



IN THE GUISE OF ECONOMIC GROWTH:

IMPACT OF GOVERNMENT GUARANTEED LOANS TO PRIVATE ENTERPRISES IN THE TEXTILE INDUSTRY IN UGANDA

**Case study: Phoenix Logistics
Project and Apparel Tri-Star
Uganda Ltd**

August 2014



Acronyms

AGOA	African Growth and Opportunity Act
ATS	Apparels TriStar
BoU	Bank of Uganda
DFCU	Development Finance Company of Uganda
FY	Financial Year
IDA	International Development Association
IFC	International Finance Corporation
IDB	Islamic Development Bank
IUIU	Islamic University in Uganda
MoFPED	Ministry of Finance, Planning and Economic Development
NRM	National Resistance Movement
UBOS	Uganda Bureau of Statistics
UDB	Uganda Development Bank Limited
UDN	Uganda Debt Network

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Introduction

The private sector often operates without the full control of Government usually with the ultimate goal of profit maximization. Private enterprises in Uganda are spread over a wide range of sectors including education, health, agriculture and banking where goods and services are provided with a view of maximizing efficiency compared to public service. In most cases, however, they are more costly since the sector works towards profit maximization, a factor which pushes some consumers, especially the rural poor to settle for low quality public goods and services. An active private sector is very crucial to the economic development of the country as it creates employment, offers better quality services and if well managed, steers socio-economic growth of the country.

In Uganda, the private sector has contributed to the fast economic growth experienced since 1986 when the NRM Government came to power and created a relatively conducive investment climate. According to an Investor Survey Report by UBOS (2011), some of the major factors that have influenced investment in Uganda are the favorable macroeconomic and political stability (74%); access to domestic and regional markets (65%) and affordable labour (56%)¹. However, some private sector firms have abused this opportunity in doing business to the disadvantage of Ugandan citizens. To this effect, UDN undertook an analysis to establish the contribution of two private enterprises in the textile industry i.e. Phoenix Logistics Project and Apparel Tri-Star (ATS) Uganda Ltd in ensuring economic growth in Uganda.

Overview of Uganda Debt Network (UDN)

UDN is a policy advocacy organization working to promote and advocate for poor and marginalized people to participate in influencing poverty-focused policies, demand for their rights and monitor service delivery to ensure prudent, accountable and transparent resource generation and utilization. To this end, UDN wishes to see public resources efficiently and effectively managed for the benefit of all citizens.

UDN was formed in 1996 as coalition of organizations and individuals to campaign for debt relief for Uganda, under the Highly Indebted Poor Countries (HIPC) Initiative of the WB and the IMF, where Uganda became the first beneficiary of the initiative. The organization works in 24 districts and in 83 sub-counties at the local levels with Local Governments, Civil Society Organizations and Community Based Organizations. At the national level, the organization engages with various Government Ministries, Departments and Agencies among including Parliament, Bank of Uganda, MoFPED and Ministry of Local Government; on issues of service delivery, public sector accountability, budget processes and

¹ UBOS Investor Survey 2011 Report –Harnessing Private Investment for Socio-Economic Transformation, p.11

policy options. This review establishes the impact of government loan guarantees to private state enterprises to the economy and provides recommendations for consideration by Parliament for their effective management.

Justification for Government Guarantees to private enterprises

Given the crucial role of the private sector in the economic growth path of the economy, it is imperative that Government accords the necessary support to strengthen the sector. Through loan guarantees, Government has on several occasions supported the private sector to ease their access to finances to grow their enterprises. In the process of loan acquisition by private enterprises, Government assumes the debt obligation on behalf of the borrower and binds itself to pay the loan in the event that the borrower defaults on loan repayment. As a result of Government's guarantee of the loan, the borrower therefore benefits from the favorable terms offered like lower interest rates, which they would otherwise not obtain by borrowing on their own. Often, without the Government guarantee, the loan cannot be approved besides the high interest rate it can attract due to the high default risk compared to interest charged on a loan guaranteed by government.²

Government on the other hand usually supports investors with a view that their contribution to the economy which include creating employment and widening the tax base.. These were equally the expectations of Ugandans when the Government guaranteed loans for Phoenix Logistics Project and ATS Uganda Ltd.

Legal Provisions to effect government Loan Guarantees

Article 159(2) of the Constitution of the Republic of Uganda (1995) gives the Government the mandate to guarantee loans for public institutions but this is subject to the authorization of Parliament. The Public Finance and Accountability Act (2003)³ also authorizes Government to guarantee loans for state enterprises and Local Governments in the interest of the public and with the approval of Parliament. Government is expected to give accountability and provide annual reports to Parliament on loan guarantees and grants to individual companies and Statutory Corporations according to Article 159(4) of the Constitution and section 13(1), (2) and (3) of the Budget Act (2001). This means that in the event of default in payment by the borrower, Government, as a guarantor is expected to re-pay the outstanding loan balance using money from the consolidated fund as stipulated under section 28 of the Act. However, this kind of spending diverts resources from the consolidated fund which would otherwise have been used for public investment. There is also a high possibility that the borrower may default and fail to pay back the loan hence causing financial loss of tax payers' money.

² <http://earthtrack.net/depth-government-loan-loan-guarantee-and-insurance-programs>

³ section 25

What is the Problem?

Whereas there is no legal provision for Government guarantee loans for private sector players, the State on the contrary has gone ahead to guarantee loans to private sector companies. The 2011/12, 2012/13 and 2013/14 Financial year reports indicate that the Government has been guaranteeing loans for private and state enterprises⁴.

The table below shows current government guarantees as at March 2014

CREDITOR	PROJECT	YEAR OF ISSUE	BENEFICIARY	AMOUNT (USD)
BoU	Apparel Tri-Star	2010	Apparel Tri-Star	6,037,986
International Finance Corporation	Partial Risk Guarantee for Bujagali Project	2007	Bujagali Energy Ltd	115,000,000
International Development Association	EA Trade & Transport Facilitation	2006	Rift Valley Railways	10,000,000
Islamic Development Bank	Student Hostels Project	2009	IUIU	5,214,000
Islamic Development Bank	Student Hostels Project	2010	IUIU	567,000
Uganda Development Bank Limited	Apparel Tri-Star	2010	Apparel Tri-Star	3,060,636
TOTAL				139,879,622

Source (MoFPED)

Secondly, Government guaranteed loans are characterized by high default rates as a result of investment in high risk ventures arising from the less stringent risk assessment prior to approving the loans.⁵ Unfortunately, defaults on Government guaranteed loans are paid out of taxpayer monies leading to wastage of resources that would have been spent on providing quality service delivery⁶. It is highly probable that this is because there was no binding legislation authoring Government to guarantee loans for private sector enterprises which led Phoenix Logistics and ATS Uganda Ltd to default. UDN therefore analyzed Government loan guarantees to these companies both which were private sector enterprises in the textile industry⁷.

⁴ As reported in the reports on public debt, grants and guarantees by the MoFPED to Parliament for in FY 2012/13 and FY 2013/14.

⁵ <http://www.eoearth.org/view/article/1153067/>

⁶ Construction of better roads, increase funding in the education sector for Ugandans to access better quality education, as well as equip hospitals for better health.

⁷ Report on Public Debt, Grants and Guarantees for Financial Year 2013/14 presented to Parliament by Hon. Maria Kiwanuka, Ministr for Finance, Planning and Economic Development, 12th June 2014 at p.22.

UDN Concerns

Government loan Guarantee to Phoenix Logistics Project

Phoenix Logistics Project was created by the Japanese Prime Minister to assist Japanese doing business in Africa. In Uganda, Government was required to guarantee the loan and in 2000, the Company acquired a Shs4.2 billion loan from UDB to create capacity in handling modern equipment in the production of textiles in Uganda.¹ However, the company failed to service the loan and the interest accumulated to Shs5 billion. In March 2008, with the President's intervention, Parliament voted to write off the debt which Government converted into shares in anticipation that the move would enable Uganda to establish herself in the lucrative organic cotton market². This was already a loss to Ugandans since the Government was required to pay the loan from the consolidated fund.

Yet in 2009, Government again guaranteed Phoenix Logistics to acquire an additional Shs 1.349 billion through Cotton Development Organization to facilitate value addition to cotton lint³. Government considered this as a strategy to invest in value addition to cotton lint since the company had already accessed the US market by exporting textiles under the AGOA arrangement⁴.

Issue:

Government guaranteed another loan to this defaulting firm and granting it a tax waiver hence exposing more public resources to risk and eventual loss⁵. In addition, the Ministry of Finance wrote off Shs3.7 billion in unpaid taxes and Phoenix Logistics (U) Ltd was among the companies listed as beneficiaries under the scheme.⁶ At this point, Government loss was compounding with no anticipated benefits achieved. In the end, Phoenix Logistics is one of the Projects where Government was called upon to pay a loan amounting to \$5.5 million to JBIC (Japan Bank for International Cooperation) in FY 2012/13 in fulfillment of its obligations under the loan guarantee⁷.

Government loan guarantee to Apparel Tri-Star Uganda Ltd

ATS Uganda Ltd, a textile firm was incorporated on 22 April 2002 as a public limited liability company with a view of exporting cotton products to the United States of America⁸. It was operating under AGOA which provided a duty-free⁹ and quota-free¹⁰ access to United States markets for Sub-Saharan

1 <http://www.monitor.co.ug/News/National/1688334/1331168/-1b09dwqz/-index.html>

2 Ibid.

3 The Hansard, Thursday 7th May 2009

4 The Hansard, Thursday 7th May 2009.

5 The tax waivers came at a time when Government was facing financial distress and was struggling to find Shs7 billion to treat children stricken by the nodding disease that had claimed hundreds of lives in northern Uganda. It was also the period when Uganda Revenue Authority had registered a shortfall of more than Shs78 billion and no sustainable jobs were created by this 'investment' hence further limiting the tax base. Refer to: <http://www.monitor.co.ug/News/National/1688334/1331168/-1b09dwqz/-index.html>

6 Ibid

7 Report on Public Debt, Grants and Guarantees for Financial Year 2013/14 by MoFPED

8 The Hansard, Wednesday 12th May 2004.

9 Exempt from customs duties / Of, relating to, or being a region or establishment in which imported goods are exempt from customs duties

10 without any limit on the amount of particular goods that can be imported or exported

Africa. The textile sector was targeting to benefit from this initiative where Government encouraged farmers to grow more cotton since there would be a ready market to increase their income through providing raw materials to the firm. It was envisaged that increasing value addition on cotton products for export would also increase export earnings for Uganda. If this arrangement was managed as required, the objective to spur the country's growth and development would have been achieved. However, the opportunity was squandered.

Government signed a Memorandum of Understanding with ATS Uganda Ltd and extended extraordinary incentives to the company which included subsidized railway transport, tax holidays and free premises which were part of the former Coffee Marketing Board Ltd (CMBL) complex. In addition, converting the premises to suit the textile factory cost Government approximately Shs5.8 billion in addition to paying for the recruitment and feeding of the staff working there¹¹. The company also had two shareholders, (Kumar and Velupillai Kananathan) who had 900 and 100 shares each respectively and were paid between US \$3,000 to US \$6,000 per month. Mr Kananathan was also paid US \$2,000 in allowances per month as the Managing Director. All this money was not taxed in accordance with the Income Tax Act-Uganda, Cap.340. This was already a heavy cost on citizens' tax through Government¹².

Issue:

Uganda has a number of tax exemptions, incentive laws and regulations to ensure favorable conditions for investors to start projects and create employment, increase supply and proper use of available resources. Government provides large tax incentives to investors with a view to attract Foreign Direct Investment. It is mostly the large domestic firms and foreign multinationals benefiting from the initiatives while citizens who own businesses hardly benefit. This creates unfair competition between companies (both local and foreign), hurts the domestic revenue base and the tax burden is shifted to citizens. For example, in a report by SEATINI (2012), World Bank (2007) also noted that Government made tax interventions to ATS (U) Limited by investing US\$ 11 million, approximately UGX. 25 billion in form of subsidies, loan guarantees, premises and incentives but two years later, the factory was closed leading to loss of taxable income. The report further indicates that Uganda loses an average of 5% of its current revenue to tax incentives and exemptions. Another report by African Development Bank estimated that for the FY 2009/10; Uganda lost about UGX 690 billion (US\$ 272 million) in tax exemptions. Without the exemptions, the tax revenue as a percentage of GDP could reach 16.15%.

11 The Hansard, Wednesday 12th May 2004

12 Ibid.

Woes of ATS Uganda Ltd

During one of the Parliamentary sessions in May 2004 (captured in the Hansard, Wednesday 12th May 2004), it was revealed that upon investigation by the Presidential Advisor on AGOA, Mr Onegi Obel and Parliament that;

- i. The company was poorly managed and characterized by lack of professionalism on the part of the Managing Director, Mr Velupillai Kananathan.
- ii. There was non-existence of a company Board of Management, employees working conditions were not favorable. For instance, they were poorly remunerated and there the factory had inadequate sanitation facilities.
- iii. The Majority of the labor force at the factory were Ugandan except at supervisory level which was dominated by Sri-Lankans. The Sri-Lankans had a communication problem since most of them did not understand or speak English.
- iv. Workers lacked protective gear and masks to guard them from fumes and dust generated during the production process.

On the basis of the above conditions, Government ignored the advice by the Presidential Advisor on AGOA to take over the company in order to minimize the risk of losing her investments in the company. The firm collapsed and was closed in 2006. Billions of taxpayers' money was spent on the project but has never been recovered. The Auditor General declined to verify and certify the company's financial status. However Parliament started investigating the firm for allegedly mismanaging the factory and misusing a \$22 million loan. The process was interrupted when the Attorney General requested that the investigation be stopped since there was a pending court case over the same matter. The investigation was then abandoned to date.¹³

Issue:

Even with mechanisms and institutions in place to control and alert Government of her actions to support a defaulting firm, the State provided more support.

¹³ <http://www.theeastafrican.co.ke/news/-/2558/519104/-/view/printVersion/-/m9lghh/-/index.html>

Recommendations:

1. **Parliament should;**

- a) Follow up on the ATS Uganda Ltd case to its final conclusion. Parliament can write to court seeking to know the stage at which this case is with a view of concluding it and recovering taxpayers' money.
- b) Legislate a law to guide the approval of loans that are guaranteed by Government to both private and public enterprises as a control mechanism to safeguard citizens' funds. It would also help the country reduce debt accumulation.
- c) Revise legislation on tax system on exemptions, incentives and holidays to investors to widen the tax base for revenue collection by URA. This will improve the tax management system to enable the mobilization of local resources and increase domestic revenues to finance development projects. Tax incentives especially tax holidays are not a prerequisite for attracting Foreign Direct Investment.

2) **Before approving a Government guaranteed loan to private or public enterprise, Parliament should determine that;**

- a) There is a government representative on the management team of companies benefiting from government guaranteed loans to safeguard public interests of increasing growth opportunities in the country.
- b) Government guaranteed loans to public and private institutions (when a legislation is in place) will be used to support enterprises right from the production to exporting level rather than concentrating on financial support at the final stage of the process. The enterprise being supported should be assessed to cause backward linkage i.e. there should be a clear possibility of purchasing raw materials from Uganda's local producers and there should be a stable and ready market for the products. This requires adequate appraisal of the project and loan request as it's an avenue for value addition in the production chain as well as providing employment to citizens. It will also act as a strategic intervention for increasing citizens' income, promoting the fight against poverty thus enhancing economic growth and development.
- c) The enterprise has adequate staff and capacity to manage operations, 70% of whom will be Ugandans and that the working conditions will be favorable.
- d) The rate of the company's earnings should be evaluated to ensure that it's commensurate to the level of investment to be able to repay the full loan.
- e) Local firms do not have the capacity to match the business ventures that foreign firms intend to establish in Uganda. For instance, local textile firms like Southern Range-Nyanza Textiles and Eladam Enterprises were doing better even without support from Government compared to Phoenix Logistics and ATS Uganda Ltd that received financial support.

Conclusion

Government loans guarantees to the two firms turned out to be a bad deal for the country. Instead of contributing to economic growth and development, the firms only sucked money from the treasury. There was no tangible contribution in terms of investment and tax since the beneficiary companies enjoyed tax exemptions. On the other hand, both ATS Uganda Ltd and Phoenix Logistics provided high level employment opportunities for Sri-Lanka citizens at the expense of Ugandans who were poorly remunerated with poor working conditions.

In light of the fact that the majority of Ugandans heavily rely on agriculture, it is imperative that government becomes sensitive to protect the rights of citizens. It should also support sectors like agriculture by subsidizing the cost of farm implements instead of spending the country's resources on opportunistic investors who make no tangible contribution to the country's growth¹⁴. The tax system has also favored foreign investors who enjoy tax exemptions at the expense of local investors which affects domestic revenue mobilization which causes economic and social stagnation. Strategic interventions in any sector should not be discriminatory since such an approach destroys the spirit of investors who are already in business and ultimately deters investments.

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¹⁴ <http://www.africanexecutive.com/modules/magazine/articles.php?article=2043>

VISION

A Uganda where public resources are prudently, sustainably and equitably managed.

MISSION

To generate advocacy expertise that influences people-based and accountable public resource management in Uganda.



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