

Taxation and the Informal Business Sector in Uganda

An Exploratory Socio-Legal Research

Jelte Verberne MSc.

Prof.dr.ir. Rex Arendsen, Faculty of Law, Leiden University

The Netherlandsⁱ

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Abstract

Sustainable taxation could build the capacity of governments in the Global South, contributing to the realization of the 2030 Sustainable Development Goals. A major challenge for developing countries today is the growing informal sector. Taxing the informal sector could support domestic revenue mobilization and build a wide tax base. However, because of the nature, size and location of informal businesses, this sector is known to be hard-to-tax. This study intends to gather a bottom-up understanding of taxation in the informal sector and tax compliance among small and medium-sized enterprises (SMEs) in Kampala, Uganda. It aims to show how socio-legal research can contribute to the study of tax and development. We use data from a two-month qualitative fieldwork research to study the social fabric from which these businesses operate. Results show a very low tax morale among SMEs in Kampala. Tax compliance attitudes are influenced by issues related to their trust, knowledge of the tax regime, perspectives on public goods and service delivery, ideas about fairness, and the power of the authorities to enforce compliance. The presumptive tax system in place is not able to align with the structure of the informal sector. We argue that it is important that the development of the informal economy and taxation go hand in hand. Building the capacity of society to pay taxes rather than the capacity of the state to enforce taxation.

Keywords: *Taxation, Socio-Legal Research, Informal Sector, SMEs, Uganda*

ⁱ j.l.verberne@gmail.com (corresponding author), r.arendsen@law.leidenuniv.nl

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1. Introduction

The 2030 Sustainable Development Goals (SDGs) seek to 'end poverty, protect the planet and ensure prosperity for all.' Sustainable taxation could contribute to achieving these goals. SDG 17 aims to revitalize global partnerships for sustainable development and encourages the international community to "strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection" (United Nations, 2015). International organizations such as the IMF, World Bank and national tax authorities collaborate with governments and tax authorities in developing countries to strengthen national and local tax systems aiming to increase the total tax revenue (Platform for Collaboration on Tax, 2018). This often involves a top-down macroeconomic approach. The Base Erosion and Profit Shifting (BEPS) initiative, is an example of such an approach (Mosquera Valderrama, 2018).

Developing countries generally have a large and growing informal sector. This is also the case in Uganda, where the informal sector covers over 50 per cent of the GDP. A substantial part of this sector consists of small and medium-sized enterprises (SMEs) which are inherently hard to tax because of their size, location and the nature of their business. Efficient taxation of this sector could help to build the capacity of the state. But how do you target a hard-to-tax segment of the economy such as SMEs in the informal sector? How can you effectively formalize these businesses? Indirect taxes have become an important source of revenue in many developing countries including Uganda. But, these SMEs are below the VAT threshold. Direct taxes are also problematic because of high administrative costs on the side of the authorities and high compliance costs for the taxpayer. Targeting SMEs, the Uganda Revenue Authority (URA), similar to other developing countries, has a presumptive tax regime. In theory, this small business tax enables the URA to tax SMEs and keep the costs for both administration and taxpayer as low as possible. However, returns have been low ever since the initiation of the tax.

Taxation plays a major role in building the capacity of the state and is an important factor determining state-society relations (Tilly, 2009). However, there is no agreement as to whether taxation contributes to state building in developing countries (Martin & Prasad, 2014). To understand how the informal sector in this specific context can be effectively taxed, it is important to understand which factors influence tax morale among SMEs. These are found in the fabric of society from which most informal businesses operate, under the radar of government authorities. Socio-legal research helps to find a better understanding of these businesses and the *social fabric* from which they operate.

The purpose of this research is twofold. It aims to show how *socio-legal research* can contribute to the study of tax and development. Furthermore, it intends to gather a *bottom-up understanding* of taxation in the informal sector and tax compliance among small and medium-sized enterprises in Kampala, Uganda. This study shows it is important that the development of the informal economy and taxation go hand in hand. Building the capacity of society to pay taxes rather than the capacity of the state to enforce taxation. Building long-term compliance and tax morale. The main question of this study is: *What is the role of taxation in the development of the informal sector, specifically among SMEs in Kampala, Uganda?* Three sub-questions support this question. (1) What is daily practice of SMEs with respect to taxation in Kampala? (2) Which factors

influence the willingness and ability to pay taxes? (3) What are the implications for the effectiveness of the governmental strategy to tax the informal sector in Kampala?

This paper proceeds as follows. In the next chapter we develop the theoretical foundation of this study. Starting with a closer look at the informal sector and an explanation of what small and medium-sized enterprises are within the context of this research. We conclude the theoretical part of this study with a section on the role of tax morale. Chapter 3 considers the methodology of the research. What is the socio-legal method? How does it fit within the context of taxation and development? How did we use these methods in this study? In the fourth chapter we present the results of the research. How is the small business tax implemented in Uganda? How is doing business in Kampala influenced by taxation? In the conclusion we answer the main and sub-questions. The final chapter discusses these results and reflects on the objective of this study and the socio-legal methods used in this research.

2. Theory

To understand how taxation influences the development of small and medium-sized enterprises in the informal sector it is important to explore a couple of concepts and theories surrounding the following issues: the informal sector, small and medium-sized enterprises, tax compliance and tax morale. This leads up to the first part of the following chapter, which discusses the added value of socio-legal research to the study of taxation and development.

2.1 The Informal Sector

The informal economy or sector is a contested concept. When first used, it referred to employment outside of the formal labor market (Hart, 1973). These days, the concept most often refers to the legal status of a business. Indicating whether a business is registered at government institutions and complies to government legislation (Gerxhani, 2004; Kenyon, 2007; Joshi, Prichard, & Heady, 2014).

Joshi, Prichard and Heady (2014) provide a comprehensive explanation of what it means when a business is part of the informal sector. They state that enterprises are in the informal sector because: "they contravene – or are not subject to – some of a variety of rules and regulations, including labor laws, environmental laws, registration, and taxation". Joshi, Prichard and Heady emphasize that in practice the duality of formal and informal businesses does not exist. It is more like a continuum ranging from informal subsistence economy to completely formal enterprises (see Appendix A). According to Joshi et al. (2014), an enterprise might for example escape national taxation, but is often burdened by several types of fees, charges, and licensing costs imposed on them by local governments. In addition, informal and formal businesses are often linked in their economic activities.

The distinction between formal and informal businesses is a fabricated duality which facilitates an institutional perspective. From the institutional perspective, a small or medium-sized business is defined as formal or informal depending on whether or not it is on the radar of the state. Even within a state the distinction is problematic because amongst government institutions the determinants of informality differ. For example, the tax authorities might define informality based on whether a SME is paying (the right)

taxes. For a municipality it might be related to whether this same business has a (or the correct) trading license.

Because of this fabricated duality, it is difficult to establish in practice whether a SME is (more) formal or informal. Therefore, instead of categorizing SMEs as either formal or informal, we adopt a description of these businesses formulated by Joshi et al. (2014). They explain that these businesses “generate enough income to warrant taxation but find it easy to escape the attention of the tax administration or to conceal a substantial part of their tax liability, because of their location, size, and/or nature of their businesses.” This perspective on SMEs in developing countries such as Uganda is useful because it is not subject to institutional dualities such as formal/informal or registered/non-registered, and therefore closer related to daily practice of these businesses.

When following an institutional approach, the formal/informal duality is instrumental. It classifies which businesses are paying taxes and which are not. Subsequently, policies are created and implemented to target those not paying taxes and if successful this will increase tax compliance and tax revenue. This can be described as a top down approach to the taxation of the informal sector. In the following part of this chapter, we elaborate on the characteristics of the small and medium-sized enterprises.

2.2 Small and Medium-Sized Enterprises

How can we define small and medium-sized enterprises in the context of the informal sector? What are the main characteristics of these businesses? There is not one universal definition of a small or medium-sized enterprise, it really depends on the economic structure of a country.¹ For this study, we use the characteristics of small businesses and SMEs mentioned in the informal economy continuum (Appendix A, column B&C), to illustrate the main features of the businesses studied in this research.

The people owning small and medium-sized enterprises are often non-poor, well-educated and skilled. They are mainly manufactures or service providers and their market is often highly competitive. Their main challenges include access to capital and insurance (personal and business). SMEs are liable to pay taxes, however they under-report earnings, use loopholes and often escape formal tax assessments. If they have employees, they are commonly unregistered (Appendix A; Joshi et al., 2014). Cash transactions are common among all small and medium-sized enterprises and they are often difficult to assess because of poor or no recordkeeping. In several developing countries, such as Uganda, they are typically below the VAT threshold and within a presumptive / small business tax regime that is aimed at further formalization. Smaller businesses that are also part of the presumptive tax regime generally have poorer owners, but they are still reasonably well educated and skilled. For these businesses it is even a bigger challenge to gain access to capital.

2.3 Compliance and Tax Morale

Ali, Fjeldstad and Sjørusen (2013) argue that if we want to deal with the problem of tax evasion an understanding of the factors underlying taxpayers' decisions about whether to pay or evade taxes is crucial. Therefore, we take a brief look at the main theories that try to explain why people pay or do not pay their taxes. Five can be distinguished, we briefly

introduce the core argument of each theory. (1) *Economic deterrence*: taxpayer behavior is determined by an analysis of the costs and benefits of evading taxes. (2) *Fiscal exchange*: the presence of public services, government providing goods to taxpayers, can increase compliance.² (3) *Social influences*: taxpayer behavior is influenced by the norms and values of an individual's reference group. (4) *Comparative treatment*: the addressing of inequities through taxation can influence taxpayer behavior. (5) *Political legitimacy*: behavior is influenced by the extent to which taxpayers trust their government (Ali et al., 2013).

Tax morale, or the intrinsic motivation to fulfill tax duties, has been and is an important determinant for tax compliance in Western countries such as the Netherlands. Tax morale is about citizens' actual motivation to pay their taxes and not just about their obligation to do so. Studies have shown that tax morale is crucial to a functioning tax system – without a positive tax morale, no efficient system (Hoevenagel, 2016).

To enhance tax compliance in developing countries it is important to understand the determinants of tax morale. In the past decades, several studies used large cross-country quantitative research to find which factors might explain a low or a high tax morale (Torgler, 2005; Ali et al., 2013). International surveys, such as the World Values Survey, Latinobarometer or Afrobarometer, are combined with other data to find determinants of tax morale. The results show that a wide range of concepts influence tax morale in developing countries. To name a few: trust in government, accountability, public goods and services, efficient and transparent legal structures, support for democratic governance, gender, age, education, and religion. Experience with paying taxes is also an important determinant of tax morale (Martin, 2014).

Tax morale concerns an intrinsic motivation and is thereby also linked to local context and cultural values. Cross-societal experiments and data on corruption, tax evasion and fraudulent politics show that weak institutions and cultural legacies, that generate rule violations, might impair individual intrinsic honesty (Gächter & Schluz, 2016). However, it is important to understand that this could be related to the fact that different cultural values and meanings shape different ideas about intrinsic honesty. Different cultural values and meanings might also explain different shapes and levels of tax morale.

The literature on tax morale and tax compliance attitudes in developing countries is growing but still relatively small today. A lot of the studies on tax behavior in developing countries build on the work of Kirchler (2007): *The Economic Psychology of Tax Behaviour*. Regarding compliance, Kirchler, Hoelzl and Wahl (2008) argue that power and trust are important determinants of tax compliance. According to them, tax compliance will increase by raising either or both power and trust. The former will result in enforced compliance and the latter in voluntary compliance. Kirchler, Hoelzl and Wahl demonstrate that tax authorities in developing countries often show little trust in taxpayers and seem to believe that deterrent actions can solve all problems related to tax compliance. Therefore, tax environments in developing countries often feature so called 'cops and robbers' relationships between taxpayers and the tax authority. Gobena & Van Dijke (2015) also look at power and trust in their analysis of tax compliance among Ethiopian business owners. Regarding tax morale, Asaminew (2010) argues that in developing countries paying taxes is not seen as contributing to public goods. He states that is rather seen as a burden imposed by government.

Abdul-Razak and Adafula (2013) look at taxpayers' attitudes and its influence on tax compliance decisions among SMEs in Tamale, Ghana. They found that: "the burden of taxes paid affects the attitudes of individuals and this informs how they evaluate the tax system and consequently their compliance decisions". Interestingly, in this study, factors such as accountability and transparency did not significantly impact taxpayers' attitudes. This trust in government could be explained by the high perceived level of benefits derived from the provision of public goods and services. Still, individuals did not clearly understand the tax laws and the researchers found a positive relationship between levels of understanding and tax compliance decisions. Other interesting examples of research on compliance or tax morale include Vadde and Gundarapu (2012), who studied factors influencing rental tax payers' compliance in Mekelle city, Ethiopia. Smulders and Naidoo (2013) address burdens of tax compliance among small businesses in South Africa and conclude that the revenue authority holds a key role in educating small business owners about the tax system.

To understand how the informal sector relates to taxation it is important to study the social fabric of society from which these businesses emerge. A relatively new movement in the study of tax law provides an interesting approach to the relation between taxation, inequality and development. We refer to *New Fiscal Sociology*, which developed over the past two decades and builds upon the work of economist Joseph Schumpeter (1883-1950) who argued that public finance was the key to understanding the development of modern societies (Martin, Mehrotra, & Prasad, 2009; Martin & Prasad, 2014). This movement is built on the study of tax law with insights from political sciences and sociology (Mann, 1943). It provides interesting insights into the development of taxation and state-building in developing countries. Kiser and Sacks (2009) state that centralized bureaucracies are not expected to work well within the context of contemporary African states, mainly caused by their limited monitoring capacity. Based on their historical comparative study, they recommend to further decentralize and privatize the tax administrations in African states.

Socio-legal research is closely related to the *New Fiscal Sociology's* research perspective and approach, both focussing on 'law in action' rather than 'law in the books'. In the following chapter we elaborate on why socio-legal research is the right methodological choice for this study.

3. Methodology

In this chapter we elaborate on the methods used in this study. First, we explain what socio-legal research with respect to taxation and development entails. In the second part the focus is on the method of this research.

3.1 Socio-Legal Research on Taxation and Development

Studying taxation and development in the Global South asks for a multi-level and interdisciplinary approach. Taxation is connected to both local, national and global issues, and involves challenges that raise governance, legal and social-scientific questions. The increased interest in taxation as a solution for domestic resource mobilization in the world of international development asks for a closer look at the social functioning of legal systems that are created and changed to increase tax revenue. Studying both taxpayers

and tax authorities, behaviour and governance, analysing current situations and looking for possible sustainable alternatives.

The roots of the socio-legal approach are found in legal anthropology. One of its pioneers, Bronislaw Malinowski (1926), concluded in his landmark fieldwork study that all societies have some form of law or other mechanism to maintain social order. Tax law in today's society is a way of maintaining order through fiscal efforts, ensuring stability in revenue collection for the state which is crucial for its functioning. Taxation becomes an instrument of governance rather than a natural part of society (Mann, 1943). A fiscal instrument that used to increase the control of the state. In the context of this research tax law in Uganda attempts to formalize SMEs and thereby aims to bring order to this sector.

The socio-legal approach can be used to study the social functioning of legal systems because it looks beyond the institutional perspective. Instead of studying what *should be* or *could be*, the socio-legal approach helps to understand what is actually *going on* in practice. In this way the socio-legal approach is analytical rather than instrumental. It looks at law in action rather than law in the books, or in the case of this research: tax law in action. In this way, it differs from the top down legal comparative studies mentioned in the theoretical part of this paper. Qualitative research methods focus on an in-depth understanding rather than quantitative analysis. The socio-legal approach aims to find a bottom-up understanding of the dynamics in the relation between state and society and the fabric of society.

3.2 Methods

The main research population of this study consists of people working at or owning SMEs in Kampala central division, an economic hotspot in the city. In the previous chapter we illustrated the main characteristics of these businesses. Besides SMEs in Kampala, the Uganda Revenue Authority and Kampala Capital City Authority also play an important role in this research.

The data for this study were collected in May and June 2017, during a fieldwork research in Kampala using qualitative research methods. The main method used was the qualitative unstructured interview. Besides dozens of informal conversations, this study is based on 20 in-depth interviews of which 15 with SMEs and 5 with URA, KCCA & NGO staff working on taxation. Other important methods include: Being There and participatory observation. 'Being There' helps to establish contact with the research population and builds a relationship of trust. It is a way of collecting data outside of formal meetings with respondents. Participatory observation, is described by DeWalt & DeWalt (2011) as taking "part in the daily activities, rituals, interactions, and events of a group of people as one of the means of learning the explicit and tacit aspects of their life routines and their culture". This is an excellent socio-legal method as it helps to understand the differences between the official story and how things work out in practice. Revealing the differences between what should be and how things actually are.

The internal validity of this research is threatened mainly by the fact that people are generally reluctant to talk about their unwanted behavior or non-compliance. That is why this research studies attitudes rather than actual (non-)compliance. Looking at perceptions and attitudes instead of actual non-compliance is a way of understanding

behavior related to tax compliance. Research from social psychology states that attitudes have a strong influence on behavior (Ajzen & Fishbein, 1977). We aimed for a diverse sample regarding gender, location and trade. The use of a local research assistant to find respondents significantly lowered the threshold to partake in this research.

4. Results

In this chapter we present the results of the research. The first part looks at the tax regime. Then, we explore the relation between SMEs and taxation in Kampala.

4.1 The Tax Regime in Kampala

SMEs in Kampala are affected by several types of fees and taxes. Direct taxes include the national income tax and trading licenses. Indirect taxes such as import and excise duties, and the Value Added Tax also impact these SMEs. Payments for services such as the collection of garbage and the supply of water or electricity is often perceived as taxation, but by definition a retribution. In the following paragraphs we discuss these taxes and the authorities responsible for collecting this revenue.

Taxes Related to SMEs in Kampala

We start with the trading license. It is obligatory to have a *trading license* for anyone in Uganda who wants to run a business. In Kampala this policy is implemented by the Kampala Capital City Authority (KCCA) under the mandate of the Ministry of Trade and Industry. The KCCA is responsible for executing the local tax regime within its administrative boundaries (GoU, 2010). Some of KCCA's main revenue responsibilities include: issuing trading licences, collecting property tax, the local service tax, hotel tax, and market fees. The trading license is required for all businesses, including service companies. The license has to be renewed each year which can be done at any KCCA division council, or at a so called 'one-stop-shop'. The KCCA uses a system called COIN (City Operator Identification Number) to identify individual enterprises. The amount that has to be paid to receive the license depends on the location and nature of the business. Locations in the city are graded in four categories and the nature of the business is classified using a list of over a hundred types of businesses.³ The size of the business or annual turnover is not relevant.

The national income tax act includes a so called 'small business tax' for SMEs. The small business tax is collected by the Uganda Revenue Authority (URA) and consists out of two parts. The first part covers businesses with a turnover between 50 and 150 million Ugandan Shillings. The second part concerns a presumptive tax for businesses with a turnover between 10 and 50 million Ugandan Shillings a year. The focus of this research is on businesses within this second part of the small business tax. The amount payable of this presumptive tax is determined by the location, nature and size of the business. This makes it much more complicated to assess what a business is liable to pay compared to the trading license issued by the KCCA. In Appendix B, we provided an overview of the schedule determining the rate of this tax. The small business tax has a significant compliance gap. It was initiated about two decades ago and changed several times but never raised more than about 4 billion Ugandan Shillings (about € 900 thousand). This is close to nothing compared to the total revenue of about 13 trillion (about € 2,9 billion) collected in the '15/'16 fiscal year (1/7 until 30/6). In '15/'16 the URA estimated the

potential revenue from the small business tax to be about 83 billion shillings, of which 24 billion in Kampala alone (Nanziri, Atukunda, & Lumal, 2016).

SMEs are not able or obliged to pay Value Added Tax (VAT). The threshold to register is an annual turnover of 150 million Ugandan Shillings. As these SMEs are within the presumptive tax regime with an annual turnover below 50 million, they do not have to and cannot register for VAT. Most SMEs do not import goods themselves, therefore they do not directly pay custom or import duties. They buy their goods at (other) wholesalers in town. However, the prices of goods are affected by these duties. Garbage collection and other services are provided by governmental and non-governmental institutions. Some business owners perceive paying for these services as also paying for taxes. VAT does influence the costs of services. For example, water and electricity are rated at 18%.

The URA, KCCA and Taxpayer Register Expansion Program

As mentioned above, responsible for revenue collection in Kampala are the Ugandan Revenue Authority (URA) and the Kampala Capital City Authority (KCCA). The URA is the oldest semi-autonomous revenue authority in sub-Saharan Africa, after Ghana's (Kiser & Sacks, 2009). It was partially privatized, legally separate from the state, can own its own assets, but is financed by parliamentary appropriation. How are the URA and KCCA involved in ensuring compliance in this sector? What measures do the URA and KCCA take to decrease compliance costs? To what extent are the URA and KCCA successful in moving SMEs from the informal to the formal sector? We answer these questions mainly by illustrating some recent developments in the policy and practice of these organizations aimed at increasing tax compliance through the Taxpayer Register Expansion Program (TREP). In this program URA and KCCA work together with Uganda Registration Service Bureau (URSB).

TREP aims to increase taxpayer registration which is a first step towards increasing tax compliance. TREP started about four years ago and was evaluated and expended each year. Several 'one-stop-shops' were opened across Kampala. A business can handle all its URA, KCCA and URSB formalities at an one-stop-shop. The one-stop-shop has three stages through which a business has to go through. First, it needs to register or verify a business registration number at the URSB officer. Second, it should apply for or verify a Tax Identification Number (TIN) at the URA official. In addition, payment has to be made for any outstanding taxes, such as the presumptive income tax. Finally, with a verified business registration number and TIN, he or she can apply for the trading license at the KCCA official. In practice businesses often first go to the KCCA official because it is the trading license for which most businesses come to the one-stop-shop. This is related to the fact that the KCCA has the most capacity to enforce compliance.

Collaboration between the different institutions in TREP increases each year. In theory, this makes it increasingly difficult for SMEs to evade or under declare taxes. Different governmental systems are integrated enhancing the level of information regarding these businesses. It is however the disintegration of different governmental systems which allows SMEs to, for example, pay local governments fees, but escape national taxation. It might be easy for businesses to stay under the radar of the URA. However, it is more difficult to avoid local government enforcement. This because the KCCA has more

capacity for enforcement than the URA; the KCCA physically checks for licenses throughout the city several times a year.

The definition of an 'informal business' differs between KCCA, URA and URSB. For example, for the URA a business could be informal because it has no TIN, regardless of whether it has a trading license or business registration number. For KCCA a business could be informal if it has no trading license, regardless of whether it has a TIN or business registration number. Finally, for URSB a business could be informal if it has no registration number, regardless of whether it has a TIN or trading license. This shows how the formal/informal duality is fabricated and facilitates the different goals of government institutions. By means of a program such as TREP governmental systems become more and more integrated and thereby also the governmental definition of the 'informal sector'.

URA and KCCA attempt to decrease compliance costs by implementing simplified tax laws that are easier to understand, and by making use of technological developments to reduce the money and time it costs to comply. Initiatives such as mobile payment aim to further decrease compliance costs. The fact that one still has to go to three different officials is one of the challenges TREP faces today, the different officials are not allowed to access the systems of the other institutions. Even though some businesses complain they have to visit three desks instead of one, the one-stop-shop does significantly decrease compliance costs in terms of time.

To what extent are the URA and KCCA successfully moving SMEs from the informal to the formal sector? It seems like the 'formalisation' of these SMEs by URA and KCCA is increasing. TREP introduces these businesses to the tax system. However, TREP has not led to an increase in the collection of revenue among SMEs by the URA. The total revenue collected through the URA small business tax has not significantly increased. The URA collected less than 10% of the target set for the '16/'17 fiscal year. The focus at URA is rather on other taxes such as the VAT and PAYE which contribute significantly more to the total revenue collected than the small business tax is even expected to raise if compliance would be at a hundred percent. Still, it will be interesting to see if and how the total revenue collected through this presumptive tax changes over the next couple of years, as TREP is supposed to start paying off.

In the previous paragraphs we examined the roles of the URA and KCCA when it comes to revenue collection among SMEs in Kampala. On paper both organizations aim to follow a 'service and client' model of interaction with taxpayers. For example, the culture statement of the URA is: 'We are a client focused & responsive organisation [...] to deliver a great client experience in an enjoyable environment'. Moreover, the URA organizes a 'taxpayer appreciation day'.⁴ In practice, the relationship between tax authority and taxpayer is more like a 'cops and robbers' relation. We elaborate on this in the following section.

4.2 Practice of Business and Taxation in Kampala

In section 2.2, we distinguished the main characteristics of the small and medium sized enterprises in this study. In this section we illustrate what day-to-day business life looks like for SMEs in Kampala. What challenges do they face? We describe how taxation affects these businesses. We demonstrate how businesses go about paying these taxes,

if they pay them at all. Furthermore, we elaborate on how the people working at or owning SMEs relate to the taxes imposed on them by the authorities. What influences their tax compliance attitudes? In the following paragraphs we describe a number of SMEs operating in various sectors in Kampala. These profiles are created to illustrate day-to-day business life of SMEs in Kampala, the information comes from several informants and the names used are pseudonyms. We use quotes from interviews, anecdotes, and general observations from data collected during fieldwork.

Day-To-Day Business and Taxation in Kampala

Second-hand clothing is a major business in Uganda and especially in Kampala's Central Division. Louisa sells second-hand clothing in her shop close to the biggest second-hand clothing market in Uganda, Owino market. Her shop is on one of the major routes leading to the market and thereby it is a prime location. Rent is expensive, people in that area pay from one million up to three million shillings a month. Because rent is expensive, Louisa has two sub-renters to ease the burden of the rent. Apart from some basics, she does not keep records. Louisa pays the URA 250 thousand shillings a year and about 200 for the KCCA trading license. Compared to the rent, these costs are affordable for her. Louisa, does not really understand where the money from the taxes she pays is going. She does believe that the government should be using tax revenue to build decent infrastructure and provide affordable education and health care. However, she does not know what the government is really doing with the money. Louisa blames the politicians, according to her, they do whatever they want and not what the citizens want. She is obliged to pay these taxes, but she does not feel like she gets anything in return.

"They are not doing anything. [I do] not know exactly where the money is going. The roads are bad. The filth in the city is quite a lot. If you go to KCC hospitals there are no medicine. The money is not doing anything. [...] Let them build good roads. Let them put drugs in the hospital. Let them clean the city so that the city everywhere is clean."

Louisa, May 2017

Fred works in a bookshop close to Kampala Road. The street is crowded with other bookshops. Trades tend to flock together in certain places of Kampala. Fred is not the only individual operating his business in this shop, four others have their collections of books (mainly educational) which they bought from importers, who in their turn got them from Kenya or Tanzania. Together they operate under one enterprise, which is registered at both KCCA and URA. Together they share the costs of rent, URA's small business tax, the KCCA trading license, and pay for services such as garbage collection, water and electricity. For the URA, it is not easy to determine in which bracket they fit because each person keeps its own records, some of which are very basic. According to Fred, even if he brings the combined books to the URA, they refuse to look at it and estimate the turnover of the business based on the size and location of the shop.

"Even if you are starting a new business you have to pay income tax in advance. Before getting a license. [...] They tell you go to URA. Pay URA charges or taxes. [...] You haven't progressed. You haven't earned in a year. But you are paying it in advance. They just ask you: 'What are your projected turnover a year? What are you investing? How much money are you having for that business?' I have 5 million. 'What is your projected turnover for the year?' Could be 10. And then they calculate and put it in the computer. Everything is programmed. And then gets your bracket. Gets your bracket and then you pay. [...] No one

is paying less than 200. So we are really puzzled, we are really tortured. You are paying that money when you haven't earned it."

Fred, June 2017

Fred, is quite frustrated about taxation. First of all, he considers it unfair that they have to pay taxes in advance, before he has earned a single coin. Furthermore, Fred mistrusts the authorities and believes they are corrupt. According to him, part of the money does not even reach the government and is kept by some officials. Fred believes taxes are too high and that this is also a reason why people do not pay or try to evade paying taxes. If taxes would be affordable people would not try to evade. Finally, he does not believe that he receives any services in return for the taxes he pays. According to Fred, the government does not provide these services because they simply do not care.

Arcades are found mainly in Kampala's Central Division. It functions a bit like a shopping mall but with hundreds of small shops. The design of the buildings aims to fit as many shops as possible on each floor. Susan trades in travel bags on the first floor of an arcade. She employs two people and does not share the shop. She pays a small business tax of about 150 thousand and 250 thousand for the KCCA trading license. Rent is expensive in these arcades and is no less than 1 million shillings each month. Her other major costs besides her employees are electricity, water and garbage collection. Susan's shop definitely turns over more than 20 million each year. However, she is still in the lowest bracket (See Appendix B). For her it is easy to under declare because the URA lacks capacity to thoroughly assess medium-sized businesses like her shop.

"There is a day that they pass through and ask for receipts. If you don't have it they will tell you: 'please carry your things inside' and they close. If they have not paid they are closed [...] and everybody has to go and pay. [At this moment] there are some that have not yet paid. Because this year they have not yet come. They can come any day. Some pay before they come but then there are those one who pay after they have come."

Susan, June 2017

Susan believes that paying for a trading license and income tax is double taxation on one activity. However, she has to pay because when you do not pay they will close your shop and you will have to go and pay anyway. Because she pays taxes herself she does believe other people should also pay taxes. Susan is not sure about what happens with the money they pay.

"I don't know even what the government is using that money [for]. I don't know how it is using that money. I don't know whether it reaches the government. [...] I don't know whether that money goes directly to the government. I am not sure. [...] Because I have never, I have never heard any like minister tell me. Explain for us about that money."

Susan, June 2017

Ibrahim and Isaac are two young boys manufacturing mainly welding and popcorn machines in Katwe, an area known for its unlimited manufacturing capabilities. They dropped out of school to work in the business that was started by Ibrahim's brother. They share their shop with a boy selling second-hand carpets and a man cutting and selling glass and mirrors. Sharing the shop lowers the burden of rent. Together they also pay for the trading license. These boys struggle to keep their business going. Sometimes it is hard to pay for the rent, and it is quite a challenge to gather enough money each year for the trading license. Therefore, Ibrahim and Isaac wait until the KCCA comes

knocking on doors and closes down the businesses without license, only then they will pay. If they are not able to gather enough money they are forced to move their business and start anew. Ibrahim and Isaac do not pay the URA small business tax, as URA officials less often visit this part of town. If they come and they can pay, they will pay. If they cannot, they have to move their business elsewhere.

"If you don't have a license they close your shop. For us. You have to pay. [...] If they don't come, no pay. The problem is money. [...] If you get some money we are paying. If we don't have. We leave."

Ibrahim, June 2017

To some extent Ibrahim and Isaac understand what the government uses the money collected through taxation for. Isaac believes the government is using this money to build roads, schools and hospitals. But, he does not believe that the government is doing a very good job.

"The government uses these taxes to pay for services such as roads and keeping the city clean. However, the government is doing a 50/50 job at this. Services should be better."

Isaac, June 2017

5. Conclusion

We formulated the main question of this research in the introduction: *What is the role of taxation in the development of the informal sector, specifically among SMEs in Kampala, Uganda?* In this chapter we answer the main and sub-questions of this study.

5.1 What is daily practice of SMEs with respect to taxation in Kampala?

In section 4.2 we presented several profiles of SMEs in Kampala and discussed how SMEs relate to taxation and the authorities. The results show that how and to what extent taxation influences day-to-day business of SMEs in Kampala varies. For some taxes are truly a burden and for others the costs of taxation is relatively low, but they find it easy to escape the attention of the authorities or under declare and avoid paying a substantial part of their taxes. The results indicate that a lot of these businesses are part formal and part informal. For example, a shop might be registered with all taxes and licenses paid for, but employs several people that are not registered. According to the KCCA the business might be formal, but not all rules and regulations are followed. Another example relates to sub-renting. One person might be renting the shop and paying all taxes and licenses that need to be paid. However, because rents are high this person is sub-renting parts of the small shop to other people. In some cases groups of people rent a shop and pay for the taxes and licenses together under the name of one enterprise. People in Kampala do not like to pay taxes, the flexibility of the location, size, and nature of their businesses is often designed to decrease the burden of these taxes or to evade paying them at all. SMEs try to adapt to the increased efforts of the URA and KCCA to formalize them. We elaborate on this in section 5.2 and 5.3.

The observation that these businesses are often part formal and part informal, supports the argument made by Joshi et al. (2014) discussed in section 2.1. The fact that a lot of SMEs are neither completely formal or informal shows how the difference between formal and informal or registered and non-registered is a duality that is built upon an

institutional perspective rather than real life observations. However, the tax system in place is based on this duality and does therefore not fit the structure of the sector. Subsequently, efficient revenue collection is frustrated by for example sub-renting, the flexibility of these businesses, and other issues such as the poor level of bookkeeping.

5.2 Which factors influence the willingness and ability to pay taxes?

People working at or owning SMEs understand that taxation is needed for the development of Uganda. However, they do not believe that the taxes they do pay are being put to good use. Therefore, they also understand why people would under declare or evade taxation. Their tax compliance attitudes are influenced by issues related to their trust in the authorities, knowledge of the tax regime, perspectives on public goods and service delivery, ideas about fairness, other social norms and values, and the power of the authorities to enforce compliance. These issues correspond directly with some of the explanations for compliance and tax morale provided by Ali et al. (2013) and Kirchler et al. (2008) in the theoretical chapter of this paper.

The level of knowledge of the tax system among the people working at or owning SMEs is generally low. It depends on the level of education, but most people do not know a lot about tax laws or the authorities responsible for executing these laws. They know that they have to pay the KCCA or the URA. Otherwise, their business is closed down or their property confiscated. Many taxes are perceived as double taxation. For example paying for the trading license and the presumptive income tax. Also paying for these taxes and services such as garbage collection. There is a lot of mistrust towards the tax authorities and the government in general. Tax administrators are often perceived as corrupt, sometimes collecting taxes twice or at a higher rate than believed they are supposed to. Besides, people do not believe that (all) the money they pay even reaches the government and eventually ends up in some individuals pocket.

People do know what they would like the government to spend tax revenues on. Infrastructure, health care and education, were basically mentioned by all respondents. People working at or owning SMEs would like to see the money they pay to be put to good use. However, they believe that politicians just use the money to enrich themselves and their family. This also helps to explain the poor tax culture. People believe that the government should support them in return for the taxes they pay. However, the government is perceived as corrupt and the conditions of the roads, hospitals and schools as poor. Still, evasion is not always seen as an option because their business might be closed or property confiscated. Interesting is that if people pay taxes, they do believe other people should pay taxes too, even though the money is not spend right. The sector has a very low tax morale, because the government lacks transparency, accountability, and legitimacy. In other words, good governance.

5.3 What are the implications for the effectiveness of the governmental strategy to tax the informal sector in Kampala?

The current approach towards the taxation of SMEs in Kampala does not seem to be working. It is a *top-down approach* because it mainly imposes taxes on these businesses and enforces them to comply. Directly targeting their tax compliance. In this way it looks a lot like the 'cops and robbers' scenario described by Kirchler et al. (2008). The authorities show little trust in the taxpayers and often use deterrent actions to enforce

compliance. However, enforcing compliance is difficult because the authorities lack the capacity. As mentioned above, taxpayers also distrust the government.

Compliance costs seem to be relatively low because of recent changes in ways of payment (URA & KCCA) and the simplified tax regime (URA). People can pay by mobile devices or they can go to any bank to pay for the trading license and presumptive income tax. The KCCA trading license is relatively difficult to evade compared to the URA small business tax. The cost of the KCCA license is a fixed rate, not depending on the turnover of the business and the KCCA will go around town to check for licenses several times a year. For the URA, it is quite difficult to establish the correct presumptive tax, because many of these businesses do not keep (proper) records or in some cases even several records. In addition, the URA lacks the capacity to systematically assess these businesses.

As mentioned in section 4.1, the total revenue collected through the URA small business tax has not increased significantly over the years. It seems like this strategy to formalize these informal businesses has not been very effective. It will be interesting to see if and how the total revenue collected via this presumptive tax will increase over the next couple of years.

Before we move on to the final chapter of this paper, we answer the main question of this study. *What is the role of taxation in the development of the informal sector, specifically among SMEs in Kampala, Uganda?* Taxation plays an important role in the development of SMEs in Kampala. It directly influences their day-to-day business. The role of taxation has become even bigger in recent years as the tax authorities attempt to increase their grip on this sector through programs such as TREP. In this way, taxation is used by the authorities to further formalize this sector. However, the current top-down strategy does not seem to be very effective.

6. Discussion

In this final chapter we discuss the main conclusions of this research, reflect on the objective of this study and the socio-legal methods used. As explained before, the top-down approach of taxing informal SMEs in Kampala does not seem to be working. Mainly because the formal alternative is not: predictable, uncorrupted, and generally save or beneficial. A top-down approach could work if it focused on the creation of a more stable political and economic context and business environment. However this is not the case.

Considering the above, it might be better to follow a different approach. Considering that the informal economy resembles the continuum presented in section 2.1 (Appendix A, Joshi et al. 2014), it could be beneficial to focus on the needs of SMEs and assist them in developing towards more formal enterprises. The deliverance of services and the construction of trust between the state and the sector could increase voluntary tax compliance, creating a tax culture, safeguarding long term compliance and decreasing the administrative costs of ensuring compliance. This different approach should consider the local conditions of doing business and the tax system should respond to that. Furthermore, taxation should have some 'added value' for these businesses to increase their willingness to register, file and pay taxes. This could be called a *bottom-up approach* towards the taxation of the informal sector. It starts from the perspectives and

needs of the SMEs. What do they need to develop and grow? How can the state facilitate this role of taxation as “a tool of collective education” (Mann, 1943)?

Such a bottom-up approach towards the taxation of SMEs in the informal sector does not focus on (just) building the capacity of state institutions, the focus is rather on the capacity of society and taxpayers to pay taxes, looking at the fabric of society and building grassroots tax morale. To develop strategies for taxing the informal sector in Uganda (and other developing countries) it is important to reflect on the question: what is capacity building and on what kind of capacity should we focus? This study suggests the focus should be on society rather than on the authorities. It shows what the grassroots capacity looks like by zooming in on small and medium-sized enterprises in the informal sector. Regarding the execution of a bottom-up approach, the informal continuum could be used as a tool providing a ‘path of development’. To move these business towards the formal sector, some interesting suggestions or starting points or focus areas can be found in both this research and the informal economy continuum: (1) knowledge about the tax system and expenditures, (2) Legal justice and certainty through protection from harassment and unexpected or arbitrary audits, (3) administrative literacy, learning how to keep simple records that can be used by the authorities in order to provide and assure each business a proper and fair assessment.

Considering the fact that the potential financial gains of taxing this sector are relatively low compared to the total amount of revenue collected in Uganda, it might be worthwhile to invest some of the revenues directly back into the sector. The three suggestions made above provide possible starting points. The state also benefits because when these businesses grow and become part of the regular tax regime they are more inclined to pay their taxes.

Before we conclude this paper, we briefly reflect on the socio-legal approach to researching taxation and development. In this study, the socio-legal approach helped to analyse the complex dynamics between state and society. More specific, the relation between SMEs and the tax authorities. The qualitative research methods used were crucial to find a deeper understanding the fabric of society from which these businesses operate. This focus on an in-depth understanding rather than quantitative analysis, provides a different and useful approach to the field of taxation and development. Thus adding new knowledge and insights to fuel the debate of taxation and development, because “scholars have barely begun to investigate the relationship between tax policy and social development” (Martin & Prasad, 2014).

As mentioned before, the increased interest in taxation as a solution for domestic resource mobilization in the world of international development asks for a closer look at the social functioning of legal systems that are created and changed to increase tax revenue. This study introduced a socio-legal approach to the field of taxation and development. Future socio-legal research directions could and should include a more multi-level approach. Looking at the role of international organizations and collaborations to find answers for questions such as: How do global discourses in taxation influence local realities in countries in the Global South? How can international organizations contribute to the sustainable development of domestic resource mobilization in these countries? An interesting subject to focus on would be the tax officer, or the street level bureaucrat. The tax officer is the point of contact between the government and the taxpayer. He or she has to implement and apply national laws and regulations, which are

influenced by global discourses, and local contexts and situations. When it comes to the implementation of a bottom-up strategy of taxation as suggested in this paper, the role of the tax officer will be crucial for the success of such an approach.

Notes

- 1 The Ugandan Investment Authority (UIA) uses the following categories: '*Micro Enterprise*' is an enterprise employing up to four people, with an annual sales/revenue turnover or total assets not exceeding Uganda shillings 10 million. '*Small Enterprises*' employ between 5 and 49 and have total assets between UGX: 10 million but not exceeding 100 million. The '*Medium Enterprise*', employs between 50 and 100 with total assets more than 100 million but not exceeding 360 million. Information derived from the UIA website: <http://www.ugandainvest.go.ug/sme/>. We do not use these categories because they come from an institutional perspective rather than an analytical perspective. Therefore, we use the characteristics described in the informal economy continuum (Joshi et al. 2014).
- 2 When non-state actors enter the arena of the provision of public services this can have a negative effect on compliance. This research does not specifically focus on this, but it would be an interesting subject to further explore in future research.
- 3 The costs or rates for the KCCA trading licence can be found on the KCCA website: https://www.kcca.go.ug/?jsp=trading_licence_rates
- 4 Both the culture statement and the 'taxpayer appreciation day' can be found on the Uganda Revenue Authority's Facebook page, which is remarkably active: <https://www.facebook.com/URApge/>. The statement can be found here: [URA Culture Statement on Facebook](#)

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Appendix A – The Informal Economy Continuum

Table 1: A typology of enterprise informality (Joshi, Prichard, & Heady, 2014)

Features	Informal economy				Formal economy	
	A	B	C	D		
Degree of informality	Subsistence enterprises	Micro enterprises and small businesses	Small and medium businesses	Small, medium, and large businesses		
Type of activity	Totally informal	High proportion of sales undeclared and workers not registered	Some proportion of sales undeclared and workers unregistered	Labour and firms registered and regulated		
Technology	Street traders, cottage/micro enterprises, subsistence farmers	Small manufacturers, service providers, distributors, contractors	Small and medium manufacturers, service providers	Range of manufacturing and services		
Owner profile	Labour intensive	Mostly labour intensive	Mixed labour and capital intensive	Knowledge and capital intensive		
Markets	Poor, low education, low level of skills	Poor and non-poor, likely educated, skilled	Non-poor, well educated, high levels of skills	Non-poor, highly educated, sophisticated level of skills		
Finance needs	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Some barriers to entry, established markets	Significant barriers to entry, established market/ product niche		
Other needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	Investment capital and working capital, letters of credit, supplier credit		
Tax status	Personal insurance, social protection, security	Personal and business insurance and business support services, security	Personal and business insurance, business development services	Personal and business insurance, business development services		
Tax design desired features	Earnings can be below minimum tax threshold, no recordkeeping, cash transactions	Liable for tax, difficult to identify and assess, poor or no recordkeeping, cash transactions	Liable for tax, under-report earnings, use loopholes, escape formal tax assessments	Taxed under formal tax assessment		

Notes: Greyscale text comprises features less relevant to taxation.

Source: Adapted from Zinnes' (2009, p. 8) adaptation of Djankov et al. (2002).

Appendix B – Presumptive Taxes URA

Domestic Tax Laws 2016 – Income Tax Act (Part II Inserted by IT (Am) ACT 2015)

1. The amount of tax payable for purposes of section 4(5) where the gross turnover is less than fifty million shillings is –

(i) Kampala City and Divisions of Kampala

BUSINESS TRADE	With turnover between 35m - 50m	With turnover between 20m - 35m	With turnover between 10m - 20m
General Trade	500,000	400,000	250,000
Carpentry/ Metal	500,000	400,000	250,000
Garages (Motor Vehicle repair)	550,000	450,000	300,000
Hair and Beauty/ Salons	550,000	400,000	300,000
Restaurants or Bars	550,000	450,000	300,000
Clinics	550,000	450,000	300,000
Drug Shops	500,000	350,000	100,000
Others	450,000	300,000	200,000