

**THE LEVYING OF EXCISE DUTY (SIN TAX) AND ITS  
IMPLICATIONS: THE CASE STUDY OF UGANDA**

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LLB/3165/22/DF

**A DISSERTATION SUBMITTED IN PARTIAL FULFILMENT OF THE  
REQUIREMENTS FOR THE AWARD OF THE DEGREE OF  
BACHELOR OF LAWS OF KAMPALA INTERNATIONAL  
UNIVERSITY**

2007

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## CERTIFICATION

The under signed certifies that, she has read and hereby recommends for acceptance by Kampala International University a dissertation entitled “The Levying of Excise Duty (Sin Tax) and Its Implications: The case study of Uganda” in partial fulfillment of the requirement of the degree of Bachelor of Laws.



JALIA KANGAVE


(SUPERVISOR)

2007

## DECLARATION

I, MOHAMED OMARY, do hereby declare that this dissertation is my own work, except where acknowledged, and it has never been submitted or examined in any University as an academic requirement for any award.

Signed

  
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Mohamed Omary

22<sup>nd</sup> Jan 2007

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22/01/2007

Date

Supervisor

M.O

JANUARY 2007



## **DEDICATION**

This research is dedicated to Mrs. Alice D Berkeley, for whose love, kindness, extreme tolerance, honesty, integrity, and deep understanding has been invaluable to my being at Kampala International University.

I also dedicate this research to my father Mr. Omar R Mchengerwa, for his ideas, love, guidance and encouragement in my four years of studies at Kampala International University, and my beloved mother Mrs. Rukiah Jumanne for her love, encouragement, support and constructive ideas which has been valuables in all time of my studies.

**M.O**

**JANUARY 2007**

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Last but not list, I thank my entire family, all my brothers and sisters, but most especially my mother and father who made sure that I get primary and secondary school education.

Notwithstanding the input of various individuals to this dissertation, I remain fully responsible for any mistakes that may be contained herein.

## LIST OF STATUTES

- The Excise Tariff Act Cap. 174
- The Excise Management (Amendment) Act 2003
- The East African Excise Management Act EAC Cap. 26
- Finance Act 2001
- The Income Tax Act 1997 Cap 340
- The Uganda Revenue Authority Act Cap 196
- The 1995 Constitution of Uganda

## ACRONYMS

EAC	East African Community
EPRC	Economic Policy Research Centre
GDP	Gross Domestic Product
PEAP	Poverty Eradication Action Plan
SRPS	The Special Revenue Protection Service
URA	Uganda Revenue Authority
VAT	Value Added Tax

## GENERAL INTRODUCTION

### 1.1 INTRODUCTION

The need to finance government expenditure in fiscally tight times has many times led to government imposing unusually high taxes. One form of tax commonly used by government in filling the fiscal deficit is excise duty, often referred to as “sin tax”.

A number of reasons have been given for levying high taxes on selected goods and services: to discourage the consumption of harmful / undesirable goods; to reduce on the consumption of luxurious goods; and the desire to improve the progressivity of the tax system by taxing highly goods known to be consumed mainly by the rich. The reasons for moderating the level of revenue excises are the principle of consumer sovereignty ; the finding that the net external costs of smoking and drinking may be low; equity considerations; and difficulties in ensuring compliance control in view of illegal bootlegging and smuggling.<sup>1</sup>

In modern times the theories and functions of taxation have been widely and broadly discussed. It is argued that it is impossible to regard taxes as merely a means of obtaining revenue since they may be and are often used for more specific purposes such as discouraging the use of alcohol, purchase of cigarettes, or as an inducement to production for the market as opposed to subsistence.<sup>2</sup>

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<sup>1</sup> Sijben Cnossen ‘The Economics of Excise Taxation in SADC countries’ paper prepared for the Southern African conference on excise taxation centurion lake hotel, Gauteng South Africa 11<sup>th</sup> -13<sup>th</sup> June 2003.

<sup>2</sup> The ministry of Finance, Planning and Economic Development, “Background to the Budget for Financial Year 2004/ 05” at <http://www.newvision.co.ug>.

Yet the temptation to impose sin taxes is one that should be resisted for economic reasons. The consequences of the sin tax are often the very opposite of those intended by its designers. Rather than increasing revenue, the sin tax can reduce it.<sup>3</sup> Rather than discouraging what are regarded as questionable behaviours, the sin tax can make them more appealing.<sup>4</sup> Rather than reducing what are perceived to be internal costs of the sin, the sin tax can increase them and expand them to society as a whole. The sin tax, moreover, fails to consider the crucial distinction between vice and crime.

Uganda's manufacturing sector is small compared to its neighbour, Kenya, and locally manufactured products have continued to struggle against imported goods mainly due to an unfavorable business environment. An issue has been the high cost of doing business as a result of rampant corruption, and unattractive tax regime – underpinned by high import duty on raw materials, a steep corporate tax, and other stringent fiscal measures, especially Value Added Tax (VAT) and the excise tax<sup>5</sup>. Collectively, and within the context of liberalization, these policies have far-reaching consequences as they render our products less competitive. In addition, they render Uganda less attractive when compared with its East African counterparts. Lately the country's focus, both from a business and an economic stand point, has been how to turn the economy around especially with the current power problem. However the whole process can only gain impetus if all requisite conditions are favorable to the private sector- where prime actors of wealth creation

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<sup>3</sup> Rev Robert A. Sirico 'Sin Tax Crazy Whose Next also at <http://www.acton.org> date visited 9<sup>th</sup> / 05/ 2006

<sup>4</sup> The bid

<sup>5</sup> Ibid

operate<sup>6</sup>. It ought to be noted though that the corporate tax rate (30%) and the VAT rate (18%) are competitive both regionally and internationally. What remains a source of concern, especially in comparison with its East African counterparts, are the excise duty rates.

This paper makes an analysis of excise duty in Uganda and measures the extent to which increase in excise duty will achieve the objective of discouraging consumption of products considered to be harmful or undesirable. The paper intends to illustrate the difficulties in tailoring an excise tax regime in the context of multiple objectives and constraints. The question of what is the right level and structure of tax is a complex one and will guide the discussion of this paper.

## **1.2 Statement of the problem**

For the past decade or so, government has emphasized the need to increase excise duty on certain goods that it considers either harmful or luxurious. Common among the goods that have constantly suffered this increase are alcohol, cigarettes and mobile phone airtime.

Part of the rationale for “sin” taxes is that they discourage socially damaging behaviour and help to recover part of the attendant social cost. However, some call such taxes punitive and regressive in that they affect lower-income people disproportionately. Anti-smoking advocates claim that excise tax boosts government revenue while reducing smoking. They also argue that lower usage of cigarettes reduces the number of

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<sup>6</sup> Ibid page 3

smoking related illnesses, resulting in less spending on health care by government and employers.<sup>7</sup> Opponents counter these arguments by stating that tax increases reduce smoking slightly and that government regulation and negative publicity about smoking side effects can on their own reduce consumption.

The problem that remains to be addressed is whether increase in excise duty has an effect on consumption and to what extent regulation can achieve this purpose.

### **1.3. Objectives of the Study**

1. The study is aimed at: Analyzing the impact of increases in excise duty on consumption of commodities affected by the same;
2. Discussing the reasons for Government's regular increase of excise duty rates;
3. Making recommendations for policy guidelines that should be considered when increasing excise duty rates.

### **1.4 Scope of the study**

This research is restricted to Uganda in terms of levying excise duty under The Excise Tariff Act (Cap. 174) as amended and The Finance Acts as have been amended from time

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<sup>7</sup> <http://www.capitol.state.tx.us/hrofr> date visited 9<sup>th</sup> / 05/ 2006.



to time. Reference will also be made to the East African Excise Management Act (EAC Cap. 26) as amended. The Paper examines the excise tax regime in Uganda and its implications on other taxes; consumption of goods on which excise duty is levied and its effects on the economy.

### **1.5 Hypothesis**

It is clear that the levying of excise duty ('sin tax') is yet to be completely streamlined. The aim of the study is to find out whether or not there is a close relationship between levying excise duty, earning of government revenue and consumption of goods on which excise duty is levied.

### **1.6 Significance of Study**

The paper is based on research designed to analyze the impact of Government policy on excise duty and other taxes in general.

The timeliness of this research derives from the high level of legislative interest in raising revenue to reduce donor dependence and the fiscal deficit. As discussed in the paper, research findings are much more likely to lead to legislative changes especially if backed by coherent and well thought –out arguments.

In the long run, the paper aims at enabling government to apply the proposed policy guidelines when considering other government policy. The significance of the paper will be:

1. To build upon prior research done by taxation experts and government on the relationship between increases in taxes and the consumption of the affected goods.
2. The study is also aimed at analyzing why the Government regularly increases excise duty to cover revenue shortfalls.
3. To assist Government in making policy reform and putting in place better administration of excise duty system.

## **1.7 Methodology**

The research will be based on, among others, desk work, where information will be obtained from different books and materials obtained from libraries, internet resources government documents and newspapers. This research will, as of necessity, be qualitative and heavily dependent on prior published documents.

Because desk work is sometimes not up-to-date and in other cases quite theoretical, the paper will also hold interviews with officials of government and members of the Private sector to gain further insight into the topic at hand. This form of research will be invaluable in understanding the rationale behind government policy and why the private sector may counter it.

## 1.8 Literature Review

The topic of excise duty in Uganda is one that has received little attention from academic scholars. In Uganda this topic has been subject to public debate, with not much literature accompanying such debate

Most Ugandan tax Authors have concentrated on the history of taxation; the definitions and descriptions of the different kinds of taxes; and the application and interpretation of these taxes (especially income tax).

Professor Bakibinga in his book *Revenue Law in Uganda*<sup>8</sup>, examines theories and criteria for taxation and distinguishes between income and capital for taxation purposes. The book focus on individual and business taxation as contained in the 1997, Income Tax Act, and the relevance of taxation to investment. The book is of little relevance to the present research and will only be used when analyzing some of the criteria for a good tax system.

Pius K.Bahemuka's *Income Tax in Uganda*<sup>9</sup> gives a brief history of income tax and an in-depth analysis and interpretation of sections of the 1997 Income Tax Act. Again,

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<sup>8</sup> D. J Bakibinnga, ' Revenue law in Uganda' Published 2003 Kampala Uganda.

<sup>9</sup> Pius K Bahemuka, *Income Tax in Uganda*, Published in 2001

Bahemuka's book, while one of the few texts on tax in Uganda, does not address the issue of excise duty and is not in principle applicable to this research.

Alka Gupta in his book *Public Finance and Tax Planning*<sup>10</sup> conceptualizes the need for taxes to fulfill government's normal social obligations in the form of defence; maintenance of law and order; and socio-economic development. He states that normally, tax policy is governed by the principles of equity, economic stability and economic growth, but he argues that in practice, this policy is determined by the pressures which are exerted on the government by different pressure groups in society. Consequently, in many cases, governments have to adopt certain policies simply because there are pressures to that effect. Alka Gupta's arguments are relevant to the present research not only as far as they determine the criteria for a good tax system, but also in their analysis of the forces directing government policies.

N.A Saleemi's *Taxation Simplified*<sup>11</sup> deals extensively with taxation theory, the law of taxation and computation of taxes. He states that government is considered responsible to stabilize the economic situation of the country. Similarly, government plays important roles in the economic development process. He further argues that excise duty, mostly levied with the object does both. It may bring in some revenue and also check people from consuming some harmful articles. Saleemi's arguments are of direct relevance to the present discussion, especially since they correctly point out that excise, much as it is a sin tax geared towards discouraging vice, is also in real sense a revenue generating vehicle.

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<sup>10</sup> Alka Gupta, "Public Finance and Tax Planning," Anmor Publications PVT. LTD New Delhi(India) pg. 69(2001)

<sup>11</sup> N.A Saleemi, *Taxation Simplified* 4<sup>th</sup> Edition, published in Nairobi 2001

A piece of literature that serves to have direct relevance to the present study is the '*The sin tax is crazy; whose next*', by Rev Robert A. Sirico<sup>12</sup>. This paper not only clearly gives the effects of excise duty but also lays its implications. Sirico argues that Sin tax is not only within the right of the state, but is also an act of responsible leadership. What is to stop the government from taxing behaviors it deems unhealthy? Once the state has moved into tax "morally ambiguous" activities, it has crossed an invisible line putting it into the business of protecting its citizens from themselves. This paper, however fails short of analyzing whether in fact, excise duty achieves its intended purpose, and this aspect is clearly brought out in Professor Dwight Lee's report.<sup>13</sup>

## 1.9 Chapterisation

The paper is divided into **five** chapters.

Chapter **one** covers the definition of taxation; objects of taxation; criteria for evaluating a tax system; and discusses the various approaches to taxation, with emphasis on excise duty. The chapter further discusses the general effects of taxation.

Chapter **two** contains a discussion on economics of excise taxation and further defines more in-depth the nature of excise duty and goods commonly affected by this tax. The paper concludes with a discussion of the economics of excise duty.

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<sup>12</sup> [www.acton.org/organization](http://www.acton.org/organization)

<sup>13</sup> Report on the increase of Excise duty, conducted by the Center for the study of American Business, economics also at <http://www.pacificresearch.org>

In chapter **three**, the rationale for excise taxation is discussed, along with the relationship between consumption taxes and import duties. The chapter gives a detailed discussion on governments' arguments for imposing this tax and contextualizes the Ugandan situation.

Chapter **four** canvasses the policy behind excise tax design and administration. It makes a case for coordinating the various consumption taxes and striking a balance between specific and ad valorem excises. The chapter concludes with a discussion on the morality of excise duty.

Chapter **five**, which is the final chapter, makes recommendations for Uganda's excise legislation and policy guidelines. The chapter concludes with a summary of the contents of this dissertation.

## **CHAPTER ONE**

### **2. INTRODUCTION**

Taxation is part of public finance and its importance can not be over emphasized. Taxation enables governments to stabilize a country's economic situation through promoting economic development and providing expenditure for national needs.

It is a tool used by governments both to collect revenue, and to check consumption of harmful articles<sup>1</sup>, by discouraging socially damaging behaviour and helping to recover part of the attendant social costs. The 1995 Constitution of Uganda empowers the government to levy taxes<sup>2</sup> and to impose tax in the overall interest of the country<sup>3</sup>.

This chapter concentrates on objectives of taxation; criteria for evaluating a good tax system; the approach to taxation and the general effects of taxation

#### **2.1 DEFINITION OF TAXATION**

Taxation is defined as "...the imposition of duties for the raising of revenue".<sup>4</sup> It encompasses every charge or burden imposed by a sovereign upon a person's property right for use and support of the government.

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<sup>1</sup> N. A Saleemi, *Taxation Simplified* 4<sup>th</sup> edition at page 7 Published 2001 Nairobi Kenya

<sup>2</sup> Article 152 of the 1995 Constitution of Uganda.

<sup>3</sup> Ibid

<sup>4</sup> D. J Bakibinga, *"Revenue Law in Uganda"*, Professional Books Publishers, (2003) Kampala. Pg.1.

The Oxford Dictionary defines “tax” to mean –

*“a compulsory contribution to the support of government levied on persons, property, income, commodities, transactions etc, now at a fixed rate mostly proportionate to the amount on which contribution is levied.”<sup>5</sup>*

The above definition tells very little apart from the fact taxes are compulsory. The definition limits the purpose of taxation to the support of government expenditure. This is not wholly true since taxes are known to be levied with non-revenue objectives such as, use of customs duties to protect domestic industries and the use of taxes to discourage certain habits, for example, the heavy taxation on tobacco and cigarettes which is intended also to discourage smoking.

Prof Bakibinga notes that taxation is a device used by government to extract money or valuables from people and organizations by the use of law.<sup>6</sup> He further notes that taxation encompasses every charge or burden imposed by a sovereign upon persons and property rights for the use and support of government, thereby enabling it to support its functions and activities.

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<sup>5</sup> ( Emphasize added) Oxford Advanced Learners Dictionary Special price Edition

<sup>6</sup> Ibid



## **2.2 Theoretical Concepts of taxation**

The often asked question is the need for taxation in society. The classical answer to this question is that taxation is a handmaid for raising revenue to meet governmental expenditure. Imperatively, the government has to provide social services, maintain law and order, and ensure defence and a horde of other undertakings which the free market cannot provide by itself<sup>7</sup>. For example, health services and education.

In modern times, the theories and functions of taxation have been widely and broadly discussed. It is argued that it is impossible to regard taxes as merely a means of obtaining revenue since they may and are often used for more specific purposes such as discouraging the use of alcohol or as an inducement to production for the market as opposed to subsistence.<sup>8</sup>

## **2.3 Objectives of taxation**

An appraisal of a tax system must be predicted on a widely accepted set of goals or objectives that the nation is seeking, and on knowledge of the potential role that a tax system can play in the achievement of this goal. Every tax jurisdiction, including Uganda,

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<sup>7</sup> Sijbren Cnossen, The Economic of excise Taxation in the SADC countries by, paper prepared for the Southern Africa conference on Excise Taxation Centurion lake hotel, Gauteng South Africa 11<sup>th</sup>-13<sup>th</sup> June 2003

<sup>8</sup> Ibid

can have a set of objectives which may be different from those in other jurisdictions. But there are several objectives which at least every tax system seems to seek.

### **2.3.1 Need for Revenue**

The main purpose of imposing taxes is to raise income or revenue. Governments need money to maintain peace and security in the country; to increase social welfare; and to complete development project like roads, dams and power stations. In the end, taxes are considered among the major source of public revenue.

### **2.3.2 Mobilization of Capital Formation**

To forge economic development, a country must possess sufficient capital for purposes of investment. In this regard, taxation plays the role of mobilizing and accumulating capital from the general public and concentrating the same to the disposal by the government through investments in enterprises that are considered to be high economic priority. Taxation can be used as a means of attracting investors and funds for investments by giving attractive tax incentives<sup>9</sup>

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<sup>9</sup> Ibid

### **2.3.3 Allocation of Resources**

Taxation can be used to allocate resources to ventures or geographical areas that are considered underdeveloped. For example, by offering liberal expense –deductions in respect of agricultural and mining business,<sup>10</sup> investors maybe attracted to invest in such enterprises. Also, by taxing goods that are considered luxurious, it could be argued that government intends that the concentration is kept on the necessities.

### **2.3.4 Stabilization of the Economy**

Taxation can be used as a tool for economic stabilization in the country. During inflation, the Government imposes more taxes in order to discourage the unnecessary expenditure of the individuals. Similarly during deflation, taxes are reduced in order to enable the individuals to spend more money. In this way, it helps to check the big fluctuations in the prices and maintain economic stability<sup>11</sup>. This is a role served by taxation mostly in developed countries.

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<sup>10</sup> The Income Tax Act (1997) Cap 340, Section 35 & 36.

<sup>11</sup> Taxation simplified, N.A Saleemi 4<sup>th</sup> edition page 8

### **2.3.5 Distribution of Wealth**

In this respect taxation is used as a means of redistributing wealth, for instance, by attempting to reduce the gap between the rich and poor. Often, this is achieved through the use of progressive rate structure.<sup>12</sup> Taxation helps to check income inequalities through three main structures.<sup>13</sup> First, progressive taxes which increase with increasing incomes as is the case with income tax. Second, regressive taxes which decrease with increasing incomes as is the case with indirect taxes such as Value added Tax (VAT). Third proportional taxes which are neutral and are of a fixed percentage for all incomes,

It has been observed<sup>14</sup> that progressive taxation when combined with social security benefits and other elements of social expenditure, for instance on education and health, are designed to improve the relative position of poor members of society.

## **2.4 Criteria for Evaluating a Tax System**

Taxation is the basic instrument of fiscal policy.<sup>15</sup> In concert with its control over the money supply (that is, its monetary policy), the government aims to maintain the stability

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<sup>12</sup> Luoga F.D.A.M Makinyika, (Supra) Pg. 11

<sup>13</sup> D. J Bakibinga, (supra) Pg. 5.

<sup>14</sup> Ibid

<sup>15</sup> Microsoft ® Encarta ® Encyclopedia 2005 © 1993-2004 Microsoft Corporation.

of the economy.<sup>16</sup> Most democracies today derive their general notions of what constitutes a good tax system from four principles enunciated in the 18th century by the Scottish economist Adam Smith.<sup>17</sup>

In order for government to effectively benefit from imposition of any form or type of tax, it must ensure that the tax system is equitable and effective. Adam Smith in *The Wealth of Nations*<sup>18</sup> proposed certain criteria for evaluating tax systems. He stated that there are four canons of taxation.

#### 2.4.1 Certainty

The application of a tax should be clear and certain. This principle, considered very important by Smith, has often been underestimated in modern tax systems.<sup>19</sup> Where the application of taxes is uncertain and arbitrary the public can have no confidence in the system. The rationale for the requirement of certainty is to protect both the tax payer and government interests against the tax collector.<sup>20</sup>

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<sup>16</sup> Ibid

<sup>17</sup> Smith, A An inquiry into the nature and Causes of the Wealth of Nations (1776)

<sup>18</sup> Adam, Smith Ibid

<sup>19</sup> (In which open and impartial administration usually can be taken for granted). Microsoft ® Encarta ® Encyclopedia 2005 © 1993-2004 Microsoft Corporation.

<sup>20</sup> D. J Bakibinga, (supra) Pg. 6.

### 2.4.2 Convenience

Every tax ought to be levied at the time, or in the manner in which it is most likely to be convenient for the tax payer to pay. Government should, therefore, ensure that the tax payer shall at a given time be in a position to pay the assessed tax. For example, collection of income tax from employees through PAYE system and the withholding tax system on dividend and interest income earned by residents of Uganda as well as on other payments made by residents to non-residents<sup>21</sup> mark the importance of convenience. A tax should also be convenient to collect. Inconvenience in collecting graduated tax in Uganda was perhaps one of the reasons for its suspension in 2005.

### 2.4.3 Economical

This means that every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what brings into the public treasury of the state. Therefore, taxes ought to be economical in collecting, implementing and enforcing, if government is to effectively benefit from its fiscal policies.<sup>22</sup> Again, graduated tax serves as a good example in this regard. The costs of collection and implementation of this tax were considerably high given that government had to stage various implementation points.

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<sup>21</sup> See, The Income Tax Act (1997) Cap 340, Sections 63, 64, 116, 117, 118, 120 & 121.

<sup>22</sup> D. J Bakibinga, (supra) Pg. 7.

#### **2.4.4 Equality**

This means that the subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities, for instance, in proportion to the revenue which they respectively enjoy under the protection of the state.<sup>23</sup> Traditionally equity or equality is divided into two suits:-<sup>24</sup>

#### **2.4.5 Horizontal Equity**

This means that those in equal circumstances should be treated similarly. This requires that administrative arrangements should ensure that the tax does not impinge heavily on some transactions while exempting others. Similarly, the system ought not create bias such that the tax paid by the honest and those without effective tax advisors or those reluctant to reorganize their affairs so as to minimize their tax liabilities.

#### **2.4.6 Vertical Equity**

This is concerned with the burden imposed by tax rates. It is the principle that those in unequal circumstances should pay different amounts of tax. In distributing the tax burden the rate structure has to ensure that persons with comparatively high income pay more in taxes than those with low incomes.

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<sup>23</sup> Ibid

<sup>24</sup> Luoga F.D.A.M Makinyika, (Supra) Pg. 13.



## **2.5 Approaches to Taxation**

### **2.5.1 Expediency Approach<sup>25</sup>**

Generally every government imposes tax to fulfil its normal social obligations in the form of defence, maintenance of law and order and socio-economic development. Theoretically, tax policy is governed by the principles of equity, economic stability and economic growth; but in practice, it may be governed by the pressures which are exerted on the governments by different pressure groups. For example, taxes are in a number of instances imposed as a protective device and not as a revenue device. This is basically the principle that, nothing should stop the Government from taxing the behaviours it deems unhealthy.<sup>26</sup>

### **2.5.2 Cost Service Approach**

According to this theory, the basis for taxation should be the cost incurred by the Government on different services for the benefit of the individual tax-payers.<sup>27</sup> Each tax payer has to pay a tax equal to the cost of service to him. It means, the higher the cost, the higher should be the tax rate and vice-versa.

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<sup>25</sup> Ibid

<sup>26</sup> Article by Rev Robbert A Sirico 'Sin tax crazy whose next' also at [www.acton.org](http://www.acton.org)

<sup>27</sup> Alka Gupta, "*Public Finance and Tax Planning*," (2001) Anmol Publicatons PVT. Ltd. New Delhi (India) Pg. 68.



The Government acts like a producer of a commodity who charges the price from his customers equal to the amount of cost of production of the commodity. By adopting this approach, the government gives up its basic protective and welfare functions. Its only job is to recover the cost of the service. The state is not concerned with the problems of income distribution. No effort is made by the government to improve income distribution or no notice is taken of the policy of levying taxes according to the cost of service principle. This deteriorates income distribution further. If this approach is adopted, quite a few sources of public revenue will be ruled out like taxes on capital gains, unearned increments, gifts, expenditure, excise duties e.t.c.<sup>28</sup> Welfare activities including all sorts of relief activities will also be ruled out. This approach is not among those commonly adopted in developing countries.

## **2.6 Effects of Taxation**

Generally, governments levy taxes with the objective of either raising revenue; balancing and maintaining economic stability of the country; achieving equality in the distribution of the national income; protectioninig policies; and promoting social welfare through imposition of taxes on things which are considered harmful for human health.

Every tax system produces various types of consequences on production, distribution, consumption and the level of economic activity. Taxation is only a small element in the structure of rules and conventions which constitute the framework of modern economic

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<sup>28</sup> Ibid

systems.<sup>29</sup> Effects of taxation can be clearly apprehended only as phases of broad budgetary implications for modifying this framework in such a manner as to make the system more efficient and more secure.

Taxes which lower the efficiency of the taxpayers adversely affect their ability to work and hence production. When taxes are levied, they reduce the purchasing power of the people who are forced to cut down expenditure on necessities, comforts and luxuries<sup>30</sup>. Excise duties are among those taxes commonly levied with an aim of reducing consumption of what is considered luxurious. Because it is levied on luxuries, the assumption is that it should not, generally, negate the will to work.

Taxation is also used to encourage the production of certain commodities by restricting the production of others. It may be considered desirable either for efficiency or equity reasons, to restrict the consumption of certain goods by imposing selective taxes.<sup>31</sup> The general effect is, therefore to act in a protective nature. For instance, excise taxes can be used to constrain the production of goods that generate external costs such as pollution and alcoholism. Similarly, when protection is granted to certain domestic industries in the form of grants, bounties, import duties, tax concessions and exemptions, there is diversion of resources from non priority industries to the protected industries.

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<sup>29</sup> Alka Gupta, ( Supra) pg 68

<sup>30</sup> N. A Saleemi, Taxation simplified (Supra) at pg 40

<sup>31</sup> Alka Gupta., Public Finance and Tax Planning., Anmol Publications., Pvt . LTD-New Delhi(2001).174

Also tax has the effects of encouraging productive diversion of capital towards production goods sector. Excise duties encourage flow of resources into priority sectors of the economy of a developing country and prevent them from flowing into non priority sector. In any economy, the composition and pattern of production depends upon the allocation of resources, Excise tends to reallocate resources among different industries and regions by imposing a duty on some. Where tax concessions and exemptions are granted to industries, resources flow into them from those regions where the rates of taxation are high. Such diversion takes place in the form of establishment of new industries. This leads to the opening up and development of new regions which provide larger employment opportunities to the people, and increase production and income<sup>32</sup> which affects the composition and pattern of production.

Another effect of taxation is that it increases government revenue. The main purpose of collecting taxes is to permit increased government spending without inflation. However, this aim may be defeated by the fact that taxation may aggravate rather than alleviate inflationary pressures. An increase in taxes may be inflationary if it reduces the flow of goods more than that of the flow of money<sup>33</sup> as is the case with excise duty.

Though a tax may serve other purposes (as has been discussed above), it may also be used for planning. Connected with more general effects on production, are considerations of the cost of collections of taxation. Unnecessarily high costs of collection diminish the

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<sup>32</sup> N. A Saleemi (Supra pg 44)

<sup>33</sup> Benjamin Higgins., Economic Development- principles, Problems and Principles, 1<sup>st</sup> Edition., W. W Norton and Co. Inc. New York( 1959) 507

revenue generating capacity of taxation. It is perhaps for this reason that excise, which has fewer collection points (and thus lower costs) is famous in a number of economies.

## **2.7 CONCLUSION**

Tax powers are given to the government by the constitution of the country and the government can impose taxes in the overall interest of the country. Tax is an important source of public revenue which has both the objective of either administrative functions as the government needs funds, protective functions, development functions and social functions that the government provide social services like education, health and housing.

This chapter has illustrated that a tax system should be characterised with criteria such as certainty, equality, convenience and economical. The approaches that guide taxation have also been discussed with the conclusion that if not properly guided, a tax system may result in undesirable effects. The chapter that follows will discuss the economics of excise taxation, its imposition and the goods affected.

## CHAPTER 2

### ECONOMICS OF EXCISE TAXATION

#### 3. INTRODUCTION

The use of excise duty and controls on vice generally dates back before the founding of the Puritan new England was awash in laws attempting to control sin. The means of levying excise varied from taxes to outright prohibition. These were known as sumptuary laws; defined as the regulation of extravagance in food, dress, tobacco use, and drinking on religious and other grounds<sup>34</sup> in 1651, the magistrates and deputies of Massachusettes passed legislation forbidding the wearing of gold or silver lace, buttons, points at their knees and walking in great boots. Import taxes were also placed on luxury items including sugar, spice, wine and tobacco.

Presently, governments, through legislation, overcome intractable desires on the part of the consuming public by making people pay for actions socially costly or sinful. To this end, governments go beyond taxing only the individual who actually commits social cost (sin) and also tax the production and distribution of the good or services, in the anticipation that higher costs will be borne by both the consumers and the producer<sup>35</sup>.

Basically, the historical development and the classical objective of excise duty is to limit the consumption of luxurious goods, reduce the production and/ or the supply of dangerous goods by taxing “morally ambiguous activities” as the business of protecting its citizens, and to reduce the harm relating to consumption of dangerous goods. In many

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<sup>34</sup> North published 1988 at page 41-61, <http://www.acton.org> date visited 9<sup>th</sup> may 2006

<sup>35</sup> Robert A Sirico “The Sin Tax Economic and Moral considerations at [www.acton.org](http://www.acton.org)

developing countries, however, excise duties have commonly been used to raise revenue in view of expected slow economic growth<sup>36</sup>.

### 3.1 DEFINITION OF EXCISE DUTY

Alka Gupta defines excise duty to be a duty charged on the production or use of goods, whether meant for local consumption or export or on a licence to deal in certain products.<sup>37</sup> This means that excise is levied on a selective number of commodities and is fiscal in nature. It is an indirect form of taxation used by government to primarily contribute to the fiscals, but also in certain instances influence the behaviours of consumers.

In Australia,<sup>38</sup> the High Court has been divided in its approach to the definition of 'duties of excise'. Initially, such duties were confined to taxes on the production or manufacture of goods. This definition was gradually extended to include taxes on goods imposed at any point in the distribution process. Over time, the Court came to accept that exceptions should be made for taxes on alcohol, tobacco and petrol, and hence the States have been permitted to tax these goods.

In *Peterswald v Bartley*<sup>39</sup> the High Court considered whether a licence fee imposed by NSW on NSW brewers who manufactured beer for sale was an excise. Griffith CJ stated

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<sup>36</sup> The New Vision, Friday, June 16, 2006

<sup>37</sup> Alka Gupta, (Supra)

<sup>38</sup> <http://www.aph.gov.au/library> date visited 9th/05/2006

<sup>39</sup> [(1904) 1 CLR 497]

that the term 'duties of excise' means 'a duty analogous to a customs duty imposed upon goods both in relation to quantity or value when produced or manufactured, and not in the sense of a direct tax or personal tax'<sup>40</sup>. Here the license fee was not an excise since it did not relate to the quantity of beer produced. It was merely the means adopted by NSW to regulate the beer industry.

Excises broadly comprise all taxes on goods than general consumption taxes, such as Value Added Taxes (VAT), manufactures and retail sales taxes, and turnover taxes (hereafter referred to as consumption taxes)<sup>41</sup>. By this definition, excises include taxes on smoking, drinking alcohol, driving, polluting, luxury goods, and other goods and services selected for specific taxation. This wide definition would also include VAT rates in excess of standard rates applied to luxury goods. Clearly, this definition goes beyond the usual Anglo-Saxon description of excises as taxes imposed on the manufacture, sale or consumption of certain domestically manufactured goods.<sup>42</sup> Dr .D Mithani considers it as a tax or duty on homemade goods either in the process of their manufacture or before their sale to consumers<sup>43</sup>.

The examples indicate that the distinguishing features of excise taxes are selectivity in coverage, and, by implication, some form of discrimination in intent. Moreover, the basis for assessment often is some quantitative amount, for instance volume, weight or strength, to which a specific rate is applied. Exceptionally, excises

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<sup>40</sup> Ibid at (p. 509)

<sup>41</sup> Sijbren Cnossen, "*The Economics of Excise Taxation in SADC Countries*", (2003), Paper Prepared for the Southern African Conference on Excise Taxation Centurion Lake Hotel, Gauteng, South Africa 11-13 June 2003.

<sup>42</sup> Ibid

<sup>43</sup> Dr. D Mithani., Money, Banking, International Trade and Public Finance., Himalaya Publishing House (2001), 892

may also be levied at *ad valorem* rates applied to the value or price of products.<sup>44</sup> Although excises may be imposed at any stage of production and distribution chain, usually they are levied at the manufacture's stage, primarily because the basis for assessment and the high rates require some form of physical control over production.

In the case of *Ha and Hammond v NSW*, the plaintiffs were charged under the *Business Franchise Licences (Tobacco) Act 1987* (NSW) with selling tobacco without a licence. The Act provided for a licence fee, which included a set amount, plus an amount calculated by reference to the value of tobacco sold during the 'relevant period'. The 'relevant period' was defined as 'the month commencing 2 months before the commencement of the month in which the licence expires'. The plaintiffs argued that the licence fee imposed by the Act was an excise and hence invalid due to section 90 of the Constitution.<sup>45</sup>

Counsel for NSW submitted that the licence fees payable under the Act were not duties of excise because:

- Liability does not attach to the manufacture or production of tobacco in Australia; and such fees are merely a licence to carry on the business of selling tobacco, not a tax on tobacco itself.

It was held in this case that: "*Duties of excise are taxes on the production, manufacture, sale or distribution of goods, whether of foreign or domestic origin. Duties of excise are*

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<sup>44</sup> Ibid

<sup>45</sup> Section 90 provides in part: "On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and excise, and to grant bounties on the production or export of goods, shall become exclusive".



*inland taxes in contradistinction from duties of customs which are taxes on the importation of goods. Both are taxes on goods, that is to say, they are taxes on some step taken in dealing with goods”.*

## **3.2 KINDS OF EXCISE DUTY**

There are several kinds of excise duty, with three main classifications:

### **3.2.1 Basic Excise Duties**

This kind of excise is levied and collected by the central Government. The proceeds of this excise duty are divided between the central Government and the local Government.<sup>5</sup> Examples in Uganda are excise on beer, tobacco and airtime.

### **3.2.2 Earmarked Cesses**

These are levied under special laws for special purposes. The entire proceeds of earmarked cesses are assigned to the Government. Examples of these are the cotton cess paid to the Cotton Development Authority under the Cotton Development Act.

### **3.2.3 Addition Duties of Excise in Lieu of Sales Tax**

Addition excise duties are levied by the Government on textiles, tobacco and sugar. These duties are in addition to the basic duties of excise and any other duty, which are expressed under the Custom and Excise Duty Act.

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<sup>5</sup> Public Finance and Planning

It should be noted that these addition duty of Excise are levied in lieu of Sales Tax which would have been levied by the government on other commodities<sup>6</sup>. It is not clear that we have this form of excise duty in Uganda.

### **3.3 Imposing of excise duty and the goods affected**

The structure, collection and administration of excise duty in Uganda is governed by the Excise Tariff Act (cap 338) as amended and the East Africa Excise Management Act (cap26) as amended.

The Excise Tariff Act (cap 338) under section 3(1) provides for the imposition of excise duty. The section provides that excise duty shall be charged in respect of manufacture in Uganda of the goods specified by the schedule to the Act; and the excise duties shall be levied, collected and paid in accordance with the Management Act.

The goods and services that are subject to excise tax in Uganda includes, soda, alcoholic beverages (such as wine, spirits and Beer) cigars, soft cup, hinge lid and all smoking tobacco (whether or not containing tobacco substitutes in any proportion), cement, sugar, fuel, greases,<sup>46</sup> airtime, land lines and public pay phone, sacks and bags, cane or beat sugar, mineral water, bottled water and other water purposely for drinking.<sup>47</sup>

The excise legislation is administered by the Commissioner-General of Uganda Revenue Authority through the Commissioner for Customs and Excise. Excisable goods

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<sup>6</sup> Ibid

<sup>46</sup> 1992/93 Integrated Household Survey and Data from the Ministry of Finance., Planning and Economic Development.

<sup>47</sup>The Excise tariff (amendment act) 2005

may be increased or reduced depending on the demands of the economy and government policy, but in most developing countries, excise duties offer a fairly fertile field to expand revenue system<sup>48</sup>. Thus, for instance, the Ugandan government had to raise revenue through increase of excise duty on some goods in the 2006 financial year in view of expected slow economic growth<sup>49</sup>. The Minister<sup>50</sup> had to increase excise duty amongst other taxes in order to raise Uganda shillings, 20.5 billion<sup>51</sup>. According to the Minister, the slow down in economic growth which was largely attributed to two domestic shocks: the prolonged drought, which affected agricultural production and the reduction in hydro-electricity generation capacity<sup>52</sup>. The almost yearly changes and increases of excise duty in Uganda can be illustrated in the table below.

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<sup>48</sup> N. A Saleemi, *Taxation simplified* at page 332, 4<sup>th</sup> edition 2001 Nairobi Kenya,

<sup>49</sup> The Government last year (2006) due to slower economic growth forced the Minister to raise excise duty on non malt Beer to 30% from 20%, 10%on bottled water and 5%on landlines also at The new vision 16<sup>th</sup> June 2006

<sup>50</sup> Dr Ezra Suruma, *Minister of Finance, Planning and Economic Development*. Bills Supplement, to the Uganda Gazette No: 39 Volume xcix dated 30<sup>th</sup> June, 2006.

<sup>51</sup> Ibid

<sup>52</sup> The New Vision, Friday, June 16, 2006. Pg. 1

# ILLUSTRATION OF EXCISE DUTY RATES UNDER THE EXCISE TARIFF ACT AND AMENDMENTS THERETO

No.	Item	1954 Excise Tariff Act Cap 174	2002 Excise Tariff (Amendment) Act	2003 Excise Tariff (Amendment) Act	2005 Excise Tariff (Amendment) Act	2006 Excise Tariff Bill
1. Beer	a) made from malt	Per 36 standard gallon of worts			60%	60%
	b) whose local raw material is atleast 75%	288 00		20%	20%	30%
2. Spirits	Spirits	Per proof gallon 170 00			60%	60%
3. Wine	a) from locally produced raw materials	a) still 6 00		20%	20%	20%
	b) other	18 00			70%	70%
4. Airtime	airtime		7%	10%	12%	12%
5. Landline & public payphones						5%
5. Waters	Including mineral waters and aerated waters	Per imperial gallon - 80			13%	13%
6. Mineral water	Bottled water and other water purposely for drinking	- 80				10%
6. Tobacco products	Including cigars, soft cup, smoke tobacco and other cigarette brands	Per pound 14 00 Per mille weight exceeds 1.75lb at 16 00. others 11 00			150% or Shs. 19,000 to 48,000 per 1,000 sticks	150% or Shs 19,000 to 48,000 per 1,000 sticks
7. Fuel	Including motor spirit, gas oil, illuminating kerosene				Between Shs. 200 and 720 per litre	Between Shs 200 and 720 per litre

8. Cane or beet sugar		Per 100 weight 20 16			Shs. 50 per kg	Shs. 50 per kg
9. Cane or beet sugar for industrial use						0%
9. Imported sacks and bags of polymers					50%	10%
10. Cement						Shs. 500 per 50kg

It is evident from the above table that certain items (notably beer and mobile phone air time) have experienced yearly increments in the excise duty rates. An explanation for this could be that they are considered luxurious (airtime) or harmful to healthy (beer).

### 3.4 ECONOMICS OF EXCISE DUTY

To understand the economic consequences of excise duty, we must temporarily leave aside the morality or immorality of the good or service being taxed. In economic terms, the excise duty is not categorically different from any tax designed to discourage consumption.<sup>53</sup> These taxes constitute one or both of two major types of government intervention: binary or triangular.<sup>54</sup>

In binary intervention,<sup>55</sup> the government deals directly with the individual in society and not with a third party. The income tax is a good example of this. The government, for example, establishes a rule that every individual must give up 30 percent (or less depending on one's tax bracket) of personal income to the public purse, which then turns it over to those deemed in need.

Excise duty can be binary.<sup>56</sup> The state can tell every person who smokes, drinks, or engages in other vices that he or she must pay a fixed price for that action to the public purse. The state can mandate all smokers to pay the state Ush. 500 per year for the privilege of smoking and Ush. 500 per year for moderate drinking. Only two parties are

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<sup>53</sup> <http://www.acton.org> date visited 9<sup>th</sup>/05/2006

<sup>54</sup> Rothbard, Murray, "*Power & Marke*",. Kansas City: Sheed Andrews and McMeel, Inc., 1970. 24-202.

<sup>55</sup> <http://www.acton.org> date visited 9<sup>th</sup>/05/2006

<sup>56</sup> Ibid

affected in this exchange: the individual taxed, who must bear the burden, and the government, which benefits from increased revenue.

For triangular intervention, three parties are affected in the forced transaction:<sup>57</sup> the producer/ distributor; the consumer, and the receiver of revenue. If the producer or distributor intends to generate the same level of sales, he or she must cut back on other areas of the business. For example, if the government taxes beer sold in supermarkets, if the store loses sales and profits, it will then have to cut back on other expenditures in inventory or wages. And if beer sales, for instance, are a substantial part of revenue, it is conceivable that this tax could lead to a cut in employment itself. If this same sin tax is levied at all points along the structure of production-on the hops producers, the beer makers, the beer distributors-jobs will probably be lost at every step of the production and distribution process.

The effect of the Excise duty cannot be measured or predicted by its percentage of the overall retail price of the good or service. It must be measured by the way consumers respond to price changes, which differs from person to person. If demand is low, a high tax will have less startling effects in terms of creating underground markets.<sup>58</sup>

If government imposes high costs on a good that consumer's desire, consumers will attempt to find ways to feed their personal desires at low cost. This propensity will make any form of Excise duty backfire in terms of its overall impact on sin itself. If cigarettes are taxed at a high rate, some consumers might turn to cigarettes that have higher nicotine

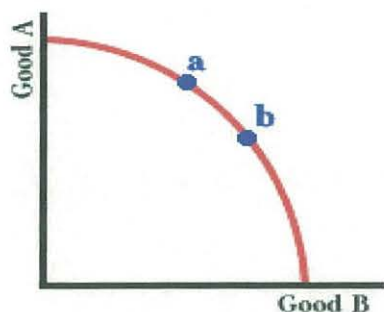
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<sup>57</sup> <http://www.acton.org> date visited 9<sup>th</sup>/05/2006

<sup>58</sup> Ibid

content, including those that are unfiltered. If wine is taxed excessively, wines of higher alcohol potency become more desirable than those of lower potency.

### 3.4.1 Economical welfare cost of an excise tax



**Excise taxes or subsidies shift an economy along its production-possibilities frontier.**

The loss of value that an excise tax can cause, in the economical consequences can also be illustrated from the graph of supply and demand above<sup>59</sup>, as with the production-possibilities frontier in the graph below. Suppose that initially the society is at point **a'** and that this point is economically efficient. Now suppose that the government collects revenue by placing a tax on good **A** but not on good **B** and then returns it to the citizens. The introduction of the tax will reduce the amount of good **A** that people will buy relative to the amount of good **B** because, with the tax, the price of **A** has risen relative to **B**. Hence, people will shift from point **a** to point **b** on the graph. But point **a** was economically efficient--not point **b**.

<sup>59</sup> <http://ingrimayne.com/econ/government/rent seeking.html>



As from the above point of view, the price system is a method of communicating information. The system works efficiently only when the information that is communicated is accurate. Taxes can distort the signals that prices carry so that they no longer correctly describe the costs and benefits that various decisions have for society as a whole. Hence, they can distort decisions as well.

Note that the welfare costs of a tax are not the same as the resources that the government uses to collect revenue or the resources that the private sector uses to comply with the tax laws. These are costs in addition to the welfare cost of taxes illustrated above.

Economical consequences also in small changes in the tobacco tax at the Government level can result to a large-scale interstate smuggling.<sup>60</sup> Canada's experience with cigarette taxes provides a poignant case.<sup>61</sup> In this case, the informal-market cigarettes were sold to the public in rented warehouses and homes at a rate approximately half the price of the official market. In February 1994, this led to an actual shoot-out between the Indians and the government.<sup>62</sup> As sensible as the reduction of the tax seems, anti-smoking groups in the United States immediately denounced the Canadian government for the change. These people had high hopes that the problems associated with Canada's high taxes were solely due to the discrepancy with the United States, a discrepancy that could only be remedied by vastly increasing the American tobacco tax.<sup>63</sup>

When the Canadian government lowered the tobacco tax, it did not admit that the real reason had to do with the violence and social chaos it caused. It said the change was in

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<sup>60</sup> Thornton, Mark. *The Economics of Prohibition*. Salt Lake City: The University of Utah Press, 1991.

<sup>61</sup> <http://www.acton.org> date visited 9<sup>th</sup>/05/2006sss

<sup>62</sup> Ibid

<sup>63</sup> Washington Post, Jan. 12, 1994

the interest of raising more revenue, a perfectly understandable rationale as well. If a good portion of the market went underground, the state would indeed lose substantial revenue.

Under Excise duty, the state finds itself in the peculiar and contradictory position of professing to discourage certain behaviors while relying on their continuance as a source of revenue.

The politicians and bureaucrats charged with drawing up and enforcing the policy are caught in a moral hazard.<sup>64</sup> What if it costs less to pay the advertising budgets of liquor and tobacco companies than to lose revenue from lost sales? In other words, it might eventually be beneficial to the government to actively promote the product it is taxing.

### **3.5 Conclusion**

In economic terms, excise duty is not categorically different from any tax designed to discourage consumption. Excise constitutes one or both of two major types of government intervention in which the government either deals directly with the individual in society and not with a third party; or a triangular form of intervention where a third party comes into the equation.

However, as explained in this paragraph, the impact of this tax either on consumption or on its collection depends largely on the elasticity or demand of a certain product. For example even relatively small changes in the tobacco tax at the state level have resulted

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<sup>64</sup> Ibid.

in large- scaled interstate smuggling thereby reducing government revenues. This raises another peculiar aspect of the sin tax. It is contradictory at its very heart. At some point in the “revenue curve” the tax will tend to reduce rather than increase government income, especially when people choose informal means of getting the desired product. When that occurs, it defeats a major purpose of the excise duty of raising revenue in the first place. On the other hand, increasing revenue might actually require propaganda to induce people to continue consuming.

## **CHAPTER THREE**

### **RATIONALE FOR EXCISE TAXATION**

#### **4. INTRODUCTION**

Generally, taxes on goods and services are used for generating revenue, providing temporary protection to industry, and improving efficiency in resource allocation. In assigning these roles to the various taxes, it is important that they are used consistently in relation to the specified ends. Ideally, each tax should be used for one goal only, although in practice there are often more goals than instruments available.

The effect of an instrument may not be fully predictable, or it may be used so intensively that it reverses direction. This chapter discusses the role of excise taxation in raising government revenue; accounting for social costs; discouraging consumption; charging for road usage; and promoting progressivity in taxation.

#### **4.1 Relationship with consumption taxes and import duties**

There is a general agreement that the main revenue-generating role in a system of taxes on goods and services should be assigned to a general, broad-based, neutral consumption tax.<sup>65</sup> This implies that all goods and services, except those specifically exempted from

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<sup>65</sup> Sijbren Cnossen, (Supra)

social or administrative reasons, should be taxed at a uniform *ad valorem* rate.<sup>66</sup> Ad Valorem Excise duties are levied on certain locally manufactured non-essential / luxury products with a corresponding Ad Valorem Customs Duty (at the same rate of duty) on imported goods of the same class or kind. The duty is assessed on the value of such excisable products consumed locally and such products include, amongst others, motor vehicles, cell phones, gaming and vending machines, cosmetics and television receivers.<sup>67</sup>

Neutrality in respect of such consumption tax means that tax cascading,<sup>68</sup> i.e. the taxation of successive stages of production and distribution (without an offset for taxes paid in previous stages), should be avoided and that imports should be taxed at the same rate as domestically produced goods. Since a consumption tax is collected on a current basis, say, monthly, its revenue-generating capacity is not affected by inflation and the effect of rate changes on revenue is immediately visible. The rapid rise of the most widely used consumption tax throughout the world including Uganda, i.e. VAT, indicates that these considerations are increasingly being appreciated.<sup>69</sup>

In theory, import duties should not be used as a major tax revenue source, because of their non-neutral effects. In practice, however, such a duty has a role if no other

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<sup>66</sup> *Ad valorem* excise duty is levied on certain luxury or non-essential items calculated on the wholesale selling price which include products such as leather and fur, certain domestic appliances, telephone hand sets, fax machines, loudspeakers and amplifiers e.t.c. Ad-valorem customs duties on imported products of the same class or kind is a contra duty which is payable on such imported products. These duties are levied for fiscal reasons.

<sup>67</sup> Taxation in South Africa, 2005/06 at <http://www.sars.gov.za>

<sup>68</sup> Sijbren Cnossen, (Supra)

<sup>69</sup> VAT was introduced in Uganda in the 1996/97 Financial year.

convenient tax handle is available and a basic level of protection is justified. For revenue purposes, the import duty should be levied at a uniform, *ad valorem* rate on all imports. As such, it would have similar revenue-generating properties as a consumption tax: it would be collected without lags and an adjustment of the rate would immediately translate into more to provide protection to domestic industries that the government wishes to encourage.<sup>70</sup>

Therefore, the latter duties would not have an important role in raising revenue. Rather they should be reduced over time as the protected industries mature and are able to compete successfully in comparison with other industries elsewhere. Excises combine the revenue role of consumption tax and the resource allocation role of import duties, albeit in a different fashion.<sup>71</sup>

Excises on selective products, such as tobacco, alcohol and mineral oils, have proven to be very productive sources of revenue. Efficiency in resource allocation is promoted if the excises are designed to internalize the social cost of the production or consumption of the products on which they are imposed. In the absence of effective income and property taxes, moreover, excises on luxury goods, considered proxies for tax paying capacity, may have a role in improving the progressivity of the tax system.<sup>72</sup>

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<sup>70</sup> Differences in product regulations and standard for health or safety reasons, environmental or consumer protection have effects equivalent to differential import duties.

<sup>71</sup> Sijbren Cnossen, (Supra)

<sup>72</sup> Ibid

Since excises do not have a protective function (which is performed by import duty), it is important that imports are included in the domestic base and that the same rate applies to them. Of course, the real world is not as nicely structured as the foregoing appears to imply.<sup>73</sup> Apart from design features, the efficacy of each type of tax in attaining the goal for which it is intended is heavily conditioned by the nature and quality of the tax administration system.

Excises (and customs duties) rely mainly on physical controls, installed at convenient bottlenecks, be it factory gates, ports or border crossings. Goods are simply not released until duty has been paid. This is evident in Uganda's Excise Tariff Act which requires excise to be charged on the ex- factory price and requiring those manufacturing excise. In contrast, consumption taxes require greater sophistication in administration since they rely basically on voluntary compliance and accounting controls.<sup>74</sup> Therefore, unless enforcement is strictly maintained, returns may not be forthcoming and payment arrears arise. The administrative features are important in appreciating the revenue role of the various taxes on goods and services.

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<sup>73</sup> Ibid

<sup>74</sup> Ibid

## 4.2 Revenue Importance of Excise Taxes

Noteworthy is that excise contribute a greater share of total revenue than consumption taxes or import duties (often the favourite tax handle in developing countries including Uganda<sup>75</sup>). This is all the more significant if in some countries<sup>76</sup> the consumption tax amounts to little more than a supplementary import duty because there is no local production of the taxed items or such production is exempted. The same point can be made by comparing the yields of excises with consumption taxes relating to the domestic base. Often, the revenue from that part of the consumption tax levied directly on domestic production is not nearly as great as receipts from single traditional excise goods, such as tobacco or mineral oil. Furthermore, in many countries,<sup>77</sup> consumption tax collections derive mainly from typical excise goods, which demonstrate further how small the domestic consumption tax base is in these countries.

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<sup>75</sup> (Emphasize added) 'the growth of this tax was influenced by better controls, better service by the URA as a whole and increased effort by staff by Mr Justin Zake (Deputy Commissioner General-Revenue) "Revenews staff magazine Vol. 4 NO.1 July-December,2003, also the financial year 2002/03 was 100.1% performance of the Customs and Excise Mrs. Allen Kagina, Commissioner Customs and Excise. Excise duty therefore even at a low rates on essential goods produce large amount of revenue, and enable the government to expand the revenue system without encountering impossible administrative problems. N.A Saleemi (Supra)

<sup>76</sup> Ibid

<sup>77</sup> Sijbren Cnossen, (Supra)



### 4.3 RATIONALE FOR EXCISE TAXATION

The following objectives can be identified in relation to the use of excise taxes:<sup>78</sup>

- 4.3.1 To raise revenue for general purposes;
- 4.3.2 Accounting for Social Costs and Discouraging Consumption;
- 4.3.3 Charging for Road Use and Congestion;
- 4.3.4 Promoting progressivity in taxation.

#### 4.3.1 Raising Revenue

In practice, most excises have probably been enacted for revenue purposes, the main consideration being that they could be administered more easily than other taxes. Excises on tobacco, alcohol, petrol and motor vehicles are good potential sources of revenue, because the products are easy to identify, the volume of sales is high, and the fact that there are few producers simplifies collection. Also, demand is relatively inelastic and there are few substitutes that consumers would find equally satisfactory, so that consumption remains high despite excise induced price rises.

The low price elasticity of demand of the products mentioned above implies that the potential for distortion of economic decisions by the imposition of excise taxes is relatively small.<sup>79</sup> More, generally, economic theory prescribes that as long as goods are unrelated in consumption, tax rates should be higher on the ground with the lowest

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<sup>78</sup> Faculty of Economics and Business Administration, University of Maastricht, and Centre for economic Policy (OCFEB), Erasmus University Rotterdam, The Netherlands.

<sup>79</sup> Ibid.

elasticity. This is known as the Ramsey (1927) rule which prescribes that tax rates should be inversely proportional to elasticities of demand (holding elasticities of supply constant).<sup>80</sup> Hence, efficient taxation requires that relatively high rates of tax be levied on relatively inelastic goods; in other words, goods with no substitutes (unless these are included in the base).

*Prima facie*, therefore, most excises appear to be efficient taxes. As an extension to Ramsey rule, moreover, Corlett and Hague<sup>81</sup> have proven that, since leisure cannot be taxed, efficient taxation requires taxing products that are consumed jointly with leisure at relatively high rate. As a result, the second-best situation in which leisure would be taxed and a general, equal rate, consumption tax would be equivalent to a lump sum tax without excess burden. Therefore if cigarettes and beer or, perhaps more likely, pleasure boats, are compliments to leisure, then taxing them improves resource allocation.

Furthermore, the collection efficiency of the excises is also high. The tax base is obvious, readily understood by the tax official and the tax payer, and generally not susceptible to varying interpretations by either party. In Uganda, for example, the companies with the financial responsibility to remit excise to the URA are those that have generally been known to be tax compliant (e.g telecommunication and beer industries), thereby increasing its efficiency.

The tax liability usually leaves little room for argument. This compares favourably with the provisions of income and consumption tax laws, relative to conditions in

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<sup>80</sup> Sijbren Cnossen, (Supra)

<sup>81</sup> (1953) Ibid

developing countries, are often unclear, overly sophisticated and insufficiently attuned to business practices.<sup>82</sup> Also, enforcement is straight forward. Basically, excise personnel guarding factories, simply weigh, count or establish the strength of products presented for clearance and apply a fixed monetary amount to determine the tax liability. In principle, goods are not released until the duty has been paid and there are no collection arrears. Tax payers play a relatively passive role, and only minimal records have to be maintained. As a result, collection and compliance costs are minimal. This description applies to most excises with the notable exception of luxury taxes.<sup>83</sup>

#### **4.3.2 Accounting for Social Costs and Discouraging Consumption**

Excises are often rationalised as charges for the social or external cost consumers of excisable products impose on others. To be sure, social costs do not include the damage that consumers inflict upon themselves. After all, the principle of consumer sovereignty implies that a rational person who weighs up all the costs and benefits of his actions should be free to smoke, drink, drive, and pollute as long as he is fully informed about the consequences of his choice for him or herself.<sup>84</sup> However, physical, financial and psychological costs imposed on others should be accounted for in price if they cannot be charged directly or indirectly (e.g. through higher insurance premiums) to the perpetrators.

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<sup>82</sup> Sijbren Cnossen, (Supra)

<sup>83</sup> Ibid

<sup>84</sup> Faculty of Economics and Business Administration, University of Maastricht, and Centre for economic Policy (OCFEB), Erasmus University Rotterdam, The Netherlands.

Along with information failures, the existence of social costs establishes a case for government intervention, among others through taxation. Once social costs have been identified and measured, the Pigouvian<sup>85</sup> prescription for taxation is clear.

Efficient consumption can be achieved through the tax system by imposing an excise on the activity equal to the marginal cost of the damage caused to other people. However, identification and measurement of marginal costs are very difficult.<sup>86</sup> In most cases, the true social cost depends on who does what, where, and under what circumstances. Obviously, this kind of information is not available. In practice, therefore, a pooling' approach (similar to insurance) is adopted in charging for the social costs.<sup>87</sup>

Perpetrators as a group meet the costs by paying uniform excise calculated as the total social costs divided by the number of cigarettes, drink, e.t.c.<sup>88</sup> consumed. Necessarily, then, the average social damage is estimated rather than the marginal social cost discussed in theory. This seems acceptable if damage, e.g. through smoking, is approximately proportional to cost. However, if there are thresholds levels of consumption below which adverse effects are absent (one or two glasses of wine per day are good for you) or attenuated, then Pigouvian taxes should exceed average social cost.<sup>89</sup>

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<sup>85</sup> Sijbren Cnossen, (Supra).

<sup>86</sup> Faculty of Economics and Business Administration, University of Maastricht, and Centre for economic Policy (OCFEB), Erasmus University Rotterdam, The Netherlands.

<sup>87</sup> Sijbren Cnossen, (Supra).

<sup>88</sup> Faculty of Economics and Business Administration, University of Maastricht, and Centre for economic Policy (OCFEB), Erasmus University Rotterdam, The Netherlands.

<sup>89</sup> Sijbren Cnossen, (Supra).

In practice, in the case of tobacco and alcohol, researchers have measured social cost by using healthcare utilisation rates to forecast the incremental health expenditures for the current generation of smokers and drinkers.<sup>90</sup>

Information failures and myopia are instances which justify government intervention, even in the absence of explicit social costs. *Prima facie*, taxation would be a poor instrument, because these problems are best addressed through prominent warning labels and the dissemination of information about health hazards through the media. Higher taxes seem particularly effective, however, in reducing the incidence of smoking and drinking among teenagers. However, as will be discussed later in this paper, higher taxes in themselves may not achieve the intended objective.

#### **4.3.3 Charging for Road Use and Congestion**

Road (and similar transport) services resemble goods produced in the private sector that are used optimally when their price, commonly referred to as the economic user charge, equals the costs of operating the road network.<sup>91</sup> Road user charges should contain charges for efficient road use, congestion and road damage, as well as charges for other externalities, such as pollution, noise and accidents, the VAT and additional taxes for revenue or equity reasons. Road user charges can be set to cover the total costs of operating the road network or the difference between the marginal social cost and the average private cost of road use.

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<sup>90</sup> Ibid.

<sup>91</sup> Sijbren Cnossen, (Supra).

The major forms of road user charges and taxes that are used in Uganda comprise taxes on fuel, taxes on motor vehicle purchases, environmental levy on used cars older than eight years and license fees.

Diesel fuel is cheaper than petrol in Uganda, although diesel delivers more kilometres to the litre and should therefore be taxed higher instead of lower than petrol. A relatively lower tax on diesel fuel may be justified, however, when governments want to promote the commercial transport of e.g. rural crops or use it to promote distributional goals since diesel is used in bus transportation, for instance. Moreover, the (partial) exemption of diesel fuel for agricultural and industrial purposes might be the source of administrative problems.

This is a clear case where trade-offs must be made between efficiency, equity and feasibility. Finally, fuel taxes may play some role as congestion charges if set higher in urban centres, but there are obvious limitations to the extent they can differ between areas. Moreover, a fuel tax cannot distinguish between peak and off-peak times of day.

While fuel taxes may be a fair proxy for the variable maintenance charge associated with the use of paved roads, excises (including consumption taxes) on motor vehicles, tires and spare parts are probably a better proxy for distinguishing between types of road. In particular, tire excises come close to measuring the relative variable maintenance costs of different road surfaces, but excises that increase the depreciable costs of a vehicle would

also work in the right direction, because depreciation per vehicle/kilometre increases from paved to gravel to earth roads.

On the other hand, these excises are unsuitable as congestion charges, and the absolute amount that can be imposed on tires, for instance, is obviously limited on the assumption that the incentive to engage in contraband production and smuggling increases the higher the duty. High excises would also induce longer use of vehicles which is likely to increase maintenance costs and the number of traffic accidents.

Whatever the reason for the high automotive taxes, the pattern of economic user charges should still be an important concern.<sup>92</sup> Perhaps more can be done to improve the design of road user charges and taxes to promote resource allocation without reducing revenue below current levels, without altering the impact of the tax system, and in most cases without increasing administrative costs. Further efforts to improve the process of identifying objectives and their relationship to alternative forms of excise taxation in the motoring field seem worthwhile.

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<sup>92</sup> Faculty of Economics and Business Administration, University of Maastricht, and Centre for economic Policy (OCFEB), Erasmus University Rotterdam, The Netherlands.

#### 4.3.4 Promoting Progressivity in Taxation

Historically, excises have been reviled, often vehemently, for falling more heavily on the poor than on the rich.<sup>93</sup> This was certainly true for the age old duty on salt, abolished long ago, and it still is for the sugar excise. Excises on tobacco products and popular alcoholic beverages also exhibit a very regressive burden distribution.

Some progressivity, however, may be achieved through the higher-than-average taxation of liquors, expensive clothes (furs), cosmetics, perfumery, electrical appliances, air-conditioning units, photographic equipment, passenger cars, foreign travel, hotel rooms, restaurant meals, admissions, gambling, and club dues. This may not translate into the same outcome for the Ugandan situation, which, as shall be discussed later, commonly affects goods consumed by the poor.

The heavy taxation of items regarded as luxuries may be achieved through higher-than-standard consumption tax rates or through separate excises. The central issue is whether the game of taxing luxury goods is worth the candle.

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<sup>93</sup> Ibid.



#### 4.4 THE RATIONALE OF TAXATION AS IT REFLECTS TO UGANDA

Considerable effort and attention in most developing countries is devoted to policies best suited to the promotion of economic development, where the major focus of these efforts is the search for desirable fiscal policies with considerable emphasis being placed on the role of taxation as an instrument of economic development. Taxation policy has always been an important instrument for augmenting revenue. This is as true in developing countries as in developed countries, where tax revenue is the major source of domestic revenue. Thus the most important motivation for fiscal policy in most developing countries is the need to raise revenue<sup>94</sup>.

In Uganda, as has been discussed above, excise is used for a number of reasons. Like many developing country economies, excise has been an important source of revenue for the Ugandan government. The government similarly imposes excise as a measure to reduce the consumption of goods it considers socially costly (such as cigarettes) and those perceived to be luxurious (such as mobile phone airtime). Whether the intended purpose is achieved by government, is of course an issue of debate; but at least thus far, government has been able to collect considerable revenues from excise. Below is an illustration on the revenue performance of excise

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<sup>94</sup> Joweri M Teera, Determinants of tax revenue share in Uganda, see [www.google.co.ug](http://www.google.co.ug) date of visit 18<sup>th</sup> December, 2006

ILLUSTRATION ON REVENUE PERFORMANCE 2000/2001-2002/2003 BILLION UGANDA  
SHILLINGS<sup>95</sup>

THE REVENUE PERFORMANCE OF EXCISE DUTY AND ITS CONTRIBUTION IN MILLIONS  
UGANDA SHILLINGS<sup>96</sup>

FISCAL YEAR	2000/2001	2001/2002	2002/2003
TOTAL REVENUE	1,075.15	1,212.47	1,409.25
INDIRECT DOMESTIC TAXES	276.02	329.68	357.65
1. EXCISE LOCAL	101.27	116.25	113.24
a) Cigarettes	27.19	29.45	30.42
b) Beer	62.02	64.53	53.45
c) Ug . Waragi /Spirits	1.64	2.35	3.74
d) Soft drinks	10.42	10.77	12.33
e)Phone talk time	0.00	9.15	13.29
f) Others( Locally produced)	0.00	9.15	13.29

Source Uganda Revenue Authority, staff magazine (revenews) VOL.4 NO: 1 July-December, 2003

The table above illustrates that in 2002/2003 local excises contributed up to 8% of total revenues. With the increase in the rate of excise duty on items such as cigarettes, beer, mobile phone airtime, and the recent introduction of excise on landlines and mineral water, it is likely that the percentage will be up by more than 5%, illustrating its revenue

<sup>95</sup> Revenews Staff Magazine( Supra) pg 13

<sup>96</sup> Ibid

collection function. Cigarettes are perhaps by far the largest contributors to excise as shown in the table below.

TABLE 3:

	2000/2001	2001/2002	2002/2003	2003/2004
Excise duty	101.27	116.25	113.24	128.56
Cigarettes	27.19	29.45	30.42	31.90
Contribution	26.85	25.33	26.86	24.81

Source URA and computation of different authors<sup>97</sup>

Excise duty is applied on a list of selected domestically produced goods as a way of protecting local industries which produce similar goods or import substitutes or on imports which are luxurious in the eyes of government mainly to raise revenue<sup>98</sup>. Thus over 80% of excise is collected from four items; beer, cigarettes; mobile airtime; and soft drinks.<sup>99</sup>

<sup>97</sup> Obwona, Waswa, and Victoria Nabwaayo, Taxation of the tobacco industry in Uganda: The case for excise duty on Cigarettes; - Economic Policy Research Centre (EPRC); November 2005

<sup>98</sup> Christopher Kiwanuka Kaweesa, Taxation and Investment in Uganda, Structure and trend, a presentation to the business forum in London, UK for investment opportunity in Uganda May2004 also see

[www.ugrevenue.com](http://www.ugrevenue.com)

<sup>99</sup> Ibid

## 4.5 CONCLUSION

Excise duty serves multiple purposes, as has been discussed in this chapter. To begin with, like most other taxes, excise duty is a source of government revenue, and one that has been greatly used by developing economies in an attempt to fill the fiscal deficit. Secondly, excise is used as a means of discouraging consumption of goods, commonly perceived as harmful such as cigarettes and alcohol. Thirdly, the use of excise as a charge for road use and congestion is one that is not atypical to many economies. And lastly, excise (though not very successful in developing economies in this regard) is also commonly used to promote progressivity taxation.

In conclusion, this chapter has expressed the importance of excise duty (especially to government). The chapter that follows will contain a discussion on excise tax design, policy, administration, and the morality of excise tax.

## CHAPTR 4

### EXCISE TAX DESIGN. POLICY, ADMINISTRATION AND THE MORALITY OF EXCISE TAX

#### 5. INTRODUCTION

Many countries tax items considered either luxurious or harmful, such as tobacco, alcohol and mobile phone airtime<sup>100</sup>. The health benefits of curbing the demand for these items may go beyond eliminating the health consequences and their impact on government revenue streams and administration efforts<sup>101</sup>.

As background to the discussion, this chapter looks at the policy behind excise tax design, administration and the morality of the excise duty which reflects the arguments for the government on imposing excise duty. While excise is a potential source of government revenue, if it does not have a strong policy background, its imposition can have adverse effects. The challenge, therefore, lies in the government having a proper understanding, structure, design and administration so that the impact of tax increase on various economic issues can be better evaluated.

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<sup>100</sup> Ibid

<sup>101</sup> Ayda Yurekli and Joy De Beyer, Economics of Tobacco toolkit, world bank Washington DC also available at [www.answers.com](http://www.answers.com) date of visit 9<sup>th</sup> December 2006

## **5.1 Excise Tax Design, Policy and Administration**

The following issues deserve attention in excise tax design, policy and administration<sup>102</sup>.

5.1.1 The proper coordination of excises, consumption taxes, and import duties.

5.1.2 The appropriate balance between specific and ad valorem taxation.

### **5.1.1 Co-coordinating Excises, consumption Taxes and import Duties**

Generally, taxes on goods and services are used for generating revenue, providing temporary protection to industry and improving efficiency in resource allocation. In assigning these roles to the various taxes, it is important that they are used consistently in relation to the specified ends. Ideally each tax should be used for one goal only, although in practice there are often more goals than instruments available. The effect of an instrument may not be fully predictable, or it may be used so intensively that it reverses direction.

In countries with Anglo-Saxon taxing traditions, generally excises have not been properly co-coordinated with other taxes on goods and services.<sup>103</sup> The better policy is that imports of items that are subject to excises when produced domestically be included in the domestic excise tax base.

At the import stage, the excises should then be levied on the import duty inclusive value of goods. Since the excise would be the same regardless of the origin of the good, the domestic industry would neither be unduly handicapped (if the excise on domestic goods

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<sup>102</sup> Faculty of Economics and Business Administration, University of Maastricht, and centre for economic policy (OCFEB), Erasmus University Rotterdam, The Netherlands.

<sup>103</sup> Ibid

would be higher than those on imported goods) nor would it be unduly protected (if the taxes on imported goods would be higher than those on similar domestic goods). Thus, this form of co-ordination would leave the protective function of taxes on goods more clearly to the import duty proper, compared to some current approaches under which the excise at the import stage is subsumed by the import duty. Co-ordination with the consumption tax would be achieved by levying that tax on the excise duty inclusive value of manufactured items, while the consumption tax at the import stage would be levied on the value of imports plus import and excise duties. Thus, the protective (and revenue) function of the import duty would be given priority, followed by the revenue and resource allocation function of the excises, and lastly by the revenue role of the consumption tax.

However in the Ugandan context, there is excise on both domestically manufactured goods and on imports which is under the category of taxes on international trade as excise duty import.

### **5.1.2 Designing an Appropriate Rate Structure**

While most work on excise taxation has focused on the appropriate level of total taxation, considerable importance may be attached to whether taxes take a specific or *ad valorem* form. Ad Valorem is assessed on the value of excisable products consumed locally amongst which are products such as motor vehicles, cell phones, gaming and vending

machines, cosmetics and television receivers.<sup>104</sup> While specific are levied based on quantity which impose the same tax per item because it is necessary only to determine the physical quantity of the product taxed, and not its value.<sup>105</sup>

In a perfectly competitive market for a homogeneous good, the choice between *Ad Valorem* and specific taxation is irrelevant: specific tax could be replaced by its percentage equivalent with no effect on consumer and producer prices or on government revenue.<sup>106</sup> For a number of reasons, actual markets for excisable products differ from this idealized framework. Here the focus is chiefly on the implications of quality differences among brands and on the market power of producers of excisable products.

To begin with, the main excisable products: tobacco, alcohol, petrol and motor vehicles, certainly, are not homogeneous products. Someone who drinks knows that there are large differences in quality among wines available in the Ugandan market. Since URA would surely be hard-pressed to choose appropriate tax rates for each quality level independently, they are faced with choice between a common specific tax rate, which reduces relative price differences between low-price and high-price brands, and a common *ad valorem* rate which does not. Uganda has tried to strike a balance by providing a specific excise for certain goods (such as tobacco) while others suffer and *ad valorem* (such as beer products).

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<sup>104</sup> Taxation in South Africa, 2005/06 at <http://www.sars.gov.za>

<sup>105</sup> Sophia Delipala and O Donnel, The comparison between *ad valorem* and specific taxation; under imperfect competition evidence from European cigarettes industry. Department of Economics Keynes College. February 1998

<sup>106</sup> Faculty of Economics and Business Administration, University of Maastricht, and centre for economic policy (OCFEB), Erasmus University Rotterdam, The Netherlands.



In a competitive market with quality differences, standard optimal tax considerations would seem to argue for ad valorem taxation. The relative price of high and low quality wines would be unchanged, and consumers would continue to choose brands on the basis of cost rather than tax differences. This may not necessarily be the case in a developing country like Uganda where for many, choice is largely driven by the price of the product.

The Pigouvian perspective leads to a very different conclusion,<sup>107</sup> however, arguing that the harm caused by abusive wine consumption is independent of the price at which it is sold, so that correction of externalities favours specific over ad valorem taxation. All else equal, the share of specific in total taxation should be smaller when the marginal cost of public funds is higher and the importance of alcohol taxes for generating revenue correspondingly greater. These arguments apply for competitive markets in which the set of quality levels on offer is given exogenously.

Economists are entering the alcohol policy arena by pointing out that consumption, and also abuse, can be reduced through price increases induced by taxation. The notion that abuse can be curbed by taxation has led to calls for increased taxes on alcohol. Consequently this would impact on the entire alcoholic beverages industry.<sup>108</sup>

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<sup>107</sup> Sijbren cossen, (supra).

<sup>108</sup> Josephat Ngile of East African Breweries also at <http://www.natiomedia.com> data visited 11<sup>th</sup>/08/2006

Just as *ad valorem* taxation seems to induce firms to cut prices, it also creates a clear incentive to downgrade product quality.<sup>109</sup> Examining again the first order conditions for profit maximization under the two excise tax systems, notice that the specific tax causes a fixed increase in cost, whereas *ad valorem* taxation acts like a proportional increase. This multiplier effect in *ad valorem* taxation makes improvements in product quality more expensive for the firm.<sup>110</sup> Likewise, it reduces incentives to invest in advertising, promotion and other demand-enhancing fixed costs of production. In contrast, specific taxation does to directly distort manufactures' decisions to invest in product quality.

In this respect, then *ad valorem* taxation may be a useful tool in "deglamorising" excisable products and reducing consumption in the long run, especially among young people<sup>111</sup> But not all investments in product quality are detrimental to health, and *ad valorem* taxation based on the retail price of excisable goods discourages 'good' and 'bad' quality improvements alike. The cost of coal filters, for instance, which purify the tobacco of tar and other harmful substances, is subject to the multiplier effect (unless the excise would be on tobacco only). In Uganda and many other developing countries, increase in the price of quality beer products have led to the consumption of dangerous and crude locally brewed alcohol (such as changaa and malwa) which easily evade taxes.

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<sup>109</sup> Sijbren Cnossen, (Supra).

<sup>110</sup> Ibid

<sup>111</sup> Ibid

It has been argued that the existence of an ad valorem excise on beer has contributed largely to this.

Other more immediate, considerations might also govern the choice of excise tax structure. Thus a specific tax can be imposed at the manufacturer's or importer's stage where it is easiest to collect, whereas, under a system of free trade prices an ad valorem levy must be collected at the retail stage if trade distortions and tax avoidance are to be avoided<sup>112</sup>.

These arguments can be summarized as follows:<sup>113</sup>

- In imperfectly competitive markets, a shift from specific to ad valorem taxation has a clear tendency to reduce mark-ups and so to increase government revenue and consumption of excisable products.
- With quality differences, specific taxation induces consumers to “upgrade” their choice of brand (at fixed producer prices), whereas ad valorem taxation discourages firms with market power from making costly investments to increase quality.
- The choice between specific and ad valorem taxation, therefore, depends on whether the primary aim of the policy is to discourage consumption or to raise

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<sup>112</sup> Sijbren Cnossen, *Isupra*)

<sup>113</sup> *Ibid*

revenue and on whether improvements in product quality are deemed desirable or not.

- If the goal of excise tax policy is to reduce consumption, there is some tension between the tendency of specific taxes to lead to higher consumer prices and the tendency of ad valorem taxes to discourage investments in quality that keep consumers “hooked”. The solution is likely to be ad valorem taxation at a higher equivalent rate to achieve the desired level of consumer prices, and with concomitant gains for government treasuries.

## **5.2 Morality of the Excise duty**

Excise duty is one of the few taxes presumed to have an overt moral justification. It is said “Overt” because other taxes imply certain covert moral categories.<sup>114</sup> For example, our nation taxes the return on capital at a higher rate than income that flows from pure wages and salaries.<sup>115</sup> This “capital gains tax” implies there is something less morally legitimate about making money through risk and investment than there is from taking home pre-set wages and salaries.

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<sup>114</sup> <http://www.action.org> date visited 9<sup>th</sup>/05/2006

<sup>115</sup> The income tax act (1997) Cap 340

When the state treats certain behaviour as sinful and thus taxable, it assumes certain moral categories.<sup>116</sup> It says that the taxed behaviors are less morally justifiable than other forms of behaviors, and therefore more justifiably taxed. The moral reasoning behind such a tax is clearly evident. Punishing wrong doers is among the usual lists of powers appropriate to government. What is not obvious is why the central state puts itself in the business of determining the sinfulness of certain behaviour given that the taxed sins are not directly invasive of other people's right.

Compare smoking and drinking, for example, with crimes against person or property. When the state declares drinking and smoking to be sins vulnerable to added levels of taxation, it also admits that these behaviors are less objectionable than theft or murder. We don't, for example, have anything like a murder tax or a theft tax. When a citizen steals something from another person, he is not taxed, he is tried and convicted as a criminal. Neither are the sins being taxed considered violations of the civil code. Instead, the state simply taxes the behaviour in an attempt to raise revenue and discourage the behaviour (these are as noted earlier, logically incompatible goals). For example the yearly increase in Uganda on excise imposed on beer and mobile phone airtime are arguably a recognition of the fact these are the easier to tax sectors given that the companies are among the top 100 taxpayers in the country, thereby profit making.

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<sup>116</sup> <http://www.action.org> date visited 9<sup>th</sup> /05/2006

This is not to say that the behaviour targeted by the excise duty are “victimless crimes”, as many civil libertarians might be inclined to say.<sup>117</sup> A person who drinks excessively victimizes his family to the extent that liquor distracts from his family life. A smoker who contracts cancer imposes sometimes terrible burdens on his family. Even sins with no identifiable earthly victims are sometime objectionable when judged by the eternal law. There is no such thing as an action without consequence. It is possible that certain behaviors that are not direct attacks on property or person are in need to a correction not best address by civil authority<sup>118</sup>.

The question often comes down to the means of discouraging sin, not whether the sin itself is harmful.<sup>119</sup> We must be careful not to confuse opposition to sin taxes with moral relativism. Rather the question is: Do we want to change politicians and bureaucrats with sanctioning sins in areas that are morally ambiguous? Or should this task be left to community, family church and tradition social institutions that are often more trustworthy in determine the limits of non-violent behaviour?

A classic statement regarding non-violent forms of social behaviour which are nonetheless frowned upon was made by John Stuart Mill in his famous tract on liberty.<sup>120</sup> *“That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral is not a sufficient warrant. He cannot rightfully be compelled to do or*

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<sup>117</sup> Ibid

<sup>118</sup> See St. Thomas Aquia, Summa Theologica, I-II Q 100< A.9

<sup>119</sup> <http://www.action.org> date visited 9<sup>th</sup> /05/2006

<sup>120</sup> Mill, John Stuart, on liberty, New York classics of liberty library 1992. (1859), pg.22.

*for bear because it will be better for him to do so, because it will make him happier because in the opinion of others to do so would be wise, or even right”.*

*“These are good reasons for remonstrance with him, or reasoning with him or persuading him, or entreating him, but not for compelling him, or visiting him with any evil in case he do otherwise. To justify that the conduct from which it is desired to deter him must be calculated to produce evil to someone else. The only part of the conduct of anyone, for which he is amenable to society, is that which concerns others in the part which merely concerns himself, his independence is of right absolute”.*

There can be little doubt that John Stuart Mill had thought himself to be stating a straightforward case for keeping private behaviour private. He did this by introducing strict limits on the ability of social and state agents to exercise coercive control over private moral behaviour. His views become enormously influential in Uganda on my view, because the central state need not be involved in affairs that are harmless and purely private.

This is an effort worthy of praise, especially in our time when the limits of government power and responsibility are disregarded as merely an old-fashioned concern. In myriad ways, government policy today goes well beyond the limits John Stuart Mill outlined for us the sin tax is only one of many readily available examples.



Yet even by John Stuart Mill's own formulation,<sup>121</sup> his statement contains two formulations of what appears to be the same principle: that there ought to be a distinction between behaviour that is permissible to control and behaviour which is not. In the negative formulation, private behaviour (that which concerns a single individual) should be kept private and should not be his concern of the state. But in the positive formulation any action which harms others or even concerns others can be socially regulated.

Another problem with the "Victimless crime" theory against taxing or prosecuting peaceful individual behaviour, like smoking and drinking, is that it disregards potential victims like other family members, to which we have moral obligations that extend well beyond a purely contractual level. While as autonomous individuals we may have legal rights to engage in certain behaviors like excessive indulgence in drink, we have no moral right given the implied obligations to family and community. It is simply not enough to claim that a legal right should equal a moral right to engage in sin.

Indeed we have no moral right to abuse drugs, abuse alcohol, to burn our lungs out with cigarettes, or to gamble God-given resources away. We have responsibilities not to do these things. The real issue has little to do with our rights so much as it has to do with the agency of enforcement. Who or what will be charged with the moral instruction and enforcement required to keep sinful behaviour to a minimum, or at least restrict its social consequences.

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<sup>121</sup> <http://www.action.org> date visited 9<sup>th</sup> /05/2006



Governments always act on moral premises of some sort. Punishing crimes against person and property are acts of moral sanction. But when we allow the central government to determine and enforce a broader vision of sin and vice, and by implication goodness and virtue, we set ourselves up for certain dangers.

A government that can tax liquor higher than water can on the same grounds prohibit liquor altogether, as well as caffeine, fatty foods, and slothfulness. It is a small but logical step for the state to institute a central plan governing all our behaviour, even excluding behaviour considered to be religious. Therein lies the danger of entrusting the state of guiding behaviour whose consequences are necessarily restricted and minimal.

### 5.3 CONCLUSION

Governments use fiscal policy to encourage healthy behaviour. The instruments of government for this purpose are taxes and subsidies, and direct provision of certain health services for free or at subsidized rates. Examples of fiscal policies for health are taxes on tobacco, alcohol and other items regarded as harmful to human health.

In general, excise can be either specific taxes (based on quantity) or ad valorem (based on value). If a primary purpose of the excise is to discourage consumption, a strong case can be made for specific excises that would impose the same tax per item. Specific taxes also are easier to administer, because it is necessary only to determine the physical quantity of

the product taxed, and not its value. Ad valorem taxes, however, may keep pace with inflation better than specific taxes, even specific taxes that are adjusted fairly frequently. However ad valorem taxes may impose additional administrative costs to collect.

Thus excise tax has long been thought to satisfy the Ramsey rule,<sup>122</sup> which states that “taxes on consumption should apply to goods with relatively inelastic demands so that the welfare losses associated with taxation will be minimized”. However it is possible that the demands for these items while still inelastic may be more responsive to price than once thought.

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<sup>122</sup> Warner, et al 1995; sunley 1998

## **CHAPTER FIVE**

### **RECOMMENDATIONS AND CONCLUSION**

#### **6.1 Recommendations**

##### **i. Increases of excise duty rates**

Countries that need to generate additional tax revenue often adopt increases in excise duty rates. In addition to the increased revenues, however, there are also health benefits from reduced consumption of these items. In setting excise tax rates, governments need to take into account several factors, including the impact of smuggling, cross border shopping and duty-free purchases. It is in the interest of governments to reduce smuggling, not only to increase excise revenues but also to limit the loss of revenues from other taxes, including income taxes and value added taxes, as underground transactions replace legal ones. Ultimately, excise tax rates should consider the purchasing power of the local consumers, rates in neighbouring countries, and, above all, the ability and willingness of the tax authority to enforce compliance.

##### **ii. Imposing excise on the destination basis as international practice.**

The government should also adopt international practice, which is to impose excises on the destination basis under which also imports are taxed and exports are freed of

tax. The tax authority is required to control shipments into and out of the production facility.

### **iii. Introducing excise stamps**

URA should introduce excise stamps on alcohol sold in Uganda. The measure will help to stamp out illegal imports. Excise stamps can assist in ensuring the payment of excises and ensuring the goods that have paid the tax appropriate for one jurisdiction are not shipped to another. The introduction of stamps, however, involves some costs for producers of excised goods. Stamps will serve little purpose in control unless their utilization is monitored at the retail level. If it will be effectively monitored the government will be able to reduce or either stop smuggling of the items either resembling items produced in Uganda or other items not produced in Uganda, like super match cigarettes from Kenya. Other benefits include increased tax revenue collected due to expected higher compliance and reduced sale of unhygienic drinks since only legitimate businesses dealing in alcohol are allocated stamps.

### **iv. Reducing/removing of excise duty on non malt beer.**

The Government should consider removing of excise duty on non-malt keg beer, which is currently at 30 per cent. This is necessary in order to make drinks in this category more affordable to Ugandans who consume illicit and unhygienic brews.

Perhaps at this stage, in recognition of fiscal deficit, this excise can not be removed. However, a reduction in the rate from 30% to 20% (where it was in 2005) would be a

welcome move. The increase was announced in the 2006. Parliament rejected this increase from 20% to 30% and the bill is yet to be passed. It is also recognized (and should be taken into account by government) that the sell of non-malt beer does not only benefit the beer industry. Because it is produced from local products such as sorghum, it has provided a source of income for local farmers and bettered their standard of living.

**v. Consideration to reduce excise duty on landlines and public pay phones**

Government should consider reducing excise taxes on landline and public phones as they are basic for low income earners. Imposing or increasing rates on landlines and public payphone which are highly used by low income earners clearly negates against the country's poverty reduction goals.

**vi. Recording of the actual alcohol consumption**

The government has to make sure that the overall alcohol consumption level for the actual Uganda population is recorded. A Global Status Report produced by World Health Organisation; Uganda was among the top countries for the case of unrecorded alcohol consumption.<sup>123</sup> It is important for the government to conduct studies on estimating the level of unrecorded alcohol consumption with the aim of finding

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<sup>123</sup> These estimate were derived from a variety of sources, including the first Global Status Report on alcohol specialized surveys that asked about unrecorded alcoholic particular counties and through local point reports or replies to questionnaires sent to individual counties. Global status report on alcohol 2004 WHO.

solutions to problems such as consumption of illicit alcohol, smuggling, and beverages with alcohol content below the legal definition of alcohol. This will help the government to control the amount alcohol legally allowed by law or to reduce the consumption especially of illicit drinks.

**vii. Compulsory studies on the effects of consuming cigarettes/alcohol**

The government should also provide studies in primary level and secondary schools, on the effects of consumption of supposedly harmful goods, for instance cigarettes, alcohol and the rest of social obligations for youth. Young people appear especially sensitive in deciding whether or not to consume.

The government should also impose the policy prohibiting selling of cigarettes/alcohol to people below the age of 18 years. Public health advocates should also be involved in various consumption control policies, and the need to know why these taxes are cost-effective and how they should be designed to effectively reduce its use, and how advocates can communicate with policy makers when a tax increase is requested.

**viii. Proportion excise rates**

The government should also make sure that the excise rates in Uganda are proportion. While VAT and corporate tax rates in Uganda are competitive with those of Kenya

and Tanzania, the same can not be said for excise rates. A constant increase in Ugandan rates may lead to reduced investment since a margin of that increase is absorbed by the manufactures. Relatively higher rates also encourage smuggling, which subsequently undermines the revenue collection objective.

## **6.2 Conclusion**

The reasons for levying high taxes on selected goods and services are the predictability of the revenue, the belief that consumers should pay for the burden they impose on others, the need to protect the young, the imperative to charge users for government provided services, and the desire to improve the progressivity of the tax system.

The reasons for moderating the level of revenue excises (not user charges) are the principle of consumer sovereignty; the finding that the net external costs of smoking and drinking may be low; equity considerations; and difficulties in ensuring compliance control in view of illegal bootlegging and smuggling.

This paper has illustrated the difficulties in tailoring an excise regime in the context of multiple objectives and constraints. The question of what the right level and structure of tax should be is a complex one. For the economist, there are conceptual and empirical limits to excessively high levels of excise taxation, at least if based on

pigouvian argumentation. As a single policy instrument, even with ideal excise tax administration, excise taxation cannot alone meet the multiple objectives of social - welfare-‘maximizing’ government (even if one ignores the political economy factors that may be involved). In addition, of course the ‘value weights’ in the social welfare functions are by no means universally agreed. Excise tax administration, moreover, is not ideal, as the quantitative and growing significance of smuggling indicates.



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