



THE REPUBLIC OF UGANDA

**BACKGROUND TO THE BUDGET
FOR FINANCIAL YEAR 2004/05
Draft**

“Promoting Economic Growth and Reducing Poverty through Public Expenditure”

**MINISTRY OF FINANCE,
PLANING AND ECONOMIC DEVELOPMENT
P. O. BOX 8147
KAMPALA
www.finance.go.ug**

May 2004

TABLE OF CONTENT

	Page
INTRODUCTION	1
CHAPTER ONE: THE DOMESTIC ECONOMIC PERFORMANCE IN 2003/04 AND GROWTH PROSPECTS	3
Overview	3
Gross Domestic Product (GDP)	3
Inflation	6
Exchange Rate	7
Interest Rate	8
Private Sector Credit	9
Domestic Debt	10
Overall Balance of Payments position	11
Export Performance	12
The External Debt Position and Sustainability	14
Regional and International Co-operation	14
CHAPTER TWO: THE BUDGET PERFORMANCE IN 2003/04	17
Overview of the Government Budgetary Operations	17
Domestic Revenue Performance	18
Disbursement of Budget Support	21
Expenditure Performance	23
Sectoral Performance	24
PAF Performance	25
Constraints to Budget Execution	26
CHAPTER THREE: PROSPECTS, CHALLENGES AND EMERGING PRIORITITES FOR POVERTY ERADICATION	27
Overview	27
Trends in Income Poverty and Inequality	27
Service Delivery	30
Population, Labour Force, and Employment Trends	39
Northern Uganda: Post-Conflict reconstruction	41
Future Policy Thrust for the Revised PEAP	42
Public Expenditure Issues for Implementing the Revised PEAP	47
CHAPTER FOUR: MEDIUM TERM BUDGET OUTLOOK IN 2004/05 2005/06	49
Overview	49
The Resource Envelope	50
Resource Allocation	52
Sectoral Allocations	53
Expenditure Options	54
Future Thrust for the Public Sector Program	54
Future Challenges for Budget Policy	55

List of Figures

	Page
1. Figure 1.1: Changes in Annual Food Crop, Headline and Underlying Inflation for the Years Ending July 2002–March 2004	7
2. Figure 1.2: Nominal Exchange Rate Movements July 2002 – March 2004	8
3. Figure 1.3: Treasury Bills Interest Rates July 2002 – March 2004	9
4. Figure 1.4: Average Weighted Lending Rates July 2002–February 2004	10
5. Figure 2.1: Budget Release by Expenditure Category, July 2003-March 2004	23
6. Figure 2.2: Budget Performance by Sector, July 2003-March 2004	24
7. Figure 2.3: PAF Cumulative Performance and Cash limits for FY 2003/04	25
8. Figure 3.1: National Poverty Trends	28
9. Figure 3.2: Regional Poverty Trends	28
10. Figure 3.3: 1999-2003 Welfare Changes by Quintile	29
11. Figure 3.4: Share of Borrowers by Economic Activity	35

List of Tables

		Facing Page
1.	Table 1.1: GDP Contribution by Sector, 1999/00–2003/04	4
2.	Table 1.2: Real Factor cost GDP growth rates (1996/97 constant prices)	5
3.	Table 1.3: Key Domestic Debt Indictors 2000/01-2003/04	10
4.	Table 1.4: Balance of Payments 2000/01-2003/04 (millions US\$)	11
5.	Table 1.5: Uganda’s Exports of Goods and Services 2000/01 – 2003/04 (US\$ Million)	13
6.	Table 1.6: Key External Debt Indicators 1999/00 – 2003/04	14
7.	Table 2.1: Summary of Budgetary Operations FY2002/03-2003/04	17
8.	Table 2.2: Provisional Outturn for Recurrent Revenue Performance 2001/02 2003/04	19
9.	Table 2.3: Provisional Revenue collection for FY2003/04 relative to Budget Estimates	20
10.	Table 2.4: Budget Support Performance H1 2003/4 (US\$ M)	22
11.	Table 2.5: Resource Envelope For FY2003/04 (Ushs Bn)	23
12.	Table 3.1: Income Inequality Indicators for Uganda (Gini coefficient)	30
13.	Table 4.1: The Resource Envelope for Public Expenditure in the Medium-Term	51

Executive Summary

During the financial year 2003/04, the economy grew at a faster rate than the last financial year: 5.8% compared to 4.9%. Higher economic growth was achieved because of continued macroeconomic stability and the recovery in the food-crop sub-sector due to adequate and timely rains.

Despite a decline in coffee export volumes, due to wet weather conditions during the coffee season, that inhibited coffee bean formation, harvesting and drying, overall export receipts have increased as a result of better export prices for non-coffee exports and higher export volumes. Much of the growth in export volumes has come from investment in fish processing facilities, improved management of tea estates, the increase in farm size of flower green houses and a decline in freight charges.

Most sectors of the economy have registered stronger growth except manufacturing, construction and community services. Electricity generation, transport and communications, wholesale and retail services have exhibited strong growth. The slow growth in manufacturing is due to low domestic consumer demand for local manufactures such as drinks, tobacco and chemicals, while the slow growth in construction has been due to lower donor funds for road and other major construction services. As a result of slow growth in construction services, the mining and quarrying sector, which supplies most of the construction materials, has declined by 1.2%.

In the financial sector, interest rates have been for a large part of the year relatively high and volatile, while the exchange rate has experienced considerable pressures to appreciate. Pressures for the exchange rate to appreciate came from the global weakening of the dollar vis-à-vis other major currencies, the lower average inflation rates of Uganda's major trading partners relative to average domestic inflation rate, and the speculative massive inflows of offshore short term capital that was attracted by the high domestic interest rates. However, the increase in sales of treasury bills and the introduction of a government long-term bond has resulted into a reversal of the situation. Notably, this process did not come at zero cost. The stock of the domestic debt has expanded considerably driving up commercial bank lending rates, while the increase in domestic interest costs has accounted for a larger share of the budget resources at the expense of other programs.

On the regional and international cooperation front, Uganda has actively participated in trade and investment negotiations leading to better market opportunities. With the signing of the protocol on the establishment of the East African Customs Union in March this year, the three partner states are expected to enjoy higher economic welfare, although Uganda's actual tariff revenues are projected to decrease in the short term. Imports are expected to increase mostly in manufactures, and exports mostly in processed foods and other primary products. Because the exporting sectors that expand are typically relatively labour intensive, there is a significant scope for productive employment. Reduction in Uganda's short-term tariff revenues should not be interpreted as an economic loss, but simply as a transfer of resources from Government to

consumers. With time, such a transfer might be won back by government through renegotiation of social contracts that govern taxation and provision of public goods.

The overall management of the budget in 2003/04 has been complicated by the presence of non-discretionary expenditure items, which accounted for 61% of the GOU budget and 46% of the entire budget, together with the rise in the domestic debt created by financing of a large fiscal deficit. Given the need to meet the higher domestic interest costs and to fund supplementary expenditures in the fourth quarter of the financial year, adjustments were made on the non-discretionary, non-wage, and development expenditure. These affected negatively the performance of these expenditure areas. In addition, resource allocation continued to be constrained by the requirements within the budget support agreements to meet counterpart obligations. Consolidation of Government accounts also continued to be complicated by omissions, as donors continued to disburse funds directly to project accounts in commercial banks and to emphasize donor as opposed to Government reporting requirements.

Domestic resource mobilization continued to perform less satisfactorily during the FY 2003/04. Despite a strong performance of direct taxes, and particularly corporate tax, there has been a shortfall in domestic revenues (provisionally estimated at Shs.28.1 billion) largely on account of a weak performance in VAT on both imports and domestically produced goods. The strong performance of corporate tax has been due to an increase in the profitability of the banking and oil sectors, and the pay reform strategy. Given a rise in import demand, the weak performance of VAT taxes from international trade is partly due to poor tax administration. The weak performance of VAT on domestically produced goods is on account of low domestic consumer demand.

The higher than programmed disbursement of budget support helped offset the shortfall in domestic revenue and project support grants, leading to a surplus of Shs.221 billion in total revenues and grants. Disbursement of budget support has been much higher in shilling terms due to offloading of budget support grants meant for last financial year, and the strength of the donor countries' currencies vis-à-vis the dollar. Despite the higher than programmed overall resource, expenditure restraint has been exercised given the domestic revenue shortfall so as to keep control of the budget deficit (excluding grants) within the program limit. It is provisionally estimated at 11.3% of GDP close to the programmed level of 11.2%. Total expenditure is estimated at 23.8% of GDP, a lower level than the programmed 24.2%.

The current financial year corresponds with the second revision of the PEAP. The current PEAP revision process has been highly participatory, and has culminated into consensus on the need to focus on the following five priority areas:

1. Economic management

- the maintenance of macroeconomic stability
- fiscal consolidation
- export promotion

- boosting private investment

2. Production, competitiveness and incomes

- the modernisation of agriculture
- preservation of the natural resource base, particularly soil and forests
- infrastructure including roads, electricity and railways; better maintenance, cost-reduction and private sector participation will be key to achieving improvements in the context of fiscal consolidation.
- enhancing private sector skills and business development.

3. Security, conflict-resolution and disaster-management

- ending rebel insurgency, by peaceful means if possible
- ending cattle-rustling
- dealing with internal displacement, which is a major sources of distress in contemporary Uganda

4. Governance

- human rights and democratization
- the development of a better legal system
- transparency, accountability and the elimination of corruption

5. Human development

- primary and secondary education: with a clear focus on quality and the ultimate objective of learning, and with better targeting of public expenditure on secondary education at those who could not otherwise afford it.
- improving health outcomes; this will be the joint achievement of several sectors
- increasing people's ability to plan the size of their families
- adult literacy

Moreover, the revised PEAP is based on transformation of the economy through private investment, industrialisation and export-led growth, hand in hand with improvements in the quality of life of each and every Ugandan.

Addressing the emerging PEAP priorities highlighted above necessitates that public resources are used more efficiently and effectively to address poverty, in line with the theme of this year's BTTB. There are two fundamental aspects to cost saving to increase resources for financing these priorities without foregoing the policy objective of fiscal consolidation: streamlining Government administration and fully integrating projects in the MTEF.

The medium-term budget outlook shows limited growth in domestic revenue as a ratio of GDP, though it is expected to grow in nominal terms in each of the financial years. This

means that there is limited scope for expanding Government expenditures as fast as they have been in the past. In the medium-term, the focus shall be on quality rather than quantity of donor support. The macroeconomic policy objectives of the budget in the medium-term are to limit expenditure to resources available and to constrain the budget deficit to a level compatible with low interest rates and a competitive exchange rate. PAF expenditures will increase to 37.3% of the discretionary budget in 2004/05 and all sector ceilings will increase in nominal terms although not uniformly. The medium-term challenges for budget policy are enhancing domestic revenue mobilization without creating excess tax burden and/or income inequalities, and targeting service delivery to the poor.

INTRODUCTION

The aim of the Background to the Budget (BTTB) 2004/05 is to provide background information on the factors that have influenced key budgetary decisions during the current financial year, together with a comprehensive report on the effects of such decisions on the Ugandan economy and the Government's quest to eradicate poverty.

This report is prepared and published on a yearly basis by the Ministry of Finance, Planning and Economic Development prior to the Budget speech. The Budget speech is the culmination of a long process of deliberations, involving all Government's agencies and its development partners, to allocate government's resources among all sector of the economy to facilitate Government's implementation of the national development plan, as reflected in the Poverty Eradication Action Plan (PEAP).

The current financial year corresponds with the second revision of the PEAP. The current PEAP revision process has been highly participatory, and has culminated into consensus on the need to focus on the following five priority areas:

1. Economic management

- the maintenance of macroeconomic stability
- fiscal consolidation
- export promotion
- boosting private investment

2. Production, competitiveness and incomes

- the modernisation of agriculture
- preservation of the natural resource base, particularly soil and forests
- infrastructure including roads, electricity and railways; better maintenance, cost-reduction and private sector participation will be key to achieving improvements in the context of fiscal consolidation.
- enhancing private sector skills and business development.

3. Security, conflict-resolution and disaster-management

- ending rebel insurgency, by peaceful means if possible
- ending cattle-rustling
- dealing with internal displacement, which is a major sources of distress in contemporary Uganda

4. Governance

- human rights and democratization
- the development of a better legal system

- transparency, accountability and the elimination of corruption

5. Human development

- primary and secondary education: with a clear focus on quality and the ultimate objective of learning, and with better targeting of public expenditure on secondary education at those who could not otherwise afford it.
- improving health outcomes; this will be the joint achievement of several sectors
- increasing people's ability to plan the size of their families
- adult literacy

Moreover, the revised PEAP is based on transformation of the economy through private investment, industrialisation and export-led growth, hand in hand with improvements in the quality of life of each and every Ugandan.

The theme of this year's Background to the Budget is "Promoting Economic Growth and Reducing Poverty through Public Expenditure". This theme reflects an attempt to focus the national Budget on the priority actions identified in the revised PEAP. This BTTB is structured into four chapters. *Chapters 1* and *2*, in turn, provide a complete account of domestic economic performance and Budget performance in 2003/04. In line with the theme of this BTTB, *chapter 3* highlights progress, challenges and emerging priorities for poverty eradication. Finally, *chapter 4* sets out the Budget outlook for the medium-term.

CHAPTER ONE: THE DOMESTIC ECONOMIC PERFORMANCE IN 2003/04 AND GROWTH PROSPECTS.

I. OVERVIEW

1.01 A sound economic framework conducive to private sector investment is the cornerstone of Uganda's growth strategy. The Government believes that the fundamentals required of its economic framework are low and stable inflation, competitive exchange rate, low interest rates, and a sustainable fiscal deficit.

1.02 During the financial year 2003/04, the economy grew at a faster rate than last financial year. Higher economic growth was achieved because of continued macroeconomic stability and the recovery in the food-crop sub-sector due to adequate and timely rains. The level of inflation is projected to be on target, at an average of 5%. Interest rates, though declining since January 2004, have been relatively high and volatile. Similarly, the exchange rate has been volatile and subject to appreciation pressures as a result of a generally weak dollar globally, and speculative inflows from the region attracted by high domestic interest rates. The high interest rates and appreciation pressure on the exchange rate witnessed in much of 2003/04 can be attributed to the high fiscal deficit, as Bank of Uganda had to sell foreign exchange and government securities to mop up excess liquidity injections arising from higher Government spending.

1.03 Coffee prices rose by 28% between June 2003 and March 2004 as a result of the lower than anticipated supply on the world coffee market, but export volumes and receipts continued to decline due to poor weather conditions which affected the harvesting and drying processes in most parts of the coffee growing areas. However, Uganda's total exports increased during the first half of the financial year compared to the previous year. This was largely due to improved export receipts from cotton, fish, tea, maize and flowers.

II. GROSS DOMESTIC PRODUCT (GDP)

1.04 Estimates for the 2003/04 GDP growth rates have incorporated results of the Uganda Business Inquiry (UBI) 2000, and Uganda National Household Survey (UNHS) 2002/03, and have also drawn on the audited accounts of Government. As a result, the GDP series presented for the past five years in this Background to the Budget differs from that of 2002/03.

1.05 During the financial year 2003/04, the economy registered a growth rate of 5.8%, which is above the growth rate of 4.9% in 2002/03 but below the medium term growth target of 7%. The overall GDP growth rate has been driven by better performance of the agriculture sector, which has grown by 5.2% in 2003/04 compared to a lower growth rate of 2.3% in 2002/03. Higher growth in the agricultural sector is attributed to the recovery in food crop output, which grew by 7.7%, this year compared to a growth of 3.7% in 2002/03.

1.06 GDP at factor cost measured in current prices is expected to amount to Shs.12.1 trillion compared to Shs.10.9 trillion in 2002/03. Of this, 82% equivalent to Shs.9.9 trillion is monetary GDP, while 18% equivalent to Shs.2.2 trillion is non-monetary. Monetary Gross Domestic Product (GDP) has expanded at the same rate as the previous year, on account of a decline in cash crop output, mining and quarrying, general government services and health services. On the contrary, non-monetary GDP has expanded faster than the previous year on account of higher non-monetary food crop output. In 2003/04, per capita GDP is estimated to amount to Shs.468,661 equivalent to about US\$250 at the prevailing exchange rate. This represents a growth rate of 2.2% compared to last year. Table 1.1 below provides a trend of the sectoral contributions to GDP in the last five years.

Table 1.1: GDP Contribution by Sector, 1999/00 – 2003/04

	1999/00	2000/01	2001/02	2002/03	2003/04
Agriculture	40.9%	40.7%	39.7%	38.7%	38.5%
Industry	18.6%	18.7%	19.0%	19.5%	19.4%
Services	40.5%	40.6%	41.2%	41.8%	42.0%

Source: Uganda Bureau of Statistics

1.07 Over the five-year period, the share of agriculture has declined by 2.4% percentage points, while the shares of industry and services have increased by 0.8% and 1.6% respectively. Although agricultural output has been higher in 2003/04 than the previous year, its contribution to GDP continued to decline by 0.2 percentage points while the contribution of industry has stagnated at about 19.5%. The contribution of the services sector increased modestly by 0.2 percentage points. Table 1.2 below shows the sector growth rates in 2003/04 relative to the past four years.

Table 1.2: Real Factor Cost GDP Growth Rates (Constant 1997/98 Prices)

	1999/00	2000/01	2001/02	2002/03	2003/04
INDUSTRY GROUP					
MONETARY					
Agriculture	5.2	4.5	5.7	3.9	5.6
o/w cash crops	7.0	-4.9	7.4	4.6	1.8
o/w food crops	5.9	8.2	5.7	3.7	7.7
Mining & Quarrying	6.3	10.1	11.1	2.7	-1.2
Manufacturing	3.6	8.9	5.3	4.0	4.0
Electricity & Water	7.9	8.2	5.4	4.7	6.8
Construction	7.1	1.8	12.5	12.9	8.1
Wholesale & Retail Trade	1.9	6.3	6.7	4.1	4.8
Hotels & Restaurants	18.7	7.1	18.1	7.5	7.9
Transport & Communications	8.5	9.6	12.4	14.9	14.4
Community Services	8.6	3.5	6.4	5.0	4.5
TOTAL MONETARY	6.1	5.3	7.4	5.9	6.0
NON-MONETARY	6.3	5.1	2.6	1.3	4.9
TOTAL GDP	6.2	5.3	6.3	4.9	5.8
GDP PER CAPITA	2.6	1.8	2.8	1.4	2.2

Source: Uganda Bureau of Statistics

1.08 From the GDP series shown in table 1.2 above, it is clear that agricultural production has increased much more in 2003/04 than in 2002/03 but only as a result of better food crop output. It is however, disappointing to note that growth in cash crop production declined from 4.6% 2002/03 to 1.8% in 2003/04 because of an estimated 8.6% fall in coffee output. Coffee accounts for about 60% of total cash crop output. In addition, the economy experienced lower growth in construction services, which include roads, buildings and informal housing, and a decline in mining output. Mining output declined by 1.2% this year compared to an increase of 2.7% last financial year largely on account of a slowdown in brick making. Construction services sector includes roads, buildings and informal housing. This sector is projected to grow by 8.1% this financial year, compared to a growth rate of 12.9% in 2002/03 due to lower growth in public construction expenditure on roads and public buildings.

1.09 In 2003/04, total manufacturing sector output is estimated to grow by 4.0%, the same rate as in 2002/03 largely on account of weak consumer demand for domestically manufactured goods, especially for drinks, tobacco, paper products, printing, publishing, paints, plastic products, vehicle parts, electricals and chemicals, which drive growth in the formal manufacturing. The slower rate of expansion in the economy over the recent

years has led to a reduction in aggregate demand. This has adversely affected the growth of output in the *manufacturing sector*.

1.10 It is however encouraging to note the positive contribution of the privatization program to improvement in efficiency and productivity in the economy. The privatization of electricity generation to a private company, Eskom, has led to a substantial increase in its generation, which has increased substantially by 6.3% in 2003/04 compared to a growth rate of 3.4% in 2002/03. The process of outsourcing power distribution (possibly to a joint partnership between the Commonwealth Development Corporation (CDC) and Eskom) is due for completion early next year. The search for a strategic investor in two hydroelectric power dams at Bujagali and Karuma falls has attracted about 10 firms and the selection process should also be completed early next year and construction will take place in the medium term.

1.11 The privatization program has also in addition to reducing the financial and administrative burden of the public sector enabled the country to attract new investments in areas of telecommunications. The transport and communications sector has increased its contribution to GDP from 5.9% in 2002/03 to 6.3% in 2003/04. Air transport services have expanded and improved. The capacity for cold storage at Entebbe International Airport has expanded and now there are adequate facilities to handle more planes, export products and tourists. Unfortunately, railway transport remains underdeveloped with much of the infrastructure being old and dilapidated coupled with an acute shortage of rolling stock. However, under the privatization program, there are initiatives for joint concessioning with the Republic of Kenya. Financial and real estate services have also expanded although less compared to the previous year.

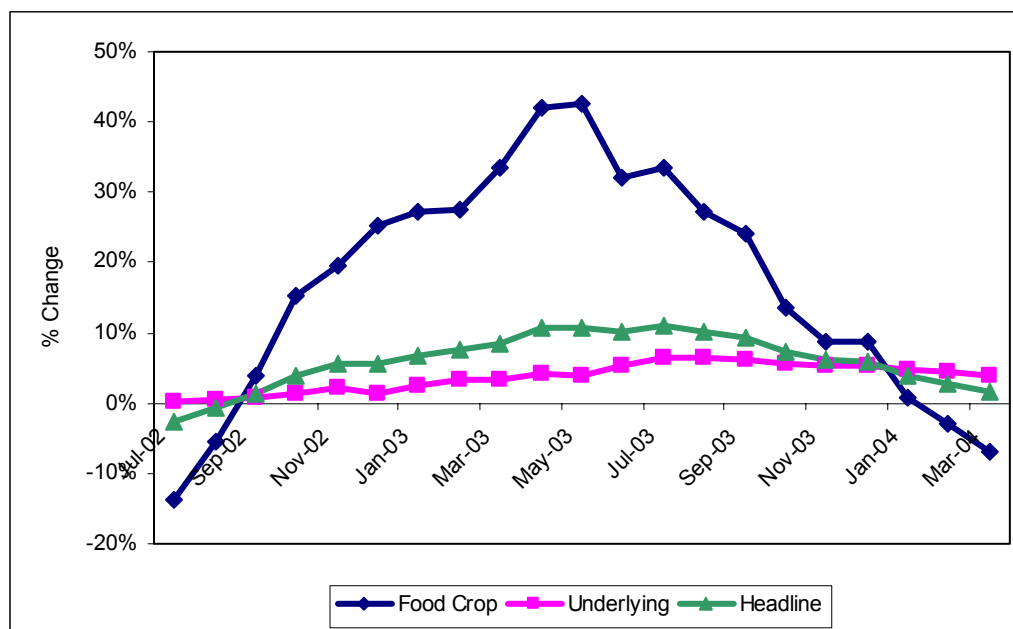
III. INFLATION

1.12 Maintaining underlying inflation at less than 5% is a cornerstone of Government's macroeconomic policy. High and volatile inflation discourages private sector investment and destroys assets of the poor. In order to achieve this inflation target, Government operates a cash budget to ensure that it does not resort to printing money, which is inflationary, to finance expenditure. This means that in any given year Government only spends resources available to it from domestic revenue and donor inflows net of debt repayments, with no recourse to excessive borrowing from the banking system/printing money.

1.13 In measuring underlying inflation, food crop prices are excluded from the Consumer Price Index. This is done so as to eliminate volatility in food crop prices caused by the effect of weather changes on harvests. The good weather conditions for much of this financial year has resulted in good harvests which in turn has caused food crop inflation to consistently decline from an annual average of 32.0% in the year ending June 2003 to -7.0% in the year ending March 2004. As a result, headline inflation, which includes the food crop component of the CPI basket, also declined from 10.2% in June 2003 to 1.7% in March 2004.

1.14 Given this trend, Government policy of keeping underlying inflation at 5% or less will be achieved even in 2003/04. Figure 1.1 below shows changes in annual underlying, headline and food crop inflation for 2002/03 and the first three quarters of financial year 2003/04.

Figure 1.1: Changes in Annual Food Crop, Headline and Underlying Inflation for the Years Ending July 2002 – March 2004.



1.15 Nonetheless, challenges to inflation control, in terms of high level of government liquidity injections arising from donor funding of domestic expenditure still remain. As Government donor-funded expenditures in the economy have increased, so have its injections of liquidity, because every dollar channeled by a donor to the Government as budget support leads to the creation of the equivalent amount in shillings by the Central Bank for Government to spend. Bank of Uganda has therefore had to issue treasury bills and to sell foreign exchange to mop up the additional liquidity generated by increased levels of donor funded expenditures to control inflation. This has had two effects; higher interest rates on treasury bills and appreciation pressures on the Shs/\$ exchange rate.

1.16 The significant challenges in monetary/inflation management seen this financial year, point to the need for further fiscal consolidation via deficit reduction to ease monetary management and produce a favourable environment (low interest rates, competitive exchange rates) for the private sector, over the medium term.

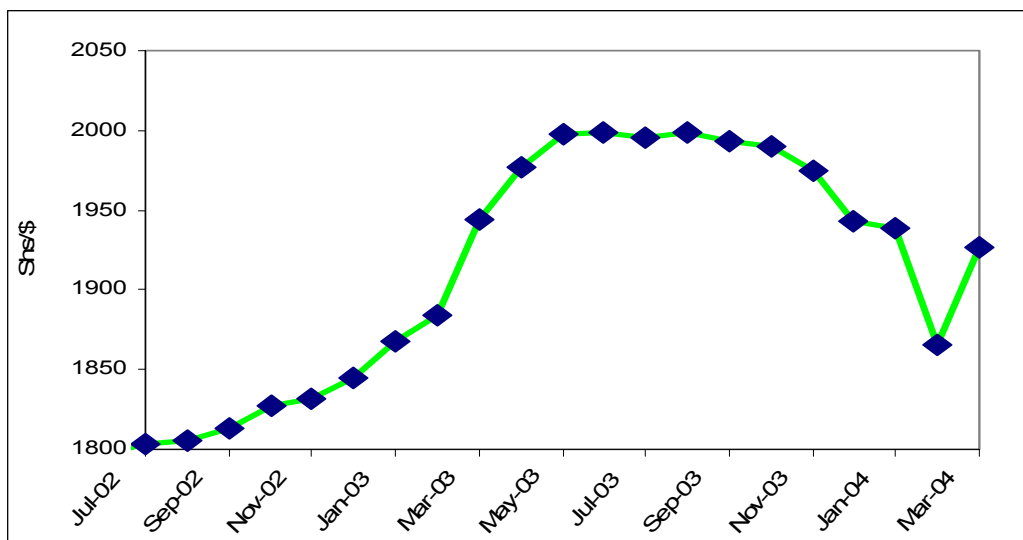
IV. EXCHANGE RATES

1.17 Maintaining a competitive exchange rate is one of the key macroeconomic policy objectives of the Government of Uganda. For the most part this financial year, the exchange rate has experienced appreciation pressures. There are a number of reasons for

this. Globally, the U.S dollar weakened (depreciated) against other international currencies as a result of low interest rates in the U.S and investor concerns about the size of the U.S current account deficit. Locally, the high interest rates on treasury bills for most of the first half of this financial year attracted speculative foreign exchange inflows from within the region into our domestic money market and put further appreciation pressures on the exchange rate. This therefore meant that Bank of Uganda had less opportunity for sterilisation using foreign exchange sale, and hence increased Treasury bill sales, which led to higher interest rates.

1.18 After closing last financial year at Shs1998.2/\$, the average inter bank mid rate appreciated by 4% or Shs 71.5 to Shs 1926.7/\$ in March 2004. As shown in Figure 1.2, the sharpest appreciation during this financial year occurred from January to February 2004 and was immediately reversed by an equal depreciation in the period February to March. The sharp depreciation was a result of market self-correction, Bank of Uganda’s intervention and an apparent loss of interest in our domestic money markets by offshore players as Treasury bill interest rates have began declining.

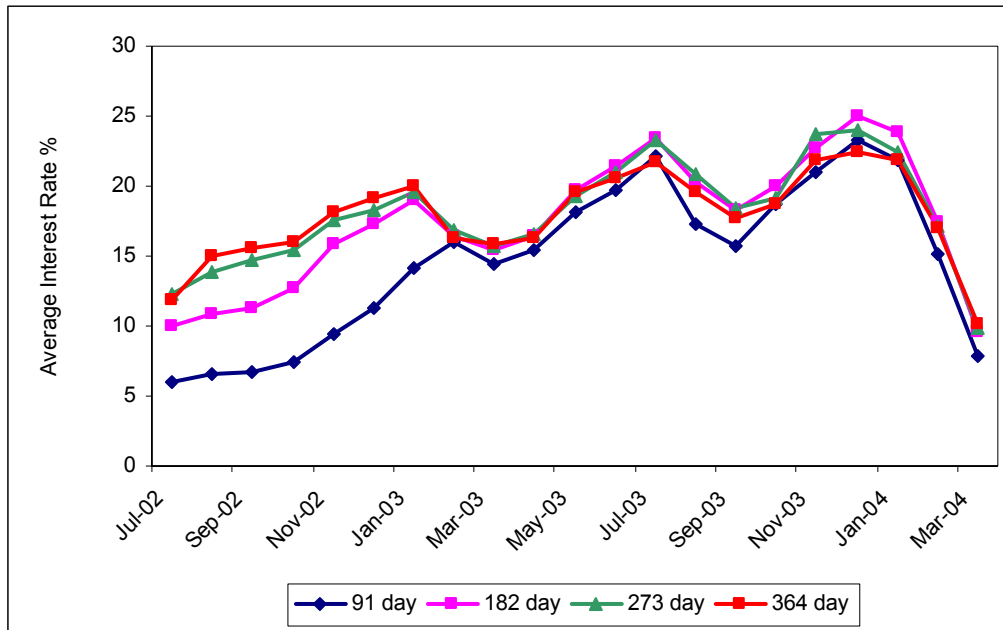
Figure 1.2: Nominal Exchange Rate Movements July 2002 – March 2004.



V. INTEREST RATES

1.19 Interest rates on treasury bills exhibited a very volatile pattern in 2003/04 as shown in figure 1.3 below. After falling across all maturities in the first quarter, they rose to their highest levels, since July 2002, in December 2003 across all Treasury Bills. While the average rate on the 91-day treasury bills fell from 22% in July 2003 to 15.7% in September, it then rose to 23% in December. Similarly, the average interest rate on the longest dated 364-day treasury bills after falling from 21.7% in July 2003 to 17.7% September, it rose to 22% in December.

Figure 1.3: Treasury Bill Interest Rates July 2002 – March 2004



1.20 As noted above, Bank of Uganda uses a mix of treasury bills and foreign exchange sales to sterilize Government liquidity injections. There was more emphasis on treasury bill sales this financial year as external factors led to upward pressure on the exchange rate thereby limiting the ability of the Bank of Uganda to sell foreign exchange for sterilization purposes as it further increased the appreciation pressures. Therefore, the increased sales of treasury bills, even as private sector credit continued to grow, caused the dramatic increase in interest rates.

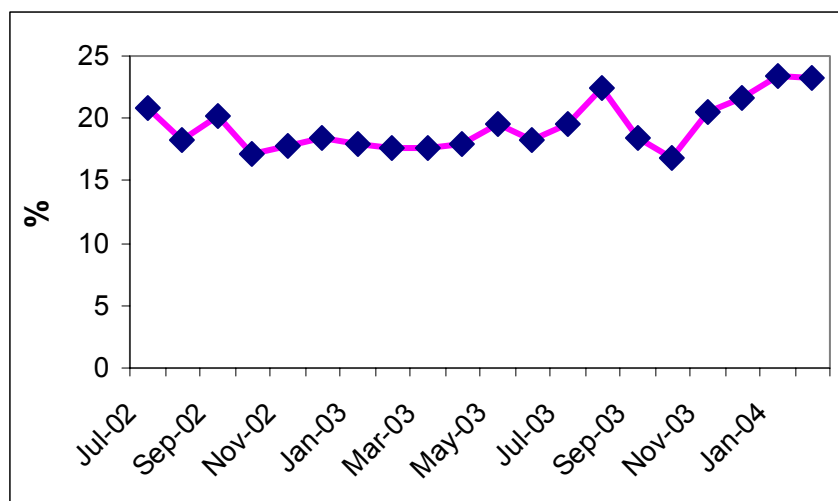
1.21 In the third quarter of the FY2003/04, interest rates on all maturities sharply declined to their lowest levels since July 2002. This came as Government introduced the long-term Government bond, which helped reduce pressure on the short-term interest rates and to extend the period of maturity or the yield curve. In addition, the exchange rate appreciation pressures eased hence allowing for the resumption of foreign exchange sales for sterilization purposes. As of March, the average interest rates on the 91-day and 364-day treasury bills had declined to 7.8% and 10% respectively.

VI. PRIVATE SECTOR CREDIT

1.22 Private sector credit is projected to grow by 23.4% this financial year compared to a growth rate of 28.2% last financial year. The continuing strong growth in private sector credit is attributed to repeat borrowings by old borrowers as well as borrowing by new customers especially small and medium scale enterprises, and introduction by commercial banks of new financial products like salary based loans. However, lending rates continue to be high, as they are influenced by Treasury bill rates, making borrowing expensive for the private sector. The movement in the weighted average commercial bank lending rate in this financial year mirrored the pattern of Treasury bill rates. After

closing last financial year at 18.3%, the weighted average lending rate rose to 22.4% in August 2003, before declining to 17% in October. Thereafter, as shown in figure 1.4 below, it consistently rose to 23.4% in February 2004, its highest level since July 2002.

Figure 1.4: Average Weighted Lending Rates July 2002 – February 2004.



VII. DOMESTIC DEBT

1.23 As noted above, the increase in the fiscal deficit has led to an increase in the net issuance of Government securities to control inflation. As a result, the stock of Government securities has increased by more than 500% in five years, and interest rates have become higher and more volatile. As shown in table 1.3, the stock of Government securities to both GDP and Government expenditure (including and excluding projects) has almost doubled in just four years.

Table 1.3: Key Domestic Debt Indicators 2000/01 – 2003/04

	2000/01	2001/02	2002/03	2003/04
TB & Bond Stock to Nominal GDP at Mkt Prices	5.0%	8.2%	8.9%	9.3%
TB & Bond Stock to Total GoU Expenditure (Excl. Projects)	31.7%	42.4%	50.4%	52.4%
TB & Bond Stock to Total GoU Expenditure (Incl. Projects)	22.5%	33.9%	38.5%	40.8%
TB Interest Payments (Shs billion)	58.8	91.2	116.8	191.7
TB Interest Payments as % Total GoU Expend. (Excl. Projects)	3.7%	4.6%	5.5%	8.1%

Source: MFPED

1.24 The increase in both the stock of Treasury bills and Treasury bill interest rates has driven up commercial bank lending rates to the private sector and also led to a significant increase in Government's interest costs. As of 2003/04, Government interest costs have increased by over 320% in four years, from Shs 59 billion in 2000/01 to Shs 192 billion this financial year. Government's domestic interest costs now account for more than 8%

of Government of Uganda expenditure. A reduction in the fiscal deficit will lead to a gradual decline in the burden of interest payments on the GoU budget.

VIII. OVERALL BALANCE OF PAYMENTS POSITION

1.25 Uganda's overall balance of payments position in 2003/04 is estimated to improve from a surplus of US\$ 55 million last financial year to a surplus overall balance of US\$ 212 million, despite a widening in the trade deficit from US\$ 642 million to US\$ 717 million over the same period. This improvement in the overall balance is mainly as a result of a substantial increase in current transfers to general Government, which increased by 77%, from US\$ 457 million in 2002/03 to US\$ 809.8 million this year. It is also worthy noting that the widening in the trade deficit occurred even when exports grew at 23% while imports rose by 17% this financial year because imports were increasing from a higher base than that of exports. Table 1.4 shows Uganda's summary balance of payments statement for the last four years.

Table 1.4: Balance of Payments 2000/01-2003/04 (millions US\$)

	1999/00	2000/01	2001/02	2002/03	2003/04 (Est.)
Current Account Balance	-414.32	-298.49	-291.43	-364.36	-119.30
Trade Balance	-494.43	-495.04	-569.73	-642.34	-716.74
Exports of Goods (fob)	459.90	458.30	474.04	507.91	626.11
Imports of Goods (fob)	-954.33	-953.34	-1043.76	-1150.25	-1342.85
Services Account (net)	-208.77	-205.75	-299.65	-228.54	-238.52
Inflows	203.34	218.12	223.24	282.77	303.51
Outflows	-412.11	-423.87	-522.89	-511.32	-542.03
Income Account (net)	-139.79	-151.42	-119.91	-134.27	-153.78
Inflows	42.09	46.15	29.47	20.26	35.48
Outflows	-181.88	-197.57	-149.38	-154.53	-189.26
Current Transfers (net)	428.67	553.73	697.86	640.79	989.75
General Government Transfers (net)	366.79	465.07	434.20	457.37	809.77
Private Transfers (net)	61.88	88.66	263.66	183.42	179.98
Capital & Financial Account Balance	307.45	315.39	398.65	419.64	330.85
Capital Account	0	0	0	0	0
Capital Transfers	0.00	0.00	0.00	0.00	0.00
Other Transfers	0.00	0.00	0.00	0.00	0.00
Financial Account	307.45	315.39	398.65	419.64	330.85
Direct Investment	176.55	143.76	145.71	153.99	162.91
Portfolio Investment	0.00	0.00	0.00	0.75	11.51
Other Investment	130.90	171.63	252.94	264.89	156.43
OVERALL BALANCE	-106.87	16.90	107.23	55.27	211.56
Financing	106.87	-16.90	-107.23	-55.27	-211.55
Use of IMF credit (net)	-15.54	-20.86	-32.94	-41.76	-47.31
Change in Gross Reserves	40.58	-33.30	-96.18	-30.41	-151.15
Exceptional Financing	77.86	37.69	22.85	19.85	2.54
Errors & Omissions	3.97	-0.43	-0.96	-2.95	-15.63

Source: Bank of Uganda

IX. EXPORT PERFORMANCE

1.26 Total export earnings of both goods and services for the year 2003/04 are projected to increase by about 18% over last financial year's outturn to US\$ 929.62 million this year largely due to improved performance of most notably, cotton, fish, tea, maize and flowers. The improved export performance is mainly on account of improved export prices especially for non-traditional exports and also higher volumes shipped. Of this, exports of goods are projected to be US\$ 626.1 million, while exports of services are projected to be US\$ 303.51 million, estimated increases of 23% and 7% respectively over last year's outturns. Coffee export earnings are projected to decline by 5% despite an improvement in export prices, due to a decline in volumes exported. For much of 2003/04, adverse weather conditions slowed down coffee bean formation, harvesting and drying.

1.27 Non-coffee exports, accounting for over 82% of total exports, are projected to increase by 28% in 2003/04. Fish and fish products, the largest non-coffee export accounting for 16% of total exports, are estimated to increase by about 18% in 2003/04. Much of the growth is expected to result from the impact of investment in processing facilities, reduction in illicit cross boarder trade and export opportunities. Higher export earnings from cotton are a result of higher prices offered last season and a production strategy being implemented by ginners. Tea production and export is benefiting from improved management of tea estates as well as strong government support services. Similarly, flower export earnings are projected to increase as result of increase in farm size, construction of more green houses and declining freight charges, which have encouraged exports. Table 1.5 below shows the projected total export earnings for the FY2003/04 in comparison with the previous three years.

1.28 Improved export performance was offset an increase in both Government and private sector import demand, which increased their import bills by 24% and 19% respectively. In line with a rapid growth in construction activities in the country, imports of building and construction materials continued to grow, especially building materials such as cement, lime, clay tiles and glass. Similarly are imports of transport and telecommunication equipment especially vehicles and mobile phones given the growing demand for transport and telecommunication services. Uganda's industries and construction sector continue to have high import content in their production structure.

Table 1.5: Uganda's Exports of Goods and Services 2000/01 – 2003/04 (US\$ Million)

	2000/01	2001/02	2002/03	2003/04 (Est.)
TOTAL EXPORTS	676.43	698.78	790.70	929.62
Exports of Goods	458.30	475.52	507.91	626.11
Coffee	109.64	85.25	105.47	107.53
Volume (60-kg bags)	2.84	3.16	2.99	2.50
Unit Value (US \$/kg)	0.64	0.45	0.59	0.70
Non Coffee	348.66	390.27	402.44	513.55
Electricity	16.67	13.94	15.47	13.16
Cotton	14.08	18.00	16.88	28.87
Volume ('000 mtons)	12.14	22.50	16.36	20.45
Unit Value (US \$/kg)	1.16	0.80	1.03	1.41
Tea	35.93	26.85	29.45	38.26
Volume ('000 mtons)	28.09	30.30	31.14	35.27
Unit Value (US \$/kg)	1.28	0.89	0.95	1.08
Tobacco	27.64	32.27	39.89	38.94
Volume ('000 mtons)	12.77	17.62	23.48	26.48
Unit Value (US \$/kg)	2.16	1.83	1.70	1.47
Fish & Its Products	50.11	80.85	83.77	98.44
Volume ('000 mtons)	22.31	27.37	24.13	31.00
Unit Value (US \$/kg)	2.25	2.95	3.47	3.18
Hides & Skins	22.70	19.65	4.18	5.43
Volume ('000 mtons)	17.85	23.29	15.67	21.00
Unit Value (US \$/kg)	1.27	0.84	0.27	0.26
Maize	6.13	13.07	8.15	18.03
Volume ('000 mtons)	29.59	89.97	33.82	91.66
Unit Value (US \$/kg)	0.21	0.15	0.24	0.20
Flowers	13.22	15.91	17.04	26.90
Volume ('000 mtons)	3.47	4.29	4.74	6.57
Unit Value (US \$/kg)	3.81	3.71	3.60	4.10
Others ¹	162.18	169.73	105.47	245.52
Exports of Services	218.13	223.26	282.79	303.51
Transportation	33.71	36.14	38.67	42.60
Travel	165.80	168.96	181.38	199.34
Communication	10.16	9.69	9.18	14.22
Insurance	0.01	0.02	0.02	2.14
Others ²	8.45	8.45	53.54	45.21

1: Includes; Gold, Regional Fish Exports, Simsim, Beans, Oil Re-Exports

2 Includes; Computer services, Financial services, Government services

Source: Bank of Uganda

X. THE EXTERNAL DEBT POSITION AND SUSTAINABILITY

1.29 Uganda's total external debt stock is projected to be US\$ 4.3 billion by end June 2004, an increase of about 1% from the end June 2003 stock position. Total payments on external debt (interest and amortization) due this financial year are projected to be US\$ 180 million compared to US\$ 172 million last year. However actual debt service after HIPC relief and deferred payments is estimated to be US\$ 97 million up from US\$ 79 million last year. Table 1.6 below summarizes Uganda's key external debt ratios.

Table 1.6: Key External Debt Indicators 1999/00 – 2003/04

	1999/00	2000/01	2001/02	2002/03	2003/04
Debt stock / GDP	65%	68%	68%	76%	70%
Debt service/Export of goods and services	21%	28%	21%	22%	19%
Debt service/Domestic Revenue	20%	26%	19%	23%	20%
Debt service after HIPC/Export of goods and services	12%	15%	8%	10%	10%
Debt service after HIPC/Domestic Revenue	11%	14%	7%	10%	11%
NPV of Debt/Exports of Goods & Services ¹	150%	171%	199%	186%	305%
Memorandum items:					
Total Debt Service (in US\$ millions)	133	165	134	172	180
Total Debt Service Excl. IMF (in US\$ millions)	91	96	92	127	104
Total Debt Service after HIPC relief	77	90	53	79	97
Debt Stock (in US\$ millions)	3,613	3,575	3,786	4,284	4,310
Export of Goods and Services (in US\$ millions)	626	584	636	790	970
HIPC Relief (in US\$ millions)	57	74	80	93	83

¹ The 1999/00 NPV of Debt/Exports ratio assumed full HIPC delivery

Source: MFPED

1.30 Uganda's continued heavy reliance on donor funds has implications for the sustainability of its external debt burden, as external loans account for approximately 40% of donor inflows in any given year. While debt relief was envisaged to reduce the debt burden to sustainable levels, to date a number of creditors have not extended debt relief to Uganda. This financial year, only two HIPC debt relief agreements were concluded between Uganda and OPEC Fund and South Korea. Moreover, some creditors have sued Government and have been paid. Since the HIPC Completion point for Uganda was reached, the country has borrowed US\$1.5bn from multilateral creditors and although these loans have been secured on highly concessional terms, their impact on the debt stock, combined with lower export growth and low prevailing world market interest rates, has been to raise the Net Present Value (NPV) of the debt to exports ratio to 305%, which is more than double the HIPC debt sustainability threshold. Uganda's policy of gradual deficit reduction will enable it to bring its debt stock back down to manageable levels.

XI. REGIONAL & INTERNATIONAL COOPERATION

1.31 Uganda's economic development challenges are beyond its individual capacity to address especially given it's being a small land locked economy. Given the global concern over the poverty incidence, national and international considerations have

become closely interwoven. As a small open economy, Uganda has cooperated closely with the international community in the interest of national development. Consistent with the country's long-term goal of eradicating poverty, Uganda has embraced regional cooperation initiatives such as the New Partnership for Africa's Development (NEPAD), the Common Market for Eastern and southern Africa (COMESA) and the East African Community (EAC). In strengthening our International cooperation, emphasis has been placed on drawing up the economic complementarities of the East African countries and arriving at a common position on regional and global investment and trade issues for mutual benefit.

1.32 During the FY2003/04, Uganda has participated in the following two significant regional cooperation initiatives.

The New Partnership for Africa's Development (NEPAD)

1.33 This is a major regional integration initiative on the African continent whose role is to promote an accelerated transformation of African economies. This is to be achieved through good political and economic governance. Uganda has established core centres for taking forward the NEPAD initiative. The Private Sector Foundation coordinates the private sector arm of NEPAD and the NGO Forum coordinates the civil society forum on NEPAD. A Parliamentary Forum on NEPAD has also been established. The Ministry of Finance, Planning and Economic Development coordinates the operationalization of the initiative.

Uganda is one of the first countries that have embraced the African Peer Review mechanism. The Government has already signed the Memorandum of Understanding and also ratified the APRM protocol. Arrangements are being finalized to embark on the peer review process.

1.34 The operationalization of NEPAD in Uganda shall involve building adequate capacity within NEPAD institutional centres to create competency in addressing development issues and creating awareness of the initiative. Under NEPAD Short-Term Action Plan, the following projects are regarded to be of high priority: the Kenya-Uganda Oil Pipeline; Institutional support for Kenya, Uganda, Tanzania, and Tazara Railways; the Northern Corridor Road Project; the Establishment of One-Stop Border Posts, Country to Country Telecommunication, involving the East African Community, and COMTEL involving COMESA. Uganda has been invited to participate in the NEPAD e-schools project, a project that aims at imparting ICT skills to young Africans in primary and secondary schools as well as the NEPAD School feeding programme.

The East African Community (EAC)

1.35 Uganda has been involved in regional integration process as one of its main strategies for widening its market and investment opportunities. In the recent past, Uganda has intensified its cooperation with the two East African countries in promoting the region's image as a favourable destination for Foreign Direct Investment (FDI). In March 2004, after four years of negotiations, Uganda, Kenya and Tanzania signed a

Protocol on the establishment of the Customs Union as regional cooperation trade arrangement that establishes a Common External Tariff for the three East African countries and phases out the import tariffs on goods moving between the three countries. The significant phase of signing the EACU has several implications for regional trade and mobility of factors of production including labour. Uganda now will no longer be an individual participant in international as well as other regional cooperation arrangements. Instead, it will have to participate as a regional economic block of the three East African countries.

1.36 There has been progress in harmonization of fiscal and monetary policies among the three member states. Progress has also been achieved in the harmonization of policies in sectors such as Education, Agriculture, Environment, Defence and the partner states also signed a Protocol for the Management of Lake Victoria.

1.37 The framework for International cooperation in the economic field has progressed through trade negotiations under the World Trade Organization (WTO) arrangement and the signing bilateral trade agreements such as with the United States on Africa's Growth and Opportunity Act (AGOA).

CHAPTER TWO: THE BUDGET PERFORMANCE IN 2003/04

I. OVERVIEW OF THE GOVERNMENT BUDGETARY OPERATIONS IN 2003/04

2.01 Government budgetary operations for the financial year 2003/04 are summarized under table 2.1 below.

Table 2.1: Summary of Budgetary Operations for FY2002/03-2003/04

(Billions of Uganda Shillings)	2002/3 Actual Outturn	2003/4 Approved Budget	2003/4 Projected Outturn	Deviations
Revenue and Grants	2253.8	2709.0	2930.0	221.0
Domestic Revenue 1/	1434.0	1690.9	1662.8	(28.1)
Grants	819.8	1018.1	1267.2	249.1
Budget Support	453.6	496.4	798.1	301.7
Project Support	366.2	521.7	469.1	(52.6)
Expenditure and Lending 2/	2770.1	3146.7	3157.4	10.7
Current Expenditures	1586.5	1771.2	1770.6	(0.6)
Wages & Salaries	612.3	666.8	675.1	8.3
Interest Payments	174.1	231.1	248.2	17.1
Statutory 3/	101.6	114.6	116.1	1.5
Other recurrent 4/	698.5	758.7	731.2	(27.5)
Development Expenditures	1142.0	1359.0	1386.1	27.1
External	682.1	799.0	861.5	62.5
Domestic 5/	459.9	560.0	524.6	(35.4)
Net Lending	(12.7)	(28.5)	(44.3)	(15.8)
Arrears	54.3	45.0	45.0	0.0
Overall balance				
Excluding grants	(1336.1)	(1455.8)	(1494.6)	(38.8)
Including grants	(516.3)	(437.7)	(227.4)	210.3
Financing	516.3	437.7	227.4	(210.3)
External Financing (net) 6/	535.0	339.1	328.6	(10.5)
Budget Support	378.2	199.8	68.2	(131.6)
Project Support	261.0	277.3	392.4	115.1
Domestic financing (net)	(53.0)	98.6	(101.2)	(199.8)
Bank financing	(93.3)	78.6	(171.2)	(249.8)
Bank of Uganda	(209.1)	78.6	(171.2)	(249.8)
Commercial Banks	115.8	0.0	0.0	0.0
Non -Bank Financing	40.3	20.0	70.0	50.0
Errors and Omissions	20.0	-	-	-
Memo:				
GDP at constant market prices	11916.2	13016.9	13251.8	
As % of GDP:				
Domestic Revenue	12.1	13.2	12.9	
Expenditures	23.2	24.2	23.8	
Overall Deficit:				
Excluding grants	(11.2)	(11.2)	(11.3)	
Including grants	(4.3)	(3.4)	(1.7)	
Total PAF	646.0	774.2	741.0	
PAF as a % of Total Budget	23.3%	24.6%	23.5%	
PAF as a % Domestic Budget	31.6%	33.2%	32.3%	

Notes:

- 1/ Domestic revenue includes non tax revenue and dividends
- 2/ Includes the macroeconomic adjustment factor
- 3/ Excludes PAF
- 4/ Includes Development PAF
- 5/ Includes total recurrent PAF and VAT payments
- 6/ Includes amortisation

2.02 Provisional figures for 2003/04 indicate an outturn of Shs.2,930 billion in revenues and grants of which the equivalent of Shs.1,267.2 billion was from budget support and project support grants. Grants have exceeded the budget estimates by Shs.249 billion, mainly on account of higher budget support offsetting the shortfall in domestic revenue. Despite the appreciation of the exchange rate, budget support in shilling terms was higher as a result of disbursements that had been expected the previous financial year, but were not realized. Domestic revenues are estimated to increase by Shs228.8 billion over last financial year's collections but representing a shortfall of Shs.28.1 billion from the budget estimates. As a proportion of GDP, domestic revenues are 12.9% compared to 12.1% the previous year, but below the budget estimate of 13.2%.

2.03 Total expenditure is estimated at Shs.3,157.4 billion, equivalent to 23.8% of GDP as compared with last year's outturn of 23.2% of GDP. This ratio is slightly lower than 24.2%, which was estimated in the budget, despite the pressures on the expenditure side. Expenditure restraint was necessary for maintaining budget control given the revenue shortfall. Interest payments were Shs.17.1 billion higher than programmed as a result of higher interest costs that were caused by an increase in Treasury bill issued to sterilize the monetary impact of the fiscal deficit that is estimated at 11.3% of GDP. This is almost the same level of the deficit last fiscal year. Total development expenditure is estimated to surpass the budget estimate on account of higher external development expenditure despite underperformance in domestic development especially on VAT payments.

2.04 Protected expenditures for poverty eradication under the Poverty Action Fund (PAF) are projected to be below budget by Shs.33.2 billion. This is a result of low absorptive capacity of the Development Expenditure budget that is brought about by delays in the procurement process. Although PAF expenditures have been below budget, they represent an increase from 31.6% of the domestic budget (total expenditure less development external and external interest payments) in 2002/03 to 32.3% in 2003/04. PAF as a percentage of total expenditure is estimated to be 23.5% that is almost the same level as last financial year.

2.05 Net external financing of the budget is estimated to be lower than the programmed level on account of the higher domestic financing. As mentioned under chapter one, there has been an expansion in the stock of Treasury bill holding increasing the size of domestic financing.

II. DOMESTIC REVENUE PERFORMANCE

2.06 Domestic revenue mobilization is affected by the performance of Uganda Revenue Authority (URA) revenue collection and the non-URA revenues. URA revenues come from direct and indirect domestic taxes as well as from international trade taxes while non-URA revenues come from fees and licenses collected by Central Government and dividends from enterprises and agencies in which Government has interests. Table 2.2 below provides the provision estimates of recurrent revenue performance for 2003/04 compared to the outturn for 2002/03 and the budget estimates for 2003/04 by major categories, while table 2.3 breaks down the performance by tax heads in 2003/04 relative to budget estimates.

Table 2.2: Provisional Outturn for Recurrent Revenue Performance 2001/02 – 2003/04

Tax Head	Outturn 2001/02	Outturn 2002/03	Budget Estimate 2003/04	Projected Outturn 2003/04	Deviation	Performance Ratio
Net Collections UShs. Bn	1212.2	1408.56	1655.2	1645.9		
Direct Domestic Taxes	284.0	318.65	351.46	429.00	77.54	122.1%
Indirect Domestic taxes	290.6	357.85	432.80	354.00	-78.8	81.8%
o/w: <i>Excise duty</i>	116.3	113.23	113.28	126.4	13.12	111.6%
VAT	174.3	244.38	299.21	227.6	-71.61	76.1%
<i>Import duty</i>	581.0	722.40	863.16	840.9	-22.26	97.4%
<i>Fees & license</i>	56.6	39.07	49.58	62.5	12.92	126.1%
Tax Refunds	(38.8)	(29.41)	(41.80)	(40.5)	-1.3	96.9%

Source: MFPED

2.07 Overall, the projected domestic revenue outturn for FY2003/04 which includes non tax revenue and dividends is UShs.1,662.8 billion which is 2% below the approved budget estimates due to lower than programmed net URA collections which include tax, fees and licenses. The overall shortfall in net URA collections of UShs.9.3 billion is largely coming from the weak performance of taxes on international trade, especially value added tax (VAT) on imports as well as VAT on domestically produced goods, particularly on soft drinks, cigarettes and beer which more than offset the over performance of direct taxes, particularly Corporate tax.

2.08 Table 2.2 shows that revenues from direct domestic taxes, excise duty and fees and licenses are projected to be above the targets in the budget while indirect taxes will be below target largely as a result of a large shortfall in revenues from value added tax (VAT) by about 24%. Table 2.3 shows that with particularly a strong performance in revenue from corporate tax, the second largest item in domestic tax revenue by UShs.61.3 billion above target, cumulative revenue from direct domestic taxes was UShs.75.7 billion above target. This strong performance in corporate tax revenue was due to an increase in the profitability in the banking and oil sub-sectors. The pay reform strategy continued to boost the collection from Pay as You Earn (PAYE).

Table 2.3: Provisional Revenue collection for FY2003/04 relative to Budget Estimates

Billions of UShs. Revenue Head	Budget 2003/04	Proj. Outturn 2003/04
Net URA collections (excl. Govt taxes & Refunds)	1,655.2	1,645.9
Gross Revenues	1,712.0	1,701.6
<u>Direct Domestic Taxes</u>	351.5	429.0
-PAYE	193.0	198.7
-Corporate Tax	82.9	144.2
-Presumptive Tax	2.9	2.4
-Other	6.3	5.0
-Withholding Tax	50.5	62.2
-Rental Income Tax	8.1	6.4
-Tax on Bank Interest	7.8	8.3
<u>Indirect Domestic Taxes</u>	432.8	354.0
<u>Excise duty:</u>	133.3	126.4
-Cigarettes	31.0	32.0
-Beer	60.8	54.9
-Spirits/Waragi	4.0	5.5
-Soft Drinks	16.6	13.1
-Phone Talk time	20.9	20.9
<u>Value Added Tax:</u>	299.2	227.60
-Cigarettes	7.1	4.0
-Beer	20.9	14.5
-Spirits/Waragi	1.6	7.0
-Soft Drinks	11.1	8.3
-Other Goods	117.6	94.5
-Services	141.0	104.7
Casino Tax	0.3	0.5
<u>Taxes on International Trade</u>	863.2	840.9
-Petroleum duty	276.6	269.6
-Import duty	126.7	133.6
-Excise duty	47.5	49.0
-VAT on Imports	334.4	325.2
-Withholding Taxes	36.6	34.3
-Temporary Road Licenses	8.1	9.7
-Commission on Imports	32.5	30.4
Hides & Skins levy	0.7	1.8
<u>Tax Refunds:</u>	-41.8	-41.8
<u>Fees and Licenses</u>	49.6	50.9
-Fees & Licenses (Traffic Act)	39.9	42.3
-Drivers Permits	3.9	3.5
-Stamp duty & Embossing Fees	5.8	5.1

Source: MFPED (This table is provisional and subject to amendment by TPED)

2.09 While the revenue from direct domestic taxes was above target, the revenue from international trade was below target by about Ushs.10 billion. Revenue from VAT on other goods and services also performed poorly with a shortfall of US\$23.1 billion as a result of the delays by Government departments in paying contractors and the failure by contractors to submit returns to URA. Revenue collections from excise duty on locally produced goods were below target by Ushs.7 billion as a result of low aggregate demand. Revenue collections from excise duty on beer recorded the largest shortfall by Ushs.5.9 billion followed by excise duty on soft drinks by US\$3.3 billion despite a 2% reduction in excise duty on soft drinks. In addition, the anticipated corresponding reduction in prices of soft drinks and an increase in demand for them were never realized. Consequently this affected the VAT base for the excisable the reduction in excise duty on beer made from locally produced raw materials brought about a shift in demand for beer from imported raw materials which led to overall shortfall in revenue from excise duty on beer.

2.10 As noted above, revenue collections from international trade taxes were below target given the low revenue realization from petroleum duty, VAT and commission on imports. The stronger performance of import duty offset the weaker performance of petroleum duty and VAT. Revenue collection from import duty was above target by 5.4%. Improvements in customs administration assisted in dealing with the lower growth in import volumes.

2.11 Non-URA domestic revenues were 22% or Ushs.3.3bn below the programmed target. This was largely due to non-payments of dividends by enterprises and agencies in which Government has interests, in addition to lower than expected receipts from revenues collected by government departments. However, URA collections of non-URA domestic revenues were 44% of the total non-URA revenues collected. Loan repayments by enterprises in which government has interests was exceptionally good. These amounted to Shs 15.8 bn out of which Shs 14.3 bn came from UEDCL (Uganda Electricity Distn Co. Ltd), while the Shs 1.2bn was from NPART.

III. DISBURSEMENT OF BUDGET SUPPORT

2.12 The disbursement of budget support grants in excess of the programmed levels by Ushs.301.7 billion more than offset the shortfalls in domestic resource and project grants. The 2002/03 Budget introduced the concept of discounting budget support inflows aimed at reducing the effect of volatilities in disbursements on cash flow management. During the first half of the FY 2003/04, budget support inflows including debt relief amounted US\$177m against a discounted projection of US\$136m, and representing a performance outturn of 130.5%. The over performance in disbursement of budget support was due to release of budget support intended for the previous financial year and the strength of currencies of donor countries against the US dollar.

2.13 Budget support grants, including debt relief have been above projections, largely due to the disbursement of grants from the Netherlands and the European Union amounting to US\$43m that were programmed for the previous financial year. In addition, grants amounting to US\$15m from Sweden and Norway for the PAF that had not been programmed were disbursed. Table 2.4 below gives a detailed breakdown of budget support inflows for the first half of the financial year 2003/04.

Table 2.4: Budget Support Performance H1 2003/4 (US\$ M)

	Annual Proj.	Projection	Outturn	Perf.
LOANS				
ADB SAL III	26.5			
World Bank - PRSC	159.6			
World Bank - LGDP (PAF)		3.0	0.0	0.0%
Sub-Total Loans	189.1	3.0	0.0	0.0%
GRANTS (NON-PAF)				
United Kingdom - General Budget Support	65.8	23.5	30.9	131.5%
Ireland - Education - ESIP	4.4	2.2	4.7	211.5%
- Commercial Justice Reform/SWAP	5.3	2.6	3.6	136.4%
EU - Commercial Justice	1.1			
- UWA	0.3			
- MTCS	0.3			
Austria - SWAP	0.7			
Netherlands - General Budget Support	9.6	9.6	9.6	99.6%
- Procurement Reform	1.6	-	0.7	
- Legal Sector	6.8			
Norway - General Budget Support	6.8	3.4		
- Justice Reform	0.4	-	0.7	
Germany - Justice Reform	0.4			
Sweden - Justice Reform	2.4			
Sub-Total - Non PAF Grants	85.9	41.4	50.2	121.2%
HIPC	92.8	49.6	30.8	62.1%
GRANTS PAF				
World Bank - LGDP	23.1	23.1	-	0.0%
Netherlands - Educ. Sector Support	5.9	3.0	12.4	416.1%
- District Devpt.	5.5	2.7	5.9	215.8%
- NAADS/PMA	1.1	1.1	0.8	68.6%
Ireland - General	17.6	8.8	10.3	116.8%
- Education	5.3	2.6	3.6	136.4%
- District Development	1.5	1.5	-	0.0%
- Health	8.3	4.2	3.9	93.4%
- NAADS/PMA	0.6	0.6	0.5	90.9%
European Union - SASP IV (PABS)	26.8	13.9	30.5	218.7%
- PMA/ NAADS	3.3	1.6	-	0.0%
Sweden -General	6.5	6.5	8.8	135.4%
-Health	2.5	-	8.5	
Norway - General		-	6.4	
- Health	4.1	4.1	-	0.0%
Austria - Water	1.6			
- LGDP	0.3			
Canada - Education	1.3	1.3	-	0.0%
Denmark - Water	1.4	-	1.6	
- LGDP	0.8			
- Health	2.2	-	2.4	
France - Health	1.1	0.5	0.47	85.9%
Sub-Total PAF Grants	139.7	75.1	96.0	127.9%
Sub-Total Grants	254.4	184.9	177.0	106.6%
Grand -Total	318.3	187.9	177.0	104.7%
Adjusted Grand Total	349.0	151.6	177.0	130.5%

2.14 The disbursement of the US\$3m World Bank loan for the second phase of the Local Government Development Program that was expected was not made. The loan is now expected to be disbursed in the second half of the financial year. Table 2.5 below details the performance of the resource envelope for the FY2003/4.

Table 2.5: Resource Envelope For FY2003/04 (Ushs Bn)

	Budget 2003/04	Outturn 2003/04	Perf.
Inflows			
A. Domestic Resources	1719.3	828.1	98.5%
URA	1655.0	805.3	98.7%
Non URA	35.7	14.8	77.7%
Loan Repayments	28.6	8.0	114.4%
B. Budget Support	737.8	295.1	117.5%
Grants	537.9	291.9	118.7%
Loans	199.9	3.2	0.0%
C. Total Resource Inflows	2457.1	1123.2	103.5%
Outflows			
D. External Debt Repayments	181.1	89.1	78.8%
E. Domestic Financing	52.5	68.2	234.9%
F. Arrears Repayments	45.0	16.6	67.5%
G. Total Resource Available	2178.5	949.1	130.8%

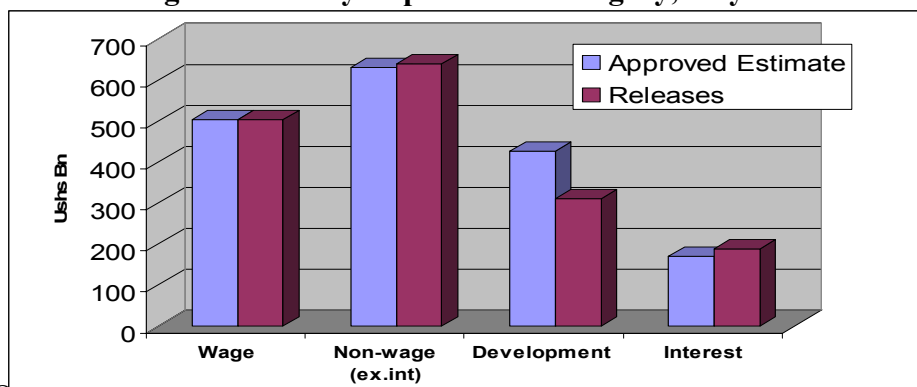
Source: MFPEd

IV. EXPENDITURE PERFORMANCE

2.15 The overall performance of the budget with respect to releases was largely as planned except for two areas that overshot their budget allocations. These include non-wage expenditure for the Public Administration sector, and domestic interest payments. This led to a reduction in the amounts released to other areas in the budget, and in particular the development component.

2.16 Releases among the main expenditure categories were close to the approved budget allocations, although non-wage releases were slightly above the approved budget estimate. Figure 2.1 below shows the performance in releases relative to the approved budget estimates by expenditure category for the period July 2003-March 2004.

Figure 2.1: Budget Release by Expenditure Category, July 2003-March 2004



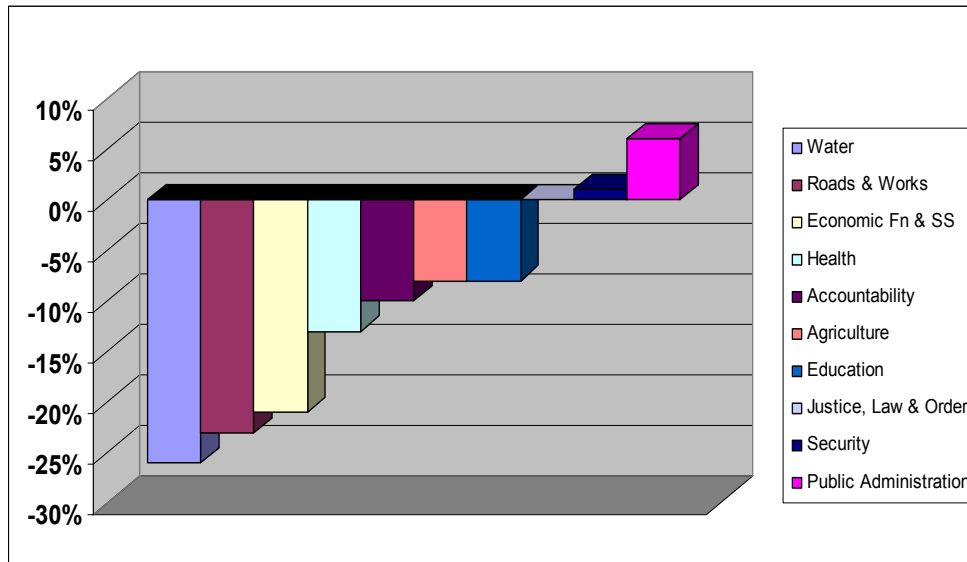
2.17 Overall, the performance for the wage and non-wage budget categories was satisfactory. However, the performance of the development budget was unsatisfactory

with releases for development expenditure being as significantly below approved budget estimates, by almost 30%. Lower development expenditure releases can be explained in part by low absorptive capacity and also accelerated release to statutory areas of the budget.

V. SECTORAL PERFORMANCE

2.18 Overall sector performance was below the pro-rata budget during most parts of the year largely due to the over-shoot in domestic interest payments. Only Security and Public Administration performed above the budget. Figure 2.2 below shows the budget performance by sector.

Figure 2.2: Budget Performance by Sector, July 2003-March 2004



Public Administration

2.19 The 5% over-performance by the sector during the July-March period was largely due to accelerated releases, in particular to State House and Missions Abroad. This was partially offset by reductions in discretionary elements of this sector's budget, such as non-PAF development expenditure. However, cash limits have been set for the fourth quarter to ensure overall performance that is closer to the approved budget, in this sector.

Security

2.20 The slight over-performance of 1% amounts to expenditure of Shs 3.3bn above the pro-rata budgeted Shs 248.4bn for the period July 2003 - March 2004. This is attributed to accelerated budget releases in order to meet the Security challenges.

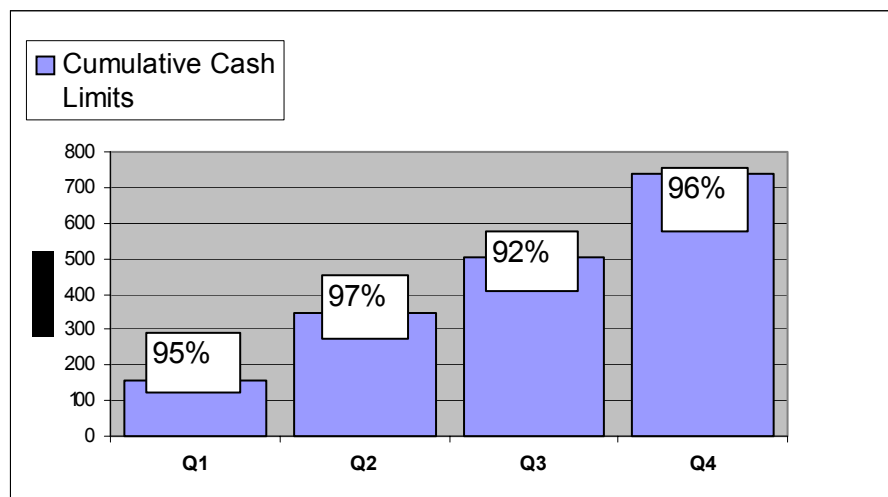
Performance of Other MTEF Sectors

2.21 The over-expenditures described above have been made possible as a result of making spending adjustments in other sectors. For instance the Education sector performed below expectation registering a performance of 92%. This was due to a restricted third quarter release of 75% attributed to poor compliance from most Local Governments. Cash limits have been set for the fourth quarter to address this short-fall and also across other sectors.

VI. PAF PERFORMANCE

2.22 During the period July 2003–March 2004, Shs 504.5bn of PAF expenditure was spent. This resulted in an overall PAF pro-rata performance of 87% for the period. This equates to 92% performance relative to the fiscal program. It is projected that by end of the financial year the performance would be at least 95% of the approved budget. Figure 2.3 shows the cumulative PAF performance and the cash limits for FY 2003/04.

Figure 2.3: PAF Cumulative Performance and Cash limits for FY 2003/04



2.23 It is important to note that the Cash limits are set in a manner that makes the overall Government spending consistent with seasonalities in revenue performance, that vary on a quarterly basis. In addition the pattern of cash limits illustrated by the graph is in harmony with liquidity and bank saving/borrowing profile and hence is consistent with the monetary program.

VII. CONSTRAINTS TO BUDGET EXECUTION

2.24 One of the major constraints to budget management is the presence of non-discretionary expenditure including statutory expenditures. These include all statutory expenditures and the wage bill. This financial year, statutory and wage expenditures are claiming Shs. 1,442 billion, equivalent to 61% of the GOU budget and 46% of the entire budget. Given the need to fund supplementary expenditures in the fourth quarter of the financial year, adjustments were made affecting negatively the non-discretionary non-wage and development expenditure. In addition, resource allocation is constrained by requirements within the budget support agreements to meet counterpart obligations.

2.25 Releases continued to vary significantly between sectors with releases to the Public Administration sector being more than the approved estimates for this sector, hence affecting releases to other sectors. This trend has continued to undermine budget management. For the past two and a half years, overall releases have been 98.0% and above with seven sectors overspending. The Public Administration sector frequently over-spends and although its excess expenditure was restricted to 1.7% during the FY 2002/03, budget indiscipline continues in this sector. Among the reasons for this year's over expenditure are the releases to the National Planning Authority, Missions abroad and other accelerated releases for allowances and rent. This led to the upward revision of the sector's non-wage recurrent budget from Ushs.400m to Ushs.1.585bn.

CHAPTER THREE: PROGRESS, CHALLENGES AND EMERGING PRIORITIES FOR POVERTY ERADICATION

I. OVERVIEW

3.01 Since 1997, Uganda has been implementing the Poverty Eradication Action Plan (PEAP) aimed at promoting economic growth, eradicating poverty and achieving better income distribution. The PEAP is prepared and periodically revised by Government through a highly participatory process to reflect emerging challenges to the economy. The first PEAP revision process was undertaken in 2000 and the second one, which commenced in 2002 with the preparation of the Poverty Status Report, has involved an in-depth diagnosis of the dynamics of poverty and key emerging policy priorities in the country. During the second PEAP revision process, wider consultation and consensus building has been promoted as a way of bringing on board new thinking regarding ways to reverse the upward trend in income poverty and accelerate improvements in human development as well as the attainment of MDGs. The 2004 PEAP will guide policy implementation and prioritization of public expenditure over the medium term.

3.02 During the seven years of implementing the PEAP, the country has achieved significant progress in economic growth as well as meeting its social objectives. These social objectives to a large extent have strong linkages and synergy with the internationally agreed Millennium Development Goals (MDGs) and the New Partnership for Africa's Development (NEPAD) principles. The MDG's eight goals are to: (i) eradicate extreme poverty and hunger; (ii) achieve universal primary education; (iii) promote gender equality and empower women; (iv) reduce child mortality; (v) improve maternal health; (vi) combat HIV/AIDS, malaria, tuberculosis and other diseases; (vii) ensure environmental sustainability; and (viii) develop a global partnership for development. Likewise NEPAD is a pledge by African leaders to eradicate poverty.

3.03 The incidence of poverty was reduced from 44% in 1997 to 34% in 2000, the reduction mainly driven by increases in average income rather than redistribution. Although in the recent past (1999/00-2003) there has been a reversal in the income poverty reduction trend as indicated in the forthcoming section, the welfare of the poor has improved with respect to increased access to services particularly education, water, health and agricultural advisory services. This chapter summarizes the progress, challenges and emerging priorities for poverty reduction in the context of the revised PEAP and the medium term expenditure framework.

II. TRENDS IN INCOME POVERTY AND INEQUALITY

Poverty Trends

3.04 According to the Uganda National Household Survey 2002/03 (UNHS II), the percentage of people living in poverty is estimated at 38%, corresponding to 8.9 million Ugandans. This marks a significant increase in poverty both in absolute and percentage terms since 1999/2000, when 34% of the population (approximately 7.2 million

Ugandans) were living in poverty. Notably, however, poverty remains below the levels recorded in earlier periods estimated at 56% in 1992 and 44% in 1996/97 (see Figure 3.1).

Fig 3.1: National Poverty Trends

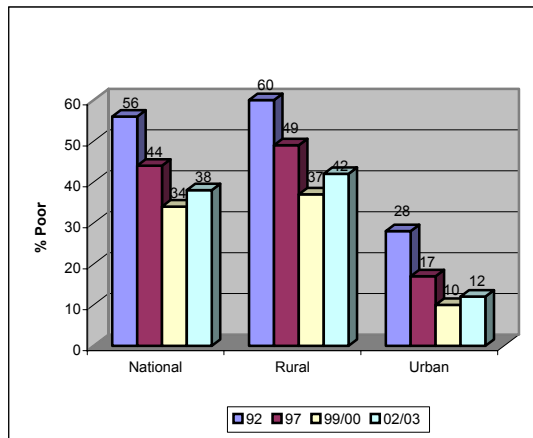
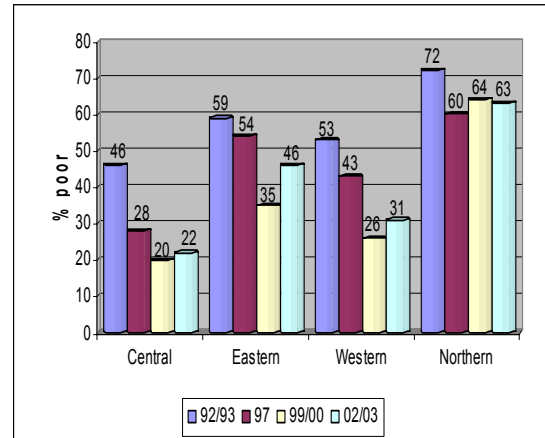


Fig 3.2: Regional Poverty Trends

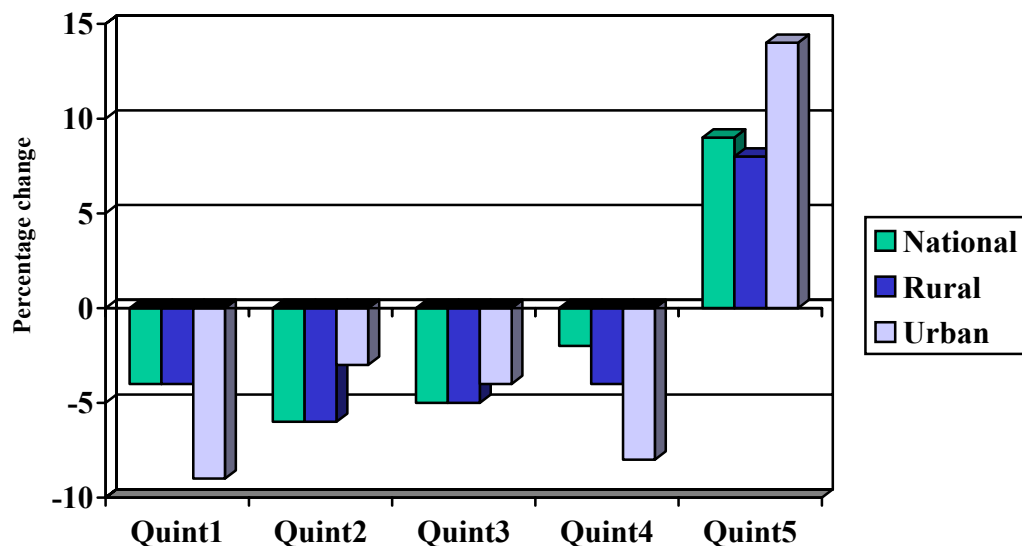


3.05 Between 1999/00 and 2002/03, the incidence of poverty increased more in rural areas than in urban areas. In terms of absolute numbers of people living in poverty, rural areas experienced an increase from 7.0 million in 1999/00 to 8.5 million in 2002/03 for the rural areas, whilst the corresponding figures for urban areas are from 0.3 million to 0.4 million. Although rural areas remain markedly poorer than urban areas and registered lower growth in mean living standards, the proportionate rise in poverty is actually higher in urban areas.

3.06 Figure 3.2 gives the breakdown of total national poverty trends by region. Although the percentage of the population in poverty remained highest in the Northern region during 2002/03, the highest increase in poverty incidence from 35% in 1999/00 to 46% was in the eastern region. This was an increase from 2.0 million to 3.2 million people over the period. In other words, poverty in the eastern region increased by 11 percentage points against a 4 percentage points average for the country.

3.07 Real consumption per capita is 6% higher in 2002/03 than in 1999/00. This implies an annualized growth rate in real per capita consumption of 2.1%. This growth rate is higher for urban areas (2.6%) than for rural areas (1.6%) and has been confined to the wealthier. Disaggregating the survey data into quintiles (5 equal proportions)- the most affluent 20% through to the poorest 20%- it is apparent that only the top quintile report higher real consumption per adult equivalent in 2002/03 than in 1999/2000 (see Figure 3.3).

Fig 3.3: 1999-2003 Welfare Changes by Quintile



Source: UNHS 2002/3003

Notes: Quint1 is the poorest 20% raising up to Quint5 which is richest 20%

3.08 The top 20% of Ugandans report 9% higher consumption. However, the lower income quintiles all report lower real consumption per adult equivalent in 2002/2003 than in 1999/2000. The rise in poverty is particularly marked for those households where the household head works in agriculture – among whom, between 1999/00 and 2002/03 poverty rises from 39% to 49%. Poverty among agricultural households was worse among those practicing crop farming than among those engaged in non-crop agriculture like livestock and fishing. The combination of growth for the more affluent and decline for the rest leads to a worsening of inequality statistics.

3.09 In part, crop farmers have been hit by lower producer prices (e.g. coffee). However, this is not the main factor underlying the rise in poverty since poverty rose less in coffee growing districts than in others¹. Prices remained constant in nominal terms, but fell in real terms as non-food prices increased. The ratio of food crop prices to other consumer good prices in the Consumer Price Index (CPI) fell by 19% between the two survey periods. It is likely that food crop output may not have kept pace with population growth. Food consumption per capita fell by 3% in nominal terms between the two survey periods. Consumption of home produced food fell by around 20% per capita. The median income from crop farming in nominal terms was lower in 2002/03 than in 1999/00.

Trends in Income Inequality

3.10 Table 3.1 below presents inequality trends in Uganda since 1992. The national Gini coefficient which is a measure of inequality in household consumption per adult

equivalent seems to be driven mainly by the observed inequality in the urban areas. The inequality levels were persistently higher in the urban areas than in the rural areas, with the highest difference in 1993/94 and lowest difference in 1997/98.

Table 3.1: Income Inequality Indicators for Uganda (Gini coefficient)

	Survey period						
	1992/93	1993/94	1994/95	1995/96	1997/98	1999/00	2002/03
Rural	0.326	0.291	0.321	0.326	0.311	0.332	0.363
Urban	0.395	0.394	0.398	0.375	0.347	0.426	0.477
Uganda	0.364	0.354	0.365	0.366	0.347	0.395	0.428
	Percentage change ^a						
Rural		-10.7	10.3	1.6	-4.6	3.5	12.5
Urban		-0.3	1.0	-5.8	-7.5	17.0	17.5
Uganda		-2.7	3.1	0.3	-5.2	10.7	11.5

Source: Appleton (2001); Appleton & Ssewanyana (2003)

Notes: ^a researcher's calculations

3.11 While the rural areas experienced the highest increase in inequality between 1993/94 and 1994/95, the urban areas experienced the highest increase in inequality between 1997/98 and 1999/00. As poverty worsened between 1999/00 and 2002/03, so was inequality over the same period. Income inequality increased by 18% between 1992/93 and 2002/03 and 23% between 1997 and 2002/03. The major cause of the widening inequality is the differences in asset base. Households with a low asset base have been unable to increase their investments. Other factors include poor producer prices and low human development indicators.

3.12 In light of the above poverty trends, a key national challenge therefore is to reverse the increase in poverty incidence and the rural-urban and regional income inequalities. The solution lies in addressing the specific challenges increasing agricultural and non-farm productivity and incomes; providing a conducive environment for private investment growth; and increasing access by rural and urban poor households to productive assets and basic services as well as amenities.

III: SERVICE DELIVERY

3.13 As a result of implementing poverty reduction programs in the PEAP, access to services by the poor has been enhanced despite some shortcomings in quantity and quality. By enabling local leaders to monitor service providers and improving incentives for service providers to serve the poor, the Government has achieved success in increasing access to services to the poor. The objective is to accelerate progress in

human development and economic growth. Substantial external resources in form of debt relief and budget support that are channeled through the Poverty Action Fund (PAF) to local governments, coupled with community participation have strongly supported increasing the quantity and quality of the available services. The following is a review of the progress made in improving access to basic services, the main challenges and the emerging priorities in the context of the revised PEAP.

Education

3.14 In the provision of basic education, Government has prioritized improvement of the quality of UPE with results showing positive trends in select quality indicators. Provision of instructional materials has resulted in the reduction of the pupil/book ratio from 6:1 in 2000 to 3:1 in 2003. School sanitation and hygiene has also improved from 700:1 as estimated in 1997 to 96:1 in 2000 with 80% of the schools having separate facilities for girls. A policy for the educationally disadvantaged children was also put in place and provides, through programmes such as COPE, ABEK and BEUPA basic education for children who are experiencing barriers to learning and includes the programmes. There is empirical evidence now to show that the returns to education in Uganda increased in the 1990s for all sub-sectors and that were highest for primary education, followed by tertiary and secondary education. This evidence confirms Government policy of prioritizing delivering quality primary education and strengthening the performance of higher levels of education.

3.15 Despite the positive trends, delivery of quality of UPE is still a challenge. Several factors including poor attitudes about the value of education among parents, especially educating a girl child, the lack of separate sanitary facilities for girls, absenteeism and late coming by both teachers and pupils, and lack of school meals contribute to the challenge. Currently, a programme funded by Government and the UN World Food Programme on school feeding covers only 325,000 pupils. The bulge of UPE graduates and the low post-primary absorptive capacity are key challenges that are gradually being addressed. The expanded multi-sectoral program for school feeding whose objectives are to improve the nutritional status of children, reduce hunger at school, improve regularity at school, and reduce the drop out rates is under discussion and is likely to be implemented beginning the school year 2005. It is expected that external resources to support the program will come from the various donor budget support mobilized under the NEPAD framework. Being multi-sectoral, its various components will be implemented through the relevant Government institutions/departments.

3.16 Government is also working on improving functional adult literacy programmes and vocationalizing the education system through inclusion of agriculture in the primary school curriculum to make UPE more practical and relevant. The focus will continue to be on improving quality and access to primary and secondary education, increasing the relevance of the curriculum at all levels, improving teacher quality and promoting recruitment and retention of high quality teachers by putting in place the right incentives. This will involve expansion of physical school facilities to cater for the increase in enrolment and creating a more conducive learning and teaching environment.

Health and Nutrition Services

3.17 The burden of disease in Uganda remains high. Prenatal and maternal conditions, malaria, acute respiratory tract infections and AIDS together account for over 60% of the total national death burden. Before 2001, the poor were paying for health services in Government health centers. Following the abolishment of cost sharing poor people's access to health care has improved although the quality of services remains a challenge. Government recognizes the need to make improvements in the following areas:

- Drug availability
- Presence of qualified health staff
- Access to health services
- Transport for referral patients
- Access to health services by disabled people especially family planning services
- Strengthening preventive primary health care activities especially to prevent malaria, HIV/AIDS and poor sanitation diseases

3.18 The Health Sector Strategic Plan (HSSP) aims at achieving the delivery of the Ugandan Minimum Health Care Package (UMHCP) to all Ugandan households. The UMHCP has been phased to start with an affordable set of priorities including immunization, malaria control, information, education and communication, reproductive health and HIV/AIDS. Under the HSSP, Government has also built 400 new HC2s, upgraded 180 HC2s to HC3 status (including maternity services and is upgrading 150 HC4s to provide emergency obstetric and surgical services. In the area of nutrition, the Government with the support of the World Bank has since 1998 been implementing the Nutrition and Early Child Hood Development Project which ends in July 2004. The project covers 34 districts.

3.19 In recognition of the mortality that despite all these efforts, health outcomes in terms of the high infant and maternal rates remain poor, Government has prepared an Infant and Maternal Mortality Strategy to deal with this challenge. The strategy recognizes that health outcomes are not the sole responsibility of the health sector. Key interventions are in the areas of improving quality of health care and treatment of malaria, sanitation, community mobilization and family planning. To further improve nutrition, under the proposed Expanded School Feeding Program, the nutrition and health education component to be implemented by the Ministry of Health will cover aspects of the importance of food for growth using the life-cycle approach, vegetable gardening and school gardening to complement school meals.

Water and Sanitation

3.20 Rural water coverage has continued to improve from around 54.9% by the end of 2002/03 to about 60% today. Urban water coverage is estimated to have increased from 54% in 2000 to about 60-65% by now, although access rates have somehow fallen back because of the rapid growth in peri-urban and informal urban settlements. Piped sewerage services are accessible to an estimated 8% of the urban centers while the

remainder of the urban population use on site systems, which are predominantly pit latrines.

3.21 Despite the progress in water coverage, the majority poor people still use unprotected water sources and travel long distances to both safe and unsafe sources. Other challenges to improving safe water provision and sanitation include maintaining the existing bore holes and providing hygienic water sources for both animals and humans; improving the construction, use and maintenance of latrine facilities, strengthening health education activities for the improvement of sanitation conditions; and strengthening the management and collection of garbage especially in urban areas and fish landing sites. Over the medium term, Government will continue to increase access to safe drinking water through direct investment in infrastructure and strengthening private partnership in operations.

Agriculture

3.22 Most households in Uganda continue to derive their incomes from agriculture. However, the agricultural sector still faces severe constraints that partly explain the increase in income poverty, especially among crop farmers as highlighted above. Key among these is the relatively low price levels for agricultural produce associated with production of low-value crops and limited end-products. Apart from limited access to agricultural support services such as crop and veterinary extension services and food processing technology, the limited access to infrastructure such as electricity and water infrastructure, limited market information and proliferation of local taxes inhibit the development of a vibrant agricultural sector with linkages to other sectors of the economy.

3.23 Given the extent of the structural weaknesses that exist in the agricultural sector, and the implications for poverty eradication, prospects for reversing the income poverty trend lie in addressing these constraints. In the revised PEAP, the Government identifies more strategic approaches to enhance the provision of public goods for agricultural production in the areas of agricultural extension, research and technology development, marketing, and preservation of the natural resource base, particularly soil and forests as an emerging high priority. In order to further improve production, competitiveness and incomes in the country, the Government will focus on modernizing agriculture, preservation of the natural resource base particularly soils and forests and provision of the necessary infrastructure including roads, electricity and railways. This will all necessitate better implementation of the Plan for Modernization of Agriculture (PMA), the Medium-Term Competitive Strategy (MTCS) for the private sector that includes the Strategic Exports Program (SEP).

3.24 A National Agricultural Research Policy to promote the delivery of high quality and effective agricultural research services has been developed as well as the Marketing and Agro-Processing Strategy (MAPS). In line with this strategy, Government has established the Uganda Commodity Exchange (UCE) that provides a meeting place for commodity buyers and sellers and the Warehouse Receipt System in which a receipt of the holder of the commodity deposited in a certified and registered warehouse can be

used as collateral for loans to enhance market access by farmers. In addition, the cooperative movement has been invigorated. So far, 25 Area Marketing Cooperative Enterprises (AMCEs) that bring together primary cooperative societies, farmer associations, and large-scale farmers in a given sub-county have been established. In some of these, farmers are reported to be realizing better prices than before.

3.25 To improve the prioritization and management of activities in agriculture, an Agricultural Sector Investment Plan (ASIP) is in advanced stages of development that will provide a coherent framework for public investments. As part of this framework, Government is investing heavily in the demand-driven agricultural extension service delivery and research into improved technologies and methods of production. The ASIP will address the issue of training farmers in areas such as agronomic practices, post-harvest handling and new techniques and technologies for farmers and fishermen as measures to improve agricultural productivity.

3.26 For network services such as rural electricity services, Government will continue to encourage private investment, particularly in rural electrification by providing subsidies to private investments in this area through the rural electrification fund. This is important for the development of agri-based industries. So far, this support has been provided to projects in West Nile, Kakiri, Rukungiri and Kilembe. In the mean time, the Government will also continue with the recent path-breaking public interventions to promote strategic exports and encourage large-scale farming by the private sector while respecting environmental and employment safeguards and standards and avoiding creation of monopoly power.

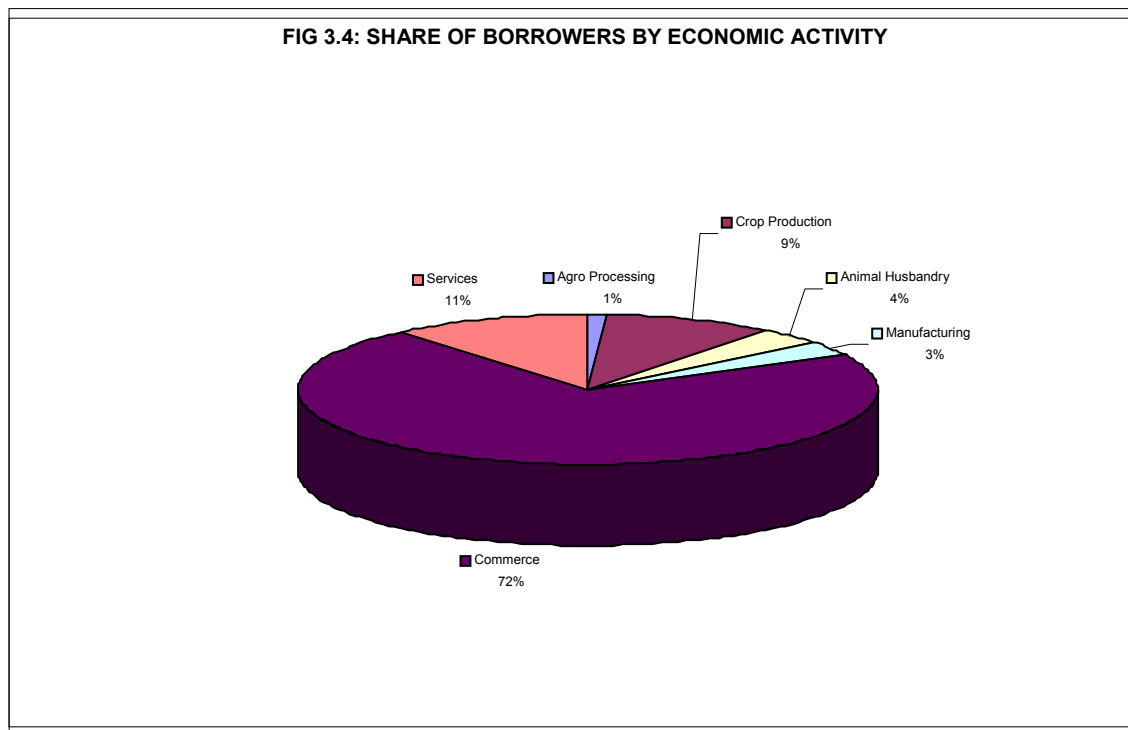
Financial Services

3.27 Current statistics on the micro-finance industry reveal that by end 2003 the sector had over Shs.86 billion as outstanding loan portfolio equivalent to approximately 0.5% of the GDP and 6.2% of national domestic credit. Their savings portfolio is over Shs.129 billion equivalent to approximately 15% of national financial savings and 0.5% of GDP. Although these proportions are still very low, they are quite significant for addressing the financial service needs of the poor. The recent surveys, have established that micro finance institutions (MFIs) have a high concentration in the central region (33%) followed by the east (23%), the southwest (19%), the north (14%) and the western region (11%). The concentration of MFIs in the central region is explained by the high rate of economic activity, while the low concentration of MFIs in the north and west regions is perhaps due to insecurity in some parts of these regions that has adversely affected economic activities in these areas. It has also been observed that the number of MFI beneficiaries is still very low with only 0.9% (196,561 clients) of the country's population utilizing these services. This percentage represents about 2% of the population estimated to be living below the poverty line.

3.28 The interest rates charged by micro finance institutions are relatively high, ranging between 22 – 48% per annum and 2 – 5% per month. This is partly explained by high operational costs experienced by MFIs and the influence of the high treasury bills interest rates. These high interest rates are prohibitive for the formal Banking sector to

lend capital funds to the micro sector. Government programmes charge interest rates as high as 16% because they tie their rates to the market rates as close as possible. The problem is further exacerbated when it comes to lending to the agriculture sector.

3.29 Figure 3.4 breaks down the proportion of loans in MFIs by economic activity. In terms of economic activities, MFI clients are mainly engaged in agriculture-related activities, manufacturing, commerce, service industry, and others. The chart shows that MFI loans are biased towards trading activities, followed by agriculture, services, manufacturing and other activities. The analysis of figures available shows that approximately 80% of the savings portfolio and 75% of the loan portfolio belongs to female clients meaning that female clients have benefited more from micro finance services. The Government-funded programs have had most of their loans in agriculture, an indication of the Government commitment to capitalize agriculture-related activities. However, the recovery rate in this area has been rather disappointing. The challenge therefore, is how to finance agriculture at affordable interest rates. Further work is on going to study further and address the current bottlenecks in the area of agricultural finance and to develop a medium-term strategy to enhance the provision of financial services to all types of farmers in the country.



3.30 Government over the past years has developed supportive policies to the development of financial services. Considering that Micro-Finance services address the financial needs of the poor, especially the rural poor who account for over 80% of the country's population, Government has developed policies to support the development of microfinance services. The key features related to the adoption of international best practices have been in putting in place a supportive policy framework; commercial orientation of microfinance to ensure sustainability in its provision; better coordination

among stakeholders, capacity building of Micro-Finance Institutions (MFIs); the development of an outreach plan; and improving the product mix. Through the Micro Finance Forum, district microfinance committees are to strengthen micro finance coordination. The micro finance outreach plan has introduced incentives for MFIs to reach rural areas and offer products tailored to the needs of communities.

3.31 In order to regulate micro-finance services, a Microfinance Deposit-taking Institutions Act 2003 is in place. This law allows eligible institutions to mobilise and intermediate savings from the public under the supervision of Bank of Uganda. This will go along way in integrating rural and microfinance as part of the financial system. A performance monitoring and consumer protection system for MFIs has been developed and accepted by the practitioners and donors in the industry. This system is gaining countrywide recognition and is likely to be adopted as a standard in other countries. Strategic alliances of MFIs with commercial banks and insurance companies are emerging as distinctive elements of Ugandan microfinance.

3.32 The future plans for the Microfinance industry will mainly revolve around strengthening the institutional capacity of MFIs and capacity building through training. Government will ensure that its programmes are rationalised and that there is no interference in the market of the microfinance operators. More work will be done to study the best ways to finance Agriculture and to also create linkages between the formal sector and the microfinance industry.

Justice, Law and Order

3.33 There has been significant progress towards clearing the case backlog with the introduction of facilitation of Police and Prisons officers to transport witnesses and suspects, the Judiciary and Directorate of Public Prosecutions to schedule extra court sessions and the government Laboratory under the Poverty Action Fund (PAF). This led to a reduction in case backlog by 15% in 2000/01 with cases dating back to 1995 completed. The Chain Linked Initiative that was piloted in Masaka district demonstrated that cooperation between the police and prisons in scheduling criminal cases is effective in reducing backlog and the initiative has been rolled out to all the 29 magisterial areas.

3.34 While the Constitution limits time to be spent on remand, only the High Court has the jurisdiction to hear capital offences. Consequently, a large proportion of suspects on capital offences stay on remand for longer period before their cases can be heard. Limited knowledge of rights and obligations by the public remain major constraints to improving access to justice.

3.35 Significant improvements have also been registered in areas of law reform. However, some laws of Uganda are obsolete and some discriminate against the poor and women. Progress has been made towards amending such laws, with the most recent path-breaking action being the ruling in favour of amending the law on divorce. In the medium term, Government will focus on two strategic areas for reform, that is, the criminal and commercial justice reform. The criminal justice reform program focuses on legal

services reform; improved administration of justice, improved civic and legal education and law reform, while the commercial justice reform program focuses on commercial court reform, companies and land registries reform, reform of key commercial laws and strengthening commercial lawyers.

Administrative improvements in service delivery

3.36 The 2003 National Integrity Survey based on a sample of public perceptions indicates that there has been progress in reducing the incidence of corruption in Uganda. However, while the rate of bribery has somewhat fallen in recent years for those institutions where comparison is possible, unofficial payments remain prevalent in some institutions with varying amounts being paid. Corruption is particularly noted in the allocation of tenders that is responsible for driving up costs of public sector investments and often leads to failure to achieve poverty reduction objectives.

3.37 Over the past three years, Government has undertaken concerted efforts to introduce further changes to improve its efficiency and effectiveness in service delivery. The reform measures undertaken cover a wide range of areas including repealing the Public Finance Act of 1964 and enacting a new one plus enacting of the Budget Act which increased accountability by the Executive to Parliament and the citizens, establishing commissions of inquiry in alleged breaches of standards and accountability, strengthening financial controls and monitoring systems, and strengthening the legal framework through legislations on moral principles and uprightness in the public service.

3.38 To support the improvement of Public Sector Budgeting and Accounting in order to achieve timelier, transparent, and accurate financial and accounting information for both local and Central government, Government has introduced the Integrated Financial Management System (IFMS). The system has been implemented in two phases, starting with six pilot ministries and four pilot districts selected on the basis of the size of their business and the readiness for the system for ministries and districts respectively. It also provides for *interface* with Bank of Uganda, and Uganda Revenue Authority. The rollout phase will cover 16 Ministries and Commissions and 6 local governments for financial year 2004/2005.

3.39 In the budget for FY 2004/05, provisions for recurrent costs as a result of operating the IFMS have been made and captured in the respective budgets of the pilot ministries and local governments as a way of ensuring ownership and sustainability of system. Some of the benefits of the system that will be realized consist of efficiency gains and cost savings are: a reduction in budget execution time through the automation; unification of the financial tracking and reporting between central and local government departments; much quicker and more accurate accounting (including immediate bank reconciliation), reporting and auditing; Virtual elimination of arrears through automation of the Commitment Control System, which would allow instantaneous checking of reported commitments against commitment ceilings and tracking of expenditures against commitments; more accurate representation of the Government fiscal position as a result of the move towards international accounting standards, enabling better fiscal management both at the budget preparation phase and during the budget execution stage.

3.40 An important component of the public sector strategy to improve service delivery has been the improvement of the payroll management, the introduction of the Results Oriented Management (ROM) system and the development of the Public Service Reform Strategy 2002-2007. Since 2001/02, significant steps were undertaken in the area of payroll management leading to a reduction in the average time taken to access health workers and primary teachers on the payroll from seven months to one month. Over the period 2000/1-2002/03, the pay reform, was focused on areas where Government was experiencing problems of recruitment, retention and poor performance, that is, health which coincided with the scrapping of cost sharing, and middle to senior level managers and professionals.

3.41 During the FY 2003/04, Ushs.1.5 bn that was provided for the pay reform was used to harmonize Salary Structures into a Single Spine Structure. The creation of executive agencies that provide excessive differentials in the pay has exacerbated recruitment and retention problems in the public service. The recent demand to enhance salaries and provide lunch allowances to health workers is another setback to a holistic implementation of the pay reform strategy. Moreover, there is no evidence of increased returns from those special cases. The challenge therefore is to harmonize the implementation of the pay reform into a holistic approach.

3.42 The implementation of results oriented management (ROM) will be supported by pay reform, capacity enhancement, and pension reform, strengthening of records, personnel and payroll systems, management of organizational structures and coordination, and monitoring and evaluation of cross cutting reforms. The logical implication of ROM is that established human resources levels could be reduced and the proportion of higher caliber, results oriented professional staff in operations could be increased. Over the medium-term, Government will continue to undertake National Service Delivery Surveys in order to support implementation of the PEAP and monitor and evaluate performance of the various public servants against targets.

3.43 Legal ground has been broken in establishing corporate Governance in Uganda by the enactment of the Financial Institutions Act, 2002, which lays the foundation for legal consequences for modern thinking of corporate Governance in Uganda. The Uganda Capital Markets Authority issued the Capital Markets Corporate Governance guidelines in 2003 that apply to public companies and issuers of corporate debt in Uganda. The institute of corporate Governance of Uganda has developed guidelines for use by all corporate bodies in Uganda irrespective of form of ownership and size of entity to meet the unique mix of corporate bodies in Uganda that tend to be family owned and small and medium enterprises (SMEs).

IV. POPULATION, LABOUR FORCE AND EMPLOYMENT TRENDS

Population changes

3.44 Uganda's population continues to grow rapidly, almost doubling in just 22 years from 12.6 million people in 1980 to 24.7 million in 2002, with an average growth rate of 3.4% between 1991 and 2002. All geographical regions in Uganda have had high increases in their population size although there are significant regional variations in the population growth rates. Northern Uganda has the highest rate of 4.5%, followed by Eastern with a rate of 3.5%. The Western region follows closely with a rate of 3.4% and the Central region has the lowest of 2.8%. Over the period 1991 to 2002, urban population increased by almost 1.6 million people to about 3.6 million people in 2002. The proportion of the population residing in urban areas increased from about 12% to 14.5%, indicating an increase in urbanization. While urbanization is an important process of development that brings about changes in population, the increase in urbanization in Uganda was largely due to rural-urban movements caused by declining living standards in rural areas as opposed to urbanization as centres of growth.

3.45 The high population growth rates in Uganda place an enormous burden on service delivery as more people need to be served than ever before at a time when resources are becoming increasingly scarce. High fertility levels have resulted in a predominantly young population with 52% of the population in Uganda being below 14 years of age. This young age structure has created a high child dependency ratio that has ultimately placed a heavy burden on the working population and constrained the provision of basic needs and services. The dependency ratio, which is the ratio of people too young or too old to work (aged below 15 years and above 64 years) to every 100 persons of working-age (aged 15 to 64 years), is estimated at 119.8% implying that those who are not economically active are more than those who are. At the macro level, a high dependency ratio implies *low national savings* given the higher household expenditure on dependants.

3.46 The rapid population growth rate is also responsible for the increasing over-use of the natural resources and therefore the degradation of the environment. All these effects have important repercussions on the rate of economic growth and transformation of the country. Family planning and reproductive health programs will therefore have positive effects on public spending and economic growth resulting in faster poverty reduction and improved outcomes from the PEAP implementation.

Labour Force

3.47 There is a definite link between unemployment and the incidence of poverty in Uganda, both in rural and urban areas. When the incidence of income poverty in rural areas declined significantly from 60% in 1992 to 39% in 2000, only a modest decline was observed among the non-working population from 65% to 53% within the same period. Similarly, within urban areas, the fall in poverty among the unemployed has been much slower than any other socio-economic category.

3.48 Uganda's labour force is characterized by a substantially less educated and skilled workforce. While literacy rates are relatively high among the Ugandan population, and a large proportion having had formal education, the proportion of the population that had completed secondary education is as small as 3%, and only 10% of persons aged 10 years and above have had vocational training which involves acquiring of artisan skills, indicating the need to intensify efforts to increase the supply of highly educated and skilled manpower.

3.49 The *labour force participation rate*, which measures the participation of the economically active population, usually referred to as "*the economic activity rate*" is estimated at 67%. Participation is highest in the age group 40-44 and among those with vocational skills as a result of a long schooling period and higher productivity respectively. Those with no vocational training have lower participation rates again indicating the need to intensify efforts to increase the supply of highly educated and skilled manpower. Rural women have a higher participation rate than their urban counterparts and those in the poorest income quintile are more economically active than men.

Employment

3.50 According to the Labour Force Survey of 2003/03, Uganda's labour force is expanding at a rate of 3.4% per annum but the growth of employment opportunities is relatively slow, particularly in urban areas. Nearly 346,000 people in Uganda are unemployed with more than half of them being in the central region followed by the eastern, western and northern. Unemployment is higher in urban areas than in rural areas (12% compared to 2%), notably highest in Kampala. However, the unemployment rate is higher in rural than urban areas and particularly among the women. This implies that, the number of persons aged 10 years and above who want to work, are available for work and are actively looking for work is higher in urban areas than in rural areas but the proportion of the total number of unemployed persons to the total number of economically active persons is higher in rural areas than in urban areas and among women. The unemployment rate is particularly high among the youth especially in the 20-29 age bracket and underemployment is a common phenomenon especially in the urban areas.

3.51 There is a debate on the appropriate employment policy in Uganda. Some arguments have centered on the need to expand public employment, while others have suggested adjusting wages to prices, union wage setting, Government minimum wage legislation and restricting hiring and firing decisions. Government, however, believes that labour codes and protective labour legislation are likely to act contrary to improving the employment situation as this may add substantially to the costs employers pay when they hire workers. It believes that improving the employment situation requires a stable macro-economic framework, accelerated economic growth, continued growth of the private sector and accelerated human resource development.

3.52 In response to the above challenges, Government has defined a long-term vision for human resource development. In the meantime, the development of a comprehensive National Employment Policy is at an advanced stage. The policy will ensure that it adheres to avoiding creating distortions in productivity between sectors by ensuring that wages are market determined to avoid unnecessary high production costs that could hamper the competitiveness of Uganda's products. The policy should lead to restructuring of the pattern of employment in a manner that will result into a rise in employment in other occupational categories other than agricultural employment. This requires building scientific, technological, administrative and managerial capacity and competence in the labour force. It has been established that currently, there is low demand among students and parents for vocational skills and technical carriers. National institutions responsible for education are trying to develop systems to eliminate this bias so that the country can have a better quality labour force. The ministry of Education is working on increasing the number of technical and science students from post primary education.

V. NORTHERN UGANDA: POST-CONFLICT RECONSTRUCTION

3.53 The Government is committed to ending the war in the North and addressing the key problems and challenges associated with the long-running conflict, particularly the persistently high poverty levels and massive internal displacement. Northern Uganda has since the mid-1990s experienced violent conflicts and rebel insurgency particularly in the sub-regions of Acholi (Kitgum, Gulu, Pader), Madi (Moyo and Adjumani) and West Nile (Arua, Yumbe and Nebbi). The concerted efforts by Government to end the insurgency restored peace in most districts apart from Adjumani, Kitgum, Gulu and Pader. But even those districts where insurgency has subsided still suffer from spill over effects of internal displacement and rebel incursions, this being prevalent in parts of eastern Uganda.

3.54 The reasons why conflict persists are complex and cannot be attributed to a single cause or failure of any particular dialogue process. Several studies¹ find that conflict has been fuelled by a combination of factors including resistance to the current government, support from external forces, the proliferation of guns in the region, poverty and imbalances to access in economic opportunities.

3.55 The Government places utmost importance on guaranteeing peace to all Ugandans and hence has undertaken numerous initiatives geared towards ending armed conflict and attaining peace in the North including military operations, peace talks with rebel groups, community mobilization, political education, disarmament and amnesty. The support and contribution of civil society organizations, spearheaded by the religious and political leaders, to the reconciliatory processes has been instrument in progressing the peace making process in the right direction.

3.56 Alongside the national programmes, special programmes targeting the North have been implemented over the years aimed at ensuring peace and improving the welfare of

¹ MFPED Discussion Paper 5, 2002; UPPAP reports, 2002; Ian Leggett, 2001; Lartin, M, 2002.

the people through provision of the basic social and economic infrastructure. Some interventions cover the entire North while others target a group of districts and even one district. Under the Northern Uganda Reconstruction Programme (NURPI), roads were rehabilitated, the telecommunications sector improved, schools were rehabilitated, markets built and water supply stepped up. The second phase NURPII has began promoting the transition from conflict to peace in Northern Uganda and consolidating gains achieved under NURPII.

3.57 Sub-programmes that are being implemented under NURPII include the Northern Uganda Social Action Fund (NUSAF), the Restocking Programme, Acholi land Programme, School Roofings Programme and Capitation of the Vulnerable Youth. The NUSAF programme that commenced in 2003 and is to be implemented over a five year period in 18 Northern districts, aims improving people's livelihoods through community empowerment, improved social services and infrastructure, peace building, supporting vulnerable groups such as youth and women and institutional development. Under the Restocking Programme that aims at restore the economic base and reduce poverty in the North and other parts of the country, over 7.5 billion shillings have been disbursed to districts in Northern Uganda to procure animals (cows/heifers, bulls, goats, pigs) and animal inputs like drugs, acaricides and ox-ploughs. Skills' training is ongoing for youth under the Capacitation of Vulnerable Youth project.

3.58 Despite all these interventions, total peace remains elusive in some parts of the North and Karamoja and poverty continues to be a major challenge. Overcoming the challenges in the North is a gigantic task that will not only require massive injection of time and resources but also a clear vision and strategy for post-conflict reconstruction. Strategic Plans for post-war recovery are being developed for the North and Karamoja, which will have to be fully embedded in national policy and budgeting processes for effectiveness. Government has recently developed a draft Internally Displaced Persons (IDP) policy that is due for approval by Cabinet. Once approved, concrete plans will be made to implement the policy.

3.59 In the meantime, resources will be made available to improve the living conditions in camps of the internally displaced while facilitating them to become productive. Disarmament in Karamoja will continue but within the regional context of small arms control and pastoral livelihood development. Continuous efforts will be made by Government in partnership with civil society organizations and humanitarian agencies to end rebel insurgency in the North and improve humanitarian access to the conflict affected areas and communities.

VI. FUTURE POLICY THRUST FOR THE REVISED PEAP

3.60 Despite the clear achievements in the quest to eradicate poverty, four core challenges remain and require urgent attention. The four challenges are:

- (i) Restoring growth in the incomes of agricultural households;

- (ii) Restoring security in parts of country experiencing insecurity, and dealing with the consequences of insecurity;
- (iii) Consolidating the achievements and addressing challenges in human development;
- (iv) Using public resources more efficiently and effectively to address poverty.

3.61 The revised PEAP provides the main policy thrust that will be followed over the medium term to address the key emerging challenges and priorities for poverty reduction. Building on existing good practices, the Government will aim at strengthening economic management; enhancing production, competitiveness and incomes; addressing security, conflict resolution and disaster management; improving governance; and improving human development outcomes.

Economic Management

3.62 The consolidation and further improvement in **Economic Management** has been identified as an emerging priority for poverty reduction. Good macroeconomic management focuses on ensuring and maintaining a viable domestic and external balance between demand and supply. It is underpinned by three key factors; (i) ensuring and maintaining macroeconomic stability through fiscal and monetary programs that reinforce each other in curbing pressures for consumer prices, interest rates and the exchange rate; (ii) increased private sector credit; and (iii) enhancement of international competitiveness of exports.

3.63 Within the macroeconomic framework, the priority shall be to continue to pursue prudent fiscal and monetary policies underpinned by discipline in the management of public sector finance; management of liquidity within prudent bounds and ensuring stability and competitiveness of the exchange rate and interest rates. Discipline in the management of public sector finance shall ensure less competition for loanable funds between Government and the private sector, while maintaining price stability shall lead to dampening of growth in consumption, promotion of savings and increased export competitiveness. However, fiscal and monetary policy prudence is not sufficient for boosting the contribution of the private sector to growth and export competitiveness.

Enhancing Production, competitiveness and incomes

3.64 While the economic fundamentals for raising Uganda's economic growth and enhancing its competitiveness in the region and internationally are partly in place, their enhancement is an emerging priority for the Government. For example, while Uganda has embraced fully the liberalization policy, achieved macroeconomic stability and made progress in removing institutional constraints to the development of the private sector through privatization and deregulation, expanding markets and increasing private investment remains constrained by low domestic consumption and limited participation in regional and international markets. The economy lacks adequate infrastructural facilities, a strong financial capability and an adequate supply of a skilled and adaptable labour force.

3.65 In light of these challenges, the focus of macroeconomic policy in the medium term shall be to raise economic growth and enhance competitiveness. To enhance greater efficiency and productivity in the economy, Government will continue to pursue its privatization program in areas that were previously a domain of the public sector as well as in new opportunities. To increase the productive capacity of the economy, public sector financing will focus on:

- i) providing public goods that are justified by market failure such as the provision of infrastructural services like roads, electricity and water supply facilities to meet industrial demand;
- ii) investing in human resource development to provide a skilled labour force for the private sector; and
- iii) developing the financial sector to provide the private sector with sufficient resources to finance private investments.

3.66 The Government will focus on promoting greater collaboration between the public and the private sector. Through the Uganda's Private, Public Partnership program dubbed (UP3) that encompasses the tripartite relationship between Government, the Private Sector and Donors, key performance indicators for infrastructure development have been identified as improved access, lower costs, and better quality of services. The continued tripartite cooperation through UP3 will provide the push for enhancing more dialogue sessions at central and local government levels, while government will continue to enable the private sector participate through review of rules, regulations and procedures.

3.67 In order to build a strong financial capability, the following performance indicators have been identified: (a) improved access, (b) cost of capital, and (c) widening the range of products. It is noted that despite a series of reforms in the financial sector, access to financial services and the cost of borrowing remains high. The high cost of borrowing is partly a result of Uganda's high fiscal deficit and the associated high Treasury bill interest rates, while the barriers to access of financial services by Small and Medium Enterprises (SMEs) include lack of entrepreneurship skills and financial records, failure to undertake business feasibility studies, and scarcity of business development services (BDS). These will be addressed through innovative programmes such as a best behavior award scheme for SMEs, expanding the use of credit guarantee schemes, and building a strong institutional framework for information exchange and coordination of SME support services. Initiatives for capital markets development will have to be monitored and evaluated.

3.68 The process of revising the PEAP has brought to the top of the poverty agenda the importance of trade, investment and export promotion strategies. The following actions have been suggested and may be implemented in the area of trade, investment and export promotion:

- i) Institutional reforms covering the Ministry of Trade, Tourism and Industry and its associated semi-autonomous bodies namely; the Uganda Investment Authority

- (UIA), the Uganda Export Promotion Board (UEPB), the Uganda Tourist Board (UTB) and the Uganda National Bureau of Standards (UNBOS) with respect to trade policy/negotiations capacity, trade and investment policy analysis, support to export development, setting and enforcement of quality standards and business registration. In addition, the role of the Ministry of Foreign Affairs in promoting trade, investment and exports is recognized as a key priority necessitating the equipping of the foreign missions to work effectively in this area.
- ii) Amending the investment code to represent best international practices. It has been observed that the current investment code has many provisions that are no longer relevant such as issuing licenses, giving approvals or supervising investments. These need to be amended and replaced with the most appropriate ones.
 - iii) Access to land remains a key constraint to investments. The process of acquiring a land title remains cumbersome and costly and the public-private sector roles relating to land ownership, infrastructure development, management, and regulation are yet to be appropriately apportioned. As a result, the process of constructing Industrial and Business Parks has been slow. In this regard, the process of establishing a clear land use policy to allow flexible and full utilization of idle land through liberal conditions and procedures of land conversion is a priority for enhancing industrialization. The Export Processing Zone (EPZ) strategy will be reviewed and the proposed policy and regulatory framework be harmonized within the East African Community framework. While emphasis shall be placed on establishing a good regulatory policy regime that simplifies administrative procedures and provides better incentives to doing business, the development expenditure of the public sector shall also go towards establishment of industrial parks as part of the industrialization strategy.
 - iv) Reviewing the Strategic Exports Program (SEP) with respect to the equity effects of the priority exports under the program, as well as the management, supervision and monitoring institutional framework of the program.
 - v) Enhancing the supply of skilled and adaptable labour force through promotion of research of science, research and technological innovations. It is established that investment promotion in Uganda, especially with respect to Foreign Direct Investment (FDI) remains constrained by the inadequate supply of a skilled and adaptable labour force to operate and manage new technologies that come along with the investments. Labor productivity, measured in terms of value added per worker, is much lower in Uganda, at US\$ 1,189 compared to Kenya at US\$2,733 and Tanzania at US\$ 1,862). This is especially low in the MSE sector partly due to low capitalization, the scale of enterprises, high concentration in agro-industry and poor work habits. In view of this, efforts to increase the supply of a more educated and skilled labour force are being prioritized through the educational system under the business, technical and vocational education (BTVET) that comprises of public, private and firm based training.

Security, Conflict resolution and Disaster Management

3.69 The prevalence of security in Uganda is recognized as a necessary condition for improved human welfare and economic development. The central thrust of the PEAP policy therefore is to ensure that all Ugandans enjoy peace at all times and where peace is elusive, measures are put in place to resolve whatever conflicts are prevalent. This makes conflict resolution a priority action area for those areas of the country that still experience conflict either due to rebel insurgency or other causes.

3.70 Disaster preparedness and management has come up on the poverty eradication agenda as one of the key ways to reduce poverty among the most disadvantaged and vulnerable populations. This encompasses improving the living conditions of the IDP camps and putting in place mitigation and coping measures for areas affected by other disasters such as floods and earthquakes.

Good Governance

3.71 Good governance is a cornerstone in the fight against poverty. It is an aspect of social justice. While it remains essential to focus on aspects of economic development in the context of poverty eradication, PEAP efforts have been extended beyond to encompass aspects of creating effective, participatory and democratic governance in line with national aspirations articulated in the Vision 20205. The key elements of this aspiration are: free and fair democratic society; fully functioning decentralized governance, gender responsive governance, peaceful and secure nation, full observance of human rights and the rule of law. The Government is committed to implementing strategies for zero tolerance of corruption in society.

3.72 In 2001, Uganda joined other African countries in the New Partnership for Africa's Development (NEPAD), an initiative which recognizes that absence of democracy, respect for human rights, peace and security inhibits development in Africa. Under the initiative, the African Peer Review Mechanism is an instrument to foster adoption of policies, standards and practices that lead to political stability, which is one of the economic fundamentals to enhance a country's competitiveness in addition to those mentioned above.

Human Development

3.73 The main policy thrust in this strategic area of intervention is to enhance health and education outcomes in the country, which are necessary conditions for development. Improving health outcomes would not be a sole responsibility of the health sector but a combination of complementary actions from other sectors that contribute towards improvement in health care and nutrition, sanitation, community mobilization and family planning. Institutional reforms will be key in ensuring that policy is effectively implemented in the decentralized framework to enhance service delivery to the poor.

3.74 Other areas of action include the transformation of employment patterns through skills development. The balance between vocational and academic education within the

post-primary sector are key areas for policy. Gradually, planning for human resources within each sector will be undertaken to ensure that the skills provided match with the development needs of the country.

VII: PUBLIC EXPENDITURE ISSUES FOR IMPLEMENTING THE REVISED PEAP

3.75 Addressing the emerging PEAP priorities that have been highlighted in this chapter necessitates that public resources are used more efficiently and effectively to address poverty, in line with the theme of this year's BTTB. There are two fundamental aspects to cost saving to increase resources for financing these priorities without foregoing the policy objective of fiscal consolidation: streamlining Government administration and fully integrating projects in the MTEF. These are some of the areas that have been identified for cost saving.

3.76 Although the privatization program was intended to contribute further to fiscal consolidation by reducing the financial burden resulting from subsidies to public enterprises, some thing that was achieved in the first phase of the program, of late there has been a growing number of regulatory bodies that are not self sufficient and acting as a replica of the privatized public enterprises with respect to exerting a financial burden to the budget. There are a number of commissions and semi-autonomous agencies created in the constitution that present expensive budgets directly to Parliament that bear little relation with public sector pay levels. The existing pay structure in these agencies cannot be justified in light of the resource constraints and the need to achieve fiscal consolidation.

3.77 It is therefore important that the expenditure proposals of such bodies be fully scrutinized as part of the budget process to improve on cost-efficiency and remove wastages that cause distortions in the labour market. A single-spine approach to posts in such agencies shall form part of the strategy towards fiscal consolidation. Cost savings will also be generated through the review and streamlining of the local government system. The conditions under which new local government authorities are established are in direct conflict with the policy of fiscal consolidation. Many are established before ensuring their affordability within the public finance program. This area will need reexamining to generate savings for funding poverty reduction programs.

3.78 In addition delays in the divestiture of Kinyala Sugar works Ltd., the Dairy Corporation Ltd., the New Vision, Uganda Air Cargo, Uganda Livestock Industries, SCOUL, UGMA and Cable Corporation has hampered the progress in privatization. Further more, over the medium term, the results of the privatization program are likely to act counter to fiscal consolidation as the costs of divestiture appear to outstrip the sale proceeds and no sale proceeds are expected from concessioning out of public utilities companies, the Uganda Railways Corporation and the Civil Aviation Authority.

3.79 The presence of a large share of the budget under non-discretionary expenditure items which include all statutory expenditures including interest payments and the wage bill currently claiming about 45% of the budget presents another serious challenge for

fiscal consolidation. The overall development expenditure of the public sector over the past has demonstrated low absorptive capacity while recurrent expenditures have tended to exceed their budgets. The current expenditure pressures for increased defense spending given the continued insurgency in the North, expenditure pressures for wage increases by sections of the public service such as medical workers and university lecturers outside the Pay Reform program present serious challenges to fiscal consolidation in light of limited scope for enhancing domestic revenue. In order to ensure that the implementation of the economic and social programs as articulated in the PEAP is on schedule, various measures will have to be undertaken to improve the implementation capabilities of both central and local government agencies. These measures shall include close monitoring of programs and projects and reprioritization of the programs and projects.

3.80 Traditionally, donor project support in form of loans and grants has been treated outside government expenditure, yet the inflow of these funds creates the demand for counter part funds to be availed in the budget. In addition, they contribute to the fiscal deficit through their impact on the exchange rate and domestic interest payments on government securities as government tries to mop up the excess liquidity in the economy caused by such expenditures. This financing of the public sector program will necessity being integrated in the overall resource envelope in order to have complete control over the level of the fiscal deficit starting next financial year 2004/05. This mechanism will keep sectoral spending in line with sectors' allocated shares in the overall budget and promote optimal sectoral allocations that are owned by government other than donors. It will also encourage ministries/departments in each sector to compete for resources available within the sector. This will ensure that their priorities are in line with national priorities. Lastly, it will enhance budget discipline since it will not be possible to circumvent budget ceilings.

3.81 In order to develop a proper strategy for public expenditure the criteria that has been recommended through the process of revising the PEAP is that: the role of the public sector should be clear; expenditures should be prioritized according to returns in terms of income and or quality of life improvement; precise output targets; a realistic and inexpensive unit cost; clear responsibilities; impact on future revenues or costs; demonstrated spin-off benefits for the poor; spending using existing administrative structures rather than creating new ones, expenditure that avoids exacerbating cost pressures.

CHAPTER FOUR: MEDIUM-TERM BUDGET OUTLOOK 2004/05-2006/07

I. OVERVIEW

4.01 The medium-term macroeconomic policy objectives of Government are two. First, is to limit public expenditure to the resources available in order to control inflation. Second, is to constrain the fiscal deficit to a level that is compatible with low interest rates and a competitive exchange rate. In order to achieve the second objective, Government is committed to increasing the share of the budget that is funded through domestic resources over the medium term. This will be done in a gradual manner in order to minimize the impact on spending programmes. The reduction will be achieved through a combination of reduced donor dependence and increased revenue mobilization. This should result into a reduction in the fiscal deficit as a percentage of GDP, and a commensurate rise in the ratio of domestic revenues to GDP, while allowing for a continued increase in Government spending in nominal terms. Government expenditure will have to grow less rapidly than domestic revenue, averaging about 6% per annum between 2004/5 and 2006/7, as compared to the average growth rate of 12% per annum delivered over the past three years. It is projected to increase in nominal terms by 18% over the MTEF period.

4.02 The macroeconomic framework is projected to deliver a 2.7 percentage point reduction in the fiscal deficit over the MTEF period. The deficit excluding grants is expected to fall from 11.3% of market price GDP projected for this financial year 2003/04, to 10.9% of GDP next financial year, and to 8.6% of GDP by 2006/7. If more resources could be mobilized domestically, Government expenditure would then be able to grow faster without jeopardizing the policy objective of deficit reduction. In addition to the combination of reduced donor dependence and increased domestic revenue mobilization, the public sector program is to focus on quality, rather than quantity of donor aid. Strong emphasis is to be placed on budget support, while project support is to be integrated into budget ceilings and to be aligned with the revised PEAP priorities. Integration of project aid into the MTEF is expected to encourage optimal resource allocation based on sectoral priorities, improve budget discipline and guide the overall strategic decisions of Government. To achieve this, it will be necessary to strengthen coordination between Government and donors to improve the three-year forecasting of aid flows and timely outturn data on project support.

4.03 However, current circumstances present challenges for fiscal consolidation. Domestic revenue next financial year is projected to grow more slowly than this financial year, and is projected to remain roughly constant as a percentage of GDP over the medium term. In addition, the implementation of the East African Customs Union is expected to reduce customs revenue by Shs 50 billion in 2004/5, with further losses expected in the following two years. Given this, therefore, the scope for increasing Government expenditure is very much limited. On the expenditure side, part of the additional resources available will be taken up by higher interest costs as a cost of managing the fiscal deficit.

II. THE RESOURCE ENVELOPE

4.04 By definition, the resource envelope for the Government budget comprises of domestic revenue, tax and non-tax, external donor grants and loans less the financial requirements of external debt repayments and the domestic Government saving needed to accommodate the monetary policy and foreign exchange reserve objectives. The largest component of the resource envelope is domestic revenue, which comprises of 61% of next financial year's projected resources. This ratio is expected to rise to 65% and 69% in 2005/6 and 2006/7, respectively. Over the next three financial years, the resource envelope, net of interest payments and arrears is projected to grow by 11%. The resource envelope for the medium term is set out in the table 4.1 below.

Domestic Revenue

4.05 Domestic revenue is projected to increase in nominal terms in each of the next three fiscal years. It is projected at Shs.1, 902 billion in the next fiscal year, which is a 10.8% increase over the current fiscal year and amounts to 13.1% of GDP at market prices. It is expected to rise to Shs.2, 056 billion, equivalent to 13% of GDP in 2005/6 and Shs.2, 285 billion, equivalent to 13.1% of GDP in 2006/7. As alluded to in the overview, domestic revenue mobilisation will be affected by the implementation of the customs union, with the loss next year projected at Shs 50 billion.

4.06 Non-tax revenues continue to play a significant role in Government's resource mobilisation efforts. These refer to collections on, among others, fees on road licenses, driving permits, passport, dividends from enterprises in which Government has interests and repayments for loans on-lent to parastatals. Non-tax revenues are projected at Shs 85 billion next financial year, which is an increase of 9% over this financial year.

Budget Support

4.07 Budget support in the form of grants and concessional loans is projected to be US\$ 344 million equivalent to Shs.688 billion in the next fiscal year. It is projected to decrease by about 7% in the fiscal year 2005/6 to US\$ 321 million and then decline further to US\$ 318 million in 2006/7. However, the expected depreciation of the shilling is expected to offset the lower projections for budget support, leaving it roughly constant over the period in shilling terms. The decline in budget support in dollars terms over the medium term reflects Government's difficulty in achieving three year programming with donor partners, who usually only commit funds one year at a time, or at most, for two years, meaning that the second and third year of MTEF budget support projections are provisional. There is need to strengthen the three year projection mechanism with donor partners, to make these projections compatible with the three year MTEF planning cycle.

Table 4.1: The Resource Envelope for Public Expenditure in the Medium-Term

GoU BUDGET RESOURCE – Shs bn		Budget 2003/4	Proj. Outturn 2003/04	2004/05	2005/06	2006/07
RESOURCE INFLOWS	A. DOMESTIC REVENUES	1719.3	1716.6	1901.5	2056.3	2284.7
	URA Revenue	1655.0	1638.2	1816.4	1975.8	2197.5
	Non URA Revenue	35.7	24.0	31.5	34.7	40.5
	Loan Repayments	28.6	54.4	53.7	45.8	46.7
	B. BUDGET SUPPORT	737.8	880.3	687.8	677.1	706.2
	Loans	199.9	69.8	190.1	161.3	170.1
	Grants	537.9	810.5	497.8	515.8	536.0
	C. PROJECT SUPPORT	785.2	906.3	946.0	890.1	939.0
	Loans	280.4	434.5	455.1	435.0	458.9
	Grants	504.8	471.8	490.9	455.1	480.1
	D. TOTAL RESOURCE INFLOWS = A+B+C	3242	3503	3535	3624	3930
RESOURCE OUTFLOWS	E. EXTERNAL DEBT REPAYMENTS	-159.9	-122.2	-153.3	-174.0	-209.0
	F. DOMESTIC AND OTHER FINANCING	53.0	-118.0	48.4	46.3	-50.5
	G. TOTAL RESOURCE OUTFLOWS = E+F	-106.9	-240.3	-104.9	-127.4	-259.5
RESOURCE ENVELOPE	H. MTEF RESOURCE = D+G	3135	3263	3430	3496	3670
	Memo Items:					
	Interest Payments (Shs Bn)	227.8	244.4	266.2	302.3	330.4
	Revenue/GDP	13.2%	13.0%	13.1%	13.0%	13.1%
	Deficit excluding grants - % GDP	11.2%	11.3%	10.9%	9.6%	8.6%

Source: MFPED

Project Support

4.08 Externally funded projects during the next financial year are expected to amount to US\$ 471 million equivalent to Shs. 946 billion. Project support in 2005/6 and 2006/7 is expected to fall to US\$ 420 million, while in shilling terms it is projected to decline to Shs 890 billion in 2005/6 before rising to Shs 939 billion in 2006/7. In the past, donor funded project expenditures have been treated separately from GoU expenditures, although any counterpart funding requirements arising from donor-funded projects are catered for within the GoU budget. However, donor funded Government projects

contribute to Governments fiscal deficit, and have associated macroeconomic effects, such as placing appreciation pressures on the exchange rate. In order to have complete control over the level of the fiscal deficit, starting next financial year, donor projects will be treated as an integral part of individual sector's budget ceilings. Any increase in donor project funding above the sector's approved budget level will necessitate an equivalent cut in their GoU allocation. This mechanism will create a greater degree of Government control over the level of the fiscal deficit, and will also keep sectoral spending in line with sectors allocated share of the overall budget.

External debt repayments, domestic financing and domestic interest costs

4.09 The components of the resource envelope that take a first call on resources include external debt repayments, domestic financing and interest payments. Amortisation (paying back) of external debt is projected at US\$ 77 million, equivalent to Shs 153 billion in 2004/5, US\$ 82 million or Shs 174 billion in 2005/6 and US\$ 94 million or Shs 209 billion in 2006/7. Domestic financing is a projected provisional net Government borrowing from the banking system of Shs 48 billion in 2004/5, Shs 46 billion in 2005/6 and a saving of Shs 51 billion in 2006/7. Domestic arrears payments are projected at Shs 44 billion next fiscal year and at Shs 41 billion for the following two years.

4.10 Government's interest payments are projected at Shs 266 billion next financial year, of which Shs 201 billion is interest on domestic securities (Treasury bills and Government bonds) and the rest is interest on external debt. This overall figure represents an increase of 9 percent as compared to this financial year, and constitutes 11% of total resources available to GoU. The figure is projected to increase to Shs 306 billion in 2005/6 and further to Shs 330 billion in 2006/7, amounting to 12% and 12.1%, respectively, of total resources available. The high level of Government expenditure on interest payments, particularly domestic interest payments, is a consequence of the size of the Government's fiscal deficit, which has necessitated an increase in the stock of Government securities issued by Bank of Uganda to control inflation and has driven interest rates upward, thus raising interest costs.

4.11 Government's policy of a gradual reduction in the fiscal deficit over the medium term will help scale back interest costs. The high level of Government expenditure on interest payments, particularly domestic interest payments, is a consequence of the size of the Government's fiscal deficit, which has necessitated an increase in the stock of Government securities issued to control inflation and has driven interest rates upward, thus raising interest costs. Government's policy of a gradual reduction in the fiscal deficit over the medium term will help scale back interest costs.

III. RESOURCE ALLOCATION

4.12 Total Government expenditure in 2004/05 is projected to increase in nominal terms by 9% over 2003/04 to Shs 3,428 billion of which Shs 266 billion will go for interest payments leaving a balance of Shs 3,162 billion for allocation between sectors.

Budgeted resources for each expenditure area will increase in nominal terms next fiscal year relative to 2003/04, with the exception of the Development Budget which is to decline by 10%. Total Poverty Action Fund (PAF) spending excluding the allocation for pay-reform is projected at Shs.789.7 billion or 37% of the discretionary budget.

IV. SECTORAL ALLOCATION

4.13 In absolute terms, the sector ceilings with the largest increases are Security, Roads and Works, and Economic Functions and Social Services. Percentage wise, Security, Roads and Economic Functions receive the largest increase. The sector ceilings in the 2004/05 budget framework adequately fund key priorities under PAF, provision of counter-part funds to projects and meeting utility bills. These should therefore not be reallocated during the execution of the budget. Whereas the expenditure under PAF in FY2004/05 does not reflect an increase relative to 2003/04, Government of Uganda's own resources to this fund will increase by Shs.63.1 billion in 2004/05 relative to 2003/04 and by Shs.34.9 billion and Shs.35.4 billion in 2005/06 and 2006/07 respectively. The Local Government Development Program (LGDP) Grant of Shs 65 billion from the World Bank will also benefit several sectors.

4.14 The 2004/05 budget is faced with additional funding commitments to cater for existing obligations and other priorities amounting to Shs.295.7 billion. These include wage shortfalls, pay reform, recruitment of primary and secondary teachers, and salary enhancement for medical workers, pension shortfalls school feeding program, the referendum and the value-addition fund for industrialization among others. In order to finance these commitments, the budget has been adjusted by adjusting the non-discretionary non-wage recurrent and development expenditure by 57%, guaranteeing utilities and rent by 75% and counterpart funding to donor projects by 80% relative to FY2003/04 provisions. However, these adjustments are not sufficient to raise the funding requirements for the additional funding commitments. Therefore, to cater for recruitment of additional primary and secondary teachers, and salary enhancement for medical workers, further budget cuts across the board or through intra-sectoral reallocations have been inevitable. However, the spending levels of the discretionary items of the budget have fallen to a minimum level beyond which some institutions will not be able to function.

4.15 Education will take the highest share of about 21% of total allocation to sectors amounting to Ushs599.9 billion followed by Public Administration which will account for USh390.7 billion about 13% of total allocation to sectors and closely followed by Security amounting to USh.390.4billion. These two sectors are increasing their allocations by USh19.2 billion and Ushs59.3 billion respectively. Education will receive a nominal increase of Ushs7.3 billion. The additional Ushs59 billion to defense has been necessitated by the poor security situation in the north and northeast of the country. The agriculture sector has its allocation increased by Sh.10.6billion from the 2003/04 approved budget and is projected to increase by Shs.13.1billion and 15.4billion in the subsequent years.

4.16 Health, Law and Order and Accountability sectors have had their allocations reduced in 2004/05 relative to 2003/04 approved budget. The reduction in the health sector allocation is justified by the need to temporarily halt the expansion of health facilities in 2004/05 to ensure a balanced growth of the inputs in the sector such as staff, equipment and drugs to permit optimal service delivery. For the FY 2004/05, Shs.20.42 billion has been allocated to Private-Not-For-Profit health facilities and Shs.6.09 billion for construction of maternity units (health centres II and IIIs). Compared to FY 2003/04, Primary Health Care will get the largest increase in allocation of 14% in FY2004/05 to take care of the operationalization of the existing Health Centres. The sectoral share of the roads and works sector is expanded in 2004/5 by Shs.61.1 billion to cater for road maintenance as a high priority.

V. EXPENDITURE OPTIONS

4.17 Given the emerging public expenditure priorities for poverty reduction namely: the provision of public goods for production; investment in human development; security and dealing with consequences of conflict, the medium-term expenditure options are likely to be the following: In the area of rural development, an increase in the agriculture sector's envelop appears to be justified and it will be possible to estimate the costs more precisely as the investment plan is developed. Government target is to increase the ratio of investment in agricultural research to 2% of agricultural GDP which implies spending about Sh.75 billion per year. Funding social organization of farmers through groups such as Area Marketing Cooperatives and an increase in funding for the Energy for rural electrification project could be expenditure priority options.

4.18 There are three possible areas for increasing funding for the Roads and Works sector; supporting the concessioning of Uganda railways; switching government debt with Civil Aviation Authority into equity; and the community roads program under the Local Government Development Program (LGDP). Improvements in education facilities should continue to be of high priority. With the increase in enrolment in primary and expected improvement in retention, post –primary education will need more expenditure in the medium-term. The highest priority should be increased funding for teacher recruitment in both secondary and Business Technical Vocational Education and Training (BTVET). Investment in water works is likely to be a public expenditure option since government will stay as the asset-holding authority and some cross-subsidies for low-income households in low-income areas. In addition to security expenditure, the consequences of conflict generate four types of expenditure. Increased public expenditure could go towards extra costs of service delivery in affected areas, expenditures to resolve conflict (provision of packages), immediate humanitarian assistance, and or post-conflict reconstruction.

VI. FUTURE THRUST OF THE PUBLIC SECTOR PROGRAM

4.19 The Public Sector Program will aim at expanding the productive capacity of the economy through public investment particularly through investment in provision of infrastructure to ease supply constraints, financing institutional reforms to improve

security and governance and investing in human development for a prosperous society. In the medium-term, Government will continue to pursue its policy of fiscal prudence and discipline in the management of public sector finance. In particular, the Ministry of Finance, Planning and Economic Development which is mandated to mobilize resources domestically and externally for public and expenditure as well as manage and control public finances in a prudent and sustainable manner will undertake to ensure this. The focus of public sector finance in the medium-term will be towards enhancing domestic revenue mobilization and efficiency in spending. This should result in a reduction in the fiscal deficit as percentage of GDP.

VII. FUTURE CHALLENGES FOR BUDGET POLICY

4.20 Apart from the current challenges for budget policy and budget management that have been highlighted above, Government is presented with three core challenges that manifest themselves in the tension between the various policy objectives. Policies adopted by Government in the budget can have a major impact on fairness in income distribution among citizens and on the general well being of different segments of society. One such a policy is that on taxation. One of the most significant challenges for budget policy is ensuring that tax policy does not only contribute to poverty reduction through generation of higher revenue for public expenditure but also through improving fairness in income distribution. Its primary objective should be avoiding making the poor worse off through taxation. The principle being that taxes should not create excess burden by diminishing the motivation for earning income and or inhibiting consumption nor should they encourage substitution of higher cost domestic production for lower-cost imports. This implies that tax policy should and will not aim at higher tax rates simply to raise more revenue to GDP. At the same time, raising this ratio is absolutely important for budget policy for fiscal consolidation.

4.21 The second most significant challenge of budget policy is targeting service delivery to the poor. The effects of public expenditures on income distribution are mixed. Certain expenditures clearly improve the welfare of the poor with relatively little impact on the non-poor. The challenge is how to allocate among income groups the benefits of general expenditures such as allocations to security, justice and public administration. In addition, not all public sector outlays are currently purchasing genuine public goods but instead are going to providing private advantage. Such public expenditures include subsidies to services consumed by the upper-income groups in urban areas that they would be willing to pay for without a subsidy. Such expenditure could end up denying the extension of similar services to the poor segments of the population in rural areas. Utilities such as electricity and piped water are emerging priorities for poverty reduction. However, to the extent that they would be obtained by the upper income groups in the absence of Government subsidies, there is no justification for public expenditure into subsidizing their provision on a blanket basis.

4.22 Lastly, while reducing Government spending to control inflation is important for avoiding hurting the poor, equity can only be preserved if expenditure cuts are not those of primary benefit to the poor. Besides, reduced spending could inhibit raising the level

of public investment for unexploited opportunities for productive public expenditures. It is therefore critical that the criteria for categorizing expenditure as PAF must be tight enough to target narrowly and directly those segments of society in greatest need. At the moment, there is unnecessary demand for each sector to be classified under PAF. This has had two negative effects. First, it has deprived of Government agencies essential recurrent expenditures that are necessary for day to day operations and tied the money under PAF with low absorptive capacity associated with problems in tendering and accounting for these funds. Second, it has created undesirable divergences in Government departments in terms of resource availability. In the subsequent budgets, this classification shall be further scrutinized.
