

# TAXATION AND THE INFORMAL BUSINESS SECTOR IN UGANDA: AN EXPLORATORY SOCIO-LEGAL STUDY

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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 countries in Sub-Saharan Africa 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 morale among small and medium-sized enterprises (SMEs) in Kampala, Uganda. It shows how socio-legal research can contribute to the study of tax and development. We use data from a two-month qualitative fieldwork study to examine the social fabric within which these businesses operate. The results show that there is very low tax morale among SMEs in Kampala. Tax compliance attitudes are influenced by issues relating to their trust, knowledge of the tax regime, perspectives on public goods and service delivery, and ideas about fairness, as well as the power of the authorities to enforce compliance. The presumptive tax system in place is not capable of being aligned 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, thereby 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.

## 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 the achievement of 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 International Monetary Fund (IMF) and the World Bank, and national tax authorities, collaborate with governments and tax authorities in the Global South to strengthen national and local tax systems, with the aim of increasing the total tax revenue generated (Platform for Collaboration on Tax, 2018). This often involves taking a top-down, macroeconomic approach.

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The Base Erosion and Profit Shifting (BEPS) initiative is an example of such an approach (Valderrama, 2018).

Countries in Sub-Saharan Africa generally have large and growing informal sectors. This is also the case in Uganda, where the informal sector covers more than 50 percent 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 and 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 important sources of revenue in many Sub-Saharan African countries, including Uganda. However, these SMEs operate 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 taxpayers. In order to target SMEs, the Uganda Revenue Authority (URA), like authorities in other countries in Sub-Saharan Africa, has a presumptive tax regime in place. In theory, this small business tax enables the URA to tax SMEs, and keep the costs for both the administration and the taxpayers 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 the Global South (I. W. 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 the society within which most informal businesses operate, under the radar of government authorities. Socio-legal research helps us to gain a better understanding of these businesses and the *social fabric* within which they operate.

This study aims to gather a *bottom-up understanding* of taxation in the informal sector and tax morale among small and medium-sized enterprises in Kampala, Uganda. It shows that it is important for the development of the informal economy and taxation to go hand in hand, thereby building the capacity of society to pay taxes, rather than the capacity of the state to enforce taxation, as well as improving long-term compliance and tax morale. The main question posed in this study is: *What is the role of taxation in the development of the informal sector, specifically among SMEs in Kampala, Uganda?* To answer this question, we take a look at the daily practices of SMEs with respect to taxation in Kampala. In addition, we explore the factors that influence their willingness and ability to pay taxes. This will allow us to elaborate on the implications that this has for the effectiveness of the governmental strategy to tax the informal sector in Kampala.

This paper proceeds as follows. In the next section, we develop the theoretical foundation of this study, starting by taking a closer look at the informal sector, and providing 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 played by tax morale in the Global South. Section 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 section, 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 Section 5, we discuss the implications of our findings and formulate an alternative

development strategy toward taxation of the informal sector. We conclude the paper by answering the research question and formulating new questions to be answered.

## **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, and tax morale in the Global South.

### **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 with government institutions and complies with government legislation (Gërxhani, 2004; Kenyon, 2007; Joshi, Prichard, & Heady, 2014). Following this 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. The formal/informal duality is instrumental for government authorities. It classifies which businesses are paying taxes and which are not. Subsequently, policies are created and implemented to target those who are not paying taxes and these, if successful, increase tax compliance and tax revenue. This can be described as taking a top-down approach to the taxation of the informal sector. However, in practice, the difference between formal and informal is more complex.

Joshi et al. (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”. They emphasize that, in practice, the duality of formal and informal businesses does not exist. It is more like a continuum ranging from an 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 will then often be burdened by several types of fee, charge, or licensing cost imposed on it by local government authorities. In addition, informal and formal businesses are often linked in their economic activities. Even within a state, the distinction between formal and informal is problematic, because the determinants of informality differ amongst government institutions. For example, the tax authority might define informality based on whether or not an SME is paying (the right) taxes. For a municipality, however, the definition might depend on whether or not this same business has a (or the correct) trading license.

The result of this is that, in practice, it is difficult to establish whether or not an 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 Sub-Saharan African countries, such as Uganda, is useful because it is not subject to institutional dualities, such as formal/informal or registered/non-registered, and is therefore more closely related to the daily practices of these businesses. In the following part of this section, 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.<sup>4</sup> For this study, we use the characteristics of small businesses and SMEs mentioned in the informal economy continuum (Appendix A, columns B & C), to illustrate the main features of the businesses examined in this study.

The people owning small and medium-sized enterprises are often non-poor, well-educated and skilled. They are mainly manufacturers or service providers, and the markets they work within are often highly competitive. The main challenges they face include gaining access to capital and insurance (personal and business). SMEs are liable to pay taxes, but they underreport earnings, use loopholes, and often escape formal tax assessments. If they have employees, these are commonly unregistered. Cash transactions are common among all small and medium-sized enterprises and they are often difficult to assess because of poor or non-existent recordkeeping (Appendix A; Joshi et al., 2014). In several countries in Sub-Saharan Africa, including Uganda, these businesses' earnings are typically below the VAT threshold and the companies fall within a presumptive/small business tax regime aimed at further formalization. Smaller businesses that are also part of the presumptive tax regime generally have owners who are poorer but still reasonably well-educated and skilled. For these businesses, gaining access to capital is an even bigger challenge.

## 2.3 Studying Compliance and Tax Morale in the Global South

The literature on tax morale and tax compliance in the Global South is growing but still relatively small. Many of the studies on tax behavior in the Global South build on Kirchler's (2007) work, "The Economic Psychology of Tax Behaviour". Kirchler, Hoelzl, and Wahl (2008) argue that power and trust are important determinants of tax compliance. According to them, tax compliance can be improved by increasing power and/or trust. Increasing the former will result in enforced compliance and the latter in voluntary compliance. Kirchler et al. (2008) demonstrate that tax authorities in the Global South 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 the Global South often feature so-called "cops and robbers" relationships between taxpayers and the tax authority. Gobena and 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 Sub-Saharan African countries, paying taxes is not seen as contributing to public goods. He states that is seen instead as a burden imposed by government.

Abdul-Razak and Adafula (2013) look at taxpayers' attitudes and their influence on tax compliance decisions among SMEs in Tamale, Ghana. They found that "the burden of taxes

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<sup>4</sup> The Ugandan Investment Authority (UIA) uses the following categories. A "micro enterprise" is an enterprise employing up to four people, with an annual sales/revenue turnover or total assets not exceeding 10,000,000 Ugandan Shillings. "Small enterprises" employ between 5 and 49 people, and have total assets of between 10,000,000 and 100,000,000 Ugandan Shillings; A "medium enterprise" employs between 50 and 100 people, and has total assets of more than 100,000,000 but not exceeding 360,000,000 Ugandan Shillings. Information derived from the UIA's 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).

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 into compliance or tax morale include Vadde and Gundarapu's (2012) study, which investigated factors influencing compliance amongst rental income taxpayers in Mekelle City, Ethiopia. Smulders and Naidoo (2013) address the burdens of tax compliance for small businesses in South Africa and conclude that the revenue authority plays a key role in educating small business owners about the tax system.

In order to enhance tax compliance in the Global South, it is important to understand the determinants of tax morale. In previous decades, the authors of several studies have used large-scale, cross-country, quantitative research methods to discover which factors might explain low or high levels of tax morale (Torgler, 2005; Ali, Fjeldstad, & Sjørusen, 2013). International surveys, such as the World Values Survey, Latinobarometer or Afrobarometer, are combined with other data in order to find the determinants of tax morale. The results show that a wide range of concepts influence tax morale in the Global South, including 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 (L. Martin, 2014).

Tax morale concerns an intrinsic motivation and is therefore 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, which 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.

### **3. METHODOLOGY**

In order to understand how the informal sector relates to taxation, it is important to study the social fabric of the society from which these businesses emerge. A relatively new movement in the study of tax law takes an interesting approach toward the relationships between taxation, inequality and development. We refer to New Fiscal Sociology, which developed over the past two decades, and which 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 (I. W. Martin, Mehrotra, & Prasad, 2009; I. W. 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 the Global South. Kiser and Sacks (2009) state that centralized bureaucracies are not expected to work well within the context of contemporary African states, mainly due to their limited monitoring capability. Based on their historical comparative study, they recommend decentralizing and privatizing the tax administrations in African states further.

Socio-legal research is closely related to the New Fiscal Sociology's research perspective and approach; both focus on "law in action" rather than "law in the books". In this section, 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 socio-legal methods used in this research.

### 3.1 Socio-Legal Research into Taxation and Development

Studying taxation and development in the Global South requires 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 international interest in taxation as a solution for domestic resource mobilization and development requires us to take a closer look at the social functioning of legal systems that are created and changed in order to increase tax revenue. We need to study taxpayers and tax authorities, and behavior and governance, both analyzing current situations and looking for possible sustainable alternatives.

The roots of the socio-legal approach are found in legal anthropology. In his landmark fieldwork study, one of its pioneers, Bronislaw Malinowski (1926/2002), concluded that all societies have some form of law or other mechanism by which to maintain social order. In today's society, tax law is a tool for maintaining order through fiscal efforts, ensuring stability in revenue collection for the state, something 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 is used to increase the control of the state. In the context of this research, tax law in Uganda attempts to formalize SMEs and thereby 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 revealing what *should be* or *could be* happening, the socio-legal approach helps us to understand what is actually *going on* in practice. It is analytical rather than instrumental. It looks at law in action rather than law in the books – or, in the case of this study, tax law in action. In this way, it differs from the top-down legal comparative studies mentioned in the theoretical part of this paper. Using qualitative research methods helps us to gain in-depth understanding rather than enabling us to produce a quantitative analysis. Taking a socio-legal approach can help us to understand the dynamics of the relationships between state and society, and the fabric of society, from the bottom up.

### 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 Section 2.2, we illustrated the main characteristics of these businesses. Besides SMEs in Kampala, the Uganda Revenue Authority and Kampala Capital City Authority (KCCA) also play important roles in this research.

The data for this study was collected in May and June 2017, during fieldwork carried out in Kampala using qualitative research methods. The main method used was the qualitative, unstructured interview. This study is based on 20 in-depth interviews, of which 15 were with SMEs and 5 with URA, KCCA, and non-governmental organization (NGO) staff working on taxation, as well as dozens of informal conversations. Other important methods used included “Being There” and participatory observation. “Being There” helps researchers 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 and 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 us to understand the differences between the official story and how things work out in practice, i.e. reveals 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 behaviors or non-compliance. That is why this study examines attitudes rather than actual (non-)compliance. Looking at perceptions and attitudes instead of actual non-compliance helps us to understand behavior related to tax compliance. Research from social psychology states that attitudes have a strong influence on behavior (Ajzen & Fishbein, 1977). We aimed to use a diverse sample in terms of gender, location, and trade. The use of a local research assistant to find respondents significantly lowered the threshold for participation in this research.

## 4. RESULTS

In this section, we present the results of the research. The first part looks at the tax regime. We then explore the daily practice of business and taxation in Kampala. In the concluding part of this section, we summarize some of the main characteristics of SMEs and taxation in Kampala.

### 4.1 The Tax Regime in Kampala

SMEs in Kampala are affected by several types of fee and tax. Direct taxes include the national income tax and trading licenses. Indirect taxes, such as import and excise duties, and the Value Added Tax (VAT), also impact these SMEs. Payments for services such as the collection of garbage and the supply of water or electricity are often perceived as taxation but are, 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 for anyone in Uganda who wants to run a business to have one. 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 implementing the local tax regime within its administrative boundaries. Some of the KCCA’s main revenue responsibilities include issuing trading licenses, and collecting property tax, the local service tax, hotel tax, and market fees (Government of Uganda [GoU], 2010). The trading license is required for all businesses, including service companies. The license has to be renewed each year, something 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 divided into four categories and the nature of the business is classified using a list of more than a hundred business types.<sup>5</sup> The size of the business or annual turnover is not relevant.

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<sup>5</sup> 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](https://www.kcca.go.ug/?jsp=trading_licence_rates).

The national income tax Act includes a so-called “small business tax” for SMEs. The small business tax is collected by the URA and consists of two parts. The first part covers businesses with turnovers of between 50 and 150 million Ugandan Shillings. The second part concerns a presumptive tax for businesses with turnovers of between 10 and 50 million Ugandan Shillings a year. The focus of this research is on businesses which fall under this second part of the small business tax. The amount payable in respect of this presumptive tax is determined by the location, nature, and turnover of the business. This makes it much more complicated to assess what a business is liable to pay, compared to the process of issuing trading licenses 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 €900,000). This is next to nothing when compared to the total revenue of about 13 trillion Ugandan Shillings (about €2.9 billion) collected in the 2015/16 fiscal year (1/7 until 30/6). In 2015/16, the URA estimated the potential revenue from the small business tax to be about 83 billion Ugandan Shillings, of which 24 billion could be raised 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 150,000,000 Ugandan Shillings. As these SMEs are within the presumptive tax regime, with annual turnovers below 50,000,000 Ugandan Shillings, they do not have to and cannot register for VAT. Most SMEs do not import goods themselves, so they do not directly pay customs or import duties. They buy their goods from (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 paying 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, the URA and the KCCA are responsible for revenue collection in Kampala. The URA is the oldest semi-autonomous revenue authority in Sub-Saharan Africa after Ghana's (Kiser & Sacks, 2009). It is partially privatized, legally separated from the state, and 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 sector to the formal sector? We answer these questions by illustrating some recent developments in the policy and practice of these organizations, which aimed to increase tax compliance through the Taxpayer Register Expansion Program (TREP). In this program, the URA and KCCA work together with Uganda Registration Services Bureau (URSB).

The aim of TREP is to increase taxpayer registration, which is the first step toward increasing tax compliance. TREP started about four years ago, and has been evaluated and expanded each year. Several “one-stop shops” were opened across Kampala. A business can handle all of its URA, KCCA, and URSB formalities at a one-stop shop. A business has to go through three stages at a one-stop shop. First, it needs to register for, or verify that it has, a business registration number with the URSB officer. Second, it should apply for, or verify that it has, a Tax Identification Number (TIN) with 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, the business owner can apply for a trading license from the

KCCA official. In practice, businesses often go to the KCCA official first, 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 greatest 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 amount of information that they have about these businesses. It is, however, the disintegration of different governmental systems which allows SMEs to, for example, pay local government 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 is 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 KCCA, URA and URSB's definitions of an "informal business" differ. For example, for the URA, a business could be informal because it has no TIN, regardless of whether or not it has a trading license or a business registration number. For the KCCA, a business could be informal if it has no trading license, regardless of whether or not it has a TIN or a business registration number. Finally, for the URSB, a business could be informal if it has no registration number, regardless of whether or not it has a TIN or a trading license. This shows how the formal/informal duality facilitates the different goals of government institutions. By means of a program such as TREP, governmental systems become more and more integrated, as does the governmental definition of the "informal sector".

The URA and the KCCA attempt to decrease compliance costs by implementing simplified tax laws that are easier to understand, as well as by making use of technological developments to reduce the amount of money and time that it takes 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 that they have to visit three desks instead of one, use of a one-stop shop does significantly decrease compliance costs in terms of time.

To what extent are the URA and the KCCA successfully moving SMEs from the informal sector to the formal sector? It seems like the "formalization" of these SMEs by the URA and the KCCA is increasing. TREP introduces these businesses to the tax system. However, TREP has not led to an increase in the amount of revenue collected from SMEs by the URA. The total revenue collected through the URA's small business tax has not significantly increased. The URA collected less than 10% of the target set for the 2016/17 fiscal year. Instead, the URA focuses on collecting other taxes, such as VAT and PAYE, which contribute significantly more to the total revenue collected than the small business tax would be expected to raise even if compliance was at one 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 the 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”<sup>6</sup>. In practice, the relationships between the tax authority and taxpayers are more like those of “cops and robbers”. We elaborate on this in the following paragraph.

## 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 and tax morale? In the following paragraphs, we describe a number of SMEs operating in various sectors in Kampala. These profiles are created to illustrate the 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*

Secondhand clothing is a major business sector in Uganda, especially in Kampala’s Central Division. Louisa sells secondhand clothing in her shop, which is close to the biggest secondhand clothing market in Uganda, Owino Market. Her shop is on one of the major routes leading to the market and is, therefore, in a prime location. Rent is expensive; people in that area pay from one million up to three million Ugandan Shillings a month. Therefore, Louisa has two sub-renters to ease the burden of the rent. Apart from some basic information, she does not keep records. Louisa pays the URA 250,000 shillings a year and pays about 200 shillings for her 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

Lawrence works as a driver of a “matatu” or Public Service Vehicle (P.S.V). Since the 1990s, when the governmental public transportation system collapsed, the matatu has been the main mode of transportation in Kampala, with Boda Boda (motorcycle taxis) and private vehicles being the next most popular options. Typically, a matatu is a Toyota van which has a line of

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<sup>6</sup> Both the culture statement and details of the “taxpayer appreciation day” can be found on the Uganda Revenue Authority’s Facebook page, which is remarkably active: <https://www.facebook.com/URAPage/>. The statement can be found here: [URA Culture Statement on Facebook](#).

blue squares painted on the side. Two people work on it: the driver and the conductor. The former is responsible for operating the vehicle, while the latter spots potential passengers on the road and collects the fees. There are dozens of routes along the main roads in Kampala, mainly connecting different residential neighborhoods with Kampala's Central Division (or city center). The vans are quite small, which makes them crowded even when the maximum number of 14 passengers is not exceeded. However, using one is the cheapest way of travelling around Kampala. Lawrence, like most matatu drivers, does not own the vehicle himself. Lawrence has to deduct 80,000 Ugandan Shillings from the 220,000 (about 50 euros) that he makes each day in order to pay the vehicle's owner. On top of that, he pays another 80,000 shillings for fuel. This leaves him with about 60,046 Ugandan Shillings (about 15 euros), which he has to share with his conductor and use to pay for the KCCA license, parking fees, and vehicle maintenance costs.

Lawrence has to sustain himself and his family on about 300,000 Ugandan Shillings each month (about 70 euros). Although he does not earn enough to be liable to pay income tax to the URA, he pays the monthly KCCA transport license fee of 120,000 shillings. Lawrence only completed primary school education, and does not know a lot about tax laws and tax authorities. What he does know is that if you do not pay for the license, they will confiscate your vehicle until you pay. The system used by the KCCA is now digitalized and people can pay with mobile money. According to Lawrence, this has made it almost impossible to evade taxation, because you can go on your mobile phone and check whether you have paid or not. There are some ways to avoid paying, but they mainly involve delaying payment and either keeping away from or bribing KCCA officials. Lawrence particularly complains about the tax on fuel. According to him, he would make more money if these taxes were lower. He believes that he is not able to do many trips because he can only put in a limited amount of fuel each time, as the price is high. Therefore, if the government could lower the tax on fuel, he might make a bit more money. Furthermore, Lawrence considers it unfair that the license fee is a fixed rate for a month. What happens if he falls ill and cannot operate the vehicle? He works almost every day from early morning until late in the evening and, at times, he gets tired and has to find somebody to replace him. However, that means he does not earn anything that day; the person operating the vehicle takes home whatever is left.

The only thing you can do is to delay. To delay paying. But if they get you. If the KCCA people come here and find out you did not pay they will just impound your vehicle. They impound the vehicle [...] and you pay even a higher fee.

Lawrence, 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 turn, got them from Kenya or Tanzania. Together they operate as one enterprise, which is registered at both the KCCA and the URA. They share the costs of rent, the URA's small business tax, the KCCA trading license, and of services such as garbage collection, water, and electricity. It is not easy for the URA to determine which bracket they fit into because each person keeps his or her 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 them, 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 shilling. Furthermore, Fred mistrusts the authorities and believes they are corrupt. According to him, some of the money does not even reach the government and is kept by 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 were affordable, people would not try to evade them. 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 it simply does not care.

Arcades are mainly found in Kampala's Central Division. An arcade functions a bit like a shopping mall, but with hundreds of small shops. The buildings are designed with the aim of fitting as many shops as possible in on each floor. They tend to have some fairly open spaces and openings in the floors, and this makes them feel a little less claustrophobic. However, these features are probably also practical solutions to the fact that power blackouts are not uncommon. As mentioned previously, specific trades crowd together on certain floors. For example, one might find only phone shops on the ground floor, travel bag traders on the first floor, and hair salons on the second floor. According to several shop owners, they crowd together so that customers know where to go. However, competition is vicious.

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 150,000 and 250,000 Ugandan Shillings for the KCCA trading license. Rent is expensive in these arcades and is no less than 1,000,000 shillings each month. Her other major costs besides her employees are electricity, water, and garbage collection. Susan's shop definitely turns over more than 20,000,000 shillings each year. However, she is still in the lowest bracket (see Appendix B). It is easy for her to under declare because the URA lacks the 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 both a trading license and income tax is double taxation on one activity. However, she has to pay because when you do not pay they close your shop and you will have to go and pay anyway. As she pays taxes herself, she believes other people should also pay taxes. Susan is not sure about what happens to 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 who sells secondhand carpets, and a man who cuts and sells glass and mirrors. Sharing the shop lowers the burden of rent. They also pay for the trading license together. These boys struggle to keep their business going. Sometimes it is hard to pay 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 businesses without licenses; 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's small business tax, as URA officials visit this part of town less frequently than other parts. 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

Ibrahim and Isaac understand what the government uses the money collected through taxation for to some extent. Isaac believes the government is using this money to build roads, schools, and hospitals, but he does not believe that it 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

### **4.3 Characteristics of Business and Taxation in Kampala**

In the previous paragraph, we presented several profiles of SMEs in Kampala and discussed how these SMEs relate to taxation and the authorities. The results show that how, and the extent to which, taxation influences the day-to-day business of SMEs in Kampala varies. For some, taxes are truly a burden, while for others, the costs of taxation are 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 partly formal and partly

informal. For example, a shop might be registered, and its taxes and licenses may all be paid for, but several people may be employed there who are not registered. According to the KCCA, the business might be formal, but not all rules and regulations may be being 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 may be sub-letting 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 paying taxes, so often ensure that the location, size, and nature of their businesses is flexible enough for them to be able to decrease the burden of these taxes or evade paying them. SMEs try to adapt to the URA and KCCA's increased efforts to formalize them.

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

People working at or owning SMEs understand that taxation is necessary for the development of Uganda. However, they do not believe that the taxes they pay are being put to good use. Therefore, they also understand why people would under declare their earnings or evade tax. Their tax compliance and tax morale 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), which are mentioned in the theoretical section 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 their 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, or their business will be 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, or paying these taxes and for services such as garbage collection). There is a lot of mistrust toward the tax authorities and the government in general. Tax administrators are often perceived to be corrupt, sometimes collecting taxes twice or at higher rates than people believe they are supposed to. In addition, people do not believe that (all) the money they pay even reaches the government and think that it eventually ends up in some individuals' pockets.

People do know what they would like the government to spend tax revenues on. Almost all respondents mentioned infrastructure, health care and education. People working at or owning SMEs would like to see the money they pay put to good use. However, they believe that politicians just use the money to enrich themselves and their families. 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 being corrupt and the conditions of the roads, hospitals, and schools are considered to be poor. However, people do not always see

evasion as an option because their businesses might be closed, or their property confiscated. Interestingly, if people pay taxes, they do believe other people should pay taxes too, even though the money is not being spent appropriately. There is very low tax morale within the sector because the government lacks transparency, accountability, and legitimacy (in other words, good governance).

## 5. DISCUSSION

The current top-down approach toward the taxation of SMEs in Kampala does not seem to be working. 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 what is happening. Because the current top-down approach mainly imposes taxes on these businesses and enforces them to comply, the relationships between the tax authorities and taxpayers look 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. Taxpayers are perceived as robbers. However, enforcing compliance is difficult because the authorities lack the capacity. As mentioned above, taxpayers also distrust the government. They perceive the administrators to be cops.

Bearing the above in mind, it might be better to take 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 working toward becoming more formal enterprises. The delivery 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, so that their willingness to register, file and pay taxes will increase. This could be called taking a *bottom-up approach* toward the taxation of the informal sector. It starts by considering the perspectives and needs of the SMEs. What do they need in order 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 toward the taxation of SMEs in the informal sector does not focus (just) on building the capacity of state institutions. The focus is rather on: examining the capacity of society and taxpayers to conduct business and administration, and (as a result) pay taxes; looking at the fabric of society; and building grassroots tax morale. In order to develop strategies for taxing the informal sector in Uganda (and other countries within the Global South), it is important to reflect on the following 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 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 that provides a “path of development”. Some interesting suggestions or focus areas relating to moving these businesses into the formal sector can be found both in 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, i.e., learning how to keep simple records that can be used by citizens to run their businesses, and by the authorities to provide support and ensure each business has a proper and fair assessment.

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

Before we move on to the conclusion of this article, we briefly reflect on the socio-legal approach to researching taxation and development. In this study, the socio-legal approach helped us to analyze the complex dynamics between state and society and, more specifically, the relationships between SMEs and the tax authorities. The qualitative research methods used were crucial to gaining a deeper understanding of the fabric of society within which these businesses operate. This focus on trying to gain an in-depth understanding rather than on quantitative analysis provides us with a different and useful approach to the field of taxation and development, thus adding new knowledge and insights to fuel the debate about taxation and development, because “scholars have barely begun to investigate the relationship between tax policy and social development” (I. W. Martin & Prasad, 2014).

## 6. CONCLUSION

What role does taxation play 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 played by taxation has become even greater in recent years, as the tax authorities attempt to increase their grip on this sector through administrative 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 and results in a “cops and robbers” scenario. Small and medium-sized enterprises now prefer to maneuver in the informal sector, mainly because the formal alternative is neither predictable or uncorrupted, nor generally safe or beneficial.

Taking the mainly informal character of the business sector being targeted into account, employing a bottom-up strategy might be more fruitful. Such a strategy aims at strengthening the conditions which enable sound, productive, and profitable business conduct. The enhancement of knowledge, legal certainty, and administrative literacy will stimulate formal business and (as a side effect) the ability and willingness to pay taxes. In such a strategy, taxation might be more of a means to, rather than the ultimate goal, of development.

As mentioned before, the increased international interest in taxation as a solution for domestic resource mobilization and development requires us to take a closer look at the social functioning of legal systems that are created and changed in order to increase tax revenue. This study introduced a socio-legal approach to the field of taxation and development. Future socio-legal research studies could and should take a more multi-level approach. Researchers taking such an approach could, for example, look at the role of international organizations and collaborations in order 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? A new and interesting perspective focuses on 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 played by the tax officer will be crucial to its success.

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## APPENDIX A – THE INFORMAL ECONOMY CONTINUUM

Source: ‘Table 1: A typology of enterprise informality’ (Joshi et al., 2014)

**Table 1. A typology of enterprise informality**

Features	Informal economy			Formal economy
	A	B	C	
Degree of informality	Subsistence enterprises	Micro enterprises and small businesses	Small and medium businesses	Small, medium, and large businesses
Type of activity	Totally informal Street traders, cottage/micro enterprises, subsistence farmers Labour intensive	High proportion of sales undeclared and workers not registered Small manufacturers, service providers, distributors, contractors Mostly labour intensive	Some proportion of sales undeclared and workers unregistered Small and medium manufacturers, service providers Mixed labour and capital intensive	Labour and firms registered and regulated Range of manufacturing and services Knowledge and capital intensive
Owner profile	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
Markets	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
Finance 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
Other needs	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 status	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
Tax design desired features	No tax liabilities	Low rates to encourage registration, minimal compliance costs, low administration costs	Higher rates to encourage graduation into formal regime	

Notes: Greyscale text comprises features less relevant to taxation.

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

**APPENDIX B – URA 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

<b>BUSINESS TRADE</b>	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