

Forum for Health Economics & Policy

Volume 10, Issue 2

2007

Article 2

(OBESITY)

Fat Taxes: Big Money for Small Change

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Fat Taxes: Big Money for Small Change*

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Abstract

In an attempt to improve the nation's health, many U.S. policy makers have or are considering imposing taxes on the fat in food. Dairy products constitute a large portion of at home fat consumption of particularly harmful types of fat, and nearly all U.S. households consume these products. We estimate a demand system for dairy products, which we use to simulate substitution effects among dairy products and the welfare impacts of fat taxes on various consumer groups. We find that even a 10 percent ad valorem tax on the percentage of fat would reduce fat consumption by less than a percentage point. Given that the demand for most dairy products is inelastic, a fat tax is an effective means to raise revenue. However, these fat taxes are unattractive because they are extremely regressive, and the elderly and poor suffer much greater welfare losses from the taxes than do younger and richer consumers.

KEYWORDS: equivalent variation, fat tax, regressive

*We are grateful to Albert Reed for his thoughtful comments and the NRI, the USDA/ERS (cooperative agreement #43-3AEM-2-80072), and the Giannini Foundation for support.

1 Introduction

People like cheese, ice cream, butter and other foods high in fat, but that fat may kill them by greatly increasing their cholesterol and obesity levels and raising their risk of heart disease. Consequently, many jurisdictions throughout the world have passed or are contemplating imposing taxes on fatty foods to save people from themselves.¹ Half of the states in the United States have already imposed taxes or restrictions on foods with high levels of sugars or fats. In fact, taxes on unhealthy foods are not new, and yet, as we discuss below, obesity rates continue to rise.

One way to tax foods that are thought to be unhealthy is to tax an entire class of foods. This is the method chosen most often by state and local legislators, where taxes are levied on soft drinks in an attempt to influence sugar consumption, or snack foods to influence both sugar and fat intakes. This is akin to taxing electricity consumption regardless of the source – whether from hydropower, nuclear, solar, wind, natural gas, fuel oil, or coal – to reduce air pollution. This type of food tax ignores differences in the nutrient content of targeted foods, and this in turn reduces the effectiveness of the food tax to create incentives to reduce consumption of the target nutrients. For example, taxing all soft drinks fails to take into account the fact that diet soft drinks have no sugar and little or no calories. The artificial sweetener used to flavor diet soft drinks also varies, with potentially different long-term health effects – especially relative to sugar or high fructose corn sweetener. Similarly, taxing all snack foods regardless of the fat or sweetener content does little to create an incentive to substitute away from snack foods that are high in fat or sugar content towards low-fat or artificially sweetened snacks.

An alternative food tax would be to tax the unhealthy component of foods; for example, a tax on foods as a proportion or percentage of their fat content (Leicester and Windmeijer 2004). This kind of direct tax system is akin to carbon taxes to reduce greenhouse gas emissions or a tax on sulfur oxides, nitrogen oxides, and ozone emissions as mechanisms to influence air pollution. The focus of this study is whether a direct fat tax can affect behavior and the healthiness of the American diet. This is an interesting question because such a tax would fall unequally on foods according to their fat content. Consumers may curtail their consumption of higher-fat foods, switching to lower-fat substitutes, or their

¹ These calls from nutritionists, politicians, and others are reported in the popular press in many countries. See for example, *Newsweek* June 25, 2000; *Roll Call* June 1, 2000; *Reuters News Service* June 3, 2000, *Associated Press* June 10, 2000, *Seattle Post-Intelligencer* April 30, 2002; *Australian IT* August 16, 2002, and www.eas.asu.edu/~nfapp/html/july98.htm in Australia.

response to the price changes may be insignificant. While consumers have a host of low-fat food options, we do not know of any other research that examines whether substitution to low-fat foods is sufficient to meaningfully affect fat intakes.

To understand the effects of a fat tax, we use estimates of demand elasticities to simulate changes in behavior resulting from a tax on fat content. If the main point of the tax is to influence behavior, then a low elasticity of derived demand for fat is disappointing because the tax will have little effect on reducing fat consumption. On the other hand, if the main point of the tax is to raise tax revenue, a low elasticity is desirable, since the tax would raise billions of dollars.² However, such a tax may be regressive and reduce consumer welfare by an amount comparable to the tax revenues generated.

Dairy products are one of the largest sources of fat in U.S. consumers' diets. In addition, the type of fat contained in dairy products leads to specific health concerns. Dairy products, including butter and margarine, contribute 16% of total fat, 28% of saturated fat, and 17% of cholesterol to the nation's food supply (USDA 2007). As a result a tax on the fat content of dairy products is likely to have significant implications for the consumption of unhealthy fat.

Therefore, we estimate a system of demand equations for dairy products using weekly city-level aggregates of grocery store scanner data that has been matched with household demographic information. We use these estimates to simulate the effects of a fat tax on consumption patterns of dairy products for different demographic groups. The results allow us to examine the extent by which a fat tax reduces the intake of fat from dairy products and the tax burden for various segments of consumers; we show how a fat tax reduces the welfare of different consumer segments.

We begin with a discussion of the health effects of fat. Next we consider the potential effectiveness of a fat tax on dairy products. We then describe our theoretical model and empirical approach to estimating the demands for dairy products. This is followed by a description of the data and how it is used in the empirical model. Finally, we report the demand system estimates and discuss the effects of a fat tax.

² Jacobson and Brownell (2000) argued that a "steep" tax would probably reduce the consumption of the taxed foods and could be used to generate funding to subsidize healthful foods; however they also noted that a small tax may be more politically feasible because it would not be noticed by the public but would raise substantial revenues, which could be used to subsidize healthy foods and raise awareness. They estimated that a 1¢ national tax per unit would raise tax revenues of \$1.5 billion annually on soft drinks (per 12-ounce), while a 1¢ per pound tax would raise \$70 million on candy, \$54 million on chips, and \$190 million on other snack foods or fats and oils. They cite a poll suggesting that 45 percent of U.S. adults would support such a tax.

2 Dairy products, fat and disease

Studies of the link between fat intake and heart disease (Ascherio et al. 1999, Hu et al. 1997, and Willett 2001) or obesity (Bray and Popkin 1998, Bray et al. 2002, Labib 2003) conclude that not all types of fat have identical effects on health. Recent research demonstrates that mono- and poly-unsaturated fats increase the levels of HDL (good) cholesterol and reduce the levels of LDL (bad) cholesterol. Saturated fat raises levels of LDL cholesterol more than it raises HDL cholesterol. These findings suggest that compared to unsaturated fats, saturated fats are more likely to lead to heart disease, than other types of fat.³

The main sources of saturated fats in American diets include whole milk, butter, cheese, ice cream, red meat, and coconut products (Willett 2001). Dairy products as a food category contribute 28% of the total saturated fat intake of Americans (USDA 2007). The high levels of saturated fats in dairy products, which may disproportionately contribute to obesity and heart related problems, make these products of particular concern when examining the intake of fat and the impacts of a fat tax.

It is estimated that one billion adults worldwide are overweight and at least 300 million are clinically obese (WHO 2004). Among OECD countries, it is estimated that the United States has the highest proportion of overweight people (65 percent), followed by Mexico (62 percent) and the United Kingdom (61 percent) (Loureiro and Nayga 2005). The percentage of overweight and obese Americans rose from 45 percent to 65 percent from 1960 to 2002.⁴ The data suggest weight problems vary by demographic group. In 1999-2000, 60 percent of U.S. black males, 68 percent of white males, and 74 percent of Mexican-American males were overweight or obese.⁵ The corresponding fractions for women were 78 percent for blacks, 58 percent for whites, and 72 percent of Mexican-Americans.

According to the American Heart Association in 2003 over 13 million Americans suffered from coronary heart disease. Coronary heart disease includes heart attack, angina pectoris, and other heart problems. Coronary heart disease resulted in over 2 million inpatient hospital visits and 500,000 deaths in 2001. Approximately 6.9 percent of white, 7.1 percent of black, and 7.2 percent of Mexican-American males have coronary heart disease. Nearly 5.5 percent of white, 9.0 of black, and 6.8 percent of Mexican-American women suffer from the

³ More generally, about three-quarters of heart disease deaths are attributed to ischemic heart disease (IHD). Roughly a third of the cases of IHD among persons 65 and younger in the United States are due to dietary and lifestyle factors (Strnad 2004).

⁴ Cutler, Glaeser & Shapiro (2003); cdc.gov/nchs/products/pubs/pubd/hestats/obese/obse99.htm.

⁵ www.obesity.org/subs/fastfacts/Obesity_Minority_Pop.shtml.

disease.

In the United States, health care for overweight and obese individuals costs an average of 37 percent more than it does for normal weight people. In particular, the average annual medical bill for an overweight person is estimated to be \$732 higher than for a person of normal weight (Loureiro and Nayga 2005). The direct costs of health care plus the indirect costs of lost productivity associated with coronary heart disease exceeds \$133 billion (Willet 2001). Obesity related medical expenditures are \$75 billion or 9 percent of all U.S. health expenditures (Finkelstein et al. 2004).

Obesity and heart disease are clearly increasing in the U.S. population, and the personal and societal costs are large. Many public health interventions at an individual level have been implemented in the hopes of changing behavior. School-based education programs, mass media education, work-site programs, home correspondence, and other community programs have been specifically targeted in attempts to reduce obesity rates. To date, these efforts have had little impact on obesity rates (Brownell and Fairburn 1995.)

A recent focus of public health researchers and policy makers emphasizes changing the environment, such as prices, instead of individual behavior. Jeffery, French, Raether, and Baxter (1994) were among the first to examine price as a public health tool to influence food choices. They found, not surprisingly, that fruit and salad purchases greatly increased in a cafeteria when the prices of these items fell 50 percent. Other work (Jeffery et al. 1994, French et al. 1997, French et al. 2001) suggests that low-fat vending snacks are more often purchased when the price of these items is reduced. We also examine the effects on fat intake associated with changes in the consumption environment when relative prices change due to a fat tax.

3 Food taxes as effective health policy

In recent years, some public health experts and politicians around the world have proposed fat taxes—“Twinkie Taxes” or “McTaxes”—as a public health tool to fight obesity and other health issues (Brownell 1997, Marshall 2000, Nestle 2002). Others view such a tax as an unnecessary government intervention (The Economist 2003) that might have unintended consequences that would reduce its effectiveness (Kuchler, Golan, Variyam and Crutchfield 2005). The growing emphasis on changing the food environment as a means to reduce fat intake has led to a debate on fat taxes. State and local taxes on soft drinks and snack foods

date back to at least 1925 (Jacobson and Brownell 2000).⁶ Table 1 shows that many U.S. jurisdictions have or are considering laws regulating sugar, snack foods, and fats. Half the states and a couple of U.S. cities have such laws. In addition, Australia, Canada, the United Kingdom and many other countries have or are considering imposing such laws.

Table 1. Laws and Proposed Laws Regulating Foods Containing Sugar and Fats.

Jurisdiction	Law/ <i>Proposed Law</i>
Arkansas	\$2.00 per gallon of soft drink syrup, \$.21 per gallon for each gallon of bottled soft drinks, \$.21 per gallon of liquid soft drink produced from powder. (a) <i>“Junk food tax” of 1% on items that contain less than 20% of the RDI of a list of vitamins and minerals, either per serving or per 100 calories – exempts beverages, fruits, vegetables, and foods with 4 or more grams of protein per serving, and foods that contain yogurt. The bill is currently inactive. (a)</i>
Chicago	Fountain drinks are taxed at 9 percent on sales of soft drink syrups.
California	Carbonated soft drinks are excluded from sales tax exemption for food. <i>A bill proposed and excise tax on soft drinks and soft drink syrup: \$2.00 per gallon of soft drink syrup, \$.21 per gallon for each gallon of bottled soft drinks, \$.21 per gallon of liquid soft drink produced from powder. (c)</i>
Connecticut	Exempts from food sales tax exclusions: Soft drinks, soda, candy, and confectionery unless sold in school cafeterias, college dining halls, sororities and fraternities, hospitals, residential care homes, assisted living facilities, senior centers, day care centers, convalescent homes, nursing homes, or rest homes, or unless sold from a vending machine for less than 50 cents. (b)
Detroit	<i>Tax fast-food at 2% in addition to a 6% general tax on restaurant food.</i>
Idaho	<i>Excise tax on soft drinks: 1¢/12 fluid ounces (or fraction) on each bottled soft drink, \$1 and in like ratio on each part gallon thereof on each gallon of soft drink syrup, 1¢ on each ounce by weight of dry mixture or fraction thereof used for making soft drinks. (c)</i>
Illinois	Excludes soda from lower sales tax rate for food. (b)
Indiana	Excludes candy, confectionery, chewing gum, soft drinks, vending machine sales, and prepared food from sales tax exemption. (c)
Kentucky	Excludes candy, soft drinks, sales from vending machines, and prepared food from sales tax exemption. (c)
Maine	Excludes soft drinks, iced tea, soda or beverages such as are ordinarily dispensed at bars or soda fountains or in connection with bars or soda fountains, water, including mineral bottled and carbonated waters and ice, candy and confections, and prepared food from sales tax exemption. (b) <i>Tax soda: \$2 per gallon of syrup or .2 cents per gallon of soft drink.</i>

⁶ Maine, the District of Columbia, California, and Maryland have recently repealed snack food taxes. In the application of these taxes, no distinction is made between the levels of fat found in each product. The taxes are simply an equal percent increase in snack food prices.

	<i>Exempts products of 10 percent or more fruit juice, as well as sales to the government and state exports. Creates a Health Promotion fund with the proceeds to be distributed as follows: 1) 50% on a per-student basis to schools that adopt “policies that prohibit the advertising and sale of soft drinks and candy on all school property and that make available on a daily basis Maine dairy products and fresh in-season farm products for sale as snack foods and as part of regular school meal programs.” 2) 50% to go to a dental health residency program at qualifying hospitals. (a)</i>
Maryland	<i>Sales tax (5%) on potato chips, nuts, and other salty snacks. (c)</i>
Minnesota	<i>Excludes prepared food sold by retailer, soft drinks, candy, all food sold through vending machines from sales tax exemption. (b)</i>
Missouri	<i>Inspection fee of \$0. 003 per gallon of soft drinks manufactured or sold in the state, up to a maximum of \$0.04/month per case of 24 bottles or cans of a manufacturer's bottling capacity. (a,b)</i>
Montana	<i>Tax of 5¢ for each bottle, can or 12 ounces of bulk items of soft drink manufactured or imported by the bottler or importer of soft drinks. (a)</i>
Nebraska	<i>Tax for vending machine items and for bakery goods, candy, snack foods, and soft drinks. (a)</i>
New Jersey	<i>Not exempt from regular sales and use tax: candy and confectionery, and carbonated soft drinks and beverages whether or not sold in liquid form. (b)</i>
New York	<i>Not exempt from regular sales and use tax: candy confectionery, fruit drinks less than 70% natural fruit juice, soft drinks, and sodas and beverages such as are ordinarily dispensed at soda fountains or in connection therewith (other than coffee, tea, and cocoa); all items excluded from the exemption shall be exempt when sold through a vending machine for less than 75¢. (b) Additional 0.25% sales tax on a) food and drink currently taxed, except for bottled water, b) sale and rental of video and computer games, and video game equipment, and sale and rental of video and DVD movies; would require a one percent sales tax on a) food and drink defined as sweets or snacks in the USDA’s National Nutrient Database for Standard Reference and b) admission to movie theaters funds from revenues raised by these provisions to be used in the NYS Childhood Obesity Prevention Program. (c)</i>
North Carolina	<i>Tax (3¢) per container tax on soft drinks to provide funds for education. (a)</i>
North Dakota	<i>Excludes from regular sales and use tax exemption: candy or chewing gum, carbonated beverages, beverages commonly referred to as soft drinks containing less than 70% fruit juice, powdered drink mixes, coffee and coffee substitutes, cocoa and cocoa products. (b)</i>
Oklahoma	<i>Soft drink tax code would levy a tax of \$2 per gallon of syrup used to make soft drinks or 21 cents per gallon for bottled soft drinks—exempting exports to other states, sales to the government and any item that contains over 10 percent fruit juice. (a)</i>
Rhode Island	<i>Tax of 4¢ on each case (12 24 oz. cans) of beverage containers (soda, carbonated soft drinks, mineral water.) (a,b)</i>
Tennessee	<i>1.9% of gross receipts derived from manufacturing, producing and selling, or importing and selling, bottled soft drinks. (a,b)</i>

Texas	<p>Excluded from sales tax exemption: carbonated and noncarbonated packaged soft drinks, diluted juices, ice and candy; and foods and drinks (which include meals, milk and milk products, fruit and fruit products, sandwiches, salads, processed meats and seafood, vegetable juices, ice cream in cones or small cups) served, prepared, or sold ready for immediate consumption in or by restaurants, lunch counters, cafeterias, vending machines, hotels, or like places of business or sold ready for immediate consumption from push carts, motor vehicles, or any other form of vehicle. (a,b)</p> <p><i>A bill would levy a snack tax of 3 percent in addition to the sales tax on all snacks, which include cookies, candy, chips and soft drinks not consumed in restaurants. (c)</i></p>
Vermont	<p><i>A bill would add soft drinks as a taxable item. The revenues would be used in a new Dairy Farm Income Stabilization Fund.</i></p> <p><i>Extend the sales tax to snack food (a long list). (a)</i></p>
Virginia	<p>Excise tax on gross receipts from carbonated soft drink sales as follows: \$50 if gross receipts are \$100,000 or less, \$100 if gross receipts are between \$100,000 and \$250,000, \$250 if gross receipts are between \$250,000 and \$500,000, \$750 if gross receipts are between \$500,000 and \$1 million, \$1,500 if gross receipts are between \$1 million and \$3 million, \$3,000 if gross receipts are between \$3 million and \$5 million, \$4,500 if gross receipts are between \$5 million and \$10 million, \$6,000 if gross receipts exceed \$10 million. (a,b)</p>
Washington	<p>\$1 per gallon (proportionate for fractional amounts) on each wholesale sale of syrup (concentrate added to water to produce carbonated soda); excludes carbonated beverages, ice, bottled water from sales tax exemption. (a,b)</p> <p><i>Eliminate state sales tax exemption for candy. (b)</i></p>
West Virginia	<p>Excise tax on sales, handling, use, or distribution of bottled soft drinks and soft drink syrup: 1¢ on each bottle of 16 9/10ths fluid ounces or half a liter or fraction of bottled soft drink, 80¢ on each gallon of bottled soft drink, 84¢ on each four liters of soft drink syrup, 1¢ on each ounce or 28.35 grams of dry mix used to make soft drinks.</p> <p>Tax cannot be collected more than once with respect to any bottled soft drink or soft drink syrup made, sold, used, or distributed in the state; revenues to build four-year school of medicine, dentistry, and nursing. (a)</p> <p><i>Extend soft drink tax to include bottled water, and to change the tax from 1¢ to 5¢ on each 16 9/10ths fluid ounces, from 80¢ to \$4.00 per gallon of syrup. (a)</i></p>

Sources: (a) National Conference of State Legislatures Health Promotion Database; (b) Lohman, Judith S. "Taxes on Junk Food," OLR Research Report, available at: www.cga.ct.gov/2002/olrdata/fin/rpt/2002-R-1004.htm; (c) media reports and State Legislature websites.

Of the 25 states with regulations that directly apply to foods with sugar or fats, 14 of them address only soft drinks. These rules generally exclude soft drinks from lower taxes for food, and/or legislate an excise tax for these drinks. These laws raise the relative price of soft drinks in the hopes of reducing sugar

consumption, but clearly do not directly affect fat consumption. Three states exempt candy, confectionery goods and soft drinks from the lower taxes to reduce sugar and perhaps fat intake. Four states exempt candy, confectionery, prepared foods and vending machine purchases from the lower taxes, and three additional states apply an excise tax on snack foods. Relatively few states have increased the relative price of fatty foods with taxes, and these foods are only bakery or snack foods.

We analyze a tax on the fat content of dairy products instead of snack or confectionery goods for three reasons. First, almost all households consume dairy products; nearly 97 percent of American households purchase milk (Cornick, Cox and Gould 1994) and over 80 percent buy cheese (Yen and Jones 1997). Between 1980 and 2004, annual per capita cheese consumption doubled to over 31 pounds, while per capita butter consumption increased 10 percent between 1995 and 2004 (Miller and Blayney 2006). Dairy product consumption also accounts for 11% of the American's daily calorie intake (USDA 2007). Second, as noted above, dairy products are a substantial source of fat in the American diet and the fat in these products raises particular health concerns. Third, dairy products include a variety of high-fat items with low-fat substitutes. For example, lower-fat yogurt can be substituted for higher-fat ice cream and 1% or skim milk can be substituted for whole milk. We therefore expect *a priori* that consumers could easily adjust their diets as high-fat foods become more expensive relative to low-fat options. If this turns out not to be the case, then we also expect that it is unlikely that consumers will make more dramatic changes, such as substituting to fruits and vegetables and away from potato chips or cup cakes as relative prices change.

Throughout this paper, when we discuss substitution from higher fat foods to lower fat foods, what we mean is substitution to different goods. With the advent of nutrition labeling in the early 1990's, a plethora of low-fat foods have become available. For example, many low-fat versions of popular cookies are on the market. Consumers that became aware of and attentive to the fat content of foods and the health consequences of a high fat diet substituted towards these low-fat options. Subsequently, however, the total level of fat in the American diet returned to its previous level. It has been speculated that consumers learned that they did not like the taste of the low-fat options and therefore returned to the better tasting higher-fat formulations (Putnam, Allshouse and Kantor 2002).

4 Demand model and welfare measures

We assume that city-level weekly aggregate purchases of dairy products can be modeled with a representative consumer. We use a generalized Almost Ideal Demand System that is linear and quadratic in prices and linear in income (LQ-IDS), is flexible with respect to price and income effects, and satisfies the necessary and sufficient conditions for the existence of a rational, representative consumer (LaFrance 2004). The demand equations for the LQ-IDS can be written in matrix form as

$$\mathbf{q} = \boldsymbol{\alpha} + \mathbf{A}s + \mathbf{B}\mathbf{p} + \boldsymbol{\gamma}(m - \boldsymbol{\alpha}'\mathbf{p} - \mathbf{p}'\mathbf{A}s - \frac{1}{2}\mathbf{p}'\mathbf{B}\mathbf{p}), \quad (1)$$

where \mathbf{q} is the vector of quantities demanded, $\boldsymbol{\alpha}$ and $\boldsymbol{\gamma}$ are vectors of parameters, \mathbf{A} is a matrix of parameters, $\mathbf{B} = \mathbf{B}'$ is a symmetric matrix of parameters, \mathbf{p} is the vector of final consumer prices for dairy products, m is income, s is a vector of demographic variables, and all prices and income are deflated by a known, positive linearly homogeneous function of the prices of other goods.

To identify and predict the impacts of dairy product price changes on consumer welfare, we need to compare the utility level at the initial prices to the utility level at the final prices. Suppose that dairy product prices change from \mathbf{p}_0 to \mathbf{p}_1 . The equivalent variation, ev , is the change in income at the original price vector, \mathbf{p}_0 , that is just necessary to bring the consumer to the new utility level at the final price vector, \mathbf{p}_1 . For the demand model in equation (1), the equivalent variation for such a price change is

$$ev = (m - \boldsymbol{\alpha}'\mathbf{p}_1 - \mathbf{p}_1'\mathbf{A}s - \frac{1}{2}\mathbf{p}_1'\mathbf{B}\mathbf{p}_1) e^{\mathcal{V}'(\mathbf{p}_0 - \mathbf{p}_1)} - (m - \boldsymbol{\alpha}'\mathbf{p}_0 - \mathbf{p}_0'\mathbf{A}s - \frac{1}{2}\mathbf{p}_0'\mathbf{B}\mathbf{p}_0). \quad (2)$$

For the model in equation (1) above, the compensating variation is proportional to the equivalent variation, $cv = ev \times e^{\mathcal{V}'(\mathbf{p}_1 - \mathbf{p}_0)}$. Hence, we focus only on the equivalent variation.

To better understand the distributional effects of a fat tax, note that the marginal effect of a change in the k^{th} demographic variable on the equivalent variation for the change in dairy product prices from \mathbf{p}_0 to \mathbf{p}_1 is

$$\frac{\partial ev}{\partial s_k} = \sum_{j=1}^n a_{jk} \left[p_{j0} - p_{j1} e^{\mathcal{V}'(\mathbf{p}_0 - \mathbf{p}_1)} \right]. \quad (3)$$

This depends on the coefficients on the variable s_k in each of the demands for dairy products, the size of the relative prices changes, and the vector of income coefficients. Therefore, we expect *a priori* that the welfare effects of a fat tax on dairy products vary systematically across consumer characteristics. This is precisely what we find in the empirical work reported below.

5 Data and variables

The quantity data are city-level weekly average household purchases of fourteen dairy products calculated from weekly Information Resources Incorporated's (IRI) Infoscanner™ scanner data for the three-year period January 1, 1997 through December 30, 1999 for 23 U.S. cities.⁷ The city populations range from 50,000 to 10 million. Each region of the country is represented with several cities. IRI records both purchase price and quantity information at the Universal Product Code (UPC) level for a panel of customers for a number of grocery stores in each city. We group the UPC code data into 14 products: non-fat milk, 1% milk, 2% milk, whole milk, cream (including half and half), coffee creamers, butter and margarine, ice cream (including frozen yogurt and ice milk), cooking yogurt (plain and vanilla yogurt), flavored yogurt (all other yogurt that is not categorized as cooking yogurt), cream cheese, shredded and grated cheese, American and other processed cheese, and natural cheese. The dependent variable in the demand system is the average quantity purchased per household in each city in each week for each of the fourteen dairy products.

Prices are city-level weekly average prices. Given a generic city, the j^{th} product category, and the t^{th} week, define the city's average price for product j in week t by

$$p_{jt} = \sum_{i_j=1}^{n_j} \left(p_{i_j,t} \bar{q}_{i_j} / \sum_{k_j=1}^{n_j} \bar{q}_{k_j} \right), \quad j = 1, \dots, 14, \quad (4)$$

where n_j is the number of unique UPC codes for that dairy product, \bar{q}_{i_j} , $i_j = 1, \dots, n_j$, is the average quantity purchased per household per week in the given city of the dairy product with UPC code i_j , and $p_{i_j,t}$ is the retail price of that good in week t .⁸

We adjusted prices for the effects of sales taxes and inflation in two ways. We first multiplied each price by one plus the state-level retail sales tax on food items to adjust for the effects of sales taxes on the final retail prices paid by consumers. We deflate prices and income by the regional consumer price index for all items excluding food for all urban consumers not seasonally adjusted

⁷ Atlanta, Boston, Cedar Rapids (IA), Chicago, Denver, Detroit, Eau Claire (WI), Grand Junction (CO), Houston, Kansas City, Los Angeles, Memphis, Midland (TX), Minneapolis/St. Paul, New York, Philadelphia, Pittsburgh, Pittsfield (MA), San Francisco/Oakland, Seattle/Tacoma, St. Louis, Tampa/St. Petersburg, and Visalia (CA).

⁸ The quantity weights are average quantities over the 156-week sample period.

(nonfood CPI) multiplied by one plus the general retail sales tax rate in the state where the city is located.⁹

We matched each household's price and quantity data with household-level weekly measures of several demographic variables. The first of these is the household's annual income bracket. There are eight income brackets with midpoints ranging from \$7,500 to \$200,000.¹⁰ We constructed an estimate of the city-level average weekly household income by taking the sum of the products of the proportion of households in each income bracket times the midpoint of that income bracket, using the number of households that purchased a given dairy product as a fraction of the number households that purchased at least one dairy product in that city during that week as weights. We deflated the city-level average household income with that city's after-tax nonfood CPI. We divided these measures of deflated average annual household income by 52 to estimate the deflated average weekly income per household for each city and week in our sample.

We constructed weekly city-level aggregate measures of several other demographic variables in a manner similar to the calculations for weekly average household income. If a household purchased any dairy product in a given week, we included that household's demographic characteristics to calculate the city-level aggregates, so that the demographic variables vary week-to-week and city-by-city as averages of dairy-product purchasing households' demographic characteristics. These demographic variables include ethnic group, home ownership, employment status, occupation, whether the household has children under 18, has young children (ages 0-5.9), has medium aged children (ages 6-11.9), or has older children (ages 12-17.9), the number of young, medium, and older children in the household, number of individuals in each household, years of education of male and female heads of household, and ages of the heads of household. Table 2 presents summary statistics for weekly household income and the other demographic variables included in the model. Not shown in the table, but included in the empirical model, are city-level fixed effects.

⁹ If the general ad valorem retail sales tax rate in the state is τ , then the after-tax nonfood CPI is $(1 + \tau)\text{CPI}$. Retail sales tax rates are taken from the Council of State Governments (1997-1999) and the regional nonfood CPI's are from the Bureau of Labor Statistics (1997-1999), with 1982 as the base year. We linearly interpolated monthly nonfood CPI data to obtain weekly series. We matched each IRI city to one of four CPI regions: Northeast, South, Midwest, and West.

¹⁰ The last category is top coded as income at or above \$100,000 per year. We arbitrarily set \$200,000 as the conditional mean of the top income category. This amount is roughly the mean income level of all U.S. households that earned at least \$100,000 per year in the years 1997-1999. We calculated this national average conditional mean income using the full household income samples in the March supplement of the Continuing Population Survey for each of these three years.

Table 2. Summary Statistics of the Households that Purchase Dairy Products.

<i>Variable</i>	<i>Mean</i>	<i>Standard Error</i>
Household (HH) Size	2.816	0.176
Weekly Income	854.030	153.289
Own House	0.826	0.074
<i>Race/Ethnicity</i>		
Share White	0.880	0.110
Share Black	0.054	0.075
Share Hispanic	0.045	0.063
Share Asian	0.014	0.032
<i>Male Head of Household</i>		
Age	54.200	2.080
Years of Education	12.900	0.492
Share Unemployed	0.030	0.012
Share Employed Part Time	0.037	0.010
Share Employed Full Time	0.650	0.051
Share Nonprofessional Occupation	0.356	0.113
Technical Education	0.110	0.058
<i>Female Head of Household</i>		
Age	53.551	2.124
Years of Education	13.373	0.398
Share Unemployed	0.226	0.046
Share Employed Part Time	0.170	0.035
Share Employed Full Time	0.366	0.051
Share Nonprofessional Occupation	0.430	0.076
Share Technical Education	0.068	0.039
<i>Children</i>		
Children present in HH	0.350	0.058
Average Number of Young Children Ages 0-5.9	0.133	0.041
Average Number of Middle Children Ages 6-11.9	0.249	0.050
Average Number of Older Children Ages 12-18	0.307	0.064
Share of HH with children with Young Children	0.309	0.059
Share of HH with children with Middle Children	0.524	0.039
Share of HH with children with Older Children	0.562	0.060

6 Demand system estimates

We estimate the demand system in equation (1), by nonlinear three stage least squares (NL3SLS) to account for the potential problems of measurement errors and/or joint determination between quantities and prices (Deaton 1988). The instruments for the first-stage price equations include city-level fixed effects, the demographic and income variables in the demand equations, the current and lagged deflated wholesale price of milk by city, the Herfindahl-Hirschman market power index (HHI) for the city, squares of income, the wholesale milk price, and the HHI, and interactions between race, home ownership, and income with the wholesale milk price and the HHI. This set of instruments produced coefficients of multiple determination in our sample ranging from 0.691 to 0.956.¹¹

In equation (1), each structural parameter enters each demand equation through the term, $m - \alpha' p - p' A s - \frac{1}{2} p' B p$. In this expression, market prices interact with each parameter. Amemyia (1985) showed that best NL3SLS estimators are obtained if (and only if) the set of instrumental variables can be expressed as a linear combination of the expected values of the partial derivatives of the structural equations with respect to the structural parameters, conditional on the instrument set. To meet this requirement, we need a set of instrumental variables for each demand equation that includes a constant, city-level fixed effects dummies, demographic variables including average weekly household income, predicted prices, own- and cross-product second-order interactions between predicted prices, and interactions between predicted prices and the city dummies and the demographic variables. Thus we need 856 instruments for the 819 structural parameters with a total of 3,583 cross-section/time-series observations per demand equation and 14 demand equations, for a total of 50,162 observations.

We include White's robust heteroskedasticity consistent covariance matrix estimator in the NL3SLS system estimates to calculate robust, asymptotically consistent standard errors. Table 3 presents summary statistics for each of the fourteen dependent variables and the model's error variances and goodness of fit measures. As can be seen from this table, the demand model appears to fit the available data reasonably well.

¹¹ We also tried additional instruments, such as the market shares of each of the eight largest firms in each city and the squared market share variables, with similar results.

Table 3. Equation Summary Statistics .

<i>Dairy Product</i>	<i>Average Quantity Purchased</i>		<i>Regression Equation</i>	
	<i>Mean (ounces)</i>	<i>Standard Deviation</i>	<i>Error Variance</i>	<i>R²</i>
Milk 1%	151.409	77.692	3553.0	.41
Milk 2%	137.592	24.049	107.7	.81
Milk No-Fat	127.630	25.798	101.8	.85
Milk Whole	121.439	27.128	169.4	.77
Fresh Cream	15.298	3.080	3.9	.59
Coffee Additives	30.249	5.194	12.6	.53
Natural Cheese	13.417	2.418	2.2	.63
Processed Cheese	15.780	2.255	2.1	.68
Shredded Cheese	11.834	1.759	1.1	.64
Cream Cheese	11.405	1.641	1.9	.30
Butter	18.302	3.929	11.0	.29
Ice Cream	79.484	12.936	90.1	.46
Yogurt Cooking	22.060	5.937	25.9	.26
Yogurt Flavored	33.882	4.480	9.7	.52

We estimated the LQ-IDS demand model for the fourteen dairy products using a large number of demographic variables, and it is impractical to report all of the coefficient estimates in a table, or series of tables.¹² Many coefficients on the demographic variables are statistically different from zero at a 5% significance level in some, but generally not all, equations. However, the demographic variables are collectively strongly statistically significant. Rather than try to describe the effects of all of the demographic variables on quantities demanded variable by variable, we turn to their effects on the price elasticities of demand and the distribution of the welfare effects due to fat taxes.

As the prices of dairy products change, households that consume dairy products alter the mix of dairy products that they demand. Table 4 shows the own- and cross-price elasticities for dairy products calculated at the mean of all of the variables (from table 2). In each row, each cell shows the price elasticity for the product due to a change in the price listed at the top of the corresponding column.

All of the own-price elasticities are negative, statistically significant, and inelastic with the exception of 1% milk. The magnitudes of the point estimates for the own-price elasticities are comparable to those reported in the previous

¹² However, a complete list of empirical results is available from the authors on request.

Table 4. Price Elasticities of Demand for Dairy Products Calculated at the Mean of the Explanatory Variables.

<i>Dairy Product</i>	<i>Milk 1%</i>	<i>Milk 2%</i>	<i>Milk No-Fat</i>	<i>Milk Whole</i>	<i>Fresh Cream</i>	<i>Coffee Additives</i>	<i>Natural Cheese</i>	<i>Processed Cheese</i>	<i>Shredded Cheese</i>	<i>Cream Cheese</i>	<i>Butter</i>	<i>Ice Cream</i>	<i>Yogurt Cooking</i>	<i>Yogurt Flavored</i>
Milk 1%	-2.052*	0.019	0.110*	0.168*	-0.038	-.046*	0.051	0.016	-0.043	0.011	0.095	0.016	-0.113*	0.011
Milk 2%	0.018	-.742*	0.079*	0.022	-0.050*	-0.045	0.163*	0.105*	0.025	-0.013	0.032*	-.098*	0.045	-0.031
Milk No-Fat	0.115*	0.084*	-.628*	-0.022	0.089*	0.091*	-0.048	-.098*	0.008	-0.013	-.062*	-0.023	0.211*	0.000
Milk Whole	0.181*	0.025	-0.022	-.652*	-0.036	-.072*	-.222*	-.098*	-0.047	0.006	0.001	0.023	-0.069	0.030
Fresh Cream	-0.063	-.084*	0.139*	-0.056	-0.407*	0.022	0.101	0.274*	0.118*	0.173*	0.004	-0.016	-0.139	0.035
Coffee Additives	-0.071*	-0.070	0.130*	-.103*	0.020	-.496*	-0.014	0.007	-0.056	-.082*	-0.016	0.137*	0.019	0.144*
Natural Cheese	0.042	0.140*	-0.039	-.176*	0.052	-0.007	-.641*	0.132*	0.040	-0.015	0.014	0.104	-0.035	0.052
Processed Cheese	0.013	0.094*	-.083*	-.082*	0.147*	0.004	0.137*	-.734*	-0.009	-.122*	-0.019	0.275	0.057	-0.028
Shredded Cheese	-0.038	0.020	0.006	-0.038	0.060*	-0.031	0.039	-0.008	-.404*	-.082*	0.022	0.036	0.068	0.044
Cream Cheese	0.014	-0.019	-0.018	0.006	0.149*	-.076*	-0.026	-.194*	-.138*	-.515*	0.064*	0.128*	-0.225*	-0.012
Butter	0.093	0.033*	-.056*	0.001	0.003	-0.009	0.019	-0.019	0.029	0.045*	-.295*	0.136*	0.047	-.038*
Ice Cream	0.010	-.062*	-0.013	0.013	-0.006	0.058*	0.077	0.196*	0.028	0.057*	0.087*	-.741*	0.187*	0.090*
Yogurt Cooking	-0.196*	0.079	0.348*	-0.111	-0.147	0.023	-0.071	0.113	0.142*	-.276*	0.084	0.520*	-0.911*	-0.070
Yogurt Flavored	0.011	-0.035	-0.001	0.029	0.023	0.103*	0.066	-0.034	0.057	-0.009	-.044*	0.154*	-0.044	-.808*

Notes: The table shows the price elasticity given that the price of the good shown in the column changes. An asterisk shows that we can reject the null hypothesis that the elasticity is zero at the 5% significance level.

literature.¹³ The own-price elasticities of demand for the four types of fresh milk (1%, 2%, no-fat, and whole) range from -0.628 for nonfat milk to -2.05 for 1% milk. The demands for other dairy products are less elastic, and the demand for butter is the least elastic, with an estimated own-price elasticity of demand of -0.295 . There are roughly equal numbers of positive and negative cross-price elasticities of demand. All of these are close to zero – generally below 0.15 in absolute value and none are larger than 0.3 in absolute value. Most cross-price elasticities of demand are not statistically different from zero at a 5% significance level. Table 5 reports the income elasticities, also evaluated at the sample means of the data. All of the income elasticities are negative, and eight are statistically different from zero at the 5% significance level. The estimated income elasticities fall generally in the range of other estimated income elasticities for dairy products.¹⁴

Table 5. Income Elasticities for Dairy Products.

<i>Dairy Product</i>	<i>Income Elasticity</i>	<i>Standard Deviation</i>
Milk 1%	-0.558	0.468
Milk 2%	-0.221*	0.058
Milk No-Fat	-0.239*	0.059
Milk Whole	-0.484*	0.075
Fresh Cream	-0.205*	0.098
Coffee Additives	-0.071	0.087
Natural Cheese	-0.209*	0.077
Processed Cheese	-0.040	0.066
Shredded Cheese	-0.115	0.068
Cream Cheese	-0.109	0.091
Butter	-0.676*	0.127
Ice Cream	-0.406*	0.082
Yogurt Cooking	-0.327	0.182
Yogurt Flavored	-0.151*	0.071

Note: An asterisk shows that we can reject the null hypothesis that the elasticity is zero at the 5% significance level.

¹³ Park, Holcomb, Raper and Capps (1996) and Huang and Lin (2000) estimate own-price elasticity of demand for milk and cheese, and total dairy products respectively, from -0.1 to -0.8 . Also see Bergtold, Akobundu and Peterson (2004), Heien and Wessells (1988), and Gould, Cox, and Perali (1990).

¹⁴ See Heien and Wessells (1990), Park, Holcomb, Raper and Capp (1996), Huang and Lin (2000), Gould, Cox and Perali (1990) and Bergtold, Akobundu and Petersen (2004).

7 Welfare effects of a fat tax

Many food taxes aimed at influencing fat consumption have been applied or proposed (table 1). However, if the intent is to discourage fat consumption, we would presumably want a tax that varies with the fat content of foods, such as an ad valorem tax based on the percentage of fat in each food item – analogous to a carbon tax used to control greenhouse gas emissions. If the tax rate on fat is τ , then the tax rate for a given product is τ times the fraction of that good that is fat. Table 6 shows the proportion of fat in each dairy product category, which ranges from 0 for no-fat milk to just over 77 percent for butter.

Table 6. Serving Size and Fat Content for Dairy Product Categories.

<i>Dairy Product</i>	<i>Serving Size</i>	<i>Fat grams</i>	<i>Percentage Fat</i>
Milk 1%	1 cup	2.5	1.10
Milk 2%	1 cup	5	2.20
Milk No-Fat	1 cup	0	0
Milk Whole	1 cup	8	3.51
Fresh Cream	1 tablespoon	4.5	31.61
Coffee Additives	1 tablespoon	2	14.05
Natural Cheese	1 ounce	9	31.61
Processed Cheese	0.7 ounces	4.5	23.68
Shredded Cheese	1 ounce	9	31.61
Cream Cheese	2 tablespoons	10	35.12
Butter	1 tablespoon	11	77.27
Ice Cream	½ cup	8	7.02
Yogurt Cooking	6 ounces	1.5	0.88
Yogurt Flavored	6 ounces	1.5	0.88

If a product is competitively supplied with a horizontal supply curve and product “quality” is constant, the tax will have a proportional effect on the final retail price.¹⁵ Given these assumptions, and the price elasticities in table 4, we calculate the quantity effects of a 10 percent and of a 50 percent fat tax on the

¹⁵ Barzel (1976) argues that an ad valorem tax imposed on a subset of characteristics of a product has the effect of reducing the product’s quality. We assume product quality remains constant. Consequently the fat consumption effect we estimate below, while small, may be overstated. Barzel’s analysis suggests that while product price may rise when an ad valorem tax is imposed, it will not rise as much as it would if quality were restricted to remain constant. We doubt that this effect is important in dairy products.

consumption of dairy products (table 7). Because the elasticities do not vary substantially across demographic groups, we report only average effects. The effect of the tax is proportional: The 50 percent tax effects are almost exactly 5 times the effects for the 10 percent tax. Thus, we only discuss the 10 percent tax henceforth.¹⁶ For some relatively low-fat items, the tax increases demand; whereas for most high-fat goods, the tax lowers demand.

Table 7. Price, Quantity and Fat Intake Changes Due to a Fat Tax on Dairy Products.

<i>Dairy Product</i>	<i>10% Fat Tax</i>			<i>50% Fat Tax</i>		
	<i>Price^a</i>	<i>Quantity^a</i>	<i>Fat^b</i>	<i>Price^a</i>	<i>Quantity^a</i>	<i>Fat^b</i>
Milk 1%	0.11	0.46	0.22	0.55	2.30	1.09
Milk 2%	0.22	0.59	0.51	1.10	2.94	2.52
Milk No-Fat	0.00	-0.44	0.00	0.00	-2.21	0.00
Milk Whole	0.35	-1.44	-1.75	1.76	-7.23	-8.78
Fresh Cream	3.16	0.64	0.88	15.81	3.19	4.39
Coffee Additives	1.40	-1.18	-1.43	7.02	-5.91	-7.14
Natural Cheese	3.16	-1.31	-1.58	15.81	-6.54	-7.90
Processed Cheese	2.37	-1.22	-1.24	11.84	-6.11	-6.20
Shredded Cheese	3.16	-1.10	-1.17	15.81	-5.48	-5.84
Cream Cheese	3.51	-1.84	-2.10	17.56	-9.21	-10.51
Butter	7.73	-1.86	-7.50	38.64	-9.32	-37.53
Ice Cream	0.70	1.21	1.92	3.51	6.02	9.57
Yogurt Cooking	0.09	-0.03	0.00	0.44	-0.13	-0.01
Yogurt Flavored	0.09	0.19	0.02	0.44	0.94	0.08
Change in fat grams from all products			-13.22			-66.26

Notes: ^(a) denotes the percentage change, and ^(b) is the change in fat grams per household per week.

¹⁶ We assume a 100% pass through, which gives an estimate of the upper bound welfare effect on consumers from an ad valorem fat tax. Equivalently, if the consumers' share of the tax burden borne is, say, 50%, then a 10% consumer tax burden is equivalent to a 20% overall tax rate. The impact of any other pass through rate can be calculated similarly to identify the implied total ad valorem tax rate that is equivalent to a final consumer tax burden of 10%.

Because the price elasticities are relatively inelastic, the tax on any one good has relatively small effects on total quantity.¹⁷ Although it is nonetheless possible that the tax could have a more substantial effect on fat consumption due to substitution between goods, it does not.

The second column of table 7 shows the estimated percentage change in the quantity of the good demanded for each category for the 10 percent tax, while the third column shows the change in fat grams per household per week. We divide by the average family size, 2.82 members, to get the per person effect. Without a fat tax, individuals in our sample consume 77.61 grams daily of fat from dairy products.¹⁸ Imposing a 10 percent fat tax on dairy products reduces the daily fat intake to 76.94 grams, a drop of only two-thirds of a gram, or less than one percentage point (0.86 percent) of total dairy fat.

These effects are negligible. For example, the estimated reduction in fat would have no noticeable effect on a person's weight. Because a gram of fat contains about 9 calories, the tax would reduce a person's average daily consumption by only 6 calories. (Even a 50% tax would cut daily consumption by only 30 calories.) It takes a reduction of about 100 calories a day for the average person to lose one pound of body weight in a month.

According to most proponents, the main justification for a fat tax would be to increase the health of consumers who eat fatty goods—whether they want it or not. Presumably people would live longer and be healthier, which would have desirable long-term effects on their well-being.

If convinced of the wisdom of this recommendation, people could increase their health and presumably their utility by reducing their fat intake voluntarily. However, if a tax is used to induce them to reduce fat consumption, consumers will view themselves as being worse off at least in the short run, as they have to pay more for food and do not see an immediate health benefit.

How great is this welfare loss? Table 8 shows the equivalent variations for various groups based on our estimates. The first column shows the mean for all variables except for the variable shown on the rows. The first row of the first column shows the mean for all variables. The equivalent variation loss of the typical (mean of the explanatory variables) family, \$40.34, is the annual change in income that the family is willing to accept instead of experiencing a 10 percent fat tax. Black families with average income suffer a relatively small loss, \$36.34,

¹⁷ A similar point is made in Kuchler, Tegene and Harris (2005) with respect to an ad valorem tax on snack foods.

¹⁸ This number is virtually the same as reported in the literature that the average U.S. consumption of fat per person was 75 grams daily from 1994-1996 (despite the U.S. Department of Agriculture 2005 Dietary Guidelines Advisory Committee Report that recommends 24 grams of healthy fat per day on a 2,000-calorie diet).

which may be due to their relatively high level of lactose intolerance. By multiplying the annual average individual household's welfare loss by 111 million households, we obtain an estimate of the national welfare loss of \$4.48 billion.

Table 8. Equivalent Variation (\$/Year) from a 10% Fat Tax for Various Demographic Groups.

<i>Demographic Group</i>	<i>Mean</i>	<i>No Children</i>	<i>Only Child's Age Bracket</i>		
			0-5.9	6-11.9	12-18
Mean	-40.34	-38.95	-49.79	-34.23	-40.13
White	-40.13	-41.45	-48.98	-33.41	-39.31
Black	-36.34	-37.67	-45.20	-29.63	-35.53
Asian	-48.22	-49.54	-57.07	-41.50	-47.40
Hispanic	-38.75	-40.07	-47.62	-32.04	-37.96
Income=\$20,000	-47.38	-46.00	-56.85	-41.27	-47.18
Income=\$30,000	-44.50	-43.12	-53.96	-38.39	-44.29
Income=\$40,000	-41.61	-40.23	-51.07	-35.50	-41.41
Income=\$50,000	-38.72	-37.34	-48.19	-32.61	-38.52
Income=\$60,000	-35.84	-34.46	-45.30	-29.73	-35.63
Income=\$70,000	-32.95	-31.57	-42.41	-26.84	-32.75
Income=\$100,000	-24.29	-22.91	-33.75	-18.18	-24.09
10 Years of Education	-32.69	-33.99	-41.54	-25.97	-31.87
16 Years or Education	-46.35	-47.68	-55.21	-39.64	-45.54
HH Heads 25 Years Old	-24.89	-26.19	-33.74	-18.17	-24.07
HH Heads 35 Years Old	-30.21	-31.53	-39.06	-23.49	-29.39
HH Heads 60 Years Old	-43.55	-44.85	-52.40	-36.82	-42.73
No Children	-38.95				
Young Family ^a	-31.49				
Childless Couple ^b	-41.72				

Notes: ^(a) The young family's household heads are 25 years old, they have a real income of \$30,000, the wife is not employed, the husband works in a non-professional occupation, they have two children under 6 years of age, and they rent their dwelling. ^(b) The Childless couple's household heads are 40 years old, they have a real income of \$60,000, both are working professionals, and they own their dwelling.

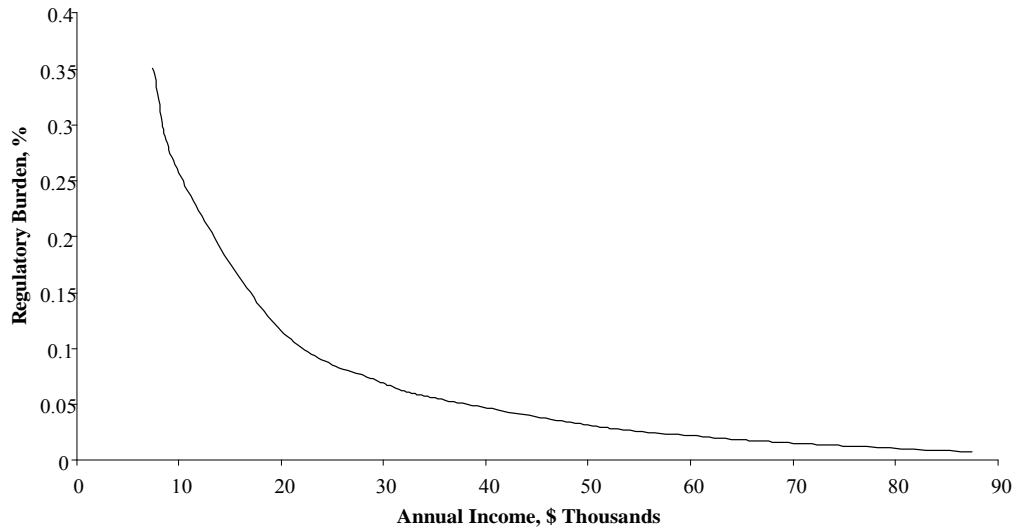
One justification of the fat tax is to raise tax revenues—according to some proponents, to be spent on promoting health. Table 9 shows that the annual tax burden from a 10 percent fat tax on dairy products for a typical household is \$40.10, and national tax revenues are \$4.45 billion. Thus, the tax revenues are almost as much as the consumers’ welfare loss. The government raises \$40.10 from the average family compared to a welfare loss of \$40.34. The comparable national figures are \$4.45 billion versus \$4.48 billion.

Table 9. Annual Tax Revenue Raised from a 10% Fat Tax on Dairy Products.

<i>Dairy Product</i>	<i>Average Household (\$)</i>	<i>National (\$ million)</i>
Milk 1%	0.19	20.89
Milk 2%	0.36	39.69
Milk No-Fat	0.00	0.00
Milk Whole	0.51	56.42
Fresh Cream	3.12	345.80
Coffee Additives	1.46	15.33
Natural Cheese	5.84	647.73
Processed Cheese	4.24	471.18
Shredded Cheese	5.99	665.50
Cream Cheese	3.87	429.39
Butter	12.50	1,387.40
Ice Cream	1.82	201.63
Yogurt Cooking	0.09	9.39
Yogurt Flavored	0.13	14.62
All Dairy Products	40.10	4,451.60

However, this tax is extremely regressive. Almost the entire burden of the fat tax falls on poor families. We define the tax’s regulatory burden as the annual equivalent variation associated with the tax divided by a household’s annual income. The regulatory burden for the average family declines rapidly with income as seen in figure 1. For an otherwise typical household, the burden is 0.24 percent at \$20,000. It falls to 0.15 percent at \$30,000, 0.10 percent at \$40,000, 0.077 percent at \$50,000, and 0.024 at \$100,000. Thus, the burden at \$20,000 is nearly 10 times larger than that at \$100,000. The regulatory burden curves associated with different ethnicities do not vary much from the average household. The burdens by income for white, black, and Asian families are slightly below these averages, and those for Hispanic families lie slightly above these averages.

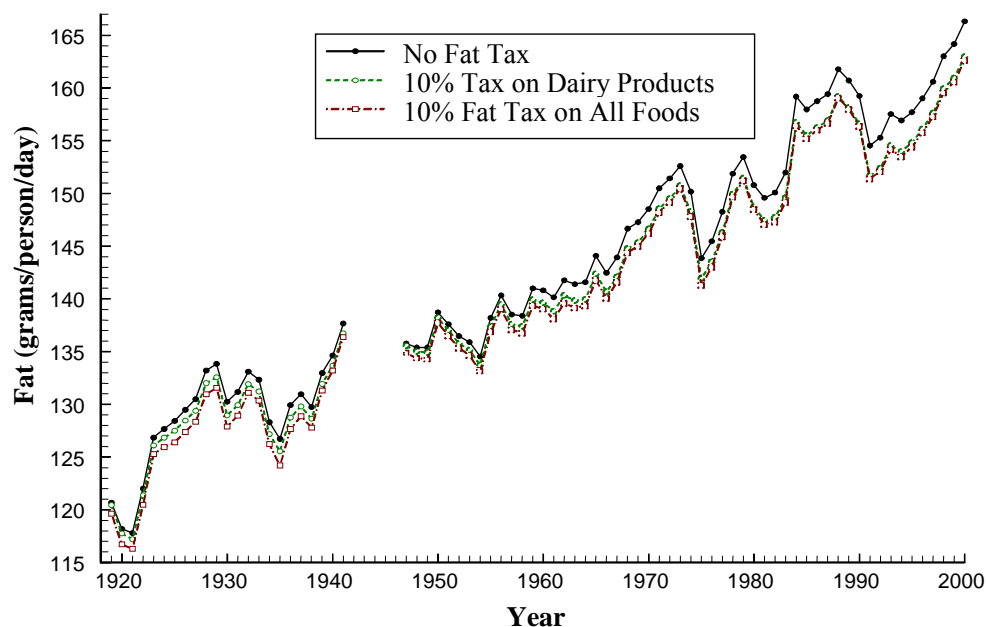
Figure 1. Percent Tax Burden for Various Income Levels.



Similarly, the welfare effects are comparably regressive as table 8 shows. The welfare loss, \$24.29, of relatively well-to-do families with an income of \$100,000 is only about half the loss of poor families with an average income of only \$20,000, \$47.38.

To check the robustness of our conclusions, we simulated the nutritional impact of a 10% ad valorem tax on the fat content of all foods and on the fat content of dairy products using the empirical results of a recent article on the U.S. demand for all food items (Beatty and LaFrance 2005). This allows us to determine how fat intake changes if all products are taxed, and how much of that change can be attributed to dairy products. Figure 2 displays the results of this exercise for the sample period 1918-2000, excluding 1942-46 to account for the significant disruption to the U.S. economy during and immediately following World War II. From the figure, we can see that virtually all of the change in fat intake is due to increased dairy product prices. These simulations also confirm that fat intake is largely unresponsive to food price increases, and an ad valorem tax on the fat content of foods would be highly regressive.

Figure 2. Changes in Fat Intake Associated with a 10% Ad Valorem Tax on the Fat Content of All Foods and Dairy Products.



8 Conclusions

Using supermarket scanner data, we estimated a system of demand equations to determine the distributional effects of taxing the fat content of dairy products on various demographic groups. We calculate the price elasticities and the equivalent variations associated with price changes that would result from imposing a 10 percent and a 50 percent ad valorem fat tax.

Household demand for dairy products is price inelastic. Price elasticities of demand also vary little across demographic groups. A 10 percent tax on fat content has relatively little effect on the quantity of dairy products consumed by any household group. Such a tax results in less than a 1 percent reduction in average fat consumption. A tax on dairy products would account for over 80 percent of the fat reduction if the tax were extended to all food items. To have a substantial effect, the tax rate would have to be quite high. For example, a 50 percent tax only lowers fat intake by 3 percent.

In the short-run, a 10 percent fat tax clearly will not raise consumer welfare. People could reduce their consumption of high fat dairy products without

government intervention. Trying to coerce them to do so by raising prices as a proportion of the fat content in foods lowers short-run welfare.

Because the demand for dairy products (and other foods) is relatively price inelastic, a fat tax generates tax revenue relatively efficiently, in the sense that consumer welfare losses are only slightly greater than the tax revenue raised. Nationally, a 10 percent tax would raise \$4.45 billion annually, while consumers would suffer a welfare loss of \$4.48 billion.

However, a fat tax would be highly regressive, falling almost entirely on poor consumers. The welfare loss to a family earning \$20,000 is nearly double that of a family earning \$100,000. Moreover, senior citizens – that is, families in their sixties – suffer roughly twice the welfare loss of families whose heads of household are in their twenties.

The justification for a fat tax may be an increase in long-run health, which could offset the welfare losses due to higher prices through longer lives and, perhaps, lower healthcare costs. If some people over-consume unhealthy fatty foods, while others do not, then O'Donoghue and Rabin (2003, 2005) argue that imposing optimal (possibly very large) “sin taxes” on unhealthy items and returning the proceeds to consumers without control problems can increase social surplus and lead to a Pareto welfare improvement. Our existing medical knowledge about the link between fat intakes and life spans is limited. This makes the calculation of any such gains infeasible at this time. However, since even relatively large fat taxes appear to do little to reduce fat intake, long-run health increases seem unlikely to materialize.

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