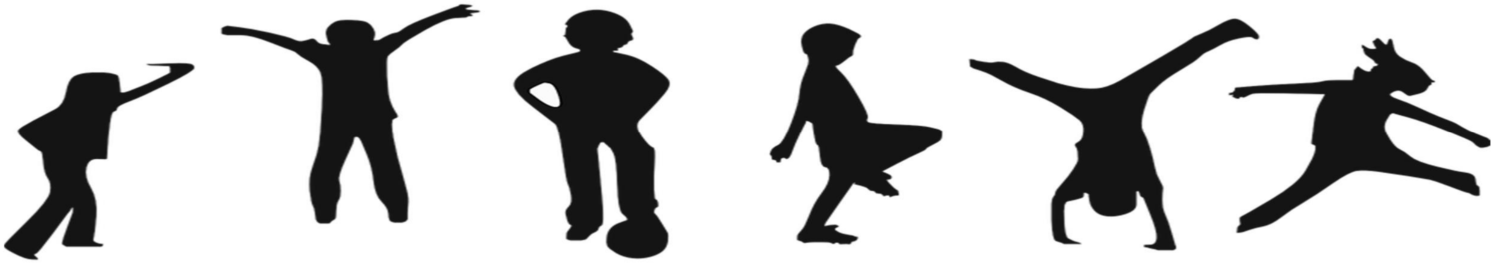

The sugar tax and the public finances

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When introducing the Soft Drinks Industry Levy, the then Chancellor, George Osborne, added that the revenues from the tax would be "tied directly"[1] to funding sport and other activities in schools. This briefing paper looks at the likely effects of the tax and associated spending on the public finances.

Key findings

- The sugar tax will not be tied directly to funding sport.
    - Revenues from the sugar tax will go into the Consolidated Fund, the government's general bank account at the Bank of England.
- Politicians will spend the additional revenue on whatever they like.
    - What the revenues from the sugar tax will be spent on is not enshrined in law, but at the discretion of the government of the day.
- Tying specific tax revenues to specific items of spending is a bad idea.
    - Hypothecated taxes – taxes that fund a particular item of spending – are undesirable as they lead to the inefficient allocation of resources.
- Politicians often do not follow through on pledges to spend specific tax revenues on specific projects.
    - Tying specific tax revenues to specific items of spending hypothecated taxes have consistently been used by governments as a means of increasing the overall level of public spending rather than being spent on their stated objective.
- It is not certain that the sugar tax will raise the money that has been stated.
    - Revenue forecasts have been assigned a "medium-high" level of uncertainty by the Office for Budget Responsibility because behavioural responses such as cross-border shopping, illicit sales and drink reformulation –reducing the amount of sugar– are highly unpredictable.
- If that is the case, taxpayers will have to pay for the shortfall.
    - If revenues are lower than forecast, additional borrowing or higher taxes will be required to fund the additional spending already pledged.

[1] George Osborne's Budget speech, 2016

- A 10 per cent revenue shortfall (c.50 million per year) is equivalent to:
  - 2 per cent additional beer and cider duties
- A 20 per cent revenue shortfall (c.100 million per year) is equivalent to:
  - 1 per cent increase in the standard rate of inheritance tax

The problems of hypothecated taxes

In his 2016 Budget speech, the former chancellor George Osborne said of the revenues from the tax:

> *"We're going to use the money from this new levy to double the amount of funding we dedicate to sport in every primary school.*
>
> *"And for secondary schools we're going to fund longer school days for those that want to offer their pupils a wider range of activities, including extra sport."*

There are a number of problems with such an approach.

Tax revenues are perfectly fungible: a pound from the sugar tax is worth the same as a pound from Income Tax, VAT, Stamp Duty or any other tax. Sugar tax revenues will go into the Consolidated Fund (the government's general bank account) and hypothecation is likely to be weak.

However strong hypothecation would not improve the case.

	Strong hypothecation	Weak hypothecation
Raises more than forecast	More money spent on school sport than was budgeted. Hypothecation leads to inefficient allocation of resources.	Additional money raised from the sugar tax spent elsewhere. Hypothecation rendered meaningless – simply another tax.
Raises less than forecast	School sport projects underfunded.	Spending on school sports topped up with additional tax revenues. No different to assigning revenues from Business Rates to the Ministry of Defence.

International experience shows that hypothecated taxes are a mechanism for increasing overall spending. The Mercatus Center[2] at George Mason University in Virginia found that:

- For each dollar of general sales tax revenue earmarked to education spending, no significant increase in education spending was observed, but an increase of $0.55 in total government expenditure was found.
- Each dollar of corporate income tax revenue dedicated to education was associated with a decrease of roughly $2.72 in spending on education and a similarly sized increase in spending on other programs.
- Tobacco tax revenue dedicated to spending on local governments was increased overall government size with no effect on spending in the targeted category evident.
- For each dollar of personal income tax revenue dedicated to local governments, expenditures in other areas increased by roughly $0.84 and total spending by $0.94.

[2] Crowley & Hoffer, June 2012, *The effects of dedicating tax revenues*, Mercatus Center

Associated costs

Originally, the Office for Budget Responsibility (OBR) forecast that the sugar tax will raise CPI inflation by a quarter of a percentage point. One effect of this inflation is to increase the cost of the interest payments for Retail Prices index-linked Gilts by £1 billion in 2018—19.[3]

In the November 2016 edition of the OBR's Economic and Fiscal Outlook the impact of sugar tax on CPI was revised down from adding 0.25 percentage points to 0.125 percentage points. While this indicates additional debt interest costs will be lower than previously expected there remains a significant additional cost.

- Other, as yet unquantified, additional costs due to the raising of index-linked benefits and public service pensions will also arise.

Any subsequent increases in the tax rate would have the same effect.

How certain are the sugar tax revenues?

The Office for Budget Responsibility designated a 'medium-high' level of uncertainty to the tax revenue.[4] This is for three main reasons: modelling challenges, lack of quality data and that it is hard to predict behaviour.

Behavioural change is the most uncertain area:

Cross-border shopping and smuggling

Local and international experience of the introduction of 'sin taxes' shows that it tends to encourage cross-border shopping.

- Consumers may buy in neighbouring jurisdictions to avoid the increased price.
- For example, Denmark's fat tax (since abolished) had such a distortionary effect that trans-border trade in fats, oils cheese and meats may have doubled.[5]

Products bought in bulk could alternatively be sold without paying due levies.

- The most common example of this is seen with tobacco.[6]
    - 2011 estimates suggest that 39 per cent of handrolling tobacco is sold illicitly.
    - £28.4 billion of tobacco duty revenue has been lost in the past ten tears, £21.7 billion of which has been due to illicit trade (as opposed to cross-border and duty free shopping).

The existence of significant cross-border price discrepancies is likely to encourage this type of illicit trade particularly at the border between Northern Ireland and the Republic of Ireland and between Southern England and continental Europe.

The effect of this would be to reduce the revenues from the Soft Drinks Industry Levy.

[3] http://cdn.budgetresponsibility.org.uk/Executive-summary-1.pdf#page=4
[4] Office For Budget Responsibility, March 2016, Economic and Fiscal Outlook
[5] Petkantchin, May 2013, "Nutrition" taxes, the cost of Denmark's fat tax, Institut Economique Molinari
[6] http://www.the-tma.org.uk/wp-content/uploads/2015/07/TMA_AIT_Gatefold_Leaflet_Proof.pdf

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Product reformulation

Product reformulation is the process by which soft drinks companies change their products, usually in response to market preferences. It has been significant over recent years, with many companies bringing down sugar levels in their products before the sugar tax debate really began.[7] The former Chancellor of the Exchequer, George Osborne, acknowledged as much when announcing the policy at the budget.[8]

The sugar tax may also create a perverse incentive to take advantage of the different rates of the sugar levy (which are detailed in the table below).

Levy thresholds	0-4.9 g/100ml	5g-8g/100ml	8+ g/100ml
Per litre	Exempt	18 pence	24 pence

- A product which is only slightly above a band's lower threshold (e.g. just over 5 grams or 8 grams) may reformulate to below the threshold and so now avoid the levy entirely or attract the lower rate.
    - This may involve a relatively small change in sugar content and so not substantially change the calorific content of the product.

Further reformulation may reduce sugar tax revenues as drinks fall into the lower tax band or fall out of them entirely.

Consumer behaviour change

Proponents of the sugar tax argue that increasing the price of the drink will lead to consumers purchasing products which are not subject to the levy and will consequentially consume fewer calories.[9]

In practice this is unlikely to have a significant effect on calorie intake as many potential substitute drinks contain similar levels of sugar but are not due to be subject to the tax. This is consistently borne out in academic literature.[10]

Consequences of revenue shortfall

The consequence of a shortfall in revenues is potentially quite large. Using HMRC's Direct Effects of Illustrative Tax Changes (for 2018-19) we can estimate that:

- A 10 per cent revenue shortfall (c.50 million per year) is equivalent to:
    - 2 per cent additional beer and cider duties
- A 20 per cent revenue shortfall (c.100 million per year) is equivalent to:
    - 1 per cent increase in the standard rate of inheritance tax

[7] British Soft Drinks Association, 2016, *Leading the way; Annual report 2016*
[8] https://www.gov.uk/government/speeches/budget-2016-george-osbornes-speech
[9] See George Osborne Budget 2016 speech
[10] Maniadakis, Kapaki, Damianidi & Kourlaba, 213, A systematic review of the effectiveness of taxes on non-alcoholic beverages and high-in-fat foods as a means to prevent obesity trends, ClinicoEconomics and Outcomes Research

Conclusion

Due to the rise in inflation, the Soft Drinks Industry Levy and associated spending will have a negative effect on the public finances after its introduction and possibly for several further years given the unquantified costs and potential for further tax increases.

The claim that the revenues will be devoted to a particular area of spending is weak and the whole principle of dedicated tax revenues is fundamentally flawed.

There are significant uncertainties surrounding the amount of revenue that will be collected. With additional spending on school sports already budgeted, if revenues fall short of forecasts, other tax revenues will have to be diverted towards the programmes, the programmes cancelled or taxes raised.

The spending associated with the sugar tax was included to increase the tax's political acceptability. It is clearly harder to object to something that will help pay for school activities and sports, however the wider fiscal impacts have not been properly considered. The sugar tax should be scrapped.