EAGER Policy Brief

NUMBER 8 / JANUARY 1999

EXCISE TAXES: A Greater Role in Sub-Saharan Africa?

This brief is based on the research* that assesses the role excise taxes play in the countries of Sub-Saharan Africa and makes the following five policy propositions:

- **Revenue from excise taxes could and should be doubled in most African countries**
- **Efficiency-enhancing changes in the structure of excise taxes can be made**
- **Excise taxes should be confined to the traditional excises and a few luxury items**
- **Excise tax administration could be substantially improved by codifying and disseminating current "best practices" within Sub-Saharan Africa**
- **Increased reliance on excise taxes is consistent with an equitable tax system**

A healthy system of public finance is a prerequisite to rapid, equitable, and sustainable economic growth. A government relies on revenue to finance basic services such as security and primary education. Currently, public revenue in Sub-Saharan Africa relies heavily on trade taxes. As African countries develop, they must become more outward-oriented by reducing their dependence on import tariffs. Excise taxes offer governments an alternative source of revenue.

Excise taxes are levied on particular products and services, typically with discriminatory intent. A government may levy taxes on goods it deems "immoral" in order to discourage consumption of those goods. Ninety percent of excise tax revenue in Sub-Saharan Africa comes from "traditional" excises on tobacco products, alcoholic beverages, and motor fuels. High taxes on addictive products such as tobacco and alcohol do not deter consumption much. In some cases they deprive families who use these commodities of funds that they would otherwise use to buy essential products.

USAID

Equity And Growth through Economic Research– an activity of USAID, Bureau for Africa, Office of Sustainable Development, Strategic Analysis Division

EAGER

Excise taxes are an effective policy tool in developing countries when they are applied to goods whose demand is income elastic. The demand for a good is income elastic if it grows rapidly in response to increases in consumers' incomes. This means that tax revenue rises as national income rises. A tax system based on such excise taxes does not require frequent modification to maintain revenue.

Another reason excise taxes are an effective policy tool is that they are efficient. An efficient tax does not unduly distort individuals' production and consumption choices. To maximize revenue, a government should apply a low tax rate to a good whose demand is very responsive to changes in price. A good with demand less responsive to changes in price should be taxed at a high rate. A system of excise taxes allows every commodity to be taxed at a different rate based on consumers' responsiveness to changes in the commodity's price.

The final reason excise taxes are an effective policy tool is that they are consistent with equity. Some economists argue that excise taxes are unfair because they fall heavily on poorer quality goods and hence on poorer consumers. However, this may not be the case in developing countries where the informal sector produces close substitutes for taxed goods (home-distilled rum, hand-rolled cigarettes), which both escape tax and are consumed disproportionately by the poor. Excise taxes, also produce equity of a different sort when they act as user charges, forcing those who benefit from a good or service to pay for it. For example, excise taxes on gasoline are fair when they are used to maintain public roads. Furthermore, excise taxes are equitable when they raise revenues that could not be raised by other means and when they finance services for the poor such as public education, primary health care, and infrastructure investments.

In 1998, USAID, through the EAGER Project, sponsored a study to assess the role that excise taxes do and should play in the countries of Sub-Saharan Africa. The researchers make the following five policy propositions:

- **Revenue from excise taxes could and should be doubled in most African countries.** During the two decades since 1973, excise taxes in Africa yielded 1.9 percent of GDP. Excise tax revenue varies from year to year and across countries. Econometric analysis of the possible factors contributing to the choice of tax policies (national income, size of government, openness to trade, and culture) found no easily identifiable reasons for the substantial variation in excise tax revenue across countries. This means that there is considerable scope for changes in policy and tax administration to increase the revenue from excise taxes. If African countries doubled their excise tax revenue, they would be in line with the countries of the Organization of Economic Cooperation and Development (OECD), whose excise tax revenues are equivalent to about 3 percent of GDP.

• **Efficiency-enhancing changes in the structure of excise taxes can be made.** Most excise taxes have been subject to years of ad hoc changes and therefore are poorly designed. Specific tax rates need to be adjusted over time to ensure that revenue keeps pace with inflation. Exemptions granted to the government, diplomats, and foreign-financed projects make excise tax systems inefficient. Some African countries grant military personnel access to beer and cigarettes at tax-reduced prices. These products are then resold, which severely erodes the excise revenue realized by government.

• **Excise taxes should be confined to the traditional excises and a few luxury items.** Limiting excise taxes to a small number of products makes them easier to administer and increases the integrity of the excise system. The demands for traditional excise goods (alcohol, tobacco, and gasoline) are not particularly responsive to changes in price, therefore taxing them increases revenue because it does not decrease the tax base. The rich consume luxury goods such as motor vehicles, soft drinks, electricity, and telecommunications more than the poor. Applying excise taxes to these items eases the burden on the poor and increases the burden on the rich. The same can be accomplished by applying a higher tax rate to higher-quality goods within any product category.

• **Excise tax administration could be substantially improved by codifying and disseminating current best practices within Sub-Saharan Africa.** Research in individual African countries shows that policy makers and tax administrators are poorly informed about, but highly interested in, what their counterparts are doing in other countries.

• **Increased reliance on excise taxes is consistent with an equitable tax system.** The tax systems of developed countries are more heavily reliant on excise taxes and more equitable than the tax systems of developing countries. Furthermore, excises that are regressive in industrial countries may be progressive in African countries, where a well-developed informal sector provides the poor with tax-free alternatives. Improving excise tax systems in African countries can have two benefits. First, the collection of excises can increase revenues that can be used to reduce fiscal deficits or to support growth-oriented spending on health, education, and infrastructure. Second, excise taxes can act as an alternative to trade taxes, thus allowing African countries to become more outward-oriented.

*** This policy brief is based on EAGER Discussion Paper Number 2, *Tax Policy in Sub-Saharan Africa: Examining the Role of Excise Taxation*, 1998, by Bruce Bolnick [bbolnick@malawi.net], Harvard Institute for International Development, Lilongwe, Malawi; and Jonathan Haughton [jhaughto@sclas.suffolk.edu], Suffolk University, Boston, Massachusetts.**

The views and interpretations in this policy brief are those of the authors and not necessarily of the affiliated institutions.

To Order Policy Briefs or Other EAGER Publications

EAGER Publications/BHM
1800 North Kent Street, Suite 1060
Arlington, Virginia 22209
tel/fax: 703-741-0900/703-741-0909
e-mail: spriddy@eagerproject.com

All EAGER Publications can be downloaded from www.eagerproject.com