R&C Trendwatch

July 2014

Anticipating the rise of junk food and soda taxes in emerging markets

Executive summary

- *Given rising public health concerns and a need to raise revenue, governments in emerging markets are increasingly applying sin taxes on junk food and soda.*
- *Companies needing to assess where sin taxes will be introduced next should consider a number of variables, including a country's health metrics, the internal political debate, government finances, regional trends, and the country's stage of development.*
- *Knowing where and how sin taxes will be applied will enable companies to modify their strategies, engage with governments and the public, and communicate with stakeholders*

Introduction

Governments in emerging markets are increasingly using sin taxes as a way to address rising public health concerns and stretched public finances. Sin taxes are typically levied on tobacco and alcohol, but authorities are also imposing them on food and beverages high in sugar and fat content. Earlier this year, Mexico unexpectedly implemented a tax of 10% on every liter of sugar-sweetened drinks and an 8% excise tax on high-calorie food—a move deemed necessary to address Mexico's obesity rate, the highest in the world at 32.8%.

Though sin taxes are appealing as a means to moderate consumption of products considered harmful to the population, an equally influential driver may be a government's need to raise revenue. Sin taxes are therefore more likely in a context of slowing growth, a high deficit, and weak tax collection, especially if political dynamics make the public more amenable to such a tax. Moreover, sin taxes appear to have a domino effect: If one country adopts them, regional peers are likely to follow.

This publication is produced in collaboration with ***Eurasia Group (www.eurasiagroup.net)****. Eurasia Group is a leading political risk research and consulting company.*

pwc

Taxing issues: Public health and the need to raise revenue

There is little doubt that sin taxes are an easy way to raise revenue. A tax on alcohol and tobacco introduced in the Philippines in December 2012 enabled the government to raise $1.2 billion in 2013, about $42 million more than the projected revenue for that year without the tax. Furthermore, increased efficiency within the tax system, combined with proceeds from the sin tax, enabled the administration to avoid raising taxes in other areas, including corporate taxes. These factors led to upgrades in the Philippines' credit rating, which other emerging markets will note with interest.

Mexico's soda and junk food tax is expected to yield an additional 1% of GDP in revenue for the 2014 fiscal year. Given that President Enrique Pena Nieto was forced to roll back plans for some other tax hikes, the junk food levy will help the country meet its fiscal goals. In Chile, a tax on sugary drinks is part of a wider program of reforms proposed by the government aimed at bolstering revenue by about 3% of GDP. Hungary's junk food tax, which is estimated to have earned a more moderate 0.1% of GDP since its introduction in 2011, was also part of a package of initiatives to raise state revenue. In Russia, excise rates on tobacco have been growing annually since 2009, but officials have only recently sought to channel them into the healthcare sector.

Public health is likewise a priority for these governments. The Philippines' Department of Health estimates that cigarette smoking kills 87,000 Filipinos every year. Mexicans drink an average of 163 liters of soda each per year, contributing to the prevalence of diabetes (14% of the population is afflicted). In Hungary, nearly two-thirds of the population are overweight or obese, and the Russian government estimates that alcohol and tobacco abuse costs it at least $104 billion, or 5% of GDP, annually. In a context of growing middle classes demanding improvements in public healthcare, sin taxes are an easily collectable, easily justifiable means to raise revenue.

Where next? An assessment framework

Companies looking to assess where sin taxes will be introduced next must consider a number of variables. The first is the political debate over health in a given country and whether the consumption of tobacco, alcohol, and/or other unhealthy products is having a significant effect on the population. This can be measured by the prevalence of non-communicable diseases brought on by smoking and drinking alcohol and the number of obese and overweight people, especially children. A related factor is whether there is a middle class engaged in this debate, pressing the government to take action. This is by no means a prerequisite for tax hikes, but it makes it easier for authorities to justify this course of action. On the flip side, because sin taxes affect the poor more than the wealthy, a government reliant on political support from the poor may be less likely to impose them, regardless of the health metrics. Another key variable is fiscal need. Because sin taxes are levied at the point of purchase, they are easy to collect and can have an immediate impact on a government's budget.

Variables affecting the likelihood of a soda or junk food tax in Latin America

	Tax Collection % of GDP	Fiscal Balance	Government spending % of GDP	Middle class size	Obesity rate	President's political strength	Public debate on junk food/soda regulations
Argentina	high	large deficit	high	high	high	low	no
Brazil	high	small surplus	high	high	med	med	yes
Chile	med	small deficit	med	high	high	high	yes
Columbia	med	small surplus	med	med	low	med	yes
Costa Rica	med	large deficit	low	med	med	med	yes
Dominican Republic	low	large deficit	low	med	med	high	yes
Ecuador	high	small deficit	high	med	med	high	yes
El Salvador	low	large deficit	med	med	high	med	no
Guatemala	low	small deficit	low	low	med	low	no
Honduras	low	large deficit	med	low	med	high	no
Mexico	low	small deficit	med	high	high	high	yes
Peru	med	small surplus	low	high	low	low	yes
Venezuela	low	large deficit	high	med	high	low	no

High political risk | Medium political risk | Low political risk

Source: Brookings, OECD, WHO, World Bank, IMF and Eurasia Group

Given these factors, companies face an increasing likelihood of sin taxes across Latin America, especially for junk food and soda. Chile and Mexico have already applied such levies, and Colombia and Costa Rica are considering them. In Brazil, the government plans to introduce a levy on beer and cold non-alcoholic beverages in September that is expected to raise prices by an average of 2.25%. Though this tax hike has been motivated by a need to boost revenue, the debate on obesity has already driven policymakers at a local level to prohibit sales of fast food and sodas in schools. Measures such as a junk food or soda tax will therefore become easier to implement as Brazil's middle class comes to expect initiatives that address health issues.

Ecuador, Argentina, and Venezuela are other examples of countries that may be spurred by fiscal need to suddenly introduce a soda tax. In Ecuador, the health debate is already underway; a food-labeling system introduced in November 2013 highlights high sugar and fat content. This development, combined with Ecuador's deficit of 4% of GDP (compared to 1% in 2012), makes the introduction of a junk food or soda tax more likely. Though there has been little debate about obesity in Venezuela and Argentina (despite high levels among both populations), these countries are in dire need of revenue. Venezuela has a large fiscal deficit, and precarious political dynamics make it difficult to predict policy.

That said, a soda or junk food tax affects the poor disproportionately, so President Nicolas Maduro may calculate that such a tax would further undermine his popularity. In Argentina, tax pressure has reached record high levels, generating concerns among consumers and in the private sector, while the country's fiscal accounts have deteriorated rapidly on the back of rising spending. A soda tax could become an attractive source of revenue and would likely find support among sections of the middle class.

Asian countries that are considering sin taxes on junk food and soda include Vietnam, Thailand, Indonesia, and the Philippines. Not all of these countries have a problem with overconsumption and obesity. Only 5.2% of Vietnam's population is overweight, for example, but the government is motivated to raise revenue and protect its domestic drinks manufacturers (the tax was apparently proposed by Vietnam's tea producers). Although the proposed soda levy of 10% is projected to collect a modest $8.46 million per year, it is an easily collectable tax that would mostly affect foreign manufacturers.

Meanwhile, soda and junk food taxes are likely to be considered in South Africa, which has a need to raise revenue and mounting levels of obesity. South Africa also has a precedent of imposing regulations on unhealthy food, particularly with high salt content. Offsetting this, however, is an urgent need to address unemployment, which stands at 24%. This could give consumer goods companies an angle with which to negotiate with the government on ways to avoid such taxes, possibly by agreeing to increase production and processing in the country and to employ more South Africans.

In the rest of sub-Saharan Africa, sin taxes on cigarettes and alcohol are in place in many countries, but direct taxation of soda and junk food is not yet part of the debate. Partly this is because there are more pressing economic issues in most countries and partly because, in a context in which malnutrition and under-nutrition is still such a glaring problem, having a political debate to address obesity would be divisive. Nevertheless, as the African middle class grows, so will its waistlines, so this is likely to be an issue at some point.

Effectiveness in reducing use—and criticism

Experts argue that to reduce consumption of harmful products, sin taxes must be high (at least 70% on cigarettes, for example) and levied in conjunction with other efforts. In Russia, sin taxes have been implemented in combination with laws that significantly restrict the sale of tobacco and alcohol, as well as the ability to smoke and drink in public. Bodies such as the World Health Organization have argued that increasing prices is the most effective way to encourage tobacco users to quit. In combating obesity, however, taxing food and drink is thought to be only one part of the equation; exercise and other healthy lifestyles also must be promoted.

Companies and consumer groups opposed to sin taxes, on the other hand, feel that if the proceeds are not used for improvements in public health, the measures are simply another permanent source of tax revenues and have little to do with reducing consumption. Middle-class voters and consumers in emerging markets are likely to insist that governments levying sin taxes become accountable in this regard. If so, consumer goods firms will want to tap into the debate over what constitutes health and wellness (particularly in the case of diet, exercise, and available health services) by helping governments identify and achieve public health goals.

The application of a sin tax is by no means simple: Unless it is calculated and applied carefully, it may not work. In fact, it may unleash unintended consequences that harm the business environment by expanding black market activity and provoking a political backlash. Consumer goods companies need to engage governments on these issues to avoid being blindsided by a tax that both dents corporate profits and harms the long-term growth prospects of the country in question.

Strategies and implications

- *Identify where sin taxes are likely: By tapping into the social and political debate on health and the wider economy in a country, consumer goods firms can identify where sin taxes are being considered and whether there is the appetite to impose them on cigarettes and alcohol—or on unhealthy food and drink. Being prepared will enable companies to rally a response to government proposals. Because the effectiveness of sin taxes is debatable, consumer goods firms could effectively argue for alternative means to improve national health metrics.*
- *Communicate the value of your contribution to the economy and society: Consumer goods companies are large employers in many emerging markets, helping people out of poverty through paid work. Governments do not always think of the knock-on effect that a sin tax could have on the business environment and may be making short-term gains at the expense of long-term growth.*
- *Work with the government to achieve its health goals: Where there are public health problems, companies can work with the government to achieve goals—particularly by promoting sport and activity as part of a healthy lifestyle and ensuring access to safe drinking water.*

Editorial

Eurasia Group
New York headquarters
149 Fifth Avenue, 15th Floor
New York, NY 10010
+1 212 213 3112
Eva Molyneux
Senior Analyst, Retail & Consumer
molyneux@eurasiagroup.net

Mike Brewster
Global Retail & Consumer Marketing
michael.j.brewster@us.pwc.com

Susan Eggleton
Global Retail & Consumer Marketing
susan.eggleton@us.pwc.com

Denis Smith
Global Retail & Consumer Marketing
denis.s.smith@hk.pwc.com

Resources

John G. Maxwell
Global Retail & Consumer Leader
john.g.maxwell@us.pwc.com

Harry Doornbosch
Global Retail & Consumer Tax Leader
harry.doornbosch@nl.pwc.com

Barbra Bukovac
US Retail & Consumer Tax Leader
barbra.bukovac@us.pwc.com

Paul De Chalain
Africa Tax Leader
paul.de.chalain@za.pwc.com

Arnaud Chastel
Europe Retail & Consumer Tax Leader
arnaud.chastel@fr.landwellglobal.com

Gabriel Martini
Argentina Retail & Consumer Leader
gabriel.martini@ar.pwc.com

Luis Reis
Brazil Retail & Consumer Tax Leader
luis.reis@br.pwc.com

www.pwc.com/r&c

PwC firms provide industry-focused assurance, tax and advisory services to enhance value for their clients. More than 180,000 people in 157 countries in firms across the PwC network share their thinking, experience and solutions to develop fresh perspectives and practical advice. See www.pwc.com for more information.

“PwC” is the brand under which member firms of PricewaterhouseCoopers International Limited (PwCIL) operate and provide services. Together, these firms form the PwC network.