SOUTHMOD

Policy Note

Reforming pay-as-you-earn (PAYE) taxes in Uganda

An assessment of alternative reforms to increase revenue and reduce poverty

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Findings

- UGAMOD simulations show that Uganda's pay-as-you-earn (PAYE) tax regime can be reformed to improve tax revenue mobilization and reduce poverty and inequality
- There are notable differences between the three hypothetical reform scenarios considered, but all of them are more progressive than the current tax schedule
- The recommended reform raises the minimum PAYE threshold from UGX 2.82 million to UGX 4.02 million per year and creates a new tax band with an applicable tax rate of 35 per cent
- This reform, when modelled, reduces income disparity, lowers the poverty rate, and increases tax receipts

Under the PAYE tax regime in Uganda, employers deduct taxes from the salaries of their employees and remit them to the Uganda Revenue Authority. The tax rates under PAYE range from 10–40% depending on the employee's earned income. The current tax schedule faces criticism for its limited progressivity, the large burden it places on low-income workers, and fiscal drag—when inflation pushes workers into higher tax brackets, resulting in an effective tax increase on their real income.

A quantitative evaluation of three hypothetical reforms of the existing PAYE regime and its findings, aimed at the above-mentioned concerns, is discussed below. For the analysis, we use UGAMOD, the tax-benefit microsimulation model for Uganda, which is underpinned by data from the Uganda National Household Survey (UNHS) 2016/17. We evaluate the effects of the alternative reforms on tax revenues, poverty rates, and income inequality, comparing each reform scenario to the existing policy.

Concerns with the current PAYE regime

The existing tax schedule comes with a threshold of UGX 2.82 million (about USD 750) per year below which an employee's income is exempt from income tax (see Table 1 below for details). The minimum threshold has not changed over the past decade, which is problematic for at least two reasons.

First, inflation and rising wages push workers into higher tax brackets, even though their income may not have increased in real terms—or has in fact decreased due to considerable inflation since 2008. Workers who were previously exempt from income tax may now find themselves subject to taxation, which can be an economic burden for those in lower-income bands.

Second, the failure to adjust the tax threshold is seen as a missed opportunity to provide relief for workers in lower-income bands. In Uganda, many workers earn salaries that are just above the tax threshold, but do not provide a comfortable standard of living. By not increasing the tax threshold, the government is effectively taxing these workers at a higher rate than they can afford, which can be a disincentive for work and also contributes to economic inequality.

Finally, the economic hardships faced by Ugandans in recent years have further underscored the need for adjustments to the tax schedule. High inflation rates, which topped 10 per cent in 2022, have eroded the purchasing power of workers' incomes, making it even more difficult for lower-income workers to make ends meet. These challenges have only been exacerbated since 2020 by the COVID-19 pandemic, increasing interest rates, and the Russia-Ukraine war.

Proposals to adjust the tax schedule and the exemption threshold

All of these factors highlight the need for amendments to the tax schedule. The main change we propose is increasing the PAYE tax exemption threshold to improve the standard of living of low-earning individuals in paid employment. This policy change can be expected to reduce income disparities and the poverty rate, as relayed below. In addition, increasing the threshold is likely to improve the incentive to work, boost consumer spending, and contribute to the tax base.

The existing tax schedule and our reform scenarios are illustrated in Table 1. Reform 1 proposes to raise the threshold to about UGX 4 million per annum (roughly USD 1,000) from UGX 2.82, which would exempt workers earning less than this from the tax. Because a large number of Ugandan workers currently paying the tax would be exempted, losses in tax revenue would also be significant. To make up for this, other amendments are also incorporated in the three reforms, including:

1. A new 35 per cent tax band for those earning between UGX 5.82 and 120 million (Reform 1);
2. Fully revised schedule that allows for complete revenue neutrality, i.e., it keeps the overall tax revenue unchanged compared to the existing policy (Reform 2); and
3. Fully revised schedule with tax rate reductions for the lower tax bands (Reform 3)

Table 1: Tax schedules under the current regime (baseline) and reforms

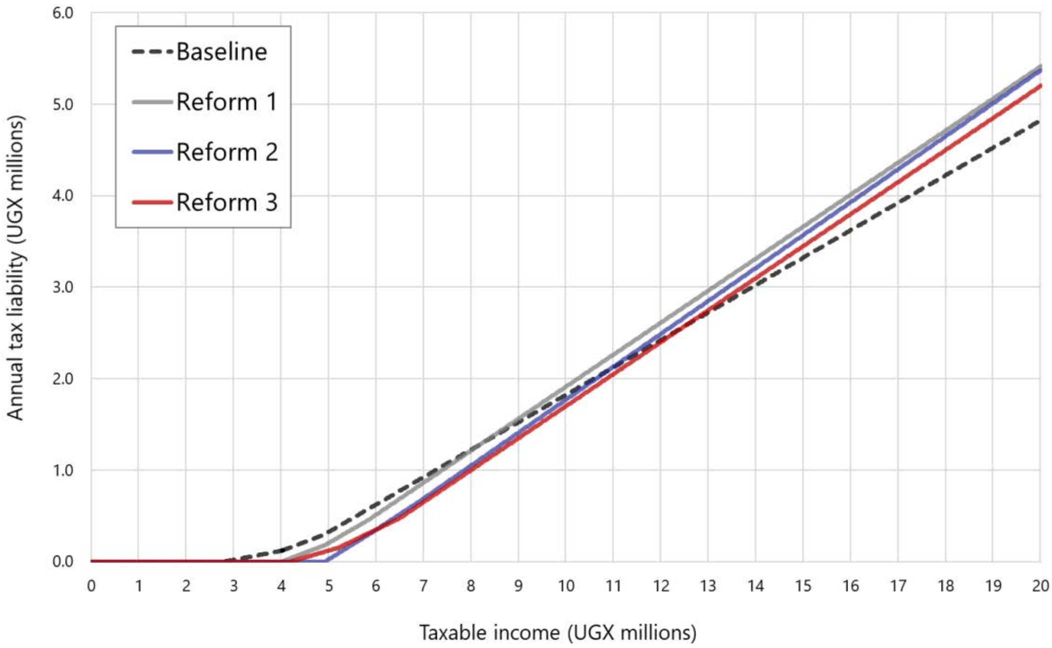
Baseline		Reform 1		Reform 2		Reform 3	
Earned income (UGX millions per annum)	Marginal tax rate	Earned income (UGX millions per annum)	Marginal tax rate	Earned income (UGX millions per annum)	Marginal tax rate	Earned income (UGX millions per annum)	Marginal tax rate
<2.82	0%						
2.82–4.02	10 %	<4.02	0 %	<4.92	0%	<4.20	0 %
4.02–4.92	20 %	4.02–4.92	20 %	4.92-5.92	32.18 %	4.20-5.20	15 %
4.92–120	30 %	4.92–5.82	30 %	5.92-6.92	34 %	5.20-6.50	25 %
		5.82–120	35 %	6.92-120	36 %	6.50-120	35 %
>120	40 %	>120	40 %	>120	40 %	>120	40 %

Notes: Baseline refers to the current PAYE regime as of 2022.

Source: Authors' elaboration of the Income Tax Act of 1 July 1997, Cap 340 of the Laws of Uganda 2000 and proposed scenarios.

All three reforms modelled are more progressive than the schedule currently in place, as evidenced by Figure 1, which plots the annual tax liability as a function of chargeable income under all scenarios.

Figure 1: Annual tax liability as a function of chargeable income under baseline and reforms



Source: Authors' elaboration the existing and proposed PAYE income tax schedules.

The reforms would reduce poverty in a cost-effective manner

Table 2 shows the estimated impact of the three reforms on revenue from direct taxes, as well as the consumption-based poverty rate and Gini coefficient of inequality.

Table 2: Impact of the reforms

	Baseline	Reform 1	Reform 2	Reform 3
Tax revenue (direct taxes, billion UGX)	3,022.5	3,167.6 (+145.1)	3,022.5 (0.0)	2,955.6 (-66.9)
Poverty after taxes and benefits, (per cent)	21.80	21.65 (-0.15)	21.57 (-0.23)	21.50 (-0.31)
Gini coefficient of inequality, (1–100)	39.83	39.60 (-0.23)	39.58 (-0.25)	39.62 (-0.21)

Notes: Poverty and inequality estimated are based on simulated consumption. 'Baseline' refers to the current PAYE regime as of 2022. Changes from the baseline are shown in brackets.

Source: Authors' elaboration of UGAMOD, the tax-benefit microsimulation model for Uganda (v1.8, system 2022).

The main results can be summarized as follows:

- Reform 1, which introduces a new 35 per cent tax band for those earning UGX 5.82–120 million, increases tax revenue by around UGX 145 billion (almost 140 million USD), while also reducing the poverty rate by 0.15 percentage points (pp.) and the Gini coefficient by 0.23.
- Reform 2 leads to slightly larger reductions in poverty (-0.23 pp.) and inequality (-0.25), achieving them in a revenue-neutral manner compared to the existing PAYE regime.
- Reform 3 is estimated to reduce poverty more than both of the other two alternatives (-0.31 pp.), but it costs around UGX 65 billion per year in lost tax revenue and reduces economic inequality even less than Reforms 1 and 2.

Figure 1 can be consulted to better understand these results.

In summary, the first reform outperforms the two competing alternatives in the sense that it not only reduces poverty and inequality by a similar magnitude but also *increases* tax revenues compared to the current regime. In principle, the government might also choose reform 2 to further improve the distributional outcomes of the reform with no additional costs (but also no increases in revenue).

New directions for PAYE in Uganda

In addition to the static impact estimates of alternative PAYE reforms provided in this policy note, increasing the tax-exempt threshold would also likely have positive dynamic and spill-over effects on the Ugandan economy. Such an increase would improve the incentive to work and raise the purchasing power of low-income earners, which would boost consumer spending and stimulate economic growth. These dynamic benefits are unaccounted for in the estimates above, but bigger gains to revenue collection from spillovers to economic growth are an entirely possible outcome to such a reform.

Moreover, by providing relief for workers in lower-income bands, a higher tax-exempt threshold can also encourage more people to join the formal economy and contribute to the tax base. This could also lead to increased revenue for the government and free-up resources for much-needed infrastructure and public services, such as healthcare and education.

Policy recommendations

- The Ugandan government should consider raising the PAYE exemption threshold to improve the standard of living for low-earning individuals in paid employment. This policy change would also reduce poverty and inequality
- It is also important to balance the benefits against the need to maintain a sustainable fiscal position. An ideal reform, in line with what is proposed in this note, could be implemented in a revenue-neutral or even revenue-increasing manner by simultaneously raising tax rates for higher-earning individuals
- Such a reform would also be expected to have positive dynamic effects on the economy by boosting consumer spending, stimulating economic growth, and encouraging more people to join the formal economy
- This analysis also underscores the need for periodic adjustments to the income tax schedule in order to counter fiscal drag and to ensure that the system remains fair and equitable over time

This note was produced using UGAMOD, the tax-benefit microsimulation model for Uganda. The note was developed at the UGAMOD Retreat in October 2022. The retreat was a capacity development initiative and a part of the activities of the SOUTHMOD project.