

**THE EFFECT OF INCOME TAX ON PROFITABILITY LEVELS OF SMALL AND  
MEDIUM ENTERPRISES (SMES)  
A CASE STUDY OF KAPCHORWA MUNICIPAL, KAPCHORWA DISTRICT**

**BY**

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**RESEARCH REPORT SUBMITTED TO THE COLLEGE OF ECONOMICS AND  
MANAGEMENT IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE  
AWARD OF BACHELOR'S DEGREE IN BUSINESS ADMINISTRATION AT  
KAMPALA INTERNATIONAL UNIVERSITY**

**JUNE 2017.**

## DECLARATION

I hereby declare that, this research report presented is my own and original work. It has never been submitted to any university for the award of any kind of diploma or Degree

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## **APPROVAL**

This research report has been supervised and submitted to Kampala International University under my supervision and approval.

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Date.....

**MR. TIMBIRIMU MICHAEL**

## **DEDICATION**

I dedicate this report to the family of Mr NYANKOLE VITALIS Arap TOROITICH and Ms IRENE NYANKOLE who has been there for me throughout my entire stay at campus; I also dedicate it to my brothers Mr Joshua Kiprotich, Ian Toroitich and sisters more so CHEKWEMOI NANCY who supported me financially throughout my course and also my beloved friends Mr Sande Edmond and Musau Salim who become closer to me for the whole time period at campus.

## ACKNOWLEDGEMENT

I extend my sincere thanks to my supervisor Mr. Timbirimu Michael for all his valuable time, cooperation guidance and effort devoted during supervision. Registering success of this research project is due to his effort. I further extend sincere thanks to the SMES, top management and customers for enabling me conduct a research in their organizations. I wish to extend my sincere thanks to my auntie Ms. Chekwemai Nancy for all the financial assistance he's parted in me to complete my studies. May God bless you abundantly sister and live longer and also be filled with luck dear.

I thank my Mom Ms IRENE NYANKOLE and dad Mr NYANKOLE VITALIS for all the parental guidance. My friend's model for all the effort extended to me throughout the study.

Last but not least, it's God who has kept me alive through this activity. Great thanks my relatives and church members for their prayers throughout my life at school right from pre-school to university level

## ABSTRACT

The study was carried out to determine the effect of income tax on the profitability levels of small and medium enterprises. The objectives included to evaluate measures used in assessing taxes on SME's to determine the relationship between income tax and profitability levels of SME's.

The study was a survey involving a collection of both quantitative and qualitative data. Primary data was collected through interviews using questionnaires and secondary data from journals, text books and periodicals. The findings revealed that income tax negatively affects a number of SME's in that all profits which would have been ploughed back into the business are eroded away by tax.

Recommendations include; sensitization of income tax payers by URA officers in form of tax education should be done regularly. URA should also train their staff about tax assessment and collection methods as well as how to handle tax payers and small scale beginners regardless of the size and level of gross annual turnover should be exempted from income tax deposits.

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## **CHAPTER ONE**

### **INTRODUCTION**

This chapter will present the background to the study, statement of the problem, purpose of the study, objectives, and research questions, scope of the study and the significance of the study.

#### **1.1 BACKGROUND OF THE STUDY**

Income tax was introduced in Uganda in 1939 as part of the common income tax regime that which was replaced with the east African tax management act which was also applicable to Kenya, and Tanzania.

In 1958, the act was repealed and replaced with the east African management act No 10, which was later in 1970 replaced with a more comprehensive east African income tax (management) act. This act governed the basic structure of income tax while national laws, which are for Uganda it was the income tax act of 1970, governed the rates of tax exemptions and personal allowances. As the relationship amongst the east African states collapsed in 1977, the three east African states had to introduce their own laws. In Uganda, the first income tax law was the income tax decree No 1 of 1944 which remained the country's income tax law till 1997 when the income tax act (ITA) was enacted.

The ITA adopted a model of income tax laws developed by the fiscal affairs department of the international monetary fund, which was published as act No 11 of 1997, in acts supplements No 8 to the Uganda gazette, No 81, dated 31 December 1997. Until an updated version was published in 2000 as CAP 340 of, the statute and this version incorporated all amendments to 2000.

**Kapchorwa District** is a district in the Eastern Region of Uganda. The town of Kapchorwa is the district's main municipal, administrative, and commercial center, and is the site of the district headquarters.

Under the colonial administration, Kapchorwa District was Sebei County, located in North Bugisu in the now defunct Bukedi District. Kapchorwa was granted district status on 1 February 1962, shortly before Uganda became an independent country.

Kapchorwa District is home mostly to Kalenjin peoples, including the sub-groups Sabiny, Pokot, and Nandi. They were mainly cattle keepers in the late 1960s, but that changed when their northern neighbors, the Karamojong, raided most of their cattle and displaced hundreds of people. The populations most affected lived along the Kapchorwa plains; particularly in Ngenge Sub-County of Kapchorwa District and in Bukwo District. This displacement of the population has resulted in abject poverty among the affected households. People have been forced to live in Internally Displaced People camps, with very limited resources.

In 2005, Kongasis County was split off of the district to form Bukwo District. In 2010, more territory was peeled off to form Kween District. Together, Kapchorwa District, Bukwo District, and Kween District comprise the Sebei sub-region, home to an estimated 200,000 according to the 2002 national census.

In 1991, the national population census estimated the district population at 48,700. The 2002 national census estimated the population at 74,300, with an annual growth rate of 4.5 percent. In 2012, it was estimated that the population had grown to about 114,100. In August 2014, the national population census enumerated the population at 104,580.

Income tax is therefore defined as; a tax imposed on a person's taxable income at specific rates. A person includes an individual, company, partnership, trustee, government and sub divisions of government. Income tax is charged on every person who has chargeable income for every year of income. Chargeable income is derived from three main types of income, namely; business, employment and property. (Kalist Okello 2009)

A tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state Tumuhir.bise M (2000).

A tax is a compulsory levy imposed upon the tax assesses who may be individuals, groups of individuals or legal entities. It is compulsory upon to whom it is imposed and they have to pay the sums so levied irrespective of any corresponding return of services or goods by the government, Balunywa, (1988).When carrying out tax administration, three distinct functions are performed. These are enumeration, assessment of tax payable and the

collection of tax dues. In Uganda, Uganda revenue authority (URA) Kibwika P (2004) performs the tax administration function.

Taxation is defined as a process by which government or public body raises money to fund its operations or the impact an investment has or the investor's liability for the payments of local and state taxes. Muwanga J,2004.

Profitability has been defined as an organizations ability to earn revenues in excess of expenses over a period. Pandey noted that, a company should earn profits to survive and grow over a long period. Firms must earn profits to maximize their shareholders wealth, to generate income for expansion and to finance their daily operations. Pandey, (1998).

“Profitability can also be defined as a company’s ability, to generate revenue in excess of the cost in producing those revenues or is a measure of business success through comparing profits made with amount sold or invested.” Hanson I, Earnest (1982).The income tax act defines small business taxpayer for income tax purposes as a resident taxpayer whose gross turn over from all businesses earned by such a person a year is more than 5million shillings but less than 50million shillings. Income Tax Act, ITA (1997) laws of Uganda. Taxpayer whose gross turn over does not exceed fifty million shillings a year may pay taxes at presumptive rates. This is not applicable to a person providing professional services.

Section 4(2) of the ITA shows the application of the relevant rates of tax determined to be charged on the incomes of the tax payer for the year of income and from the resulting amount are subtracted any tax credits allowed to the tax payer for the year of income.

**Table 1: showing small business tax payer rates**

Gross turn over	Tax payable
Where the gross turnover of the taxpayer exceeds shs5million but does not exceed shs20million per annum.	Shs100,000

Where the gross turnover of the taxpayer exceeds shs20million but does not exceed shs30million per year.	250,000/= or 1% of gross turn over whichever is the lower.
Where the gross turnover of the taxpayer exceeds shs30million but does not exceed shs40million per year.	Shs350,000 or 1% of the gross turn over whichever is the lower.
Where the gross turn over exceeds shs40million but does not exceeds shs50million per year.	Shs450,000 or 1% of the gross turn over whichever is the lower

.Source; Ismail Kintu (2015)

Taxation has played a big role in helping the government to intervene in the market mechanism in order to perform the functions of allocation, regulation, distribution and stabilization.

However, the existence of multiple taxes has been a major barrier to the operations of small-scale businesses.

The multiplicity of taxes whose burden also falls on small-scale enterprises has a negative effect on their performance. In addition to the above, the existence of a large number of minor taxes such as residue taxes on non-citizens and car benefit taxes on all cars owned by these firms has also affected their performance. Notably, the rationale of these taxes is questionable and their implications have to be fully considered before they are imposed. Thus, taxes impede the natural evolution of successful and dynamic small-scale firms into ones that are more efficient because they reduce the firm's profits and hence saving and investment potential, winters and McKay, (2002).

Income tax administrators have been faced with confusion interpreting the law. In most cases, the administrators have not followed the law or followed it but interpreted it to favor themselves to the disadvantage of the taxpayers, which has brought about friction between the taxpayers and the administrators. Poor tax administration involves poor assessment of taxes and tax liability, computation based on estimates leading to over charge of small-scale business enterprises. Since tax is a cost and has to be paid out, poor tax administration greatly reduces the firms would be

profits, Musgrave R, (1980). Therefore there should be a political will to make tax systems work and all tax payers should be treated fairly but not equally for a more transparent tax system.

### 1.1 Problem Statement

It's believed that income tax rates that are charged on small and medium enterprises are not accurate since its base on assumptions without assessing the actual turn over of the enterprise, yet at times these enterprises may be making losses. Its alleged by Abid Alarm (2006) that high Income tax rates affect the level of consumption and increase the unit cost.

According to Uganda manufactures Association (UMA 2006) journal, a number of SME's wrote to the chairman (UMA) concerning high income tax rates that are levied on the SME's.

The tax rate affects the profitability levels as in the table shown below.

**Table 1: Effects of tax rates on profitability**

Year	2014	2015	2016
Profit before tax	28,310,264	55799099	80,650530
Tax liability	8,493,0792	16.739,729.7	24,195,159
Profit after tax	19,817,184.8	3905309.3	56.455371

**Source: Financial statement of simo & sons ltd from 2014-2016**

From the table above when profits increase taxi liability also increases thus affecting the overall profits made for the year.

It's not accurately estimated how income tax affects the profitability levels of SME's thus prompting the researcher to assess the impact of income tax on profitability levels of SME's.

### 1.2 Purpose of the study

The purpose of the study is to establish the overall effect of income tax on profitability levels of SME's in Uganda.

### 1.3 Study objectives

- 1) To evaluate measures used in assessing taxes on small and medium enterprises.
- 2) To determine the relationship between income tax and profitability levels of SME's.

- 3) To assess other factors that affects the profitability levels of SME's.

#### **1.4 Research questions**

- 1) What are the measures used in assessing taxes on small and medium enterprises?
- 2) What is the relationship between Income tax and profitability levels of SME's?
- 3) What are the other factors that affect the profitability levels of SME's?

#### **1.5 Scope of the study**

##### **1.5.1 Subject scope**

The study will covered small-scale businesses in Kapchorwa; specifically the study will investigate the impact of income tax administration on the profitability of small -scale businesses

##### **1.5.2 Geographical scope.**

The study will be carried out in Kapchorwa municipal, Kapchorwa district; The district is bordered by Kween District to the northeast and east, Sironko District to the south, and Bulambuli District to the west and northeast. The district headquarters at Kapchorwa, which means "home of friends", are located approximately 65 kilometres (40 mi), by road, northeast of Mbale, the nearest large city.<sup>[2]</sup> The district is approximately 295 kilometres (183 mi) northeast of Kampala, the capital and largest city of Uganda.<sup>[3]</sup> The coordinates of the district are 01 24N, 34 27E.

##### **1.5.3 Time scope**

The study will be carried out in a period of 3 months, April to June2017. This period will enable the researcher come up with coherent information from the respondents as it will enable the respondents to give responses that are typical of their opinion from the observations made over this period

#### **1.6 Significant of the study**

The study is expected to:

- 1) Enable tax payers to realize the contribution of income taxes towards economic development of SME's



- 2) Benefit the Income tax department by providing Information towards improvements of the standards of administering and collecting taxes.
- 3) Contribute literature on income tax and performance to other potential researchers during the study on related topics.

### 1.7 conceptual framework

The conceptual frame work shows a linear relationship Between Income Tax as the independent variable and profitability of small and medium enterprises as the dependent variable.

#### Independent variables

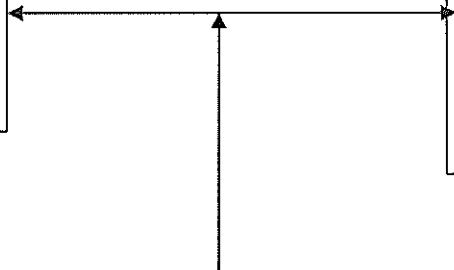
#### dependent variables

- Taxation policies
- Socio-economic factors
- Tax administration

- Increased gross turn over
- Increased standards of living

#### Intervening Variables

- Government
- Fiscal policies
- URA



## CHAPTER TWO

### LITERATURE REVIEW

#### **Introduction**

This part will cover the existing literature on the relationships between taxation and profitability levels of small scale enterprises which is a theoretical frame work up on which this study will be built. Secondary data will be sourced from text books journals and periodicals.

#### **2.0 Concept of Taxation**

According to Tumuhimbise (2000), taxation refers to a compulsory and non refundable contribution enacted by government for public purposes. This payment is not followed by concurrent benefit in return the charge or levy is instituted by law.

A tax on the other hands is defined as a compulsory levy imposed by government up on assessment of various categories. This definition means that a tax is paid by the assesses without a corresponding return in form of goods and services on government hence it is referred to as a non-quid-pro-quo payment (Balunywa, 1998).

Justine, H. (1999) defined tax as a price of civilization and this is the most appropriate definition considered by Uganda revenue authority (URA).

Economics also stated that “a tax is leakage from the circular flow of income in to the public sector with the exception of loan transactions and direct payment of publicly produced goods and services”.

Dalton (1987) in his view suggested that a tax is compulsory contribution imposed by a public authority irrespective of the exact amount of service rendered to a tax payer in return this means that one is bound to adhere to taxation requirement and then compare it with the social services provided by the government.

Balunywa W. (1998) defined a tax as a compulsory levy imposed upon the tax assesses who may be individuals or other legal entities.

Saleem N.A (1996) brought in an element of expenses. He said that a tax is a compulsory contribution which is levied on persons to meet the expenses which are incurred for a common cause.

Khalizadh, J. (1999) agrees with Saleemi he adds that a tax is considered to be a compulsory contribution imposed on individuals or persons to meet the expenses incurred by the state to help pay its operations.

However, Kanyunyuzi (2001) deferred in his approach as compared to the above. He added that the definition of a tax is just like other definitions within the academic world.

This draws us to a general conclusion that taxes are non-quid-pro-quo compulsory levy imposed on assesses and on which the tax payer does not expect a direct return.

## **2.1 Origin and development of income tax in Uganda.**

According to Balunywa (1998), the concept of taxation in Uganda is based on the system that existed in British since Uganda was a British colony.

The process begun in 1900 with the hut tax regulation which imposed standard charge for every hut or dwelling it was followed by a poll tax which imposed by a poll tax which was administered in non-government system characterized by a hierarchy of county and parish chiefs.

The local authority ordinance of 1919 governed the collection of taxes in Uganda. It was later amended in 1925 due to problems involved and this amendment allowed people to work harder.

Income tax has however introduced in 1939 on the outbreak of Second World War. This was because the colonial government needed funds to finance the war (URA Tax Guide 1996-1997). Also as a means of making Africa work harder in monetary, economic activities such as planting of cotton and coffee.

By 1973, the three East Africa states could not move along together due to the economic and political situations at that time. This led to enactment of income tax decree 1974 of Uganda which replaced the East African income tax management.

According to Ojok (2000) in 1991 Uganda revenue authority (URA) was formed to replace ministry of finance for tax administration and collection. However, due to the loophole in the system, 1997 income tax Act was enacted to replace the income tax decree 1974 on which all the taxation methods are based.

## **2.2 Income tax**

According to income tax Act 2005, Section 22, income tax is levied on incomes of all Ugandan residents not only on income arising in the country but also from non-residents whose originating from within Uganda is also liable to income tax irrespective of where the tax payer lives. With the exception of exempted ones as provided for in the income tax Act.

Any tax levied on a person's income generally qualifies as an income tax. This general definition includes all taxes levied on income. Income tax is an example of direct tax levied on individuals and entities usually imposed on their benefit, reward, compensation, games and enrolments.

The income tax Act refers to income on which tax is charged as a chargeable income. Chargeable income of a person for the year of income is the gross income of the year of a person less total deductions allowed under the year's tax Act for the year of income.

In Uganda, income tax Act finds it hard to spell out the sources of income tax and how they are to be determined for purposes of income tax. Income may not be easy to define because what is income in the hands of one person may be a capital receipt in the hands of another.

Gross income refers to the aggregate income earned by a person in a given year of income from different resources and hence income includes any employment, business and property that is earned by a person in a given year of income.

### 2.2.1 Computation of income tax

According to Mahassel (2000) an enterprise is considered to be in small business when its gross annual turnover is less than 50 million Uganda shillings.

According to the 1997 income tax Act, presumptive method for computation of tax liability is applied. There is always an option of either to pay a fixed amount or 1% of the annual gross turnover whichever is lower is always considered as shown in the table below;

**Table 2: Small business tax payer's rate**

Gross annual turn over	Tax liability/tax rates
Less than 5 million	Exempt
More than 5 million but less than 20 million	100,000
More than 20 million but less than 30 million	250,000 or 1% whichever is lower
More than 30 million but less than 40 million	350,000 or 1% whichever is lower
More than 40 million but less than 50 million	450,000 or 1% which ever is lower

**Source: Income tax Act 1997.**

### 2.3 Principles/cannons of taxation

When imposing any tax, some conditions have to be fulfilled for its easy implementation, administration and collection (Saleemi 1998). However in an attempt to achieve these, the following principles have to be observed. These cannons include simplicity, economic, convenience, flexibility and certainty (Bhatia, 2003).

### 2.4 Types of taxes

According to Parvaiz and Ishaq (2000), taxes are of various types to meet particular fiscal policy but for purposes of this research, direct taxes on which tax incidence or burden rest directly up on the tax payers are to be considered and they include the cooperation tax PAYE tax, taxes on property and withholding tax.

#### 2.4.1 Direct taxes

Dalton, (1991) noted that a direct tax is one that is paid by the person or company on whom it is legally imposed and cannot be shifted to other firms or individuals.

Stuart M.S., (1994) agrees with Dalton. He defined a direct tax as one which is demanded from every person who it is intended or desired should pay it.

In line with the above, Sessaka, (1996), defined it as one that is imposed on individuals or companies and has to be paid on cash basis. He brought in an element of “cash” examples of direct taxes include, taxes on payroll and labor, taxes on net wealth, and taxes on property.

**Corporation tax;** this is a tax levied on company’s profits. All limited liability companies are expected by law to file their returns declaring profits for the year to URA. The tax rate is 30% on profits above the set threshold by URA.

**Property tax;** this is a tax charged on individuals who receive rental income from renting residential houses, commercial properties, machinery and other real assets. The tax rate applicable to rental income is 20% on income exceeding the threshold.

**Withholding tax;** this is advance income tax which is had by URA on supplies of goods and services. The Tax Credit Certificate (TCC) is prepared by the authority for each tax payer. The tax payer is required to present his TCC at the end of the financial year if he has to benefit from the payments withholding rate is 6% on payment of goods and services whose value exceeds 1m Uganda shillings.

**Pay As You Earn (PAYE);** this is a tax collected by URA from employees through the employer which is normally deducted before payment of salaries and other employee benefits like bonus, retirement benefit and gratuity. It is deducted basing on various tax brackets which depend on the level of earning.

## **2.5 Importance of taxes**

### **Economic stability**

Taxation is an important source of government revenue and an economic policy tool to attain economic stability and ensure justice. Taxes are imposed to maintain economic stability in the country during inflation. The government imposes more taxes in order to discourage unnecessary expenditure of individuals. Similarly, during deflation, taxes are reduced in order to enable the individuals to spend more money.

In this way, the increase or decrease in taxes helps to check the big fluctuations of prices and maintain the economic stability (Salemi, A.N (2001).

### **Optimum allocation of resources**

According to Bakibinga (1996) he asserted that taxation is helpful in reallocation of resources from private to public sector. It's viewed as a saving tool in any economy which is partly re-invested in the basic and strategic industries as well as infrastructure development for public utilization and consumption.

### **Raising revenue**

Taxes can be imposed to raise revenue. The government needs money to maintain peace and security in the country, increase social welfare to complete developmental projects like roads, dams, power stations and et al (Mueller, 1986).

### **Protection policy**

Serwanga A. (2002), adds that taxes are used to protect local industries from unfair competitions that arises from imported products.

### **Higher income levels**

Murphy (1989) stressed that taxes enable the state to complete some public works programs. It employs individuals to complete such programmes which imply that the government can solve the problem of unemployment by starting new projects. In this way, taxes help to create more employment opportunities.

### **Economic growth**

However Balunywa (1988) argued that taxation is used to accelerate economic growth. Government is considered to be a key factor in influencing economic growth and development through formulating policies and implementing them. It can reduce taxes to increase marginal prosperity to consume set bans on imports and provision of subsidies to protect infant industries. Taxation is an important tool for controlling and checking inflation, the other reason of taxation is to raise revenue for meeting the needs of the public sector.

### **Fair Distribution of Income**

Taxes are imposed to archive equality in the distribution of national income. Taxes are imposed at high rate on the rich persons or persons and these are spent to increase the welfare of the poor persons. In this way, taxes help to achieve the fair distribution of income in the country, adds Dalton, (1991).

### **Increase standards of living**

According to justice Zake (1986), taxation reduces the extreme inequalities of wealth, income and consumption standards which undermine productive efficiency. The level of expenditure depends much heavily on the ability of the tax system in place, the required revenue at the disposal of the government.

## **2.6 Analysis of financial profitability/performance.**

The Economist note that a firm is said to be making an economic profit when its revenue exceeds total opportunity cost of its inputs.

(Knight, 1921) He added that a single goods case, economic profit happens when a firm's average cost is less than the price of the product or service at profit maximizing output. The economic profit is equal to the quantity of output multiplied by the difference between the average total cost and the price.

According to Lipsy(1998), he argued that profit can be defined as the excess of revenue over all opportunity costs including those of capital nature. He stated that profits are the best measure of financial performance and businesses cannot attain their goals and objectives unless they make profit.

Frank wood (1993), defines profit as the excess of revenue earned over total costs incurred in the process of providing goods and services. Profits are thus a function of revenue and cost incurred.



Muelle (1986), added that profit refer to the returns received in a business undertaking after all operating expenses have been met. He also referred to profits as the amount received for a commodity or service in excess of the original cost.

Once a company realizes that its profitability is not stable or steadily increasing, then action has to be taken immediately.

Profits signals that resources can be portability moved in the industry while losses indicate that resources can profitability be moved somewhere else as stated by (Lipsey 1998) and others.

Fisher, (1988) defined profits as the excess of total revenue over total costs during a specific period of time. He noted that with the development of corporations, profits are apportioned between dividends to shareholders of stock and investment and depreciation funds in the control of hired managers.

## 2.7 Types of profits

There are various types of profits as noted by different scholars.

**Operating profit;** this is a measure of a company's earning power from ongoing operations equal to earning before the deduction of interest payment and income taxes (Hobbes, 1990).

**Optimum profit;** This is the right amount of profit a business can achieve. In business, this figure takes account of marketing strategy and other methods of increasing returns above the competitive rate (Gale, 1993).

**Normal profits;** This is a profit in which the entrepreneur receives the minimal necessary amount to encourage him to open or stay in a particular business.

**Excess profit;** Mahatma (1995) defined excess profit as that which exceeds normal profits. He added that "what is a man if he is not a thief who openly changes as much as he can for the goods.

**Net profit;** This is got after the deduction of either corporation tax or income tax. Some economists define further types of profit as:

- Abnormal Profits (Super normal profits)
- Subnormal profits.
- Monopoly profits (super profits).

## 2.8 Profit measurement

According to Karuru (2003), profit measurement is one of the different problems facing most accountants. It is measured by use of profitability rates which include:

i) Net profit margin;

It's given by; 
$$\frac{\text{earning after tax}}{\text{Total sales}} \times 100$$

ii) Return on investment;

It's given by; 
$$\frac{\text{earning after tax}}{\text{Investment}} \times 100$$

For the purposes of this research the emphasis will be put on the net profit margin ratio as a means of measuring profitability.

## 2.9 Income tax and the performance of small scale businesses

Taxes have an important role to play in the investment as it can have substantial impact on the desirability or otherwise of an investment opportunity.

Generally, taxes affect almost every area of financial decision making both in practice and theory context. According to income tax Act 1997 a provision was made for businesses whose annual gross turnover is less than 50m. Such business had an option either to pay a fixed tax amount or 1% of annual gross turnover whichever is lower. However, if any of such businesses feel that it should submit returns, then it must comply with all the procedures and regulations of tax assessment. The guidelines of tax payers' rates are as in the table shown below.

**Table 3: Presumptive rate**

Gross annual turn over	Tax liability /rate
Shs. 20m	Shs 250,000 or 1% of gross turnover whichever is less.
Above 30m but below 40m	Shs. 350,000 or 1% of gross turn over whichever is less
Above 40m but below 50m	Shs 400,000 or 1% of gross turn over whichever is less.

**Source: Income tax Act Cap 340.**

According to the Income tax act (2005), the presumptive is considered to be a final tax on business income of a tax payer. No any other deduction is allowed for any expenditure incurred in the production of business income and no tax credit is allowed.

According to Byamukama (2000), a tax payer with annual gross turnover of shs. 30m having to pay 350,000 force him out of business because he will have very little to survive on and in order to survive he will be forced to increase prices of their products so as to incorporate the tax element, but this will rather leave most of them unhappy as the number of consumers will decrease and as such financial health will also worsen accordingly.

This implies that income tax has a negative significance on the performance of small enterprises. However, according to Balunywa, there are other factors which contribute to poor performance of small scale enterprises like lack of managerial skills, lack of market opportunities, lack of access to finance, level of technology and unfavorable emoluments.

## **Conclusion**

The researcher will review literature on income tax and performance of small scale business. The literature will be reviewed in line with the stated objectives such as evaluating measures used in assessing taxes on small scale businesses, assessing other factors that affect the profitability levels of small scale and as well as establishing the relationship between income tax and performance. It's observed that small scale enterprises have failed to grow and expand due to excessive income tax imposed on them hence retarding expansion. This calls for a study to assess the effect of income tax on small scale enterprises and how the traders will maneuver through their business with the existence of the tax because it makes an important contribution to tax revenue as it will reduce government off the reliance on external donor support.

## **CHAPTER THREE**

### **METHODOLOGY**

#### **3.0 Introduction**

This chapter gives a background against which the findings of the study will be evaluated in light of their reliability and conclusions. The chapter highlights the description of the research design, population of the study, sample population, techniques used in data collection, processing and presentation and analysis and the likely problems faced during the study.

#### **3.1 Research Design**

In order to collect data as much as possible, descriptive, and analytical and cross sectional research design were used. These were used because descriptive design helps to ascertain and describe the characteristics of the variables. Cross sectional research design was used because it helps to gather data just once perhaps over a period of time like days or weeks and a sample is observed as it is at the time of the study. Analytical research design was used to analyze the information.

#### **3.2 The study population and sample**

##### **3.2.1 Study population**

The survey population of over 1000 people was composed of traders both retail and whole sellers and venders in Kapchorwa municipal, Kapchorwa district.

##### **3.2.2 Sample size**

In order to acquire the necessary information about income tax. The respondents were chosen at random basing on the fact that they are normally distributed and these included various traders and venders.

The samples of 30 respondents was selected from two levels of traders and venders using simple random sampling.

**Table 4: Respondents to be used in the study;**

<b>Respondents (category)</b>	<b>Sample size</b>
Whole sellers	10
Retailers	10
Venders	10
Total	30

**Source: Primary Source 2017**

### **3.2.3 Sampling method**

Here stratified sampling was used where traders were put in three categories, wholesalers, Retailers and venders. This was done by means of stratified sampling and simple random sampling. Each category (strata) will be properly identified/selected and then 10 respondents chosen randomly.

The researcher will obtain sampling frame from the market offices showing the names of business traders and they were written on small pieces of paper and the researcher randomly picked ten (10) traders in each category (i.e. wholesalers and retailers).

For vendors, the researcher randomly chooses 10 within the market as there was no sampling frame available at the offices.

### **3.3 sources of Data**

The research was based on both primary and secondary data. Primary data was obtained through interviews and secondary data was got from existing relevant literature, journals and periodicals.

#### **3.3.1 Primary data**

This is the information that was directly obtained by the researcher from the respondents through direct face to face interview or observation methods.

### **3.3.2 Secondary Data.**

This is the already processed published or unpublished data which is ready for use by anyone who wants it. It's collected from publications like text books, journals.

### **3.4 Data collection methods and instruments**

The survey techniques which were used for data collection in the field are questionnaires and interview guides for primary data also from the internal and external sources like reports, journals, text books and periodicals.

#### **3.4.1 Questionnaires**

The basic tool the researcher will base on for data collection will be by means of Questionnaires designed to target respondents. This method will be used because its quicker compared to other data collection methods and it minimizes business.

#### **3.4.2 Interview guide**

Interview guide was used as one of the tools by drawing up guides and asking questions following the guide this tool was used because traders did not have the time to sit down and answer questionnaires and others were illiterate.

#### **3.4.3 Procedures**

The questionnaires were hand delivered to the respondents to avoid delays.

The completed questionnaires were collected by hand and where there were difficulties in filling the Questionnaires the respondents were provided with back ground information. However for those who were not able to write, Questions with in the Questionnaires were asked and the responses filled by the researcher.

### **3.5 Data processing and Analysis**

#### **3.5.1 Data processing**

Data processing includes coding and editing all the responses collected from the field will be edited with the view of checking for completeness and accuracy to ensure that data is accurate

and consistent. Coding was done after editing and it indicated the processing of data which was done manually and by use or complete through word processing and excel.



### **3.5.2 Data analysis**

The analysis and presentation of data form the biggest part of a research report. The researcher personally analyzed the data got from secondary and primary sources by editing and tabulation so as to condense the data in to a few and manageable groups. The income tax paid by various enterprises was presented in tables for easy interpretation.

### **3.6 Likely limitations to the study**

The respondents were not willing to provide some of the information about their business which they treated as being confident. In addition getting full attention of the respondents was also a problem as many of them were up and down attending to customers as they came by.

Financial constraint was also another major problem the researcher encountered during the study since the whole exercise involved, typing, photocopying delivery of the Questionnaires and picking them and so many others a lot of fund were needed to facilitate all these activities involved.

The time allocated for the dissertation was short and the researcher had other theory papers to be studied during the course of the semester.

The researcher also faced a problem of inconveniences while accessing the library at Makerere University since it serves so many students and even non students.

### **Conclusion**

The growth of SME's is retarded due to poor income tax administration and most enterprises struggling with no or very little profit and hence no taxable income, yet they are forced to pay on presumptive basis. Income tax has thus greatly reduced their profits there by undermining their struggle to expand.

## CHAPTER FOUR DATA ANALYSIS

### 4.0 Introduction.

This chapter lays down the analysis of findings and their interpretation from the primary data. The study was intended to find out the effect of income tax on the performance of SME's the analysis was carried out using Ms Excel and explanation was done in form of working.

### 4.1 General findings about the characteristics of respondents.

The study that was carried out involved both male and female respondents who were selected at random to avoid gender bias.

#### 4.1.1. Respondents by gender (Sex)

**Table 5: Respondents by gender (Sex)**

Category	No. of respondents	Percentage
Male	19	63
Female	11	37
Total	30	100

#### Source; Primary data (2017)

The findings indicate that 63% of the respondents were male and 37% female. This implies that most of the SME's in Kapchorwa municipal are conducted by men.

#### 4.1.2 Age group of respondents

**Table 6: Age group of respondents**

Age group (years)	Frequency	Percentage
20-30	8	27.6
30-40	14	46.6
40-50	5	16.6
Above 50	3	10
Totals	30	100

**Source; Primary data (2017)**

The study indicates that most businesses in Kapchorwa municipal are dominated by the age group of people between 30-40yrs constituting 46.6%of the respondents,27.6%between 20-30yrs,16.6% between 40-50yrs,and 10% are above 50yrs.

This therefore implies that the SME's in Kapchorwa municipal are being carried out mainly by youth between the age of 30-40yrs.this has been a result of unemployment problems in Kampala and around.

#### 4.1.3: The level of education

The study found out that most SME's in Kapchorwa municipal are run by people whose education qualification varies.

**Table 7: Level of education**

Level	Frequency	Percentage
Primary	3	10
Secondary	15	50
Tertiary institution	8	26.7
University	4	13.3
Total	30	100

**Source; primary data (2017)**

The findings indicate that 13.3% of the respondents have a university qualification, 26.7% qualified from tertiary institution, 50% at least reached secondary level, 10% reached primary level.

This therefore implies that the majority of the business owners are literate.

#### 4.2 Tax assessment and collection.

##### 4.2.1: Existence of the business.

The time period during which the business lasted was established by asking the respondents for how long they have been in business.

**Table 8: Time the business has been in existence**

Years	Frequency	Percentage
Less than 1 year	2	6.7
2 years	5	16.7
3 years	8	26.7
Above 3 years	15	50
Total	30	100

**Source; primary data (2017)**

It was found out that 50% of the business had existed for more than 3 years while 26.7% existed in the period two to three years, 16.7% existed between the period one to two years and only 6.7% existed for less than a year. This therefore shows that very few people are joining business.

##### 4.2.2 Registration for income tax

**Table 9: Business registered for income tax**

Registered	No. of respondents	Percentage
Yes	22	73.3
No	8	26.7
Total	30	100

**Source: Primary data (2017)**

The findings indicate that 73.3% of respondents are registered while 26.7% were not registered. Therefore this implies that the majority of the business enterprises are registered though a few respondents still lack information about income tax and their business enterprises are not registered.

#### 4.2.3 Effect of income tax on survival on SME's

**Table 10; How Income tax affects the survival of SME's**

Detail	No. of respondents	Percentage
Greatly	18	60
Moderately	10	33.3
Fairly	0	0
Does not affect	2	6.7
Total	30	100

**Source: Primary data (2017)**

The findings indicate that 60% of the respondents said that income tax greatly affects the survival of their businesses while 33.3 % of the respondents asserted that income tax moderately affects the survival of their businesses and no one answered that tax fairly affects the survival of their businesses. 6.7% of the respondents said that income tax income tax does not affect the survival of their businesses. This therefore implies that income tax greatly affects the survival of SME's.

#### 4.2.4 Frequency of paying income tax

**Table11: How income tax should be paid**

Period	Frequency	Percentage
Monthly	4	13.3
Quarterly	5	16.7
Annually	21	70
Total	30	100

**Source: Primary data (2017)**

The findings indicate that 70% of the respondents willing are to pay income tax annually, 16.7% are willing to pay tax quarterly and 13.3% said that tax should be paid monthly. This therefore indicates that majority of the business owners are interested in paying income tax annually this is possibly because it would reduce the burden of paying tax monthly.

#### 4.2.5 Types of taxes paid by SME's

**Table 12: Taxes paid by SME's**

Type of tax	No. of respondents	Percentage
Corporation	3	10
Income tax	21	70
Customs duty	1	3
Sales duty	5	17
Total	30	100

**Source: Primary data (2017)**

The study indicates that 10% of the respondents said that corporation tax affects their businesses most. 70% said income tax affects their businesses .3% said that customs duty affects their businesses and 17% said that sales tax affects their business. This therefore indicates that most businesses are affected by income tax.

It also indicates that the business owners have mixed feelings on various types of taxes they pay since these affect their businesses at different levels as shown by the percentages as in the table above.

### 4.3 Effect of income tax on SME's

**Table 13: Effect of income tax on the profitability**

Detail	No. of respondents	Percentage
Very much	21	70
Moderate	6	20
Rarely	3	10
Does not affect	-	-
Total	30	100

**Source: Primary data (2017)**

From the table above, majority of the respondents revealed that income tax greatly affects the profit levels of their businesses. This was indicated by the 70% response rate.

**Table 14: The Chi – square test**

Responses	Expected frequency (e)	Actual / Observed Frequency (f)	$\{(f - e)^2\} / e$
Very much	20	21	0.05
Moderate	7	6	0.14
Rarely	1	3	4
Doesn't affect	2	0	2
Total	$\sum (e) = 30$	$\sum (f) = 30$	$\sum \{(f - e)^2\} / e = 6.2$

**Assumptions:**

1.  $\sum (e) = \sum (f) = 30$
2.  $X^2$  (chi-square) =  $\sum \{(f - e)^2\} / e = 6.2$

The chi square test indicates a computation figure of 6.2 which did not exceed the value of 7.815. This implies that the underlying argument that income tax affects the profit margin of small and medium enterprises could not be rejected. The critical value of  $X^2$  from the table was determined as follows.i.e.

$X^2$ a where;

A is the level of significance = 5%=0.05

No. of degrees of freedom= K-1=4-1=3

Thus  $X^2 = 0.05 = 7.815$

The critical value of  $X^2$  that is 7.815 is greater than the computed value of 6.14. Therefore the argument that income tax largely affects the profits of SME's is acceptable.

#### 4.3.1 What should be done to help reduce the negative effect of income tax?

**Table 1: Negative effect of income tax on small businesses**

Option	No. of respondents	Percentage
Reduce tax rates	18	60
Payment by installment	9	30
Tax education by tax authorities	3	10
Total	30	100

**Source: Primary data (2017)**

The findings indicate that 60% of the respondents suggested that tax rates should be reduced, while 30% suggested that tax should be made by installments and 10% said that tax education should be provided to the tax authorities.

This therefore implies that majority of the respondents want tax rates to be reduced.



## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS AND RECOMMENDATIONS**

#### **5.0 Introduction**

This chapter gives a summary on findings, conclusion and recommendations in line with the research objectives.

Areas for further research have also been mentioned under this chapter.

#### **5.1 Summary and findings.**

According to research questions on the measures used in assessing taxes on SME's and whether there is a relationship between income tax performance of SME's. The research findings indicate that 73.3% are registered for income tax purposes and 70% revealed that income tax greatly affect the profit levels of their business.

##### **5.1.1: Income tax and its likely effects on performance.**

The findings indicate that 60% of the tax payers claimed that income tax greatly affect the survival of their business.

According to Dalton (1997), "Every tax system has economic activities. The effects may however have either positive or negative impact on the economy"

Many scholars have come up with different views on how taxation affects performance of SME's.

However according to Keynesian model (1946), government revenues can be raised through fiscal policy mechanism.

However, this has adverse effect on the business, individual savings and marginal propensity to consume.

It is also argued that since taxation affects the rate of savings, consequently the rate of investment must be low leading to low propensity and capital accumulation in some instance if a tax levied is high and unfair in relation to income earned. This enhances tax evasion and avoidance.

Taxation therefore negatively affects the profitability of SME's from income tax statement, after getting off taxes; little will be left for appropriations.

This scares away new entrants into the industry.

### **5.1.2 Other problems affecting SME's profitability.**

Besides tax burdens, the respondents argued that they face number of other problems such as lack of enough capital, swift competition, lack of knowledge and procedures about financial sourcing, problems of bad debts and the problem of strikes and riots within the city .all these can also contribute to low profitability.

## **5.2 Conclusion**

The findings indicate that solutions should be got to address the problem of income tax, the burden cited comes about as a result of poor calculations and unfair assessment, lack of awareness on the side of tax payers to keep records ,high tax rates, poor handling of income tax related problems should be solved.

The assessment by URA without considering what problems businesses are facing in the long run, which affects the revenue collection. It's out of these problems that the under listed recommendations are made.

## **5.3 Recommendations.**

Sensitization of income tax payers by URA officers in form of tax education should be done regularly, this can be done by the use of various media such as radios, TVS and newspaper. Tax education should be conducted in various local languages so as to enable all the business operators understand.

Income tax for SME's operators should be revised which is believed to be high and affecting the retained earnings.

URA should be also train their staff about tax assessment and collection methods as well as how to handle tax payers.

Small scale beginners regardless of the size and level of gross annual turnover should be exempted from income tax deposits. Because it's so discouraging for investors to be required to

pay taxes before the business commences irrespective of whether they are residents or non residents.

#### **5.4 Areas for further research.**

During the course of the study, the following areas were identified for further research.

- The role played by government in reviewing the tax policies.
- The effect of income tax in relation to big business's performance.
- Effect of tax administration on performance of SME's.

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**APPENDIX 1**  
**QUESTIONNAIRE**

Dear respondent; am a student of Kampala international university carrying out research about the effect of income tax on the performance of SME'S in Uganda a case study of Kapchorwa municipal. Please respond to this questionnaire as truthfully as possible. The research is purely academic and your response will be treated with at most confidentiality. Answer the following questions by ticking the relevant option. **Tick one option only from each question.** It's thus important that you read each question very carefully.

**SECTION A:**

**GENERAL INFORMATION**

1. Gender

Female	Male

2. Age group

20-30	31-40	41-50	51-60	ABOVE 60

3. Marital status

Married	Single

4. Education background

Primary	Secondary	Tertiary institution	University

5. What's your position in the business enterprise?

Owner	Employee

6. How long have you been in business?

Less than 1 year	1 year	2 years	3 years	More than 3 years

**SECTION B:**

**TAX ASSESSMENT AND COLLECTION**

1. Is this business enterprise registered?

Yes	No

If yes, when was it registered?.....

2. What type of business do you deal in?

Grocery items	
General merchandise	
Consultant service	

3. What is your annual gross turn over?

Below ugx 20m	
Between ugx 20m-30m	
Between ugx 30m-40m	
Between ugx40m-50m	

4. What type of taxes is your business liable to?

Vat	
Income tax	
Excise duty	

5. How often do you pay these taxes?

Promptly	
After reminder	

6. Which tax affects your business most?

Income tax	
Customs duty & domestic vat	
Vat	

7. How does the income tax affect the survival of your business?

Greatly	
Moderately	
Does not affect	

8. How much your business pay in form of income tax?

.....

.....

9. Do you furnish returns of income?

Yes	
No	

10. Who do you use to prepare your returns which you submit to URA?

Manager	
Director	
Accountant	

11. Do you have any problem with the assessment of income tax?

YES	
NO	

12. If yes, what type of problem?

High tax rates	
Un fair assessment	
Period of payment	
Harassment by tax authorities	

**SECTION C:**

**Effect of income tax on SME'S**

1. Does the imposition of income tax affect your profitability?

YES	
NO	

2. If yes, to what extent does it affect your profitability (profit margin)?

Very much	
Moderately	
Rarely	
Does not affect	

3. Do you think that taxes collected contribute anything to the economy?

YES	
NO	

If yes, how?

.....  
.....

If no, why?

.....  
.....



4. What other possible factors affect the performance of your business apart from tax?

.....  
.....

5. What do you think can be done to help reduce the negative effect of the tax?

Reduce tax rates	
Payment by installments	
Tax education to tax authorities	

THANK YOU FOR YOUR PARTICIPATION.

**APPENDIX II: RESEARCH PROJECT SCHEDULE**

Activity		WEEKS															
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1	Topic selection	█															
2	Proposal writing		█	█	█	█	█	█									
3	Distribution of questionnaires and interview guides (data collection)							█	█								
4	Editing and coding									█	█						
5	Data entry											█					
6	Data presentation and interpretation of findings												█				
7	Presentation of 1st draft dissertation													█			
8	Correction of the draft dissertation													█	█		
9	Submission of final report																█

**APPENDIX III: RESEARCH PROJECT BUDGET**

<b>ITEMS</b>	<b>COST (Shs)</b>
Transport	60.000
Lunch	30.000
Stationery	15.000
Printing	45.000
Binding	24.000
Telephone calls (air time)	5.000
<b>Total</b>	<b>179.000</b>