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Rural Taxation in Uganda:

Implications for Growth, Income Distribution, Local Government Revenue and Poverty Reduction

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Uganda Rural Taxation Study: Final Report

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Executive Summary

1. The purpose of the research underlying this report is to contribute towards the process of policy change in Uganda with respect to local government taxation. The report sets out to cover an additional set of policy priorities related to local revenue generation from those that have arisen mainly from a local revenue enhancement perspective.
2. In particular, the research uncovers serious flaws in the design and practice of existing local government taxation regimes in rural areas. These flaws include serious revenue leakages in the private tax collection system (tax tendering); negative impacts on income distribution due to the steep regressiveness of local tax systems; and harmful impacts on local economic growth caused by local taxes and charges which distort relative prices on goods and services and differ widely between sectors, and across councils. Moreover, the lack of effective linkages between taxes collected and services delivered by local governments legitimises tax evasion and contributes to undermine state-citizen relations.
3. The report addresses the following poverty reduction aspects of local government taxation:
 - income distribution effects of existing rural taxes;
 - resource allocation and growth effects of rural taxes;
 - debates and policy issues concerning the G-tax;
 - privatised tax collection (tenders) and how it works in practice; and
 - proposals for reform of the local taxation system.
4. The report takes as given that the objective of a reformed local revenue system is to raise and stabilise local government revenues in ways that support Uganda's poverty reduction goals and stimulates, rather than inhibits, local economic growth. However, the way the current local tax systems operate in practice is seriously flawed with respect to revenue generation, equity and economic growth. These problems cannot be overcome simply by capacity building in local tax administrations improving auditing and revenue management. Nor, will they disappear by so-called "sensitization" of bureaucrats or citizens towards the social obligation of paying taxes. Instead, they require a robust understanding of flaws in tax regimes and revenue collection practices, in the context of multiple arrays of

taxes that have come into existence more by historical accident than by intentional planning or deliberate design.

5. Flat rate taxes are in general regressive in character, and the local tax system in Uganda proves no exception to this. In order to explore this facet systematically, the research investigated the tax burden experienced across 138 small enterprises in six districts of Uganda. The districts were Mbale, Kamuli, Mubende, Masaka, Ntungamo and Arua. The enterprises comprised 30 small and medium urban enterprises in Mbale town; 69 small rural businesses divided across the six districts; and 39 small rural and urban market traders also distributed across those districts. It was found that for all types of small enterprises, the tax burden on the smallest category of enterprises was substantially greater than that for larger entities. For example, for the largest sub-sample, that of small rural businesses, small enterprises were found to pay 47 per cent of their gross margin in tax while the largest enterprises only paid 5 per cent.

6. Aside from income distribution effects, the rates set in rural tax systems can have adverse effects on resource allocation and economic growth. This happens when tax rates vary arbitrarily across commodities, an occurrence demonstrated to be widely prevalent for official levels of market dues in districts. It also happens if the business license systems are complex and impose undue burdens on start-up businesses, which was found to be the case in the case-study districts of this research.

7. The G-tax in Uganda contributes to the overall regressiveness of local taxes when it is applied in practice at the basic level flat rate of US\$ 3000. G-tax has a history of being subject to extensive political interference. Moreover, its collection methods have been characterised by oppression and harassment of taxpayers, unacceptable from a human rights perspective. Furthermore, although the number of G-tax bands was reduced to 17 in March 2003, from 22 bands in 2001, this is still strikingly complex and impractical when compared to the 4 bands of PAYE income tax.

8. The issue of whether the G-tax should be abolished has been raised on several occasions in recent years. The experience of Tanzania, where the development levy, a poll tax comparable to G-tax, was abolished in June 2003 may shed light on important issues of relevance for Uganda with respect to the future of the G-tax. The report provides a

description of the events in Tanzania that led to the abolition of their development levy, and the compensating finance from central government that was required when this came into effect. The Tanzania reform demonstrates that radical reforms of the local government tax system is possible. Local taxes that originate in the mists of history can be abolished without the sky falling in.

9. Privatised tax collection (tax tendering) seems to provide a viable response to corrupt bureaucratic collection where leakages between the taxpayer and the revenue office tend to be high. There are two reasons in principle for this. First, private collectors have a personal interest in ensuring that their tax agents do a good job. This is rarely the case for public collectors. Second, private collectors are often better placed to penalise poor performance on the part of their agents, since they are not bound by public sector job security rules. Nevertheless, it is worth noting that few modern states have granted private collection a permanent status in their revenue generating machinery.
10. The private tender system as it currently operates in Uganda is demonstrated to have some strengths, unfortunately more than offset by severe flaws. Its strengths are: (i) the motivation of private collectors already mentioned; (ii) the ease in reality with which the revenue potential of markets can be estimated; and (iii) that private tax collection meets local councils preferences for predictable and stable revenue flows. As it works in practice, however, the current system is driven by the rents generated by the gap between the reserve price and taxes collected, resulting in a massive transfer of money from taxpayers to private tax tenderers and their business associates including political "godfathers".
11. Summarising the findings, the report demonstrates that the local tax system in Uganda has an anti-poor bias in practice, distorts relative prices, inhibits the multiplication of enterprises and economic growth in rural areas, and has some in-built organisational defects that result in low yields to local governments compared to tax collected through private tendering. The tax system is also complex, it is non-transparent, and there are huge differences in taxes and rates across councils. Furthermore, taxes on the same items are unevenly implemented across different districts and markets within districts.
12. This report does not argue that in view of these problems local taxes should be abolished. The basic argument that a positive relationship needs to be developed between

taxation and service delivery is a good one, and is acknowledged as a key principle of democratic local government. However, the existing local tax system works badly with respect to all major criteria characterising a good tax system, and it contributes to undermine efforts to build democratic accountability in Uganda. Hence, there is a case for rationalising and improving local revenue collection. The focus should be on a limited number of local tax bases and to ensuring that they are transparent and understandable to taxpayers and local revenue departments alike.

13. The report identifies four main areas where reforming the existing system is required: (i) market dues and closely related taxes (parish dues, fish taxes etc); (ii) the private tendering system; (iii) business licences; and (iv) G-tax.

14. Market dues and related taxes are essentially 'nuisance' taxes. They do not yield much revenue (partly due to the way the tendering system works in practice), their principles are complex (hundreds of tax rates invented for every conceivable item for sale, even if these are seldom applied in practice), and they provide no linkages between taxes collected and service improvements, e.g. improving the quality of market places. For non-agricultural consumer goods, they also imply an element of double taxation, since these goods will have already incurred VAT. It is proposed that:

- market dues and related taxes are abolished, to be replaced by "user fees" earmarked for improving market place infrastructures and the associated trading environment (weights & measures etc);
- these "user fees" would be fees charged for having a place in the market, not tax rates by commodity;
- an exception to the latter might be made for livestock, since livestock trading involves other considerations (sanitation, health, etc) compared to crops and consumer goods; and
- parish dues and other charges that occur outside markets should be abolished, they often cost more to collect than the revenue collected from them.

15. Principles that should be considered for the future operation of the private tender system, assuming it is retained (which is co-dependent on the previous proposal) include:

- default by tenderers can be avoided by payment of the agreed tender price at the beginning rather than the end of the tender contract
- the propensity for overzealous collection may be controlled by:
 - encouraging a structure of rural markets that present traders with genuine options,
 - a "softening" of the collection regime by ensuring the local origin and residence of tenderers;
- the institutional problems relating to the mechanisms for setting the reserve price and awarding contracts, described in this report need urgent attention; new institutional mechanisms that disconnect the assessment of the reserve price from vested interests in district administrations need serious consideration. Likewise, current practice of awarding contracts to bids that fall within a narrow margin of the reserve price should be revisited.

16. The abolition or simplification of market dues put forward in the preceding sub-section would evidently alter, probably for the better, the scope of operation of private tenderers. A simplified regime of market user fees would make assessment of the revenue potential of a market more straightforward. Also if private tenderers were returning revenues to a management association of markets, rather than to district revenue offices, the motivation to create artificial differences between assessments and actual collections could be substantially reduced. In this case, revenue would be 'lost' to districts, but services delivered to taxpayers.

17. The licensing of businesses represents a policy area of public regulation (and deregulation) that was not part of the scope of this study. As stated in various policy documents, business registration should be encouraged for a variety of reasons. But license fees and registration are two different things, and it is plain that very small businesses should only pay a nominal administrative fee for registration rather than a tax in form of a business license.

18. Like other taxes, if the G-tax is retained, it needs to operate simply and transparently, with minimal political interference, and taxpayers must be able to see visible evidence of services delivered in return for paying this tax. Aside from the option (that Tanzania has demonstrated is feasible) of abolishing G-tax; its improvement might involve some combination of the following considerations:

- No citizens should pay both G-tax to the local government and personal income taxes (including PAYE) to the central government. This is double taxation which confuses the purpose of having a G-tax, and causes unnecessary resentment on the part of those on whom this duplication is imposed.
- Since PAYE only has 4 tax bands, G-tax should be brought into line with such a simplified structure.
- Systems should be established to inform citizens on how much G-tax has been collected in their area of residence and how these revenues are spent, including the share retained at different levels of the LC system. This information should be provided by council administrations, and disseminated on notice boards in public places in sub-counties and parishes.

19. The following two areas of local revenue generation need considerably more research-generated knowledge in order to move forward with local revenue generation policies that make sense in a poverty reduction and democratization context:

- A. The private tax collection system (reform of tax tendering).
- B. The achievement of local taxation – service delivery linkages.

Uganda Rural Taxation Study: Final Report

1. Poverty Reduction Issues Guiding the Research

The purpose of this report is to contribute towards the process of policy change in Uganda with respect to local government taxation. However, the report covers a different set of policy priorities related to local revenue generation from those that have arisen mainly from a local revenue enhancement perspective. In particular, the study uncovers serious flaws in the design and practice of existing local government tax systems in rural areas. The strengthening of the local tax collection regime envisaged in many of the proposals for local revenue enhancement will merely reproduce these flaws on a broader scale, and are unlikely to increase revenues by anything like the amount that their proponents suppose. The existing local tax system needs to be reformed before proposals to extend certain of its powers, for example towards further privatised collection, are introduced.

The departure point for most work on local government revenue in Uganda is to focus on two dimensions: the relationship between central and local financing of local governments, on the one hand, and the capacity within local governments themselves to collect, administer, audit and manage tax revenues, on the other. Proposals that set out to enhance local revenues fall within this basic approach. This report, in contrast, considers local revenue generation from the viewpoint of its impact on poverty reduction and on the vitality of local economies in rural areas. In summary, the study addresses the following poverty reduction aspects of local government taxation:

- income distribution effects of existing rural taxes;
- resource allocation and growth effects of rural taxes;
- debates and policy issues concerning the G-tax;
- privatised tax collection (tenders) and how it works in practice; and
- proposals for reform of the local taxation system.

The perspective taken on poverty reduction here is the effect of taxes and rates on different rural income groups, not the expenditures by local governments on mainly centrally-funded pro-poor service delivery. This is an important initial distinction to get straight. The levels and types of taxes can by themselves result in the burden of local taxation falling more on the

poor than on the relatively better off in rural areas. This is not necessarily due to problems in tax administration that may be separately very important, but to the basic design and practice of a local tax system that needs rethinking when poverty reduction is the overall objective.

In addition to the directly disequalising effects on rural incomes, local taxes may have distorting effects on resource allocation decisions. In particular, the local tax system may have inhibiting effects on the start-up of new enterprises and the achievement of economic growth, which add up to further hampering of poverty reduction goals in rural areas. These effects occur when effective tax rates vary between different goods that are traded, within and across markets, or when business license fees are set too high for start-up small-scale enterprises to survive. In addition, the sheer complexity and array of taxes confronted by ordinary citizens undermines the development of trustworthy relations between local governments and citizens, discourages initiative and enterprise, and reinforces the common observation that "there is not much going on apart from agriculture" in rural areas of Uganda.

In this regard, rural livelihoods research in Uganda strongly demonstrates (a) that individuals and families are better off when they are able to diversify their income sources across farm and non-farm activities, and (b) that agriculture itself benefits from cash flow generated by non-farm activities since this allows more inputs to be purchased and better cultivation practices to be followed than in the absence of such financial resources (Ellis & Bahiigwa, 2003).

This study takes as given that the overall objective should be to raise and to stabilise local government revenues in ways that support Uganda's poverty reduction goals and stimulates, rather than inhibits, local economic growth. However, as demonstrated in this report, the way current local taxation systems work in practice does not contribute toward this poverty reduction objective. These problems cannot be overcome simply by capacity building in local tax administrations with respect to improved auditing and revenue management; nor, for certain, will they disappear by so-called "sensitization" of bureaucrats or citizens towards the social obligation of paying taxes. Instead, they require a robust understanding of how the tax system and revenue collection work practice, in the presence of the multiple arrays of taxes that have come into existence sometimes by historical accident, in other instances by intentional design.

Taxation can be viewed as an implicit contract between citizens and their government, in which the amount and types of tax paid are related in some way to services delivered by public institutions (Moore, 1998; Moore & Rakner, 2002). In the case of local government, the idea of services delivered in return for tax revenues collected also includes the notion of local governments providing an enabling environment for ordinary people to go about their daily business of making a living without fear of unpredictable and unreasonable charges being made against them. Furthermore, if local governments foster a climate conducive to the diversifying and multiplying of economic activity in the local economy, the ability to increase revenues in the future will be enhanced compared to just trying to get the maximum tax from the current level of activity. Unfortunately, politicians in local governments want to maximise current benefits given at the expense of more sustainable future local revenue collections.

2. The Regressive Nature of Existing Rural Taxes

Flat rate taxes are regressive in character. As pointed out in the inception report of this research (Bahiigwa *et al.*, 2003a), when the G-tax is in practice implemented as a flat rate tax of USh 3000 it represents a relatively bigger share of a poor person's income than that of a richer person. Similarly, when market dues are set so that the flat rate imposed on a small quantity of a product is relatively high compared to the flat rate imposed on a large quantity of a product, then this will hit the poor who can only sell small quantities harder than the better off who are able to bring to market greater quantities. In addition, flat rate business licenses will take a relatively bigger share of net income of small or micro enterprises. For example, if all bicycle repairers pay a flat annual fee rate of USh 12,000, and one nets an annual income of USh 50,000 while another nets an annual income of USh 250,000, the tax represents 24 per cent of net income in the first instance and 5 per cent of net income in the second.

This adverse income distribution effect of flat rate taxes may be considered acceptable if kept within reasonable bounds. Proportional taxes are administratively more difficult to implement than flat rate taxes, so that a trade-off between objectives is to some degree to be expected. In order to explore this issue more systematically, the research underlying this report investigated the tax burden experienced across 138 small enterprises in six districts of Uganda. The districts were Mbale, Kamuli, Mubende, Masaka, Ntungamo and Arua. The enterprises comprised 30 small and medium urban enterprises in Mbale town; 69 small rural

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businesses divided across the six districts; and 39 small rural and urban market traders also distributed across those districts. Data were collected on the variable costs of running businesses, the annual sales, and the amount of taxes paid (comprising income tax, G-tax, market dues and license fees). Annual sales were ranked from lowest to highest, and the sample then divided between four equal quarters (quartiles) representing a distribution between smallest and biggest enterprise sizes.

The results are striking as shown in Table 1 below. For all types of small enterprise, across six districts, the tax burden on the smallest category of enterprises is substantially greater than that for larger categories of enterprise. For example, for the largest sub-sample, that of small rural businesses, the smallest enterprises were found to pay 47 per cent of their gross margin in tax while the largest enterprises only paid 5 per cent (see Figure 1). A similar regressive pattern was found among urban small and medium business sample investigated in Mbale town. Only the sample of small market traders varies slightly from this pattern, but even here the smallest turnover traders pay twice as much of their margin in tax as the largest turnover traders.

**Table 1: Share of Local Taxes in Gross Margins, by Sales Quartile:
Rural and Urban Small Businesses in 6 Uganda Districts, 2003**

Sales Quartile	Small Rural Businesses n = 69 %	Small Market Traders n = 39 %	Urban Small & Medium Businesses* n = 30 %
Quartile I	47.2	47.2	25.5
Quartile II	36.4	21.2	12.3
Quartile III	9	12.1	7.2
Quartile IV	5	23.8	6.7

* sample of small and medium businesses in Mbale town only

Source: Enterprise surveys conducted by the research team between June and Sept 2003

These investigations demonstrate that local taxation is steeply regressive in practice, even if not in intention. The confused state of G-tax is partly the reason for this, since evasion is prevalent and the single flat rate, rather than the scale, is often applied in practice. However, market dues and business licenses that are also flat rate or vary little across different scales of enterprise also play their part. In the context of an overriding national objective of poverty

reduction, the degree of regressiveness represented by the data in Table 1 implies that the local tax system undermines the poverty reduction objective.

Figure 1: Share of Tax in Gross Margin for Small Rural Businesses

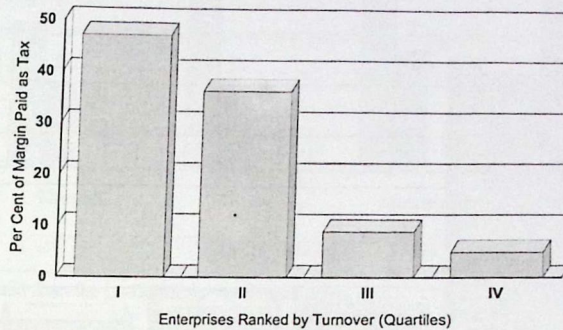


Table 2 shows the different roles that licenses and G-taxes play in these findings for the Mbale sample of small and medium sized enterprises. Again the overall sample is divided into quartiles going from the lowest to highest quarter of enterprises ranked by sales amount.

Table 2: Share of Licenses and G-Taxes in Total Taxes, Mbale Small and Medium Enterprises, by Sales Quartile

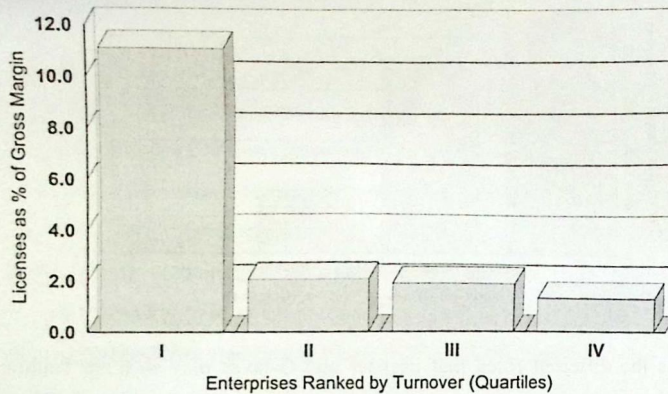
	Sales Quartile			
	I	II	III	IV
Total taxes (USh)	363,571	899,167	259,400	634,167
Business licences (USh)	132,857	145,000	110,000	171,667
Licence in taxes (%)	55.2	41.7	46.2	30.2
G-tax (USh)	70,000	45,833	48,000	61,667
G-tax in taxes (%)	18.4	14.0	20.2	12.4
Number of observations	7	6	5	6

Source: Enterprise surveys conducted between June and Sept 2003

It can be seen that business licenses represent a much larger burden for small enterprises than for larger ones; going from 55 per cent to 30 per cent of total taxes paid across the quartiles. This is also clearly illustrated when license fees are separately expressed as a proportion of enterprise gross margins (Figure 2). The position for G-tax is more mixed, representing variable proportions of the total tax burden for different enterprise size groups. However, the

table further demonstrates that business licenses are a much bigger burden to small businesses than the highly politicised G-tax.

**Figure 2: License Fees as a Share of Gross Margins, by Sales Quartile
(Mbale Small & Medium Enterprises)**

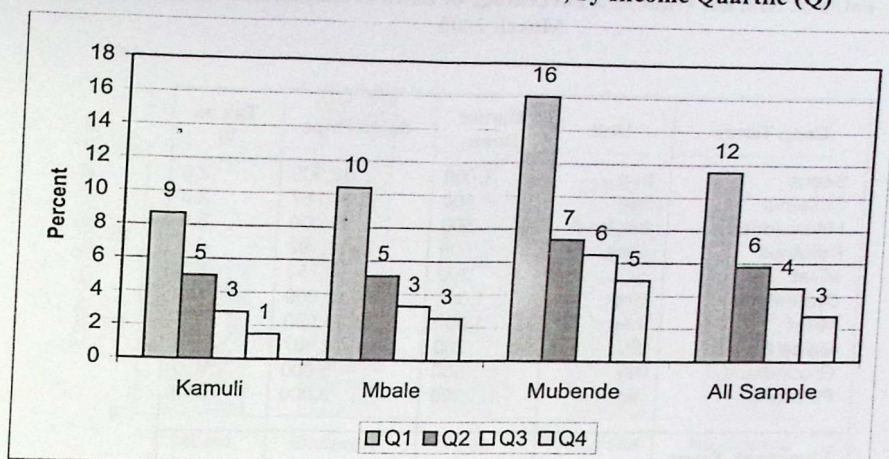


The research further analyses the incidence of rural taxes in household income using the LADDER survey dataset of 315 households collected in 2001 in three districts (Mbale, Kamuli and Mubende). In this case the taxes paid by a household were computed as a share of total household income and ranked by quartiles. The results also consistently reveal that rural taxes are very regressive, hurting the poor more than the better-off households. Figure 3 presents the results, indicating that for the entire sample, the share of household income paid in taxes by poor households is four times more than for richer households. For the Kamuli sub-sample, the results are more dramatic, the share of the poor being nine times more than that of the richer households.

3. Resource Allocation and Growth Effects of Taxes

Aside from income distribution effects, rural tax rates can have adverse effects on resource allocation and economic growth. Flat rate taxes may in practice be highly variable in their incidence on different agricultural outputs, causing relative prices to become distorted and

Figure 3: Rural Taxes in Total Household Income, by Income Quartile (Q)



Source: Computed from the LADDER survey dataset 2001.

encouraging - in economic terms - wrong decisions to be made about what to produce. If for example, beans are a highly valued commodity, but a high tax rate on them reduces their producer price, and cassava is not such a valued commodity but has a low rate of tax so producer prices are relatively increased, then farmers will grow less beans and more cassava to the disadvantage of society as whole. One of the axioms of a good tax system is that it should avoid interfering in relative prices between commodities.

Some examples of such variations in percentage rates as discovered by research in Kamuli district are provided in Table 3 below. Note that with the exception of millet, larger quantities or sizes of all products (bags, sacks, and larger animals) attract lower tax rates than smaller quantities (tins and small stock). In some instances this distortion is especially severe. For instance, the effective tax rate on a chicken is over 10 times the rate on a head of cattle. Needless to say these variations, when they apply in practice, also mean that market dues are steeply regressive in character. Poor people with small quantities to sell pay relatively much higher dues than less poor people with larger quantities to sell. A similar pattern is observed for market dues in Mubende district (see appendix 1). Although for crops these rates are not always applied in practice (see discussion under tendering below), the fact that they are set with such high variation in effective rates is indicative that the rates chosen are accidental rather than obeying any clearly thought out principles.

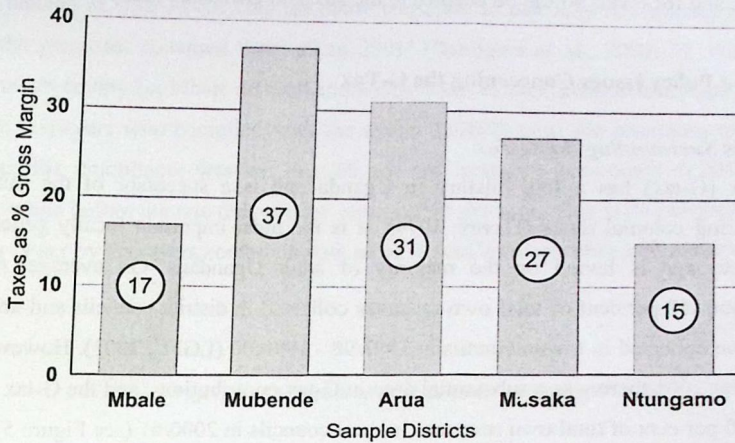
**Table 3: Market Dues as a Percentage of Sales Prices, Kamuli District
March 2003**

Crop Taxes	Unit	Market Dues	Sales Price	Tax as %
Beans	bag	1,000	38,300	2.6
Cassava	bag	500	21,667	2.3
Maize (dried)	bag/sack	500	15,000	3.3
Potatoes	sack	500	11,192	4.5
Millet	tin	300	5,750	5.2
Groundnuts	bag	1,000	18,000	5.6
Millet	bag	1,000	14,000	7.1
Maize (dried)	tin	200	2,667	7.5
Groundnuts	tin	500	5,000	10.0
Potatoes	tin	300	3,000	10.0
Livestock Taxes				
Cow (live)	animal	2,000	180,000	1.1
Pig (live)	animal	1,000	24,750	4.0
Goat (live)	animal	1,000	18,500	5.4
Duck	bird	300	3,091	9.7
Chicken	bird	300	2,526	11.9

Source: Finance Department, Kamuli District Local Government, 2003
LADDER dataset for average crop and livestock sales prices

Tax rates do not just vary by commodity, they also vary widely by district, creating spatial distortions in markets and prices. As part of the research underlying this report, data were collected from 20 small-scale matooke traders across the six case-study districts. Information was obtained on purchase and sales prices per bunch and taxes paid per bunch. This allows various tax rates and margins to be calculated. In Figure 4 the results are graphed for the proportion that market dues on matooke represented as a share of the gross margin (sales price minus purchase price) in trading matooke.

Figure 4: Variations in Tax Rates of Matooke Across Districts



It is not a sufficient rebuttal of these data to say that the amounts involved are too small to really matter. This is to distort the very meaning of poverty, which is that people's consumption is already below the minimum acceptable level that would permit them to lead 'normal' lives free from persistent hunger and lack of basic necessities. The rural poor in Uganda already pay taxes principally in the form of VAT on the few consumer goods that they are able to purchase. It is paradoxical that those very agents who are pushing so hard for countries like Uganda to adopt proper poverty reduction policies at the same time enthusiastically promote additional taxation of the poor by local governments.

Economic growth is inhibited as well if the business license systems are complex and impose undue burdens on start-up businesses. It should be borne in mind here that poverty reduction does not just occur directly, in relation to things that the poor themselves are normally found doing. It also occurs indirectly when new enterprises and flourishing economic activity creates new employment opportunities, and enables individuals to gain steady wage income rather than relying on subsistence production of food crops. In general, all types of new business activities create multiplier effects in the local economy by employing people, purchasing inputs, and increasing the money in circulation. The implementation of business licenses within an enabling environment would take these considerations into account (MoFPED, 2001). Very small businesses, even if required to register, would tend to be

exempted from fees. Start-up businesses would be given time to get going before license fees were imposed, and fee levels would be adapted to the size and growth of firms.

4. Debates and Policy Issues Concerning the G-Tax

General Issues Surrounding the G-Tax

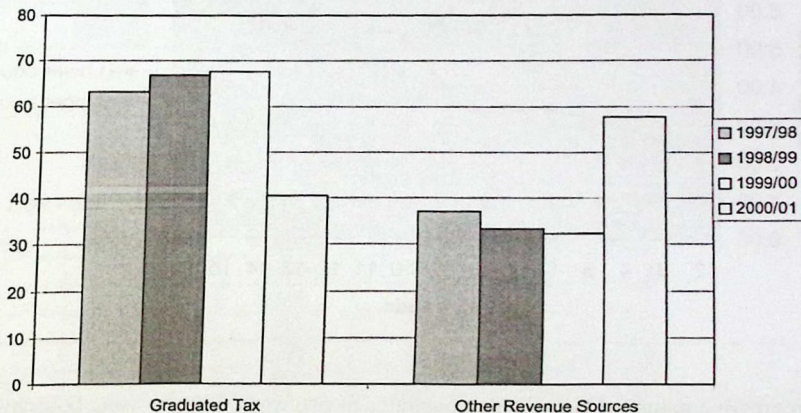
Graduated tax (G-tax) has a long history in Uganda and is a successor of the hut tax introduced during colonial times (Davey, 1974). It is the most important locally generated revenue source, and is levied on the majority of adult Ugandans. On average, G-tax contributed about 67 per cent of total own revenues collected in district councils and about a third of revenue collected in town councils in 1997/98 - 1999/00 (LGFC, 2002). However, in the election year 2001 there was a substantial drop in G-tax contributions, and the G-tax share fell to about 40 per cent of total own revenues in rural councils in 2000/01 (see Figure 5). The corresponding figure for urban councils dropped to 18 per cent.

Local councils are in general heavily dependent on transfers from the central level. On average, almost 90 per cent of total expenditures in local authorities are funded by the central government, although this reliance varies among districts. During the mid-1990s, central government transfers expanded in line with increasing responsibilities, and they more than doubled in the four years prior to 1996/97 (Livingstone & Charlton, 2001: 83). At the same time, since the late 1990s there has been a decline in local revenue generation. From 1997/98 to 2000/01 local revenue collection declined slightly from about US\$ 45.3 billion to US\$ 43.8 billion, and then in 2001/02 there was a sharp decline to US\$ 18.3 billion (LGFC, 2003).

The drop in revenue collection for G-tax in 2001 was prompted by political interventions during the presidential election campaign. The opposition candidate, Kizza Besigye, campaigned for the abolition of G-tax, while President Museveni promised to reduce the minimum level of G-tax from US\$ 11,000 per year to US\$ 3,000 per year. This political intervention understandably caused confusion among taxpayers regarding the legitimacy of the G-tax.

After the 2001-election, the President's promise was implemented and the minimum G-tax rate reduced to US\$ 3,000. This led many taxpayers to pay only the minimum rate arguing that the president 'assessed them all in 2001' (Bahiigwa et al., 2003: 2). For instance, in Butiru sub-county (in Mbale district) and independent of their income levels, over 98 per cent of the taxpayers who complied with the tax in 2002/03 paid the minimum rate. However, despite this, compliance was less than 60 per cent in Butiru sub-county in 2002/2003 fiscal year, while before the rate reduction it was over 90 per cent. This is due to greater resistance to pay G-tax by taxpayers combined with more lax enforcement than before the election.

Figure 5 : Composition of rural taxes and fees (1997-2001)

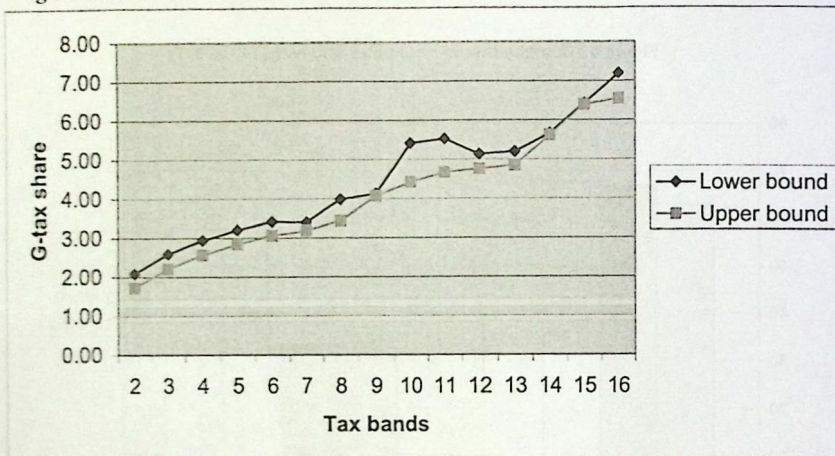


A variety of sources, including regular newspaper articles, reveal that the G-tax is in a mess in Uganda. On the one hand local politicians often discourage taxpayers from paying, especially close to election times. On the other hand extensive use of force in G-tax collection has been reported across the country. The two rounds of the UPPAP are instructive in this regard (Muhumuza& Ehrhart, 2000; MFPED, 2002).

In recent years, there has been a substantial simplification of the income tax bands of G-tax. In the period 1993-2001, the G-tax schedule had 37 tax bands. This schedule was reduced to 22 bands in 2001, and further reduced to 17 bands in March 2002. But still, the G-tax system schedule is complicated. For comparison, there are at present only 4 tax bands in the central

government personal income tax schedule. Hence, there should be room for substantial further simplification of the G-tax schedule. The simplification of the G-tax schedule posted in March 2002 has put in place a progressive schedule (see Figure 6). This is a positive development which reverses a previously regressive character of the schedule across the lower income ranges. However, as discussed above, the most commonly applied rate across all income groups today is the flat rate USh 3,000. So although the G-tax schedule is progressive in principle, it is regressive in practice for those local governments unable to collect G-tax above the minimum level (e.g. Butiru sub-county in Mbale district).

Figure 6: G-tax Schedule, March 22, 2002



The regressive nature of G-tax is demonstrated in two ways. First by using household income from the LADDER dataset and computing the share of G-tax in household income. This is illustrated in Figure 7, which shows that households in the lowest income quartile pay a share of their income that is about three times more than that of households in the highest quartile (the richer households). The second illustration is provided by assuming that all taxpayers pay the minimum amount of Ush 3,000. Table 4 for presents the results of the computations using the LADDER dataset, indicating that when taxpayers pay a flat rate due to political interference (as happened in Butiru sub-county), the poor pay a proportion of their income that is 18 times more than the richest households in the fourth quartile. That proportion is 26 times more for Mbale district. Perhaps it is also important to note that despite the steep regressive nature of G-tax, the share of this tax in household income is quite low, ranging from one percent to three percent for households in the highest and lowest income quartiles,

respectively. This contrasts sharply with PAYE where the lowest income earners pay 10 percent of their income, while the highest income earners pay 30 percent. This is an important result in that, despite the politicisation of G-tax, it does not represent a significant burden on households, rich or poor.

Figure 7: G-tax in Total Household Income, by Income Quartile

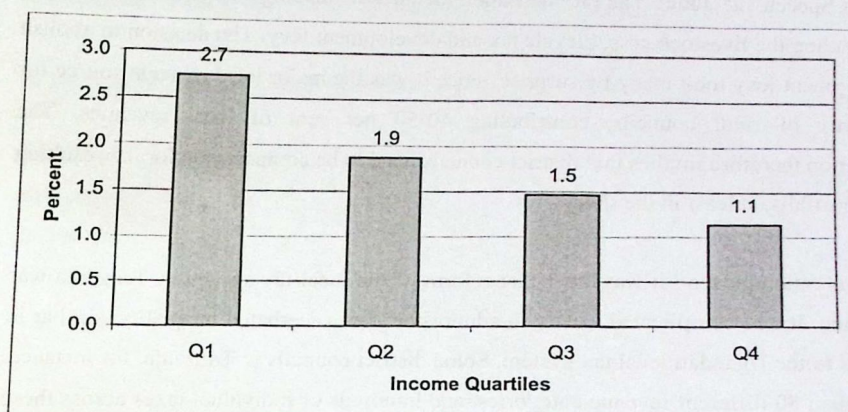


Table 4: Flat rate G-tax share in household income, by income quartile

Quartile	All Sample	Kamuli	Mbale	Mubende
Q1	1.48	1.43	1.84	1.18
Q2	0.45	0.46	0.45	0.44
Q3	0.21	0.21	0.21	0.22
Q4	0.08	0.08	0.07	0.10
Q1/Q4	18	19	26	11

Source: Computed using LADDER dataset, 2001

Abolition of graduated tax has been raised on several occasions in recent years. Most recently, in August 2003 some MPs suggested that G-tax should be abolished altogether. They argued that G-tax was a regressive tax which imposed extra hardships on poor people. Moreover, it was argued that G-tax was costly to administer and implied a double taxation on personal income taxpayers in the formal sector, who had to pay both PAYE to the central government and G-tax to the local authority. The debate was at least temporarily halted when the President announced in September 2003 that G-tax would be retained. Certainly, given the importance of G-tax as a local revenue base, there is need for thorough consideration before abolishing the tax. The experience of Tanzania, where the development levy (a poll

tax very similar to the Uganda G-tax when this is applied at a flat rate), was abolished in June 2003 may shed light on some important issues of relevance for Uganda with respect to the future of the G-tax. The following section assesses the Tanzanian experience.

Abolishing G-tax? Lessons from Tanzania

In June 2003, the local government tax system was rationalised in Tanzania (announced in the Budget Speech 12th June). The rationalisation included abolishing a large number of local taxes, including the livestock cess, bicycle tax and development levy. The decision to abolish the development levy took many by surprise, since it was the major local revenue source for the majority of rural councils, contributing 40-50 per cent of local revenues. The rationalisation therefore implies that district councils need to be compensated for the resulting revenue shortfalls, at least in the short term.

Prior to this rationalisation it was clear that reform of the local tax system in Tanzania was long overdue. It was complicated, costly to administer and exacerbated inequality; similar in many ways to the Ugandan local tax system. Some district councils in Tanzania, for instance, had more than 80 different revenue categories, and hundreds of individual taxes across these categories. Tax evasion was widespread, reflecting persistent public resistance to pay. Moreover, the linkages between the central and local government tax systems were in general weak leading to double taxation and inconsistencies between tax policies implemented at different levels of government.

Before the local tax reform was implemented, the government issued two directives to the local authorities which laid the foundation for the reform. Firstly, a directive on tax enforcement was issued in 2002 (announced in the Budget Speech for FY 2002/2003). This directive instructed local authorities not to use roadblocks and the local militia as instruments for tax collection. Interestingly, in June 2003 a similar move on roadblocks was implemented in Uganda. Secondly, a directive was issued in December 2002 requiring all local authorities to provide proposals for the rationalisation of their own revenue sources by April 2003. Many district councils complied with this directive. But the government in the end opted for much bolder reforms, making the decision in June 2003 to abolish the development levy as well as a broad range of other local taxes.

A positive thing that the Tanzanian reform demonstrates is that radical change is possible.

Local taxes that originate in the mists of previous history can be abolished without the sky falling in. It is too early to assess the longer term impacts of the Tanzania reform. Councils have had to tighten their expenditures in the 2003/2004 financial year, and special compensating transfers from central government to cover most of the immediate revenue shortfall have recently been agreed. It has also been noted that some of the energy previously devoted by local civil servants to tax collection is in process of being diverted towards undertaking more useful activities in service delivery to citizens.

5. Tax Tendering in Uganda: Principles and How It Works in Practice

Tax collection systems, across countries and history, have contained elements of both public and private collection. Even so, few modern states have granted private collection a permanent status in their revenue generating machinery. Stella (1993), among others, predicts that privatisation will result in overzealous collection, i.e. seriously aggressive extraction from ordinary citizens. Historical evidence gives some credence to this expectation, especially when gradual consolidation of tax "farms" presented opportunities to exercise monopoly power. This was for instance the case in 18th Century France where the general tax farm controlled as much as 45.3 % of all revenue collected. Private tax collection appears to provide a workable response to the problem of corrupt bureaucratic collection documented in many SSA countries (Reinikka and Collier 2001; Fjeldstad 2003; Fjeldstad and Tungodden 2003; Svensson 2003). There are two reasons in principle for this advantage. First, private collectors have a personal interest in ensuring that their tax agents do a good job. This is rarely the case for public collectors. Second, they are better placed to penalise poor performance on the part of their agents, since they are not bound by public sector job security rules.

In Uganda, practices in tendering private contracts for the right to collect taxes vary across district administrations (USAID, 2003; Wilson 2002; LGFC 2003). A widespread feature is that market places, landing sites and parishes are tendered out on the basis of a reserve price, based on an assessment of the revenue potential of the individual market or site. Studying practice in 11 districts, Wilson (2002) found that a combination of previous tender prices and an assessment by the District Market or Finance Officer was a common approach for determining the reserve price. In Mubende our study found the potential of rural markets to be assessed by one district officer who works in tandem with sub-county and parish officials.

In Ntungamo, in contrast, the district revenue officer estimates the reserve price. Collecting the counter foil receipts from the market tenderer for previous market seasons, the revenue officer computes the amounts collected and determines the reserve price.

The tenderer is often permitted a gross margin in the range of 20 per cent above this reserve price. Hence, for a revenue potential of US\$ 1,000,000, the reserve price would be US\$ 800,000. All tenders are made public, and sealed bids invited. The principles for awarding, and the content and duration of the contract vary across districts. For example, in Mubende district, contracts are awarded for twelve months, in Kamuli and Ntungamo for six months, while in Mbale contracts have a duration of only three months.

Sealed bids will often be opened and read in public immediately after the deadline. This is commendable practice and ensures some transparency. In Mbale district, bidders for a market are required to (i) pay a non-refundable application fee of US\$ 25,000, (ii) possess a G-tax certificate, and (iii) have no outstanding debts. The latter condition is, of course, difficult to verify. In general, all applications will be vetted by the Technical Evaluation Committee (TEC) which ranks the bids and advises the District Tender Board (DTB). While some councils require that only district residents may be awarded tenders, the Local Government Act permits the DTB to give preference to local bidders. Practice varies in terms of the rules for paying the agreed amount into the revenue office. Mbale district represents good practice in this regard since the agreed amount must be paid up front which eliminates the risk of later and often costly default.

An underlying principle is that only bids above the reserve price will be considered and in practice, accepted bids are seldom significantly higher than the reserve price (Wilson 2002). Some districts operate a policy of eliminating bids outside ± 10 per cent of the reserve price. In Mubende, for instance, the DTB perceives bids outside the range of ± 10 % as unrealistic, and likely to increase the risk of default. Indeed, a policy of eliminating bids exceeding the reserve price by 20 per cent has been proposed for fish landing sites by Wilson (2002). This recommendation would perhaps make sense if reserve prices were robustly assessed. However, in light of the substantive gaps between the reserve prices and the de facto revenue potentials of rural markets uncovered below, this recommendation is deeply flawed.

The TEC evaluates bids and makes recommendations to the DTB. In Mubende, the TEC has seven members, representing all departments. In awarding the contract, the DTB has discretionary jurisdiction, and principles for ranking one candidate over another can therefore be quite arbitrary and subject to political interference (LGFC, 2003). Wilson (2002) found the DTB to overturn the TEC's recommendations in 70 per cent or more of the cases. The gravity of conflicts between the TEC and DTB do, however, vary.

Bidders will usually be assessed on multiple criteria. In Kamuli district the bidder's past experience is assessed (on a scale from 1 to 3) alongside other criteria including the bid price (pointed from 1 to 3). In principle, each applicant is rated on each criterion and the bidder with the highest overall score should win the contract. However, according to Wilson's (2002) observations *"it was in practice impossible to win a tender if the applicant was from a less favoured political party and should the applicant not have contacts at DTB."*

Two of the markets covered by the current study provide further insights into the scramble for the right to collect taxes as exemplified by strategies to control the bidding process. The company holding the tender for Butawaata public and livestock market in Mubende district is controlled by the LC III Chairperson of Kasambya sub-county where the market is located. In 2002/03 this tender attracted four bidders. The aforementioned company won the contract after submitting the second highest bid. Following a campaign to intimidate rival bidders, others have subsequently abstained from bidding for Butawaata, which happens to be biggest and most lucrative market in the area. As a result of intimidation, in 2003/2004 fiscal year, there was no other bidder for Butawaata market. In Rubare Weekly Market in Mubende, in contrast, tenderers have formed an informal cartel that effectively controls the bidding process, keeps bids low and share contracts amongst themselves.

A key presumption, both in the literature on taxation and in the debate on fiscal reform in Uganda is that assessment of the revenue potential of a market poses a formidable challenge, and that capacity building to make assessments more accurate should be a high priority (USAID, 2003). This is simply not the case, as anyone who has visited a real market and observed the tax collection system at work, would be able to verify. Markets are typically fairly well-organised. Part of the space is assigned to agricultural produce, part to livestock and part to clothing, and part to household goods and other items. Most traders in practice pay a single flat fee (e.g. USh 200) for the right to set up and sell produce from their market

patch, in contrast to the multiple official rates that vary across commodities and the quantities taken to the market. Thus, a simple count of the number of traders in different market categories suffices in this instance. The main exceptions are matooke and livestock where taxes are levied per bunch or per animal entering the market. It is a minor chore to post an assistant to count these two categories of items into and out of the market on a market day. Accurate assessment of market yield is thus not by a long way the critical factor inhibiting the proper working of the private collection system.

Investigation of the relationship between agreed bids and market revenue yields in six markets reveals how poorly the private collection system in Uganda performs in practice. The data for these six markets is presented in Table 5, and a graphical representation for two of them is provided in Figures 8 and 9. The table compiles data on the total revenue collected in each market, measured as described in the preceding paragraph. The first line gives the agreed tender levels for the same markets, as provided by district revenue offices. The gap between total revenue collected and agreed tender can be divided between two categories: (i) a 20 per cent margin private tenderers are permitted to realise on their collections in some districts, and (ii) an amount representing the "lost revenue" to councils, i.e. the additional revenue they could have obtained had they correctly assessed the revenue potential of each market.

The graphs (Figures 8 and 9) for two of these district markets help to clarify this deficit. This compares the LG estimate of the revenue yield of the market with the actual revenue yield showing clearly the "lost revenue" that is involved. In these two instances, "lost revenue" represented 50 per cent and 74 per cent of the total revenue collected in each market, respectively. Returning again to Table 5, the actual gross margins realised by private tenderers due to the undervaluation of market yields varies between 71 per cent to as high as 970 per cent. The private tax collection system in Uganda clearly ends up by transferring money from ordinary tax payers into the pockets of tax agents and their various associates rather than to district revenue authorities.

Overzealous collection is unlikely to occur in the system as so described for two main reasons. First, there is no real need for tax collectors to take draconian measures to recover as much revenue as possible in a situation where they are able effortlessly to operate with such

Table 5: Operation in Practice of Market Tender System in 6 Districts

Category	Data Based on Sample Markets					
	Mbale	Kamuli	Mubende	Masaka	Ntungamo	Arua
Agreed Tender	900,000	750,000	1,400,000	60,000	500,000	710,000
"Lost Revenue"	598,792	2,416,583	2,083,667	268,750	3,958,875	509,833
20% Margin Permitted	299,758	633,317	696,733	65,750	891,775	243,967
Total Collected	1,798,550	3,799,900	4,180,400	394,500	5,350,650	1,463,800
Actual Total Margin	898,550	3,049,900	2,780,400	334,500	4,850,650	753,800
Actual % Gross Margin	99.8%	406.7%	198.6%	557.5%	970.1%	106.2%

Note: while agreed tenders and total amounts collected are as stated, other categories vary across districts incl. the tender period and the margin permitted.

Source: Original data collected by the Uganda Tax Study team. March-July 2003

generous margins. Second, the prevalence in some cases of different private tax collectors operating in markets that are closely adjacent to each other means that unduly heavy extraction in a particular market would result in market participants moving to a nearby market where conditions were less unfavourable. Hence, one possible way to avoid overzealous collection is by ensuring competition between independent tender holders in adjacent markets.

The flaws in the private tender system as it currently operates in Uganda are amply demonstrated by the foregoing evidence. Since assessing the revenue yield of markets is not, in fact, a difficult task, it is apparent that reserve prices and agreed tenders are set deliberately low. The mechanisms that conspire to generate these low reserve prices may, as indicated above, vary across councils. It is also evident that the low reserve prices provide ample scope for collusion between members of the tender board, local politicians, and the collector awarded the contract over the division of the generous gross margins currently being created.

The more generous these margins, the better the bargaining power of local bureaucrats and politicians in extracting potential bribes from tax tenderers. There is thus a stark conflict between the official objective of local revenue enhancement, on the one hand, and the private interests and incentives of corrupt local bureaucrats, on the other. However, even when members of the TEC and DTBs behave impeccably, the existing routines for reserve price assessment may provide market tenderers with opportunities to influence the reserve price assessment by controlling the supply of foil tax receipts to the official responsible for determining the reserve price (e.g. Butawaata). The current margins also encourage collusion among tenderers and intimidation of potential competitors to ensure that the status quo is maintained. A lesson for donors who think that this is basically a question of capacity building is to reconsider their position and to consider more carefully the incentive mechanisms and the array of loopholes in tax collection, tendering design and procedures for reserve price assessment. We will pursue this issue in more detail in section 6.

Figure 8: Working of the Tender System in Butawaata Market, Mubende District

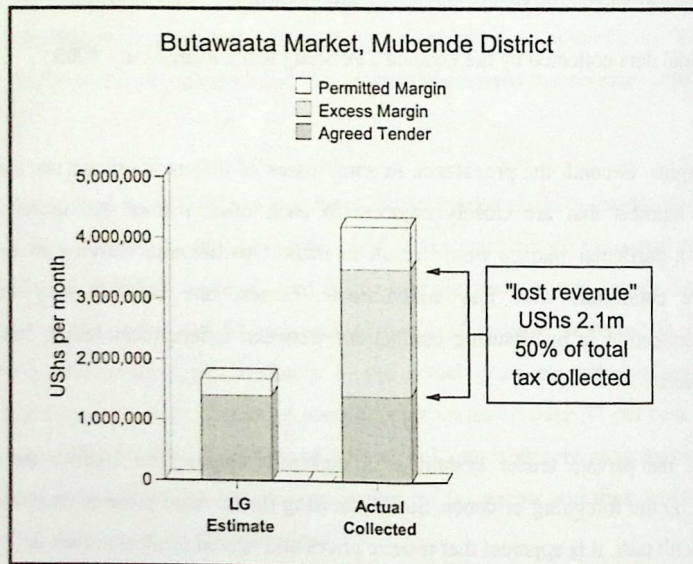
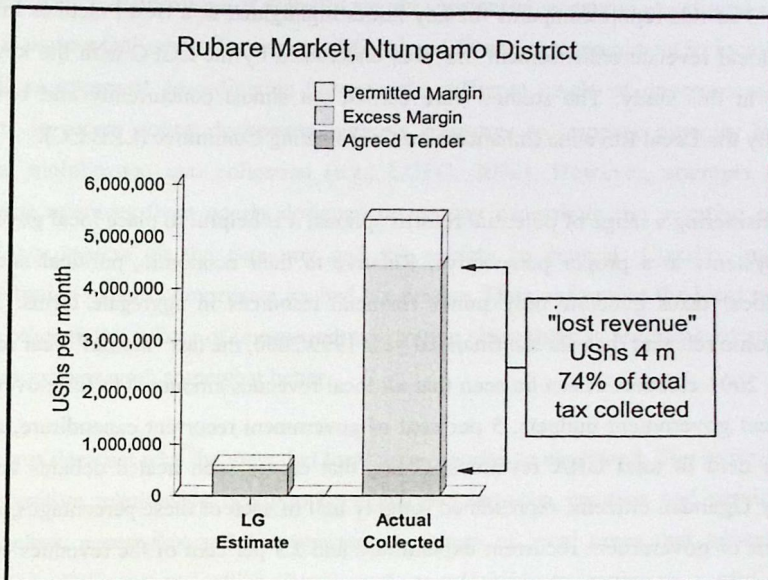


Figure 9: Working of the Tender System in Rubare Market, Ntungamo District



6. Proposals for Reform

The preceding sections of this report have demonstrated that the local tax system in Uganda has an anti-poor bias in practice, distorts relative prices, inhibits the multiplication of enterprises and economic growth in rural areas, and has some in-built organisational defects that result in low yields to local governments compared to tax collected through private tendering. The tax system is also complex and non-transparent. Moreover, it varies across councils and markets within districts.

The response of donors and the government to this situation has been to advocate capacity building in local councils and increasing tax revenues through a variety of admonitory devices (so-called "sensitization"). These approaches are located within the broad context of "local revenue enhancement". They do not, however, address the adverse behaviours that have been identified in this report and are as likely to reinforce as to ameliorate them. Nor is this report alone in identifying such problems: many of them emerged clearly in both rounds

of the UPPAP (Muhumuza & Ehrhart, 2000; MFPED, 2002), and they are routinely reported and discussed in newspapers and the media. However, this report has used more systematic research methods to verify them, as against depending on fragmentary evidence or hearsay. Appendix 3 of this report compares the key issues highlighted in a Best Practices Inventory study on local revenue enhancement that was undertaken by the LGFC with the key issues addressed in this study. The studies were carried out almost concurrently and both were overseen by the Local Revenue Enhancement Coordinating Committee (LRE CC).

Before considering a range of potential reform options, it is helpful to place local government revenue systems in a proper perspective. Relative to their economic, political and social impacts, local taxes generate only minor financial resources in aggregate terms. Table 5 provides some relevant data for the financial year 1999/2000, the last "normal" year for G-tax before the 2001 election. It can be seen that all local revenues amounted to little over 10 per cent of local government budgets, 5 per cent of government recurrent expenditure, and less than 5 per cent of total URA revenues. G-tax, that causes such heated debates and is so disliked by Ugandan citizens, represented roughly half of each of these percentages, i.e. only 2.6 per cent of government recurrent expenditure and 2.3 per cent of the revenues collected by the URA.

The point of making these comparisons is not to suggest that there should be no local tax collection at all. Rather it is to show that there is more scope for innovative thinking than current wisdom supposes. None of these taxes are sacred, and abolition of some of them,

Table 5: Local Revenues Compared to National Aggregate Revenue Flows 1999/2000

		Total Local Revenues	G-Tax	Other Taxes
	UShs million	43,365	22,654	20,711
Total LA Budgets	413,664	10.5%	5.5%	5.0%
Govt Recurrent Expenditure	860,153	5.0%	2.6%	2.4%
URA Revenue	981,338	4.4%	2.3%	2.1%

Source: Uganda, MFPED, 2003

or replacement of some by others, would not cause decentralised local government in Uganda to collapse. The main lesson of the recent local tax reform in Tanzania, in which that country's equivalent of the G-tax was abolished, is that comprehensive changes can be made, and the resource implications of doing so are not substantial measured in national aggregates. There is undoubtedly room for improved fiscal and financial management in local authorities as well as improved co-ordination between the different levels of government. Prevalent thinking in recent policy documents suggests measures to improve capacity building for revenue mobilisation and collection (e.g., LGFC, 2003). However, attempts to squeeze additional revenues from poorly designed taxes may exacerbate the negative effects of a flawed tax system on the economy and the society in general. Clearly, improved tax administration cannot compensate for bad tax design. Thus, reforming the local tax structure should precede the reform of revenue administration since there is not much merit in making a bad tax system work somewhat better.

This report does not take the view that local taxes should be abolished. The basic argument is that a positive relationship needs to be developed between taxation and service delivery. Nevertheless, a complex and non-transparent system of local taxes that adversely affects equity and efficiency, and which also is costly to administer, serves no useful purpose for strengthening democratic accountability in Uganda. Therefore, there is a case for simplifying and improving the local revenue system. However, this does not necessarily mean that one should follow the recommendations given in recent revenue enhancement documents (e.g. LGFC, 2003). The emphasis must be on selecting a few basic categories of local taxes and ensuring that they are transparent and understandable to taxpayers and local government revenue departments alike.

The report identifies four main areas where reforms of the existing tax system are required before efforts are taken to squeeze more revenues out of the existing system. These are:

- (i) market dues and closely related taxes (parish dues, fish taxes etc);
- (ii) the private tendering system;
- (iii) business licences; and
- (iv) G-tax

(i) Market dues and related taxes

Market dues and related taxes are essentially 'nuisance' taxes. They do not yield very much revenue (partly due to the way the tendering system works in practice), their principles are complex (hundreds of tax rates invented for every conceivable item for sale, even if in practice shortcuts are taken in collecting them), and they currently provide no linkages between taxes paid and service delivery, e.g. improving the quality of market places. For non-agricultural consumer goods, they also imply an element of double taxation, since these goods already will have incurred VAT in their price. In addition, some councils extract 'parish dues' for goods sold outside formal market places (see the section on tendering below), and some items are subject to multiple taxes when they cross parish or district boundaries (thus discouraging trade). Our proposals for market dues are as follows:

- (a) the principle of setting rates for every commodity should be abolished
- (b) market dues should be abolished as a category of tax and replaced by "user fees" that are earmarked for improving market place infrastructures and the associated trading environment (weights & measures etc)
- (c) the levying of these "user fees" could be distinguished between rural markets and municipal markets
- (d) for rural market, the "user fees" would be daily fees charged for having a place in the market, not tax rates by commodity
- (e) for municipal markets, entry dues could be retained, reflecting the greater volume of business and higher infrastructural cost of urban markets
- (f) an exception to (d) might be made for livestock, since livestock trading involves other considerations (sanitation, health, etc) compared to crops and consumer goods
- (g) parish dues and other charges that occur outside markets should be abolished, they almost certainly cost more to collect than the revenue received from them
- (h) the possibility could be considered of utilising a small proportion of a relevant category of national level tax receipts to compensate districts for the loss of revenue incurred by abolishing market dues

Abolishing dues in rural markets (and parish dues where they are applied) would go a long way towards simplifying the over-elaborate and non-transparent current local tax regime. It would help with encouraging the more rapid monetisation of the rural economy (a goal of the PEAP and the PMA), and make markets work better by placing less blockages in the way of buying and selling goods of all kinds in rural areas. Daily fees in market places would be

retained, but these would be principally, and possibly exclusively, earmarked for running markets and generating funds to improve market infrastructures (running water, toilets, shelter, improved security, improved access and traffic management etc.). This might also entail changing from a private tendering system to one of market associations for the collection of such fees, although this is an aspect that requires further consideration.

(ii) The private tendering system

The private tendering system has been shown earlier in this report to have very serious flaws. The most obvious of these is the substantial gap in practice between the revenue potential of markets assessed by local governments, and the revenue that is in practice collected from market places by the tenderers. The size of this gap reveals that District Tender Boards and local tax administration more generally do not operate as they should in theory, and the tender system has come to be operated as a way of generating rents that can then be divided between various parties behind the scenes. The vested interests in retaining low reserve prices which undermine official goals of local revenue enhancement are strong and take a number of different forms as illustrated above. Given this situation, the advocacy in some reports (LGFC, 2003; 71 that "all LGs that have not yet contracted out collection of other sources of revenue should be encouraged to do so as soon as possible" should, at this juncture, be treated with considerable scepticism.

Nevertheless, some advantages of private tendering have been recognised in this report. The incentives for improved collection are there, provided that realistic estimates of the potential revenue yield of markets are made, and the tendering process made less prone to hijacking by officials and politicians seeking the income supplementation opportunity it provides. It has been shown that estimating the revenue yield of markets is not difficult. However, effective reforms of the tendering process represents an intricate challenge.

Some principles that are worth considering for future operation of the private tender system if it is to be retained include:

(a) default by tenderers can be avoided by payment of the agreed tender at the beginning rather than the end of the tender contract.

(b) the propensity for overzealous collection may be controlled by:

- encouraging a structure of rural markets that present traders with real options
- ensuring the local affiliation of tenderers as proposed by Wilson (2002)

(d) the institutional problems relating to the mechanisms for setting the reserve price and awarding contracts, as identified above, need urgent attention:

- the principle that bids that exceed the reserve price by 10 or 20 per cent should be eliminated from consideration, as proposals of this kind are inexplicable and clearly not thought through;
- alternative institutional mechanisms that disconnects the assessment of the reserve price from the vested interests of bureaucrats in the district administration and from individual or groups of tenderers, need careful and immediate consideration.

The simplification of market dues put forward in the preceding sub-section will alter the scope of operation of private tenderers. A simplified regime of daily market user fees will contribute to make the assessment of the revenue potential of a market more straightforward than at present. However, as discussed above the difficulties of assessing markets have been much exaggerated in reports concerned with revenue enhancement. Perhaps if private tenderers were returning revenues to a management association of markets, rather than to district revenue offices, the motivation to create artificial differences between assessments and actual collections would be reduced.

(iii) Business licenses

The licensing of businesses represents a policy area of public regulation (and deregulation) that was not part of the scope of this study. There is much ongoing work on in Uganda on this important topic (e.g. MFPED, 2001). However, the results of our enterprise survey suggest that business licenses are highly regressive in practice, penalising small enterprises compared to larger ones. This occurs because the levels of flat rate licenses are skewed against small enterprises: Firstly, the types of enterprise that are found in the small scale sector pay proportionately more in license fees than the types of enterprise that are found in the medium and large scale sector. Secondly, license rates do not rise in line with the sales turnover of businesses. As stated in various policy documents, business registration should be

encouraged for a variety of reasons, but license fees and registration are two different things. Finally, micro enterprises should only pay a nominal administrative fee for registration rather than a tax.

(iv) The G-tax

Whatever is original intentions, the main contemporary purpose of a G-tax could be interpreted as bringing into the tax system income that is not covered by PAYE arrangements. Like other taxes, if the G-tax is retained, it needs ideally to operate simply and transparently, without political interference, and taxpayers need to see visible evidence of services delivered in return for paying this tax. Aside from the option (that Tanzania has demonstrated is feasible) of abolishing G-tax; its improvement might involve some combination of the following considerations:

- (a) No citizens should pay both G-tax to the local government and personal income taxes (including PAYE) to the central government. This is double taxation which is patently unfair. It also confuses the purpose of having a G-tax, and causes unnecessary resentment on the part of those on whom this duplication is imposed.
- (b) Since PAYE only has 4 tax bands, G-tax should be brought into line with this. The current schedule of 17 bands is certainly an improvement on previous schedules, but it remains unrealistic to administer, and contributes to discretionary decisions by local administrations. Furthermore, the large number of tax bands is not necessary in order to ensure that G-tax is a progressive tax.
- (c) Systems should be established to inform citizens on how much G-tax has been collected in their area of residence and how these revenues are spent, including the share retained at different levels of the LC system. This information should be provided by council administrations, and disseminated on notice boards in public places in sub-counties and parishes
- (d) One alternative to the present local collection of G-tax is to allocate this task to the URA, while establishing formal mechanisms to return revenues so collected to the districts

- (c) Some policy reports have proposed the privatisation of G-tax collection. However, before such a measure is taken, it is recommended that careful investigation is carried out by the LGFC as to how private tendering would work in practice with respect to an income tax.

7. Further Work Required

This report has established empirically several dimensions of local taxation that should be a serious cause for concern, in the context of poverty reduction efforts in Uganda. The finding that poverty increased in Uganda between 2000 and 2003 (UBOS, 2003), and that much of this increase in poverty has been experienced by food crop producers adds to this concern. Principally, the critical flaws relate to the operation in practice of the privatized tax collection system (tax tendering), and the overall regressive nature of taxation as experienced by small businesses in Uganda (which brings in G-tax reform and business license regimes in addition to commodity taxes).

There are parts of this overall picture that require further investigation if they are to remain features of local revenue generation in Uganda. The principle one of these is the tax tendering system, about which surprisingly little is known amongst policy makers and donors in Uganda despite its widespread use by local governments. It is unclear where this idea came from, how long it has been in use, on what country or system elsewhere it was modeled (and, how it works there), why it has been implemented in the particular way that has occurred in Uganda, what variations can be found in practice between districts (leading possibly to discovering best practice), and how it might be restructured in order to work more closely to its intended modalities and outcomes. These are important questions and issues to resolve if the private tendering system is to be reformed at some time in the future.

The second area that requires more work is how to improve the linkages between taxes paid and services delivered. At present, many documents on local government reform pay lip service to the tax-service delivery links, but none of them specify ways of achieving this so that citizens can genuinely make the connection. Yet, achieving this link is the only way that a proper civil relationship will develop between those that govern at the local level and ordinary citizens. Such linkages may also enable citizens to express priorities for tax expenditures and veto over decisions with which they disagree. The current approach of

requiring local authorities to meet a proportion of the budget of expenditures that are centrally funded (e.g. education and health) is clearly flawed. If these are services that it is expected that the central government should provide, then the small contribution that local government makes to this will go almost unnoticed. Far better to separate out facilities and services that central government fund, from those that local governments fund, so that failure of delivery of the latter can be squarely laid at the door of local representatives.

In summary then, the following two areas of local revenue generation need considerably more work in order to move forward with local revenue enhancement policies that make sense in a poverty reduction and democratisation context:

A. The private tax collection system (reform of tax tendering)

B. Improvement of local taxation – service delivery linkages

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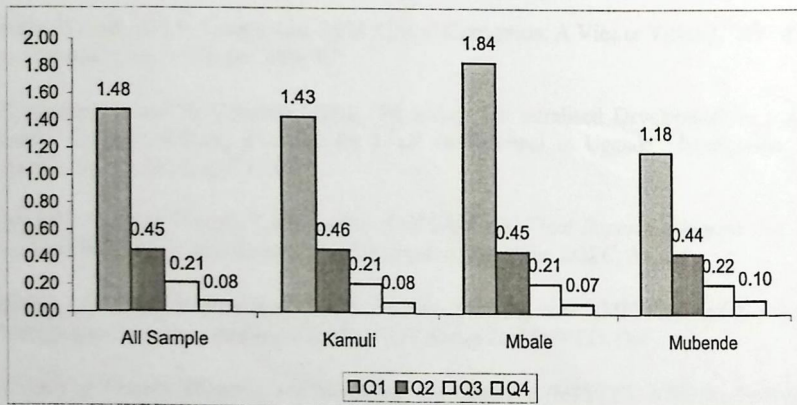
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Appendix 1: Market Dues in Mubende Central Market (Municipal Council)

Crop	Unit	Price	Market Dues	Tax as %
Cassava	Half Sack	6,000	300	5.0
Charcoal	Sack	5,000	200	4.0
Irish potatoes	Tin/Basin	4,000	300	7.5
Irish potatoes	Half Sack	12,000	600	5.0
Matooke	Bunch (on bicycle)	4,500	200	4.4
Matooke	Bunch (on pickup)	4,500	150	3.3
Onions	Sack	8,000	600	7.5
Sweet potatoes	Sack	19,000	600	3.2
Sweet potatoes	Half Sack	6,000	300	5.0
Tomatoes	Box	12,000	300	2.5
Livestock				
Cow	Animal	190,000	6,600	3.5
Goat	Animal	25,000	2,500	10.0
Chicken (He)	Bird	6,500	150	2.3
Chicken (she)	Bird	3,500	150	4.3

Source: Survey of Mubende Central Market, November 2003.

Appendix 2: Flat rate G-tax share in household income, by income quartile



Appendix 3: Comparison of Key Issues from the Best Practices Inventory and the Rural Taxation Study.

	LGFC Inventory of Best Practices in Revenue Mobilisation and Generation	Rural Taxation Study
Overall objective	Best practices defined as "those methods and ways of generating and mobilising local revenue that effectively use the scarce resources (people-power and money) available in a local council to enhance tax administration and promote awareness in a manner that reduces the cost of compliance and maximises the revenue collected" (ES, iv)	A broader focus that goes beyond the narrow goal of local revenue enhancement and places the need for local tax systems and administration to account for the effects of taxation on poverty and local economic growth at the centre of the policy process.
On existing practice	"the failure by LGs to link taxes paid with service delivery, the poor attitude and brutal actions of enforcement officers and contractors towards taxpayers" (ES, v)	Reinforces the important link between tax payment and service delivery.
On sensitisation of taxpayers and others	"Sensitisation of LG officials and tax enforcement officers (including contractors) of their duties and obligations in delivering services to the communities and linking it to taxes paid. Sensitisation programmes should involve community leaders and LG officials who are close to the taxpayers." (ES, v)	Argues that sensitisation is unlikely to be effective and that more careful attention be paid to problems of vested interests and corruption in tax administration. The design of incentive mechanisms that redress such weaknesses are urgently needed but pose difficult challenges with numerous pitfalls. The Inventory of Best Practices has failed to address such incentive problems in depth.
Graduated Tax	Subject to further research, the Inventory is quite open about the scope for privatising G-tax collection and privatising collection from G-tax defaulters.	<p>Recommends a further reduction in the number of G-tax brackets.</p> <p>Argues that lessons from Tanzania's experience with abolishing the development levy should be taken onboard.</p> <p>Advocates that lessons from private tax collection from elsewhere feature as backdrops to the policy process. Privatisation involves a risk of "overzealous collection". While mechanisms for controlling overzealousness in collection of market dues may be identified, private G-tax collection and private collection from defaulters may be harder to control. Effective feedback mechanisms from taxpayers are required. The local affiliation of contractors and collectors may soften a private collection regime.</p>
Markets and other sources of revenue	"the plethora of taxes destroys local initiatives and undermines the credibility of LGs (p.64)"	Recommends drastic simplifications of systems for business licenses and market and other dues. For rural markets, official sales tax rates that vary across produce and quantities should be replaced by user fees. This will remove arbitrary distortions that harm growth, while simplifying administration and fostering transparency.
Privatisation of tax collection and tendering	"All LGs that have not yet contracted out collection of other sources of revenue should be encouraged to do so as soon as possible. However contractors must be sensitised to their obligations, both to the LGs and to the taxpayer (p.71)."	Current procedures for setting reserve prices and awarding contracts for rural markets have serious flaws that need urgent attention. The massive profits currently being created lead to a perverse redistribution from rural and often poor taxpayers to tax tenderers and their well to do. Further privatisation should be put on

		<p>hold until these flaws have been effectively redressed.</p> <p>Emphasis is placed on the various vested interests in retaining reserve prices at the artificially low levels currently observed. Better market surveys are required but need to be conducted by individuals or institutions that lack a vested interest in retaining the status quo. One possible solution is to remove the responsibility for market assessment from LGs to a more centralised body.</p> <p>Averaging incomes (revenues) from a market across seasons as a basis for reserve price assessment is counterproductive. Instead reserve prices should be allowed to vary across seasons.</p> <p>The proposed procedure is not watertight and creates incentive for collusion between contractor and taxpayer (c.f. report for the problem of reserve price assessment based on received receipts).</p> <p>Agrees that feedback mechanisms are important, while adding that:</p> <ul style="list-style-type: none"> *Market associations may be considered for collection of dues. *Dues should be based on official rates and not be determined by individual contractors *The propensity for overzealous collection may be checked by preventing monopolisation and encouraging structures of rural markets that give small scale traders real choice *That preference be given to contractors with local affiliation
	<p>"LGs should conduct surveys to establish the average income from markets. This will also assist them in setting reserve prices."</p>	
	<p>"Revenue receipts are issued by LGs instead of allowing contractors to print their own receipts. This enables proper accountability, facilitates tracking of revenue trends and avoids counterfeits."</p>	
	<p>"LGs should operate service desks to receive complaints from market goers. In addition, LGs should have periodic meetings with market traders to hear their views about issues affecting them. LGs should ensure that contracts executed with contractors have provisions for safeguarding against abrupt increases in rates (p. 65)"</p>	

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