

# Tax Reform in Uganda



# Tax Reform in Uganda:

## *A Case Study of the Reform of Direct Taxation of Business Profits in the Formal and Informal Sector*

By

Dorothy Kwagala-Igaga

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of Business Profits in the Formal and Informal Sector

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This work is dedicated to Matthews, Asasila and Ayinza



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## PREFACE

Uganda is credited for carrying out extensive reforms in its tax system in the 1990s. The system of administration was overhauled together with a complete overhaul in legislation. The aim was mainly to increase tax revenues. Improvements were registered in the tax revenues but only temporarily. Since 2004, there has been stagnation in the tax revenue figures. The revenue from direct taxes only contributes about 20% to the total revenue, well below the Sub-Saharan average of 40%. This has focused attention on the appropriateness of the reforms. The focus of the reforms on achieving efficiency did not sufficiently take into account the fundamental importance of equity within the system. As a result, the Income Tax Act 1997 embodies distortions and inequalities in the treatment of taxable income and taxpayers that have led to inefficiency in the system as a whole. The tax reforms also took a narrow technical view of the tax system. Taxation has an impact on state-building and is, therefore, affected by the state of governance. The reforms, even where they were well designed, have been affected by institutional weakness and the lack of accountability in the political process. The fact that institutional capacity affects effectiveness of the tax system is well documented yet it does not seem to have been taken into account (UNDP, 1991:70). Taxpayer morale and revenues have been constrained by high levels of corruption within the Uganda Revenue Authority (URA) and arbitrariness in the award of tax waivers and other tax advantages.

The purpose of this book is, therefore, to examine the distortions engendered by the tax system and their impact on taxpayer morale, tax revenue and investment. The research focuses on the direct taxation of profits from business activity in the formal and informal sector. An examination of the taxation of business profits provides an opportunity to highlight the distinctions in the tax system with regard to the treatment of the same type of income based on the legal status of the taxpayer and other considerations. The taxation of business profits in the corporate sector is compared with the taxation of business profits under the personal income tax system, taxation of partnerships and other unincorporated businesses. There is emphasis on the taxation of the informal sector which is presently less than satisfactory. However, the analysis is done in the context of the socio-political situation in Uganda. The weaknesses in governance and

corruption have had an impact on the tax system by encouraging tax avoidance and evasion among political elites as well as on activities in the informal sector. The research also explores possibilities of broadening the tax base within the existing legislative framework as well as other possibilities for reform, for example, the call for the expansion of the tax base through taxation of land and agriculture by various experts and the Uganda Revenue Authority itself (Private Sector Foundation-Uganda, 2009:122). Account must also be taken of Uganda's membership of East African Community (EAC) and the constraints this puts on its exercise of fiscal sovereignty.

The book comprises six chapters. Chapter One titled "Reform of Direct Taxation of Profits from Business Activity in Uganda" is a general introduction. The statement of the problem presents a brief critique of the tax system and the reforms generally. The methodology is also presented at the end of Chapter One.

Chapter Two is titled "The Development of Uganda's Tax System" and explores the development of the tax system from the pre-colonial period to 1986. It is largely descriptive but serves to draw out areas of comparison with the 1997 reforms. The approaches to tax reform are presented as a contrast to the technical and *ad hoc* approach followed in 1997 to 2014. The Chapter also explores the development of themes in the tax system for example the balance between corporate income tax and personal income tax. The period 1986 to 2014 is covered in Chapter Three which presents an overview of the reforms of the system of taxing business profits.

Chapter Four is titled "Theories of Taxation and the Political Economy of Taxation in Uganda" and presents the theoretical framework. Optimal tax theory is used to analyse the appropriateness of the tax system. Some of the shortcomings in the 1990s tax reforms are attributable to the governance and institutional framework in Uganda thus the political economy analysis. The Chapter contains a description of Uganda's relationship with the International Financial Institutions (IFIs) which constrains the exercise of fiscal sovereignty. This relationship is analysed through the Foucaultian conceptions of conduct and counter conduct. There is a brief description of the East African Community (EAC) and the proposed harmonisation process that will have an impact on direct taxation in Uganda.

Chapter Five is titled "Direct Taxation of Profits from Business Activity in the Formal and Informal Sector in Uganda". This Chapter presents the main content of the study. The system of taxing profits in the formal and



informal sector is examined. The taxation of companies, partnerships, unit trusts and small businesses is analysed in light of its impact on investment and economic growth. Chapter Six is the conclusion and recommendations.

This book is based substantially on my doctoral thesis. It is the culmination of research undertaken under the supervision of Assoc. Prof David Salter at Warwick University. The research commenced in 2006 before the financial crisis of 2008. Initial interest in the area was sparked in 2000-2001 while studying for the LLM in Commercial Law at Cambridge University. I studied International Commercial Tax under Prof Tiley and was gripped by the discussions on the various considerations that underpinned the tax system. I continued to research the area and eventually enrolled for the PhD at Warwick. I was alarmed by the technical focus on the tax system in Uganda and was keen to highlight the context and in particular the experience that has shaped Uganda's tax system and every aspect of the state. The financial crisis of 2008 put pressure on the Ugandan government to increase domestic resources. This makes it pertinent to examine the efficacy of the tax system and its usefulness in this endeavour.

I spent five wonderful years at Warwick as a research and Teaching fellow. I am grateful to the Graduate school for the funding which made the PhD possible. Warwick provided a supporting and stimulating environment and I owe a debt of gratitude to several people who have shaped my thinking on tax reform and political economy. I would like to express my sincere gratitude to my supervisor, Assoc. Professor David Salter, for his patient guidance and invaluable advice throughout the PhD. He encouraged me to look at taxation in the somewhat unorthodox fashion that I have documented in this book. I was lucky to benefit from the advice and encouragement of Assoc. Prof John Snape who is engaged in studying the political economy of taxation in the UK. I am also grateful to Professor David Bakibinga of the Law School, Makerere University, for his very useful comments and advice on various aspects of the thesis that formed the basis of the book. I would also like to express my sincere thanks to my fellow PhD students and friends at the University of Warwick for their support and kind help and advice with my research. The research was completed while I was at Kingston University and I am grateful to colleagues at the Law School for their support. I would like to thank my family for their continuous encouragement and support. The PhD has only been possible because of the huge sacrifices made by my husband and young children. Finally, thanks to the team at CSP for their patience and editorial work on the manuscript.

## LIST OF ABBREVIATIONS

<b>ACODE</b>	Advocates' Coalition for Development and Environment
<b>ACT</b>	Advance Corporation Tax
<b>AfDB</b>	African Development Bank
<b>BOU</b>	Bank of Uganda
<b>CFPED</b>	Committee on Finance Planning and Economic Development (Parliament of the Republic of Uganda)
<b>CHOGM</b>	Commonwealth Heads of Government Meeting
<b>CIDA</b>	Canadian International Development Agency
<b>CIT</b>	Corporate Income Tax
<b>CLA</b>	Central Legislative Assembly
<b>CMB</b>	Coffee Marketing Board
<b>CMS</b>	Church Missionary Society
<b>COMESA</b>	Common Market for Eastern Southern Africa Countries
<b>CTL</b>	Commercial Transactions Levy
<b>DFID</b>	Department for International Development
<b>DP</b>	Democratic Party
<b>EAC</b>	East African Community
<b>EACA</b>	East African Court of Appeal
<b>EACLA</b>	East African Central Legislative Assembly
<b>EACSO</b>	East African Common Services Organisation
<b>EADB</b>	East African Development Bank
<b>EAHC</b>	East African High Commission
<b>EAITD</b>	East African Income Tax Department
<b>EARHA</b>	East African Railways and Harbours' Authority
<b>EPA</b>	Economic Partnership Agreement
<b>EPRC</b>	Economic Policy Research Centre (Makerere University)
<b>EPZ</b>	Enterprise Protection Zone
<b>EU</b>	European Union
<b>FDI</b>	Foreign direct Investment
<b>FOWODE</b>	Forum for Women in Development
<b>GDP</b>	Gross Domestic Product
<b>GOU</b>	Government of Uganda
<b>GTZ</b>	German Organisation for Technical Cooperation (Currently GIZ Deutsche Gesellschaft für Internationale Zusammenarbeit)
<b>IBEACo</b>	Imperial British East African Company

<b>IBRD</b>	International Bank for Reconstruction and Development
<b>ICA</b>	International Coffee Agreement
<b>ICPA-U</b>	Institute of Certified Public Accountants-Uganda
<b>IDRC</b>	International Development Research Centre-Canada
<b>IFI</b>	International Financial Institutions
<b>IMF</b>	International Monetary Fund
<b>ITA</b>	Income Tax Act Cap 340 Laws of Uganda
<b>ITD</b>	Income Tax Decree 1974
<b>KCCA</b>	Kampala City Council Authority
<b>KACITA</b>	Kampala City Traders' Association
<b>LST</b>	Local Service Tax
<b>LTD</b>	Large Taxpayers' Department
<b>MDG</b>	Millennium Development Goals
<b>MoEMD</b>	Ministry of Energy and Mineral Development
<b>MoFPED</b>	Ministry of Finance, Planning and Economic Development
<b>MTD</b>	Medium Taxpayers' Department
<b>NGO</b>	Non-Governmental Organisation
<b>NRM</b>	National Resistance Movement
<b>ODA</b>	Official Donor Assistance
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>PAYE</b>	Pay As You Earn
<b>PDR</b>	Pool of Distributable Revenue
<b>PEAP</b>	Poverty Eradication Action Plan
<b>PIT</b>	Personal Income Tax
<b>PSA</b>	Production Sharing Agreement
<b>PSF-U</b>	Private Sector Foundation-Uganda
<b>PWC</b>	PriceWaterhouse Coopers
<b>SAP</b>	Structural Adjustment Programme
<b>SEZ</b>	Special Enterprise Zones
<b>TAT</b>	Tax Appeals Tribunal
<b>TIN</b>	Tax Identification Number xii
<b>UBOS</b>	Uganda Bureau of Statistics
<b>UDHR</b>	Universal Declaration of Human Rights
<b>UDN</b>	Uganda Debt Network
<b>UIA</b>	Uganda Investment Authority
<b>UMA</b>	Uganda Manufacturers' Association
<b>UNC</b>	Uganda National Congress
<b>UNECA</b>	United Nations Economic Commission for Africa
<b>UNHS</b>	Uganda National Household Survey
<b>UNLF</b>	Uganda National Liberation Front
<b>URA</b>	Uganda Revenue Authority

<b>URSB</b>	Uganda Registration Services Bureau
<b>USE</b>	Uganda Securities Exchange
<b>UTODA</b>	Uganda Taxi Operators and Drivers' Association
<b>VAT</b>	Value Added Tax

# CHAPTER ONE

## REFORM OF DIRECT TAXATION OF PROFITS FROM BUSINESS ACTIVITY IN UGANDA

### 1.1 Introduction

In an era of economic integration, the economic and institutional barriers to cross-border investment continue to wane (OECD, 1991:21). Therefore, the decision to invest in assets in one country is more likely than before, to be influenced by cross-country differences in personal and corporate income tax rates and tax systems. The liberalization of international financial markets has led to an unprecedented level of interaction between national tax systems. Whereas tax systems are constrained by national frontiers, multinational enterprises and capital are not. Entrepreneurs have adopted a global strategy of resource allocation based on the levels of return on investment that can be gained in each particular tax system. Therefore, reform of the system of taxing profits from business activity has been and continues to be a major preoccupation of countries around the world. There is also evidence that countries compete in establishing tax systems that are attractive to investment in order to gain a larger share of global capital (OECD, 1998:15, Devereux, Lockwood and Redoano, 2008:2). East African countries have not been slow to address perceived barriers to investment in order to attract Foreign Direct Investment (FDI). There has been reform of tax systems throughout East Africa in the past two decades in order to make the countries more attractive destinations for foreign investment (AfDB, 2010a:1, AfDB, 2011:1). The revival of the East African Community (EAC) is partly aimed at increasing competitiveness in the region and facilitating economic growth. The main justification for the efforts to attract foreign investment is to facilitate economic growth and address the high levels of poverty in the region. It is argued that increased investment will lead to an increase in tax revenues. The expansion in tax revenues is expected to equip Governments with the capacity to invest in structural and social infrastructure and provision of social services to improve the living standards of their citizens. Improved

infrastructure is expected to further encourage private investment in these economies.

Throughout the 1990s, Uganda undertook extensive reforms in its tax system as part of the broader Structural Adjustment Programmes (SAPs) spearheaded by the International Monetary Fund (IMF) and the World Bank and other development partners aimed at encouraging economic growth as described in Chapter Three of this book. The reforms involved a complete overhaul of tax legislation and the system of tax administration. The reforms in tax administration were proposed and supported by the Department for International Development (DFID) and its partners (Moore, 2013:8). There were various considerations for tax reform and these reflected the concerns of the stakeholders.

On the one hand, the Government was keen to increase tax revenues and tackle the budget deficits in a bid to reduce donor dependence. This was to be achieved through an overhaul of the system of tax administration and tax legislation. The approach of the government was to simplify the tax legislation and broaden the tax base in order to make the tax system pro-business (Reinikka and Chen, 1999:2). An independent revenue authority (Uganda Revenue Authority (URA)) was created in 1991 to improve tax administration. A new Income Tax Act was passed in 1997 (hereinafter ITA 1997) to consolidate the tax legislation and assist in administration. The tax system was rationalised by lowering the tax rates and dramatically reducing the scale of exemptions through the repeal of a number of sections in the Investment Code Act of 1991. One important aspect of the new legislation was the removal of the Minister of Finance's discretionary powers to grant tax holidays and other tax advantages under the Investment Code Act 1991. Instead, a system of allowances and deductions was created to operate across the board. The newly created URA was set a target of increasing the tax to GDP ratio by a percentage point annually (Reinikka and Chen, 1999:2, Ayoki, 2007:4). Indeed this was achieved for a number of years but it has stagnated since 2004 as explained later and illustrated in Fig 1 and Fig. 2 below. This was against the background of an expanded economy. The economic base had, in the 1990s, shifted from largely subsistence agriculture to a mixture of commercial agriculture, industry and services. In 2002-2003, the contribution of subsistence agriculture to GDP dropped by 10 percentage points. At the same time, industrial production rose from 12% to almost 20% while services increased from less than 35% to more than 41% (Republic of Uganda, 2004:8). The economic development was driven by increased government spending largely financed by high levels of development assistance

(Mwenda, 2006:3, Le, 2007:189, Hisali and Ddumba-Ssentamu, 2013:356).

The second priority of the Government of Uganda was to encourage private investment and economic growth (Republic of Uganda, 1999:6). There were wider reforms in economic regulation covering banking and business registration. The Uganda Investment Authority (UIA) was created in 1991 to act as a “one-stop-shop” for investors with regard to licensing and the grant of investment incentives under the Investment Code Act 1991. The investment incentives ranged from the grant of tax holidays which have now been legally phased out to the distribution of land in the industrial parks around Kampala and other urban centres and the Islands in Lake Victoria.

The business community was keen to have a tax system that was efficient and equitable. The Uganda Manufacturers’ Association (UMA) and Private Sector Foundation-Uganda (PSF-U) especially lobbied for lower tax rates and simplified tax procedures to reduce the cost of doing business (Uganda Manufacturers’ Association (UMA), 1996:3). They argued against the discretionary powers of the Minister of Finance reasoning that the selective grant of tax waivers and tax holidays not only distorted competition, but also complicated the tax system. They further argued that it affected the taxpaying morale of those who were not in receipt of the tax incentives (Uganda Manufacturers’ Association, 1997:11). They pointed out that the tax advantages often accrued to big businesses especially large foreign multi-nationals which then had an unfair advantage over the medium-sized businesses which were often the indigenous companies (Uganda Manufacturers’ Association (UMA), 1996:4). The unfair and inequitable situation was exacerbated by the fact that the informal sector was hardly targeted by the tax system (Uganda Manufacturers’ Association (UMA), 1997:11).

The IMF, World Bank and DFID, on the other hand, advocated for an optimal and efficient tax system that was simple to administer. Their argument was based on the limited capacity of Developing Countries to administer a complex or sophisticated tax system (Mirrlees, Adam, Besley et al, 2011:44). As explained in Chapter Three, equity of the tax system was not considered a priority at the time.

These priorities were dictated by the need to rapidly expand tax revenues in order to reduce the budget deficits and safeguard the international financial system (Reinikka and Chen, 1999: 2, Fjeldstad and Moore,

2009:12). This is particularly reflected in the short term focus on tax administration and the support for the creation of an independent revenue authority to create a “pocket of efficiency” removed from the traditional civil service that was clearly weak and inefficient (Prichard and Leonard, 2010:654, Moore, 2013:12). The IMF, World Bank and DFID chose to concentrate on tax administration rather than champion wider structural reforms in Uganda that would not have been easy to implement in the short term. It is also evident in the balance between the taxation of the formal and informal sector which is further explored in Chapter Three and Chapter Five of this book. In light of the difficulty of taxing the informal sector, the IMF recommended a “transitional” approach that involved a presumptive system of taxing informal businesses in the hope that they would be taxed adequately when they made the transition to the formal economy (van der Heeden et al, 1997:81). This has not worked in practice and the informal sector remains lightly taxed creating resentment among the formal sector businesses and lowering their tax morale (Private Sector Foundation-Uganda, 2009:70, Matovu, 2010:35, Mwesigwa, 2012).

This book seeks to examine the success of the tax reforms in as far as they have achieved the stated objectives and to examine the suitability of the reforms to Uganda’s socio-political environment between 1997 and 2014. It will be demonstrated that there has been limited success in increasing tax revenues. Notably, even the modest increase in tax revenues has not led to any significant improvements in either structural or social infrastructure (Mwenda, 2006:2). Increased tax revenues have not led to increased social spending as the government is currently perceived as corrupt and inept so that the public believes it is incapable of delivering value for money (AfDB, 2010a:7, Tabaire and Okao, 2010b:9). Increased investment has not had a commensurate impact on tax revenue collection either as illustrated in Fig. 1.1 compared to Fig. 1.3 below. The failure to address equity concerns in the tax system has lowered the taxpayer morale even further and this has in turn affected the capacity of the URA to hit revenue targets. The tax system does not adequately target the small businesses operating in the informal sector yet at the same time provides favourable treatment to selected taxpayers through the discretionary powers of the Minister of Finance under the Budget Act as illustrated in Chapter Five. It will also be demonstrated that the tax reforms have had undesirable outcomes by increasing business activity in the informal sector through the poor tax strategy of imposing presumptive tax at token rates on small businesses operating in the informal sector (Reinikka and Collier 2001:285). It will be demonstrated that the outcome of the reform is a haphazard patchwork that is neither coherent nor efficient.



## 1.2 Background to the Study

Since 1986, the Ugandan economy has grown steadily at a rate higher than the Sub-Saharan African (SSA) average of 2.4%<sup>1</sup> (Republic of Uganda, 2009:3, Whitworth and Williamson, 2010:1). This has endeared it to the International Financial Institutions (IFIs) that have praised its economic transformation dubbing it the “Ugandan Success Story” (Holmgren et al., 1999:103, Robinson, 2005:2, Mwenda, 2006:2, AfDB, 2010a:2). This success is attributed to the plethora of economic reforms implemented by the National Resistance Movement (NRM) government backed by the IMF and the World Bank (Dijkstra and Kees van Donge, 2001:841). 1986 was in many ways a turning point for Uganda, a country emerging from decades of political and economic crisis (Hansen and Twaddle, 1998:30, Kaweesa, 2004:3, Tumusiime-Mutebile, 2010:35, Schlichte, 2008:369). As fully described in Chapter Two, the public finances of Uganda were in a state of collapse and manufacturing had come to a standstill (Department for International Development, 1999:4). This was a direct result of the economic decline of the 1970s and 1980s. The economic decline is attributed to economic mismanagement, the oil crisis of 1974 and the failure of the economic policies that advocated Government control over production and regulation of economic activity (World Bank, 1980:6, World Bank, 1991:3).

Tax revenues were very low and in 1990, even after 4 years of stability and exceptional growth in the economy which averaged 8% over the period, the tax to GDP ratio was less than 7% (Republic of Uganda, 1988:16, Republic of Uganda, 1990:25). The decline is best illustrated by the fact that tax to GDP ratio was 13% in 1971/72 but had reduced to 3.3% in 1989/1990 (Republic of Uganda, 1990:23, Sserwanga, 1993:2). The tax rates were very high with the corporate tax rate at 60% in 1989 which was considered predatory by the business community (Kaweesa, 2004:3). The tax rates had been driven up by the desire to raise tax revenues which was counterproductive and inefficient because of a very narrow tax base and general underperformance of the economy. The export sector had been greatly undermined by the collapse of the quota system under the International Coffee Agreement (ICA) in 1973 and subsequent fall in coffee prices (Kiiza, 2007:4). The private sector was dominated by

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<sup>1</sup> Real GDP growth was around 6.6% in 2004/05, 5.1% in 2005/06, 6.5% 2006/07, 8.9% in 2007/08, 7.0% in 2008/09, 6.7% in 2010 (Republic of Uganda, 2005:2, Republic of Uganda, 2006:3, Republic of Uganda, 2007:2, Republic of Uganda, 2008:2, Republic of Uganda, 2009:5, Republic of Uganda, 2012:4).

agriculture which had low revenue productivity (Republic of Uganda, 1989a:14, Kayizzi-Mugerwa, 2002:1). The political instability had reduced the levels of investment in the economy. The tax base was further narrowed by the various tax exemptions, tax holidays and other incentives introduced throughout the 1970s and 1980s in a vain effort to attract foreign investment and encourage economic recovery (Kaweesa, 2004:4). There was serious weakness in tax administration and large sections of the public did not pay tax as the Ministry of Finance did not have the capacity to assess and collect taxes on all individual taxpayers and small businesses (Republic of Uganda, 1987:12, Coopers & Lybrand, 1992:3, University of Birmingham, 1998:4). There was an acute need to mobilise resources to finance the much needed social services and rehabilitation of the infrastructure (Reinikka and Chen, 1999:1). The priority of the NRM government on taking power in 1986, beyond providing security, was economic transformation and reconstruction (National Resistance Movement, 1985:7, Republic of Uganda, 1987:3).

The NRM Government immediately embraced the Structural Adjustment Programmes (SAPs) of the IMF and World Bank and embarked on an economic recovery and rehabilitation programme (Mamdani, 1988:1163, Nabudere, 1990:7, Republic of Uganda, 1992:6). The overall policy of the Government was to encourage private sector led development. In line with the IMF and World Bank policies, the economy was liberalized (Macculloch, 2001:10). The Government undertook the privatization of all government owned parastatals and the overhaul of business regulation to encourage competition in the market and support investment especially foreign investment. The importance of private investment to the economic development of Uganda cannot be overemphasized. In 1999/2000 private investments accounted for 14% of the GDP. In a developing economy, like Uganda, the bulk of private investment is foreign investment. It is undisputed that one of the constraints to private investment is inappropriate tax policies and weakness in tax administration.

In light of the economic constraints and inefficiency in the tax system, Uganda introduced extensive reforms in the area of taxation as part of the wider SAPs (Gloppen and Rakner, 2002:31, Republic of Uganda, 2010b:10). The tax reforms were designed to achieve fiscal consolidation, lowering the tax burdens and reducing tax induced distortions in investment and financing decisions in the economy. The focus was on boosting the private sector to signal a change in economic policy direction with the final abandonment of the Government led development policies of the 1970s and 1980s (Sennoga et al, 2009:1, Matovu, 2010:8).

One of the priorities was improving tax administration and widening the tax base (Bird, 2008:6). In 1991, a semi-autonomous revenue authority, the Uganda Revenue Authority (URA), was established by statute. It is a Government agency charged with the administration of the various central government taxes. Tax administration had been the function of the Income Tax Department, Customs and Excise Department and the Inland Revenue Department of the Ministry of Finance (Bakibinga, 2006:11). The reform of the tax administration institutions was based on the proposition of the IFIs that in weak states, revenue collection agencies are more effective when they operate autonomously rather than as a department of the government (University of Birmingham, 1998:11, Gray and Chapman, 2001:5, Taliercio, 2004:2). Independence of the URA was designed to limit political interference (Coopers & Lybrand Uganda, 1992:2, Private Sector Foundation-Uganda, 2009:9). It would also be able to offer better remuneration than the traditional civil service and, therefore, have the capacity to attract and retain competent staff and improve its efficiency in tax collection (Collier, 1999:14, Fjeldstad and Rakner, 2003:16, Kangave, 2005:146, John, 2006:5). Further, a Tax Appeals Tribunal (TAT) was established by statute to provide a specialised dispute resolution mechanism for tax disputes.

There was also an effort to encourage private investment in order to encourage economic growth and increase tax revenues. This was to be achieved through fiscal and regulatory reforms. Besides the creation of the UIA in 1991, the business registry was restructured and procedures improved to reduce the cost of business registration. The other reforms were in taxation and involved lowering and rationalising the tax rates while broadening the tax base (Reinikka and Chen, 1996:2, Sunley et al., 1996:8, Gray and Chapman, 2001:2). In 1991, Parliament also passed the Investment Code Act 1991, designed to attract foreign direct investment through granting tax exemptions and holidays among other tax advantages initially to foreign investors but subsequently made available to all investors. In 1996, Value Added Tax (VAT) was introduced to replace Sales Tax and Commercial Transactions Levy (CTL). In 1997, the Income Tax Decree of 1974 (ITD 1974) was replaced with the Income Tax Act 1997 (ITA 1997). The Income Tax Decree needed an overhaul because it had gone through several amendments which needed to be consolidated for ease of interpretation and administration. The situation was complicated further by the existence of discretionary powers to grant tax holidays under the Investment Code Act of 1991. The tax base was broadened under the ITA 1997 through the abolition of the tax holidays and general reduction in exemptions through the repeal of several sections

of the Investment Code Act 1991. The ITA 1997 also made all employee benefits connected to the employment for example, health insurance, accommodation and transport taxable under the Pay as You Earn (PAYE) scheme.

One of the key reforms was the reform of direct taxation of profits from business activity in the formal and informal sector<sup>2</sup>. A uniform rate of corporate income tax of 30% was introduced in 1993. This was a marked reduction from the rate of 60% which had been introduced by the same government in 1989 (Abed et al., 1998, Teera, 2003:21). An IMF Team of Experts had recommended that the rate of corporate income tax be lowered to 25% in 1993 (Mahler et al., 1993:11) but another IMF team recommended a rate of 30% in 1996 (Sunley et al., 1996:48). A variable rate of corporate income tax for the mining sector was introduced of between 10%-45%. In 1997, the rate for non-resident companies was lowered from 35% to 30%. The classical system of taxing corporate profits was maintained but the anti-avoidance provisions regarding deemed distributions in the Income Tax Decree 1974 were repealed. Subsequently, other anti-avoidance provisions have been introduced concerning thin capitalisation and transfer pricing but not deemed distributions. Under the ITA 1997, capital gains tax was introduced for the first time since Independence.

A separate regime of presumptive taxation was also introduced to tax the small businesses that operate in the informal sector. This replaced the complicated system of trade licences for small businesses under the Income Tax Decree that had been repealed in 1993 (van der Heeden, 1997:63). Unit trusts and members' clubs which had been taxed under the personal income tax regime under the Income Tax Decree were now defined as companies subject to corporate income tax. Barriers to 100% ownership of companies by foreign investors introduced in the 1970s as part of the "economic war" (outlined in Chapter Two) were abolished. The Investment Code Act of 1991 which had vested the Minister of Finance with wide powers to grant tax exemptions and tax holidays was amended and most sections were repealed in 1997.<sup>3</sup> A new scheme of capital

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<sup>2</sup> The informal sector is fully described in Chapter Three (3.3(c)).

<sup>3</sup> The Minister of Finance Planning and Economic Development (MFPED) currently has similar powers under the Budget Act to spend tax revenue on meeting the tax liability of specific taxpayers which achieves the same purpose as a tax exemption without the parliamentary scrutiny under the Investment Code Act but subject to audit by the Auditor General.

deductions and allowances was introduced under the ITA 1997. The top rate of tax for individuals was reduced from 40% to 30% under the ITA 1997. This followed an expert report in 1993 which recommended such reductions for efficiency and “equity” reasons (Mahler et al., 1993:10). During her Budget Speech 2012/2013 delivered on June 16, 2012, the Minister of Finance announced that the top rate personal income tax would effectively be increased to 40% in the financial year 2012/13. An additional 10% would be imposed on individuals with annual income of or exceeding UGX 120 million (about US\$46 000 in 2012) (Republic of Uganda, 2012). The changes were effected in October 2012 in the Income Tax (Amendment) Act, 2012 no 4/2012. It is not clear whether this is intended to create a new tax rate of 40% or a temporary measure intended to boost revenues in light of the aid cuts. However, the move demonstrates an *ad hoc* approach to tax policy that is reminiscent of the *surtaxes* introduced in 1942 to boost revenues during the Second World War but were never withdrawn when the War ended (discussed ahead in Chapter Two).

### 1.3 Statement of the Problem

The central argument in this book is that the tax reforms carried out in Uganda in the 1990s were not very successful because of a failure to take into account the social, economic and political context. It is further argued that the incoherent approach of the government to tax policy and indeed policy formulation makes it difficult to discern the long term goals or themes. As Mick Moore (2013:3) asserts, the success or failure of any reform process must be viewed against the backdrop of its context. Taxation and tax reform must also be seen in its wider scope beyond the policy instruments and focusing on the processes and discourses that impact and constrain both the reform process and the implementation of the legislation post-reform. The argument in this book is that the context affected the implementation of the reforms and the subsequent operationalization of the reforms negatively. The impact of the political, economic and social context on the implementation of the reforms is fully explored in Chapter Four. As stated in that Chapter, it is not disputed that the reforms in themselves were based on sound policy. The argument is that the implementation of the IFIs recommended policies was affected by the political, economic and social context. It is also argued that the application of the tax rules is likewise affected by the context in which the URA seeks to apply them.

The essence of any reform whether of an institution or legislation is to improve it (Stevenson & Soanes, 2004). Tax reform involves the change or restructuring of an existing system of collecting and managing taxes by Government with a view to making improvements (Sandford, 1993:2, Feldstein, 1976:90). Whether or not a change in the tax system is an improvement may be subject to differing value judgments from the perspective of the evaluator. This research does not attempt to judge whether there were improvements in the tax system as a result of the reforms but rather takes the theoretical approach of assessing whether the reforms were successful. Sandford suggests that the success of a reform process must be judged against three criteria i.e.

- a) how far the tax reforms meet the objectives the reformers set themselves;
- b) the sustainability of the reforms; and
- c) the extent to which the tax reform has desirable or undesirable by-products (Sandford, 1993:5).

Besides the above criteria it is important to consider the perception of the public about the impact of the tax reforms on economic activity. These criteria are adopted here because of the nature of the study in this book. The study does not purport to assess the impact of the reforms on economic growth from an economic perspective but rather a theoretical approach similar to that adopted by Sandford.

The success or failure of any reform must also be considered against the background of the role that taxation plays in any particular economy (Karingi and Wanjala, 2005:1). According to Tiley, the classical function of taxation is raising revenue to fund government expenditure (Tiley, 2008:4). Other functions include resource redistribution and management of the economy. Within the context of developing countries, attention has been focused on the revenue raising function of taxation which is critical to economic development. Most of the countries in SSA experience budget deficits which are widening and pose a threat to economic growth. Since 2000, there has been an impetus to increase tax revenues in order to meet the Millennium Development Goals (MDGs) (Foster and Briceño-Garmendia, 2010:2). The tax reforms carried out in Uganda in the 1990s as part of the SAPS focused on increasing tax revenues hence the widespread reforms in tax administration and tax legislation.