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Microeconomics Commentary

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HITTING THE SWEET SPOT

THE NEW SUGAR TAX IS AIMED AT CURBING MALAYSIA'S SWEET TOOTH

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Much has been said about the state of Malaysia's health, with the 2015 National Health and Morbidity Survey reporting that 48% of Malaysian adults are overweight or obese and at risk for lifestyle-related diseases such as diabetes, hypertension and cancer.

To curb this burgeoning health problem, the Malaysian government introduced a new sugar tax in November 2018 aimed at reducing Malaysians' consumption of sugary drinks. As of July 1, 2019, a MYR 0.40 tax per litre will be added to the price of soft drinks with more than 5 grams of sugar per 100 ml and juice or vegetable-based drinks with more than 12 grams of sugar per 100 ml.

MANUFACTURERS GET CREATIVE AMID NEW TAX

The government has imposed the tax at the manufacturer level, and we expect manufacturers to pass the increased cost on to customers.

When pressed, it's common for manufacturers to reduce the size of their products while leaving the cost unchanged, which makes the impact of the overall cost less visible to consumers. In fact, this has become a common cost-reduction strategy over the past few years. And this new sugar tax could be a reason for manufacturers to continue using this strategy to protect their profit margins. If downsizing a product is too constant or highly noticeable to the consumers, however, consumers may lose faith in brands and consider alternatives.

But manufacturers aren't going to simply address the issue with price and pack sizes. We also expect to see an increase in low- and zero-sugar beverage variants in the market, particularly in light of the government's push for a healthier Malaysia. Over the past 12 months, low-sugar carbonated soft drinks have tripled their share of the beverage market, signifying manufacturers' aggressiveness in experimenting and testing consumers' acceptance of healthier drink options. For example, bottled water sales are up 15% over the past 12 months, and we expect this trend to continue.

HOW WILL MALAYSIAN CONSUMERS REACT?

Despite the drive to be healthier, Malaysians love their carbonated soft drinks, which are affected by the sugar tax. Carbonated beverages are the most-consumed type of beverage in Malaysia, accounting for 21% of the beverage market.

Despite the stronghold these beverages have in the market, a recent Nielsen study on consumer awareness of the sugar tax in Malaysia found that a majority of consumers intend to change their purchase behaviour in light of the new sugar tax. One way they plan to change is by purchasing fewer carbonated soft drinks. In this price-sensitive market, consumers say they would either buy smaller beverage packs or buy less quantities in general, thereby altering their lifestyles in the process.

To prevent a decline in their overall sales, manufacturers should market their low-sugar variants more aggressively through the effective use of branding and advertising. By raising awareness about the appeal of healthier variants, manufacturers can attract consumers to low-sugar variants. And since these options are not affected by the new tax, consumers can buy them in the same quantities.

THE SUGAR TAX IS NOT A NEW PHENOMENON

The idea of a sugar tax is not unique to Malaysia. In fact, more than 40 countries around the globe have some form of sugar tax on the books. Given the notoriety of the concept, we can envision three possible scenarios that could play out in Malaysia based on the effects that we've seen in other countries:

1. Consumption of soda drops—temporarily. In Mexico, one of the world's largest soda markets, the sugar tax caused the price of the affected beverages, including carbonated soft drinks, to rise 10%. Consequently, consumption declined by 3% shortly after the tax came took effect, but returned to pre-tax levels just two years later.

2. Consumer preferences outweigh change. In the U.K., the sugar tax has encouraged manufacturers to reformulate their offerings and make low-sugar options available. Despite the efforts of manufacturers, however, many consumers have stated that their consumption behavior has not changed.

3. Soda consumption drops dramatically. In Saudi Arabia and the Philippines, the sugar tax led to a steep decline in soda consumption, falling by 14% and 6%, respectively. The pullback led to a notable rise in bottled water sales.

The next year will tell us which of these three possible outcomes will play out in Malaysia. The implementation of the sugar tax won't, however, solve Malaysia's health problem. It is, however, a component of the overall issue and is a step in the right direction, as it will lead to increased availability and awareness on the healthier beverages available in the market.

https://www.nielsen.com/apac/en/insights/article/2019/hitting-the-sweet-spot/

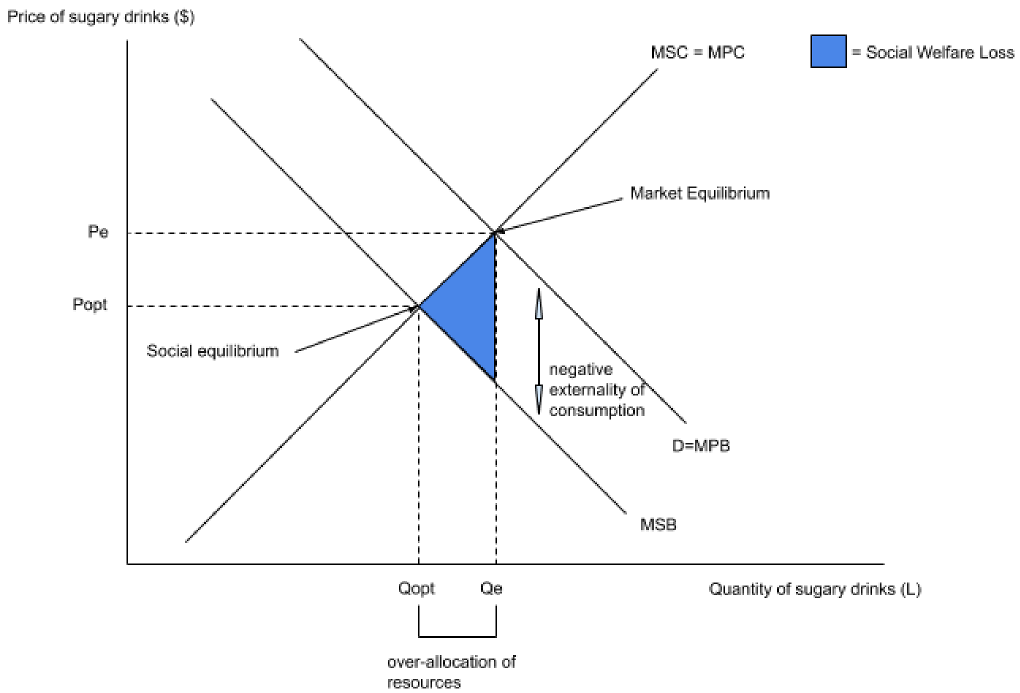
Commentary

This article discusses the imposition of MYR0.40 per unit tax, a type of specific tax which is “a tax calculated as an absolute amount per unit of the good or service sold” (Tragakes, 2012) to correct negative externalities of consumption in Malaysia.

Traditionally sugary drinks are considered demerit goods - “goods that are considered to be undesirable for consumers and are overprovided by the market” (Tragakes, 2012). Hence, market failure - the misallocation of resources from a social optimal perspective arises, imposing undesirable impacts onto third parties.

Shown diagrammatically below, market forces are driven by self-interest maximization incentives. Consumers only consider private benefits when consuming; producers only consider private costs when producing. Thus, market output is where marginal private cost equates marginal private benefit. However, social optimal output is where social cost equates marginal social benefit where externalities must be considered. Therefore, market output Q_e exceeds social optimal output Q_{opt} as external cost of sugary drinks is ignored.

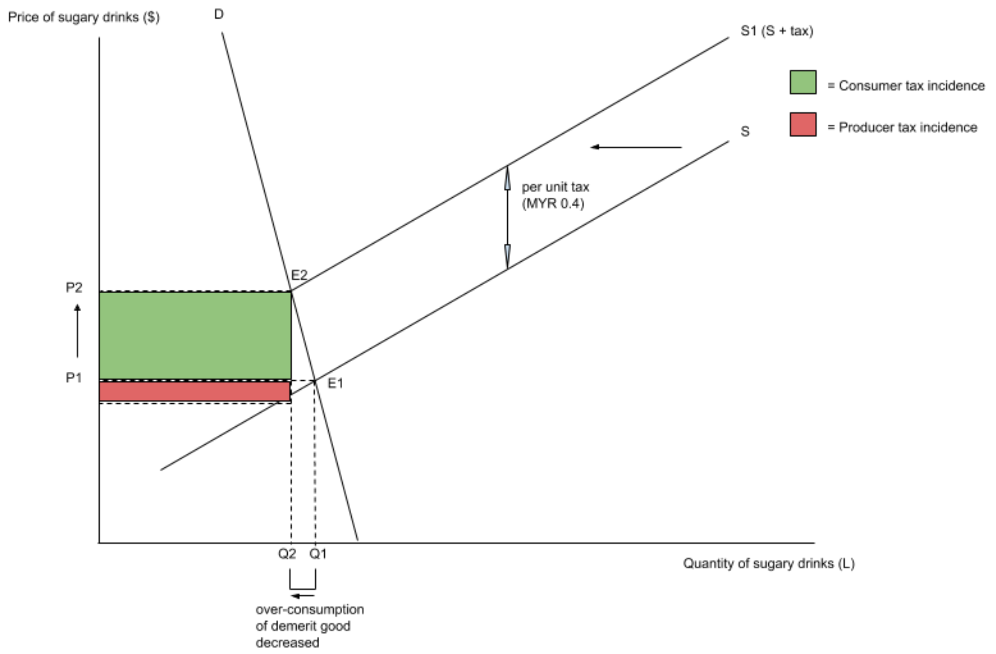
Figure 1: External costs resulting in over-allocation of resources



"48% of Malaysian adults are overweight or obese and at risk for lifestyle-related diseases". Negative externalities - the negative impacts that affect third parties, would arise because the government would allocate more resources on healthcare, leading to opportunity cost as less amount of resources could be spent on other social needs. Moreover, health problems may affect productivity, hindering economic growth.

Therefore, indirect tax may help correct market failure - producers would pass part of the tax onto consumers by raising the price, discouraging consumption. However, the effectiveness is affected by price elasticity of demand. In the UK, "many consumers have stated that their consumption has not changed" despite substitutes available. It suggests that consumption of sugary drinks could be habit-forming and the demand is price inelastic. In Figure 2. the price inelastic demand allows the producers to pass a large proportion of tax, as shown by differing tax incidences, onto consumers by raising the price significantly ($P_1 \rightarrow P_2$) as consumers can only reduce consumption to a proportionally lesser extent ($Q_1 \rightarrow Q_2$). Therefore, tax alone may not be effective in discouraging consumption unless raised significantly.

Figure 2: Tax incidence graph suggesting ineffectiveness of indirect tax



Additionally, in "price-sensitive" Malaysia "a majority of consumers" plan to purchase "fewer carbonated soft drinks". Since the availability of substitutes in the market is a determinant of PED, tax could be more effective in discouraging consumption amongst low-income consumers in developing countries like Malaysia as their demand tends to be more price elastic over developed countries like the UK.

However, indirect tax is regressive which means the tax would represent a smaller proportion of income when income increases. The distribution of income and poverty would worsen because low-income consumers spend a larger proportion of their budget on sugary drinks, having less to spend on other areas including essential goods. This may lower the standard of living and worsen poverty. However, it also may benefit low-income consumers in the long run because indirect tax would be more effective in discouraging consumption of sugary drinks and avoiding long-term potential health problems. On the other hand, richer consumers may not suffer in the short run as the price hike is negligible, however are more likely to suffer in the long-term as health problems such as diabetes may occur.

Comparatively, using legislation such as prohibiting the sales of unhealthy drinks in schools or colleges may be more effective than taxation as the availability of demerit goods would be reduced. Furthermore, legislation is not affected by PED which makes it more viable. However, legislation would lead to allocative inefficiency in that it does not allow price signalling leading to loss of consumer sovereignty, and resources must be used to enforce said legislation, creating opportunity cost. Alternatively, negative advertising or education that reduces the perceived benefits of sugary drinks may effectively reduce consumption in the long run, as consumers may choose not to consume by free will. Furthermore, it may convince manufacturers to decrease sugary drink production in accordance to consumer sovereignty as social trends may increase demand for lower-sugar substitutes - “low-sugar carbonated soft drinks have tripled their share of the beverage market.” However, a large time-lag is present, which may decrease effectiveness in the short-term.

In conclusion, if carefully planned, indirect tax could be effective in correcting market failure of demerit goods, as it would not only discourage consumption via higher prices, but also increase availability and awareness of healthier beverages in the market through market mechanisms. However, the government must be astute in its implementation; over or under-taxing the market would lead to government failure and may reduce the tax’s effectiveness.