UGANDA ECONOMIC UPDATE

14th Edition February 2020

Strengthening Social Protection to Reduce Vulnerability and Promote Inclusive Growth

WORLD BANK GROUP

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CONTENTS

FOREWORD

Social protection has become a core part of a country's development strategy to address poverty and protect households exposed to increasing shocks from disasters such as droughts, floods, international price shocks, and conflict. Throughout sub-Saharan Africa, cash transfers, public works programs, and other in-kind and cash interventions and services continue to change the lives of millions of vulnerable people. When times get tough, such programs protect households, helping them to avoid selling critical assets or taking children out of school in order to survive.

Social protection programs that help mitigate shocks and support investments in human capital do not just contribute to reducing vulnerability, they are also critical for supporting economic growth and creating a more inclusive society. They support households during the time it takes to recover from shocks, so that economic growth is not completely undermined. They also help to develop and, during times of shock, sustain human capital, which is essential for a more productive economy.

The same is true in Uganda where programs such as the third Northern Uganda Social Action Fund, the Senior Citizens Grant and other social care and services interventions continue to enable poor and vulnerable people, across the different stages of their lives, to increase their household incomes, access better services for themselves and their families, and to protect themselves against unforeseen shocks. Recognizing the role of these instruments, government is progressively introducing new programs. In 2019 the Kampala Capital City Authority launched Uganda's first urban social protection program for adolescent girls, targeting girls who are both in and out of school.

Government's limited resources necessitate a progressive expansion of these programs. An important recommendation of the report is to prioritize any social protection expansion to areas with the highest levels of vulnerability and risk. The report uses indicators of human capital development, vulnerability to risk and shocks, as well as poverty, to suggest different options for scaling up social protection programs geographically.

It is against this backdrop that I am pleased to introduce the Fourteenth Uganda Economic Update, which looks at social protection systems in Uganda and proposes a more effective approach to reduce vulnerability and to support more inclusive growth. This report comes at a critical time to inform both budget decisions over the next few years, and the on-going development of Uganda's Third National Development Plan.

In line with the structure of earlier editions of the Uganda Economic Update series, this report reviews recent economic developments, provides an outlook for the macro-economy, and then delves into the special topic of social protection.

Carlos Felipe Jaramillo
Country Director
Eritrea, Kenya, Rwanda and Uganda
Africa Region

6.5%

FY18/19 REAL GDP GROWTH

20% TO 30%

Increased share of industry in GDP

3% TO 5% OF GDP

Increase in Foreign Direct investment in FY18/19

20 %

Growth in total imports FY18/19

12.6 % OF GDP

Tax Revenues in FY18/19 compared to Kenya 17.9% and Rwanda 16.3%

600,000

New jobs needed annually to cater for young people leaving the education system

ABBREVIATIONS

Bbl	Barrel
BoU	Bank of Uganda
CNOOC	China National Offshore Oil Corporation
CDD	Community Driven Development
DAS	Domestic Arrears Strategy
DRC	Democratic Republic of Congo
DRF	Disaster Risk Financing
DSA	Debt Sustainability Analysis
EFU	Energy, Fuels and Utilities
EMDE	Emerging Market and Developing Economies
GFN	Gross Financing Need
GNI	Gross National Income
HCI	Human Capital Index
IC	Information and Communications
ICT	Information Communication and Technology
LIPW	Labor-Intensive Public Works
MGLSD	Ministry of Gender, Labour and Social Development
MoFPED	Ministry of Finance, Planning and Economic Development
NDEF	National Drought Emergency Fund
NDP	National Development Plan
NSSF	National Social Security Fund
NPL	Non-Performing Loans
NDVI	Normalized Difference Vegetation Anomaly Index
NUSAF	Northern Uganda Social Action Fund
NSNP	National Social Net Program
OPEC	Organization of the Petroleum Exporting Countries
PFM	Public Financial Management
PIM	Public Investment Management
PIP	Public Investment Plan
PPP	Public Private Partnerships
PMI	Purchasing Managers' Index
PSPF	Public Service Pension Fund
PV	Present Value
ROA	Return on Assets
ROE	Return on Equity
SCG	Senior Citizens Grant
SSA	Sub-Saharan Africa
SWC	Soil and Water Conservation
UBOS	Uganda Bureau of Statistics
URA	Uganda Revenue Authority
US	United States
UAIS	Uganda Agricultural Insurance Scheme
USh	Uganda Shilling
US$	Unites States Dollars
VAT	Value Added Tax

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KEY MESSAGES

State of the economy: Impressive growth, but risks are tilted to the downside

Following the release of new GDP estimates, nominal GDP for FY18/19 increased and the structure of the economy has changed. In October 2019, the Uganda Bureau of Statistics (UBOS) released new GDP estimates, updating the base year for estimating economic activity to 2016/17 from 2009/10. As a result, nominal GDP for FY18/19 was revised upwards from USh 109,945 billion to USh 128,499 billion. Furthermore, the share of industry in GDP has increased from about 20 percent to almost 30 percent. At the same time, there has been a drop in the share of services from about 58 percent to 46 percent. Drilling down further, manufacturing has doubled its share from about 8 percent to over 16 percent of GDP, whilst information and communications (IC) has fallen from 12 percent to just under 2 percent of GDP.

Real GDP grew by 6.5 percent in FY18/19, maintaining the rebound in economic activity over the last two years. This has been driven by strong levels of domestic consumption and sustained levels of public and private investment. Net FDI inflows shot up to 5.1 percent of GDP in FY18/19 from 3 percent of GDP the previous year. The construction sector continues to grow at double-digit levels. There has been a jump in manufacturing growth supported by recent expansions in the sector, including investments in new factories. Agriculture was boosted by another decent harvest and a strong rebound in fisheries. Levels of GDP growth of about 6 percent and above are expected over the medium-term, driven by consumption spending, intensified private and public investments in infrastructure for industrialization, electricity transmission, and preparation for oil extraction.

Still, this growth is not high enough for Uganda's lower middle-income status and poverty reduction ambitions. Although growth is now back on track with the National Development Plan II (NDP II) target, Uganda's level of per capita income was, by 2018, still behind its neighbors. Furthermore, with the expected population growth over the next 10 years, it is estimated that average annual GDP growth rates will need to exceed 8 percent for Uganda to have a chance of reaching lower middle-income status by 2030. This is an extremely tall order given underlying factors such as low productivity and a failure to shift to higher productivity activities that are resilient to shocks and can generate and sustain high growth rates. Uganda also needs to create about 600,000 new jobs per year to cater for the young people leaving the education system, an objective that is not currently being met. As noted in the *FY20/21 Budget Strategy,* only about 75 thousand new wage jobs are being created each year. Therefore, significant economy-wide productivity improvements, particularly in the agri-food sector, are needed to accelerate growth and to absorb excess rural labor into better and more productive employment.

> **Although the growth of the last two fiscal years is now back on track with the NDP II target, Uganda's level of per capita income was, by 2018, well behind its neighbours**

More inclusive growth will also require building resilience to shocks. Recent favorable weather and stronger agricultural growth has contributed to the recovery of household incomes and lowered the estimated poverty levels down to those observed in FY12/13. However, environmental shocks and climatic risks can quickly reverse this trend. Amongst other interventions (e.g. investing in irrigation systems, modernizing agriculture production and practices), the expansion of existing social protection programs or the introduction of new ones can help mitigate risks, increase resilience and reduce the negative effects of adverse shocks on vulnerable households. Part 2 of the report will examine ways of increasing social protection coverage in a cost-effective and fiscally sustainable manner.

Inflationary pressures remain subdued. Inflation remains below the Bank of Uganda's (BoU) annual core inflation target of 5 percent. Headline inflation fluctuates in line with seasonal changes, but reasonable agricultural performance will largely keep domestic inflationary pressures subdued. Limited external inflationary pressures are anticipated through fuel and other imported goods, as oil prices are expected to average US$62/bbl in 2019 and US$60/bbl in 2020. Against this favorable inflation outlook, BoU reduced the policy rate to 9 percent in October 2019. This, as well as a positive economic outlook and continued improvement in commercial banks' credit environment, will keep lending rates within reasonable margins and private sector credit growth sustained beyond 2019.

The current account deficit almost doubled to 9.8 percent of GDP in FY18/19 from 5.4 percent last year, but remains manageable as it is financed by large net FDI inflows. Aided by real exchange rate appreciation, total imports grew by 20 percent in FY18/19. Merchandise exports also grew by 12 percent over the FY18/19 period, surpassing last year's 8 percent growth in exports. The rise in exports of goods occurred despite export volumes of coffee falling by over 6 percent in FY18/19, and coffee prices declining by 10 percent. Export growth will likely continue but will not be enough to offset the increase in imports of oil, machinery, vehicles and chemical products related to the investment drive. Hence, the current account deficit will likely decline only modestly to around 7 to 8 percent of GDP over the medium term.

Slow execution of capital spending and higher-than-expected tax revenues have kept the fiscal deficit below target. The fiscal deficit of 4.9 percent of GDP in FY18/19 was well below the budgeted deficit target of 5.8 percent of GDP. This is reflected by capital spending – at 5.3 percent of GDP in FY18/19 – being well below the budget of 6.4 percent of GDP. Deficiencies in the 'quality at entry' of projects largely explain some of the implementation challenges such as time-overruns, contract disputes, cost escalations and abandonment of projects. Tax revenues (at 12.6 percent of GDP) exceeded the budget target of 12.4 percent for FY18/19, but remain significantly lower than government's medium-term target of 16 percent of GDP and regional peers like Kenya (17.9 percent) and Rwanda (16.3 percent). Thus, efforts need to be made to expand the tax base, including through better managed and more restrained use of tax exemptions.

Although Uganda remains at low risk of debt distress, debt vulnerabilities are increasing.[1] According to certain shock scenarios, an unexpected downturn in GDP growth or increased reliance on non-concessional/commercial borrowing would enhance vulnerabilities. Furthermore, total debt service (interest and principal due) is expected to average around 41.5 percent of government revenue over the next six years, until oil revenues ensue. Additional liquidity pressures could arise if debt servicing of oil-related borrowing comes sooner than oil revenues themselves, as the final private sector investment in oil production gets delayed. Apart from prudent borrowing, this all highlights the significance of raising tax revenues and limiting the procurement and implementation delays of investment projects.

While the growth outlook for Uganda is favorable, risks are tilted to the downside. As the 2021 elections draw closer, heightened political activity and uncertainty could lead to a rise in spending, and a fall in investment and economic activity. Reliance on rain-fed agriculture and systemic challenges in the sector remain risks to GDP growth, the poor's income, and export earnings. Regional and global factors could also undermine the outlook. Reduced foreign demand, which would weaken exports and present risks to external stability, could come in the form of regional instability or as a result of trade uncertainties between the US and China, which might further slow global growth.

In order to sustain macroeconomic stability and enhance inclusive growth, policy actions in three key areas are needed:

Significantly enhance domestic revenue mobilization. At just 12.6 percent of GDP in FY18/19, tax revenues are strikingly low. A key reform would be the establishment of a *Tax Expenditure Governance Framework* to help manage tax exemptions, limit leakages and improve transparency.

Address implementation challenges for public investments and manage public assets to preserve value and maximize their return. A key implementation challenge involves better management of social risks, including land acquisition and resettlement. It is thus important for the government to finalize a revised *Land Acquisition Act and Policy*, as well as a legal framework for streamlining and strengthening *Social Impact Assessments.* Current road maintenance financing can only meet about 26 percent of the needs, leaving a big chunk of the road network unattended to. So, budget allocations for roads maintenance need to be progressively increased and sustained at about a quarter of the total roads budget.

Strengthen public debt management and transparency. Maintaining public debt on a sustainable path will require strengthening the budget process to ensure that budget targets become more binding; that public spending and public debt management become more effective (including continuing to maximize concessional borrowing); and that fiscal risks (including contingent liabilities and state-owned enterprise debt) are comprehensively monitored, controlled, and reported.

Strengthening social protection: To reduce vulnerability and promote inclusive growth

The coverage and design of social protection programs are currently insufficient to meaningfully address the range and scope of vulnerabilities to shocks in Uganda. Firstly, the existing direct income support programs in Uganda have low coverage, with the overall reach of the two main programs at only 3 percent of the population – which is very low given the needs in the country. Direct income support reaches more than 6 percent of the population in neighboring Kenya. Secondly, financing to the sector is limited. Direct income support in Uganda is currently composed of two major and several minor programs. The two major programs are the Senior Citizens Grant (SCG) and cash grants given through the Northern Uganda Social Action Fund 3 (NUSAF 3). Spending on the two major programs amounted to about 0.14 percent of GDP in FY17/18, which is lower than neighboring countries like Kenya and Rwanda who spend 0.4 percent and 0.3 percent of GDP, respectively, on direct income support.[2] Further, a large part of spending on SCG and NUSAF 3 is provided by donor grants or concessional loans. This raises concerns about the medium to long-term sustainability of financing to the sector.

1. According to the 2019 World Bank-IMF debt sustainability assessment.

Social protection programs can support investments in human capital, reduce vulnerability to shocks and, thereby, help drive inclusive economic growth. Programs can be designed to provide direct support to households with children, enabling them to invest more in human capital formation and development. Considering the long-term benefits accruing from investing in children and for Uganda to benefit from its demographic dividend, such programs are desirable and affordable when targeted appropriately. Simulations show, for example, that programs covering the poorest 50 percent of households with infants under 2, would cost an estimated 0.23 percent of GDP, whereas similar programs covering the poorest 50 percent of all households with children under 5 would cost 0.50 percent of GDP. To better mitigate shocks, the design of social protection programs should consider the nature, frequency and geographical location of large-scale shocks faced by Ugandan households. Expanding Disaster Risk Financing (DRF) models, based on regional (Kenya) and local (NUSAF 3 pilot DRF component) examples, is recommended.

Given government's limited fiscal space, it is important to prioritize any social protection expansion and focus it on the poor and vulnerable in the neediest geographical areas. The regional variation in Uganda's Human Capital Index (HCI), as well as the vulnerability and risks that are presented in this report, can provide government with an evidence base to prioritize these investments. This could then support better targeting of the most vulnerable groups and regions, and those facing the highest levels of risk.

Agricultural finance and insurance are critical in terms of reducing the vulnerability of households dependent on the agricultural sector for their livelihood. In 2018 about 87 percent of the working poor were engaged in agricultural activities. Further, nearly 85 percent of all farming households in Uganda are smallholder farmers and are characterized by low levels of productivity. The agricultural sector continues to be highly exposed to covariate (or country-wide) risks and access to finance continues to be a major constraint. Agricultural finance and insurance are critical to enable the structural transformation needed to accelerate growth in Uganda, alongside other interventions such as investing in irrigation systems, and modernizing agriculture production and practices. It is recommended that agricultural insurance be scaled up, including accelerating digital financial solutions, and enlarging the scope of the Uganda Agricultural Insurance Scheme (UAIS) to support the transformation of the agricultural sector.

Given the low coverage of social insurance schemes, fiscal incentives may need to be provided to improve take-up of voluntary savings schemes by informal sector workers. The coverage of social insurance is low in Uganda because of the low degree of formalization in the economy. About 89 percent of household heads are employed in the informal sector in Uganda; so social insurance provided through traditional employment contracts is not a reality for most Ugandans. Gaining a better understanding of the heterogeneity of workers in the informal sector, understanding savings patterns, risk coping strategies, and the intrinsic value these households place on old-age savings, could help to better design and customize relevant savings products. More appropriate products may then encourage savings among informal sector workers. The government could also consider providing fiscal incentives to achieve mass-scale uptake of such schemes by informal sector workers.

In order to strengthen social protection to reduce vulnerability and promote inclusive growth, the key recommendations are that:

a. Direct Income Support be expanded to support investments in human capital and to help mitigate shocks.
b. Existing disaster risk financing pilots are scaled up to better prepare for drought and mitigate other shocks.
c. Given the limited fiscal space, social protection expansion is focused on the poor and vulnerable in the neediest geographical areas.
d. Given that drought risks predominate, and households engaged in agriculture are most affected by such risks, agricultural insurance is scaled up.
e. Fiscal incentives are provided to improve the take-up of voluntary savings schemes by informal sector workers.

2. Government of Uganda (2018). Uganda Social Protection sub-sector report 2018. MGLSD. May 2018.

PART 1

STATE OF THE ECONOMY

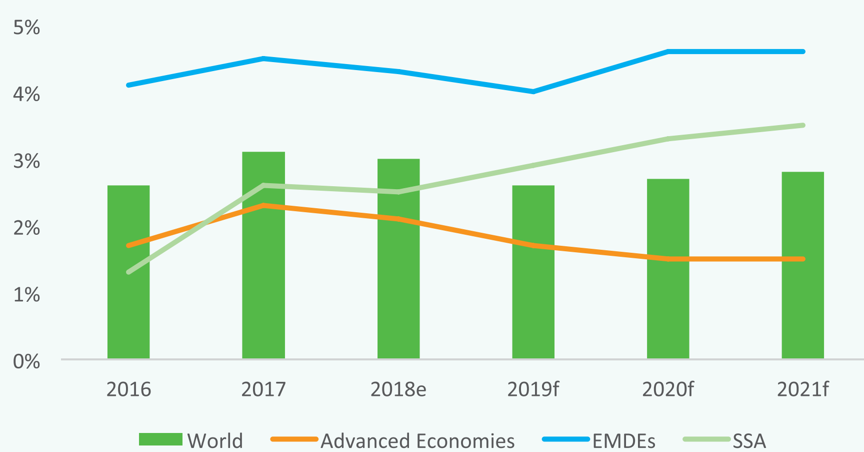
Global growth in 2019 has been downgraded to 2.6% - 0.3 % below previous forecasts, reflecting weaker-than expected international trade and investment.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Global growth has continued to weaken [3]

Global growth in 2019 has been downgraded to 2.6 percent, 0.3 percent below previous forecasts, reflecting weaker-than-expected international trade and investment. Growth in the United States (U.S.) is expected to slow to 2.5 percent in 2019 and further decelerate to 1.7 and 1.6 percent in 2020 and 2021 respectively. Tariff increases and associated retaliatory actions are expected to weigh on trade and investments, whilst the effects of the recent fiscal stimulus also wane. On the other hand, growth is being supported by more accommodative monetary policy than previously assumed and by sustained increases in productivity growth and labor force participation. Economic conditions in the Euro area, one of Uganda's main export markets, have deteriorated rapidly since mid-2018. This slowdown, particularly in the manufacturing sector, also reflects a decline in exports, especially to China, Europe and Central Asia. Euro area growth is projected to slow from 1.8 percent in 2018 to 1.2 percent in 2019 and then edge up to an average of 1.4 percent in 2020-21. Global growth is projected to gradually rise to 2.8 percent by 2021 (Figure 1), predicated on continued benign global financing conditions, as well as a modest recovery in emerging

Figure 1: Real GDP growth (percent y/y)



Source: World Bank, 2019
Note: e = estimate; f = forecast; aggregate growth rates calculated using constant 2010 US$ GDP weights; GDP growth values are on a fiscal year basis.

3. This section is based on the World Bank, Global Economic Prospects, June 2019

> Among non-resource-intensive countries, such as Uganda, rising consumption growth and sustained public investment in infrastructure are supporting economic activity

market and developing economies (EMDEs) previously affected by financial market pressure. This recovery in the global economy is expected to positively impact Uganda's economic outlook, particularly through stronger export growth during FY21 (see section 2).

EMDEs growth momentum continues to be generally subdued and is expected to be about 4 percent in 2019. Although there have been recent improvements in external financing conditions – given that the prospect of larger economies tightening monetary policy in the near term has faded – these are partially offset by slowing global trade and persistent policy uncertainty in key economies. In China, growth is projected to decelerate from 6.6 percent in 2018 to 6.2 percent in 2019, primarily reflecting softening manufacturing and trade activity. The recent increase in tariffs on trade with the U.S. is projected to weigh on growth in 2020, which has been revised down to 6.1 percent. Growth in low-income countries (LICs) is projected to remain robust in 2019, at 5.4 percent, sustaining a strong demand base for Uganda's exports, especially in regional markets. Among non-resource-intensive countries, such as Uganda, rising consumption growth and sustained public investment in infrastructure are supporting activity (see section 1.3). LICs growth is projected to rise to 6.0 percent in 2020 and 6.1 percent in 2021, which reflects the expected trend in Uganda, as domestic demand continues to strengthen, and as increased oil and metals production supports activity among industrial-commodity exporters. Risks to this outlook include slower-than-expected growth in major trading partners, a resumption in the tightening of international financial conditions, and adverse weather and health crises. Some of these risks also pertain to Uganda's economic outlook, as discussed in section 2.2.

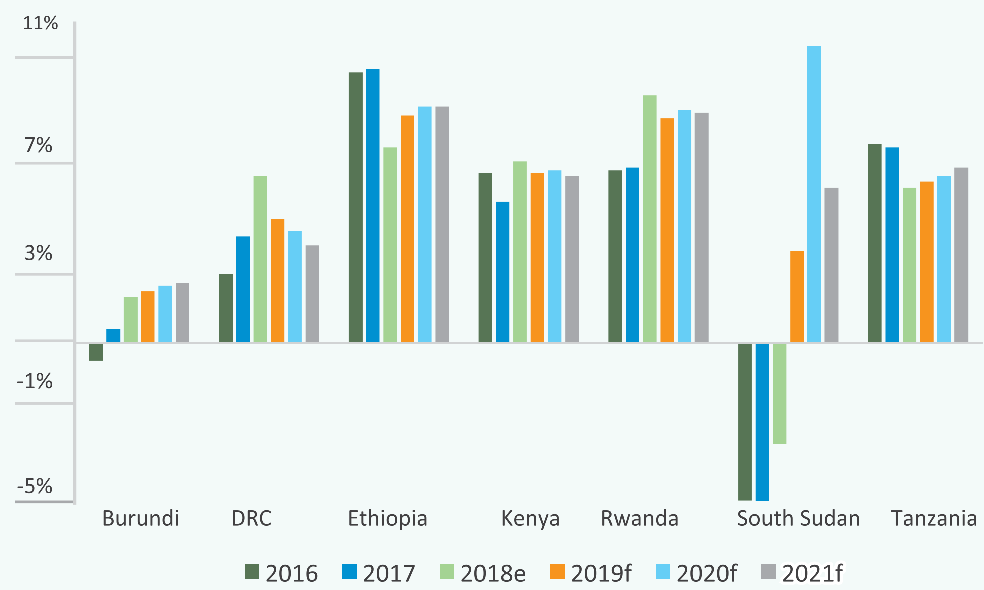
Prices of most industrial commodities picked up in the first half of 2019, but remained well below peak values from last year, while agricultural prices were mostly flat. Oil prices recovered in the first half of the year, averaging US$64 per barrel (bbl), and are expected to average US$62/bbl in 2019 and US$60/bbl in 2020, a downward revision relative to January, reflecting softening global activity. Whereas lower oil prices limit external inflationary pressures for import dependent Uganda, it could negatively affect the country's prospects for becoming an oil producer. However, the oil price outlook remains highly uncertain and dependent on policy decisions, particularly whether the production cuts among OPEC and its partners will be extended into the second half of 2019. Agricultural prices were stable, on average, in the first half of 2019, amid high stock levels and favorable crop conditions for the fourth consecutive year. Heightened trade tensions have clouded the outlook for commodities demand, and so agricultural and metals prices are projected to broadly decline in 2019 and stabilize in 2020. In addition to the slowing of economic activity in key markets for Uganda's agriculture exports, such as the Euro area, the decline in agricultural prices is concerning, given that agriculture-based products (i.e. both primary and processed products) account for more than 50 percent of all Uganda's exports.

1.2 Recovery in Sub-Saharan Africa has disappointed [4]

Growth in Sub-Saharan Africa is expected to pick up to 2.6 percent this year from 2.5 percent in 2018, as domestic demand gathers pace and oil production recovers in large exporting economies. However, this expected recovery is significantly slower than previously projected, reflecting persistent headwinds in major economies, and will lead to a lower rate of poverty reduction, especially given the demographic challenges in the region. Growth in the region's three largest economies – Angola, Nigeria, and South Africa – has remained subdued in 2019, given that the anticipated recovery and performance in the oil sector has been weaker than

4. This section is based on the World Bank, Global Economic Prospects, June 2019 & the World Bank, Africa's Pulse, October 2019

Figure 2: Real GDP growth (percent y/y)



Source: World Bank, 2019 & World Bank Staff Estimates
Note: e = estimate; f = forecast; Ethiopia is based on fiscal-year numbers

expected (Angola and Nigeria), and continued policy uncertainty and rolling power blackouts in South Africa have slowed economic activity in the first half of 2019. Elsewhere in the region, growth has been strong among non-resource-rich countries, supported by sustained public investments and strong agricultural production. Exchange rates have been broadly stable this year against the U.S. Dollar, amid improved external financing conditions. This has, in part, supported moderating inflation in many countries in early 2019. Reduced inflationary pressures have allowed authorities to pause monetary policy tightening in some countries and ease their stance in others (including Uganda). Public debt vulnerabilities in the region remain a concern, and higher interest burdens reflect the shifting composition of debt toward more expensive non-concessional financing. Growth in the region is expected to improve gradually, reaching an average of 3.1 percent in 2020 and 3.2 percent in 2021. This assumes that investor sentiment will improve in some of the larger economies, that oil production will recover, and that robust growth in non-resource-intensive economies like Uganda will be underpinned by continued strong agricultural production and sustained public investment.

With growth levels around 5 to 6 percent per year, economic activity is expected to largely remain strong in East Africa (Figure 2). Recent good weather, sustained infrastructure spending, and increased foreign direct investment (FDI) have broadly underpinned the pickup in activity in East Africa over the last few years. Among Uganda's main trading partners, the outlook is largely positive, which should bode well for Ugandan exports, given the softening levels of growth and demand in some of Uganda's other export markets. The rebound in Kenya's economy is expected to continue in 2019-21, supported by favorable agricultural output, a pick-up in industrial activity, strong performance in the services sector, and strengthening aggregate demand from pending investments and improved business sentiment. Rwanda's growth is expected to stay around 8 percent over the medium term driven by improved agriculture performance, large infrastructure projects, and stronger domestic demand. The medium-term outlook for the Democratic Republic of Congo (DRC) has deteriorated recently given a continued decline in commodity prices and mining production, with growth expected to only average around 3.9 percent in 2019-21. South Sudan's economy continues to recover, with average annual growth rates likely to exceed 6 percent in 2019-21. However, this assumes that the peace agreement, signed in September 2018, remains in place and security starts to improve.

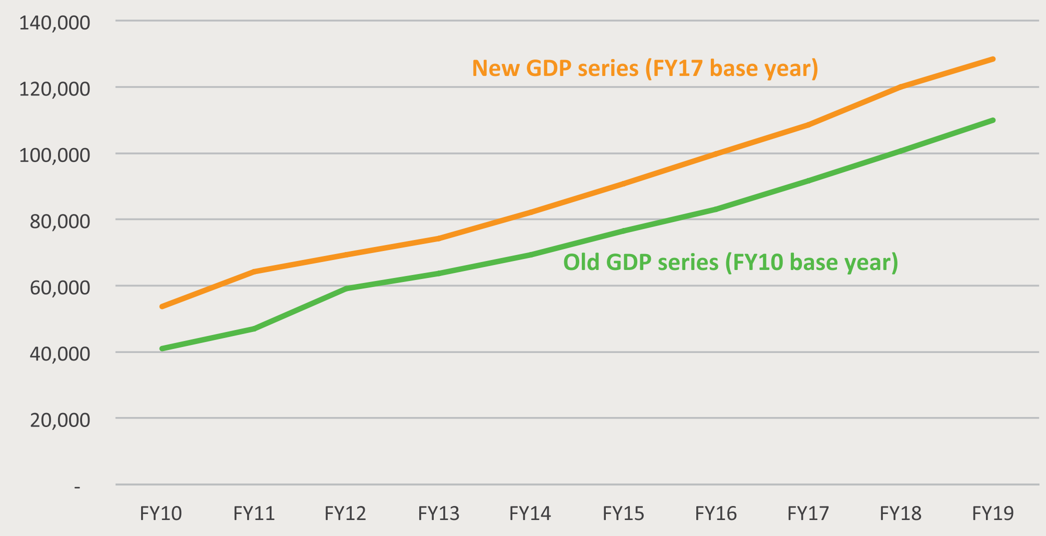
4. This section is based on the World Bank, Global Economic Prospects, June 2019 & the World Bank, Africa's Pulse, October 2019

Box 1: New GDP numbers show better progress on Uganda's industrial transformation

In October 2019, the Uganda Bureau of Statistics (UBOS) released new GDP estimates, updating the base year for estimating economic activity to 2016/17 from 2009/10. Such an exercise is a routine step that all governments do periodically to ensure that GDP calculations more accurately reflect current prices and better capture the changing structure of an economy. The new GDP estimates also benefit from improvements in the estimation methodology that UBOS has adopted and expanded data sources. As a result, there are some significant changes to the size and structure of the Ugandan economy.

The value of nominal GDP over the entire series is now higher. For example, nominal GDP for FY18/19 was revised upwards from USh 109,945 billion to USh 128,499 billion – or a 17 percent increase. Over the last ten years, the new GDP series is about, on average, 21 percent higher. This also implies that all other indicators expressed as a percentage of GDP (e.g. revenue to GDP, expenditure to GDP, public debt to GDP) will be affected. For example, as nominal GDP is revised upward, the ratio of revenue and expenditure to GDP are smaller than previously reported.

Figure B1: Nominal GDP (billions of USh) – comparing the old and new GDP estimates

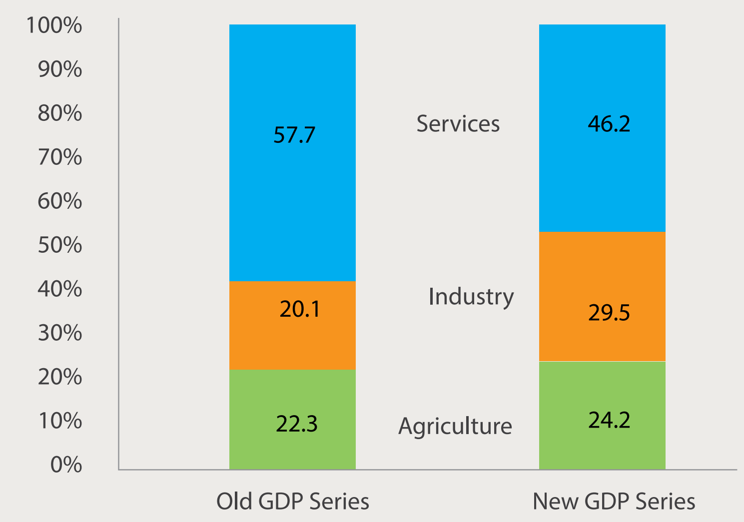


Source: UBOS

The annual growth rate in GDP for FY18/19 has improved from 6.1 percent (under the old estimates) to 6.5 percent (under the new estimates). For all the other years, the annual growth rates are the same.

The structure of the economy is now different from what was previously thought. Under the new GDP estimates, the share of industry in GDP has increased from about 20 percent to almost 30 percent (Figure B2). At the same time, there has been a drop in the share of services from about 58 percent to 46 percent. Drilling down further and as shown in Table B1, manufacturing has doubled its share from about 8 percent to over 16 percent of GDP, as the new estimates reflect the changing structure, including unmeasured elements, of the sector. After disaggregated data become available, including the new *Index of Production*, the Uganda Economic Update will analyze the manufacturing sub-sectors driving this much larger share of GDP, as well as which additional sub-sectors are now being captured. Even more stark though, is the drop in the share of information and communications (IC) from almost 12 percent to just under 2 percent of GDP. This sector had been seen as a key mainstay of the economy, driving growth for many years. However, given a change in methodology for measuring activities in the IC sector from mostly monitoring talk-time to now assessing VAT outcomes, it is apparent that this sector was not as big, nor growing as fast, as previously estimated.

Figure B2: Sector share of GDP – comparing the old and new GDP estimates



Source: UBOS

Table B1: Selected sub-sectors share of GDP

(Selected sectors)	Old GDP estimates	New GDP estimates
AGRICULTURE		
Crops	13.6	15.4
Livestock	3.8	3.3
Forestry	3.7	3.7
Fishing	1.1	1.8
INDUSTRY		
Mining & quarrying	2.0	2.1
Manufacturing	7.6	16.5
Construction	7.2	7.1
SERVICES		
Trade & Repairs	11.4	9.6
Trans. & Storage	3.1	3.6
Accomm & Food	2.6	3.1
Info. & Comm.	11.8	1.8
Fin. & Insurance	3.3	2.8
Real Estate	5.9	7.0
Public Admin.	3.8	2.5
Education	6.3	4.5
Health & Social Work	3.2	3.4

Source: UBOS

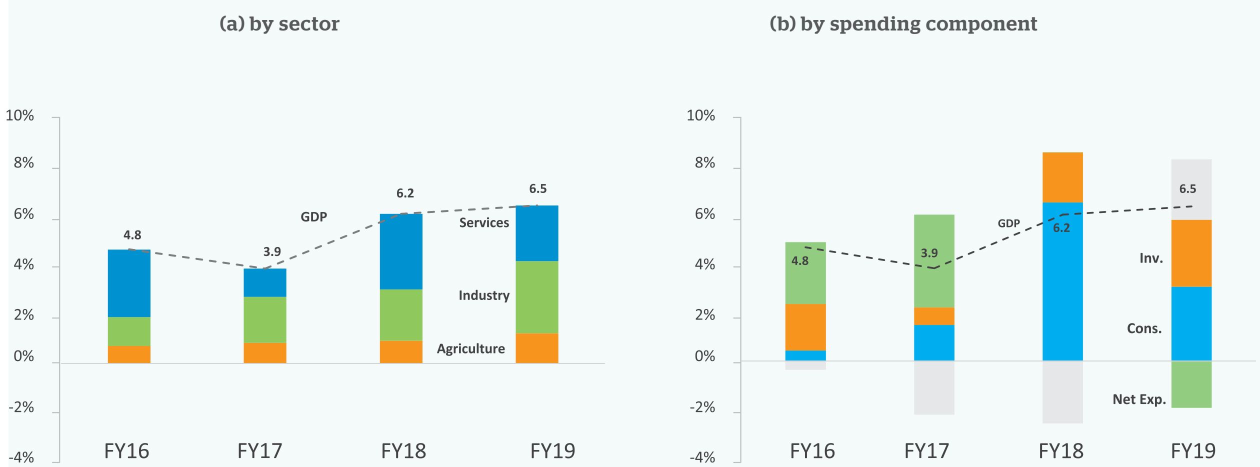
The new GDP estimates show that Uganda's industrial transformation is further advanced than what had been thought. This is certainly a boon for government's policy focus on and investments to industrialize the economy. Part of this industrialization agenda was also to increase the number of employment opportunities and to provide jobs outside of rural areas. However, this doesn't seem to have happened, and further analysis is required to understand why rapid growth in manufacturing has not translated into significant numbers of new and better jobs.

1.3 Uganda's growth momentum is sustained

After rebounding to 6.2 percent in FY17/18, real GDP grew faster than had been anticipated at 6.5 percent in FY18/19. This is 0.3 percentage points higher than the forecast in the May 2019 Economic Update and is as a result of the new GDP estimates released in October 2019 (see Box 1). Nominal GDP for FY18/19 was revised upwards from USh 109,945 billion to USh 128,499 billion – or a 17 percent increase. The annual growth rate has also changed, including the better than initially forecast growth in FY18/19. However, these growth levels are still not adequate for Uganda to meet its aspirations of reaching lower middle-income status by 2020 (see Box 2).

On the demand side, growth has been driven by strong levels of domestic consumption and sustained levels of private and public investment (Figure 3b). The Purchasing Managers' Index (PMI) rose consistently in FY18/19 (compared to more constant levels in FY17/18), signaling improved business conditions in the Ugandan private sector, as stronger levels of customer demand drove increases in both output and new orders.[5] Net FDI inflows shot up to 5.1 percent of GDP in FY18/19, compared to 3 percent of GDP in FY17/18 (see section 1.5). Recent FDI has largely been in the oil and gas, manufacturing and hospitality sectors.[6] Public investment spending increased by 0.4 percent of GDP in FY18/19 compared to FY17/18 (see Table 4). These stronger levels of consumption and investment have been particularly beneficial to the manufacturing, construction and real estate sectors. The on-average positive contribution of net exports to GDP over the last three fiscal years (Figure 3b) was reversed in FY18/19 on account of the rapid growth of investment-related imports, compared to the more moderate growth in exports (see section 1.5).

Figure 3: Sources of real GDP growth in Uganda (percent y/y)



Source: UBOS

Note: The lightly shaded section of each column is the statistical discrepancy, which is an adjustment factor to ensure any omissions or differences in source information used to measure GDP from the income, production and expenditure sides are accounted for and the final GDP numbers are aligned.

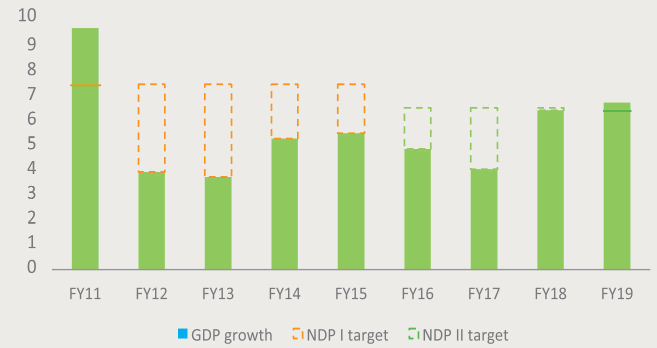
5. The PMI is compiled monthly by IHS Markit and is sponsored by Stanbic Bank Uganda. It is a composite index, calculated as a weighted average of five individual sub-components: new orders (30%), output (25%), employment (20%), suppliers delivery times (15%), and stocks of purchases (10%). It gives an indication of business operating conditions in the Ugandan economy.

6. UNCTAD (2019)

Box 2: Growth is not adequate for Uganda's lower middle-income status and poverty reduction ambitions

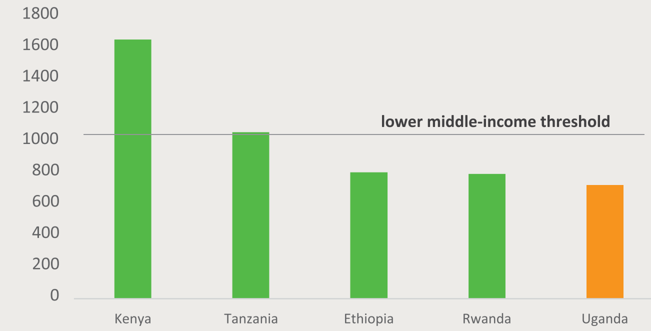
Following average annual GDP growth rates of about 7.5 percent during the decade prior to FY11/12, growth averaged only 4.4 percent from FY11/12 to FY16/17. As shown in Figure B3, this was far below the first National Development Plan (NDPI FY11–FY15) target of 7.2 percent and the NDPII FY16–FY20 target of 6.3 percent. This slowdown was mainly attributed to challenges for productivity growth, several shocks including adverse weather conditions, unrest in South Sudan, private sector credit constraints and poor execution of public projects. At the same time, between 2012 and 2016, the poverty rate increased from 19.7 to 21.4 percent; an increase that resulted in around 1.4 million Ugandans slipping into poverty. Encouragingly, growth in the last two years is now back on track with the NDP II target and, as discussed in section 2, levels of growth of around 6 percent are expected over the medium term.

Figure B3: GDP growth – actual vs. target (%, y-o-y)



However, due to a high population growth rate of over 3 percent per year, per capita income growth has averaged less than 3 percent. In fact, Uganda's level of per capita income was, by 2018, well behind its neighbors (Figure B4). The current growth outcomes will be insufficient to propel Uganda to lower middle-income status any time soon – even though the government's goal is to achieve this by 2020.[7] Furthermore, with the expected population growth over the next 10 years, it is now estimated that average annual GDP growth rates will need to exceed 8 percent for Uganda to have a chance of reaching lower middle-income status by 2030. This is an extremely tall order given underlying factors such as low productivity and a failure to shift to higher productivity activities that are resilient to shocks and can generate and sustain solid growth rates.

Figure B4: 2018 Gross National Income (GNI) per capita (US$)



Moreover, growth is increasingly less inclusive as its impact on poverty reduction appears to have declined. During the past decade, each unit increase in GDP has resulted in a lower decline of the poverty rate, compared to the outcome observed between 2000 and 2009.[8] The poverty-growth elasticity rate declined from -1.24 (for the period 2000-2016) to -0.5 (for the period 2009-2016).[9] Thus, a stronger focus on inclusive and equalizing policies will be required for further poverty reduction.

Consequently, Uganda must attain significant economy-wide productivity improvements for it to reach higher and more inclusive growth rates. Raising the quality of growth will be critical for the future economy to better support the aspirations of all Ugandans. This would include support to those who may be left behind and building resilience to shocks that undermine economic growth when they occur and during the time it takes for households to recover. Developing and sustaining human capital, especially when households are faced with shocks, is also essential for a more productive economy. This will be further discussed in Part 2 of the report.

Sources: UBOS and World Bank Staff Estimates

7. Lower middle-income economies are defined as those with a GNI per capita between US$1,006 and US$3,955.

8. World Bank, 2019 (October)

9. The elasticity of the poverty headcount rate under the international poverty line to GDP growth per capita.

Services sector growth slowed to 4.9 percent in FY18/19 (Table 1). This was largely due to slower growth in the trade, transportation and storage, and accommodation and food sub-sectors (Figure 5). In FY17/18 these sectors grew on average at almost 9 percent, but eventually slowed to 3.4 percent in FY18/19. The slowdown could be on account of slower intra-regional economic activity, following the lingering effects of the South Sudan conflict and closure of the Uganda-Rwanda border. By March 2019, the protracted feud between these two countries reached a peak, which brought cross-border activities to a halt. In contrast, the real estate sector continued to grow at more than double digit levels, as the sector continues to attract investments by both domestic and foreign investors.

Sustained double-digit growth in construction activities and a strong year for manufacturing drove industrial sector growth of over 10 percent in FY18/19 (Table 1). As shown in Figure 4, the industrial sectors were the main drivers of growth in FY18/19. The construction sub-sector continued its double-digit growth of the last four years as a result of intensified public and private investments in energy and oil projects, real estate activities, and the expansion of industrial zones. Following the last three fiscal years where manufacturing growth averaged about 3 percent, the jump to 7.1 percent growth in FY18/19 is very encouraging (Figure 6). This is mirrored by the growth in credit to the manufacturing sector by almost 16 percent in FY18/19 (compared to an average fall of about 3 percent over the last couple of years). This has supported recent expansion in the sector, including investment in new factories. Moreover, these more attractive growth rates going forward should be sustained and provide increasing job opportunities.

Continued growth in crops, particularly cash crops, and a very strong rebound in fisheries contributed to the 5 percent growth in agriculture in FY18/19 (Table 1). Crop growth was, however, somewhat constrained by the performance of the coffee sector, where export volumes fell by over 6 percent, whilst international coffee prices also declined throughout FY18/19.[10] From an average contraction of about 10 percent over the last three fiscal years, fisheries rebounded to grow at over 24 percent in FY18/19 (Figure 7), with fish exports growing by almost 30 percent in FY18/19.[11] On-going efforts to address key challenges (e.g. poor-quality fish larvae/fingerlings, limited access to feeds, trade in illegal and unrecorded immature fish) and foster a sustainable fisheries and aquaculture sub-sector seem to be paying off.

Although the agriculture sector accounted for only 1.2 percent of the growth rate of 6.5 percent in FY18/19 (Table 1), the sector's importance for livelihoods, poverty reduction and the broader economy is much greater. Agriculture-based products (i.e. both primary and processed products) accounted for about 45 percent of exports in FY18/19. The sector also employs about 64 percent of Ugandans (and 72 percent of young Ugandans)

10. For example, the price of Robusta coffee fell from an average of US$1.93/kg in the last quarter of FY17/18 to an average of US$1.61/kg in the last quarter of FY18/19 (World Bank Commodities Price Data, August 2019).
11. At around 6 percent of total exports in FY19, fish and fish products are Uganda's fourth largest export, after coffee, industrial products and gold.

41.5 %

expected average total debt service (interest and principal due) of government revenue over the next six years

and is, thus, critical for household income growth and consumption, which helps stimulate growth in other sectors. Moreover, the performance of the largely rain-fed agriculture sector and corresponding environmental shocks is closely linked to the living standards of those whose primary income source is from agriculture. When agriculture commodity prices are poor or when the rains fail, crop income growth falters and consumption falls, with adverse consequences for poverty reduction. The drought and pest infestations in 2016 and 2017 largely explained the increase in poverty incidence between FY12/13 and FY16/17 from 19.7 to 21.4 percent (under the national poverty line), as households engaged in agriculture accounted for most of the increase.[12] Alternatively, the recent favorable weather and stronger agricultural sector growth have supported household consumption, particularly in rural areas. Therefore, the poverty rate is estimated to have declined to incidence levels observed in FY12/13.

Beyond impacts on immediate income, environmental shocks and climatic risks also become an important constraint to productivity growth. When individuals are not covered for such risks, they are less willing to invest in inputs and skills that help improve productivity. Amongst other interventions (e.g. investing in irrigation systems, modernizing agriculture production and practices), the expansion of existing social protection programs or the introduction of new ones can help mitigate risks, increase resilience and reduce the negative effects of adverse shocks on vulnerable households. As discussed in Part 2 of the report, regional and national experiences demonstrate that social protection programs and delivery systems that can scale up rapidly in response to shocks are an effective risk mitigation channel.

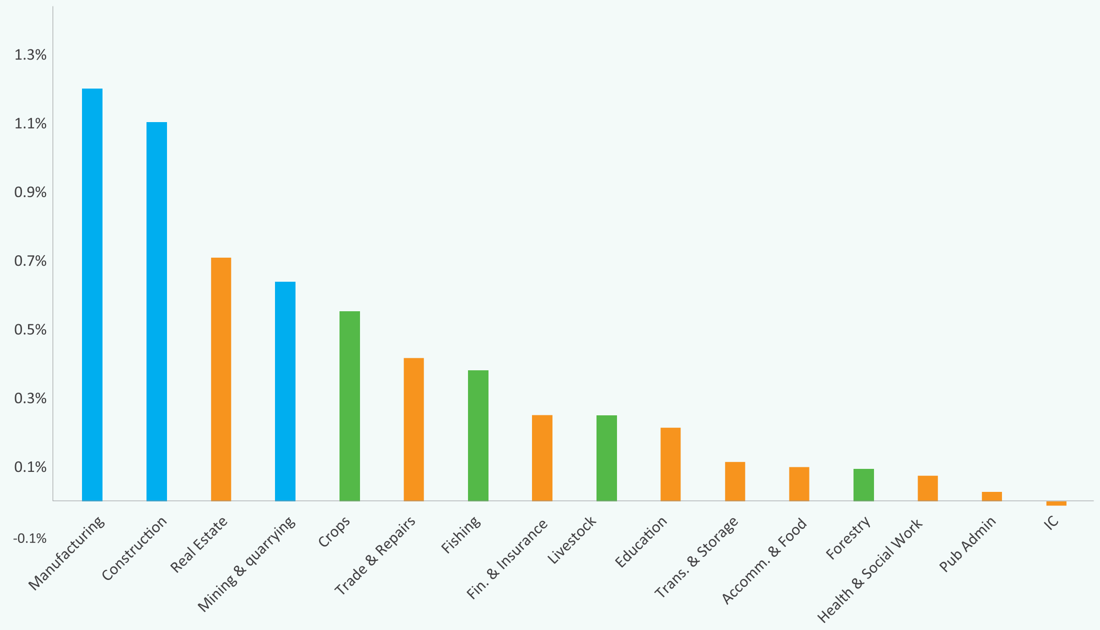
Table 1: FY18/19 Real GDP (percent change y/y unless indicated, selected sub-sectors)

	Growth rate	% share of GDP	% contr. to Growth
GDP	**6.5**	**----**	**----**
AGRICULTURE, FORESTRY & FISHING	**5.0**	**24.2**	**1.2**
Cash crops	7.7	2.4	0.19
Food crops	2.6	13.0	0.35
Livestock	7.3	3.3	0.24
Forestry	2.4	3.7	0.09
Fishing	24.3	1.8	0.37
INDUSTRY	**10.8**	**29.5**	**3.1**
Mining & quarrying	37.4	2.1	0.62
Manufacturing	7.1	16.5	1.16
Construction	16.5	7.1	1.07
SERVICES	**4.9**	**46.2**	**2.3**
Trade & Repairs	4.1	9.6	0.40
Transportation & Storage	3.0	3.6	0.11
Accommodation & Food Services	3.0	3.1	0.10
Information & Communication	-0.6	1.8	-0.01
Financial & Insurance	8.8	2.8	0.24
Real Estate Activities	10.2	7.0	0.69
Public Administration	1.0	2.5	0.03
Education	4.5	4.5	0.21
Health & Social Work	2.1	3.4	0.07

Source: UBOS

12. World Bank (2019, March).

Figure 4: Contribution to FY18/19 growth of 6.5 percent (selected sub-sectors)



Source: UBOS
Note: Orange depicts the services sub-sectors; green the agriculture sub-sectors; and blue the industry sub-sectors

Figure 5: : Services – another good year for real estate
(sectoral growth rate, contribution to sectoral growth, percent y/y)

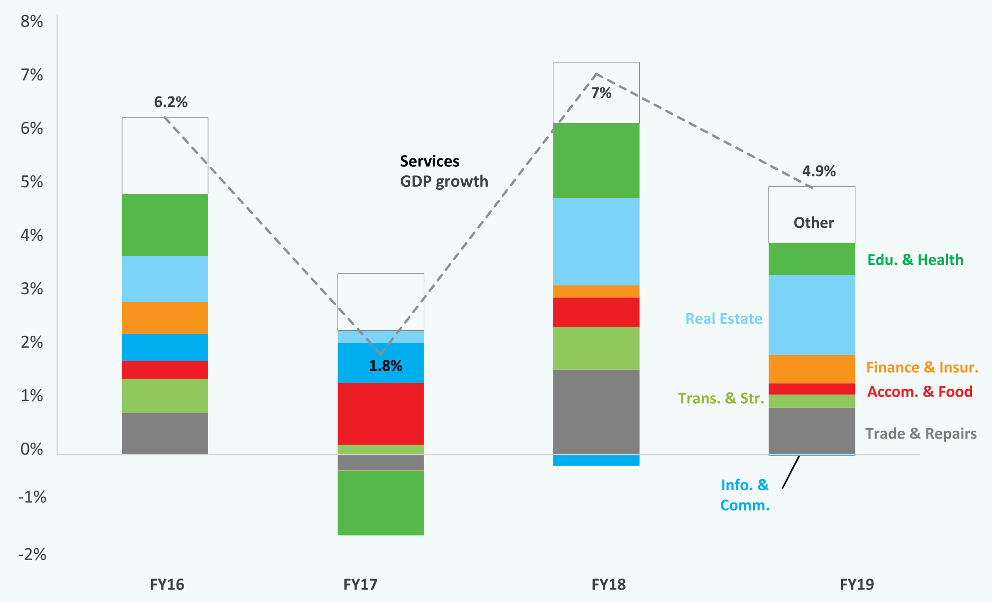


Figure 6: Industry – manufacturing and construction continue to boom
(sectoral growth rate, contribution to sectoral growth, percent y/y)

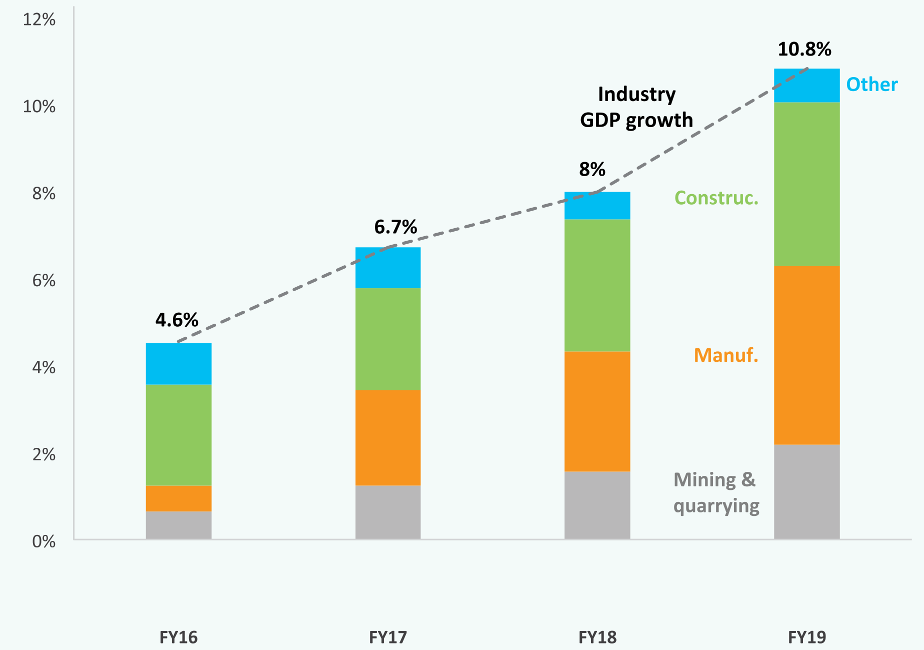
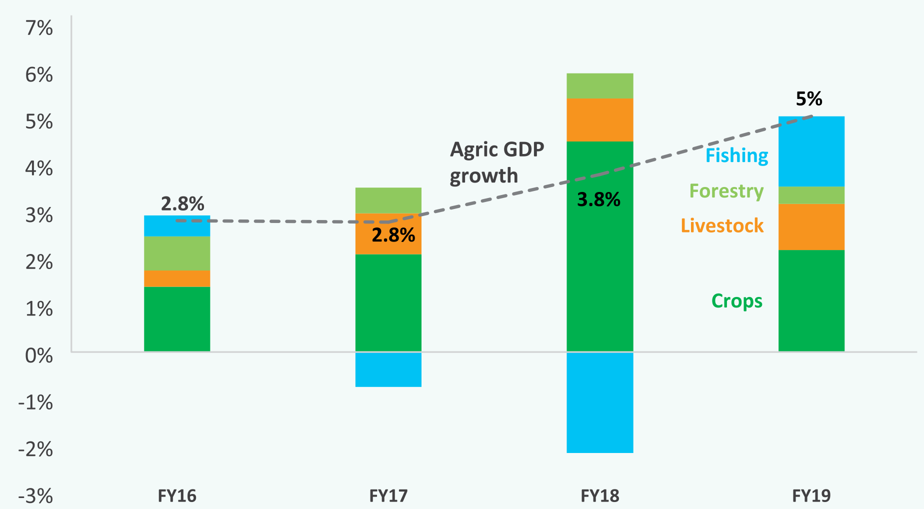


Figure 7:Agriculture – a strong rebound in fisheries
(sectoral growth rate, contribution to sectoral growth, percent y/y)



Source for Figures 5-7: UBOS

1.4 Inflationary pressures subdued as private sector credit continues growing strongly

Inflation remains below the BoU's annual core inflation target of 5 percent, despite a recent spell of increasing prices (Figure 8).[13] While core inflation eased to 2.8 percent in December 2018 (yoy), following monetary tightening in October, a sharp acceleration to 4.9 percent took place in June 2019 (yoy) largely fueled by strong domestic demand, but also due to a sharp increase in the price of services, particularly for communication and transport. Helped by an appreciation of the shilling, and a strong deceleration in sugar prices, headline inflation subsequently slowed to 2.5 percent and core inflation to 3.5 percent in August (yoy). Overall, 12-month headline inflation decelerated in August to 2.9 percent, after edging up in June and July to 3.1 percent, and remains significantly lower than two years ago, when it stood at 5.7 percent. Meanwhile, 12-month core inflation stood at 3.8 percent in August, rising steadily from 2.4 percent since December.

Continued favorable weather and corresponding ample food supply kept food prices subdued. Food crop price deflation continued in August at -1.5 percent (yoy), but at a much slower pace than seen in previous months (Figure 9). This is due to an increase in fruit prices and a slowdown in the reduction of vegetable prices, which led to a monthly increase in food crop prices by 1.1 percent in August. Prolonged deflationary pressures in food prices helped consumption of the urban poor, but equally reduced income of the rural poor at a time when charcoal prices started increasing. Meanwhile, Energy, Fuels and Utilities (EFU) prices rose to 1.1 percent in August (yoy) due to higher charcoal prices, which more than offset a decline in prices of liquid fuels.

Figure 8: Inflation remains below the inflation target (percent change y/y)

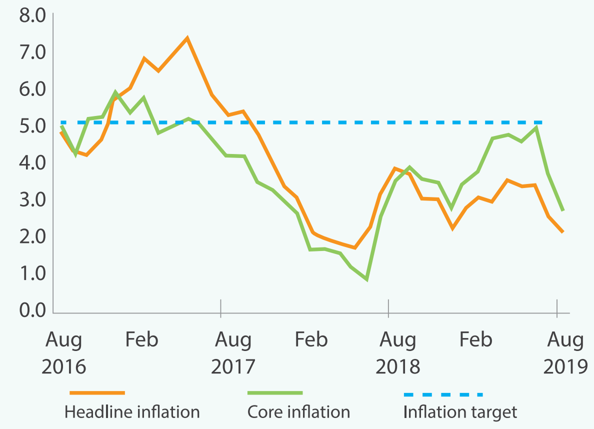


Figure 9: Food crop prices are bottoming out (percent change y/y)

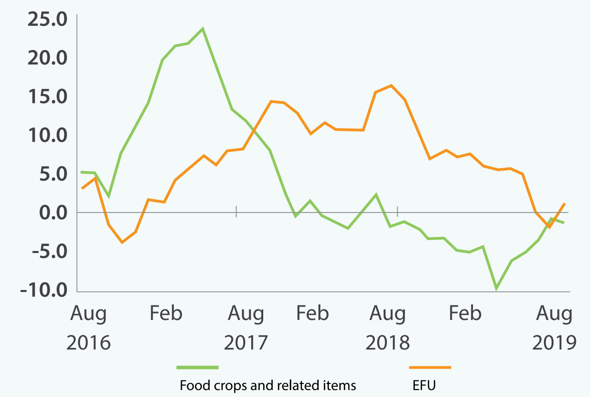


Figure 10: Private credit continues with robust growth (percent change y/y, real terms)

Figure 11: Credit growth accelerates to retail trade and manufacturing (percent change y/y, real, 3-month moving average)

Source: Bank of Uganda
Note: Nominal credit growth is deflated by Consumer Price Index.

13. Where possible and relevant to the analysis, this section includes data beyond the end of FY18/19.

Table 2: Financial sector indicators

	Jun-16	Dec-16	Jun-17	Dec-17	Jun-18	Dec-18	Jun-19
Capital adequacy (%)							
Regulatory capital to risk-weighted assets	21.7	19.8	23.6	23.2	21.8	21.6	22.1
Regulatory tier 1 capital to risk-weighted assets	19.0	17.3	21.4	20.9	19.7	19.8	20.3
Total capital to total assets	16.3	15.5	17.0	17.6	17.0	17.6	17.0
Asset quality (%)							
NPLs to total gross loans	8.3	10.5	6.2	5.6	4.4	3.4	3.8
Earning assets to total assets	68.0	67.3	69.2	71.9	68.2	69.1	71.7
Large exposures to gross loans	41.5	42.4	37.4	38.0	43.2	42.9	44.3
Large exposures to total capital	121.5	133.2	97.5	94.8	113.7	112.5	116.7
Earnings & profitability (%)							
Return on assets	2.2	1.3	1.7	2.7	2.8	2.5	2.7
Return on equity	13.8	8.3	10.2	16.4	16.7	14.4	15.8
Overhead to income	47.9	47.5	48.4	48.9	51.2	53.7	52.2
Liquidity (%)							
Liquid assets to total deposits	43.4	51.5	50.1	54.6	46.6	45.5	45.5
Liquid assets to total assets	29.6	35.3	34.6	37.4	32.8	31.7	31.5

Source: Bank of Uganda and UBOS

Credit to the private sector continued to grow strongly, although at a more sustainable rate (Figure 10). Supported by healthy economic growth, flourishing trade and private investment on the demand side, and steady reduction in NPLs on the supply side, the increase in lending to the private sector averaged, in real terms, 10 percent during January to July 2019, compared to 5.8 percent during the same period last year. Private sector credit growth continued rising despite high lending rates, averaging 19.5 percent for domestic currency loans and 7 percent for foreign currency loans, during the second quarter of 2019. While lending rates exhibited a declining trend, even after the key monetary rate rose in October 2018, rates in Uganda are still much higher compared to neighboring countries. This high financing cost adversely affects the competitiveness of domestic companies.

Lending to manufacturing has taken off since early-2018 and drives the strong private sector credit growth (Figure 11). Credit to the manufacturing sector is in large part led by lending to the chemicals, pharmaceuticals, plastic and rubber industries. With credit growth up to 90 percent in the second quarter of 2019 (yoy), manufacturing appears to be amidst a credit growth cycle last seen in the telecommunications sector in early 2016. This acceleration in credit growth also supported a 30 percent increase in plastic product exports in FY18/19. The building and construction materials producers, as well as food, tobacco, and beverages manufacturers, have also experienced double digit credit growth.

While stronger borrowing by retailers has benefitted from continuously robust domestic demand, lending to the agriculture sector has decelerated to more sustainable levels (Figure 11). Credit growth to the trade sector really picked up from January to July 2019, averaging 11.2 percent in real terms, compared to 6.4 percent during the same period last year. Booming trade and private consumption have resulted in lending to retailers' more than doubling to 24.2 percent during the first seven months of 2019, in real terms, compared to the same period last year. Meanwhile, real credit growth to the agriculture sector has slowed to 11.6 percent during the first half of 2019 from 19.3 percent in the same period a year ago. This slowdown in borrowing was primarily led by crop and livestock producers, where real credit growth has halved to close to 12 percent during the first six months of 2019 from 22.7 percent a year ago.

The financial system is stable, with the banking sector well capitalized, asset quality improving, and profitability increasing (Table 2). The banking sector remains well capitalized, and all banks meet the minimum core and total capital adequacy ratios of 8 and 12 percent, respectively. Bank capital is bolstered by increased profitability, with a return on equity of almost 16 percent, which is a consequence, among others, of the domestic economic upturn witnessed over the past two years. Asset quality has also improved as non-performing loans (NPLs) contracted to 3.8 percent of total gross loans at end-June 2019, after peaking at 10½ percent in December 2016.

This reduction in NPLs benefitted from the closure of Crane Bank, NPL write-offs by other banks, and an improvement in general liquidity conditions that allowed for the recovery of loans. Banks maintain adequate liquidity buffers above the regulatory minimum requirements, thus keeping liquidity risk low.

1.5 The current account deficit widened sharply

The current account deficit almost doubled to 9.8 percent of GDP in FY18/19 from 5.4 percent last year, yet the external position remains manageable due to large net FDI inflows (Table 3). The sharp widening of the external shortfall was largely driven by the merchandise trade deficit, which rose to 8.2 percent of GDP, while the deficit in services doubled to 2.6 percent of GDP compared to a year ago. With a surplus of only 1 percent of GDP, the income balance did not manage to offset the overall trade deficit (10.8 percent of GDP) to the same extent as in past years. The double-digit current account deficit remains, nevertheless, manageable due to net FDI inflows of about 5.1 percent of GDP. Together with 0.3 percent of GDP in capital transfers, non-debt creating inflows financed 55 percent of the external shortfall reducing the extent of external vulnerability that the widening of the current account deficit may otherwise suggest.

The surge in non-oil import volumes was caused by private consumption and investment that was fueled by higher incomes and credit growth. Aided by real exchange rate appreciation, total imports grew about 20 percent in FY18/19, exceeding last year's sharp increase totaling close to 19 percent. Higher volumes of investment goods raised private sector non-oil imports by 35 percent, while oil imports grew 7.5 percent because of rising oil prices, although oil import volumes remained flat compared to last year. Government project-related imports picked up significantly in the last quarter of FY18/19 owing to a large order. This offset the declining trend observed over the first three quarters of FY18/19, when government imports declined 6 percent compared to the same period last year. As a result, government imports for the year increased by another 13 percent, after growing at 42 percent in FY17/18,

Merchandise exports performed well, despite a reduction in the value of coffee exports. Merchandise exports grew 12 percent in FY18/19, surpassing last year's pickup in exports totaling 8 percent. The rise in exports of goods occurred despite export volumes of coffee falling by over 6 percent in FY18/19 and coffee prices declining by 10 percent. As a result of such developments, refined gold has replaced coffee as the leading export product in Uganda, growing in value from US$343 million in FY17/18 to US$1.1 billion in FY18/19. The latter accounts now for one-third of total merchandise exports. That said, the longer-term sustainability of this development remains questionable. Refined gold exports helped elevate total merchandise exports to over 13.4 percent of GDP during in FY18/19 from 12.9 percent of GDP the year before. Traditional export products, such as tobacco and cotton, also performed well with growth rates of 58 and 32 percent, respectively.

Table 3: The current account balance and financing

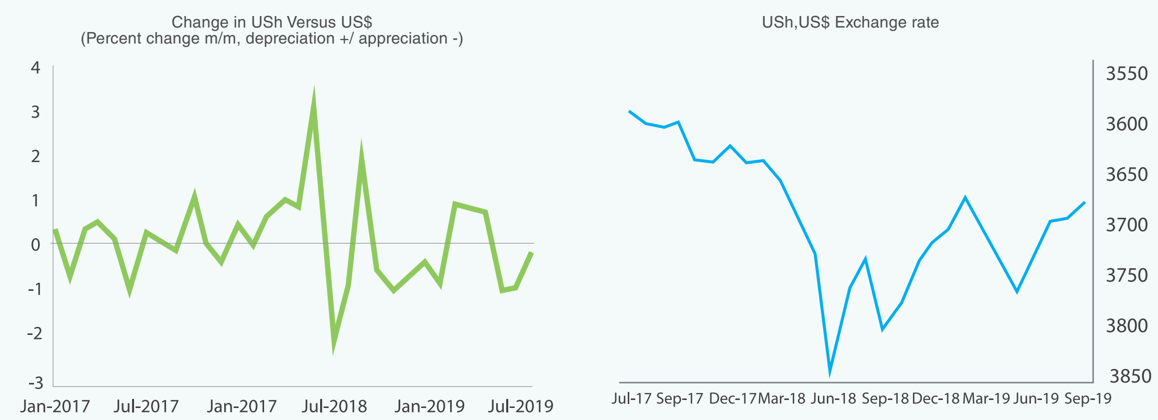
Balance of Payments (in percent of GDP)	FY15/16	FY16/17	FY17/18	FY18/19
Current account balance	**-4.7**	-3.3	**-5.4**	**-9.8**
Trade balance	*-7.8*	*-5.7*	*-7.6*	*-10.8*
Exports	16.1	16.2	16.4	17.1
Goods	9.3	10.6	10.8	11.5
o/w coffee	0.0	0.0	0.0	1.2
Services	6.9	5.5	5.6	5.6
o/w net travel	3.0	2.7	2.4	2.4
Imports	23.9	21.9	24.0	27.9
Goods	16.2	15.5	17.1	19.7
o/w fuel	0.0	0.0	0.0	2.8
o/w government imports	0.0	0.0	0.0	2.0
Services	7.7	6.4	6.8	8.2
Incomes balance	*3.1*	*2.4*	*2.1*	*1.0*
Credits	5.5	5.4	5.5	5.4
o/w personal transfers	3.3	3.8	3.8	3.6
Debits	2.4	3.0	3.4	4.5
Capital account balance	**0.4**	**0.5**	**0.3**	**0.3**
Financial account balance	**4.3**	**3.7**	**3.3**	**8.7**
Direct investment, net	2.4	2.3	3.0	5.1
Portfolio investment, net	-0.5	-0.6	-1.0	-0.5
Other investment, net	2.4	1.9	1.4	4.1
o/w Government loans, net	3.1	2.9	3.2	3.2
Disbursements	3.4	3.2	3.9	3.9
Repayments	0.3	0.3	0.7	0.7
Net errors and omissions	**0.3**	**0.5**	**1.3**	**1.0**
Overall balance	**0.4**	**1.4**	**-0.5**	**0.2**
Net increase in Central Bank reserves	**0.4**	**1.4**	**-0.5**	**0.2**
Memorandum				
GDP, nominal (in mil US$)	28,967	30,744	32,769	34,392

Source: Bank of Uganda
Note: o/w stands for "of which"

FDI inflows and capital transfers financed more than half of the external shortfall (Table 3). Net FDI rose to over 5 percent of GDP in FY18/19, and together with capital transfers totaled 5.4 percent of GDP during this period. This is a sizable increase compared to last year's net FDI inflow of 3 percent and is explained by a ramping up of investment spending to prepare for oil extraction. Meanwhile, government's net borrowing amounted to 3.2 percent of GDP, largely through long term project financing. Thus, 88 percent of the current account deficit was financed either through non-debt creating flows or long-term financing, which reduces the vulnerability of the sizable current account deficit. Such financing inflows enabled a build-up of the central bank's foreign exchange reserves by close to US$129 million. Thus, foreign exchange reserves accumulated to US$3.3 billion, which implies a coverage of 4.1 months of imports of goods and services, according to the BoU.

The Ugandan shilling has remained broadly stable so far in 2019 (Figure 12). After a depreciation spell of 2.5 percent from March to May, the shilling recovered subsequently against the US Dollar through September 2019 and appreciated by 2.4 percent. The nominal effective exchange rate, meanwhile, appreciated 2.5 percent during FY18/19, while favorable price developments vis-à-vis competitors meant that the real exchange rate appreciated close to 3 percent. The stability of the nominal exchange rate is likely the result of larger net FDI inflows and net external government borrowing, which in part offset the widening of the trade deficit in goods and services.

Figure 12: Nominal exchange rate recovered after early 2019 depreciation spell

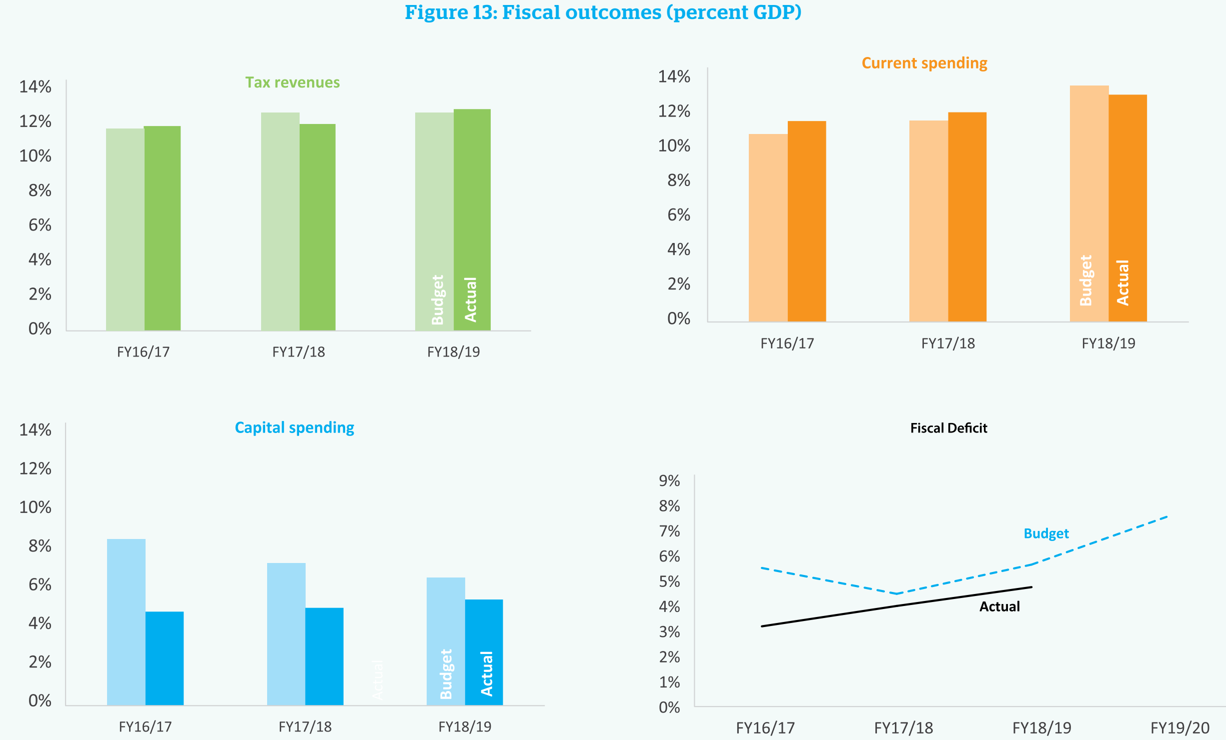


Source: Bank of Uganda

1.6 Slow execution of capital spending has kept the fiscal deficit below budget

The fiscal deficit of 4.9 percent of GDP in FY18/19 was well below the budgeted deficit of 5.8 percent of GDP. This slower than budgeted increase in the fiscal deficit can largely be attributed to both a significant rise in tax revenues, by about 0.9 percent of GDP compared to FY17/18, and slower-than-planned execution of capital spending (see Figure 13). Capital spending is only 0.4 percent of GDP higher in FY18/19 than in FY17/18, and about 1.1 percent of GDP lower than what was budgeted (Table 4).

Figure 13: Fiscal outcomes (percent GDP)



Source: : MoFPED, BoU, UBOS and World Bank calculations
Notes: Capital expenditure includes net acquisition of nonfinancial assets and net lending for policy purposes; FY19/20 is calculated assuming GDP growth of 6.2 percent in FY19/20 (table 5)

Tax revenues exceeded the budget for FY18/19, but remain significantly lower than government's medium-term target and regional peers. At 12.6 percent of GDP, tax revenue collections were higher than the FY18/19 budget of 12.4 percent of GDP. This is also in line with the government's ambition of annual revenue increases of 0.5 percent of GDP from new administrative and tax policy reforms.[14] However, this is significantly lower than government's medium-term revenue target of 16 percent of GDP, and lower than that recorded by regional peers - Kenya at 17.9 percent and Rwanda at 16.3 percent.

Stronger revenue performance was driven by higher payroll, corporate income and withholding tax collections, growth in VAT receipts, and a jump in excise duties. Corporate income tax collections grew by over 30 percent in FY18/19. This was due to the strong economic performance, as well as URA compliance actions to reduce the amount of tax losses carried forward by major players. Withholding tax collections increased by over 65 percent in FY18/19, because of reforms introduced in the FY18/19 budget. These included a 10 percent final withholding tax on commissions by telecommunication companies on mobile money and airtime agents; a 1 percent withholding tax on agriculture supplies; and a withholding tax on all payments for winnings of gaming, sports and pool betting.[15]

Government needs to quickly establish a framework to help manage tax exemptions. These exemptions drain the system of revenues forgone and will make it harder for government to achieve its revenue ambitions. Estimates suggest that revenue forgone across all tax sources due to tax exemptions was in the range of 4½ to 5 percent of GDP in FY16/17.[16] As discussed at the National Growth Forum in August 2019, there is, however, very little evidence that these exemptions encourage greater investment, with investment decisions being made on more tangible issues related to the business environment (e.g. availability of suitable infrastructure). Therefore, a framework to manage exemptions should include rules to assess their efficiency, impact and equity, and to remove them if warranted (see Box 3).

Current spending continued growing fast and increased by 0.9 percent of GDP in FY18/19. This was, however, lower than what was announced in the budget for FY18/19 of just over 13 percent of GDP. Large (by about twenty percent or more) spending jumps in two areas, wages/salaries and transfers to local governments, constitute about a third of current spending, and reflects the increase in wages for health workers and higher local government recurrent grants for education. Furthermore, spending on goods and services to support the increase in capital investments rose by over 100 percent in FY18/19. Given the rising share of domestic borrowing (from 1.1 percent of GDP in FY17/18 to 1.9 percent of GDP in FY18/19), the reported decline in interest payments as a percentage of GDP over the last few years is surprising. This will be closely monitored and, following further consultations and data analysis, additional insights will be provided in subsequent Uganda Economic Updates on what's driving the decline.

14. The government is finalizing a five-year domestic revenue mobilization strategy, with implementation set to start in FY19/20. The strategy targets annual increases of 0.5 percent of GDP from administrative and tax policy reforms and is being developed with assistance from the IMF, World Bank and other development partners.

15. According to the URA, for the period July 2018 to January 2019, total agricultural supplies withholding tax collection was about 60 percent higher than target (i.e. USh 13.87 billion collected against a target of USh 8.75 billion). This was supported by administrative measures to bring more fishing and agricultural operators into the tax net.

16. See World Bank, 2017, Uganda: Improving Domestic Revenue Mobilization – An assessment of Uganda's Domestic Revenue Gaps and how to tap the potential; and World Bank, 2018a, Uganda Revenue Authority: An Assessment, Recommendations, and the Way Forward.

Table 4: Government finances

Central Government Cash Balance (in percent of GDP)	Outcome			Budget	
	2016/17	2017/18	2018/19	2018/19	2019/20
Total revenues	12.8	12.7	13.4	14.0	16.5
Tax revenues	11.6	11.7	12.6	12.4	13.8
o/w VAT	*3.6*	*3.7*	*3.8*		
o/w Income and profit	*3.9*	*3.9*	*4.3*		
o/w International trade and transactions	*1.3*	*1.4*	*1.5*		
Non-tax revenues	0.3	0.4	0.4	0.3	1.1
Oil revenues	0.0	0.0	0.0	0.0	0.1
Grants	0.9	0.6	0.5	1.3	1.4
Expenditures and net lending	16.1	16.8	18.3	19.8	24.2
Current expenditures	11.2	11.7	12.6	13.2	
o/w Compensation of employees	*2.0*	*2.0*	*2.1*	*2.7*	
o/w Purchases of goods and services	*2.4*	*3.0*	*3.6*	*3.8*	
o/w Interest payments	*2.2*	*1.9*	*1.7*	*2.1*	
o/w Grants (transfers)	*4.0*	*4.4*	*4.8*	*4.0*	
o/w Local Governments	*2.4*	*2.1*	*2.5*	*2.4*	
Capital expenditures	4.7	4.9	5.3	6.4	
Arrears repayments	0.2	0.3	0.3	0.2	
Overall balance, incl. arrears payments	-3.3	-4.1	-4.9	-5.8	-7.7
Financing	3.3	4.1	4.9	5.8	7.7
o/w domestic	0.6	1.1	1.9	1.5	2.2
o/w external	2.4	2.9	2.8	4.2	5.5
o/w errors and omissions	0.3	0.0	0.1	0.0	0.0
Memoranda:					
Petroleum fund withdrawals	0.0	0.1	0.2	0.2	0.3
Primary balance, incl. arrears payments	-1.1	-2.2	-3.1	-3.7	
Public debt (% GDP)	33.5	35.4	36.4		
GDP, nominal (in billions of shillings)	108,518	119,907	128,499	128,499	136,851

Source: MoFPED, BoU, UBOS and World Bank calculations
Notes: o/w stands for "of which"; Capital expenditure includes net acquisition of nonfinancial assets and net lending for policy purposes; FY19/20 is calculated assuming GDP growth of 6.2 percent in FY19/20 (table 5)

In recent years (prior to FY18/19), current spending above what was budgeted (Figure 13) has contributed to an accumulation of arrears. With USh 419 billion in arrears repayments made in FY18/19, the target of clearing USh 300 billion worth of existing domestic arrears in FY18/19 was exceeded.[17] However, although the government's Domestic Arrears Strategy (DAS) has set a target of clearing an additional USh 600 billion worth of arrears in FY19/20, this is unlikely to be achieved given only USh 450 billion has been committed for this in the FY19/20 budget.[18] At the same time, it is uncertain whether all the resources committed to clear arrears are being used for this purpose, given a still incomplete picture of the full stock of arrears. Furthermore, too little is being done to prevent the accumulation of new arrears.

Capital spending continues to fall short of expectations, diminishing the expected returns from public investments. While capital spending did increase by 0.4 percent of GDP in FY18/19 to 5.3 percent of GDP, some of this increase was due to domestically financed expenditures to fund unbudgeted priorities, such as purchase of land and planes for the revival of Uganda Airlines. However, at 5.3 percent of GDP, it is well below the budget of 6.4 percent of GDP. This inability to really ramp up capital spending over the last few years is constraining the ambitions of Uganda's national development plans for rapid growth and socio-economic transformation.

17. An independent audit to verify the stock of domestic arrears up to the end of FY16/17 showed that of the total stock of USh 2.9 trillion, about USh 426 billion (15 percent) were rejected. The audit up to the end of FY17/18 is still on-going.

18. A Domestic Arrears Strategy (DAS) was released in March 2018 to address the issue of domestic arrears. The strategy has four main objectives: a) establish a comprehensive and reliable database for verified domestic arrears; b) clear existing stock of arrears within four years; c) strengthen measures to inhibit the diversion of domestic arrears resources; and d) enhance initiatives to stop the creation of new arrears.

Box 3: Recent encouraging steps in fiscal reforms

The recently approved Uganda PFM Reform Strategy (FY18/19–FY22/23) and on-going PIM reforms provide a sound basis for reining in current spending and improving capital spending. The PFM reform strategy aims to ensure that multi-year commitments are accurately reflected in annual budgets, commitment controls (including reporting and clearing of arrears) are reinforced, and PFM compliance is improved through better incentives and sanctions mechanisms.

Capital budget execution will improve as further reforms are undertaken to streamline and strengthen the PIM institutional arrangements and capacity, standardize information and documentation needed to guide the entire project cycle, rationalize projects and improve costing and baseline information in the Public Investment Plan (PIP). The PIM process will also need to be underpinned by an appropriate legal and regulatory environment that strengthens planning, mandates, incentive structures, and accountability. Importantly, government is committed to ensuring this process applies to all public projects, including those financed and delivered through Public Private Partnerships (PPPs).

During FY20/21, the government is planning to develop a tax expenditure governance framework to limit leakages and improve transparency. This framework is to be published annually with National Budget documentation and will be used to assess the fiscal cost and benefits of all existing tax incentives, exemptions and holidays.

Sources: World Bank (November 2018) and Budget Strategy for FY2020/21. Delivered by Hon. Matia Kasaija, Minister of Finance, Planning & Economic Development. 12 September 2019.

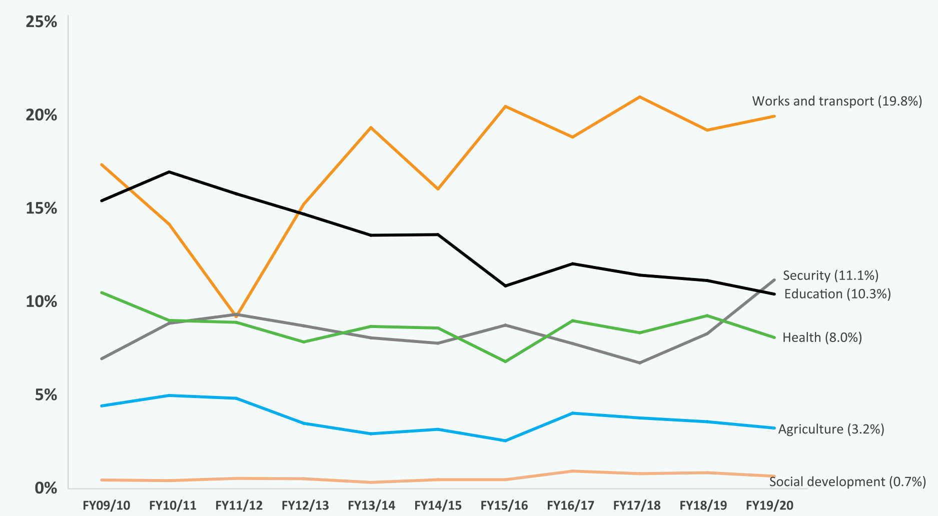
Resources, including loans, are being committed to projects (infrastructure in particular) that face implementation challenges despite pressing needs in other sectors. Converting investments into productive assets requires effective management at all stages of the public investment project cycle – from inception to the management and maintenance of the completed asset. Reforms to Public Financial Management (PFM) systems in Uganda have ensured that some parts of the PIM cycle meet several standards of good practice (see Box 3). Nonetheless, deficiencies in the 'quality at entry' of projects largely explain the implementation challenges such as time-overruns, contract disputes, cost escalations, and abandonment of projects. Appropriate resources also need to be committed to the maintenance of public investments/assets to preserve their value and maximize their economic return.

Concurrently, budget allocations to important sectors such as agriculture, education, health and social protection have declined or remained flat over the last decade (Figure 14). In FY19/20 the works and transport budget increased by 35 percent in nominal terms and is now about a fifth of the overall budget; yet in FY's 16/17 and 17/18 only about 70 percent of the funds allocated to this sector were spent. Committing and not spending these resources is a serious constraint to Uganda's growth. It also means that priorities in other sectors are difficult to finance. For example, the National Budget Strategy for FY20/21 includes reforms and initiatives that will enable social protection to play a key role in promoting equity. Government wants to "target the most vulnerable groups/regions and those at higher risks of food insecurity, and social and health related problems".[19] This would include fast-tracking implementation of Universal Health Coverage and expanding coverage of the Senior Citizens Grant (SCG). However, these reforms and initiatives are taking place amongst numerous budget priorities and in an environment where debt vulnerabilities are significant and increasing. Part 2 will examine ways of increasing social protection coverage in a cost-effective and fiscally sustainable manner.

Government financing has largely been met by external project-related disbursements, although recourse to the domestic debt market has intensified in FY18/19. There was, however, a fall in external borrowing to 2.8 percent of GDP in FY18/19 from 2.9 percent in FY17/18. This reflects completion of the two largest infrastructure projects, Karuma and Isimba dams, and the fact that major new infrastructure projects, such as access roads to oil wells, are yet to start in earnest – there was a fall by about

19. Budget Strategy for FY2020/21. Delivered by Hon. Matia Kasaija, Minister of Finance, Planning & Economic Development. 12 September 2019.

Figure 14: Evolution of budget allocations (percent of budget, selected sectors)



Source: MoFPED and World Bank calculations **Notes:** In the context of Uganda, social protection is considered part of a broader social development sector. The core programs in the sector are Social Protection for Vulnerable Groups, Community Mobilisation and Empowerment, Mainstreaming Gender and Rights, and Promotion of Labor Productivity and Employment. Social Protection spending, as discussed further in Part 2 of this report, is therefore significantly less than what is represented by Social Development in this figure.

43 percent in FY18/19 of external financing disbursements to the roads sector. As a result, external borrowing was also well below what had been budgeted. Domestic borrowing played a more pronounced role in FY18/19, especially from commercial banks, increasing from 1.1 percent of GDP in FY17/18 to 1.9 percent in FY18/19. More than a quarter of this increase was used to finance the revival of Uganda Airlines.

Resources from the petroleum fund (see Box 4) are already being used to help finance the budget. The reduction in the value of the petroleum fund from USh 470 billion in June 2018 to USh 289 billion at the end of December 2018 was due to a transfer of USh 200 billion to help finance the FY18/19 budget (this follows a similar withdrawal of USh 125 billion in FY17/18).[20] A concern in the current fiscal year is that USh 198 billion was budgeted to flow into the petroleum fund. However, the bulk of these inflows are unlikely to be realized given the recent termination of an arrangement for Tullow to sell off two-thirds of its 33 percent stake in the Albertine Graben region to other joint venture partners (CNOC and Total), arising partly from a failure to agree on the government's tax treatment of this deal. At the same time, a withdrawal of USh 446 billion from this fund has been included as part of the financing for the FY19/20 budget.

Public debt rose to about US$12.5 billion, or 36 percent of GDP at end June 2019. This represents about a 10 percent increase (in GDP terms) over the past five years (Figure 15). Two-thirds (US$7.3 billion) of outstanding public debt is owed to external creditors, largely for energy and infrastructure projects.[21] Domestic debt totals US$4.2 billion, with roughly three-fourths in Treasury Bonds and the rest in short-term Treasury Bills. These figures do not, however, include state-owned enterprise debt of about 7.6 percent of GDP, a PPP stock of about 2.3 percent of GDP, or other contingent liabilities.[22]

Nevertheless, based on the joint IMF-World Bank debt sustainability analysis (DSA), Uganda remains at low risk of debt distress.[23] All external debt and total public debt burden trajectories remain below their respective indicative thresholds under the baseline and stress test scenarios. In present value terms, total public sector debt amounts to about 26.3 percent of GDP due to the large share of highly concessional debt in the portfolio (see Box 5). This level of public debt, in GDP terms, is lower than Uganda's peers in East Africa, such as Tanzania and Rwanda, and is substantially lower than Kenya's (estimated at 58 percent of GDP in FY17/18).

20. Petroleum Fund, Semi-Annual Report for the period ended 31st December 2018, MoFPED.
21. External debt is measured on a residency basis and includes locally issued debt held by non-residents.

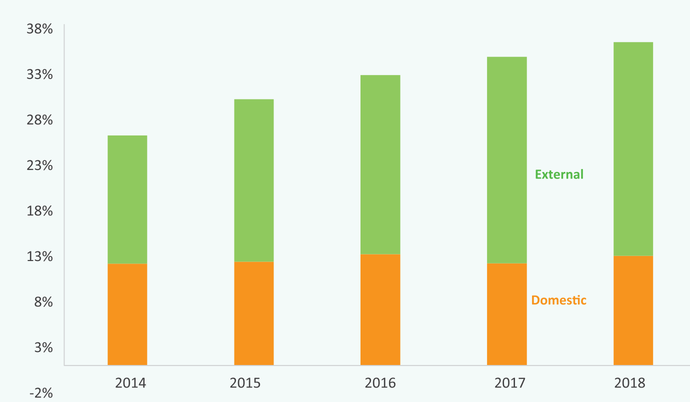
Box 4: The legal framework for Uganda's Petroleum Fund needs to be streamlined

The Petroleum Fund (PF) is the depository for all revenues accruing to government from petroleum and related activities. It was established by section 56 of the Public Finance Management (PFM) Act that came into effect on March 2015 and is overseen by Parliament. The PFM Act defines petroleum revenue to include tax paid under the Income Tax Act for income derived from petroleum operations, Government's share of production, dividends due to Government, proceeds from the sale of Government's share of production and any other duties or fees payable to the Government under a specific petroleum agreement.

Withdrawals from the PF are permitted under the PFM Act and can be granted by an Appropriation Act and Warrant of the Auditor General. These withdrawals can go to the: (i) Consolidated Fund, for spending in the annual budget; and (ii) Petroleum Revenue Investment Reserve (PRIR), as a sovereign wealth fund for future use.

Guidelines to allocate between spending and savings, to optimize investments in the PRIR, and to ensure a smooth interaction between the two windows are lacking. Furthermore, there is a contradiction in the PFM Act related to the treatment of remaining balances after appropriation. Clause 59(4) suggests that these could be invested by BoU, but should remain available to the budget when required. Whereas, clause 62(6) suggests that these shall be transferred to the PRIR. Such contradictions could allow for inappropriate discretion when withdrawing funds from the PF, which may present challenges depending on the political environment. These guidelines and contradictions need to be addressed, and the legal framework streamlined.

Figure 15: Public debt on an upward trajectory (in percent GDP)



Source: BOU, UBOS and World Bank calculations

22. IMF and the World Bank, Debt Sustainability Analysis, March 2019. Adjusted with new nominal GDP figures released by UBOS in October 2019.
23. With debt-carrying capacity updated to 'strong' in the revised IMF-World Bank Low-Income Country Debt Sustainability Framework (LIC DSF), Uganda remains at low risk of debt distress, despite significantly higher debt burden trajectories than anticipated in the last December, 2016 DSA.

Box 5: Non concessional borrowing and Uganda's debt portfolio

Concessional loans are extended on terms substantially more generous than market loans. The concessionality is achieved either through interest rates below those available on the market, by longer grace periods, longer maturities, or a combination of these. A measure that combines these elements in one number is called the grant element.[24] A loan is considered concessional by the World Bank and IMF when its grant element is equivalent to or more than 35 percent.

Concessional loans are an important component of debt sustainability. Concessional loans carry a low interest rate and, hence, interest payments from the budget are also smaller. Longer grace periods and maturities mean that principal payments are also stretched over a longer time and, therefore, the gross financing need is smaller. This in turn means that the government does not need to borrow as much for rollover purposes as in the case of commercial loans.

Over the last few years the government has signed a group of loans each year that were, on average, concessional in nature. In 2016 and 2017, the government signed loans worth US$1.1 billion and US$827 million, respectively. These loans are largely project-related and will therefore disburse over many years to come. The share of non/semi-concessional loans amounted to 25 and 43 percent, respectively (Figure B5), based on the size of the loans and their corresponding financing terms. The remainder of loans in these years were extended on highly concessional terms, which meant that all the loans, taken together as a group in each year, exhibited a future cash flow corresponding to a concessional loan with a weighted average grant element of 43 and 40 percent, respectively (Figure B6).

An example to help clarify the concept of weighted average grant element. In 2019, the government signed two loans on non-concessional terms, with the UK's Export Finance agency (UKEF) and Standard Chartered Bank, totaling EUR250 million (approximately 0.8 percent of GDP) and with a weighted average grant element of 18 percent. However, the government has already signed other loans this year that were on highly concessional terms (for example, two IDA loans worth US$516 million with a grant element of 51 percent). Taken together, the overall cash flow that results from all loans signed in 2019 (worth US$1.3 billion) resembles a concessional loan with a grant element of 38 percent (Figure B6).

Figure B5: Share of concessional and non/semi-concessional loans signed each year (percent)

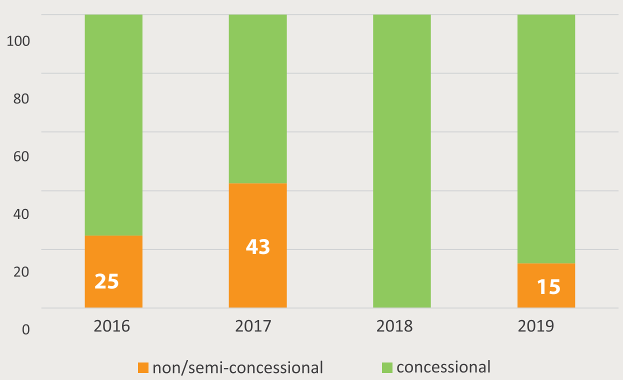
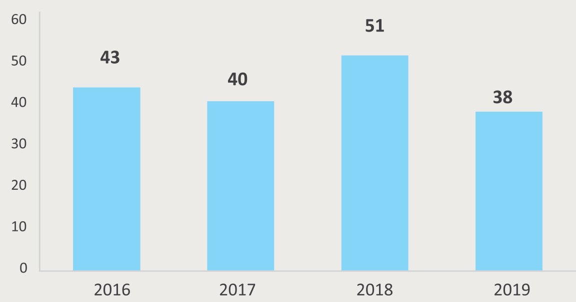


Figure B6: Overall annual grant element of loans signed (percent weighted average)

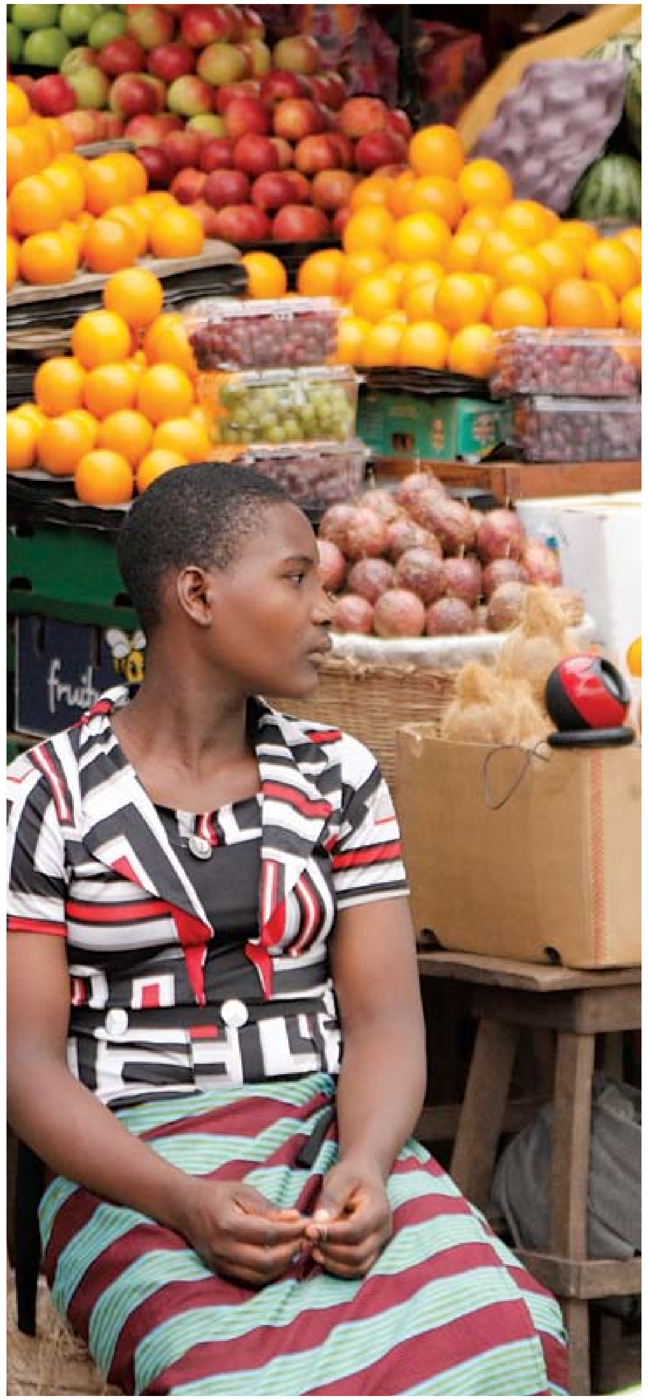


Source: MoFPED

24. The grant element is defined as the difference between the loan's nominal value (face value) and the sum of the discounted future debt-service payments to be made by the borrower (present value), expressed as a percentage of the loan's face value.

AN IMPORTANT RECOMMENDATION OF THE REPORT IS TO PRIORITIZE ANY SOCIAL PROTECTION EXPANSION TO AREAS WITH THE HIGHEST LEVELS OF VULNERABILITY AND RISK

2. ECONOMIC OUTLOOK AND RISKS



2.1 The outlook is broadly favorable, supported by consumption spending and sustained private and public investments

Real GDP growth is expected to be above 6 percent in FY19/20, which is broadly in line with the May 2019 Uganda Economic Update projection. This growth will continue to be driven by intensified private and public investments in infrastructure for industrialization and export promotion, electricity generation and transmission, and to prepare for oil extraction. In addition to ongoing works on about 600 km of roads in the oil region, construction of infrastructure will continue in export processing zones and industrial parks.[25] Favorable weather conditions are projected to sustain decent performance in the agriculture sector. Supported by improved financing conditions, private investments will also pick up, particularly in the manufacturing and hospitality sectors. The scale-up in investments is also expected to sustain consumption spending, as the bulk of investments support more rapid growth in construction and services. This outlook assumes continued strong external demand, and further growth in FDI inflows as oil production draws closer. The economy is projected to slow down in FY20/21 due to the general elections scheduled for 2021.[26]

Inflation is expected to remain well within the target of 5 percent over the next year, barring price volatility due to weather and external factors. Headline inflation will fluctuate in line with seasonal changes, but reasonable agricultural performance will largely keep domestic inflationary pressures subdued and the core inflation rate within target. Limited external inflationary pressures are anticipated through fuel and other imported goods, as oil prices are expected to average US$62/bbl in 2019 and US$60/bbl in 2020. Against this favorable inflation outlook, the BoU reduced the policy rate by 1 percent to 9 percent in October 2019. This, as well as a positive economic outlook and continued improvement in commercial banks' credit environment, will keep lending rates within reasonable margins and private sector credit growth sustained beyond 2019.

25. The total number of free zone areas declared more than doubled to 14 at the end of FY17/18.

26. Growth has traditionally dipped in election years as heightened political activity leads to lower investment and economic activity. At the same time, however, government consumption expenditure is expected to rise in the lead up to the elections, which will likely lead to a deterioration in the expenditure mix, expansion in the fiscal deficit, and a rise in public debt to over 40 percent of GDP.

Table 5: Medium term outlook (annual percent change unless indicated otherwise)

	FY19/20f	FY20/21f
Real GDP growth	**6.2**	**5.8**
Private consumption	5.0	4.6
Government consumption	17.9	7.5
Gross fixed capital investment[27]	11.8	8.9
Exports (goods and services)	4.0	5.1
Imports (goods and services)	14.0	7.8
Agriculture	4.2	3.8
Industry	7.1	6.5
Services	5.8	4.5
Inflation (consumer price index)	3.5	4.5
Current account balance (percent of GDP)	-8.1	-6.9
Net foreign direct investment (percent of GDP)	4.2	3.4
Fiscal balance (percent of GDP)	-5.7	-5.8
Public debt (percent of GDP)	38.6	41.1

Source: UBOS, IMF and World Bank staff estimates
Notes: Gross fixed capital investment includes both public and private investments.

Export growth will likely continue, but will not be enough to offset the increase in imports related to the investment drive. Hence, the current account deficit would decline only modestly to around 7 to 8 percent of GDP over the medium term. Export volumes are expected to increase due to the sustained industrialization and export promotion drive. In addition, the outlook for coffee prices is favorable, with Robusta prices expected to increase from US$ 1.62/kg in 2019 to US$ 1.76/kg in 2022. However, a slower global economy combined with mixed economic performance of Uganda's main export markets could undermine exports. Although countries like Kenya, Rwanda and DRC have strong growth prospects going forward (Figure 2), Euro Area growth is projected to decelerate to 1.2 percent in 2019. While South Sudan is gradually recovering, this may still be insufficient to support previous Uganda-South Sudan trade levels. The strong investment push will also require significant imports of oil, machinery, vehicles and chemical products. The current account deficit is projected to decline significantly over the longer term with the onset of oil exports expected in 2023/24.

The current account deficit is expected to be largely financed by net FDI inflows and long term public external borrowing. Together with other capital inflows, including external borrowing, foreign exchange reserves will remain within a comfortable level of about four months of imports of goods and services. Such international reserve levels surpass by comfortable margins the standard rules of thumb, such as three months of import coverage and a ratio of reserves to short-term external debt remaining at maturity of at least one.

The fiscal deficit is likely to average between 5½ and 6 percent of GDP over the next three years, as considerable government investments continue, and election spending emerges. The FY19/20 budget envisages a significant increase in the fiscal deficit to 7.7 percent of GDP, driven by investments in public infrastructure. The infrastructure investments include new oil-related roads, the Kampala-Hoima infrastructure/utility corridor, the East African Crude Oil Pipeline (from Uganda through Tanzania), and transmission and distribution networks to special economic zones and rural growth centers. However, given the historical under-execution of capital expenditures, the fiscal deficit is likely to remain just above 5½ percent of GDP over the medium term (Table 5).

Oil production is expected to commence in 2023/24, assuming the recent termination of equity sales by Tullow does not cause more delays to a final investment decision in the oil sector. A two-year long negotiation of a deal for Tullow to sell off two-thirds of its 33 percent stake in the Albertine Graben region to other joint partners (CNOC and Total) was terminated on August 30, 2019, after failure to agree on the tax arrangement. Following this, Total, the lead joint venture partner in the East African Crude Oil Pipeline, froze all activities on the multibillion-dollar

27. Includes both public and private investments.

project (including laying off workers), citing uncertainty over its Uganda operations. These events have created uncertainties in the sector, which had expected the final investment decision by the three players to be signed before end-2019.

As public debt is projected to rise above 40 percent of GDP in FY20/21, from about 30 percent in 2015, debt vulnerabilities and sustainability challenges are increasing (Box 6). Although the government has not issued international bonds and therefore does not face external principal repayment spikes (as do Kenya and Rwanda), total debt service (interest and principal due) is expected to average around 41.5 percent of government revenue over the next six years, until oil revenues ensue. Interest payments alone accounted for roughly 15 percent of government revenues over the past three years. This highlights the significance of raising tax revenues and reducing tax exemptions.

2.2 Risks remain tilted to the downside

The recent termination of the Tullow deal has increased uncertainty for oil sector related investments. This could reduce private sector investments and broad sentiment over the medium term. Also, subsequent delays in oil exports beyond 2023/24 could result in liquidity pressures, given the current heavy borrowing for oil sector-related infrastructure that is relying on an enhanced repayment capacity from oil exports, and especially if more non-concessional borrowing occurs.

Heightened uncertainty around the 2021 elections could slow investments and economic activity. While factored into the outlook for FY20/21, political risks could arise sooner or could be more pronounced. Furthermore, civil unrest may increase uncertainty and lead to a fall in investor sentiment (both domestic and international), which may slow oil investments and deter tourism inflows.

Box 6: Public debt sustainability

Although public debt is manageable under current policies and expected economic conditions, debt vulnerabilities remain. Simulations conducted in the recent IMF-World Bank DSA find that the three most important risks are an unexpected downturn in GDP growth, the realization of contingent liabilities (from public-private partnerships and debt owed by state-owned enterprise), and the possibility that the full amount required for building transmission lines is financed by government borrowing.

The increased reliance on semi-concessional and commercial borrowing to finance investment projects creates additional vulnerabilities. Not only are interest payments higher on these loans, they also put higher demands on the government's gross financing needs because principal repayments generally start earlier, due to shorter grace periods, and are larger because of shorter maturities. To meet this gross financing need, the government may have to borrow more. Therefore, governments that have access to concessional loans should first maximize borrowing from these financing sources before looking to non-concessional financing.

Other risks to debt sustainability include:

- Oil export receipts are realized later than expected (i.e. beyond FY 23/24), thus postponing large inflows of foreign exchange. This would leave the budget without the planned revenue for the government to repay debt coming due.
- Political pressures for higher current spending, as well as new ad-hoc tax exemptions.
- There are large investments financed with semi- or non-concessional loans that were not included in the DSA simulations and which are sources of additional fiscal risk.

Maintaining public debt on a sustainable path will require strengthening the budget process to ensure that budget targets become more binding, that public spending and public debt management become more effective, and that fiscal risks are comprehensively monitored.

Source: Largely taken from the IMF and the World Bank, Debt Sustainability Analysis, March 2019

Businesses continue to face critical constraints such as access to finance, skills and electricity, and an uncertain regulatory environment. The cost of finance is particularly high in Uganda, so very few Ugandan firms have a bank loan or line of credit, and the ones who do face high costs and large collateral requirements. Only 26.7 percent of the population currently has access to electricity compared to 70 and 33 percent in Kenya and Tanzania respectively.[28] This has resulted in one of the lowest electricity consumption rates per capita in the world. Such circumstances inhibit productivity and private sector development. Although Uganda has improved across several measures of business environment performance in recent years, significant challenges remain. These include cumbersome processes to obtain an investment license and difficulties with regulatory and contract enforcement.

Regional and global factors could also undermine Uganda's outlook. GDP growth could be adversely impacted by a sudden decline in foreign demand. Reduced foreign demand, which would weaken exports, could come in the form of regional instability – due to a resumption of conflict in South Sudan and increased hostilities and a continuation of the Ebola crisis in the DRC – or because of the trade hostilities between the US and China, which might further slow global growth.[29] While lower oil prices are beneficial to Uganda's trade balance and real growth outcomes, significantly lower oil prices could also mean increasing risks to investment plans in the Ugandan oil sector. If oil prices fall below the estimated break-even price of US$60 per barrel for Ugandan production, different choices, with respect to the phasing of extraction and investments into the refinery and oil pipeline, may be required.[30]

Spending pressures and adjustments to government's debt profile could jeopardize Uganda's hard-earned macroeconomic stability. Whereas Uganda's spending boom has been mainly related to investments, additional pressures may arise from excessive spending in the run-up to the 2021 elections and unexpectedly high subsidies to sustain the revived Uganda Airlines. Furthermore, new ad-hoc tax exemptions ahead of the elections and weak implementation of new tax-enhancing measures and reforms may strain the government's ability to raise additional revenue to offset higher expenditures. A significant shift in debt towards more non-concessional borrowing and/or the issuance of a Eurobond would disrupt the smooth repayment profile Uganda currently enjoys and raise debt burden trajectories and further increase debt vulnerabilities.

Reliance on rain-fed agriculture and systemic challenges in the sector remain risks to real GDP growth, the poor's income, and export earnings. As discussed, the performance of the agriculture sector, and corresponding environmental shocks, has been closely linked to household income growth, and subsequently, to poverty reduction. To improve performance and build resilience to weather and other shocks, it is crucial to increase agricultural productivity in the most fertile areas of the country, attract investments in agri-food value chains, and stimulate off-farm jobs, particularly in secondary towns.[31] However, even with these improvements, poorer Ugandans, particularly in rural areas, will still face increasing climatic risks to their livelihoods.

Reducing the vulnerability of households to adverse shocks will be vital to build human capital, sustain progress of poverty reduction and ensure inclusive growth. The expansion of existing social protection programs (currently concentrated in the north and exhibiting low coverage rates) and the introduction of new ones can help reduce the negative effects of adverse shocks on vulnerable households. Part 2 will discuss how increasing allocations to existing or new programs could be used to mitigate risks, increase resilience and support vulnerable households in times of adversity.

2.3 Policy actions for sustaining macroeconomic stability and enhancing inclusive growth

This section outlines immediate policy actions for sustaining macroeconomic stability and enhancing inclusive growth. These actions are urgent and could have a significant impact on both their sectors and the broader development agenda in Uganda. They also draw from the analysis in sections 2.1 and 2.2.

As has been discussed, there are risks to Uganda's macroeconomic stability that need careful management.

28. World Bank Development Indicators, 2016
29. The DRC and South Sudan are Uganda's third and fourth top export destinations.
30. Analysts estimate that an oil price of US$60/bbl is the break-even point for production in Uganda (Patey, L., 2015).
31. Given demographic projections (World Bank, 2017a), it is estimated that Uganda will have to accommodate an additional 600,000 new entrants into the labor market each year up to 2020 and even more thereafter.

26.7%

of the Ugandan population currently has access to electricity compared to 70 and 33 percent in Kenya and Tanzania respectively

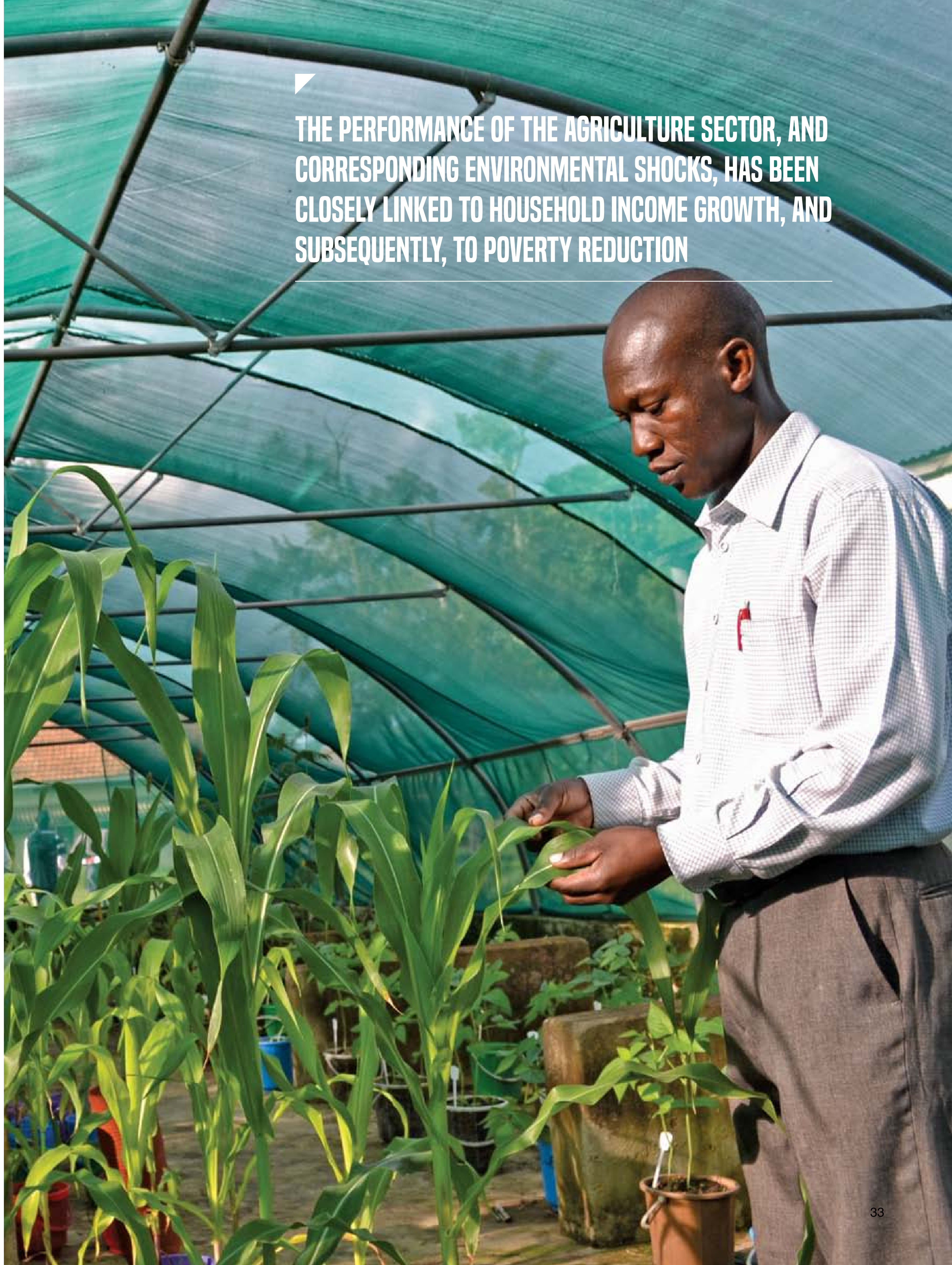
These include low levels of revenue mobilization, poor public investment outcomes, shortfalls in capital spending, increasing debt vulnerabilities, and additional pressures for pre-election spending and subsidies to sustain the revived Uganda Airlines. Furthermore, more inclusive growth is required for Uganda's lower middle-income status and poverty reduction ambitions. Policy actions in three key areas are required to manage these risks and promote more inclusive growth:

a) *Significantly enhance domestic revenue mobilization*. At just 12.6 percent of GDP in FY18/19, tax revenues are strikingly low. A key reform would be the establishment of a *Tax Expenditure Governance Framework*.[32] This framework is supposed to be developed in FY20/21 and should be the first step in helping manage tax exemptions by introducing stronger restraint in granting of exemptions, introducing cost-benefit analysis of new exemptions, periodic assessment and public disclosure of existing exemptions, and establishing ceilings; all of which should limit leakages and improve transparency. This should be in addition to improving efficiencies in tax administration and continuing to clean up other leakages.

a) *Address implementation challenges for public investments and manage public assets to preserve value and maximize their return*. A key implementation challenge involves better management of social risks, including land acquisition and resettlement. Thus, it is important to finalize a revised *Land Acquisition Act and Policy*, as well as a legal framework for streamlining and strengthening *Social Impact Assessments*; both of which would help underpin a clear and cohesive framework for managing social risks.[33] Road development still takes the biggest share of the budget, at about 90 percent, with road maintenance only allocated about 7 percent. As a result, current road maintenance financing can only meet about 26 percent of the needs, leaving a big chunk of the road network unattended to. This presents a precarious situation for the sustainability of the roads asset base if it can't be maintained adequately.[34] As a result, budget allocations for roads maintenance needs to be progressively increased and sustained at about a quarter of the total roads budget.[35]

a) *Strengthen public debt management and transparency*. Even though debt to GDP ratios have recently dropped, with the release of revised GDP numbers, it is strongly in Uganda's interest to maintain debt on a sustainable footing. Shocks, such as a sudden decline in economic growth, can rapidly erode debt sustainability, particularly as the country is moving into an election period. Oil production could be delayed further resulting in liquidity pressures, given the reliance on enhanced repayment capacity from oil exports. Maintaining public debt on a sustainable path will require strengthening the budget process to ensure that budget targets become more binding; that public spending and public debt management become more effective (including continuing to maximize concessional borrowing); and that fiscal risks (including contingent liabilities and state-owned enterprise debt) are comprehensively monitored and reported.

32. See World Bank (2018, May)
33. See Ministry of Gender, Labour and Social Development (2017) and World Bank (2017, May)
34. Over the medium term, the proportion of roads in fair to good condition will decrease, while those in poor condition will increase. At the same time, the backlog of maintenance is growing and will result in higher replacement costs of the road asset in the future.
35. See Ministry of Finance, Planning and Economic Development (2019, May)



PART 2

STRENGTHENING SOCIAL PROTECTION

Social protection programs are important policy tools for building resilience, mitigating risks and supporting households to invest in human capital.

3. THE ROLE OF SOCIAL PROTECTION IN UGANDA'S ECONOMIC TRANSITION

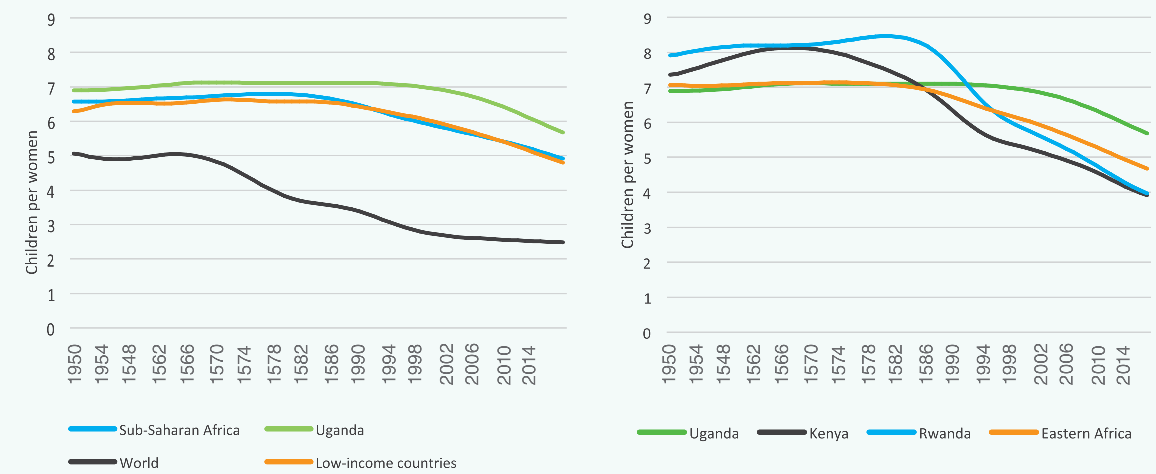
3.1 Social Protection has an important role to play in achieving inclusive growth

As highlighted in Part 1, although Uganda experienced strong economic growth in the 1990s and 2000s, more recently there has been a slowdown (see Box 2). This has been particularly pronounced in per capita terms, due to the persistently high fertility rates still observed and increasingly low levels of productivity. As a result, one in five Ugandans still live in extreme poverty and more than a third live on less than US$1.90 a day (in 2011 PPP dollars). Beyond poverty, many households in Uganda remain vulnerable. These households are susceptible to income fluctuations, food insecurity, and often do not have the means to cope with shocks that they may experience. The most common shocks include droughts, irregular rains, serious illnesses, or accidents to the main income earners.

Social protection programs are important policy tools for building resilience, mitigating risks and supporting households to invest in human capital. When individuals are vulnerable, it is difficult for them to make longer term investments to improve their own livelihoods or educate their children. Individuals who are risk averse will invest less in inputs for their farms and in upgrading skills that could make them more productive. Appropriately designed social protection systems can encourage informed risk taking, innovation, and ultimately dynamism and growth in the economy. For instance, fertilizer use in Ethiopia is 13 percent higher among beneficiaries of social protection programs (Hoddinot et al). Social protection also enables and empowers people to access better health care and enjoy better nutrition; to send their children to school; to access more abundant and higher-quality employment; and to spend, invest, or, if necessary, migrate in search of better opportunities. For instance, in Kenya households that receive direct income support have higher consumption levels when compared to similar households that do not receive such support.[36] There is also a higher probability that households receiving support are food secure and that their children remain enrolled in schools.[37] Finally, cash transfers are shown to increase asset holdings and improve psychological well-being and mental health.[38] Evidence from Indonesia, for example, demonstrates that direct income support helps reduce stunting levels in children significantly.[39]

36. World Bank (2018, July)
37. Ibid
38. Haushofer, Mudida and Shapiro. The Comparative Impact of Cash Transfers and Psychotherapy on Psychological and Economic Well-Being. Working Paper.
39. World Bank (2017b, December)

Figure 16: Fertility rates have been declining in Uganda, but remain high



Source: UN Population Division (2017 revision), using OurWorldInData.org

Social protection programs can help Uganda invest in children and youth thereby taking advantage of the demographic transition. Uganda has a very young population, with almost half the population younger than 15, and more than three quarters younger than 30. It has a high fertility rate, with total fertility standing at 5.59 children per woman in 2018. The fertility rate started declining in Uganda in 2000, much later than when East and Sub-Saharan Africa fertility rates began their decline (see Figure 16). This means that Uganda has one of the world's highest population growth rates; the population increased from 24 to 35 million between 2002 and 2014 and is expected to be above 80 million by 2040. The combination of rapid population growth and a predominantly young population makes it imperative that Uganda invest in the human capital of infants, children and youth so as to continue to improve productivity and living standards. Further, by empowering women and expanding access to services for poorer segments of the population, social protection programs can support the continued decline in fertility rates and can help the poor benefit from investments in human capital, thereby making growth more inclusive.

The design of social protection programs in Uganda will need to consider the large informal sector. In 2016, only 10.4 percent of household heads were employed in Uganda's formal sector.[40] This has several implications for the design of social protection systems. The first is that traditional social insurance schemes that are typically offered through formal employment are not a reality for most Ugandans. Protection for the elderly will need to be provided through some combination of encouraging voluntary savings among informal sector workers and through social assistance transfers. The second implication is the need to provide risk mitigation to those employed in subsistence agriculture.

It is important for social protection programs to mitigate agriculture sector related risks. Most Ugandans work in agriculture – constituting some 64 percent of the overall labor force, and 72 percent of young Ugandans. Further, much of agricultural employment is in subsistence agriculture – nearly 85 percent of all farming households in Uganda are smallholder farmers and are characterized by low levels of productivity.[41] Seasonality in agricultural

40. Uganda Social Protection Public Expenditure Review. World Bank 2020. Forthcoming

employment and the lack of opportunities to access wage employment in the off-season results in low labor productivity for the rural population. Close to 50 percent of Ugandan workers work less than 35 hours per week. Social protection programs such as labor-intensive public works can improve labor productivity of the rural population by providing access to employment during the off-season. The agricultural sector continues to be highly exposed to covariate risks and access to finance continues to be a major constraint, particularly for smallholder farmers. Hazards include floods, droughts and landslides. It would be important to enlarge the scope of programs such as UAIS to provide insurance against such hazards and to support the transformation of the agricultural sector.[42] Designing social assistance programs so that they can be scaled up in response to a shock through disaster risk financing is also important in order to rapidly respond when shocks materialize.

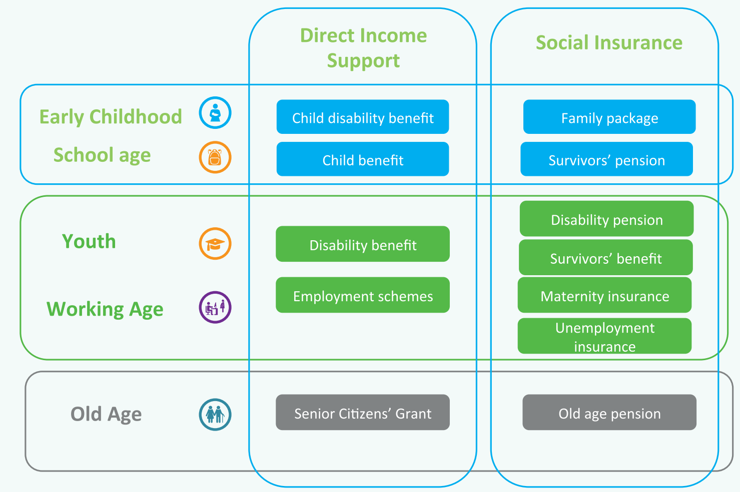
3.2 Current state of Social Protection in Uganda

Uganda's Vision 2040 commits to using social protection for addressing risk and vulnerability.[43] The national development plans (NDP) prioritize social protection as one of the key strategies for transforming Uganda from an agrarian society to a modern and prosperous country. This includes expanding the scope and coverage of social security to the informal sector, strengthening the scope of social assistance grants to vulnerable groups and the informal sector, expanding labor-intensive public works, and enhancing access to social care and support services.

Social protection was defined in Uganda for the first time in the National Social Protection Policy (NSPP) published in 2015. While there have been programs to support certain vulnerable groups in Uganda for some time (i.e. the elderly), the Government has recently defined social protection and what it will and will not include. A comprehensive National Social Protection Policy was published in November 2015 and approved by Cabinet in 2016. Social protection provision is to be based on evidence of need and with priority given to the most vulnerable. The policy clearly defines social protection as having two pillars: social security and social care and support services.[44] Social security is divided into two components, namely social insurance through contributory schemes targeting the working population in both formal and informal sectors, and direct income transfers, which are non-contributory transfers targeting vulnerable children, youth, women, people with disabilities and the elderly (see Figure 17).

41. World Bank (2019 August)
42. Ibid
43. The strategic focus for Uganda's future development is presented in the Uganda Vision 2040 document, which outlines the longer-term trajectory to which national development plans contribute.
44. Social Care and Support Services are a range of services that provide care, support, protection and empowerment to vulnerable individuals who are unable to fully care for themselves. This area has not been sufficiently elaborated in the Policy.

Figure 17: Conceptualization of social security by the Ugandan Government



Source: Ministry of Gender, Labor and Social Development (MGLSD)

As outlined in the draft national development plan III (NDP III), social protection remains a key component for achieving inclusive growth. It is envisaged that within social protection, direct income support transfers and contributory social insurance schemes will play complementary roles. Direct income schemes provide a minimum income below which individuals and families know they will not fall, while contributory schemes offer consumption-smoothing benefits across the lifecycle to those who can afford to contribute. The social security system will also be refined to be more responsive to shocks. Direct income transfer programs will scale up as needed in response to shocks - horizontally, vertically, or both – and a trigger system will be designed to inform such a scaling up.

Although a vision for social protection has been articulated in Uganda, the current levels of expenditure on social protection are very low. The allocation to social development, which includes social protection expenditures, was only 0.7 percent of the overall government budget in FY19/20 (see Figure 14). Expenditure on the two largest direct income support programs, the Senior Citizens Grant (SCG) and the Northern Uganda Social Action Fund (NUSAF) 3, was just 0.14 percent of GDP in FY17/18, which is lower than in neighboring countries like Kenya and Rwanda who spend 0.4 percent and 0.3 percent of GDP, respectively, on direct income support.

Coverage of both pillars of social protection, direct income support and social insurance, are low. The two largest direct income support programs in Uganda have an overall coverage of just 3 percent of the population, significantly below that of the average in countries in East Africa, which is 9 percent of the population, as well as the average for low-income countries, which is 7 percent of the population.[45] The coverage of social insurance is also minimal due to the low levels of formalization in Uganda. Although the existing social protection programs are fairly effective in protecting elderly recipients and in enabling recipient households to smooth consumption during lean periods, the impact of such programs in terms of mitigating risks and reducing poverty and vulnerability is not fully realized, particularly when considering the very low levels of coverage and the immense needs of the population. Section 3.2.1 provides further details on direct income support programs in Uganda while Section 3.2.2 looks at the current state of social insurance and explores how voluntary savings schemes can be better designed to attract informal sector workers.

3.2.1 Expenditure on and coverage of direct income support programs is low

Direct income support in Uganda is composed of two major and several minor programs. The main direct income support programs currently in Uganda are outlined in Table 6.[46] The two major programs are the Senior Citizens Grant (SCG) and NUSAF 3. The SCG is Uganda's main program to mitigate old-age poverty – it provides a bimonthly cash grant to the elderly. The government has announced a national roll-out of this program, a vision that effectively transforms the SCG into a social pension for everyone above the age of 80 (see Table 7). Details on the NUSAF 3 program are provided in Box 5.

45. World Bank (2019, July)
46. This update focuses on the two major direct income support programs in Uganda, SCG and NUSAF3. For details on the minor programs, please refer to Uganda Social Protection Public Expenditure Review (World Bank, 2019b June).

Table 6: Direct income support programs in Uganda

	Core objectives	Benefit modality	Targeting	Coverage	No. of beneficiaries
Senior Citizens Grant (SCG)	• Supporting elderly citizens who cannot provide a livelihood for themselves anymore • Mitigating old-age poverty	Cash grant of USh 25,000 paid every two months	• Community-based targeting at the district level • Planned rollout announced which makes this program accessible for everyone 80 and older	Age 65 in pilot districts (60 in Karamoja) and age 80 elsewhere.[47]	157,284
The Third Northern Uganda Social Action Fund (NUSAF 3)	• Provide effective income support and build the resilience of poor and vulnerable households in Northern Uganda	Labour-intensive public works and direct income support for households without the ability to work	• Poor households in Northern Uganda	Northern Uganda	136,571
Disability Grant	• Strengthen capacities and livelihoods of households whose members have disabilities • Poverty reduction of households whose members have disabilities	Block grant from the MGLSD to each district	• Each district can implement its own targeting approach	National	Not available
Community-based rehabilitation program	• Assist households with disabled members • Strengthen local markets	Block grant from the MGLSD to each district	• Each district can implement its own targeting approach	26 districts	Not available

47. In the original pilot districts, everyone above age 65 will continue to receive the SCG, while in any subsequently added districts, only those above age 80 are eligible to receive the grant.

Box 7: Building resilience and shock-responsiveness in northern Uganda: The Northern Uganda Social Action Fund (NUSAF 3)

The Northern Uganda Social Action Fund 3 (NUSAF3) aims to provide effective income support and build the resilience of poor and vulnerable households in Northern Uganda. It also helps beneficiary households and communities build assets and improve the capacity to adapt in the face of shocks.

The project has three primary components, namely: (i) Labor-Intensive Public Works (LIPW) combined with a disaster-risk financing element, (ii) a sustainable livelihoods pilot program, and (iii) a component focusing on strengthening transparency, accountability and anti-corruption systems.

The LIPW component provides beneficiaries from poor and vulnerable households with a seasonal cash transfer in return for their participation in public works. It has the dual benefit of enabling households to smooth consumption during lean seasons, as well as building local assets in communities such as small roads, soil and water conservation (SWC) infrastructure, and flood control structures.

Additionally, the project has piloted a Disaster Risk Financing (DRF) mechanism. The DRF aims to mitigate the impact of droughts in the Karamoja region by providing additional financing and scaling up of LIPW support. To do so, the DRF element puts in place the necessary systems and provides capacity building so the LIPW activities can be scaled up rapidly as a response to the occurrence of droughts.

The NUSAF 3 project has successfully implemented the scalable DRF element for drought-related disasters and triggered it in three consecutive years. Both national and local government institutions were able to identify shock-affected areas and devise adequate responses. An evaluation study conducted in October 2018 reported that 98 percent of beneficiaries were satisfied with the DRF modality. Furthermore, the study noted that the mechanism enabled households to acquire food reserves to cushion against and mitigate the effects of droughts. By doing so, the mechanism allowed the government to save on emergency food aid that would have been needed in the absence of the scalable disaster response under the project. Overall, the report estimated that the government realized savings of USh 9.6 billion against an overall emergency fund of USh 19 billion in FY16/17.

Source: Government of Uganda (2019)

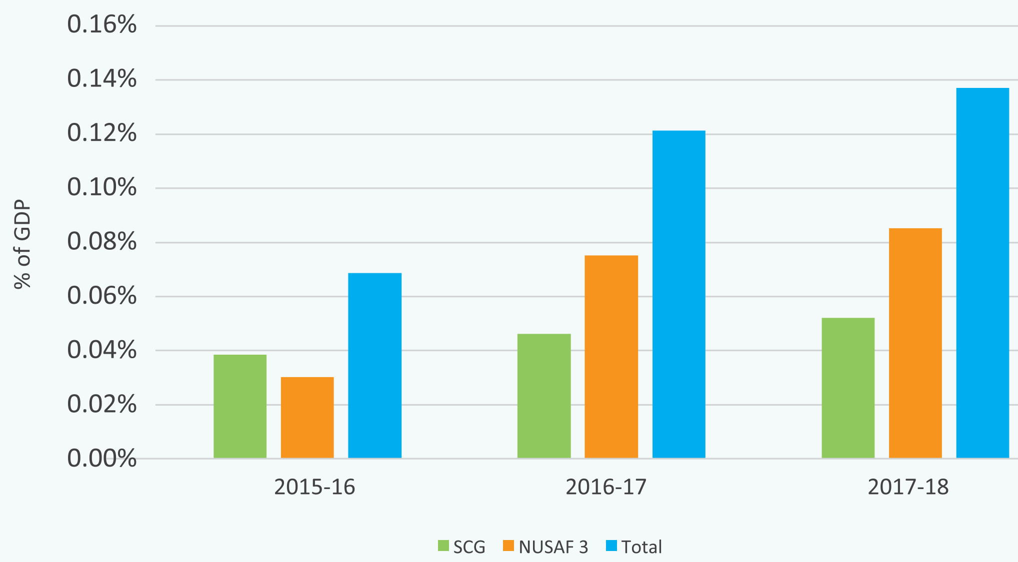
Overall spending on direct income support programs is low in Uganda. Figure 18 shows that recent spending on NUSAF and SCG, both in terms of absolute spending and as a percentage of GDP, has increased over time. In particular, spending on the NUSAF program reached about USh 100 billion or 0.08 percent of GDP in FY17/18, making it by far the largest direct income support program in the country. Spending on the smaller programs is dwarfed in comparison to the SCG and NUSAF (overall spending on both the disability grant and the community-based rehabilitation program in FY17/18 was about USh 200 million, or less than 1 percent of the spending on SCG and NUSAF). Although spending on the two major direct income support programs increased to about 0.14 percent of GDP in FY17/18, when compared to other sub-Saharan African countries, expenditures on social safety nets in Uganda are very low (Figure 18, panel b).

50%

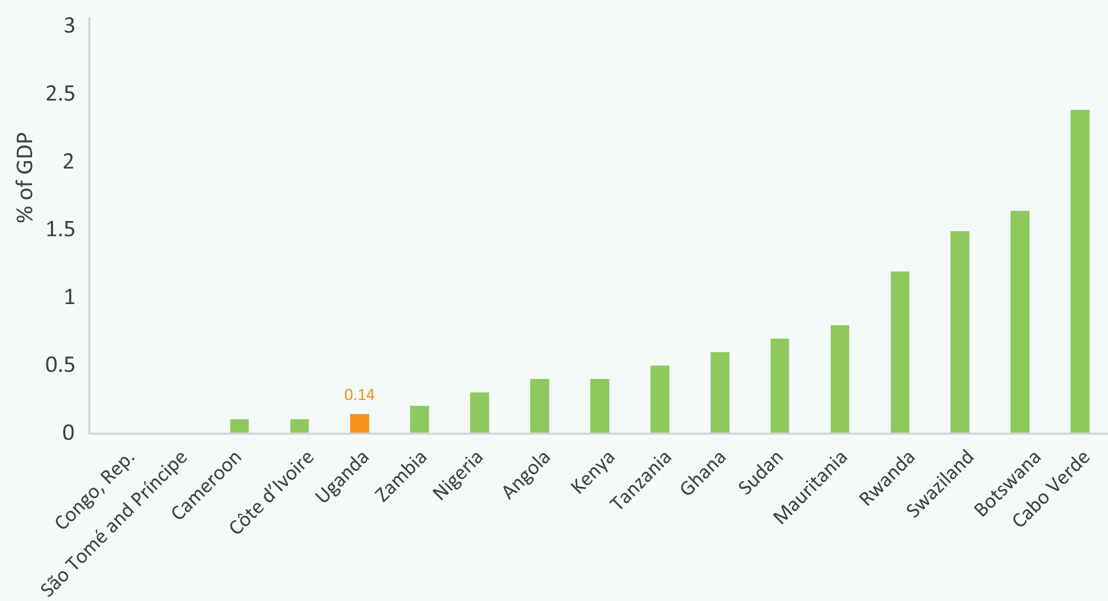
of Ugandan workers work less than 35 hours per week

Figure 18: Expenditure on major direct income support programs

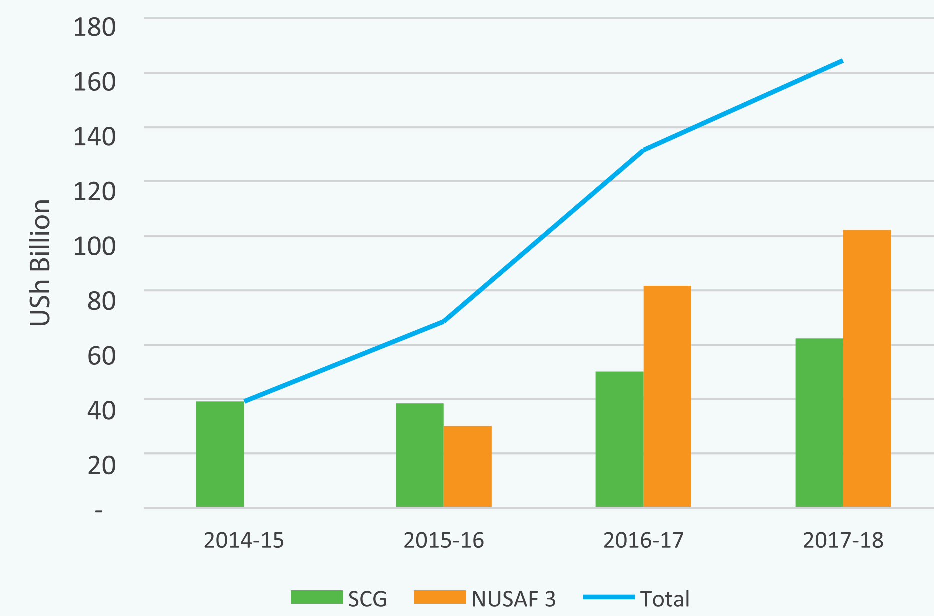
(a) Expenditure (percentage of GDP)



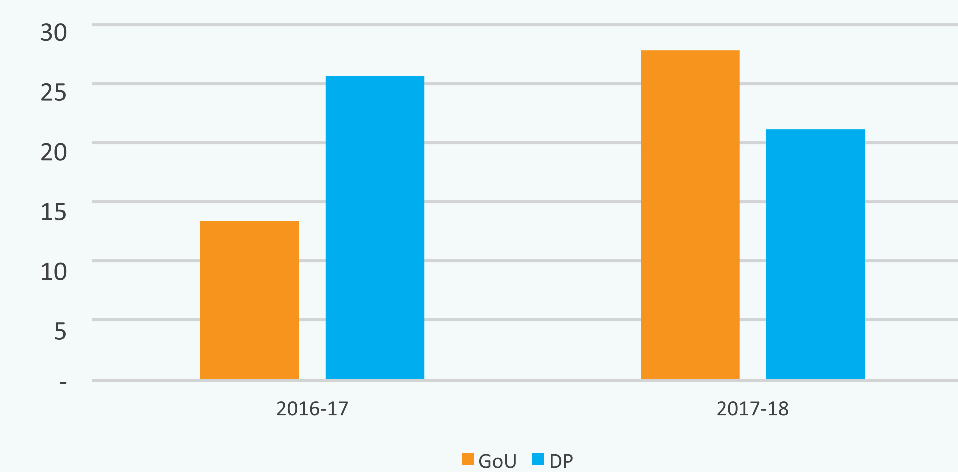
(b) Cross-country comparisons (most recent data)



(c) Expenditure (USh billion)



(d) Breakdown of SCG spending by entity (USh billion)



Source: Authors' calculations based on administrative data for Uganda and "Realizing the Full potential of Social Safety Nets in Africa, World Bank, 2019" for other countries

Spending on SCG and NUSAF 3 is partly financed through donor grants or concessional loans. NUSAF 3 is financed through a concessional World Bank loan to the Government of Uganda. Although government spending on the SCG has increased in recent years, development partners financed about 35 percent of the SCG expenditures in FY17/18 (Figure 18, panel (d)). The sustainability of these programs over the medium term will require the government to increase its fiscal commitments to them.

Expanding the SCG to all elderly in Uganda, while effective in protecting recipients over the age of 80, will more than double the cost of this program. The SCG consists of a grant of USh 25,000 which is paid every two months. It is estimated that the full national rollout of the SCG will cost USh 145 billion in 2019.[48] This is more than double the amount currently spent on the SCG program and represents an increase in expenditures on direct income support programs. By covering the risk of extreme longevity, the SCG grant provides an important income for the elderly with positive spillover effects. There is evidence that the SCG has a positive impact on the wellbeing of pensioners and other household members. Studies show a 33 percent increase in average household expenditure among recipient households (Gelders and Athias, 2019).

It will be important to maintain the adequacy of the SCG, as well as other transfers, in Uganda. The nominal transfer value of the SCG has not been adjusted since the scheme started in 2010. Given significant inflation over the last decade, the benefit's real value has declined by about 40 percent since 2010 (Figure 19). It would be important to ensure that the real value of the transfer does not continue to erode. If the SCG, as well as other transfers such as those provided through NUSAF, are not indexed for inflation, there is a risk that the transfer value will become too little to have any meaningful impact on recipients.

While maintaining the benefit's adequacy is critical, it is also important to monitor costs over time. If the SCG benefit value were to be indexed to inflation, the cost of covering the elderly in Uganda would increase over time. In absolute terms, Uganda's 65+ population will increase by close to fourfold, approaching 4 million by 2050, up from its current level of around 1 million. At the same time, it would be important to monitor any arbitrarily large increases in the value of SCG, or any other categorical transfers. Experience in Africa shows that social pensions, while effective at protecting the elderly, can become expensive if substantial increases in benefit levels are announced before elections, or if the age-threshold is decreased resulting in a larger number of people becoming eligible.[49]

Overall, the coverage of direct income support is particularly low in Uganda. As shown in Figure 20, panel (a), only 3 percent of the population is covered by direct income support. In terms of coverage, this is one of the lowest amongst East African countries (Figure 20, panel b). Whereas SCG beneficiaries are in poor and non-poor districts, beneficiaries of NUSAF 3 are, by design, mostly in Uganda's poorer Northern and Northeastern districts.

Although national and regional coverage of NUSAF 3 is minimal, coverage reaches reasonable levels within the specific districts in which NUSAF 3 operates. Based on data from the NUSAF 3 project implementation unit, there are a total of 111,697 households that include LIPW beneficiaries in the 27 districts within the four sub-regions of Karamoja, Acholi, Teso and West Nile. Given there are a total of 218,103 households in these districts, the LIPW covers 51 percent of households in these districts

48. This includes the cost of covering everyone over the age of 80 nationwide and continuing to cover those 60 and older in Karamoja and those 65 and older in the other 15 SCG pilot districts.
49. See Guven et al. (2019). In Mauritius, the basic retirement pension was increased by almost 40 percent in advance of elections. The government of Seychelles increased the universal pension benefit to the level of the minimum wage in 2017 a month before elections.

Figure 19: Real value of the SCG benefit

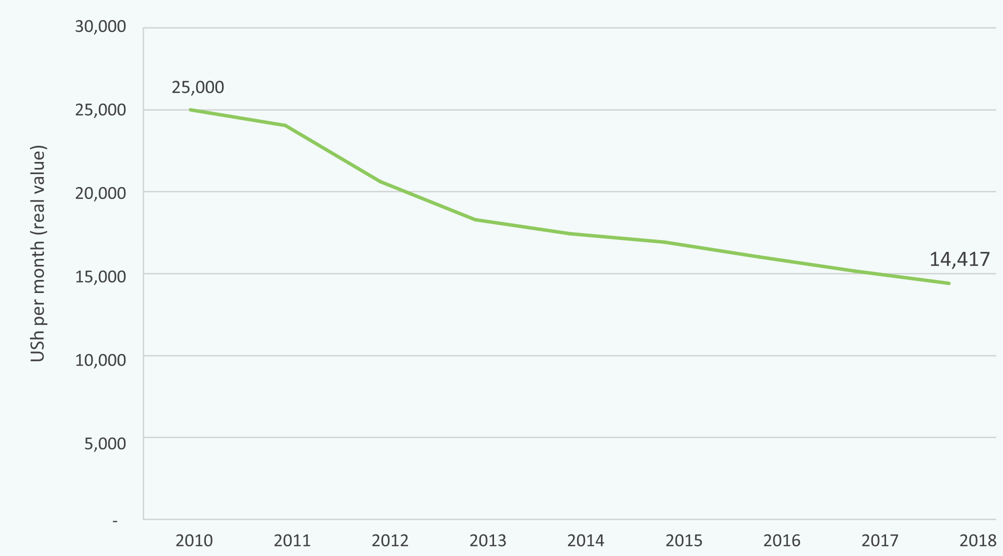
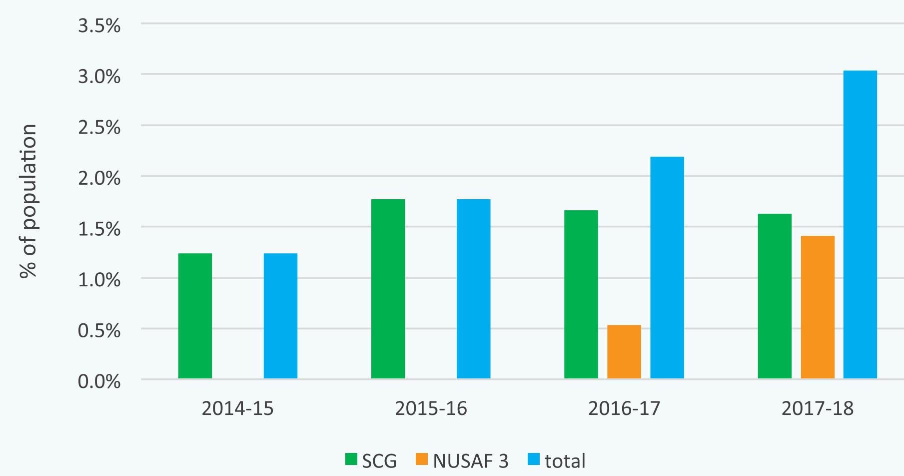
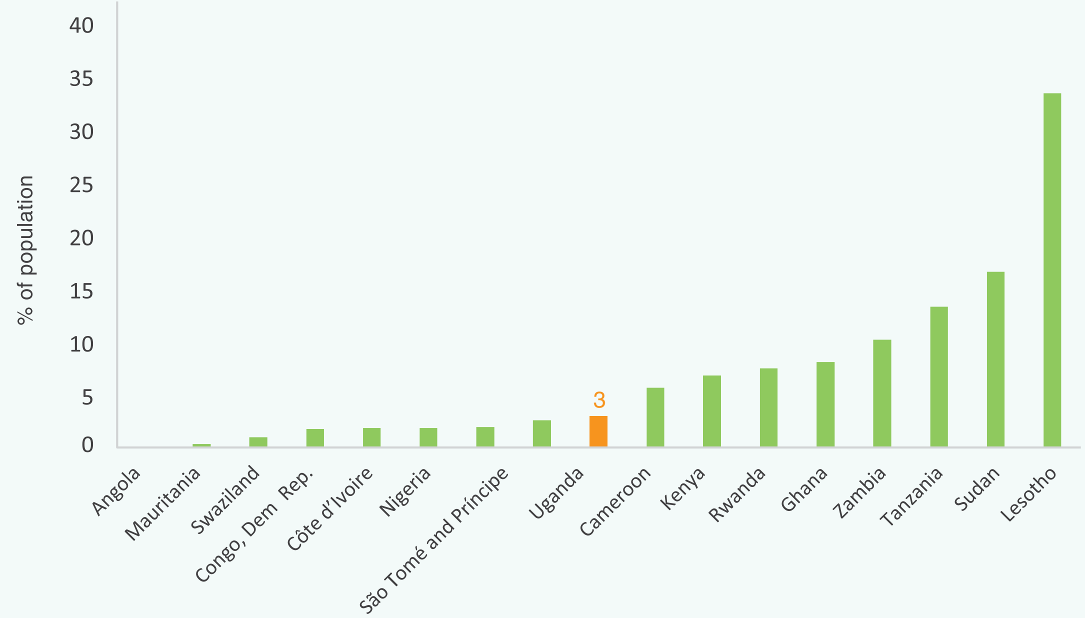


Figure 20: Beneficiaries of main programs over time

(a) DIS beneficiaries, both direct and indirect (% of population)



b) DIS beneficiaries (comparison in SSA)



Source: Panel (a): Authors' calculations based on administrative data and UNHS 2016. Panel (b) comparator data are from "Realizing the Full potential of Social Safety Nets in Africa"

In conclusion, overall coverage of direct income support programs is low in Uganda, despite reasonable targeting accuracy and effectiveness for the recipients. The main programs are reasonably well-targeted, benefiting the elderly, poor and vulnerable in the neediest districts of Northern Uganda. One approach for expanding direct income support would be to focus on maintaining and increasing the productivity of the population by mitigating shocks and investing in human capital. Given the limited fiscal envelope available to the government (see section 1.6), it would be important to carefully select the beneficiary population for such an expansion, both in terms of the districts where direct income support might be expanded and the population groups within those districts. Section 3.3 provides guidance to inform such an expansion, including which geographical areas have the most need for investments in human capital and which areas are most affected by shocks.

3.2.2 Coverage of social insurance is low

Uganda's Vision 2040 prioritizes the expansion of the scope and coverage of social insurance. In 2016, only 10.4 percent of household heads were employed in the formal sector in Uganda. High and persistent informality in the country has precluded traditional employer-employee social insurance arrangements from reaching most Ugandans. Unless social insurance coverage is dramatically increased, most elderly Ugandans wishing to avoid destitution in old age will have to rely on alternative forms of income support such as private savings, part-time employment, or receiving help from family members.

The schemes that cover the small proportion of formal sector workers are fragmented. Two separate schemes aim to provide old age security to those working in the formal sector. Formal private sector workers are covered by a mandatory defined contribution provident fund, the National Social Security Fund (NSSF), and public sector workers are covered by a mandatory non-contributory (tax funded) defined benefit pension, the Public Service Pension Fund (PSPF). Formal sector workers can also contribute to supplementary voluntary occupational schemes that are provided entirely at the discretion of employers.

Two very small savings schemes exist for those in the informal sector, but currently have only about 1,000 contributors. The informal sector schemes – the MAZIMA Voluntary Individual Retirement Benefit Scheme and KACITA Uganda Provident Fund Scheme – are focused on low-income informal sector workers who are unable to meet explicitly defined, regular contributions. These schemes allow participants to choose how much and when to save through mobile money networks. However, these schemes have only been able to attract about 1,000 contributors to date. Table 7 provides an overview of the retirement benefits sector and key performance statistics.

Table 7: Composition of the retirement benefits sector in Uganda

	Senior Citizens Grant (SCG)[50]	PSPF, AFPS[51], PPS[52]	National Social Security Fund (NSSF)	Supplementary Voluntary (Occupational)[53]	Supplementary Voluntary (Individual)[54]
Target Group	Age 65 (60 in Karamoja region) and age 80[55]	Civil service, Parliamentarians, Armed Forces	Formal and informal sector workers[56]	Formal sector salaried workers	Informal sector, self-employed
System Design	Targeted based on age; currently operates only in 50 districts	Mandatory Employer Based Defined Benefit	Defined Contribution Provident Fund. Mandatory for formal sector, voluntary for (selected) informal sector workers	Voluntary work-based schemes	Voluntary schemes
Financing	Non-contributory, General revenue	Non-contributory, General revenue	Defined Contribution	Defined Contribution	Defined Contribution
Coverage	157,284 elderly	Registered: 274.2 thousand Beneficiaries: 45.2 thousand	All Registered: 1,788,876 Active: 574,628 Claims paid[57]: 15,291 people	39,326 contributors	1,128 contributors
Expenditure	57 billion USh, about 0.05 percent of GDP	0.4 percent of GDP	Benefits paid: USh 278.25 billion, about 0.27 percent of GDP	n/a	n/a
Benefit Amount	25,000 USh per month (US$ 7), about 12 percent of GDP per capita	Average annual old age pension: USh 3,460,400. This amounts to about 1.34 times GDP per capita	Average benefit paid per person (lump sum): USh 13,850,409. This amounts to 5.75 times GDP per capita	n/a	n/a

Source: Uganda Social Protection Public Expenditure Review. World Bank, 2019

Despite a modest increase in recent years, the share of the Ugandan population that saves for old age remains low. According to the FINDEX survey only 14 percent of individuals above age 15 saved for old age in 2017. Saving for old age is lower among the poorest 40 percent of the population, at 9 percent, compared to 17 percent among the richest 60 percent.

The government has taken steps to increase the coverage of social insurance among the informal sector, but more can be done. In July 2019, a draft amendment was proposed to the NSSF expanding mandatory NSSF contributions to include small firms. Currently, NSSF contributions are mandatory only for employers with five or more employees. The bill also proposes that informal and formal sector workers be allowed to participate on a voluntary basis. Although these amendments are well-intentioned, it is not likely to result in increased NSSF coverage among formal and informal sector workers. Currently, despite NSSF contributions being mandatory for formal firms employing five or more employees, NSSF coverage among such firms remains low. Therefore, while it makes sense that pension coverage should be accessible to employees regardless of the size of the firm they are working for, mandating participation through legal action alone, without examining and addressing the factors behind the current low coverage rates among those currently required to contribute, is unlikely to result in coverage expansion. The enactment of the Uganda

50. The SCG is included in both Table 6, as a DIS program, as well as in Table 7, as part of the retirement benefit sector. The reason for this is that the program is a non-contributory government transfer to the elderly (therefore in Table 6). It is also a key pillar of the Ugandan pension system, and so is included in Table 7 to provide a complete picture of how the elderly are covered in Uganda.

51. This is the Armed Forces Pension Scheme and no data is available on this scheme.

52. Parliamentary Pension Scheme had 904 registered members as of June 2017.

53. Voluntary work-based schemes established by employers under irrevocable trusts for the benefit of employees. Most are contributory. Can be stand-alone schemes or subscribed to an umbrella scheme.

54. Voluntary non-employer schemes established to cover workers in the informal sector or self-employed persons who elect to participate on a voluntary basis.

55. In the original pilot districts, everyone above age 65 continues to receive the SCG while in any subsequently added districts, only those above age 80 are eligible to receive the grant.

56. Workers who have worked in the formal sector and have an NSSF number can continue to contribute to this scheme if they subsequently work in the informal sector. Workers in the informal sector who do not have an NSSF number cannot elect to contribute to the NSSF scheme

57. NSSF (2017) pg 20.

Retirement Benefits Regulatory Act of 2011 (URBRA) and the establishment of a regulatory agency for the sector marks an important step towards extending voluntary savings coverage to informal workers.

Because the informal sector is very heterogeneous, understanding the characteristics of informal sector workers can help with designing schemes that have a greater probability of success. Informal sector workers typically have lower earnings compared to those in the formal sector. Moreover, these may be irregular and unpredictable, making financial planning a challenge. Informal sector workers are usually more vulnerable to economic shocks due to lower incomes, lack of social protection, and limited savings to draw upon. Informal sector workers are also more likely to live in remote areas, making them harder to reach by pension product providers and financial services more generally. Even for urban informal sector workers, access may still be a challenge to the extent that they may switch jobs frequently and lack official registration documents. The heterogeneity of the informal sector means that while some workers face significant barriers to save for old age, others have the ability to overcome them.

Analysis using household survey data suggests that a third of Ugandan households employed in the informal sector are not vulnerable to economic shocks and thus could potentially be willing and able to accumulate some long-term savings. The analysis applies a simple typology of Ugandan households shown in Figure 21. At one end of the spectrum are households that are already participating in the formal sector (henceforth "formal households"). At the other end are households below the poverty line. For these households, setting money aside for old-age would imply costly deprivations in the short-term that would outweigh the benefits of receiving an income in old-age. Among non-poor informal households, the typology separates households who are/are not able to smooth consumption in the short-run in the face of economic shocks. The latter are labeled "Informal, not poor, but vulnerable" households (or IV). IV households are unlikely to benefit from locking away income that could help them smooth consumption in the event of economic shocks. Instead, they may benefit from help with purchasing insurance against the economic risks they face (price risk, employment risk, health risk, weather-related risks). The last group of households is labeled "Informal, not poor, not vulnerable" households (or INV). INV households are not under threat from severe economic shocks, or have enough resources to cope with them, and thus could potentially save for old age and would therefore be more likely to participate in a voluntary pension scheme.

Figure 21: Typology of household types and likely approach to pension provision

Informal sector (89.4 percent of all households)			Formal sector (10.6 percent of all households)
Informal, poor (14.6 percent)	Informal, not poor, but vulnerable **(IV)** (40.8 percent)	Informal, not poor, not vulnerable **(INV)** (34 percent)	
Government pays insurance premium	Government subsidizes insurance premium	This segment of population can put aside money for precautionary savings and longer-term savings	Get coverage through formal social insurance arrangements

Source: Authors analysis using Uganda National Panel Survey (UNPS) round 2014/2015

In Uganda, 34 percent of households are informal but report no damaging shocks or basic deprivations over the past 12 months. When compared to formal households, they exhibit lower but comparable levels of consumption, assets and literacy levels. Conversely about 55 percent of households are informal and likely to be too poor or vulnerable to set aside money for old age. Specific regions and occupations exhibit larger fractions of non-vulnerable informal households. These geographical and economic locations should be considered when piloting or targeting pension schemes for the informal sector.

The government may have to provide subsidies if it wishes to extend social insurance to all households. The typology outlined in Figure 22 can guide government policy in terms of which households to subsidize and by how much. The informal and poor households may need the government to pay the full insurance premium, as they cannot afford to divert resources from current consumption. The IV households may be able to partially afford insurance premiums, but will need government subsidies to encourage savings and achieve reasonable returns by old age. The INV households can put aside money and it is this segment that can be targeted by tailored voluntary savings schemes.

While understanding who can save is essential, a meaningful increase in voluntary savings will require that schemes cater to the informal sectors' heterogenous groups in addition to decreasing administrative costs and providing subsidies. Establishing a central administrative platform that micro-pension schemes can leverage would help them with building scale and subsequently, sustainability. Rwanda serves as an example of this approach, namely the arrangement where the existing formal sector pension administrator is also the central administrator for the informal sector pension scheme. The Ejo Heza scheme also includes a matching government contribution along with free life insurance coverage to provide further incentives to save (see Box 8)

Box 8: Rwanda's Ejo Heza Long Term Savings Scheme

In December of 2018, Rwanda launched the Ejo Heza Long Term Savings Scheme (LSSS), which is a voluntary defined contribution scheme open to all Rwandans and foreigners residing in Rwanda. Level and frequency of contributions depend on the capacity of the participants to pay. Pensions will be provided as a monthly annuity at the age of eligibility.

Ejo Heza LTSS will provide a special, means-tested fiscal incentive package for the first three years to encourage mass-scale enrolments. With these incentives, the Government aims to inspire a sustained savings discipline among non-salaried workers. The incentive package includes a matching government contribution of up to RWF 18,000 per year (roughly US$20 per year) along with free life insurance coverage of RWF 1,000,000 (about US$1,100) and a funeral insurance cover of RWF 250,000 (about US$277). Only citizens with a permanent national identification (aged 16 years and above) will be eligible for the co-contribution and insurance benefits.

The aggregate cost of matching government contributions and free life and funeral insurance is estimated to be around RWF 20 billion (US$22 million) over three years. It is estimated that effective implementation of Ejo Heza LTSS could produce long-term household savings of RWF 200 billion (US$220 million) within 5 years, growing to nearly RWF 0.5 trillion (US$549.5 million) over the next decade.

Members will have access to 40 percent of accumulated savings for housing and/or education. For liquidity needs, participants will have access to 25 percent of total accumulated savings. Moreover, 40 percent of total savings can be used as a collateral to obtain a loan. While the Ejo Heza LTSS scheme certainly provides an example of a well-designed nationwide savings scheme that has enjoyed a successful national launch, it is too early to draw conclusions about outcomes and performance.

Source: https://www.ejoheza.gov.rw/

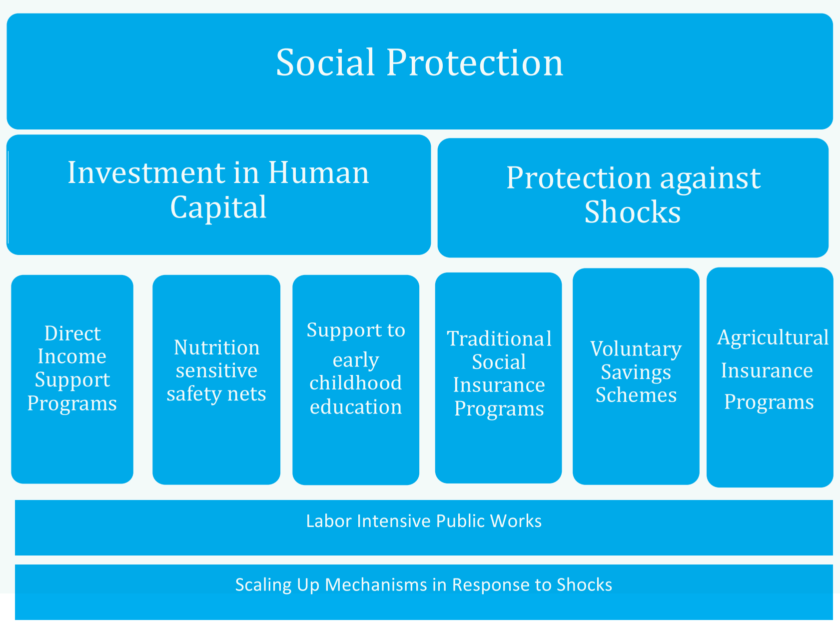
3.3 Expanding social protection to support investments in human capital and to protect against shocks

Focusing social protection programs on improving both resilience and economic opportunity is particularly important in a country like Uganda. The government's limited fiscal envelope (see Section 1.6) makes it difficult to meaningfully redistribute resources through social protection programs. As a result, given the high levels of poverty and vulnerability (measured at over 55 percent of the population – see Figure 21), any expansion in social protection programs could instead focus specifically on maintaining and increasing the productivity of the population by mitigating shocks and investing in human capital. This approach is discussed in this section and conceptualized in Figure 22.

Social protection programs that support investments in human capital can include direct income support programs, nutrition-sensitive social safety nets, and programs that support early childhood education. There is broad evidence that Direct Income Support Programs enable families to spend more on goods (nutritious food, clean water, medicines and so on) and services (health care and education). Income support can allow better time-use for family members; for instance, ensuring children are at school instead of working in the field. Income support can decrease stress levels by reducing the pressure of financial strain and deprivation. It allows family members to improve the quality of the personal interactions at household and community level, increasing their human and social capital. Regular and predictable income support allows families to increase precautionary savings, to access credit through formal and informal sharing mechanisms, and to improve livelihood strategies.[58]

Risk mitigation against shocks can be achieved through labor intensive public works programs, by scaling up shock-response mechanisms and traditional social insurance programs, and through voluntary savings and agricultural insurance. For instance, LIPW is a social protection instrument that allows communities to not only gain experience and restore communal assets and locally shared infrastructure, but it also provides a direct income that allows participants to save and meet household needs (including keeping children in school). Voluntary savings schemes that cater to the heterogenous needs of the informal sector encourage individuals to save for old age and help reduce the burden of old age income security on future government budgets. Further, given the large number of individuals employed in agriculture – some 64 percent of Ugandans (and 72 percent of young Ugandans) – it is important to invest in agricultural insurance programs to help mitigate risks faced in the agricultural sector and to improve agricultural productivity. The scaling up of safety nets in response to shocks represents another channel that can support a faster recovery following a shock (including keeping or getting children back into school).

Figure 22: Vision for a social protection system in Uganda



58. World Bank (2019b, May)

In order to prioritize the expansion of social protection in Uganda, it is important to understand which segments of the population and which geographic areas are most affected by shocks and have lower levels of human capital. Section 3.3.1 discusses the sub-national human capital index, section 3.3.2 looks at shocks and vulnerabilities, and section 3.3.3 provides options for geographic focus areas that the government may consider when expanding social protection programs.

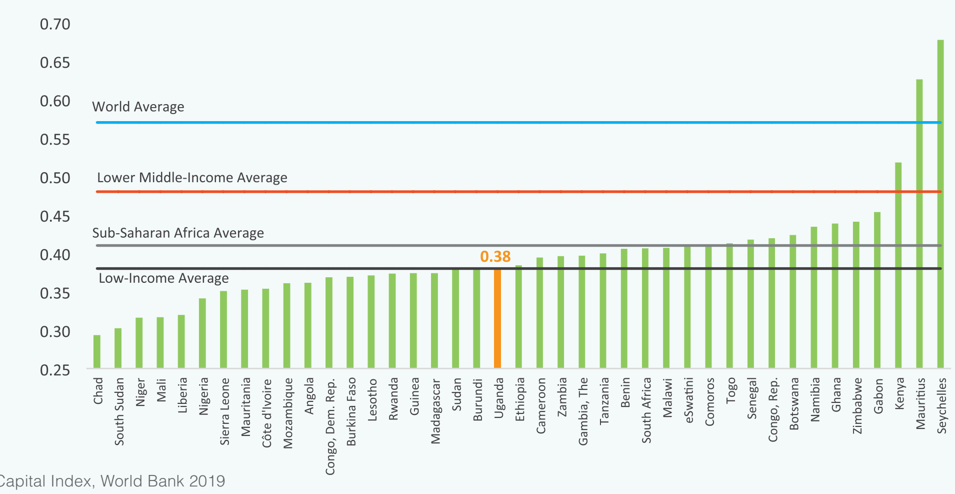
3.3.1 Human capital context in Uganda

Investing in human capital will help growth in Uganda be more inclusive, as well as increase the resilience of citizens to risks and shocks. Some of the main characteristics that distinguish the vulnerable from those not vulnerable in Uganda include literacy and low schooling attainment of household heads (World Bank, 2019). When the head of household is literate and when s/he has some secondary or even tertiary education, the household is less likely to be vulnerable to various types of shocks. Poverty and vulnerability are propagated across generations because children living in poor and vulnerable households are less likely to attend school. Improving Uganda's Human Capital Index (HCI) by investing in the health and education of children and infants, will help improve the resilience of the next generation of Ugandans.[59]

Uganda ranks 137 out of 157 countries in terms of the HCI. The HCI measures the amount of human capital that a child born today can expect to attain by the age of 18 and is an indicator of the effectiveness of social investments. It looks across health, education, nutrition and skills and is calculated based on five indicators: (i) probability of survival to age 5; (ii) children's expected years of schooling; (iii) quality of learning; (iv) adult survival rate, and (v) the proportion of children who are stunted.[60] The World Bank's analysis of cross-country data on human capital indicates that Uganda is underinvesting in the future productivity of its citizens. A child born in Uganda today will only be 38 percent as productive when she grows up as she could be if she enjoyed complete education and full health. Uganda has an HCI index that is slightly lower than the average for the Sub-Saharan Africa (SSA) region, and on par with the average for low-income countries (see Figure 23).

The within-country variation in human capital outcomes across sub-regions in Uganda is significant. Figure 25, panel a, shows the composite HCI by sub-region in Uganda. Interestingly, the areas where human capital is lower in Uganda do not match perfectly with the poverty map (Figure 24, panel b). The overall HCI index is the lowest in the northern regions of Karamoja, Acholi and West Nile, followed by Elgon, Bunyoro and Tooro. Much of this is driven by the expected years of school (EYS) indicator, which is lower in the northern districts (see Figure 24, panel c)[61]. Test scores also contribute, with harmonized learning outcomes being the lowest in Acholi, Elgon and Bunyoro (see Figure 24, panel d). Tooro is the sub-region with the highest percent of children who are stunted (see Figure 24, panel e), although it is not one of the poorer regions in the country. Other sub-regions with high stunting levels among

Figure 23: Human capital index (Uganda in the Africa perspective)



Source: Human Capital Index, World Bank 2019

59. See World Bank (2019 a, May) for a description of the Human Capital Index

15%
of children in the poorest quintile have access to early childhood development programs

55%
of households are informal and likely to be too poor or vulnerable to set aside money for old age

children include Elgon, Bunyoro, Karamoja, and West Nile. When one considers the probability of survival until age 5, the regions with lower survival probabilities include Busoga, Bunyoro, Karamoja and West Nile (Figure 24, panel f).

Within any region, poorer children have some of the worst outcomes in terms of human capital. Firstly, children in Uganda are the poorest subset of the age spectrum, with 24 percent of children aged 0-5 and 6-17 living in poor households, compared to 15 percent for those aged 18-35, and 19 percent for those aged 36-64 and 65 or older (World Bank, 2019b, June). Both health and education outcomes are worse for poorer children. Among children in the poorest wealth quintile, 15 percent are underweight compared to just 4 percent in the highest wealth quintile. Stunting also declines with the wealth quintile, with 33 percent of children in the poorest quintiles being stunted when compared to 18 percent in the richest. Only 15 percent of children in the poorest quintile have access to early childhood development programs compared to 66 percent of children in the highest quintile.

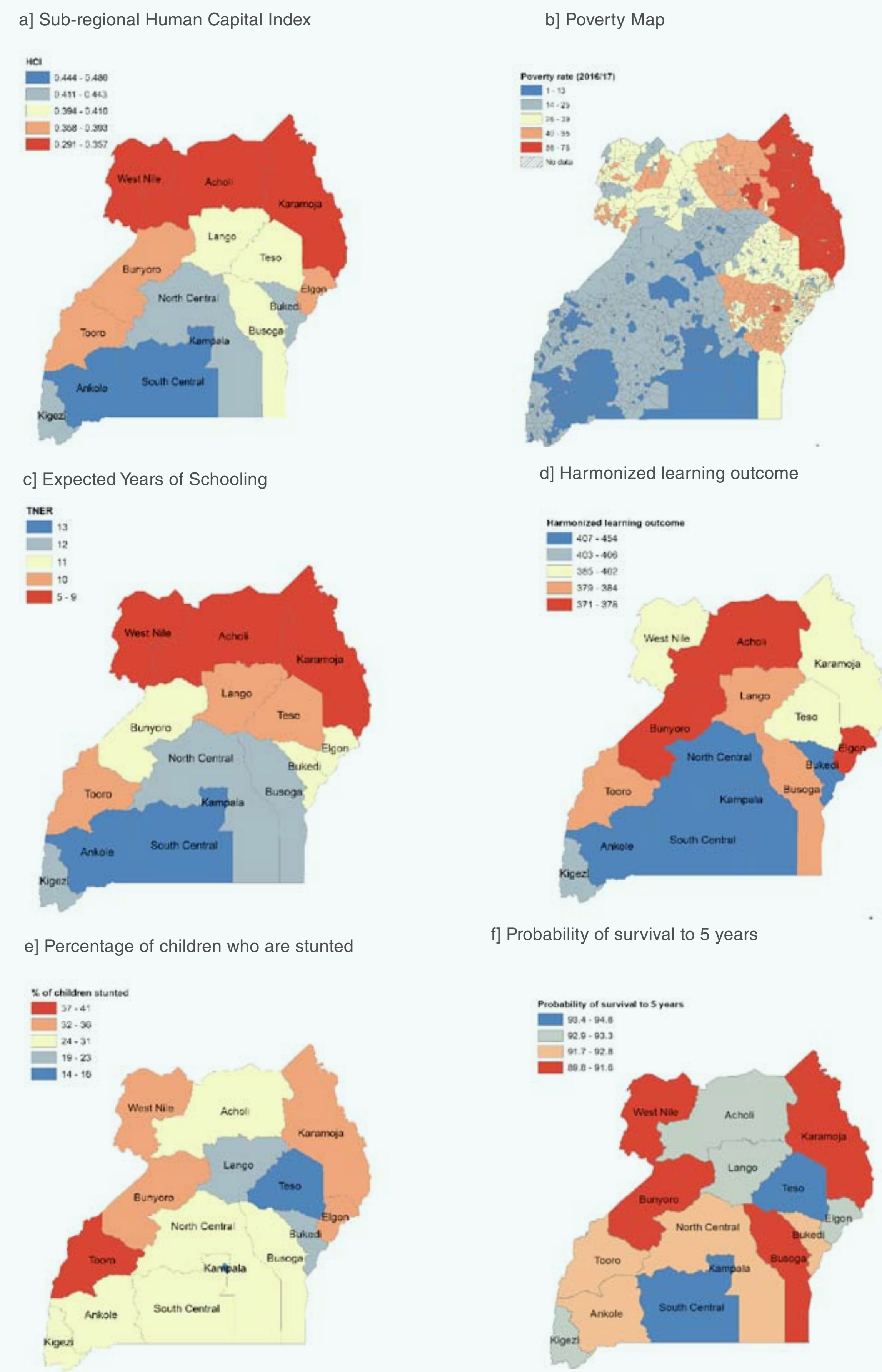
Given budgetary constraints, focusing on specific sub-regions and on children from lower socio-economic strata could help the country improve its overall human capital. For instance, the introduction of nutrition-sensitive social safety nets, targeted to the poor and vulnerable, in sub-regions or districts with high stunting rates could better support reduction in stunting among children, thereby pushing up the sub-regional HCI as well as the national HCI. Similarly, improving access to health services for pregnant mothers, infants and children could help bring down infant and child mortality in specific sub-regions. Programs aimed at children and complemented by access to good quality early childhood education can help improve child performance when they enter school. Direct income support programs have been shown to have a significant impact on increasing school attendance and decreasing child labor in other countries and contexts.

If targeted toward the most vulnerable, the introduction of a direct income support program to infants is cost-effective.[62] The Uganda SP PER (World Bank 2019b June) simulates a nation-wide direct income support program targeted to families with infants aged 2 and below, and who are in the poorest 50 percent of the population. The analysis shows that such a program would reduce poverty by two percentage points and costs about 0.23 percent of GDP, which would be a 137 percent increase on what was allocated to social development in the FY18/19 budget. About 35 cents of each Uganda shilling spent on this program would go to reducing the poverty gap.[63] With the information available from the sub-national HCI, the government may choose to introduce such a program in regions with higher stunting rates first, before expanding nationwide, in order to ensure initial affordability.

Similar programs for children below the age of five are also feasible, but depending on how they are targeted, they may require a larger budget outlay (although they would have a larger impact in reducing poverty). Creating a direct income support program for all families with children below the age of 5, across the whole country, and who are in the poorest 50 percent of the population, would reduce poverty by more than four percentage points. This would cost about 0.50 percent of GDP, which would be a 293 percent increase on what was allocated to social development in the FY18/19 budget. About 34 cents of each Uganda shilling spent on this program would go towards reducing the poverty gap. The government may choose to introduce such a program in regions with higher child mortality and stunting rates first, before expanding

60. Adult survival rates are not available for 15 to 60 year-olds at the subnational level in Uganda.
61. Expected years of school is calculated using the total net enrollment rates (TNER) and the share of repeaters by levels of education, based on the data from the UNHS 2016/17. The TNER measures the fraction of children in the theoretical age range for a given level of school, who are in school at any level. It is the preferred enrollment rate for primary and secondary levels since it captures the fraction of children of the relevant age group at any level of school, thus most closely resembling an age-specific enrollment rate.
62. This benefit would be targeted at pregnant women and infants 2 and younger.
63. Even when social protection programs are well-targeted, and reach the very poorest, they may not be able to fully lift them out of poverty. Therefore, the change in the poverty headcount is an imperfect way to measure the effectiveness of social protection programs. A complimentary measure is to look at the effect of the program in reducing the depth of poverty. This measure looks at how many cents, out of each shilling, goes towards bringing the poor closer to the poverty line. The larger this number, the more efficient the program in decreasing the depth of poverty.

Figure 24: Regional distribution of HCI, poverty rates and HCI indicators



Source: Authors' calculations based on 2014 Census, DHS and UNHS 2016 nationwide – again with the objective of ensuring initial affordability.

Programs that help to keep girls in school are likely to help delay marriage and childbearing, with significant economic benefits.[64] Each year of secondary education leads to a reduction in the likelihood of early childbearing by seven percentage points. Ending child marriage and early childbearing could also reduce population growth by 0.17 percentage points. Furthermore, early childbearing may also affect the health of young children, as those born to mothers younger than 18 have substantially higher risks of dying by age 5 and being stunted.[65] Higher educational attainment is also associated with substantial increases in adulthood earnings. Thus, the benefits from keeping girls in school longer arise from a lower rate of population growth, increased educational attainment and consequently earnings, and reductions in under-5 mortality and stunting.

These challenges are further exacerbated in urban areas, where only 21 percent of children complete primary school, and an even smaller fraction (2 percent) complete secondary school.[66] In 2019, the Kampala Capital City Authority launched Uganda's first urban social protection program for adolescent girls in response to the challenges identified in urban areas. Targeting girls who are both in and out of school, the GirlsEmpoweringGirls program seeks greater inclusion and protection of adolescent girls through strengthened socio-economic outcomes and prospects, in addition to helping them transition safely into adulthood. This mentoring, plus a cash program, helps empower girls (through a network of peer mentors), engages girls through referrals to services, and enables the take-up of services (including education) through a cash transfer provided to the girls through a caregiver.

3.3.2 Shocks and vulnerability in the context of Uganda

Households in Uganda experience shocks, the most common of which are droughts, irregular rains, and serious illnesses or accidents to income earners. As reported in the Uganda National Panel Survey (2014/15), 18 percent of households in Uganda reported being affected by drought (see Figure 25). Climatic shocks vary significantly across Uganda – for instance, 71 percent of households in Northern Uganda reported experiencing drought compared to 9 percent of households in Western Uganda (see Figure 26). As a result, the regional distribution of vulnerability varies substantially. Strengthening household and community resilience is also particularly important in Uganda given the broad risks around forced displacement. Uganda is the largest refugee-hosting country in Africa and the third largest worldwide. This large influx has placed a significant strain on social and economic resources for host communities, which historically have also been the least developed in the country. In addition to country-wide or covariate shocks, households are also impacted by specific or idiosyncratic shocks. The sudden onset of illness or disability, unemployment, or growing frailer as one grows older are a few examples of specific shocks that can push vulnerable households into poverty. In this section, the focus is on climatic shocks and providing evidence for which regions and districts the government may wish to prioritize in its expansion of shock-resistant social protection programs.

The agriculture sector is highly exposed to covariate risks. Uganda is among the most vulnerable and least adapted countries to climate change, placing 155th out of 188 countries on the ND-Gain Index.[67] The agriculture sector is exposed to weather, biological, infrastructure (post-harvest loss), price, and market risks, all of which suppress the appetite for investment in the sector. Figure 27, panel a, depicts the historical drought risk in the different regions. Districts in the northeast of Uganda, particularly in Karamoja, face some of the harshest drought conditions. The last time this area was severely affected by a drought was in 2009, when substantial year-over-year rainfall deficits impacted most of the county (Figure 27, panel b). Considering the economic impact of rainfall deficits, losses in 2010-2011 for livestock production alone amounted to US$123.3 million, representing 40.3 percent[68] of all losses attributed to the drought. That said, recent patterns of rainfall deficits show that regions outside of the northeast actually suffered greater deficits (see Figure 27, panel c, which shows the average annual rainfall deficit for the years 2012 to 2017).

64. World Bank (2017, November)
65. Wodon, Q. et al. (2018).
66. Government of Uganda and UNICEF (2017).
67. The ND-GAIN Country Index summarizes a country's vulnerability to climate change and other global challenges in combination with its readiness to improve resilience.

Figure 25: Reported incidence of shocks (past 12 months)

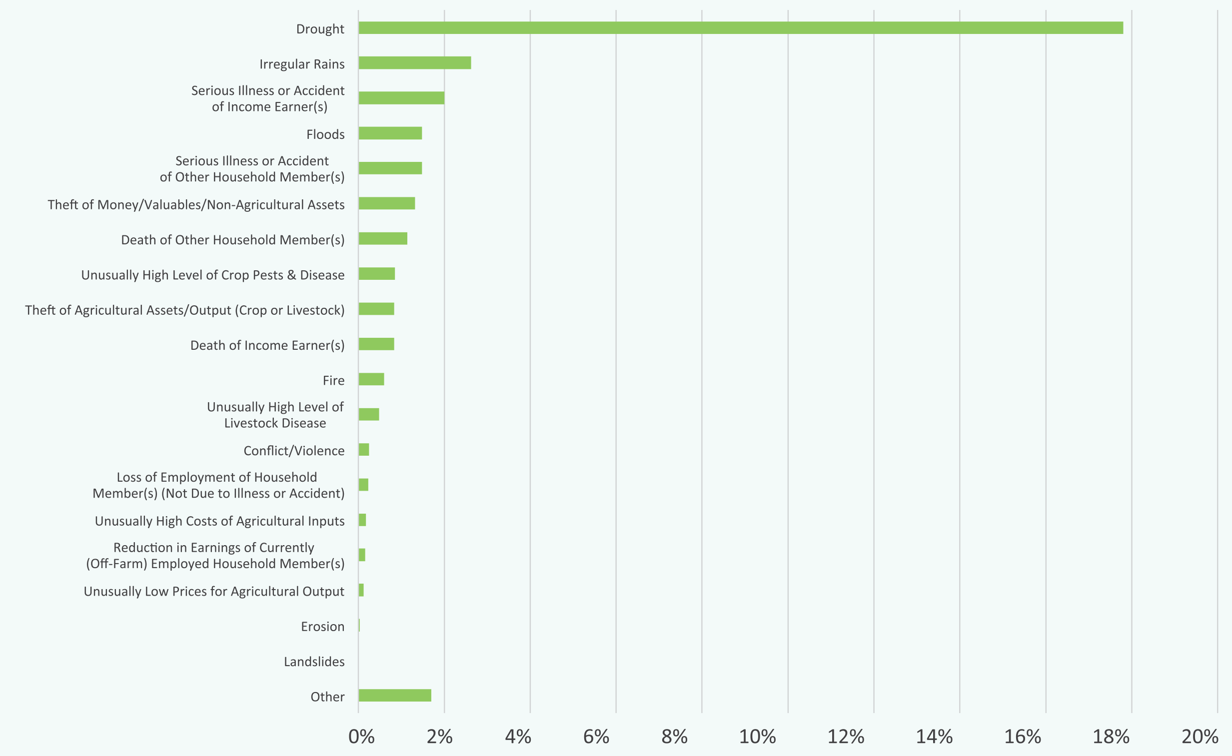
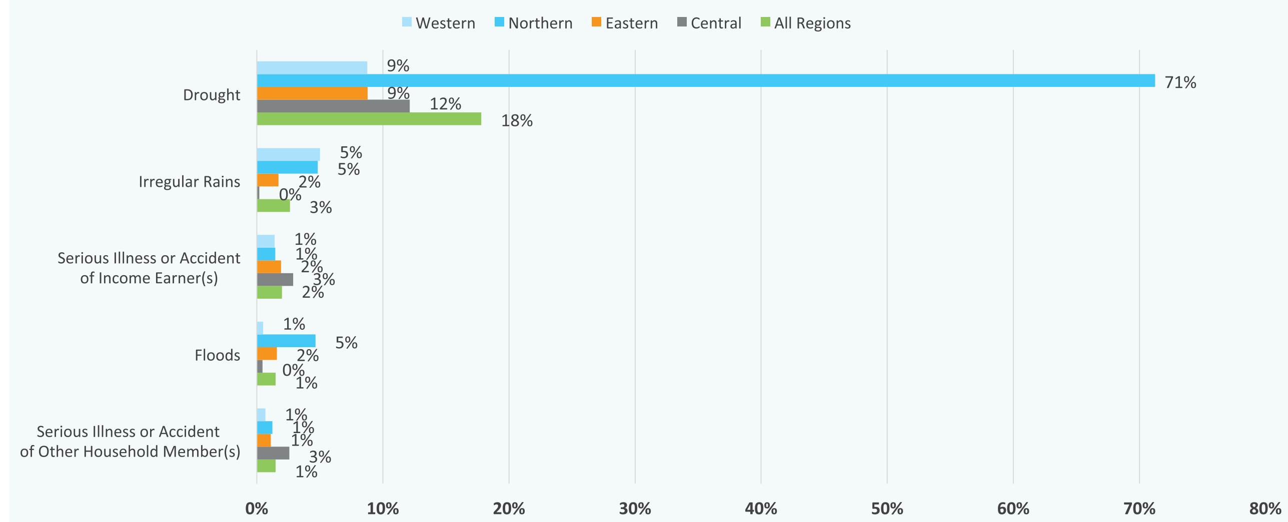


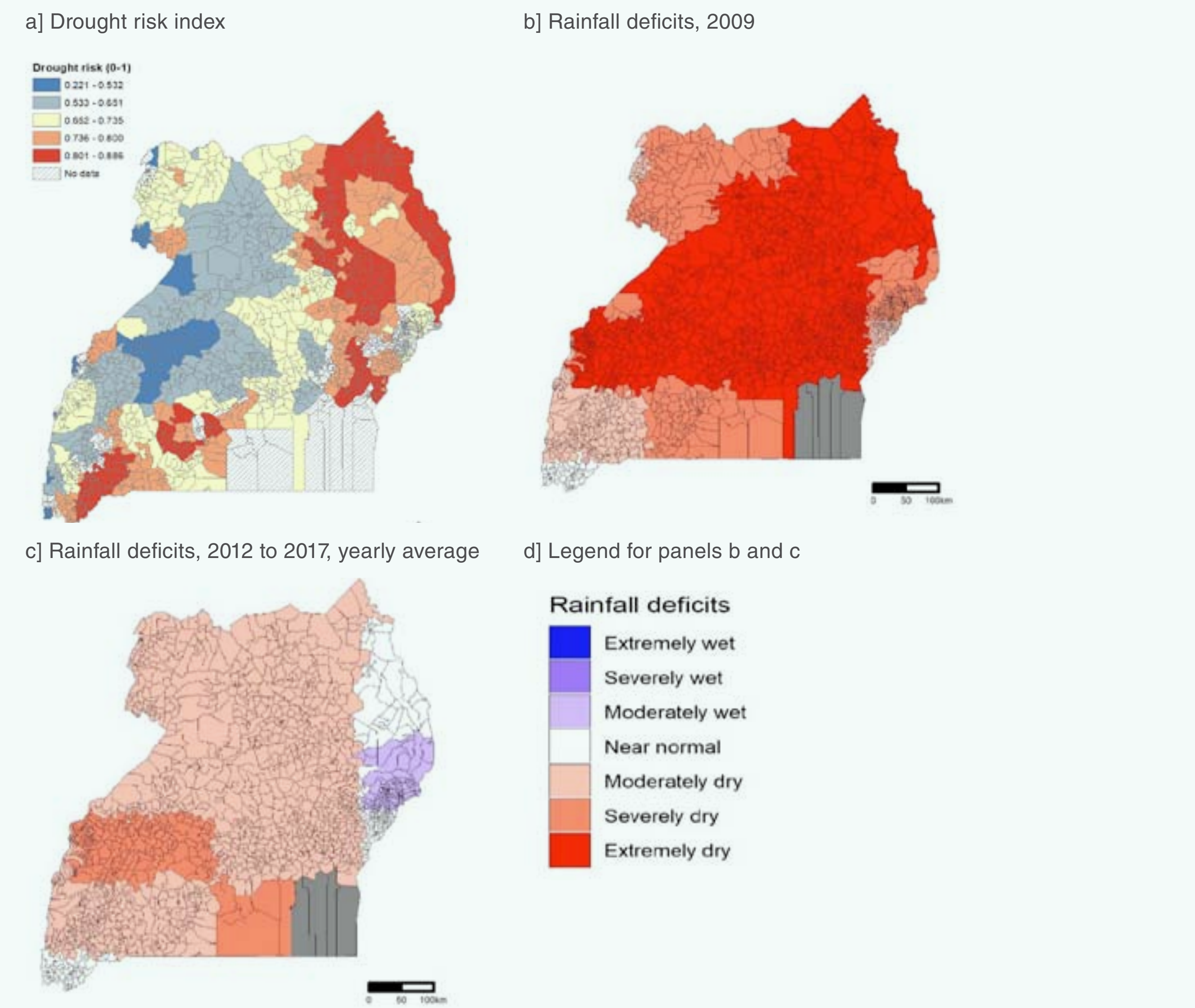
Figure 26: Top 5 reported shocks by region (past 12 months)



Source (for both figures): Author's calculation using the Uganda National Panel Survey (UNPS) round 2014/2015

68. Office of the Prime Minister (2012) pp 14.

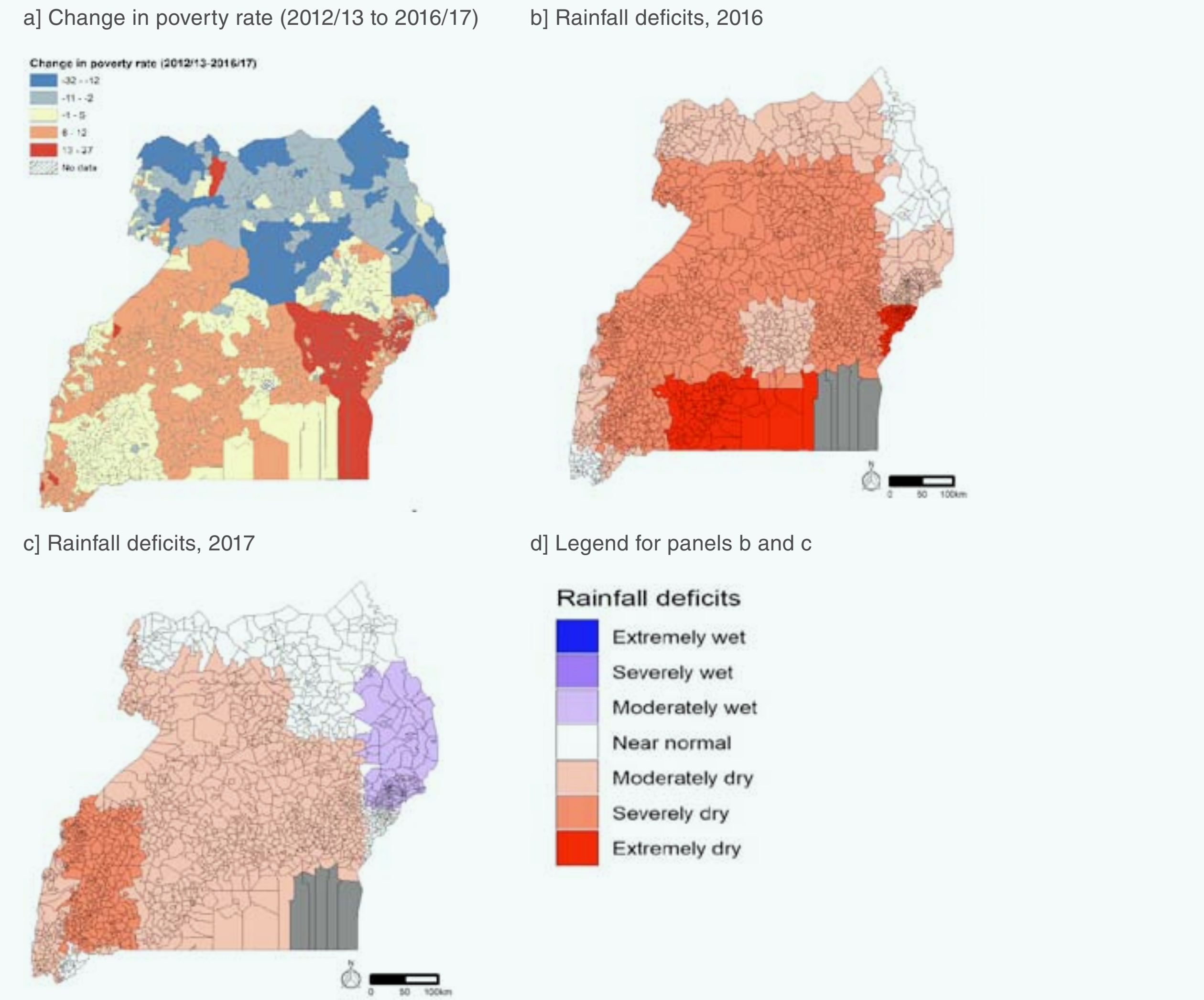
Figure 27: Historical drought risk, the drought of 2009, and rainfall deficit in more recent years



Source: Drought risk from Carrão et al.'s (2016) index of drought risks; Standardized Precipitation and Evaporation Index (SPEI) for annual rainfall deficits information

Although the drought that occurred in 2016/17 affected a large part of Uganda, the Northeast was one of the less affected regions. The most recent drought occurred in 2016/2017. Unlike previous drought episodes, rainfall deficits in 2016 led to extremely dry conditions in the southeast and southern parts of Uganda (see Figure 28, panel b). While much of the rest of Uganda was also severely dry, the northeast experienced near normal rainfall. Likewise, in 2017, the northern and northeastern parts of Uganda experienced near normal to moderately wet conditions, while other parts of Uganda experienced moderate to severely dry conditions (see Figure 28, panel c). The 2016/17 drought's seemingly abnormal pattern had large impacts on the welfare of people in various regions of Uganda (see Figure 28, panel a).

Figure 28: Drought of 2016 and poverty impacts



Source: Authors' calculations based on the 2014 Census, UNHS 2016, and Standardized Precipitation and Evaporation Index (SPEI) for annual rainfall deficits information

Overall, poverty increased in Uganda between 2012 and 2016, albeit with significant regional variation, and while the poverty headcount decreased significantly in the north, it increased in the east of the country. The latest round of available data shows a statistically significant increase in poverty in Uganda from 19.7 percent in 2012 to 21.4 percent in 2016. The overall increase was mainly explained by the increase in rural poverty, which went up from 22.8 to 25.3 percent over the four-year period.[69] Additionally, the percentage of subsistence farmer-led households that are poor increased from 20.3 to 38.2 percent between 2012 and 2016.[70] This increase in poverty is largely explained by drought and pests that affected the agricultural sector and particularly impacted rural households. As can be seen in Figure 28, panel a, the poverty rate declined in the north of the country and increased in the east. It is striking to see that regions with a reduction in poverty also seemed to enjoy near normal rainfall in 2016/17. Regions that experienced more extreme and severe dryness saw the poverty rate increase.[71]

Existing social safety nets and Adaptive Social Protection (ASP) systems are critical for responding to shocks. The orthodox approach to dealing with disasters in Uganda has been to provide emergency aid after the disaster hits, largely in the form of food. This is not very cost effective and often reaches the affected community too late to address the immediate aftermaths

69. World Bank (2019, March).

70. Uganda Bureau of Statistics Household Survey, 2016/17.

71. There are several reasons for the pattern of change in the poverty rate, and rainfall deficits may be one part of the answer. The northern parts of Uganda have also experienced peace over the last decade following conflict, which may be yielding dividends. Finally, a small part of the strong performance of the northern region in reducing poverty could be due to the disaster risk financing (DRF) component under the Northern Uganda Social Action Fund (NUSAF) 3 project.

of the shock. To reduce the costs of disasters and to equip households to be less vulnerable to all manners of shocks, it is important to set up ex-ante ASP systems. Underlying social assistance architecture, such as existing social assistance programs that target the poor and vulnerable, provide reliable registries, and identify existing beneficiaries of social protection programs, can help with efficient scaling up in response to shocks. ASP systems can also provide adequate and regular benefits to build household resilience, alongside programs with capacity for rapid expansion following shocks. The rapid expansion of the programs in response to a crisis is also dependent on 'adaptive financing' that may be rapidly, efficiently, accurately and objectively triggered under a national disaster risk financing strategy following a shock.

The current NUSAF 3 Disaster Risk Financing (DRF) pilot is an example of a successful ASP system. The NUSAF 3 DRF aims to mitigate the impact of droughts in the Karamoja region by providing additional financing and scaling up of LIPW support. It has been triggered for three consecutive years and, since the DRF component's inception in the Karamoja sub-region, no food security crisis has occurred. An evaluation study shows that the mechanism enabled households to acquire food reserves to cushion against and mitigate the effects of droughts. By doing so, the mechanism allowed the government to save on emergency food aid that would have been needed in the absence of the DRF. Overall, the study estimated that the government realized direct savings of USh 9.6 billion against an overall emergency fund of USh 19 billion in FY16/17.

The current NUSAF 3 DRF pilot could be expanded to include: (i) other regions, (ii) different types of perils, and (iii) a larger number of direct beneficiaries. Expanding the scope of the DRF has fiscal implications. Simulations from the Uganda SPJ PER demonstrate that scaling up the DRF mechanism through LIPW, to include four sub-regions, (i.e. Karamoja, Acholi, Teso and West Nile) would cost an average of US$7.6 million per year, about a 13 percent increase of what was allocated to social development in the FY18/19 budget. There are examples from East Africa and beyond, which show how to structure financing in order to scale up adaptive safety nets. Kenya, for example, developed an innovative funding instrument to better respond to shocks (see Box 9).

Box 9 Kenya's National Drought Emergency Fund (NDEF)

The Government of Kenya has set up a National Drought Emergency Fund (NDEF) equivalent to US$20 million and managed by the National Drought Management Authority.

The NDEF enables immediate provision of funds for a variety of drought response interventions guided by the National Drought Response Manual, including emergency household payments via the National Safety Net Program (NSNP). Extreme drought or the vegetation condition index (VCI) triggers transfer payments to households within 2 weeks (over 20 monthly emergency payments have been triggered since 2015).

This approach embeds NDEF as a core government disaster risk financing instrument.

Source: NDEF regulations on the NDMA website

85%

of all farming households in Uganda are smallholder farmers, and the agricultural sector continues to be highly exposed to covariate risks

Considering that drought is the most dominant and widespread climatic shock in Uganda, agricultural insurance is also critical for reducing the vulnerability of households dependent on this sector for their livelihood. Given that 85 percent of all farming households in Uganda are smallholder farmers, and that the agricultural sector continues to be highly exposed to covariate risks, agricultural insurance is of critical importance – alongside other interventions such as investing in irrigation systems, and modernizing agriculture production and practices. However, limited access and the lack of an enabling environment are key reasons why agriculture finance and insurance remain at sub-optimal levels in Uganda.[72]

3.3.3 Geographic targeting of social protection programs in Uganda

Given the limited fiscal space for social protection in Uganda, it is critical to ensure that the sector's resources, including the potential expansion of some of the existing programs, are channeled to the areas that need them the most. This allocation should consider the potential for social protection programs to *both* address deficiencies in human capital *and* help mitigate the vulnerability of households to shocks. For example, LIPW is an effective instrument for both enhancing human capital formation and a cost-effective instrument to support households at risk of being exposed to droughts. Thus, it would be useful to understand which geographic areas emerge as priorities if the dual purpose of building human capital and responding to shocks is considered.

It is possible to combine the two criteria – human capital deficits and vulnerability to risks (particularly weather shocks) – into a composite index that can guide the geographical targeting of social protection programs. In order to respond with enough flexibility to focus on different aspects of human capital (e.g. education or health) and vulnerability (e.g. drought risk or recent incidence), we present two different versions of a possible composite geographical targeting index.

If the priority is to improve primary school attendance (thereby improving the education outcomes of children) and to reduce the vulnerability of households historically exposed to drought, the composite index would place equal weight on: a) the percentage of age-eligible children not attending primary school, and b) historical drought risks (see Figure 29, panel a). Under this scenario, most of the northern districts, particularly Karamoja, come out as high priority areas due to low school attendance, as well as the high likelihood of droughts affecting this region. Notably, parts of the western region – particularly the southwest – are also rated as high priority mainly due to their exposure to drought.

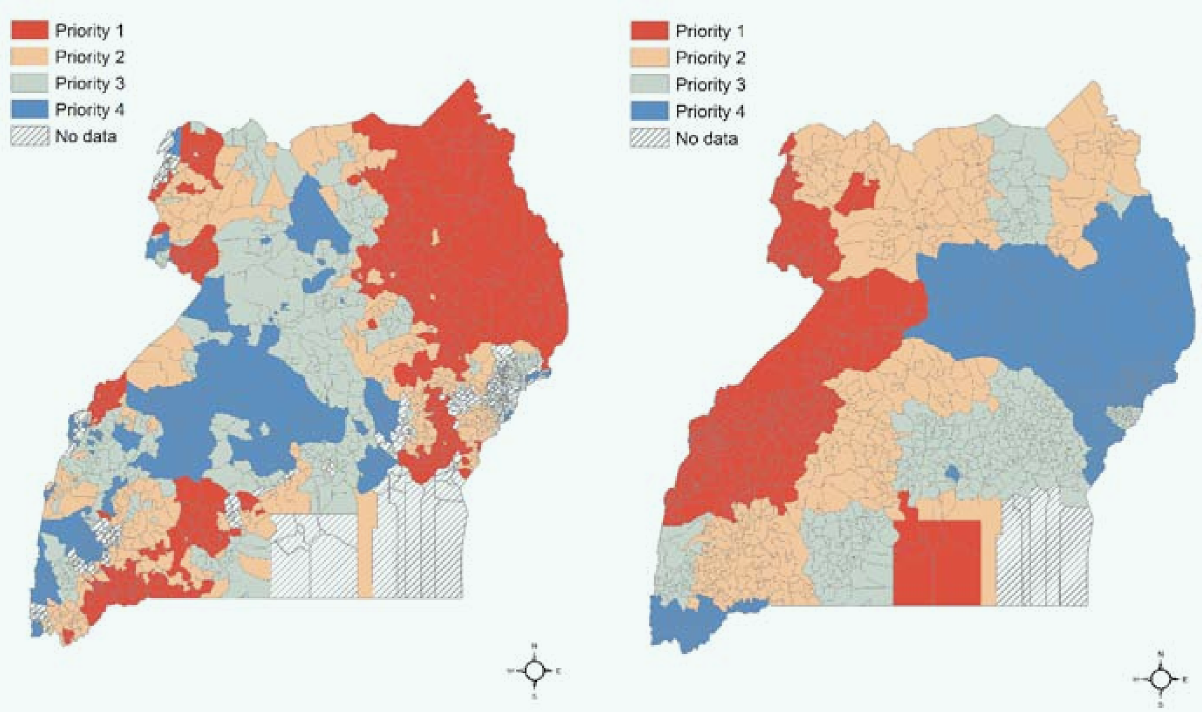
If the priority is to improve the nutritional outcomes of children and to support households that have recently suffered from weather shocks, the composite index would place equal weight on: a) human capital deficits measured by the percent of stunted children, and b) average rainfall deficits between 2012 and 2017 (see Figure 29, panel b). Based on these criteria, the western region and the sub-region of West Nile emerge as priority areas due to relatively high stunting rates and recent episodes of rainfall shortages. Ultimately, it is the choice of the policy maker on which aspect of human capital investment and what type of vulnerability to prioritize.

72. The "Towards Scaled-Up and Sustainable Agricultural Finance & Insurance in Uganda. World Bank. 2019" study delves in-depth into the gaps in agricultural finance and insurance, and provides detailed recommendations on how to improve the current systems.

Figure 29: Guiding the geographical targeting of social-protection programs

A] Composite index based on school enrollment and drought risks

B] Composite index based on child stunting and recent rainfall deficits



Sources: School enrollment and drought risks are measured by the share of children aged 6-12 not attending school (2012 Population Census) and Carrão et al.'s (2016) index of drought risks.

Sources: The percent of stunted children under 5 is based on the 2016 Demographic Health Survey (DHS). Recent rainfall deficits are measured based on the average of the Standardized Precipitation and Evaporation Index (SPEI) for the period 2012 to 2017.

Given Uganda's predominantly youthful population, all aspects of human capital formation, including interventions to reduce stunting and improve school enrollment and quality of education, need to be ultimately addressed. Accelerated human capital development has strong implications for long term growth rates and poverty reduction. Investments in physical capital (e.g. infrastructure) can increase growth rates in the short to medium term, but sustained rates of inclusive growth can only be achieved if investments in physical capital are balanced with investments in human capital. Moreover, it is important to begin investments in human capital immediately, since such investments take time to bear returns. For example, reducing stunting levels among those born today will result in increased growth rates in 15 to 20 years when they join the labor force. To help prioritize, human capital development (though social protection programs) can initially focus on the poorest people within the geographical areas that are lagging the most.

3.4 Conclusions and recommendations

Social protection programs, if well designed and implemented, represent an investment in national development and strengthen the social contract between the state and its citizens. They have been shown to enhance economic growth through a healthy and productive workforce, support economic transformation, and increase agricultural productivity, local economic activity, and the impact of investment in other sectors. For example, these programs can increase human capital development – complementing investments in health and education – by helping people meet the costs of accessing health and education services and supporting them in eating regular and nutritious meals.

The existing social protection programs in Uganda, addressing both direct income support and social insurance, have low coverage and receive limited funding. The overall coverage of the two main direct income support programs reach only 3 percent of the population – which is very low given the needs in the country. For instance, direct income support reaches more than 6 percent of the population in neighboring Kenya. Financial support for the social protection sector is also limited in Uganda. Overall expenditure on direct income support was just 0.14 percent of GDP in FY17/18. By comparison, neighboring countries like Kenya and Rwanda spend 0.4 percent and 0.3 percent of GDP, respectively, on direct income support.[73]

Investing in social protection programs can reduce the burden of multiple vulnerabilities amongst Ugandans. The existing social protection ecosystem is insufficient to effectively respond to the large and varied deprivations in the country. There is, therefore, a need to systematically expand existing pilot programs towards more national social protection programs. Moreover, and given the limited fiscal space, investments in the sector need to be focused on priority areas and to also consider the appropriate mix of programs that would lead to inclusive growth and reduce vulnerability.

Social protection programs provide a means for cost-effective support to people affected by covariate shocks such as drought and floods. There is increasing global interest in using the architecture put in place for social assistance and insurance to help with the management of covariate crises, such as drought, crop devastation or floods. Social protection also provides a means to support those affected by forced displacement. Developing ASP systems that rapidly expand when needed enables communities to better respond to unforeseen shocks.

This report recommends that:

a) **Direct Income Support be expanded to support investments in human capital and to help mitigate shocks.** Programs can be designed to provide direct support to households with children, enabling them to invest more in human capital formation and development. Considering the long-term benefits from investing in children, such programs are desirable. Simulations show, for example, that programs covering the poorest 50 percent of households with infants under 2 would cost an estimated 0.23 percent of GDP, whereas similar programs covering the poorest 50 percent of all households with children under 5 would cost 0.50 percent of GDP. Given the former program would be a 137 percent increase in the FY18/19 social development budget, it may be more feasible to initially target such interventions.

73. Ministry of Gender, Labour and Social Development (2018, May).
74. The "Towards Scaled-Up and Sustainable Agricultural Finance & Insurance in Uganda. World Bank. (2019, August)" study delves in-depth into the gaps in agricultural finance and insurance and provides detailed recommendations on how to improve the current systems.

- **b) Existing disaster risk financing pilots are scaled up to better prepare for drought and mitigate other shocks.** The design of social protection programs should consider the nature, frequency and geographical location of large-scale shocks faced by Ugandan households. Expanding DRF models, based on other country (Kenya) and local (NUSAF 3 pilot DRF component) examples, is recommended. The objective of this expansion would be to: (i) reach more people, (ii) address different types of perils, including floods and mudslides, and (iii) ensure adequate regional coverage in relation to shocks, given that these occur on a national level. Scaling up of the current pilot interventions will require additional financing, and the consideration of different financing mechanisms.
- **c) Given the limited fiscal space, social protection expansion is focused on the poor and vulnerable in the neediest geographical areas.** The regional variation in Uganda's HCI and the risks that are presented in this report can provide government with an initial evidence base to prioritize these investments. This could then support better targeting of the most vulnerable groups and regions, and those facing the highest levels of risk.
- **d) Given that drought risks predominate, and considering that households engaged in agriculture are most affected by such risks, agricultural insurance is scaled up**. This would include expanding the scope of the UAIS to support the transformation of the agricultural sector.[74]
- **e) To improve the take-up of voluntary savings schemes by informal sector workers, fiscal incentives are provided.** Better designed and more relevant savings products can be attained through a deeper appreciation of the heterogeneity of informal sector workers and by understanding savings patterns, risk coping strategies, and the intrinsic value these households place on old-age savings. More appropriate products may then encourage savings among informal sector workers. The government could also consider providing fiscal incentives to achieve mass-scale uptake of such schemes by informal sector workers.

3.5 A final word: Prioritize improvements in child stunting, school enrollment, and learning outcomes

For Uganda to benefit from its demographic dividend, it is critical to invest in the human capital of the current cohort of both infants, to reduce stunting, and children, to improve education and skills outcomes. This would mean prioritizing the sub-regions of Acholi, Bunyoro, Busoga, Elgon, Karamoja, Lango, Teso, Tooro and West Nile for the geographic expansion of social protection. Scaling up of the LIPW scheme to support poor families that are not labor constrained would be appropriate in these sub-regions – in highland areas to reverse alarming soil erosion and land-slides – in dry areas to create water points and build resilience to withstand future drought – in wet areas to protect land and communities from flooding, and so on. Direct income support could be extended to poor families with infants and children that are labor constrained and that cannot participate in LIPW activities. Such direct income support would be complimented by services aimed at improvements in early childhood development.

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