TAXATION OF THE TOBACCO INDUSTRY IN UGANDA
THE CASE FOR EXCISE DUTY ON CIGARETTES

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ACRONYMS

BATU	British American Tobacco Uganda
EAC	East African Community
MTEF	Medium Term Expenditure Framework
URA	Uganda Revenue Authority
VAT	Value Added Tax
SRPS	Special Revenue Protection Services
KIPPRA	Kenya Institute of Public Policy Research and Analysis

Executive Summary

This report investigates the impact of high excise tax rates and the current three-tier tax regime being applied by the government on tobacco cigarettes, and the high level of illicit (smuggled) cigarette volumes on the tobacco cigarette industry. It is estimated that total excise revenue from locally produced cigarettes totaled about 24.8 percent of the total excise duty collections by the government in 2003/2004.

Available data on excise rates for cigarettes indicate that the tax rates on cigarettes especially for high value brands are higher compared to those in other East African countries, and are imposed on a narrow tax base. Over 80percent of excise revenue is collected from domestic productions of only three items: beers, cigarettes and soft drinks. This observation indicates that the absolute level of the tax (tax burden) may be falling on very few firms. Further more, the high tax rates have led to high prices and consequently a reduction in sales and consumption of cigarettes. Declining volumes of sales and consumption have persisted in the high value brands an indication that consumers are down trading thus volumes shifting from the high value to low value brands due to high prices of high value brands.

Increased levels of illicit cigarettes trade volumes is another reason suspected of constraining the cigarette market sales. For example, BAT Uganda-the biggest sellers of cigarettes in Uganda, recorded only a 0.85 percent growth in market sales in 2004. The poor performance was partly due to increased volumes of illicit cigarettes trade. Supermatch a product of Master mind was pointed out as the main cigarette brand smuggled. It is estimated that over 200 million sticks of cigarettes on the Uganda cigarettes market is smuggled. This represents about 20 percent of the total market and about sh2b in lost revenue to the government in excise revenue collections.

The third problem relates to the current three-tier tax regime. It appears that the tobacco industry has welcomed the new tax regime. However, the major concern of the industry is sustainability of the current tax rates. The industry cannot take more increases in the tax rates and therefore the government needs to maintain the current tax rates. We further note that the current three-tier tax regime has a high tax incidence compared to other EAC member states despite the move to harmonize the tax rates in the region.

This paper highlights the following key concerns that require immediate attention of both the industry and the government:

- Currently, all excise taxes on cigarettes ranging from \$10.9 to \$27.4 per 1000 sticks compared to \$6.0 to \$18.7 and \$8.5 to \$15.5 for Kenya and Tanzania respectively, and generally Uganda's tax rates are high compared to other East African Community member states.

- The increase in the price of cigarettes partly resulting from higher taxes made consumers more sensitive to price increases. This is evident from the down trading (that is to say consumers switching from highly priced brands to low priced brands). For example the growth in sales of Safari Regular (low priced brand) in 2002 after tax increments from 100 percent to 122 percent in 2001 was 81 percent while there was a decline in sales for Sportsman and Safari King of 10.65 percent and 97.5 percent respectively.
- Smuggling of cigarettes has increased and persisted from an estimated 180 million sticks per annum to currently 200 million sticks per annum as recent evidence shows. This translates into about UShs2bn in lost excise revenue.
- Since low value brands contribute less revenue, reduced consumption of high value brands results into revenue losses by the government. Secondly, consumers are likely to compromise on their safety; environmental and other externalities are bound to arise with the increased consumption of low quality cigarette brands and unregulated alternative tobacco products. Evidence shows that consumption of low priced cigarettes increased from 15 percent in 1999 to approximately 71 percent in 2004, compared to a decline in sales of high priced brands from 85.6 percent in 1999 to 29.1 percent in 2004
- The reduction in sales and consumption of legitimate high priced cigarettes will reduce industrial growth and employment as current production may be substituted by illicit imports from Kenya- (the major source of smuggled cigarettes to Uganda) and informal alternative products (snuff, roll your own tobacco and chewing tobacco).
- Finally, three-tier specific tax regime is bound to encourage production of high quality products and increase government revenue since it is simple to administer and manage. However, the tax rates need to be harmonized with the rest of the EAC countries by forming a benchmark rate so that there is consistency on the rate per pack or per 1000 sticks.

In conclusion, the report urges the government to consider:

a. Harmonization of the tax rates with those of other countries in the region.
b. Adopting more aggressive ways of curbing smuggling by introducing more punitive penalties and increasing cross-border policing and strengthening the customs tax administration and fully facilitating it so as to enable it efficiently handle smugglers.
c. Intensification of efforts to widen the tax base so that the tax burden does not fall on very few firms in the industry.
d. Maintain the current three- tier tax regime and align tax stamp with the current tax structure coupled with their enforcement so as to minimize smuggling and maximize the industry and government revenues.

1.0 Introduction

1.1 Analysis of the Excise duty tax

Excise duty taxes contributed 1.4 percent of Gross Domestic Product (GDP) in Uganda in 2003/04 (Table 1). The tax capacity- defined as excise duty as proportion of GDP declined from 1.65 percent on average for the period 1996/1997-1999/00 to 1.2 percent in 2000/01 and then increased to 1.4 in 2003/04.

Table 1: Uganda: Excise Duty Revenues as a percentage of GDP

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Excise duty (domestic)	1.4	1.4	1.4	1.2	1.0	1.1	1.0	1.0
Excise duty (International) Trade	0.3	0.3	0.3	0.3	0.2	0.2	0.3	0.4
Total	**1.7**	**1.7**	**1.7**	**1.5**	**1.2**	**1.3**	**1.3**	**1.4**

Source: URA

In Uganda, excise duties from cigarettes make significant contribution towards government revenue. It is estimated that total excise revenue from cigarettes totaled about 24.8 percent of the total excise duty collections by the government in 2003/2004 (Table 2) below.

Table 2: Percentage contributions of cigarettes taxes to total excise duty

	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/2004
Excise duty	61.36	86.26	98.18	104.64	107.77	101.27	116.25	113.24	12.8.56
Cigarettes	24.72	29.76	31.30	32.3	33.57	27.19	29.45	30.42	31.90
Contribution	40.28	34.50	31.88	30.86	31.14	26.85	25.33	26.86	24.81

Source: URA and authors own computations

Overtime, there have been strong concerns about the high excise tax rates and the tax regime being applied by the government on tobacco cigarettes, and the high level of illicit (smuggled) cigarette volumes. Excise duty is applied on a list of selected domestically produced as well as imported goods, including cigarettes. In addition to excise taxes, cigarettes are subjected to Value Added Tax (VAT), and import duties in the case of imported cigarettes. Until July 01, 2004, excise taxes on cigarettes were Ad valorem and charged at 130% whereas VAT on all goods and services was charged at 17% (adjusted to 18% w.e.f July 01, 2005). On July 01 2004, the excise taxes on cigarettes were fully changed to a three-tier specific tax system with rates as shown below:

Table 3: Specific tax rates on cigarettes in Uganda

Description	Excise duty (2004/05)
Soft cup: Safari, Supermatch, Crescent & Star and their variants	Ug Shs. 19000/= Per 1000 sticks
Soft cup: Sportsman, Sweet menthol, Boss and their variants	Ug Shs. 25000/= Per 1000 sticks
Hinge lid: Benson & Hedges, Embassy, Rex, Amber and their variants	Ug Shs. 48000/= Per 1000 sticks
Other cigarette brands	Ug Shs. 48000/= Per 1000 sticks

Source: Government of Uganda finance bill 2004/05

It should be noted that these specific tax rates are based on the cigarettes pack characteristics such as packaging (i.e. soft cup and hinge-lid) and the consumer price of the cigarette pack.

In general, the excise tax rates in Uganda are levied at rates higher than many countries in the region and on a narrow base. Over 80 percent of excise revenue is collected from four items: beer, cigarettes, mobile airtime and soft drinks (Ayoki et al, 2005). First, this observation highlights the fact that the excess burden may be falling heavily on very few taxpayers. Second, the high tax rates have led to negative impacts on the tobacco cigarette industry and the general economy in that they have led to high prices of cigarettes in Uganda and reduced the demand for cigarettes. This may not only discourage the local production of cigarettes, thus reducing revenue yields for the government, but also, have negative implications for employment. Thirdly, the high levels of illicit (smuggled) cigarette volumes have led to unfair competition for legitimate industry and deprived government of its revenue. Illicit products are goods whose duty has not been fully paid for in the market where it is being sold; these include smuggled products, duty free products beyond allowable limits and counterfeit products. Supermatch was pointed out as the most smuggled cigarette brand from Kenya to Uganda.

The major objective of this study therefore, is to analyze the problems related to the current tax rates and tax regime (Three-tier specific tax system). It is limited in scope to taxes charged on cigarettes. The following sections explain the rest of the structure of this paper: section 1.2 outlines objectives of the study; section 1.3 looks at the methodology; section 2.0 reviews the literature on taxes on tobacco cigarette industry and international experience with high tax rates and different tax regimes; section 3.0 assesses the structure and performance of cigarette industry in the past 8-10 years in Uganda by analyzing the trends in prices and sales and revenues from the cigarette industry; section 4.0 gives a detailed analysis of the taxation structure in Uganda cigarette industry; highlighting the impact of high excise tax rate on prices of cigarettes, legitimate cigarette market volumes, illicit cigarette volumes, down trading and the overall impact on government and industry revenue. Section 5 draws conclusions and recommendations.

1.2 Objectives

The study aims at addressing the following issues with regard to taxation of the cigarette industry in Uganda:

(i) Understanding the dynamics of excise tax structure in Uganda

(ii) Addressing the problems of illicit (smuggled) cigarette volumes. In particular, the study would carry out the following:

  a) Review the performance of the tobacco cigarette industry in Uganda over the last 8-10 years and identify the key factors that have contributed to the observed trends.
  b) Undertake a comprehensive analysis of the cigarette tax regime and administrative structures for the three countries with in the East African Community (EAC), Uganda, Kenya and Tanzania with an aim of analyzing the possibility of harmonizing taxes across the region.
  c) Assess the impact of the current taxation structure for Uganda with the aim of establishing the optimal tax rate and structure for Uganda.

(iii) Make recommendations based on (i) and (ii) findings.

1.3 Methodology

- Review of any available literature on issues of taxation of the cigarette industry.
- Asses the performance of the cigarette industry in the past 8-10 years
- Examine the evolution of the taxation structure in Uganda cigarette industry
- Analyze the impact of the excise tax increases and tax regime changes on government revenue and industry performance
- Assess the effects of excise tax increases on the following:
  1. Impact on prices of cigarettes.
  2. Impact on legitimate cigarette market volumes.
  3. Impact on trends in cigarette market segmentation (i.e. down trading from high to low priced brands)
  4. Impact of limited usage of coins on cigarette price increases
  5. Overall impact on government and industry revenues.
- Examine the nature; causes and extent of illicit cigarette trade in Uganda and impact on government and industry performance.
- Assess the relative cigarette tax structure in Uganda, Kenya and Tanzania and possibilities of harmonizing excise taxes across the East African Community.

- Make recommendations for cigarette tax policy regime that maximizes revenues for government and industry and that is in line with the broader government policy objectives of safeguarding growth of revenues, EAC tax harmonization and encouraging private sector development.

2.0 Literature Review

2.1 Principles of a good tax system

A good tax system should follow two main principles namely fairness and efficiency.

2.1.1 Fairness

Economists consider two principles of fairness to determine whether the burden of the tax is distributed fairly. Fairness can be vertical equity or horizontal equity. Under vertical equity, the tax system should distribute the burden fairly across people with different abilities to pay. This idea implies that a person with higher income should pay more in taxes than one with less income. Horizontal equity requires that people in equal positions should pay the same amount of tax. That is to say people with equal income or wealth should pay the same amount of tax. Excise tax is not a good tax as far as vertical equity is concerned because when the non poor and the poor consume say a similar pack of cigarettes the poor pay a greater proportion of their income in taxes. While with horizontal equity if two people earn the same income but one of them consumes more of the commodity he /she pays more of their income in taxes even if they both earn the same income. The justification of this is that those who consume more of the cigarettes cause more negative externalities to the society hence excise tax in this case functions like a Pigouvian tax (A tax charged on each unit of polluter's output in an amount just equal to the marginal damage it inflicts at the efficient level of output) forcing smokers to internalize the costs associated with smoking and should therefore pay more of the tax in absolute terms.

2.1.2 Efficiency

When the government levies a tax on a good, it distorts consumer behavior-people buy less of the taxed good and more of the other goods. Instead of choosing what goods to buy solely on the basis of their intrinsic merits, in this case consumers are influenced by taxes. The tax-induced change in behavior called the excess burden is low for goods with low price elasticity of demand and high for goods with high price elasticity of demand. The additive nature of consumers to cigarettes makes the price elasticity of demand for cigarettes low. This implies that with an increase in the price of the cigarette consumers' quantity demanded would slightly be reduced implying consumers are less sensitive to the price. The low price elasticity makes the good attractive for high taxation since the excess burden arising from the tax is minimal. However, there is evidence that in middle and low-income countries, elasticity of demand for tobacco is higher than in high-income countries Jha and Chaloupka (1999) making consumers more sensitive to price increases.

Determining the appropriate level of taxes for tobacco is a complex policy issue and goes beyond determining just the revenue-maximizing tax rate. There three issues to consider.

i. Substitution to more dangerous products- if the rate is set too high, there is a danger of substitution to more dangerous products like heroin or similar drugs especially to those who are more addicted. Moore and Hughes (2000) claim that mortality increases with the quantity of nicotine although literature available on this subject is not conclusive.

ii. Cross border shopping- if rates are set higher than those in neighboring countries cross boarder shopping is inevitable. Thus harmonizing the rates with neighboring countries is more critical than setting the rate at a revenue maximizing level.

iii. Smuggling- cigarette smuggling is a serious problem globally. It is estimated that 30 percent of the exported cigarettes are lost to smuggling. On top of reducing excise revenues, smuggling has a spillover effect to VAT and income taxes, as underground transactions replace legal ones. It should therefore be in the interest of government to minimize smuggling. Therefore the governments' option for increasing revenue through domestic consumption taxes like VAT and excisable as a means of financing its projected budgetary expenditure over the MTEF period should be treated with caution (National Budget Framework Paper 2005/06-2007/08).

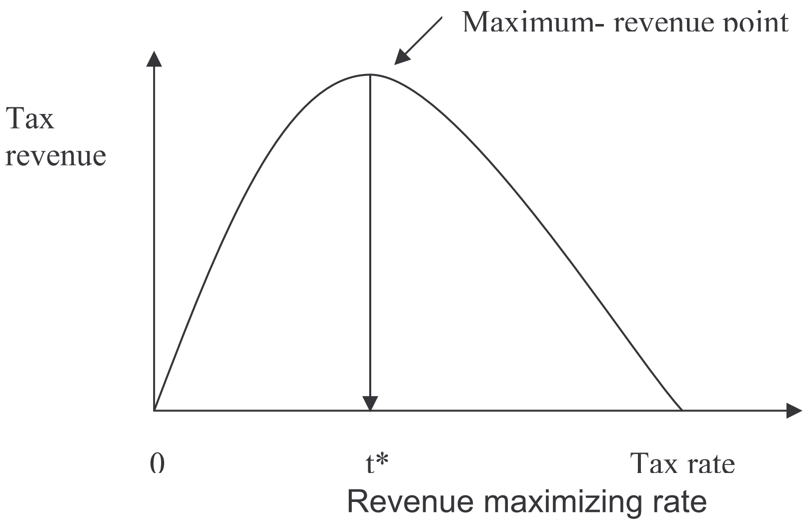
2.1.3 Effects of Taxation on Efficiency and Equity

The effects of any tax on equity and efficiency depend in part on the performance of the tax administration, which may encourage or discourage tax evasion and avoidance and thus alter the real effects of the tax. Apparently, raising revenue is surely the major objective of cigarette taxes as well as other taxes, but there are other factors that enter as well. The costs of raising taxes include deadweight loss to consumers who are making informed decisions, costs associated with smuggling and contraband activities, and possible adverse trade effects. Other benefits of taxes include deterring smoking behavior and the associated harms to the individual and society.

2.1.4 Effects of Overtaxing Cigarettes on Government Revenue

The "Supply- side" macroeconomic school of thought, argue that government over taxation and other regulatory burdens on people discourages incentives to work, save and invest. Consequently, government revenue declines as a result of high tax rates. The principal question with regard to cigarette industry is: what is the optimal tax rate that maximizes both industry and government revenue? This principal question can be illustrated using the Laffer curve as shown in figure1 below. A laffer curve shows the relationship between tax revenue and the tax rate. It illustrates the supply-side argument that tax revenue will fall if government raises tax rates above a certain point (optimal point). For any excise tax, we can chart the tax revenue- tax rate relationship. Figure1 below shows revenue yield will zero when the tax rate is zero, and increases as the tax rate increases, reaches a maximum and eventually declines as the tax rates become more prohibitive. The tax rate that maximizes tax revenue is called the bliss point as far as the tax policy makers are concerned. Given data on tax revenue, taxes and pack sales, the marginal impact of tax revenue resulting from a unit increase in tax rate can be determined. In theory, there is a trade off in raising cigarette taxes. Government gets more tax revenue on the packs of cigarettes sold, but there are likely to be fewer packs sold as the tax rates increase and eventually tax revenue will decline.

Figure 1 Laffer curve



2.1.5 How is Tobacco Cigarette Taxed?

As with other commodity taxes, cigarette taxes can take three forms – Unit taxes/specific taxes, Ad valorem taxes or a combination of the two. Unit taxes are in terms of a fixed amount of Uganda shillings (UShs), usually on a tax per pack basis, for example UShs. 19,000 per (Mille)[1]**.** Products with similar characteristics or prices pay the same excise tax rate depending on the definition of the tiers. In contrast, Ad valorem taxes are proportional taxes with respect to the retail price or ex-factory price. Premium brands consequently would pay a higher tax amount than lower priced brands.

Whichever tax form is most appropriate is controversial and may differ depending on the details of implementation of the chosen method. Each approach has its merits, and problems, and the best trade off between the two may differ from

[1] 1 Mille is equivalent to 1,000 cigarettes

country to country and even from item to item. Specific tax rates have a number of advantages including the following:

- They are easy to administer and generate a steady stream of tax revenue with lower administrative costs
- They are non-discriminatory since they apply equally to all products regardless of their value for example premium brands and lower priced brands pay the same tax.
- To the extent that one objective of cigarette taxation is to discourage cigarette consumption, it is only logical to impose the tax on the cause of costs imposed on the community by misuse of cigarette, namely the amount of nicotine contained in the cigarette and not something essentially irrelevant from this perspective such as its value.
- They provide greater flexibility to governments since they can easily be adjusted to take into account changes in circumstances and government policy.
- They can help to deter trade in counterfeit and smuggled goods since high quality goods will be less disadvantaged from a price standpoint and as a result consumers will be prepared to purchase quality brands from legitimate sources.
- They reduce barriers to trade by applying equally to all products irrespective of their origin, type or value.
- They encourage investment and product development by not penalizing high quality products but they are discriminative against cheaper products.

2.1.6 Problems with Specific Taxes

- They may prove sticky – difficult to change – in the face of inflation, with the result that real revenues may fall in the face of price increases. However, the real value of the revenue may be maintained under specific tax rate by regularly adjusting the rate or introducing automatic adjustments to the specific rates when inflation reaches a certain threshold.
- Specific taxes may also discriminate against relatively cheaper products. The tax incidence (the ratio of total taxes to retail price) will be larger the lower the price and this may worsen the welfare of the poor who mostly consume low priced products.

2.1.7 Ad valorem tax rates

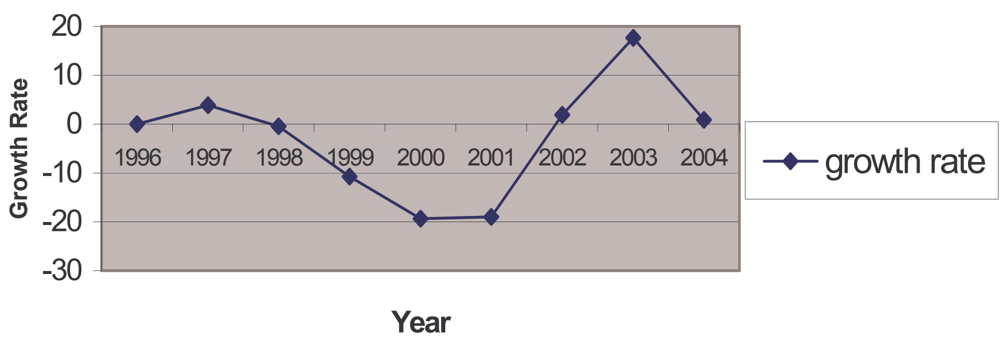
Ad valorem taxes, which are levied as a proportion of the value of the product at specific tax point which may be ex-factory, ex-retail selling price or ex-wholesale, make it possible for the value of tax base to be protected from inflation. In addition, they appear more attractive since they increase as the value of goods increases. However, they have a number of disadvantages, which make them unattractive, and these include:

- They raise difficulties of determining the taxable value related to the stage of production or distribution point where the excise should be levied. Thus, in situations where under valuations of domestic goods or imports are common due to inadequate tax administrative capabilities, specific tax may be more appropriate than ad valorem.
- Have a multiplier effect. By building the costs of import duties, transportation and insurance into the taxable base, together with profit margins at different stages of the distribution chain, ad valorem taxes increases the final cost of the consumer manifold.
- Encourage trade in smuggled and counterfeit goods because they inflate the cost of high value quality products.
- Function as a progressive tax on quality. The additional tax burden panelizes producers for developing quality products and discourages consumers from buying them.

3.0 Structure and Performance of Tobacco Cigarette Industry in Uganda

The cigarettes brands in Uganda are Sportsman, Rex, Embassy, Benson & Hedges, Safari and Supermatch. On average, for the period under study, sales grew at a declining rate of 3.16 percent. The reason for this is partly due to the continuous increase in the excise duty tax growth rate for the period 1996-2004 .The strong growth in the cigarette production (Figure 2) in 1997 of 3 percent was partly due to lower excise duty of 100 percent.

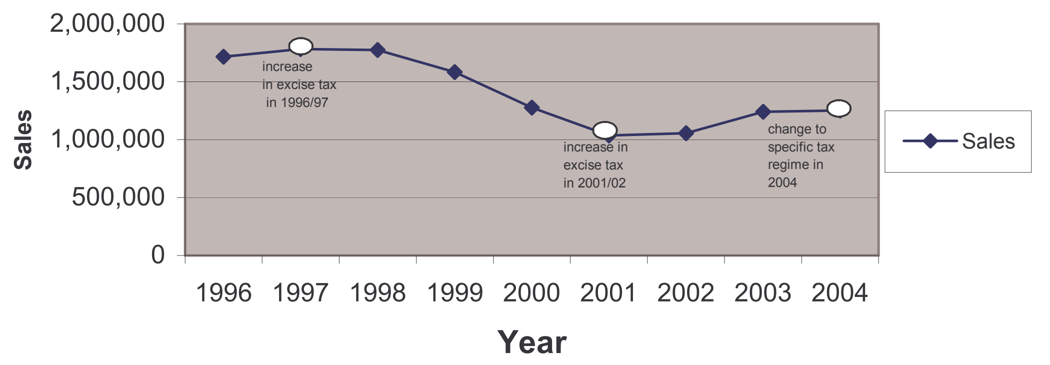
Figure 2: Growth rate of Sales per year



Source: Author's own computation from BAT data.

3.1 Effect of Excise Tax on BAT Sales and Total Revenues

Figure 3: Sales ('000) per Year



Source: Author's computation from BAT data
Note: Data on sales of Cigarettes from BAT are in Calendar years while the changes in tax rates where effective in fiscal years

Despite the achievements of increased growth during the 2002-2004 period, British American Tobacco (BAT) is vulnerable to both internal and external shocks.

During the year 1996/97 when excise tax was increased to 100 percent (Figure 3) excise tax from tobacco (Table 4) grew by approximately 5.2 percent in FY1997/98 and by 3.19 and 3.93 percent in FY 1998/99 and FY 1999/00 respectively. However, sales grew by 3.84 percent by end of 1997 but declined further by 10, 20 percent in 1999 and 2001 respectively (Figure 1). Despite this growth in excise revenues, cigarette excise tax contribution to total revenue declined from 4.01 percent in 1996/97 to 2.42 percent in the FY 2000/01 (Table 4).

During the fiscal year 2001/02 excise tax on cigarettes was increased from 100 percent to 122 percent, as a result cigarette excise tax grew by of 8.3 percent in the same year. On the 1st of July 2002, excise tax on cigarettes was increased from 122 percent to 130 percent. As a result cigarettes excise tax grew by only 3.29 percent in the FY 2002/03 down from 8.31 percent the previous fiscal year. Excise cigarette tax contribution to total revenue declined to 2.1 percent down from 2.33 percent (Table 4). Although cigarette tax contribution to total revenue declined sharply, sales increased by 1.88 percent in 2002 and by 17.6 percent in 2003. This can be explained by the addictive nature of the consumers to cigarettes, which makes the price elasticity of cigarettes low. Uganda being a low developed country with low incomes among her people, there is a high probability that many of these consumers are left with little money to spend on food consumption as a result of high excise tax on cigarette.

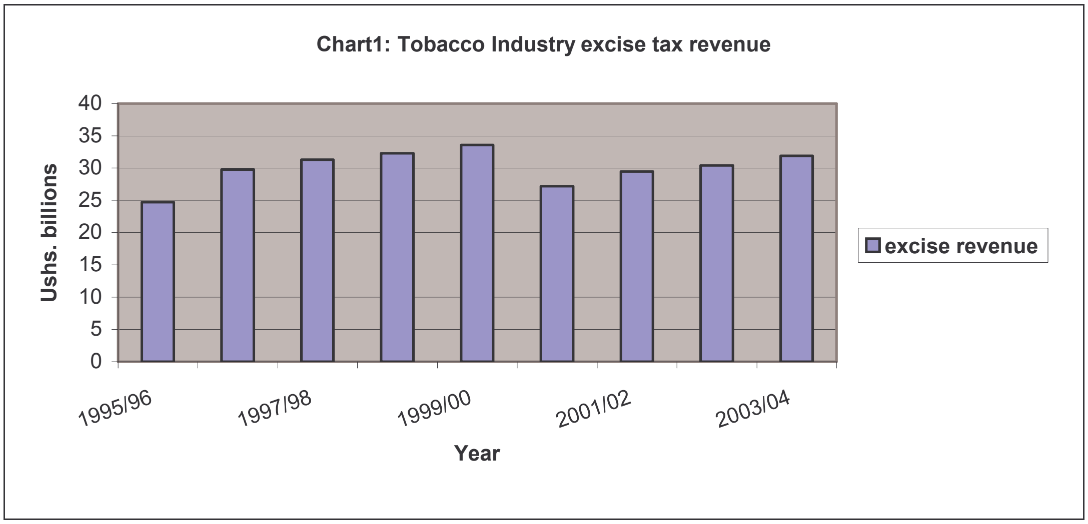
On the 1st of July 2004, excise tax on cigarettes changed to a three-tier specific tax (Table 3). As a result the growth in sales was only 0.85 percent in 2004. The explanation for this is that it is more probable that consumers are now becoming more sensitive to the price increases, hence making the price elasticity of demand high for the cigarettes. Although sales grew by only 0.85 percent, revenues from cigarettes excise tax grew by 4.87 percent. The growth in revenues can be explained by down trading; consumers are switching from highly priced brand like Sportsman to cheaper but lower quality brand Safari regular and supermatch (Table 7). Such down trading within the legitimate market is an indication of excessive taxation. Generally, contribution of excise cigarette tax to total revenue has declined over time from 3.87 percent in FY 1995/96 to 1.88 percent in FY 2003/04. This is due to increased excise tax on cigarettes over time affecting the demand of highly priced brands but increasing the demand for lower priced brands which attract a lower tax of UShs19, 000 per 1,000 sticks for Safari Regular and Supermatch as compared to UShs 25,000 per 1,000 sticks for Sportsman brand.

Table 4: Excise Tax Revenue from Tobacco Products

	Excise tax from Tobacco products UShs. billions (nominal)	**Percentage Change from Prior Year**	**Total Excise Taxes**	**Gross Tax Revenue**	**Total Excise Tax as % of Total Tax Revenue**	**Total Cigarette Excise Revenue as % Gross Tax Revenue**
1995/96	24.72	0.00%	61.36	639.37	9.60%	3.87%
1996/97	29.76	20.39%	86.26	742.62	11.62%	4.01%
1997/98	31.3	5.17%	98.18	821.59	11.95%	3.81%
1998/99	32.3	3.19%	104.64	969.57	10.79%	3.33%
1999/00	33.57	3.93%	107.77	1031.58	10.45%	3.25%
2000/01	27.19	-19.01%	101.27	1125.39	9.00%	2.42%
2001/02	29.45	8.31%	116.25	1264.31	9.19%	2.33%
2002/03	30.42	3.29%	113.24	1451.85	7.80%	2.10%
2003/04	31.9	4.87%	128.56	1696.5	7.58%	1.88%

Source: URA and Author's own computations

As shown in (Table 4), the excise tax revenue from tobacco products is increasing but its contribution to total government revenue is declining considerably. The main reason for the decline in the contribution to total revenue is the decline in BAT Uganda market sales. BAT market sales increased from 1581.001 million sticks in 1995 to 1773.295 million sticks in 1998 and thereafter declined steadily to 1251.189 million sticks in 2004. This reflects mainly consequences of down trading. While the market sales by other tobacco manufactures more than quadrupled, from 91.635 million sticks in 1998 to 441.549 million sticks in 2004, it is believed this has not produced a proportionate increase in excise tax payments. This is because all brands showing a growth in volume yield much lower absolute excise tax payments. As prices have increased over the period under review, the illicit (smuggled) cigarettes trade has also increased resulting in loss of excise revenue to government.



Source: URA

Chart 1 shows that excise tax from tobacco products increased from UShs24.72 billion in 1995/96 to UShs33.57 billion in 1999/00, and then declined in 2000/01 to UShs27.19 billion and there after increased steadily to reach UShs31.9 billion in 2003/04.

Trends in the market sales in (Table 5) indicate that if BATU market sales continue to decline, total industry sales would deteriorate further and consequently the share of the industry in total revenue.

Table 5: Cigarette Market Sales in Uganda (Millions of sticks)

	1998	1999	2000	2001	2002	2003	2004
BATU	1773.295	1582.881	1277.279	1035.181	1054.663	1240.591	1252.189
Competitors	91.635	126.170	122.873	170.694	218.005	181.662	441.549
Total sales	1864.930	1709.051	1400.152	1205.875	1272.668	1422.253	1693.738

Source: BAT Uganda

British American Tobacco Uganda sales were declining (Table 6) over the period 1998-2004, Mastermind (Supermatch) sales increased. Significant portion of the Supermatch sales were of smuggled product.

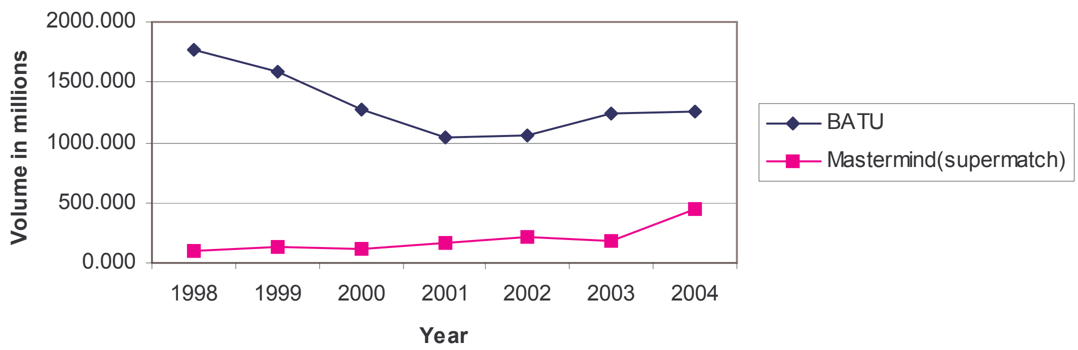
Table 6: BATU and Mastermind sales in Uganda (millions of sticks)

	1998	1999	2000	2001	2002	2003	2004
BATU	1,773	1,582	1,277	1,035	1,054	1,240	1,251
Mastermind (Supermatch)	90	119	112	155	185	167	231

Source: BAT Uganda

3.2 The Effect of increases in Taxation on the Legitimate Cigarette Consumption

Figure 3: Cigarette sales by BATU and Mastermind in Uganda



During the year 1998, Master mind sales as a proportion of sales of BATU was only 5 percent (Figure 3) and has gradually kept on increasing and in the year 2004 it was approximately 18.50 percent. This observation suggests that cigarette imports are cheaper as compared to the locally produced cigarettes. Consumers can switch between the legitimate cigarette markets but between different competitors, in this case from BATU to Master mind.

Table 7 shows that cigarette retail prices have in most cases doubled during the period 1998-2001. This sharp increase in prices partly explains the decline in sales.

Table 7 British American Tobacco sales (000), Price charge (shillings), Brand

Brand & quality	1996	1997	1998	1999	2000	2001	2002	2003	2004
Benson & Hedges (Premium)	0.00 (*)		1,121 (2,500)	2,398.6 (2,500)	3,781 (2,500)	4,239 (2,500/3,000)	4,506.2 (3,000)	5,875.4 (3,000)	6,903 (3,000)
Embassy Rex (High)	(*) 100,999 (1,500)	(1,500) 107,524 (1,500)	1,496 (1,500) 111,947.4 (1,500)	4,872.6 (1,500/2,000) 138,720 (1,500/2,000)	21,006 (2,000) 163,101.6 (2,000)	21,535 (2,000/2,500) 131,825.2 (2,000/2,500)	17,448.6 (2,500) 86,741 (2500)	17,605 (2,500) 80,553.2 (2,500)	17,466 (2,500) 76,855 (2,500)
Sportsman Sweet Menthol (Mid)	1,344,627 (1,000) 12,565 (1,000)	1,296,892 (1,000) 540 (1,000)	1,346,873.4 (1,000) 60 (1,000)	1,207,870.8 (1,000/1,500) 70 (1,000/1,500)	612,190.8(1,500) (1,500)	337,207.2 (1,500/2,000) (1,500/2,000)	301,376.4 (2,000) (2,000)	294,257 (2,000) (2,000)	262,380 (2,000) (2,000)
Safari King Champion KSFT (Low)	(*) (*)	(*) (*)	(*) (*)	(*) 24,749.2 (1,000)	(*) (1,000)	111,603 (1,000/1,500) 24,660 (1,000/1,333)	2,783 (1,500) (*)	19,006 (1,500) (*)	2,088 (1,500) (*)
Safari regular C & S Supermatch Boss Amber (Very low)	55,217 (500) 202,017 (500) 30 (500) (*) (*)	155,283 (500) 208,800 (500) 12,309 (500) (*) (*)	114,599.6 (500/650) 181,778 (500) 15,419.6 (500) (*) (*)	27,134 (650/1,000) 162,018.4 (500/650) 15,046.6 (500/650) (*) (*)	353,966 (1,000/650) (650/1000) (650/1,000) (*) (*)	321,171.6 (650/1,000) 78,500 (1,000) 4,440 (1,000) (1,000) (*)	584,368 (1,000) 53,449 (1,000) 3,991 (1,000) (1,000) (2,000)	773,879 (1,000) 45,559.4 (1,000) 38,55.8 (1,000) (1,000) (2,000)	838,710 (1,000) 42,590 (1,000) 4,197 (1,000) (1,000) (1,000)
Total	**1,715,455**	**1,781,348**	**1,773,295**	**1,582,880.8**	**1,277,279.43**	**1,035,181**	**1,054,663.20**	**1,240,590.8**	**1,251,189**

Source: British American Tobacco, Figures in parentheses refer to prevailing price and words in parentheses refer to price sector of brand.

With the exception of Benson & hedges, Embassy and Rex, which are premium priced offers and probably consumed by high-income earners (Table 7), increase in prices of Sportsman/Sweet menthol leads to a decline in sales. For example an increase in price from UShs1, 000 in the year 1998 to UShs1, 500 in the year 2000 led to 49.3 percent decrease in sales. A further increase in price from UShs1, 500 in 2000 to UShs2, 000 inn 2002 resulted in fall in the quantity of sales by approximately 51 percent. A study by International Tax and Investment Center (ITIC, 2003) argues that an increase in taxes encourages consumers to switch within the legitimate cigarette market from higher priced cigarettes to lower priced cigarettes. It can be deduced further that consumers (probably low income earners) switched from high priced Sportsman to a cheaper but lower priced brands like safari regular and supermatch.

3.2.1 Cigarette Prices and Coin Usage

Limitation in use of coins results in rapid increases in Cigarette prices following small increments in excise taxes. For example, a 5 percent excise tax increment on a pack of say Benson & Hedges, which costs UShs3, 000 results in an increment of UShs150. This implies that at the new price of UShs3, 150 per pack one stick would cost UShs157.5. If BAT, for example can't absorb this tax in form of increased costs of production then it has to transfer the tax to the consumers by an increase in the price of UShs7.5 per stick. Because the use of coins is very limited either BAT will charge 2 sticks for UShs350, instead of UShs315 or charge a stick at Ug Shs200 instead of UShs157.5 for those consumers who can afford a stick at a time. This implies that a 5 percent increase in excise tax causes a 33.3 percent increase in price per stick. It is important to note also that 92 percent of the market sales of cigarettes is stick purchase market. This further implies that the tax burden is highest on the consumers (in form of very high prices), while the producers like BAT and Uganda Leaf Tobacco Company suffer from reduced sales and hence reduction in revenues on the side of the Government resulting from low sales.

3.2.2 Effect of increasing excise duties

Increasing excise duty taxes does not necessarily lead to increases in revenues in Uganda nor discourage smoking. Instead, it makes regular consumers shift to the alternative tobacco uses like rolling and snuffing, which are not usually taxed. Eventually both government and the producers lose out with the former losing tax revenues while the latter experience a decline in their market sales.

For instance, studies conducted by Research International during the years' 1994 and 2004 show that regular (those who smoke one stick per day) and occasional smokers (smoke less than one stick per day) have reduced from 27 percent in 1994 to 16 percent in 2004 and that alternative tobacco users (those who roll, snuff) have significantly increased to 15 percent in 2004 up from 3 percent in 1994.

3.3 Current Tax structure in Tobacco cigarette industry in Uganda

The major objective of tobacco taxation seems to be collection of government revenue as opposed to restriction of consumption of cigarettes in order to reduce related healthcare problems and hence reduce morbidity and mortality rates associated with smoking and externalities of social nature[2].

In Uganda, tobacco taxes are mainly indirect taxes namely excise duties, import duties and VAT. For a long time, relatively high excise rates have been levied on cigarettes. The justification for these high excise rates has been that tobacco because of its supposed addictive nature, tended to have a lower own and cross price elasticity of demand. However, empirical studies in other countries like Kenya show that the current tax rate in Kenya is way above the revenue maximizing rate and consumers are much more price sensitive (high price elasticity of demand) as (African Center for Economic Growth, 2002) argue.

Table 8 shows different excise tax rates applied to different brands of cigarettes in Uganda, over the period 1998 – 2002.

Table 8: Cigarette excise tax rates in Uganda 1998-2001

YEAR	TAX (%'GE)	B&H	EMBASSY	REX	SPM	SWEET METHOL	CHAMPION	SAFARI	C&S MED
1998	Excise/VAT	122/17	122/17	122/17	122/17	122/17	-	98/17	98/17
1999	Excise/VAT	132/17	122/17	122/17	122/17	122/17	132/17	98/17	98/17
2000	Excise/VAT	132/17	122/17	122/17	122/17	122/17	132/17	98/17	98/17
Jul-01	Excise/VAT	130/17	130/17	130/17	130/17	130/17	130/17	130/17	130/17
01 July 02	Excise (advolerom)	130%	n/a	n/a	130%	n/a	130%	130%	130%
	Minimum specific	n/a	25000/=	25000/=	N/a	25000/=	n/a	n/a	n/a
	VAT	17%	17%	17%	17%	17%	17%	17%	17%

Source: Finance Acts 1998/99-2001/2

On the 01 July 2004, the tax regime changed from ad valorem system to a tiered specific tax system at the following rates:

- UShs19, 000, for low priced Soft cups (safari, supermatch, crescent &star and their variants).
- UShs25, 000, for high priced Soft cups (sportsman, sweet menthol, boss, and their variants).
- UShs48, 000, for hinge-lids (Benson & Hedges, embassy, rex, amber and their variants).
- UShs48, 000, for all other cigarette brands.

Theses changes came into place after the industry contested the proposed increases by the government in Ad valorem tax rates from 130 percent to 150 percent for the financial year 2003/04.

In addition to the new three-tier system (Specific Tax system), there are also tax stamp duties levied according to whether the cigarettes are imported (have a

[2] Tax structure in Uganda is comprised of domestic indirect taxes (customs, import duty, export duty, and VAT), and direct taxes mainly income tax. Other sources of government include fees and licenses, and Non- tax revenue (mainly Appropriation in Aid).

Blue Tax Stamp), locally produced King size (Red Tax Stamp) and locally produced Reg size (Green Tax Stamp). It should be noted that the different tax stamps do not take into consideration the characteristics of the packs or the price per pack. For example, Sportsman and Supermatch brands fall in different excise tax tiers (see Table 3 above) but both relate to a Red tax stamp. Secondly, Sweet Menthol, which is imported but has similar characteristics like the Sportsman (produced locally) relate to different tax payment, while the former relates to a Green Tax Stamp the later relates to a Red Tax Stamp.

The tax liability under the new system is computed by applying the relevant excise duty rate, which is based on cigarette packet characteristics and the ex-factory price. VAT is levied at every point of production and distribution, and is charged at a constant rate of 18% for every firm with a threshold of UShs50 million. Currently, the tax regime in the tobacco cigarette industry in all the three East African states is a specific tax regime. However, price disparity for identical products due to differences in taxes, combined with challenges facing taxation of tobacco cigarette in the region, has led to wider advocacy by policy and industry actors for harmonization of excise tax in the region. Table 9 shows the wide disparity in the excise rates on the three brands of cigarettes in the three East African Community (EAC) countries.

Table 9: Excise rate on cigarettes in East Africa

Brand	Excise rate in US$		Excise rate in US$		Excise rate in US$	
	Uganda		**Kenya**		**Tanzania**	
	Per 1000	Per pack	Per 1000	Per pack	Per 1000	Per pack
B&H	27.4	0.60	18.7	0.4	15.5	0.3
Sportsman	14.3	0.30	12.0	0.2	8.5	0.2
Safari	10.9	0.20	6.0	0.1	-	-

Source: Obwona & Ayoki 2005
Notes: exchange rate: US$ =Ug Shs. 1750(Uganda), K Shs. 75 (Kenya), T Shs. 1,099 (Tanzania), price per 1,000 sticks

It is clear that countries where excise rates are high, prices also tend to be high as clearly demonstrated in (Table 10); confirming that tax is the main driver of prices in Uganda. For example, four major brands in Uganda: B&H, Embassy, Sportsman and Safari, attract higher prices compared to Kenya and Tanzania. Thus, overall prices are higher in Uganda than in any of its counterparts

Table 10: Cigarette prices in East Africa

Brand	Price per pack in US$	Price per pack in US$	Price per pack in US$
	Uganda Per pack	**Kenya** Per pack	**Tanzania** Per pack
B&H	1.71	1.33	1.18
Embassy	1.43	1.07	0.73
Sportsman	1.14	0.80	0.63
Safari	0.57	0.51	-

Source on domestic prices: BAT Uganda
Notes: exchange rate: US$ =Ug Shs. 1750(Uganda), K Shs. 75 (Kenya), T Shs. 1,099 (Tanzania)

Based on the observed trends in prices among the three countries, it can be deduced that Tanzania has been generating sustainable levels of excise tax from a declining tobacco market. In contrast, Kenya and Uganda have continued to experience decline in revenues. The decline in revenues is even worse for Uganda's case as depicted in (Table 11).

Table 11: Kenya, Uganda and Tanzania volumes (Bn) & revenues ($mn)

Country		1998	1999	2000	2001	2002	% Changes 98-02
Kenya	Volumes	6.7	6.3	6.2	5.9	5.7	-14.9%
Uganda		1.9	1.7	1.4	1.2	1.3	-31.5%
Tanzania		3.8	3.4	3.5	3.5	3.4	-10.5%
Kenya	Revenues	107	87	79	72	66	-38.3%
Uganda		34	30	24	20	20	-41.2%
Tanzania		50	44	45	46	45	-10.0%

Source: Research Study on Taxation of the Tobacco Industry in Kenya

Further more, it appears financially lucrative from the profit standpoint to smuggle cigarettes from Kenya (low price country), or even Tanzania (much lower price country) into Uganda. Available information points out Kenya as the main source of smuggled cigarettes sold in Uganda. The biggest concern of tobacco industry in Uganda is with illicit (smuggled) supermatch. Table 12 shows supermatch brand being relatively cheaper in Kenya than in Uganda and hence an incentive for smugglers of the product. A study by Obwona and Ayoki (2005) revealed that small traders at the boarder operate with lower costs in regard to custom clearance thus it is convenient for traders to buy from them than to clear big consignments

Table 12: Supermatch price in Kenya &Uganda

	Uganda		Kenya	
	Domestic	US$	Domestic	US$
1997	500	0.30	24	0.30
1998	500	0.30	28	0.40
1999	500/600	0.40	28	0.40
2000	650/1000	0.40	30	0.40
2001	1000	0.60	30-35	0.50
2002	1000	0.60	35	0.50
2003	1000	0.60	35-40	0.50
2004	1000	0.60	40	0.50

Source: BAT Uganda and authors computations
Notes: exchange rate: US$ =Ug Shs. 1750(Uganda), K Shs. 75 (Kenya), T Shs. 1,099 (Tanzania)

4.1 Harmonization of Taxes under EAC Treaty

The customs union between Uganda, Kenya and Tanzania commenced on 1st January 2005, with the overall objective of promoting trade and investment in East Africa. Much consideration under this treaty would be given to how EAC member states would put in place a tax system for excisable products through harmonization of tax rates. Harmonization of tax rates is necessary in order to address:

- Cross border- pricing problem.
- Illegal trade between EAC member states including DRC and Rwanda.
- Tax administration simplification.

All EAC partner states are already operating under a specific tax regime in the tobacco cigarette industry. However, there still exist excise tax rates disparities among the member states that need to be harmonized.

4.2.0 Nature, Causes and extent of illicit trade in Uganda

4.2.1 Nature of illicit trade

Illicit products are goods whose duty has not been fully paid for in the market where they are being sold; these include smuggled products, duty free products beyond allowable limits and counterfeit products.
In URA, illicit trade is simply referred to as outright smuggling, including goods in excess of allowable limits/ quantity (duty free limits). Hence, illicit products are products that have not been declared to customs at all.

In Uganda, the most serious form of illicit trade activities is smuggling and one of the major products posing a challenge under this illicit trading is cigarette. It is against this background that this study intends to inform both the cigarette industry and the government about the negative impacts of cigarette smuggling. The presence of smuggled cigarettes continued to impact the cigarette market adversely and severely constrained growth. Smuggling of cigarettes has persisted and unless it is checked, it will continue to constrain market growth and government revenue collections from the cigarette industry.

4.2.2 Forms of illicit trade

Illicit trade takes several forms:

- Diversion of goods on transit in order to evade taxes;
- Illicit manufacturing in which enterprises target and orient their merchandize for the parallel market and hence underground economy;
- Production of substandard and counterfeit goods;
- Diversion of goods destined for exports into the local market.

The most serious form of illicit cigarette trade in Uganda is the diversion of cigarettes (especially supermatch) destined for exports into the local market. Illicit trade therefore, reduces industry and government revenue, causes unfair competition and predatory pricing by unscrupulous competitors. Consumers too are not left out. In exchange of cheaper commodities, consumers have compromised on personal safety and on environmental and other standards.

4.2.3 Causes of illicit cigarette trade

There is substantial evidence globally that cigarette smuggling is on the rise and the explanation given for its increasing magnitude and structure is the lack of harmony in policy. For EAC, it is believed that the wide differentials in the excise tax rates across the region have increased tax evasion and tax avoidance in countries like Uganda where excise tax rates are high (refer to table 9) for excise tax rates on cigarettes in East Africa. A comparison of the excise with the retail-selling price (tax incidence- measured by the ratio of excise tax to the retail price) equally indicates the excise burden in Uganda is greater than that in other EAC countries as shown in the (Table13) below. The price gap between Kenya and Uganda acts as an incentive for smuggling.

Table13: Tax incidence on cigarettes in East Africa

BRAND	Excise as a % of Retail Selling Price Uganda	Excise as a % of Retail Selling Price Kenya	Excise as a % of Retail Selling Price Tanzania
B&H Embassy	32% 38%	28% 35%	19% 19%
Sportsman	25%	30%	23%
Safari & Supermatch	38%	33%	-

Source: BAT Uganda

One more factor worth mentioning is that the Ugandan market has continued to be very price sensitive. The own price elasticity of demand for cigarettes is high. This means that there are some consumers who are faced with no option but to down trade hence volumes shift from high value brands to low value brands. This increased demand for low priced brands has increased smuggling of supermatch brand into the Ugandan market since it a relatively cheaper brand.

Further more, the government role in law enforcement and tax administration in curbing smuggling of cigarettes has been constrained to some extent. World Bank (1999) argues that increasing the certainty and severity of law enforcement and prosecution is the most straightforward and sometimes the most efficient way of discouraging smuggling. The government has undertaken some initiatives. Tax stamps were introduced, but since the change from Ad valorem tax regime to three-tier excise tax regime, the current tax stamps have not been aligned to the tax structure. Further more, the Penalty for sale of product without tax stamp of UShs50, 000 only is too low to discourage smugglers who are making big profit margins.

4.2.4 Extent of illicit cigarette trade

Illicit trade between Uganda and Kenya has certainly persisted and is growing as available evidence shows. Kenya is the main source of smuggled cigarettes particularly supermatch to Uganda. It is believed that a significant percentage of the Supermatch consignments destined for DR of Congo and Southern Sudan either reach their final destinations and some of it comes back to Ugandan market illegally or it is offloaded in Kampala under the pretext that the consignments are exports and ends up being sold in Kihihi and Rukungiri, Ntungamo, Mbarara, Ishaka and Kasese (Obwona and Ayoki 2005).

The Uganda Revenue Authority (URA) estimated that 20 percent of the cigarettes on the Ugandan market are smuggled (URA, 2004). BAT Uganda estimates this at 15 percent an equivalent of about 180 million sticks of cigarettes per annum equivalent to annual loss of about UShs2.0 billion in tax revenue from one product (cigarettes) alone.

The following selected media/ newspaper articles quoted below provide further insight about the problem of cigarette smuggling in Uganda.

Smuggled cigarettes impounded
"Six vehicles with about 100 cartons of smuggled supermatch cigarettes worth UShs30 million from Kenya have been impounded by the Special Revenue Protection Services (SRPS) operatives…"

Monitor, 13 May 2005, by Kirunda Abu Baker

SRPS Seize…
"The Special Revenue Protection Services (SRPS) on Saturday impounded smuggled Supermatch cigarettes valued at over UShs7m…."

New Vision, 11 April 2005, p4 by Charles Kakamwa

Govt losing UShs2b to cigarette smuggling
"The Government loses UShs2b and local cigarette distributors at least UShs700m to illicit trade, BAT officials said on Friday…"

New Vision, 18 April 2005, by Emmy Olaki

These and more articles not quoted here is a strong indication of the magnitude and structure of illicit cigarette trade in Uganda and the damaging impact it has on both the legitimate industry and the government in terms of lost revenue and market share especially for major participants in the industry-BAT Uganda.

5.0 Conclusions and recommendations

Legitimate and contraband smuggled cigarettes are very close substitutes. High excise rates on cigarettes in Uganda particularly on high value brands can therefore lead to large – scale consumption of contraband cigarettes, limiting their impact on overall cigarette consumption and undermining government tax revenues. Furthermore, large tax differentials encourage smuggling and cross-border shopping even in countries where corruption and considerable resources are provided for policing and customs enforcements. This implies that smuggling is essentially a demand –side rather than a supply–side problem. Smuggling of cigarettes in Uganda will continue as long as consumers can achieve significant savings by buying from illegal sources and traders can make super normal margins

Furthermore, smuggling creates problems not only with government but also for the legitimate manufacturers, who then lose control of their product distribution and pricing, which diminishes the value of their brands and undermines investments. It also encourages increased criminality and disrespect for law and order.

As regards the tax regime, the current three-tier specific tax regime seems to be preferred for its simplicity and transparency and incentives towards production of high quality brands, while maintaining, the revenue yields for the government. This tax regime is in line with other tax regimes already adopted by Kenya and Tanzania.

The key recommendations are:

i. Harmonization of the excise tax by setting regional tax benchmarks so as to achieve 'tax consistency' in terms of the absolute level of tax per pack of cigarettes. We believe this will reduce the incentives for smuggling.
ii. The government should put in place more aggressive ways of curbing smuggling. It is estimated that over UShs2 billions is lost revenue as a result of smuggling. We recommend the following initiatives:

a. More punitive penalties should be put in place for example, the penalty for sale of a product without tax stamp need to be increased from the current value of
UShs50, 000. This figure is too low to act as an efficient deterrent to smuggling.
b. Increased border post policing: it is extremely important that policing of the market is done in an efficient and timely manner if smuggling is to be reduced. The Special Revenue Protection Services (SRPS) needs to be further strengthened and facilitated to be more effective. There is also need for closer cross-border cooperation and monitoring of product across borders by all EAC member states hence enforce the law.

iii. The government should broaden the tax base so as to reduce the tax incidence on few individuals in the tobacco industry. Moreover, broadening the tax base is possible with, first, government campaigning to identify and register unregistered cigarette producers and secondly, cultivating a culture of voluntary compliance for the producers that might be evading taxes and last but not least re-classification of the ready-to – smoke cigarettes which are possibly currently placed in other tax brackets.

iv. Maintenance of the specific tax regime that was started last year in July 2004 to avoid any discrepancies in the price across the region, also to build confidence among industrialists through tax regime stability.

v. For easy control of the administration, we recommend to have reconciliation between the excise payments and tax stamp utilization (that is to say all brands falling in the same tier should pay same stamp tax). In addition, the tax stamp should be based on the cigarette characteristics irrespective of the origin (that is to say locally produced or imported). Further more, there is need to redefine the tier system in a way that fully reflects the cigarette characteristics (for example, Soft cups and Hinge lids), instead of having two categories of Soft cups and each relating to a different excise tax.

vi. Increase smaller denomination coin usage by the consumers, which will allow small increments in prices resulting from small increases in excise duty. As noted earlier, a 5 percent increase in excise tax results in an increase in price of 33 percent per stick due to rounding up of prices.

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