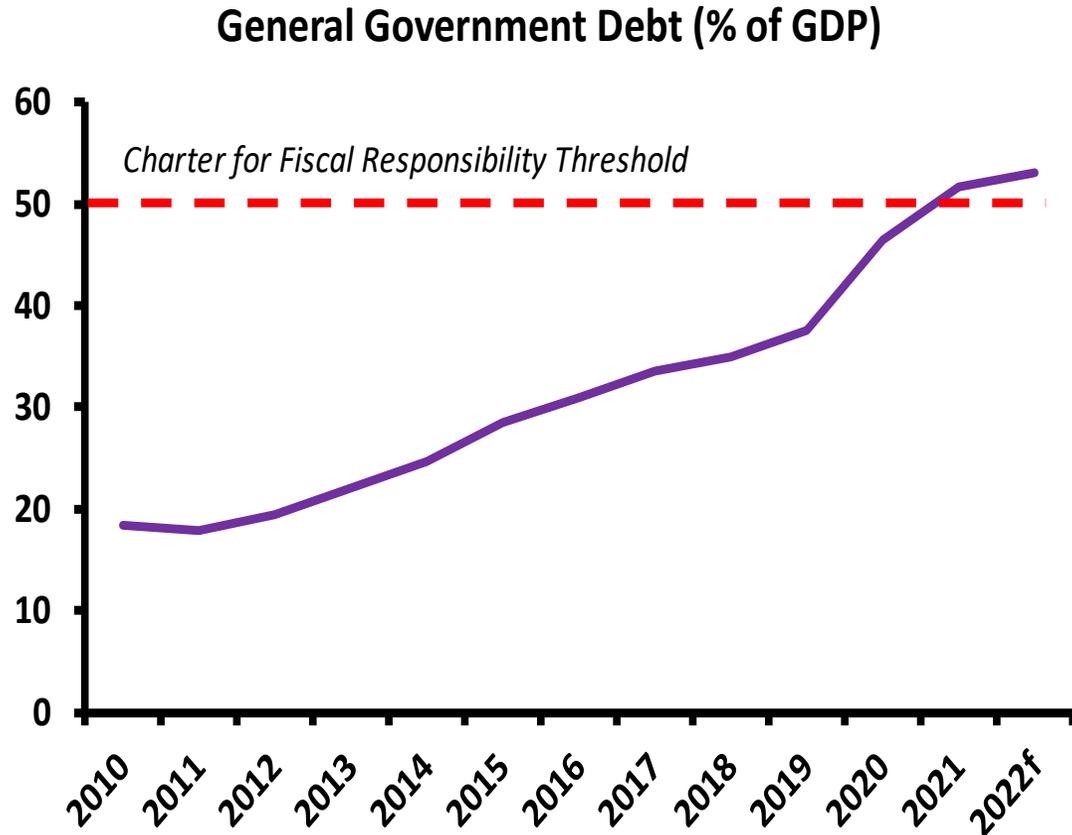
**TaxDev**

# Key Messages

---

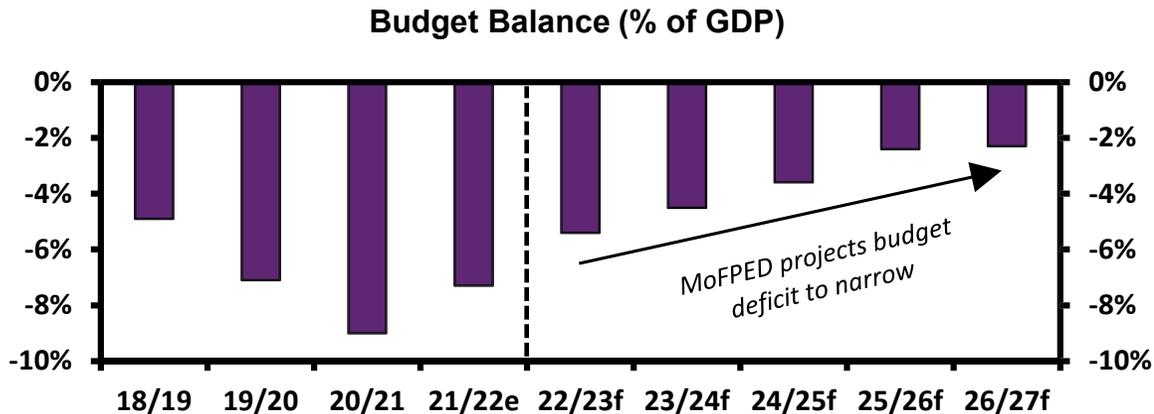
- **The foregone revenue arising from tax expenditures in Uganda has rocketed in recent years, prompting policymakers to commit to rationalising and ultimately trimming some of these expenditures.**
- **Our study focuses on estimating the economic benefits associated with the most widely-used investment incentive in the domestic tax laws – Section 21.1.af of the IT Act, which offers 10-year CIT holidays to strategic investors.**
- **We find that, since the introduction of the provision in FY 2018/19, it appears that beneficiaries of the incentive have invested more than non-beneficiaries.**
- **However, there has been no evidence of any positive impact on firm turnover or labour market outcomes.**
- **The number of beneficiaries from the provision has risen sharply in recent years, potentially eroding the CIT base further down the line.**

# Ugandan public debt has risen sharply ...

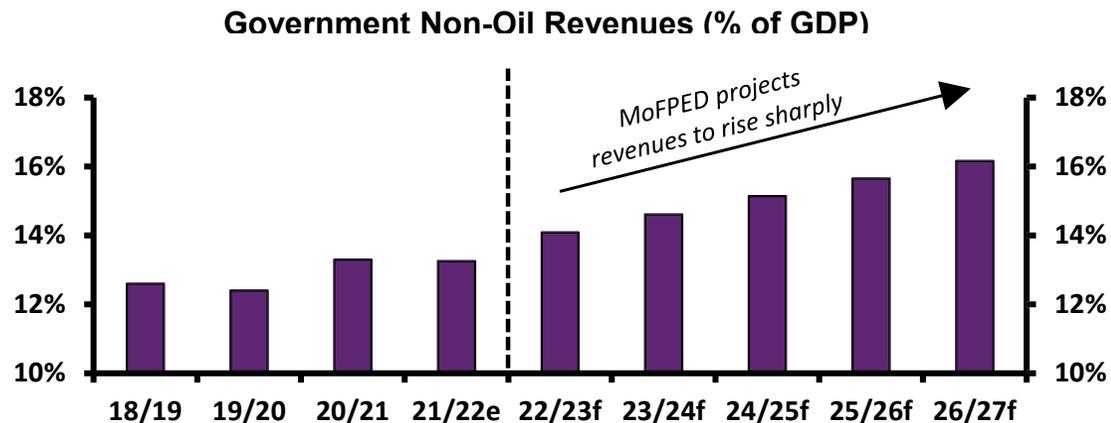


- Uganda has seen a sharp rise in public debt over the past decade.
- According to IMF data, government debt increased from 18.0% of GDP in 2011 to 37.6% of GDP in 2019.
- Since the Covid-19 outbreak, the ratio has climbed steeply as policymakers raised social and health spending.
- The IMF projects that government debt will reach 53.1% of GDP in 2022 – above the 50% threshold outlined in the Charter for Fiscal Responsibility.

# Fiscal consolidation projected to involve a sharp increase in tax revenues...

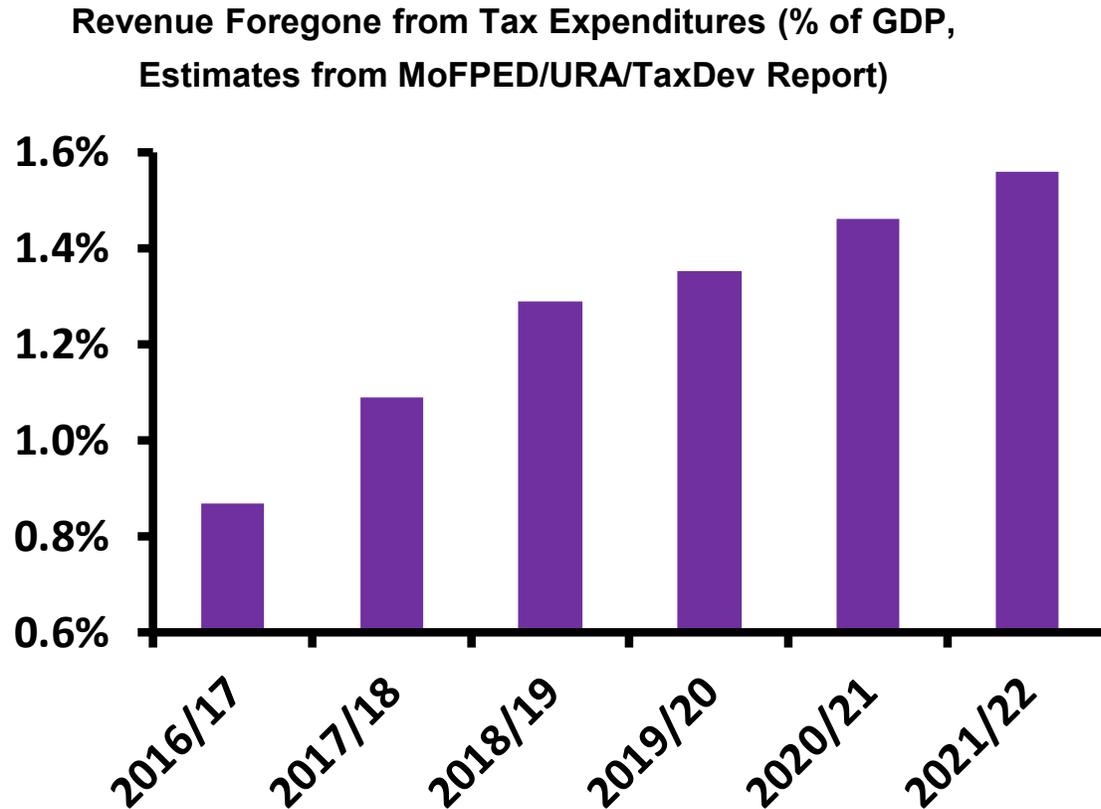


- MoFPED projects fiscal deficit to be lowered from estimated 7.3% of GDP in FY 21/22 to 2.3% of GDP in FY 26/27.
- This is set to come largely via an increase in domestic non-oil revenues.



- MoFPED forecasts that domestic non oil revenues will rise from 13.3% to 16.2% of GDP between FY 21/22 and FY 26/27.
- This brings the rationalisation of tax expenditures under the spotlight.

# Raising tax revenues likely to involve a paring back of tax expenditures...

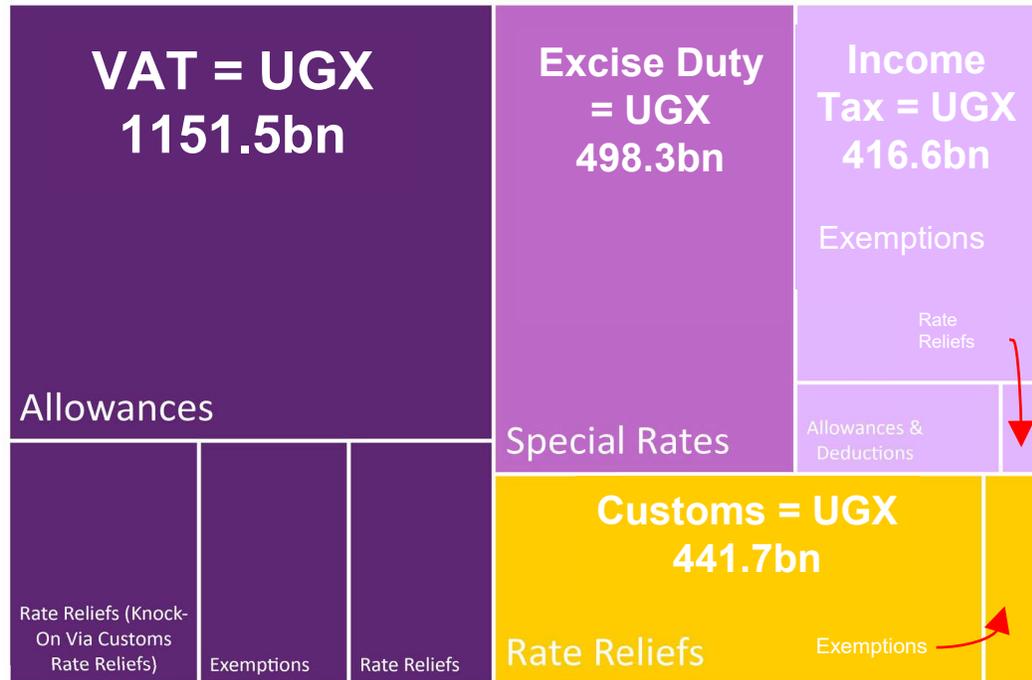


- Revenue foregone from TEs has risen sharply over time, from 0.87% of GDP in FY 16/17 to 1.56% of GDP in FY 21/22.
- As part of an IMF agreement, MoFPED committed to reducing revenue foregone from TEs by 0.1% of GDP in FY 22/23 & 0.2% of GDP in following years.

Source: TaxDev, URA, MoFPED

# Revenue foregone from tax expenditures is broad-based across tax heads ...

Revenue Foregone from Tax Expenditures  
(By Tax Head, Type of Tax Expenditure)

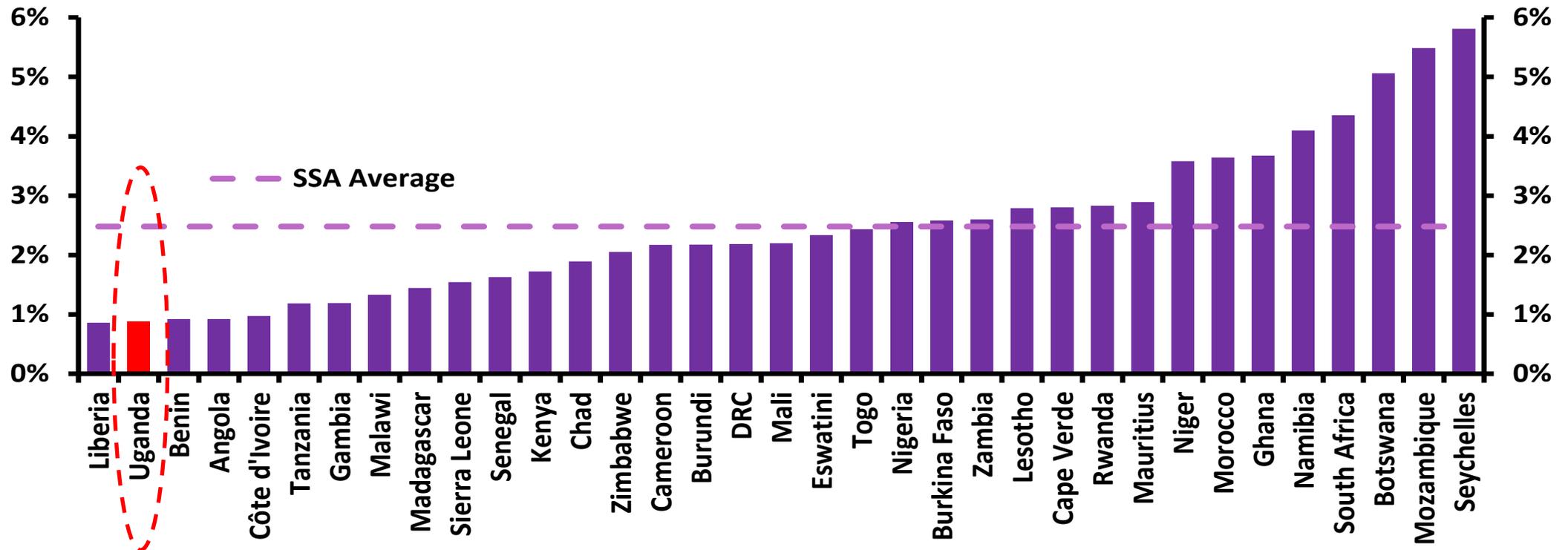


- VAT tax expenditures account for the largest source of revenue foregone, predominantly through the deemed VAT provision (classified as allowances).
- However, tax expenditures under the income tax, customs and excise duty tax heads are also substantial.

Source: TaxDev, URA, MoFPED

# Our study will focus on corporate income tax incentives. Uganda performs poorly at collecting CIT, meaning policymakers must be wary about further CIT base erosion ...

Corporate Income Tax Revenues (% of GDP, Latest Data\*)

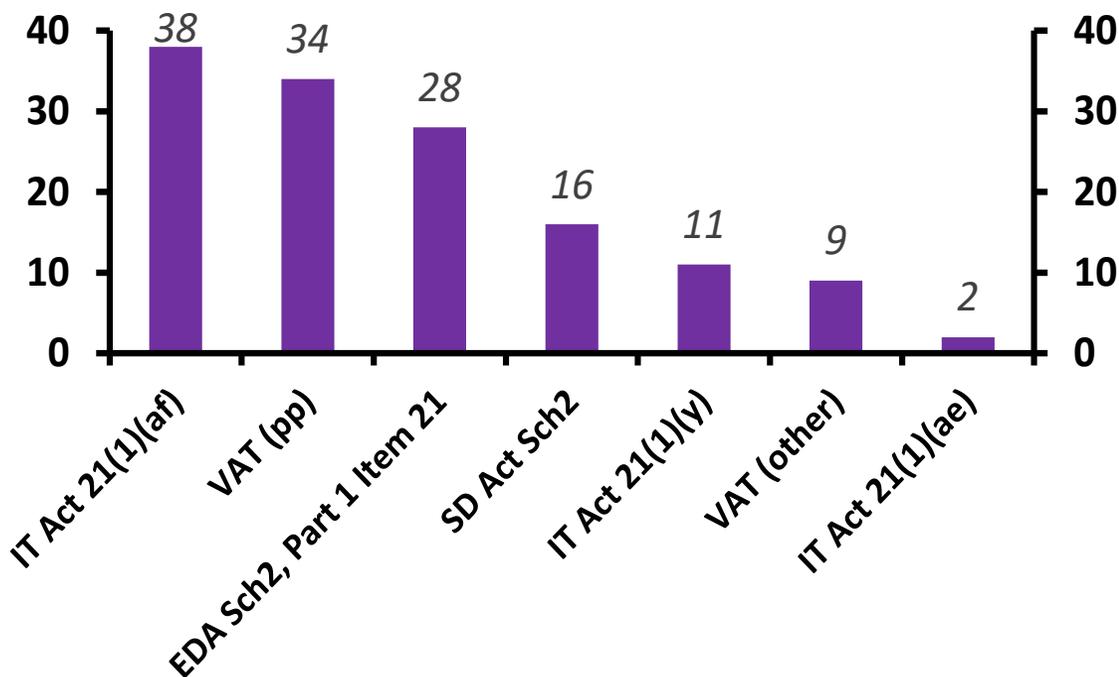


Source: UNU-Wider Government Revenue Dataset (GRD)

Notes: \*Latest data refers to the latest data point in the GRD and varies on a country-by-country basis.

# The most widely-used investment incentive in the domestic laws is Section 21.1.af of the Income Tax Act ...

No. of Firms Benefiting from Statutory Income Tax Incentives (Latest Data)



Source: URA

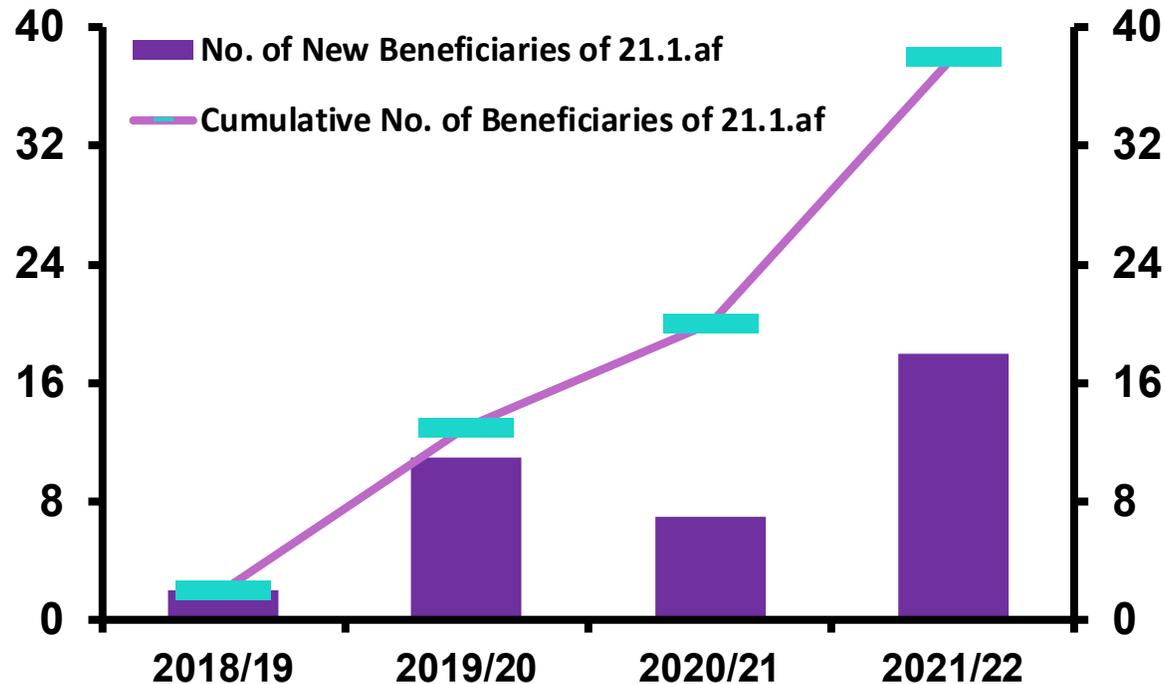
- The most recent URA data show that Section 21.1.af has been used by 38 firms (as of FY 2021/22) – more than any other statutory incentive
- Section 21.1.af was introduced in the IT Act in FY 2018/19 and allows for a ten-year CIT holiday for firms/investors which:
  - Operate in priority sectors\*
  - Meet a qualifying investment threshold (USD 10mn for foreigners and either USD 0.30mn or USD 0.15mn for citizens depending on whether asset is placed in Kampala or upcountry\*\*)
  - Sources at least 70% of raw materials locally
  - Have Ugandan citizens accounting for at least 70% of the aggregate wage bill
  - Have Uganda citizens accounting for at least 70% of employees
- Similar conditions are in place for firms to qualify for exemptions in the VAT, Stamp Duty & Excise Duty Acts
- Next most widely-use incentive is 21.1.y – which provides exemptions for firms who export > 80% of their production

# Section 21.1.af has been adjusted significantly since its introduction ....

Year	Qualifying Investment	No. of Years	LRM Requirement	Local Employment Requirement	Qualifying Sectors Added
2018/19	Foreigners - USD 15m Citizens – USD 5m	5	-	-	-
2019/20	Foreigners - USD 10m Citizens – USD 1m	10	Source 50% of raw materials locally	-	<ul style="list-style-type: none"> <li>Agro-processing</li> <li>Manufacturers or assemblers of medical appliances &amp; sundries, pharmaceuticals, building materials, vehicles &amp; HH appliances</li> <li>Manufacturers of furniture, pulp and paper</li> <li>Printers &amp; publishers of instructional materials</li> <li>Establishers or operators of VTIs</li> <li>Logistics, warehousing, ICT &amp; comm. farming</li> </ul>
2020/21	Foreigners - USD 10m Citizens (Kampala) – USD 0.30m Citizens (Upcountry) – USD 0.15m	10	Source 70% of raw materials locally	Citizens account for 70% of employees. Citizens account for 70% of wage bill.	<ul style="list-style-type: none"> <li>Manufacturers of tyres, footwear, mattresses and toothpaste</li> </ul>
2021/22	Foreigners - USD 10m Citizens (Kampala) – USD 0.30m Citizens (Upcountry) – USD 0.15m	10	Source 70% of raw materials locally	Citizens account for 70% of employees. Citizens account for 70% of wage bill.	<ul style="list-style-type: none"> <li>Manufacturers of chemicals for agricultural and industrial use</li> <li>Manufacturers of textiles, glassware, leather products, industrial machinery, electrical equipment, sanitary pads and diapers</li> </ul>

# The number of new firms benefiting from the investment incentive has increased dramatically over time...

New Firms Benefiting from Section 21.1.af in Income Tax Act



Source: URA

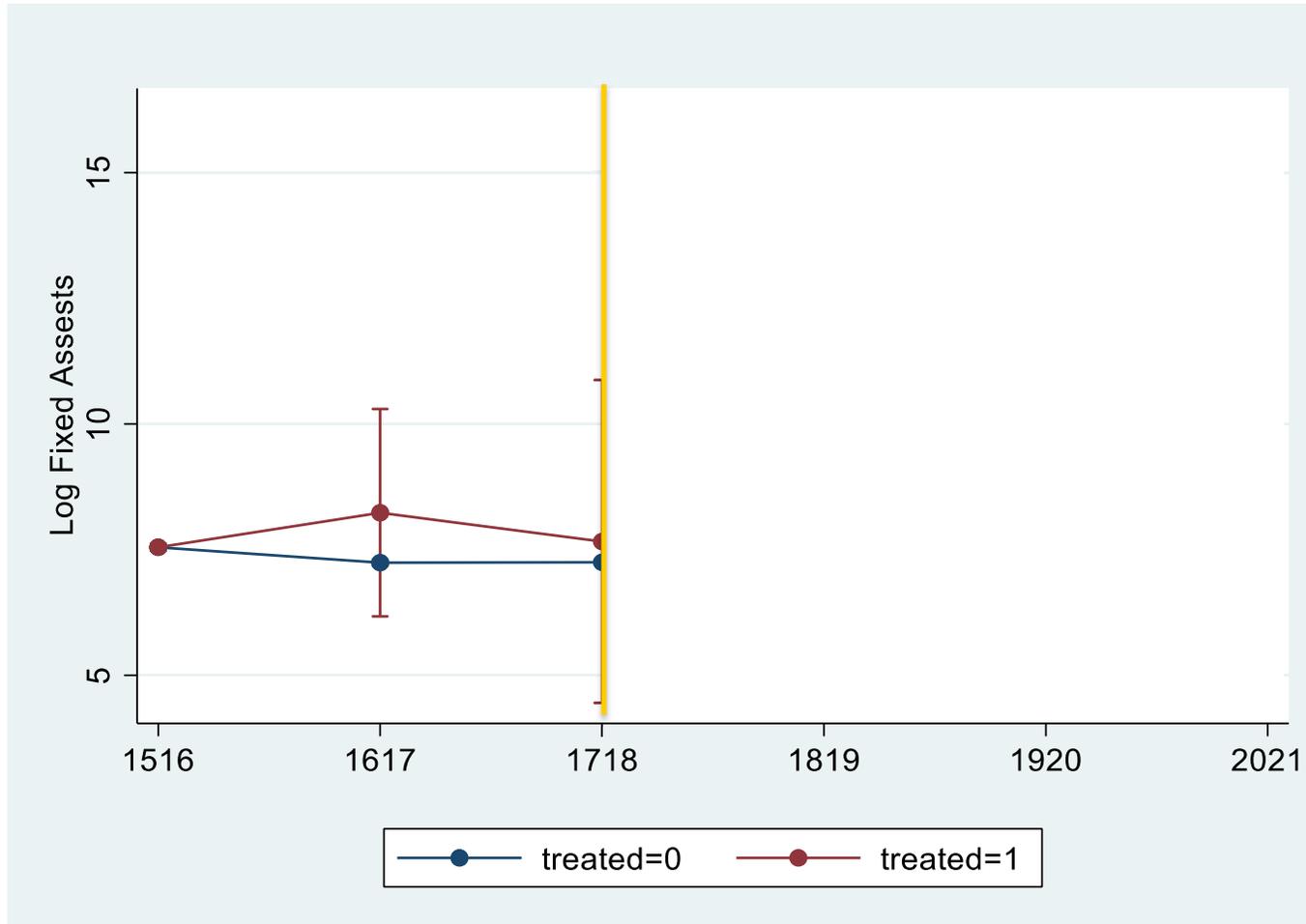
- Number of new beneficiaries of Section 21.1.af since introduction in FY 2018/19 has risen from 2 to 18 p/year.
- The increase may have been driven by:
  - Expansion of qualifying sectors
  - Firms having adequate time to raise investment to meet the qualifying threshold
  - Lowering of thresholds for local investors
- Recent patterns suggest that further sharp rise in beneficiaries of Section 21.1.af may lie in store.

# Empirical approach to understanding the impact of 21.1.af

---

- **Technique: Difference-in-Difference (DiD)** is used to estimate the economic impact of the introduction of the investment incentive on three outcomes, namely
  - i. **Investment,**
  - ii. **Sales revenues (turnover) &**
  - iii. **Total wage bill**
- We attempt to measure the changes in these outcomes for beneficiaries (“treatment”) relative to non-beneficiaries (“control”).
- Data is from firm-level CIT returns (URA).

# Effects on Investment (fixed assets)



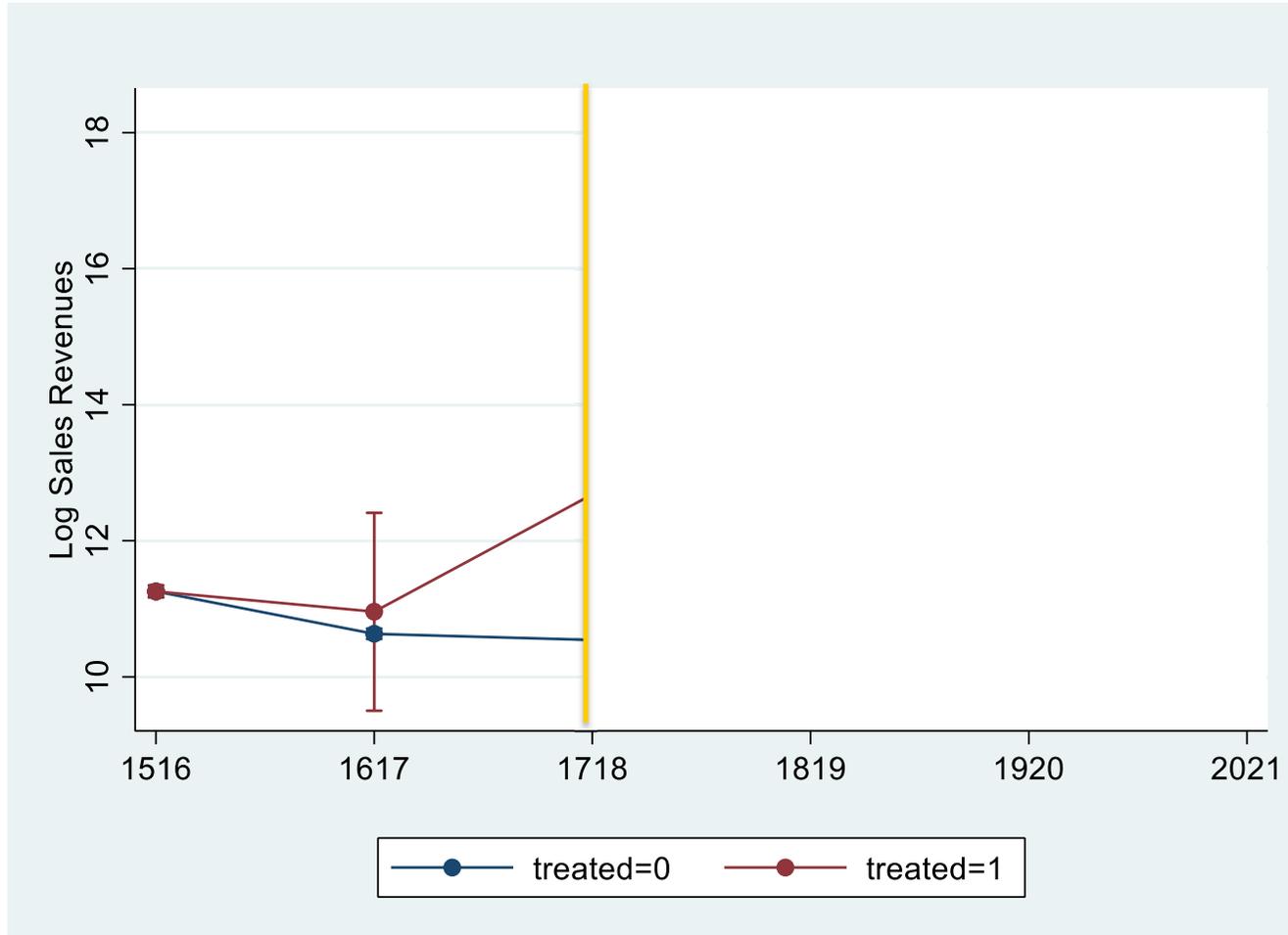
We measure firms' fixed asset stocks

**Q:** How have the (avg.) asset stocks of **beneficiaries (treatment)** and **non-beneficiaries (control)** evolved over time, before and after the insertion of 21.1.af?

**Before:** Broadly moving in the same direction (no difference in trends).

**After:** We observe an increase in the stock of fixed assets of **treatment** firms, vis-à-vis the **control group**

# Effects on Sales Revenues (Turnover)



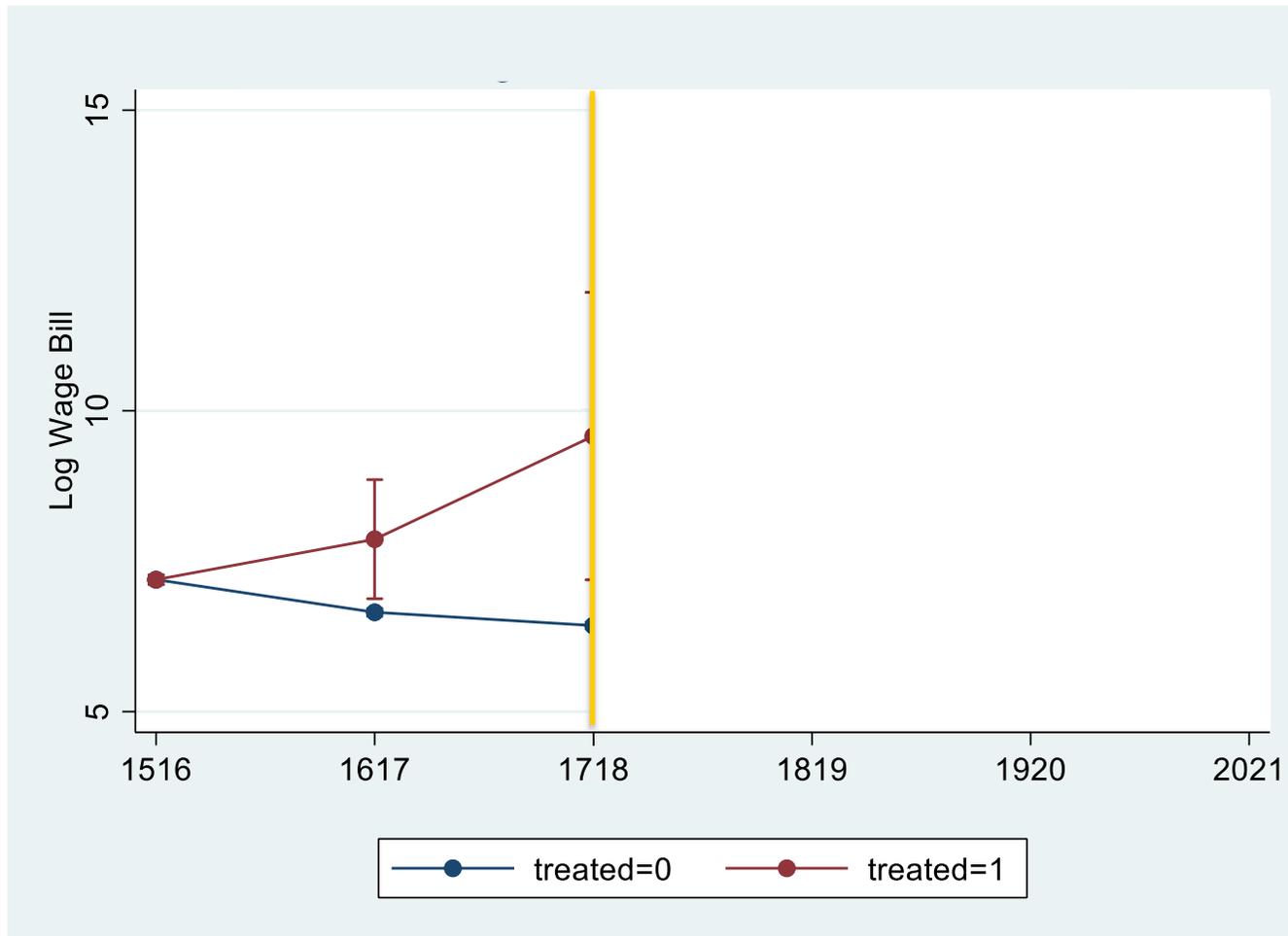
We measure firms' turnover

**Q:** How has the (avg.) turnover of **beneficiaries (treatment)** and **non-beneficiaries (control)** evolved over time, before and after the insertion of 21.1.af?

**Before:** Some difference in trends. **Beneficiary firms'** turnover **already higher** in FY17/18 than **non-beneficiaries**

**After:** The gap is sustained, and indeed grows marginally in later years, even during pandemic

# Effects on Wage Bill



We measure firms' total wage bill

**Q:** How has the (avg.) total wage bill of **beneficiaries (treatment)** and **non-beneficiaries (control)** evolved over time, before and after the insertion of 21.1.af?

**Before:** Again, difference in trends. **Beneficiary firms'** turnover **already higher** in both FY16/17 & FY17/18 than **non-beneficiaries**

**After:** The difference is sustained, and grows in later years, even during pandemic

# Results of Econometric DiD model

Coefficients of Receiving Tax Incentive Under Different Estimations				
Outcome Variable	Equation One	Equation Two		
		1Y Post	2Y Post	3Y Post
Total Fixed Assets	4.025**	3.092	3.207	4.235
	(1.654)	(2.022)	(2.453)	(3.175)
Sales Revenues	3.0433*	-0.038	0.049	0.058
	(1.819)	(1.380)	(1.541)	(2.637)
Total Wage Bill	2.831*	-2.162	-1.448	-1.639
	(1.631)	(1.668)	(2.317)	(3.130)

The statistical significance of the results previously shown holds only under certain modelling assumptions. Estimated coefficient on Total Fixed Assets is always positive. The effects on investment are positive across specifications; Turnover is ambiguous. Estimated coefficient on Wage Bill is also ambiguous.

**Notes**

- Estimation includes one control variable – In interest expenses
- Robust standard errors in parentheses and clustered at a firm level
- \*\*\*, \*\* and \* denote the significance at the 1, 5 and 10% levels respectively
- Equation 1 assumes that parallel trends assumption holds; equation 2 relaxes this assumption
- All specifications include firm-level fixed effects, a common time trend & dummy variable for final period
- These estimations do not use matching techniques

# Key Takeaways

---

1. Context: Uganda's CIT collection is poor relative to its peers; Government Debt-to-GDP is rising; pressure to curb revenue foregone from Tax Expenditures.
2. There is evidence that the introduction of Section 21.1.af in the IT Act may have prompted beneficiaries to invest more in relation to non-beneficiaries.
  - Also some evidence that larger firms benefitting disproportionately.
3. Our results provide **no strong evidence**, however, that firms benefiting from this incentive generate higher turnover or have a total higher wage bill than non-beneficiaries.
4. An increasing number of firms are benefiting from 21.1.af, presenting a growing **risk of more substantial erosion of the CIT base** erosion in medium term.

# Key Policy Recommendations

---

- Policymakers should **closely monitor** the rising no. of beneficiaries of Section 21.1.af due to the **risk of future CIT base erosion**, & re-calculate the outcomes estimated in our study on an annual basis as new data becomes available.
- **To protect future revenues, policymakers might consider the following options:**
  1. Repealing 21.1.af after a number of years (generous incentives already exist via e.g. capital allowances and uncapped loss-carry forward provisions).
  2. Trimming the list of benefiting sectors.
  3. Increasing the qualifying investment threshold.

# Contacts

---

International Growth Centre  
London School of Economics  
and Political Science

Houghton Street  
London WC2 2AE

[www.theigc.org](http://www.theigc.org)



DIRECTED BY



FUNDED BY



31 August 2022

# Annex Slides

---

# An empirical approach to understanding the impact of the introduction of the investment incentive ...

- **Difference-in-Difference (DiD)** is used to estimate the economic impact of the introduction of the investment incentive on investment, sales revenues and the total wage bill of beneficiaries.
- We attempt to measure the changes in the outcome variables (investment, sales revenue, total wage bill) of the beneficiaries relative to firms who are not benefiting from the incentive.
- Equation 1 assumes that the parallel trends assumption holds, while equation 2 relaxes this assumption.

$$\ln(Y_{it}) = f_i + \tau \text{time} + X_{it}\beta + \delta(I_i * \text{After FY 2018-19}) + \varepsilon_{it} \quad (1)$$

$$\ln(Y_{it}) = f_i + \tau_0 \text{time} + \tau_1(\text{time} * I_i) + X_{it}\beta + \delta_1(\text{One year post exemption} * I_i) + \delta_2(\text{Two years post exemption} * I_i) + \delta_3(\text{Three years post exemption} * I_i) + v_{it} \quad (2)$$

## Notes

- $\ln(Y_{it})$  is the log of the outcome variables (firms' sales revenue, wage bill, and total fixed assets) for firm  $i$  at time  $t$ ;
- $f_i$  is a firm-level fixed effect;
- $\text{time}$  is a time trend that is assumed to be the same for both treated and comparison group firms, controlling for transitory shocks affecting all firms in the same way;
- $X_{it}$  is included to control for time-varying observable firm-specific characteristics, i.e. leverage of a firm (*includes a dummy variable for period  $t = 6$  – i.e. the last time period in our sample – to control for any time-specific shocks that affect both treated and comparison group firms in the same way at that time*). We only include interest expenses as a control variable.
- $I_i$  is a time-invariant dummy variable that equals 0 for comparison group firms, 1 for firms with a CIT exemption;
- "After FY 2018-2019" is a dummy variable that equals 1 for  $t = 4, 5$  and 6 (i.e. the years following the introduction of 21.1.af);
- $\varepsilon_{it}$  is a time-varying firm-level error term
- $v_{it}$  is a time-varying firm-level error term

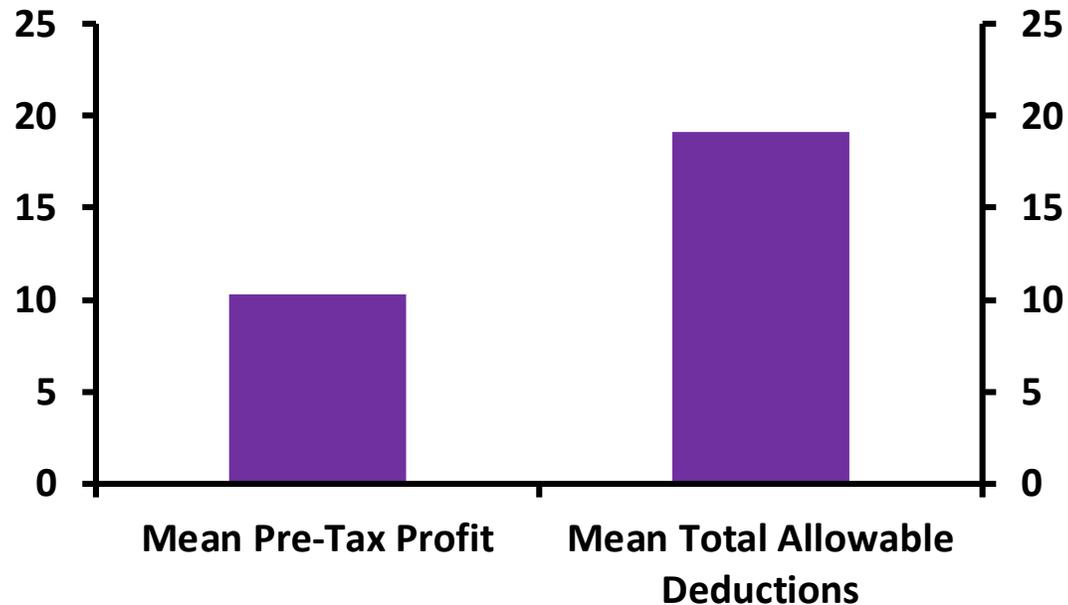
# A look at the data used in our empirical approach ...

No. of Tax Returns for Treated and Comparison Group Firms

FY	Before Matching			After Matching		
	Comparison group returns	Treated group returns	Total returns	Comparison group returns	Treated group returns	Total returns
2015/16	24,323	16	24,339	11,793	14	11,807
2016/17	24,756	16	24,772	11,907	13	11,920
2017/18	26,696	17	26,713	12,775	14	12,789
2018/19	28,809	25	28,834	11,840	14	11,854
2019/20	30,712	28	30,740	10,990	14	11,004
2020/21	30,058	33	30,091	9,456	14	9,470
<b>TOTAL</b>	<b>165,354</b>	<b>135</b>	<b>165,489</b>	<b>68,761</b>	<b>83</b>	<b>68,844</b>

# Investing to meet the threshold has pushed up the value of total allowable deductions for firms, pushing down chargeable income...

**Pre-Tax Profit & Total Allowable Deductions of Firms Benefiting from 21.1.af (UGX Bn, Averages, 2018-19 to 2020-21)**



Source: URA

Notes: These calculations are made at a return-level using the available returns of 14 beneficiaries of the provision.

- Firms benefiting from Section 21.1.af need to make a qualifying investment to utilise the provision.
- These qualifying investments can be written off for tax purposes and increase total allowable deductions.
- As a result, total allowable deductions are much higher than pre-tax profit for most beneficiaries of the provision.
- Indeed, no beneficiaries of the provision actually recorded a positive chargeable income.
- Accordingly, the static revenue foregone from this provision is currently zero.
- However, L-R revenue leakages are almost certain.