

# Oil for Uganda – or Ugandans? Can Cash Transfers Prevent the Resource Curse?

**Alan Gelb and Stephanie Majerowicz**

## Abstract

In 2009, commercially exploitable reserves of oil were found in the Albertine Lakes Basin in Uganda. Along with a number of new oil exporters, Uganda now faces the challenge of using the new resources to advance its development agenda, while avoiding the corrosive effects oil often has on governance. This paper considers the tradeoffs and potential impact of alternative uses of the oil rent. It argues that alternative approaches towards absorbing rents should be judged from two perspectives – the direct impact on growth and living standards, and the indirect effect on governance. The Ugandan authorities favor using the oil revenues to build much-needed infrastructure; while this could have very large benefits, evidence of Uganda’s already deteriorating governance and mounting corruption raise questions about its capacity to wisely invest the oil revenues. This paper considers an alternative—distributing oil rents to the population through cash transfers—as a potential tool to mitigate some of the governance risks associated with oil revenues by giving Ugandan citizens a stake in their own resource wealth, and considers the strengths and limitations of such an approach.

**JEL Codes:** O13, I38, Q32, H20

**Keywords:** Oil Rents, Resource Curse, Cash Transfers

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Alan Gelb  
Center for Global Development

Stephanie Majerowicz  
Center for Global Development

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**Center for Global Development  
1800 Massachusetts Ave., NW  
Washington, DC 20036**

202.416.4000  
(f) 202.416.4050

**[www.cgdev.org](http://www.cgdev.org)**

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*"I have made revenue collection a frontline institution because it is the one which can emancipate us from begging, from disturbing friends... if we can get about 22 percent of GDP we should not need to disturb anybody by asking for aid....instead of coming here to bother you, give me this, give me this, I shall come here to greet you, to trade with you."*

*-Yoweri Museveni, President of Uganda, Washington DC, September 21, 2005.*

*"No one, in Uganda or internationally, can now doubt the country's steady and deliberate path to a middle-income country status in the near future...This is more so with the reasonable discoveries of oil, which, without any doubt, will accelerate our progression to middle-income country status... With the recent discoveries of oil in western Uganda, the country's prospects for domestic revenue and self-reliance in financing public investments and programmes are much brighter today than any other time in the past."*

*- President Yoweri Museveni, National Address, October 9, 2009.*

## **I. Introduction**

Oil deposits had been suspected in the Albertine Lakes Basin on the border between Uganda and the DRC for over 80 years before the discovery of commercially exploitable reserves was confirmed in October 2006. In January 2009 British wildcat Heritage Oil, in partnership with Tullow Oil, announced details of a major find, possibly the largest onshore field in Sub-Saharan Africa and one far exceeding the 400 million bbl threshold needed for commercial viability. This find represents a major transformation in the outlook for Uganda, a landlocked low-income country heavily dependent on foreign aid, and with fuel costs reaching up to one fifth of its import bill. While future revenue estimates are highly uncertain, it is likely that the known fields alone could provide rents of up to 15% of GDP at peak and some 10% of GDP for a period of 20 years.

Will oil transform Uganda's development prospects? How should it be used? What are the implications for donors, who currently contribute in total some 11% of GDP to Uganda? The recent nature of the oil finds, as well as the fact that several years will elapse before oil flows and revenues become appreciable, means that the policy framework relating to these questions is at a very early stage of development. This paper considers the issues, and outlines arguments for alternative uses of the oil rent and their potential impact. It argues that alternative approaches towards absorbing rents should be judged from two perspectives – the direct impact on growth and living standards, and the indirect effect on governance.

In this context the paper considers the arguments for and against the hypothetical possibility of distributing oil rents to the population through a system of cash transfers. This option has attracted considerable international academic attention in recent years, drawing on the experience of Alaska, on recent research into the developmental impact of direct transfers, and on interpretations of state-building that place a central emphasis on the importance of a “fiscal compact” between the state and its citizens. While many oil states maintain large transfer programs in various forms, the direct individual approach has been implemented only in a limited way, including Bolivia’s pension system tied to natural gas receipts, and most recently in Iran where transfers have been initiated to compensate citizens for the withdrawal of costly fuel and food subsidies.<sup>1</sup> The question is hypothetical in the Uganda context because, even though legislation relating to the oil sector and the use of oil income is at an early stage, there are strong indications that government’s plans envisage a quite different use of oil rents, oriented towards growth-enhancing infrastructure investments and industrial development. Nevertheless, the question is still relevant not only for Uganda’s donors, who will need to consider whether to continue to support current sector programs using current support modalities, but also for members of Ugandan civil society and groups who may want to broaden the discussion of how to spend the oil rents. For those who want to hold the government accountable for the use of the oil revenues, cash transfers represents at least a benchmark.

## **II. Projected Oil Production in the Macro Context**

Estimates of Uganda’s oil reserves and income, like those of other countries, are subject to considerable uncertainty. In January 2009 Paul Atherton, chief financial officer of Heritage Oil, told *The Times* that the wider field it was developing, dubbed Buffalo-Giraffe, had several “billions of barrels of oil in place,” although it was unclear how much of this would be recoverable. Of the 18 wells the company had drilled in the basin so far, all had produced oil. “Clearly the entire basin is full of oil,” he said. “It’s a world-class discovery, the most exciting new basin in Africa in decades.”<sup>2</sup>

Nevertheless, it was recognized that it would take at least another three years to start commercial production, partly because of the difficulty of getting the oil to market. Crude could be exported by road or rail, but the most cost-effective solution would be to build an 806-mile pipeline to take it to Kampala and then the Kenyan coast. The pipeline would be a technological and security challenge however. It would need to be continuously heated to maintain the

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<sup>1</sup> India has also launched a massive program to provide citizens with identification as part of a major effort to reform wasteful subsidy systems.

<sup>2</sup> Previously, the largest onshore fields discovered in sub-Saharan Africa were at Rabi-Kounga in Gabon, where 900 million barrels were found in 1985, and at Kome in Chad, where 485 million barrels were found in 1977.

liquidity of the crude because of its “waxy” nature. It would have to traverse swamps and mountainous land and would cost an estimated \$1.5 billion to complete. While the reserves are expected to yield some 150,000-250,000 bpd for some 20 years, full-scale production and export would therefore not be reached until at least 2016.

Another option, and one strongly favored by the government, is to refine the oil near the production points, probably in the district of Hoima and, in the first instance, to sell the refined products into the local market. This could include not only Uganda, but Rwanda, Burundi and parts of Kenya, Tanzania and the DRC. Because of high transport costs fuels are very expensive in much of this region, about twice the cost at the coast. A study of the commercial viability of this option has been completed but not yet been released. It reportedly finds that a refinery of up to about 60,000 bpd would be commercially viable. This leaves open the question of how to market the rest of the oil. Should Uganda incur the double cost of building the refinery and the crude export pipeline, or limit production to local market needs? Could a larger refinery be built and refined product exported by reversing the flow through the current pipeline linking Kampala to the coast? These are still open questions. The possibility of refining oil for domestic use also poses the tradeoff in stark terms of whether to continue to price fuel at high current levels, which reduces the competitiveness of industry, or to reduce domestic fuel prices at the expense of fiscal revenues.

All of these factors increase the uncertainty over the size and timing of oil-related income. The dispute in late 2010 between Uganda and Tullow Oil on the capital gains tax payable with the sale of Heritage’s assets to Tullow may also delay planned moves to bring in CNOOC and ENI to partner with Tullow in the development of the reserves. Because of these factors, fiscal revenues from oil may turn out to be lower and farther off than initially thought. Yet they could also be larger, especially as much promising acreage has yet to be explored.<sup>3</sup>

With all these caveats, oil revenues on the order of those projected, at 10% of GDP, would certainly have a major macroeconomic impact on Uganda (Table 1). Economic growth has been high in the African context, averaging around 6.5% since the early 1990s. Even with one of the world’s highest population growth rates (currently 3.3%) this has enabled incomes to rise and contributed to a sustained fall in poverty, from over 50% in 1992/3 to 30% in 2005/6 (Table 2). Poverty has declined even more rapidly in the oil-producing region of Bunyoro-Kitara. New export sectors have emerged, including aquaculture and tourism. Nonetheless, like other low-income African countries, Uganda’s economy is still primary-based. Total investment is only

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<sup>3</sup> Reserves commonly continue to rise for an extended periods despite extraction, as activities in the oilfields lead to the discovery of new reserves; Uganda is likely to follow this pattern. Globally, proven reserves have continued to grow despite continued extraction and a decline in older fields in the United States and North Sea (Gelb, Kaiser and Vinuela 2011).

some 24% of GDP, domestic saving 13% of GDP and national saving 18% of GDP. In addition, fuel imports, which come through Kenya, have accounted for some 6% of GDP, so the indirect impact of eliminating them would be a major reduction in the import bill as well as a boost to energy security.

The fiscal impact would also be enormous (Table 3). About half of all aid (which in total amounts to 11% of GDP) goes through the budget, to finance a major part of development spending. About half of budgetary aid is provided in the form of project support and half as general budget support. If fully received by the budget, projected oil rents would therefore exceed the fiscal resources now provided by aid, and would be about three times larger than current levels of budget support. Oil income would almost equal the meager domestic revenues of 12.4% of GDP in 2008/9, collected through a Revenue Authority characterized in a recent study as “the second most corrupt institution in Uganda.”<sup>4</sup>

**Table 1. Macroeconomic Data (recent years)**

|                                   | 2000 | 2005 | 2008 | 2009 |
|-----------------------------------|------|------|------|------|
| Annual growth rate (%)            | 3.1  | 6.3  | 8.7  | 7.1  |
| Investment/GDP                    | 19   | 22   | 24   | -    |
| Domestic savings/GDP              | 8    | 12   | 15   | 13   |
| National savings/GDP              | 14   | 21   | 22   | 18   |
| Exports of goods and services/GDP | 11   | 14   | 24   | 23   |
| Imports /GDP                      | 22   | 25   | 32   | 35   |
| Fuels (% imports)                 | 17   | 20   | 19   | -    |

*Source: World Bank's World Development Indicators and African Development Indicators 2010.*

**Table 2. Income Poverty**

|                     | Uganda  |         |         | Bunyoro |         |         |
|---------------------|---------|---------|---------|---------|---------|---------|
|                     | 1992/93 | 2002/03 | 2005/06 | 1992/93 | 2002/03 | 2005/06 |
| Poverty Headcount   | 56.4    | 38.8    | 31.1    | 68.3    | 33.5    | 25.9    |
| Poverty Gap         | 20.9    | 11.9    | 8.7     | 26.9    | 7.7     | 5.9     |
| Severity of Poverty | 10.3    | 5.1     | 3.5     | 13.9    | 7.7     | 1.9     |

*Source: Kiiza et al paper (forthcoming).*

<sup>4</sup> African Development Bank 2010, p. viii.

**Table 3. Fiscal data**

|                        | 2006/07               | 2007/08 | 2008/09 |
|------------------------|-----------------------|---------|---------|
|                        | <i>Percent of GDP</i> |         |         |
| Revenue                | 12.6                  | 13.0    | 12.4    |
| Expenditure            | 18.2                  | 17.8    | 19.4    |
| Development spending   | 5.7                   | 5.5     | 7.7     |
| Balance (incl. grants) | -1.1                  | -2.1    | -3.7    |
| Grant financing        | 4.5                   | 2.7     | 4.1     |
| ODA                    | 16.0                  | 14.9    | 11.7    |

Source: IMF Country Report 2009.

### III. Is Uganda Vulnerable to the “Resource Curse”?

Studies of the “resource curse,” including some recently that cast a skeptical eye on the assumption that countries will be worse off with larger endowments of natural resources, have increasingly argued that the “curse” is conditional on initial country institutions rather than absolute (Mehlum, Moene & Torvik 2006; Acemoglu et al. 2001; Isham et al. 2003; Sala-I-Martin and Subramanian 2003). Countries with strong pre-existing institutions and capacity are not likely to be negatively affected by an influx of resource revenues; on the contrary, they tend to use them to strengthen capacity and institutions and increase incomes and welfare (Iimi 2006; Kenny 2010). On the other hand, countries that start off from weak institutional capacity and poor governance prior to the discovery of oil or large mineral resources are likely to fall victim to the curse. Oil revenues are likely to exacerbate these institutional weaknesses, leading to greater corruption and poor overall governance. From a “Wealth of Nations” perspective (World Bank 2010), the problem is therefore not the abundance of “natural capital” but the lack of complementary “governance capital” and “human capital” needed to make good use of it.

Examples of such diverging results can be found in Africa. Botswana, at one end of the spectrum, has used diamond wealth to boost capacity and strengthen governance (Iimi 2006; Acemoglu et al. 2001). At the other end of the spectrum are Africa’s traditional oil exporters, which sit as a group in the bottom decile of governance indicators worldwide (Gelb and Turner 2007). In such “bottom of the barrel” countries, oil revenues tend to be misspent or misallocated, including to maintain incumbent governments in power (Karl and Gary 2003). Sadly, the countries that need the extra income the most are precisely those least capable of using it well. The impact of oil on Uganda is therefore likely to be dependent on the state of its governance and institutional capacity.

## **Governance and Institutions: from Mediocre to ....?**

By the standards of low-income countries, Uganda, together with Tanzania, Ghana and a number of other African countries favored by donors are fairly well-rated by various governance indicators, including the World Bank's Country Policy and Institutional Assessment (CPIA). Despite being far poorer than Africa's oil exporters, these countries typically rank around the fourth governance quintile globally (Gelb and Turner 2007). Uganda falls below the 50<sup>th</sup> percentile on all six of Kaufmann, Kraay and Mastruzzi's Governance Indicators (2010), and below the 25<sup>th</sup> percentile on both the corruption and political stability indicators. While this is not unusual for a poor country, governance in Uganda appears not to be progressing in line with increasing income. Some studies suggest that it has entered a phase of deteriorating governance and that risks are rising, although it may be too early to see a significant indicator trend.

**Entrenchment.** Once held up by the donor community as a gold standard for a new kind of "developmental" African leadership, some observers see the NRM government led by President Yoweri Museveni as becoming increasingly entrenched, clientelistic and corrupt (Global Integrity 2009). The current president has remained solidly in power for 25 years. The base of support for the NRM government has narrowed, and it now bases its rule more on the personalized power of Museveni than on any institutional capacity (Global Witness 2010). Observers argue that basic freedoms are being curtailed, human rights abuses are escalating (Uganda Human Rights Commission Annual Report 2009), and that the freedom of the press has suffered significant setbacks (Uganda dropped in Freedom of Press ranking from 52<sup>nd</sup> in 2002 to 86<sup>th</sup> in 2009). As expected, Museveni won the 2011 elections, in a campaign marked with indications of widespread allegations of vote-buying and intimidation.<sup>5</sup>

**Corruption.** Uganda ranked 127 out of 180 in Transparency International's 2010 Corruption perceptions Index (CPI), a significant drop from its rank of 80 in 2001. Over the past few years a number of high-profile corruption scandals have rocked the government, including those involving the Global Fund, GAVI, the AIDS Information Commission, National Medical Stores, and the 2007 Commonwealth Heads of Government meeting (CHOGM).<sup>6</sup> These have led to estimated losses in the millions of dollars. Numerous other irregularities have been unearthed in the education, energy, agriculture, police and social security sectors. An audit of public sector

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<sup>5</sup> Senator Russ Feingold (2010), in recent Congressional Testimony, warned that Uganda "had become a one-party state" and that Museveni's legacy "has been tainted by his failure to allow democracy to take hold in Uganda." Human Rights Watch (February 10, 2011) documents a number of cases of intimidation and measures to deny media coverage to opposition politicians. It also notes the payment of 20 million Uganda shillings (\$8,500) to each Member of Parliament. Especially given that there were no guidelines for spending the money and that it came just before the elections a coalition of NGOs considered the money to be a bribe, and urged MPs to return it.

<sup>6</sup> Global Witness 2010 Annex summarizes a number of prominent corruption scandals.

payroll found 9,000 “ghost workers”.<sup>7</sup> A recent report by the Ugandan Inspectorate of Government (2010) concludes: “Corruption remains an impediment to development and a barrier to poverty reduction in Uganda” (p. 6). A World Bank assessment reportedly estimated the annual cost of corruption at \$250 million.<sup>8</sup> These studies indicate that corruption, both petty and grand, is pervasive.

Other analyses argue that corruption, in the form of patronage and clientelism, is entrenched as a tool for rewarding political loyalty and securing support of key constituencies in the military and local government (Global Witness 2010, 6; Barkan 2005). It has become a critical mechanism through which the regime stays in power. One of the areas with the most systemic corruption is, unsurprisingly, the procurement system. Collusion, bribes and inducements, political interference, lack of supervision and issuance of false certificates of completion are commonplace (Transparency International 2003; Ugandan Inspectorate of Government 2010). Moreover, corruption in procurement is rarely punished. A study commissioned by the Netherlands Embassy estimated that around US\$ 100 million or 7.7 % of annual budget was absorbed by corruption, while a more recent PPDA report cites much higher estimates of US\$184 million per year (Zwart 2003, 2; Global Witness 2010, 7). Any advances in reforming the system appear to be slow. Oil rents, if unchecked, could simply turn into additional sources of patronage to perpetuate the regime.

More worrying than the corruption cases themselves, is perhaps the appearance of widespread impunity for the perpetrators. While the legal anti-corruption framework is sound, laws are not enforced and those agencies responsible for prosecuting corruption face severe institutional and capacity constraints (Global Integrity Report 2008 in Global Witness 2010). Global Integrity 2009 concludes that the gap between the existence and implementation of key anti-corruption safeguards is “one of the largest in the world” (cited in Global Witness 2010, 6).

**Low Capacity.** A third feature of Uganda’s governance is weak capacity in much of the administration, including at local levels of government. While the core Ministry of Finance and Central Bank are well regarded, sector ministries are weaker and capacity is especially weak in rural areas. Absenteeism is widespread among service providers, with teacher absenteeism estimated at 35%. Supervision and inspection are lacking and oversight by school management committees ineffective.<sup>9</sup> Local government is particularly weak, partly because new districts

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<sup>7</sup> <http://webarchive.nationalarchives.gov.uk/+/http://www.dfid.gov.uk/casestudies/files/africa/uganda-ghosts/asp>

<sup>8</sup> <http://ipsnews.net/asp?idnews=50956>. This level of corruption would be equivalent to about 8.8% of public spending or 1.67% of GDP.

<sup>9</sup> [http://www.observer.ug/index.php?option=com\\_content&task=view&id=5599&Itemid=106](http://www.observer.ug/index.php?option=com_content&task=view&id=5599&Itemid=106)

have continuously been created out of old ones for political reasons.<sup>10</sup> Many district governments are therefore struggling, dysfunctional or largely absent (Green 2010). Administrative capacity constraints contribute to the corruption and undermine the rule of law, as local governments are neither able to ensure public service delivery, nor to enforce the law in cases where public funds are misappropriated. Initially ambitious decentralization policies have therefore been pulled back, as described further below.

**Low Domestic Revenue Mobilization.** A fourth feature of Uganda is its narrow and ineffective tax system. Revenue increased from 6.8% of GDP in 1991/2 to 12.1% in 1996/7 but then failed to increase further, despite the goal of moving closer to self-sufficiency as enunciated by the President in 2005. This may be because donor financing was available to plug the fiscal deficit, which ranged between around 5% and 11% of GDP (Table 4). Uganda's ineffective and narrow tax system is characterized by rampant tax evasion and arbitrary exemptions (AfDB 2010). About one third of revenues come from an 18% VAT largely levied on imports, with most of the rest coming from customs and excise duties (Table 5), again mostly taxes on petroleum and other imports. Corporate income tax yielded only 6% of tax revenue, or under 1% of GDP, while income tax in the form of PAYE yielded only 13% of revenues. Outside of the VAT, the tax base is extremely narrow, with taxpayers primarily made up of a relatively small number of private firms, public employees through payroll taxes, and importers. A large proportion of the informal sector falls outside the tax net, and the top 35 tax payers alone account for about 50% of the tax revenue (AfDB 2010). Moreover, tax evasion, either through smuggling or other means, is widespread. This is compounded by the erosion of the URA's autonomy and capacity to collect taxes and enforce the law. Most of the revenues collected, as a result, come from the import and excise taxes, or the VAT.<sup>11</sup> In the words of a recent assessment, "There is no semblance of a fiscal contract between Uganda and its citizens."<sup>12</sup>

Contributing to this situation is corruption. The Ugandan Revenue Authority was ranked as the second most corrupt institution in Uganda, and the seventh most corrupt in the three EAC countries (AfDB 2010). The problem of political patronage extends to the tax system, with exemptions and tax incentives granted on a political and ad hoc basis, which undermines both the fairness and the breadth of the tax system.

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<sup>10</sup> A recent study shows that budget allocations to new districts are higher, in per capita terms, than to the older districts from whence they emerged (Green 2010).

<sup>11</sup> This is despite a low level of VAT compliance, which is 36.50 in comparison to World and SSA averages of 65.48 and 38.45, respectively (AfDB 2010).

<sup>12</sup> African Development Bank 2010, p. 6.

**Table 4. Selected Government Revenue Indicators**

| Fiscal Year | Revenue (tax and non-tax) as % of GDP | Fiscal Deficit excluding Grants (% of GDP) | Tax Revenue/Total Domestic Revenue |
|-------------|---------------------------------------|--|------------------------------------|
| 1996/97     | 12.1                                  | -6.4                                       | 94%                                |
| 2000/01     | 10.9                                  | -11.0                                      | 95%                                |
| 2004/05     | 12.9                                  | -7.2                                       | 94%                                |
| 2007/08     | 12.8                                  | -5.1                                       | 95%                                |

Source: African Development Bank 2010, p.36.

**Table 5. Major Sources of Tax Revenue (as % of total revenue collected by URA)**

| Fiscal Year | Customs and Excise |              | VAT                  |              | CIT | PAYE |
|-------------|--------------------|--------------|----------------------|--------------|-----|------|
|             | Total              | % on imports | Total (% of Revenue) | % on imports |     |      |
| 1996/97     | 53                 | 41           | 30                   | 18           | 2%  | 5%   |
| 2000/01     | 42                 | 32           | 36                   | 20           | 5%  | 9%   |
| 2004/05     | 35                 | 27           | 33                   | 18           | 8%  | 12%  |
| 2007/08     | 36                 | 27           | 34                   | 19           | 6%  | 13%  |

Source: African Development Bank 2010, p. 37.

**Heavy Aid Dependence.** The final feature affecting governance is Uganda's sustained high dependence on donor funds. The weight of donor support, which once accounted for a staggering 50% of the national budget, has gradually declined to 38%, with the expectation that it will continue to decline as soon as oil starts flowing (Global Witness 2010, 15). Nevertheless, ODA figures remain high with Uganda receiving roughly 1.7 billion USD in foreign assistance 2008, equivalent to 11.4% of its GDP (OECD-DAC).

**Table 6. Fiscal Spending, by source of funds**

|                          | 2006/07                 | 2007/08 | 2008/09 |
|--------------------------|-------------------------|---------|---------|
|                          | <i>(percent of GDP)</i> |         |         |
| Total Fiscal Spending    | 18.2                    | 17.8    | 19.4    |
| Development Expenditures | 5.7                     | 5.5     | 7.7     |
| Domestic-financed        | 2.4                     | 2.6     | 3.9     |
| Donor-supported projects | 3.4                     | 2.9     | 3.8     |
| Balance of Payments      |                         |         |         |
| Including Grants         | -1.1                    | -2.1    | -3.7    |
| Excluding Grants         | -5.6                    | -4.8    | -7.0    |

Source: IMF.

Aid dependence is a double-edged sword for the cause of good governance in Uganda. On the one hand, at least in more recent years donors have supported good governance in many ways, including through a large fiscal management and procurement reform component in budget support and programs in fiscal decentralization. Donors have also introduced innovations, such as Public Expenditure Tracking Surveys (PETS) to help reduce corruption; the celebrated experiment of publishing school-level allocations to cut fiscal leakages was undertaken in Uganda which led to massive improvements in the 2002 PETS, a survey tool that has since been extended to many other countries. Donors have also responded gradually to the disappointing governance situation, including cutting aid in response to political developments in 2005 and reducing budget support in response to failure to meet anti-corruption targets and to prosecute individuals implicated in the CHOGM scandal.<sup>13</sup>

On the other hand, the still significant donor dependence continues to itself dilute domestic accountability, by providing a cushion against the adverse impact of political manipulation of taxes and public spending. Much like petro-dollars, aid dollars do not come from tax revenue and render the government accountable to donors rather than its own citizens, potentially undermining the social contract (Moss, Pettersson, and van de Walle 2006).

Ultimately, while there have been some positive developments especially in the more technical aspects of public financial management,<sup>14</sup> the Ugandan governance trend is for the most part bleak. There are some favorable trends. Perhaps as a result of continued growth and rising living standards, Uganda has an increasingly vocal civil society; on the WWG indicator for Voice and Accountability its percentile rank has risen from 22 in 1992 to 33 in 2009. But the narrowing of the power base in Uganda is particularly problematic in light of the incoming oil revenues, as it implies that decisions on how oil revenues should be used are likely to be increasingly politicized. The weak accountability that the government enjoys, due at least in part to its reliance on donor funds rather than tax revenues, is likely to be perpetuated or worsened by the influx of oil revenues. As a result, if susceptibility to the “resource curse” is dependent on institutional strength, Uganda might be particularly vulnerable to the detrimental side effects from oil revenue.

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<sup>13</sup> Global Witness 2010, p. 15.

<sup>14</sup> For instance, there has been substantial improvement in Public Financial Management, the Accountability Strategic Investment plan has been developed and approved, and a new, more independent Office of the Auditor-General has been established. The Ministry of Fiscal Policy and Economic Development (MoFPED) has established a Budget Monitoring and Accountability Office to track the implementation and effectiveness of selected government programs in a number of sectors.

#### IV. Strategic Issues and Risks in the Use of Oil Rents

How then should Uganda plan to use its oil rents, and what are the major risks? From the above, one overarching risk is that of deteriorating governance.<sup>15</sup> Alternatives for using rents should therefore try to take into account both their indirect potential effect on governance as well as their direct benefits, whether in terms of contributing to future growth through investment or to consumption in the shorter-term.

In approaching this question, it should be recognized that the framework for oil development and revenue use is in its early stages. The latest available statement is the National Oil and Gas Policy for Uganda prepared by the Ministry of Energy and Mineral Development in February 2008. A draft Petroleum Bill has been circulated for comments, and is to go before Parliament after the February 2011 elections. A draft Revenue Management Bill is also in preparation. This reportedly includes the management of revenue volatility, including through the establishment of a savings fund to help stabilize spending. Unless political pressure is overwhelming, oil revenues are likely to be centralized rather than shared with producing regions.

**4.1 Managing the Volatility of Oil Revenues.** One clear risk, given the huge volatility of oil prices, is over-spending. However, the MoF and the Central Bank intend to continue the tradition of conservative demand management that has characterized Uganda in recent years. Both institutions are headed by experienced technocrats, which bodes well for the prudent management of the revenues. But the oil incomes lie some years into the future so there is some uncertainty as to who will actually implement fiscal and monetary policy. Regardless of what the ultimate revenue spending policy Uganda chooses to adopt, it should probably include some type of stabilization fund to shield the budget from highly volatile oil prices.

**4.2 Spending Rents: the Investment Strategy.** Even though the policy framework is not fully developed, the intended direction of use of oil revenues is clear. From many pronouncements of government officials, and also from the National Oil and Gas Policy of 2008, oil revenues will be used to boost investments in Uganda, in particular in infrastructure, with a view to increasing growth and diversifying Uganda's currently primary-based economy towards industry. Infrastructure constraints have long been a pressing concern of Uganda's government, and of the President in particular, who has long emphasized the centrality of economic growth to achieving durable improvements in wider development outcomes such as

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<sup>15</sup> An extensive discussion of the relationship between resource rents and governance is beyond the scope of this paper. Tsui (2010) offers a useful discussion, as well as evidence linking oil discovery to deterioration or lack of progress in democratic governance. This study is noteworthy because the methodology permits stronger causal inference than most studies that relate resource dependence to governance.

maternal and child health.<sup>16</sup> The National Oil and Gas Policy paper (2008) describes the contribution of the oil and gas sector as “...enhancing the country’s capacity to invest in productive sectors of the economy, development of new economic and social infrastructure, increasing power generating capacity and the general enhancement of energy security through production and refining of oil...” (p. ix).

This direction for policy is also significant for donor relations. The President has long been impatient with the slow pace of infrastructure development and the modest share of infrastructure funding in total aid.<sup>17</sup> Noting that it took 15 years of negotiation with foreign sources to finance one hydroelectric dam he concluded that dependence on external funding for infrastructure development was dangerous: “The money begged for or borrowed is too little and too slow to help in infrastructure development. But with our own funds we are able to move faster” (Opening Address to the 15<sup>th</sup> Session of the AU Assembly, January 2, 2010). Oil money is therefore also seen as a way for Uganda to break away from the shackles of its donors and to implement its own strategic priorities.

An investment-driven strategy could of course have enormous benefits for Uganda’s economy if investments are well chosen and well executed. In common with many other African countries, Uganda faces an enormous “infrastructure deficit” which poses a severe constraint on productive firms and farms. Following the improvements in policies in many African countries after the 1990s, infrastructure has emerged as a major constraint in firm surveys. Power is especially a concern, and is seen by many as the major binding constraint. Few parts of the country are connected to the grid. The latest estimate (2001) showed that only 8% of Ugandans had access to electricity nation-wide. Power outages have a huge adverse effect on firm productivity (AICD Database 2011); they are cited in business surveys as a prime constraint on growth and investment. Many parts of the country are not connected by all-weather roads, limiting the ability to market crops. Rail links, including the line connecting the oil-rich areas with Kampala, are largely not functioning, and need to be rehabilitated and upgraded to conform to basic safety standards.

The Africa Infrastructure Diagnostic Study gives some idea of the severity of these constraints and the very large investments needed to “catch up.” It estimates that the infrastructure deficit in low-income African countries depresses firm productivity by around 40 percent (in Uganda

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<sup>16</sup> See for example, statements by President Museveni January 2, 2010 (Afrique en Ligne, January 4, 2010); November 2, 2010 (Tribune NGR World); November 1, 2010 (Reuters); June 2, 2010 (The Monitor); his Address at the 46<sup>th</sup> Independence Anniversary of Uganda (October 9, 2008) and his 2011 Election Manifesto (New Vision, January 4, 2011);

<sup>17</sup> The OECD-DAC estimates that around 15% of aid goes towards the sector “economic assistance and infrastructure,” so that infrastructure accounts for a fraction of that and is less than 15% of total aid.

this is estimated closer to 60%), and that catching up to the infrastructure level of Mauritius would increase regional per capita economic growth by 2.2 percentage points (Foster 2010). In Uganda gains would be closer to 4 percentage points (AICD 2010, p.4). Roughly speaking, this would require at least doubling the level of infrastructure investments of recent years for an extended period. AICD suggests that on average middle income countries would need to spend 10% of GDP on infrastructure investments to catch up, while low-income countries would need to spend an impossible 20% of GDP (Foster 2010). Like Tanzania, Uganda currently spends around US\$30 per head annually on infrastructure, and would need to increase this to approximately 20% of GDP or almost US\$100 per head to catch up (AICD 2010, p.26).

However, an investment-driven approach brings its own set of risks, including governance-related ones. Especially in countries flush with oil money, investment programs have frequently been selected for political reasons rather than for their payoff in terms of service delivery. Construction as a sector is notoriously susceptible to corruption, increasing the likelihood that programs will be promoted for their expected kickbacks rather than their effectiveness. Rough estimates suggest that anywhere from 5 to 20 percent of construction costs are lost in bribe payments, which could account to \$18 billion a year in developing countries alone (Kenny 2006). In a Ugandan Enterprise Survey undertaken by the World Bank, over 80% of Ugandan firms surveyed reported that they paid bribes, which on average accounted for 7.9% of the total costs (Svensson 2000). Around half of firms reporting bribes spent more on bribes than they did on security (including guards, investment, etc.). The enterprise survey does not provide an estimate for infrastructure exclusively, but since the sector is known to be particularly prone to corruption the sectoral figures would probably be even higher (Kenny 2006). Importantly, bribe payments represent only one of the many costs of corruption. The total economic impact of corruption on performance as a result of poor quality in construction and skewed spending priorities is likely to be substantially higher than the cost of the bribes (Kenny 2006).<sup>18</sup> Especially considering the recent picture of governance (including slowness to reform procurement), the potential indirect impact on governance of such an approach needs to be taken into account.

Finally, blind adherence to the principle that all resource income has to be re-invested to preserve national wealth (the Hartwick Rule) reckons without the potential to sustain consumption out of the return on investment. The larger is the reserve/production ratio, the higher, in general, is sustainable consumption relative to resource income.<sup>19</sup>

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<sup>18</sup> For example a 10% bribe payment to acquire a contract that ultimately results in quality infrastructure is ultimately less costly than the same amount taken from the project budget, and that ultimately results in poorly built infrastructure (Kenny 2006).

<sup>19</sup> In the simplest case of constant output and prices, a 3% real return on investment, and no discounting, sustainable consumption is 25% of resource rents for a reserve level of 10 years and 59% for reserves of 50 years.

### 4.3 Spending Rents: a Distribution Strategy.

Are there alternative approaches to using oil rent that have potentially favorable governance implications? Some have suggested that a better use of oil revenue would be to take all—or more realistically—part of oil revenues and redistribute them to the citizens, for example through a transparent, universal, cash transfer (Moss 2011; Moss and Young 2009; Birdsall and Subramanian 2004). The government would then have an incentive to tax back at least part of the transfer. This, they argue, would build the fiscal contract between the government and citizens, strengthen accountability mechanisms, and create a constituency for the responsible management of the natural resources (see Moss 2011). In this section we consider the political and technical feasibility of establishing a cash transfer scheme in Uganda, and explore the economic and political implications of such a scheme.

Before moving to the individual cash transfer option, one should recognize that there are many ways in which rents can be transferred to citizens. These may not generate the governance benefits sometimes claimed for direct transfers, but by moving rent flows from government to citizens they do increase the potential reliance of government on a conventional tax system.

**Transfers through Pricing.** Most oil producers have followed cheap fuel policies, providing energy to domestic consumers at subsidized prices. When taken to extremes this practice has serious consequences. Fuel subsidies are regressive, and encourage wasteful, growing consumption and fuel smuggling. These ultimately threaten the fiscal sustainability of the policy, which is politically very difficult to reverse. However, a policy of pricing crude at world levels and then levying low or zero taxes on fuel use is not a subsidy. In the case of Uganda, shifting to such a policy would absorb roughly 2% of GDP or 20% of the potential rent.<sup>20</sup> As oil production grows, pressure is likely to mount for some relief from high fuel price levels so that this policy is not unlikely.

**Transfers through Communities.** A second option used by some producers has been to distribute part of the rents through community-based programs. Indonesia has been a leader here, building on a long tradition of local action to provide a high share of public spending to rural areas through programs such as INPRES and the KDP. These and similar programs have been generally successful in creating rural jobs and building rural infrastructure, and have also contributed to the building of local capacity. In Uganda's case, such a program would need to address the weakness of capacity at district level that has contributed to the rollback of fiscal decentralization efforts.

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<sup>20</sup> Taxes on oil imports currently represent about 17% of fiscal revenues or 2.2% of GDP.

**Transfers to Individuals.** What would a Ugandan oil cash transfer scheme look like? This is quite a difficult question to answer concretely because Uganda is so far from this policy. Nevertheless, if long-run rents were 10% of GDP, a full and uniform distribution would amount to some \$50 per head annually. This would provide a huge income boost to those at the lower end of the income scale; it would probably double income in some cases, given the fact that families in Uganda are large and tend to pool incomes. Even a more modest—and in many ways more realistic—distribution of only 50% of the oil rents would yield \$25 per head annually, which would still be a significant contribution to those families under the poverty line. For the 30% of Ugandan’s living under \$1.25/day, an annual income increase of \$50 or \$25 per head would go a long way toward eliminating extreme poverty, and reducing overall poverty levels.

Assuming for a moment that the political hurdles were overcome, would it be technically feasible to distribute the rents? There is at present no infrastructure set up for general institutionalized individual distributions. Past distribution programs, such as cash grants to schools, have shown the importance of transparency to reduce leakages (Reinikka and Svenson 2007). It is likely that a program running through several layers of government (central, district, municipal) would incur substantial leakages. Setting up a good system is not, however, an impossible feat. Several governments have successfully introduced wide-ranging systems of cash transfers, including South Africa (pensions, child allowances, disability payments), Pakistan (low-income females, flood relief), Andhra Pradesh (social transfers, employment guarantee payments), and Bangladesh (social transfers). Building on their experience, the most efficient approach would be to use new technology, including biometric identification, smartcards and electronic payments into mobile bank accounts (Gelb and Decker 2011). Iran’s recent shift towards providing direct transfers to households through the banking system shows what can be done.

A national ID program, which could enable such mechanisms to be developed, was reportedly tabled some years ago, but little has been heard of it since responsibility for the project was transferred to the Ministry of Defense. However, a comprehensive national ID scheme would bring benefits that extend well beyond the cash transfer program, and could provide a platform for undertaking more efficient and successful poverty reduction strategies, education, or health initiatives. In fact, Uganda may already be moving towards mobile, bio-metric banking system. Through public-private partnerships, companies like MAP International are seeking to invest heavily in building up financial access and biometric information throughout Uganda, with the goal of giving financial access to over 15 million people in Uganda (from the 1.7 million that currently have access; MAP International 2010). This would not only extend financial access to traditionally under-banked citizens of Uganda, but make setting up a cash transfer system relatively secure and inexpensive.

## Some Considerations.

*Infrastructure and the Pattern of Primary Spending.* How likely is Uganda to move towards such a program? At present it seems unlikely that those in power would seriously consider such an option. Their main argument would be the influence of the transfer distribution channel on the composition of spending. Cash distribution, or at least the share that is not taxed back, would be expected to largely boost consumption. Those favoring infrastructure spending would argue that even if households might want to use some of their gains for developmentally valuable investments (like health, education or micro-enterprises), the severity of infrastructure constraints would limit the options for good investments and reduce the returns on those that were made.

*Will Transfers Cause Dependency and Waste?* Those skeptical of cash transfers worry that simply handing out money will lead to a culture of dependency, or that handouts will be wasted by the poor who lack the ability to make wise choices with their money. This paternalistic perception of the poor does not stand up well to evidence. Studies suggest that cash transfers tend to lead to increased spending on health, nutrition, sanitation, and education (Case 2001; Yanez-Pagans 2008). There is also increasingly strong evidence linking certain cash transfers to improved health and education outcomes (DFID 2011). Furthermore, there is no evidence that modest cash transfers create labor disincentives; in some contexts it can increase labor market participation by facilitating migration and job searches, improving health, lowering the burden of child-care (DFID 2011). While a detailed review of the impacts of cash transfers is beyond the scope of this paper, concerns that the poor will simply waste the money or become dependent on state welfare are not supported by existing evidence.<sup>21</sup> A culture of dependency on the state may be more likely to materialize when the government spends resource rents through a patronage system that doles out government jobs and lucrative contracts instead of universal cash transfers.

*Will Transfers Actually Encourage Accountability?* A third concern is how long the fiscal compact between government and citizens would take to materialize, given the severe weaknesses of the tax system. Despite the longstanding intent to strengthen domestic resource mobilization, there is simply no tax system with the wide base needed to tax back a part of the distribution. With taxes today largely on trade and on a few big corporations, and the tax yield low, accountability mechanisms that rely on strengthening the tax systems (and rebuilding the “social compact”) do not exist in Uganda. Having said this, just because an adequate tax system is not in place today does not mean that a cash transfer scheme could not be a powerful

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<sup>21</sup> A recent report by DFID (2011), *Cash Transfers*, offers a good synthesis of the various studies that have documented these effects to date.

incentive to strengthen the tax system and broaden the base for the future. One benefit of a distribution scheme could be if it provides incentives for informal workers currently outside the tax system to register in order to receive their cash transfers. The experience of other countries suggests that oil revenue, if not distributed, will further reduce political will to improve the tax system.

While the general link between taxation and accountability is theoretically well established (Brautigam 2008), there are specific reasons to question the ability of this mechanism to work in young democracies like Uganda. Young democracies without established programmatic political parties rely more on personal appeal at the ballot box than a coherent party-platform backed by credible campaign promises (Keefer and Vlaicu 2005). The accountability mechanism between broken campaign promises (failure to improve schools or deliver clean water) and the consequence of being voted out of political office might not materialize in systems that rely on patronage and clientelism for political survival. On the other hand—much like the tax system—accountability systems can be improved. The basic principle that taxpayers will be more likely to monitor projects funded by their own taxes remains valid. Governments, in turn, have incentives to produce at least some of the bridges and roads promised, lest citizens simply refuse to continue paying taxes. Accountability through elections can be slowly built over time, if the incentives are pulling in the right direction. The Ugandan personalistic—“big man”—democratic system will probably in part undermine the accountability benefits of a cash transfer scheme, but not necessarily nullify them.

Accountability concerns aside, however, a cash transfer system could have an alternative effect that could benefit the long term growth of the Ugandan economy. Redistributing oil rents to Ugandan citizens and forcing the government to rely on taxes—both corporate and personal income taxes—ties the fortune of government revenue to the broader welfare of the Ugandan economy. In other words, without oil funds to boost government coffers, the Ugandan government has strong incentives to adopt policies that maximize the growth in non-oil sectors as a way to maximize its tax revenue. A booming economy will boost revenues, while stagnation in non-oil sectors would negatively impact government revenues. Thus, by aligning the interests of the government with greater economic productivity, a system of cash transfers could boost household incomes and tax revenues without sheltering the government from the dangers of neglecting the overall welfare of the economy at large.

*Weak Local Capacity.* A fourth concern would be the weakness of local government as a platform for a decentralized development approach. After an ambitious start to decentralization, there has been a retreat from providing unconditional funding to district-level governments in favor of more centrally-driven de-concentrated central government programs

(Kaiser forthcoming). District-level governments are not seen as having the capacity to manage funds effectively; moreover, many of the impediments to development (roads, power) lie outside the purview of an individual district government. The situation has not been helped by the remorseless process of subdivision to create new districts, essentially for political reasons; supporters have been paid off with appointments and opponents co-opted. There is little expectation, therefore, that district governments as they currently function would be able to tax back a part of a distribution and use this well to fund local investment goods. An option is of course to simply tax distributions centrally and implement programs at federal level to circumvent the weakness and possible additional leakage associated with district-level administrative weakness, but this does not solve (and could contribute to) the problem of excessive centralization.

*Managing Volatility.* There is also of course concern over volatility. While management may be cautious at macro level, households may not have the foresight or mechanisms to make good inter-temporal decisions over the oil cycle. However, this could be mitigated through program design, for instance by distributing revenues averaged over several years or by basing distributions not on revenues but on the spending from a stabilization fund, possibly based on the Chilean model. There is no reason to believe that a cash distribution and a fund are mutually exclusive; in fact, any revenue management plan for Uganda will almost certainly need to establish some kind of fund to mitigate volatility. The question is then how best to use the smoothed revenue emanating from such a management system.

## **V. Is There any Hope for Cash Transfers?**

Taking into account potential indirect governance effects as well as direct spending effects, there could well be a case for considering the option of cash transfers of at least a portion of the oil revenues as part of a general program to create incentives to reform and strengthen Uganda's institutions, including the tax system. However, there is no political appetite among Uganda's elite for the establishment of such a program. For a portion of the elite, especially those closely associated with the government, the main underlying reason to reject the option may be the desire to be able to use the patronage from oil rents to cling onto power. However, concern over infrastructure constraints is widespread and probably extends well beyond this group. It is not clear that the President's preoccupation with physical investment is unpopular; indeed, its prominence in his electioneering suggests the opposite and that, following re-election, he will be pressed to deliver. Power and transport needs are self-evident every day, whereas the potential governance benefits from a transfer program – even if recognized as desirable – will seem to many citizens only a faint long-run prospect.

However, Uganda does have three characteristics that offer a slight glimmer of hope for advocates of such a scheme. As a new oil producer, interests by individuals who stand to benefit from oil are not yet entrenched, as opposed to trying to start a scheme like this in a country like Nigeria (Gillies 2010). It has a vibrant and increasingly vocal civil society with much concern over corruption which could possibly mobilize public support. Finally, while it is clear that the 2011 elections did not see a political transition, the risk of an increasingly entrenched and unaccountable government is recognized as a long-run issue and not one that is likely to go away. Uganda is not Egypt or Tunisia, but recent events in North Africa and the Middle East will remind the government that citizens' expectations are only going to become a more potent force in the longer-run.

A final question for cash transfers is the response of donors to Uganda's oil discovery. Aid is likely to be reduced, and perhaps re-routed away from funding public investments and traditional services towards other programs which deliver resources more directly to non-governmental agents. Looking forward, the main challenge for donors in this pre-oil stage is to help develop programs that ultimately enable Uganda to spend its own resources effectively. These could include a range of transfer options, such as child allowances. For example, why should Uganda's oil endowment not provide every child in Uganda the resources to enable her or him to demand a good education? The development of such programs, initially donor-funded but with the potential to be increasingly supported from Uganda's own resources, could open a way towards the wider sharing of oil rents and reduce the tendency for government to simply rely on oil income.

## **VI. Conclusion: Transfers -- Yes or No?**

The national patrimony of a country—including historical, cultural, and natural resource wealth—belongs almost by definition to each and every citizen. Why should oil or natural gas resources extracted from Nigerian or Iraqi or Ugandan soil automatically end up as public resources to be used – or abused – as determined by the government of the day? Why should they not be seen as private citizen property, to be used for private or public purposes as determined by normal tax and spending policy? It could be argued that this is a matter for government to decide, in its role as the delegated authority of the people. But the power of this argument depends, of course on the integrity and representativeness of electoral processes, and on the quality of the mechanisms of public accountability. No-one challenges the decision of the people of Norway to delegate the management of its oil resources to their government, for the purpose of servicing future public pension obligations. But the situation looks somewhat different from the perspective of a country like Equatorial Guinea or – as recently seen – Libya.

Uganda is somewhere in between these extremes. Its government can claim a long-run record of development gains, and also that it has been democratically elected, albeit in a contest marked by irregularities and vote-buying. The concern, as seen by many, is a weakening governance trend and a tendency towards entrenchment that oil revenues retained in public hands could make irreversible. The potential benefits of a transfer program in setting up some countervailing pressures for accountability are large in the longer run. To realize these benefits Uganda would clearly need to make major institutional improvements in several areas, including the tax system. While this would be a longer-run goal, absent a transfer program government will have little incentive to improve the tax system. Some would argue that donor flows have blunted any impulse to do so to date, and these are smaller, in terms of fiscal impact, than potential oil revenues.

It is extremely unlikely, however, that government will move towards a transfer program on the scale needed to rebalance governance incentives. Whatever the motivations of those in power to hold onto the control of oil rents, the stated goal of investing them into infrastructure and industry to boost growth probably resonates across a wide swath of the population, including the business community. If investments were well chosen and well implemented and the assets well managed, the benefits could be large given the extreme constraints that poor infrastructure services now pose for the economy.<sup>22</sup> The investment path is perhaps a first-best in terms of direct potential material impact: in most models of Ugandan growth that seek to maximize the sum of citizens' future consumption per head, the shadow value of sound investment in infrastructure would probably be higher than that of private consumption.<sup>23</sup> But the investment path also represents a riskier strategy in terms of the indirect governance effects; in a government without strong internal checks and accountability, there are few guarantees that the government will use the funds appropriately. And while every country thinks of itself as the exception to the rule, there are enough Nigerias and not nearly enough Botswanas to call for extreme caution.

Ultimately, distribution of the oil rents therefore can be considered as a way to mitigate the risk that Uganda will succumb to the resource curse. This, coupled with the benefits of the cash itself in reducing poverty, and the possibilities of building up a tax system that can produce a more accountable delivery of public services (including the much needed infrastructure)

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<sup>22</sup> Well-chosen and effective infrastructure investments could also mitigate the Dutch Disease, by increasing supply potential in the non-oil traded goods sectors. Success is critically dependent on the quality of investments and complementary policies; large investment programs in oil exporting countries have often not had good results.

<sup>23</sup> This is not to say that an all-investment strategy is optimal. Productive investment opens up space for consumption on the basis that future generations will be better off than the current one.

suggests that cash transfers are an option worth considering in the Ugandan context, even though finding politicians willing to adopt such a policy may prove impossible.

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