TAXATION,

STATE-BUILDING AND GOVERNANCE

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Acknowledgements

This publication was produced jointly by SEATINI-Uganda, Tax Justice Network-Africa and Oxfam. We extend our appreciation to the following for their contributions towards the production of this report: Mr Moses Kawumi,MrStephen Mugenyi Lubega, Mr Jason Chiminya, Ms Jane Nalunga,Ms Nelly Busingye Mugisha, Mr Africa Kiiza, Ms Regina Navuga and the officials at Democratic Governance and Accountability Programme (DGAP) Uganda. This document has been produced with the financial assistance from European Union through Democratic Governance and Accountability Programme (DGAP). The contents of this document are the sole responsibility of SEATINI-Uganda, Tax Justice Network Africa (TJNA) and Oxfam and can under no circumstances be regarded as reflecting the position of the European Union.

2013

1.0. Introduction

This brief is a product of a baseline study on taxation inUganda that was commissioned by SEATINI Uganda, Tax Justice Network Africa and Oxfam with financial support from European Union through Democratic Governance and Accountability Programme (DGAP). The baseline study was conducted between July-October 2012. The findings were consolidated into a report titled: Taxation, State-building and Governance. The studywas premised on the recognition that every modern state needs to be effective in its mobilisation of domestic revenue and rationally spend the collected revenue on public goods and services in order to attain macro-economic objectives such as economic growth and development, employment and controlling the general price level (or inflation). If the state does not manage taxationwell and public expenditure, and ensure that tax administration costs are controlled, this will curtail both its capacity to grow and provide adequate social welfare to the citizens. Additionally, this has implications to carry out state-building and good governance in the country. This policy brief therefore focuses on institutional measures to improve the efficiency, coverage and effectiveness of the Ugandan taxation public expenditure dictum, and explores the avenues of enhancing the linkage between taxation, civic participation and governance in the country.

1.1. Context of the Baseline Study

The Ugandan economy is not insulated from the global economic down turn, and its growth has been declining from 10.8% in 2005/06 to 7.3% in 2008/09 and 3.2% in 2011/12. Using the 2002 constant prices, the Per Capita income has also been growing at a declining rate and in the year 2011/12 declined by -0.4%, down from 7.2% in 2005/06, and 3.5% in 2007/08.

The economy has a considerable informal sector, and though agriculture and forestry contributes about 14% to the value of GDP, it actually occupies about 70% of the working population. Uganda's population is growing at a considerably fast rate of 3.3% against the average growth rate of Sub-Saharan African Countries of 2.6%. The population below 15 years is 51%, and the potential working population (15-64 years) is about 43%. About 7.5 million of the total pupation of 34 million lives under poverty, while 10 million are categorised as middle class. The definition of the poverty benchmark is, however, based on an out-dated measure developed in the 1990s, which gives Government an illusory gratification on pulling people out of poverty, yet a comparison with other countries using objective measures such as the Human Development Index[1] and using international benchmarks such as the number of people who survive on less than US$ 2 per day shows that the country is still impoverished[2]. The income inequality within the population has become more pronounced, with the Gini coefficient moving from 0.37 in 1992/93 to 0.41 in 2005/06 to 0.43 in 2009/10.

In 2006, Uganda discovered oil in the Albertine Graben which is estimated to be between 2-6 billion barrels and is projected to yield a daily production of 100,000-150,000 barrels per day when production starts in a couple of years to come. There are governance issues to consider if the country is to pre-empt the resource curse that has been noted in oil producing countries on the continent.

[1] The HDI is an informative measure sponsored by the United Nations Development Programme (UNDP) which is primarily determined on dimensions of socio-economic development and standard of living such as health, education, food security and income that describes the level of human development as an indication of development and is used as a yardstick for comparison between countries and regions in the world. There are four classes of HDI Group: (1) Countries with an index over 0.800 are categorized as Very High Human Development group; (2) Countries with an index between 0.700 and 0.800 are categorized as High Human Development; (3) Countries with an index between 0.500 and 0.700 are categorized as Medium Human Development; and (4) Countries with an index below 0.500 are categorized as Low Human Development group. Uganda falls in category 4 with an index of 0.44 (Position: 161st out of 187 participating countries), compared to Kenya with 0.51 (143rd); Tanzania with 0.47 (152nd); South Africa with 0.62 (123rd).

[2] Up to 75.6% of the population is surviving on less than US$2 per day.

2.0. Overview of the Baseline Study Findings

2.1. Impact of the Context on Tax Reform

The context in Uganda has features/challenges that need to be addressed, if tax reform is to be realised. There are considerable parts of the economy, especially agriculture and the informal sectors, which are very difficult to tax. The applicable taxation tools are also very limited; for example the number of people paying personal income tax is less than 1% of the population. The economic and political conditions are very challenging; there is considerable revenue leakage through corruption, smuggling and evasion; and the collection effort does not rhyme with the revenue yield.

2.2. Major Fiscal Policy and Practices

(a) The citizens' understanding of taxation, partly informed by the colonial psychic under which taxation was introduced, and partly by the inability of Government to educate the citizens about the role of taxation and the citizens stake in taxation, has affected their (the citizen's) attitude towards taxation.

(b) There are two principal institutions responsible for raising tax revenue in the country: (1) The Local Government Finance Commission, that is constitutionally provided for under Section 194 of the Constitution, and mandated to plan and advise the President on Local Government revenue issues; and (2) the Uganda Revenue Authority (URA), which is the institution responsible for national tax revenue administration. Whereas URA is obliged to advise Government on tax policy, it does not have a clear constitutional mandate, and is administratively a department in Ministry of Finance that has to wriggle through negotiations for resources to implement its programmes.

(c) Tax on employment income collected under the Pay AS You Earn (PAYE) system is the most significant source of revenue under Income Tax, contributing over 50% of the total (income tax) revenue. The ratio between PAYE tax and corporation tax (income tax paid by companies) is almost 2:1. Government has largely focused on this tax's productivity and has not considered its impact on the low income earners. This is illustrated by the following: Despite the continuous change in the price structure, as illustrated by shift in the Consumer Price Index (CPI)[3], Government did not vary the annual threshold or tax free income granted to individual income taxpayers from the year 1993/94 until recently in 2012/13. During the almost 20-year period, the CPI changed by a factor of 3.32 or 332%; this would indicate the change in the general price level. Using the June 2012 exchange rates, the annual threshold or tax free income was increased from of UGX. 1,560,000 (USD 624) to UGX. 2,820,000 (USD 1,128)[4]. In 1993/94, the threshold was equivalent to about USD 1,415[5].

(d) The productivity of income taxes, both personal income tax and corporation tax[6], is also not very encouraging. The computed measures for the Corporate Income Tax Revenue Productivity (CITPROD) and Personal Income Tax Revenue Productivity (PITPROD) amounted to measures of 0.03 and 0.11 respectively. The comparable performance by other countries in respect to PITPROD and CITPROD is as follows: Kenya has 0.11 and 0.15; South Africa has 0.22 and 0.27; Rwanda has 0.09 and 0.06; Tanzania has 0.08 and 0.05; Sub-Sahara Africa has 0.08 and 0.09; and the World averages of 0.13 and 0.14, respectively. With the exception of Sub-Saharan Africa on PITPROD,Uganda uses these taxes less efficiently in generating revenue than other countries mentioned. It is also notable that in all other cases, CITPROD measures are higher.

[3] This is an index which shows a change over time in the price of a fixed basket of goods and services that would be bought by typical consumer.
[4] The exchange rate used is for June 2012 USD 1=UGX 2,500.
[5] The average exchange rate for 19993/94 is USD 1= UGX 1,102.97(based on Bank of Uganda Annual Report, 2004/05).
[6] The two measures used determine the efficiency and effectiveness of the major forms of Income Tax, that is, Personal Income Tax and Corporation Tax are: (a) the Personal Income Tax Revenue Productivity (PITPROD), and (b) the Corporate Income Tax Revenue Productivity (CITPROD). They consider how well Income Tax performs in terms of generating revenue, given the prevailing (effective) tax rate. They are calculated by dividing total income tax revenues by Gross Domestic Product and then dividing this by the prevailing or effective income tax rate.

In Uganda, corporate tax contributes about 6-8% of the total revenue, compared to 24% for South Africa and 16% for Rwanda. The dismal performance points to very low levels of voluntary compliance, especially among corporate taxpayers. The facts on the ground would however have pointed to a better performance of Corporate Income Tax. Over the years 2007-2012, Uganda Investment Authority indicated that the country received annual Foreign Direct Investment (FDI) averaging more than US$ 700 million which should have translated into a substantial increase in Corporate Income Tax from the investing Multi-national Corporations but this does not seem to be the case.

(e) One of the greatest challenges facing Uganda is the overdependence on taxes on consumption of goods and services. Taxes on goods and services compared to income taxes contributed 67% to 26% in 2006, and 65% to 30% in 2011 respectively. Collection of taxes dependent on consumption is very volatile and unstable. The citizens do not also feel the pinch of tax that would push them to demand accountability so as to improve governance in the country.

(f) The establishment of URA was originally exciting in the sense that it was able to raise the tax-to-GDP ratio to 12% from about 7% in a 5-year period. Since 1996/97 however the URA has practically failed to break out of the 12-13% mark

(g) Though Uganda has exerted substantial tax collection efforts (through efforts such as establishment of the semi-autonomous revenue collecting agency and on-going modernisation of tax system), the country's tax system was found not to be as resourceful and productive as other comparable tax systems within the region. Uganda's tax revenue-to-GDP ratio of about 13% was found to be the lowest in the region; with other countries in the East African Community (EAC) having a tax revenue-to-GDP ratio ranging between 14%-24%[7].

[7]The tax revenue-to-GDP ratio is actually Rwanda with 14%, Tanzania with 18% and Kenya with 24%. There are no reliable statistics for Burundi.

Uganda's tax revenue-to-GDP ratio is also far below the Sub-Saharan Africa average ratio of 18%. The stagnant tax revenue-to-GDP ratio is attributable to a substantially big informal sector. The informal sector or shadow economy encompasses economic activities not exposed to government regulation, taxation or observation such as:

(1) unregistered economic activities that contribute to the officially calculated (or observed) Gross Domestic Product;

(2) legal and illegal production of goods and services to which a market value can be attached but have escaped detection in the official estimates of GDP. Currently, the informal sector is estimated to have a value amounting to be about 45% of the economy[8].

(h) The continued economic integration through the EAC and COMESA justifies the movement towards more dependence on domestic taxes than international taxes. The ratio which was 6:4 in favour of international taxes has shifted to 5½:4½ in favour of domestic taxes.

(i) A tax incentive program was found to be a potential 'black hole' of unknown proportions, and dependent on the favoured taxpayer's interpretation. This is based on a deliberate policy to engage in tax competition or using generous tax incentives to attract FDI. For the year 2009/10, Uganda lost about UGX 690 billion (US$ 272 million) in tax exemptions, an amount which would have grossed a tax yield of 16% of the revenue or at least 2% of the GDP.
The impact is also seen on the performance of Value Added Tax (VAT) which would be established using the universally accepted measure of VAT Gross Compliance Ratio (VATGCR)[9].

[8]This refers to the part of the economy not captured or determined by the formal sector measurement and can at best be an estimate. However, more than 80% of the working population is employed in this informal sector.

[9]VATGCR measures the productivity of VAT or the actual revenue realised out of the potential revenue collectible by the government. Since VAT is mostly applied to final consumption by households and individuals, and VATGCR is computed by dividing net VAT revenues by total private consumption in the economy and then dividing this by the VAT rate. It (VATGCR) is the actual VAT collections divided by potential VAT collections, expressed as a percentage.

Uganda realises only 26.5% of the potential VAT collectible and this unfavourably compares with Rwanda (30.3%), Kenya (40.5%), South Africa (89.6%); the global average (65.48%) and Sub-Saharan Africa average (38.45%). There is no firm evidence that the tax relief supported the Uganda economy or influenced the investors' decision to place business in Uganda. There is, however, universal agreement that the revenue foregone is not justified by the FDI inflow to the country.

(j) There are notable tax administration deficiencies: In the year 2011, Uganda's Tax Register had a total number of 147,956 taxpayers, if we were to presuppose that taxpayers are not registered for a multiplicity of taxes[10]. This statistic does not muster up to even 1% of the population and is, in real terms, not comparable to the 1961 Tax Register that had about 9600 individual taxpayers. The Tax Register should be related to the population. Of the population of Uganda which was 33 million in 2011, 42% (or 13.8 million) constitute that potential labour force. If one takes into account the following: 1,696,411 students (1,421,262 students in secondary education and tertiary education institutions) and 275,149 civil servants; the 21% of the potential labour force or 2.9 million (who are employees); and the proportion of the people under poverty line (probably another 25%) or some 3.45 million, then Tax Register should have had taxpayers in the range of about 5 million. Secondly, a good tax system operates on a system of taxpayers declaring their due tax liability or filing the tax returns without URA looking for them.

The filing ratio among the taxpayers on the Tax Register which is about 58% is not encouraging. Thirdly, URA's tax auditing function, though intended to address the MNCs' abusive tax planning and evasion practices, is neither robust nor effective. Of the tax assessed as a result of auditing, only 7.5% has been collected.

[10] In practice, taxpayers would at least register for both Value Added Tax and Income Tax. The figure has therefore an inherent double counting. In determining PAYE taxpayers, the count considered individual employers and not employees who actually meet the tax liability. Taking into account these inadequacies, the figures are still too low for the Ugandan economy.

(k) As part of its effort to widen the tax base and stem tax avoidance, URA introduced the Tax Identification Number. This comes as another identifier which is restricted to URA, and cannot support URA effort to collect information on taxpayers beyond what URA already has access to. There is therefore need for a national identifier that will enable URA to collect all the information from different sources and institutions in Uganda.

(l) Though taxation has a symbiotic relationship with good governance, and the strengthening and improvement of the two institutions is interdependent, there is no evidence of deliberate effort to exploit this relationship in the Uganda tax system. This has been attributed to the following factors: (1) Most citizens are oblivious that Government is obliged to account to them for its actions, including taxation and public expenditure; and they accordingly see provision of social services as a favour that may depend on their electoral choices; (2) the Government of Uganda principally relies of MNCs for its lion's share of tax revenue; actually more than 50% of the revenue is paid by about 20 MNCs; (2) Central government finances more than 80%[11] of the Local Government revenue, and coupled with the scrapping of Graduated Personal Tax, the citizens do not directly contribute to local government budget; (3) Most citizens do not pay taxes and see no link between social services and taxation.

(m) The ultimate challenge to tax administration is tax compliance which is reflected through low tax morale. It was clear from the baseline study that Ugandans are not enthusiastic about their tax obligation. This may be due to the fact that the Government of Uganda does not have an explicit fiscal contract or a tax bargain with its citizenry.

[11] Government transfers up to 20-30% of the national budget to Local Governments; for example in the financial year 2008/09, Government transferred to local governments UGX 1.2 trillion (US$ 700 million) as opposed to the national budget of UGX. 4.9 trillion (about US$2 billion). This transfer amounted to 25% of the national budget

The bargain would indicate that citizens are obliged to fully comply with their tax obligations in return for the Government to deliver quality social services, the rule of law and accountability. Related to this factor is the increasing wastage of Government resources through corruption and skewed definition of national priorities. For example, agriculture which occupies 70% of the country's population is receiving a declining budget allocation of 5%, 4.5% and 3.8% for the years 20010/11, 2011/12 and 2012/13 respectively.

(n) In public expenditure management, Government needs to ensure a continuously expanding fiscal space in respect of its capacity to fund social services without compromising the stability and sustainability of the economy. Uganda spends about 10% of the total expenditure on health services; this amounts to a per capita expenditure of US$15, which is far less than the Abuja Declaration recommendation of US$28 or the World Health Organisation recommendation of US$34 for low income nations. Without increased fiscal space, Uganda may not meet these targets. The expenditure on education is about 15.3% of the budget or about 3% of GDP, comparing unfavourably with Tanzania at 18.3% (or 5.6% of GDP) or Kenya with 17.4% (or 5% of the GDP).

3.0. Tax Reform Recommendations

3.1. Tax Reform Objective

The ultimate objective of the tax reform efforts is to ensure increased revenue yield hinged on a progressive tax system and on the bedrock of a highly participative and tax compliant populace. This can only be realised if both Government and Civil Society initiate measures to improve the efficiency, coverage and effectiveness of the Ugandan taxation system; and secondly explore avenues of buttressing the linkage between taxation, civic participation and governance in the country.

3.2. Tax/Fiscal Reform Recommendations

(a) Context of Operation

Government needs to focus on the context within which the tax and public expenditure operates. Effort should be geared at ensuring that factors such as the informal sector, economic growth, population growth and income distribution and management of natural resources and the environment are influenced to make them supportive and conducive to improving tax operation and reform.
This will require instituting measures that will lead to economic growth to be translated into improved condition of living for the population; address the matter of income inequality and redesign the framework for defining the poor so as to make the formula appropriate and sensitive to changing times.

(b) Positioning of URA

URA needs to be supported to get out of the current status of being an administrative department under Ministry of Finance, and be granted the status of an autonomous self-accounting constitutional body responsible for national tax revenue administration. This would enable URA play its role of improving tax administration more freely, have improved access to resources, and negotiating its mandate/scope of activities.

(c) National Identifier

In order to enable URA/Government to get all the required information to support tax administration, budgeting and other policy decisions, there is a need to institute the use of one national universal identifier for all transactions such as TIN, Passport Number, Social Security, Voter Registration Number, Utilities, Bank Account etc. Such an identifier would make it easier to track and trail transactions in different institutions. This should be in line with the national identity card project.

(d) Introducing an income-based mass tax.

The deep-seated feeling/perception that Government is spending its money and citizens have no stake in it can be partly addressed by obliging them (citizens) to pay some tax. The resultant pinch will enable them to question how the money they pay is used. The greater the number of people who pay the tax, the more viable it will become to demand accountability from Government.

Given the high tax threshold for the subsisting income tax regime[12], the mass tax can only be introduced as a revenue source for Local Government to replace Graduated Personal Tax or its successor, the Local Government Service Tax, whose performance is not sustainable as a principal source of revenue. This will be done after making a balance between the costs of collection and revenue yield, and interesting people in civic affairs.
The mass tax needs to be designed in such a way that it brings into the tax net the substantial informal sector and agricultural[13] activities in the economy without disregarding their economic welfare.

[12] Reducing the threshold of Income Tax to bring on board low income taxpayers has to be considered in light of targeted revenue yield and administrative costs; and then the rationale and impact of the threshold on welfare for taxpayers in a formal monetized economy who depend exclusively on the income they earn.

[13] The current tax regime, under the VAT Act, (CAP. 349 of the Laws of Uganda) excludes agricultural products, services and inputs from payment of the tax (Par. 1(a), (h), (r), (s), (aa), (hh) & (ii) of the Second Schedule, and Par. 1(c), (e), (f), (g) & (h) of the Third Schedule of the VAT Act)). The Income Tax Act (CAP 340 of the Laws of Uganda) also exempts profits from agro-processing, under given conditions (Section 23(z)), and the interest earned by a financial institution from a loan used for agricultural purposes).

(e) Local Government revenue

Central Government transfers to Local Governments largely depend on Central Government priorities and make decentralisation fallacious.[14] There is therefore urgent need for Central Government to review its relationship with Local Governments; to define new avenues or sources of revenue, and strengthen capacity of collecting Local Government tax revenue and assure service delivery to the citizens.

A related consideration is considering the level to which locally raised revenues can be spent for the benefit of local tax-payers to illustrate the direct link of the tax to the benefits received by the community as a whole. This means that the local citizens should be made to pay higher taxes if they want better services and it is also an incentive for citizens to demand accountability from their leaders.

A third factor affecting local government revenue that needs to be addressed is the creation of new districts through splitting existing districts into small unsustainable geographical units, an action that simply expands public expenditure to an unmanageable level and adversely affect service delivery. Government need not only stop creating new districts but also consider consolidating the unsustainable units back into economically viable districts. There is need to create a clear criteria that will be followed in creating new districts.

(f) Mainstreaming Tax Justice Matters.

In considering new tax options especially in relation to Local Government revenue, there is great need to mainstream issues affecting the poor and marginalized as a way of ensuring tax justice.

[14]Article 176(2) (d) of the Constitution of the Republic of Uganda requires that each local government should have a sound financial base with reliable sources of revenue.

(g) Definition of National Priorities

There is a need for national consensus on national priorities. This is reflected in defining how national budgetary resources will be allocated between competing national demands. There is a skewed relationship in agriculture which gives up to 70% of the population a source of livelihood, yet it only gets 4% of national budget. A related matter is to review budgetary priorities to provide fiscal space for the benefit of the citizens. This will be in relation to social services such as education and health, where the minimum required per capita expenditure on the health sector should at least be doubled from the current US$15 to at least US$30. Government should also make the social security transfer for the elderly more reasonable.

(h) Performance of Income Tax

The performance of both corporate tax and personal income tax needs to be urgently addressed as the measures of CITPROD and PITPROD show a discouraging rate. This may require carrying out a detailed research to establish the basis for the dismal performance.
The importance of performance of income tax lies in both the fact that increased regional economic integration is diluting the contribution of international taxes, and income taxes play a pronounced role in cultivating governance in a country. Income taxes are also critical in reducing Government's reliance on taxes on goods and services which currently contribute over 65%.

(i) Managing National Resources

The country will need to evolve, develop and build consensus through a national dialogue of how to manage national resources such as oil to preempt the resource curse in the country.

(j) Tax Incentives

Government needs to carry out a dedicated research to establish to what extent tax incentives in Uganda impact on FDI, revenue yield and tax competition in the EAC. This will form the basis for reviewing the tax exemption structure. Government also needs fully implement its commitment to withdraw its generous tax incentives regime.

(k) Tax threshold

The level of the tax free income needs to be fair and also take into account the general price level in the country. The current threshold for Personal Individual Income Tax should therefore be reviewed to a level that would in real terms be equivalent to the 1993/94 level. That would amount to at least UGX. 3,679,500[15] if it is to afford appropriate justice to individual income taxpayers.
Government would also need to explore whether the threshold cannot be tied to a basket of (consumable) goods such as the way the Consumer Price Index[16] is computed. This would imply changing it as and when there is a shift in the price level.

(l) Growing the Tax Register

In order to grow the tax register and improve filing ratios, there is need to inculcate into the citizenry the civic duty to pay taxes. This is matter where Government will have to partner with Civil Society organizations to get the people to realise the relationship between tax, government expenditure and good governance.

(m) Revenue Leakage and Corruption

Revenue leakage occurs across the whole stretch of tax administration. Taxpayers engage in tax evasion measures including illicit capital flight, money laundering, shadow economy and other similar or related avenues.

This can be addressed through improving the regulatory and legal framework, improving staff competence in URA, and seeking strategic partnerships through international agreements. The taxing statutes provide for these measures on international tax agreements[17].

In respect of corruption, it occurs both at the tax collection and government expenditure levels. Corruption is currently at an alarming rate and multi-faceted measures for curbing it need to be instituted. The link between Government corruption, on one hand, and tax compliance and good governance (or their absence) on the other hand, need to be brought to the fore.

(n) Taxpayer Knowledge

Citizens' action on tax payment and compliance and taking the interest and initiative to demand for accountability from Government will depend on the extent to which the citizens are informed of their stake in national resources and taxation. The citizens also need to be trained to understand and participate in the national budget processes. Both Government and the Civil Society Organisations should focus on educating the population to gain appropriate knowledge, and capacity to demand for accountability.

[15] This is based on the exchange rate of US$1= UGX. 2,600, and would be equivalent to US$1,415, which was the threshold in 1993/94.

[16] This is an index which shows a change over time in the price of a fixed basket of goods and services that would be bought by typical consumer.

[17] For example Section 88(1) of the Income Tax Act provide that "An international agreement entered into between the Government of Uganda and the government of a foreign country or foreign countries shall have effect as if the agreement was contained in this Act".

(o) National Score card.

The Government should in a participatory way develop a national scorecard that shows the minimum service menu on offer and how it intends to deliver them. The scorecard will have a rolling definition of objectives that will be adjusted as circumstances and times evolve.

The consensus on the scorecard will be the fiscal social contract that provides a benchmark that can be used to improve Government performance in delivering quality social services, the rule of law and accountability and get the citizens to reciprocate through meeting their tax obligations.

This will be rolled out through enabling citizens to appreciate the role of the different stakeholders in promoting tax compliance and good governance. By focusing both Government and the CSOs on cultivating the citizen's civic responsibility towards tax payment, citizens will be enabled to demand for their entitlements from the Government, and in turn build the national framework towards good governance and accountability.

4.0. Conclusion

The fiscal reform leading to improved tax administration, budgeting and public expenditure has the ultimate result of improving the tax revenue to GDP ratio out of the 12-13% range, where it has stagnated, to a new level of at least 16%[18] through implementation of a progressive tax system and improved tax compliance. This will be accompanied by improved tax morale and participation in civic duties by the citizens who are demanding accountability from a Government that is obligingly accounting for its performance. There should also be a deliberate and firm effort to develop the appropriate policy in the public administration that will sustain the new dispensation that require the participation and shared responsibility between Government and Civil Society Organisations.

[18] The removal of tax incentives would lead to the figure (of 16%, as a tax revenue-to-GDP ratio), considering the impact of the UGX 690 billion of the year 2008/09.

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