Italian Wine Consumers’ Preferences and Impact of Taxation on Wines of Different Quality and Source

Antonio Stasi
University of Foggia, Italy
a.stasi@unifg.it

Antonio Seccia
University of Bari, Italy
seccia@agr.uniba.it

Gianluca Nardone
University of Foggia, Italy
g.nardone@unifg.it
Abstract

*Purpose:* The paper aims at predicting the possible effect of taxation on Italian wine market by analyzing the structure of Italian wine demand differentiated by quality and source.

*Design/methodology/approach:* The approach adopted is an early application of the EASI demand system developed by Lewbel and Pendakur on micro data. Censoring at household level has also been taken into account by means of a Shonkwiler-Yen approach. Elasticities are used to proxy the effect of taxation on wine market.

*Findings:* High level of consumption has been found correspond to inelastic demand, opposite to more price sensitive preferences for occasional consumers. Also, wine quality affects responses to price changes.

*Practical implications:* Excises have been found not to be an effective policy for reducing alcohol abuses; it rather reduces the number of purchases for occasional consumers. Lower quality wine market would be affected more.

Key words: Demand estimation, Excises, Censoring, Italian wine
1. INTRODUCTION

The purpose of the paper is to predict the possible effect of taxation on Italian wine market by analyzing the structure of Italian wine demand differentiated by quality and source.

The background of this study sees some relevant aspects of Italian wine economics and policy. Wine consumption in Italy is cultural. Drinking wine at each meal is part of the Mediterranean diet, in fact per capita consumption level has always registered high volumes. Nonetheless, overall consumption is decreasing –per capita consumption has reduced from 42 to 36 liter over the last decade (OIV, 2005)– in favor of a higher share of quality wines. Wine market is also getting globalized. In fact, an increasing number of foreign wines are sold into Italy: over the last decade, foreign wine shares moved from less than 1% to about 7% of the total (ISMEA, 2005).

Despite the overall reduction in per capita volumes and the structural consumption because of the Mediterranean diet culture, EU is in favor of imposing taxes on wine in support of other policies aimed at lowering alcohol consumption and limiting abuses. Most of the EU Member States have already applied excises on wine as well as other spirits. Contrarily, Italy has chosen not to apply excises on wine arguing that the income of traditional producers would get seriously affected. This argument enters into discussion, at this point, next to the position of the European Parliament, which, after having liberalized the market, is pointing to a more harmonized intra-Communitarian trade through the imposition of common duties. Different excises, in fact, could lead non-EU producers to prefer exporting to a country with minimal tax regimes.

Hence, the paper predicts the effect of excise imposition on the market of wines of different quality (color and strictness of the Geographical Indication 1) and source (Italian or Foreign) by using demand elasticities as proxies. Secondarily, it provides demand estimates in order to understand the structure of Italians’ preferences. The quality differentiation allows predicting different effects for different segments of the market. In addition, the effect of taxation have been calculated for segments of the population selected on the consumption level in order to verify whether the taxation can actually have effects on reducing alcohol abuses or in reducing market participation.

2. REVIEW OF WINE DEMAND LITERATURE

Demand estimation, hence price sensitiveness analysis, is fundamental in order to understand the effect of taxation. A plethora of empirical studies have analyzed alcohol consumption and the demand for various types of alcoholic beverages. However, only a few studies have focused more narrowly on the analysis of demand for wine and various types of wines (Larue et al., 1990; Pompelli and Heien, 1991; Buccola and VanDerZanden, 1997; Seale et al., 2003; Carew et al., 2004; Torrisi et al., 2006). Source differentiation and color differentiation are recurring approaches to the analysis of demand for this product; in fact, little has been done on quality differentiated wines. The question of substitution between foreign and domestic wines has been examined from several perspectives: Pompelli and Heien estimated a discrete-continuous model using a cross section of households from the United States. With household-level consumption data, they also dealt with zero consumption points. Additionally, their analysis consisted in estimating demand over two consumers segments differentiated by volumes consumed.

1 Referring to the quality hierarchy generated by Italian Geographical Indications, quality classification, from higher to lower, consists in DOCG, DOC, IGT, and Table.
The magnitudes of own- and cross-price elasticities reported in the studies listed above, Table 1, may be considered “large”, indicating a high degree of responsiveness to own- and cross-price changes.

<table>
<thead>
<tr>
<th>Authors</th>
<th>Model</th>
<th>Types of Wines</th>
<th>Own-Price Elasticities</th>
<th>Cross-Price Elasticities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Larue et al., AIDS with 1990 Habit-Formation Parameters</td>
<td>Color: Red &amp; White, both Canadian &amp; Foreign (4 goods); Country: Canada, France, Germany, Italy, Others, no Color Distinction (5 goods)</td>
<td>-1.889 (Canadian White, Pre-Structural Change); -0.671 (Canadian red, post-structural change)</td>
<td>-0.622 (Foreign Red vs. Canadian Red)</td>
<td></td>
</tr>
<tr>
<td>Pompelli &amp; Heien, 1991 Single-equation, sample selection; abstainers omitted from sample</td>
<td>Dependent Variables: White Only, domestic &amp; imported (sample partitioned by heavy vs. light drinkers). Prices of red, rose, &amp; sparkling included as explanatory variables.</td>
<td>-0.86 (domestic white, light users); -0.15 (imported red vs. domestic white, light users); 0.75 (imported vs. domestic white, heavy users)</td>
<td>-1.25 (imported red vs. domestic white, light users)</td>
<td></td>
</tr>
<tr>
<td>Buccola &amp; Vander-Zanden, 1997 Rotterdam system</td>
<td>Color &amp; Origin: Oregon red &amp; white; California/Washington red &amp; white (4 goods)</td>
<td>-1.413 (Oregon white); -0.517 (Oregon red)</td>
<td>-1.866 (OR white vs. OR red); 1.983 (OR red vs. CA/WA red) [1.902 (OR white vs. CA/WA white)]</td>
<td></td>
</tr>
<tr>
<td>Seale et al., 2003 LA/AIDS, differenced &amp; AR(1) Correction</td>
<td>Reds only by country: Italy, France, Spain, Australia, Chile, US, Rest of World (7 goods)</td>
<td>-1.63 (US); -0.27 (Italy)</td>
<td>-0.86 (Italy vs. US); -0.28 (Chile vs. US)</td>
<td></td>
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<tr>
<td>Carew et al., 2004 Source-differentiated AIDS</td>
<td>Color &amp; Origin: Red &amp; White from British Columbia, US, ROW &amp; (B.C. red)b</td>
<td>-1.78 (ROW white); -0.29 (Eur. white vs. B.C. white); 1.39 (ROW white vs. Eur. White) [no white-red cross-price elasticities]</td>
<td>-1.36 (Eur. white vs. B.C. white); 0.97 (Castellino vs. Tavernello)</td>
<td></td>
</tr>
<tr>
<td>Torrisi et al., 2006 Linear AIDS with demand shifters</td>
<td>(%Red table wine by 3 major brands, private label, &amp; all other brands)</td>
<td>2.21 (Ronco brand); 1.10 (all other brands)</td>
<td>-0.29 (Castellino vs. all other brands); 0.97 (Castellino vs. Tavernello)</td>
<td></td>
</tr>
<tr>
<td>Cuellar &amp; Huffman, 2008 Single-equation, double log, with instrumental variables</td>
<td>Six varietals each of red &amp; white wines, price points of $10 &amp; &gt; $10/750 ml bottle.</td>
<td>1.00 (Cab. Sauvignon); 2.25 (&gt; $10 Zinfandel); 1.07 (&gt; $10 PinotGrigio), not statistically significant.</td>
<td>-3.37 (&lt;$10 CheninBlanc)</td>
<td></td>
</tr>
</tbody>
</table>

Our expectations, then, are positive towards significant effect of taxation on wine consumption. Nonetheless, different results could be found in Italy given the structural and cultural consumption of wine.

This study extends the wine demand literature by using a demand system with household data from Italy, and a source and quality differentiation. Consumers’ segmentation, in addition, provides different estimates for population subgroups recording different consumption intensity.
3. **The EASI Implicit Marshallian Demand**

Approaching the demand estimation for such a complex good, there is the need to account for preference heterogeneity in order to get improved prediction ability of demand models. At this purpose, Lewbel and Pendakur (2008) developed a demand approach that addresses the issues above and maintains the linear specification. The full nonlinear EASI demand system for estimation:

\[
\begin{align*}
  w_j & = \sum_r b_{jr} y^r + \sum_r g_{jr} y_j + \sum_k a_{jk} z_j \ln p_j + \sum_k b_{jk} \ln p_j y + \varepsilon_j \\
  y & = \left( \ln x - \sum_j w_j \ln p_j + 0.5 \sum_j \sum_k a_{jk} z_j \ln p_j \ln p_k \right) / (1 - 0.5 \sum_j \sum_k b_{jk} \ln p_j \ln p_k)
\end{align*}
\]  

Where \( w \) is the market share, \( y \) is the total wine expenditure, \( p \) is the price, and \( z \) refers to the individuals’ socio-demographics. The parameter \( a \) measures the price sensitiveness of \( w \), \( b_r \) controls the shape of Engel curves (relationship between share and expenditure) through an additive function, \( r \) is the corresponding exponent varying between -1 and \( j-1 \), \( r = 0 \) it is excluded (Pendakur, 2008). The intercept is represented by \( z_0 \), the term \( g_r \) represents a socio-demographic intercept shifter; \( h_t \) represents the Engel curves socio-demographic slope adjuster (Lewbel, 1991; Lewbel and Pendakur, 2008; Pendakur, 2009).

Cross-equation restrictions provide theoretical properties to the estimated demand. More specifically, the required adding-up and homogeneity conditions are satisfied by imposing \( \sum_j b_{jr} = 1 \), \( \sum_j b_{jr} = 0 \) for \( r \neq 0 \), \( \sum_j a_{jk} = \sum_j b_{jk} = \sum_j g_r = \sum_j h_t = 0 \), and \( \sum_j \varepsilon_j = 0 \), while symmetry of \( \alpha \) and \( \beta \) matrices ensures symmetry.

4. **ACNielsen Wine Homescan Data**

The data employed are drawn from the ACNielsen Italian Homescan. The particular sample of 6,701 households includes unit prices and quantities consumed of all types of wine over the two-year period from December 2002 to December 2004; expenditures on all other types of beverages and food are not included. Socio-demographic variables for each household are also included.

Despite widespread consumption of wine in Italy, 1,551 households (23.1% of the total) made no purchase of wine during the two years. Nonetheless we cannot state weather those consumers are abstainers or their wine consumption has not been recorded.

Wines are classified by source categories, Italian and Foreign and color. While Italian red and white wines follow a sub classification into four categories based on different types Geographical Indication (GI): IGT (Indicazione Geografica Tipica); DOC (Denominazione Di Origine Controllata); and DOCG (Denominazione Di Origine Controllata e Garantita), foreign white and red wines are included in just one category. These geographical indications are designed to assure consumers that specified production methods and quality disciplines have been adhered to and thereby indicate a quality hierarchy which is stricter and stricter going from IGT to DOCG. Not all wines are of GI, common table wines, subsequently indicated as Table, are produced without a recognized quality discipline and, therefore, the law establish that they cannot use any quality signaling onto their labels.
5. Estimation

The estimation of the EASI model has been carried out with a robust seemingly unrelated regression (SUR), which contrarily to the estimator adopted by Lewbel and Pendakur, given the cross-sectional nature of our data, corrects for heteroscedasticity.

Moreover, in order to account for censoring, we adopted the approach developed by Shonkwiler and Yen whereby the density and distribution functions from a binary choice model\(^1\) are used to adjust for censoring (Shonkwiler and Yen, 1999; Mutuc et al., 2007).

\[
w^j = \phi_j(z, \delta) (\sum b^j, y^j + \sum g^j z^j + \sum^t b^j z^j y^j + \sum^t a^j z^j \ln p^k + \sum^t b^j \ln y) + \phi_j(z, \delta) + \epsilon^j \tag{11}
\]

Where the distribution, \(\Phi_j(z, \delta)\), and density, \(\phi_j(z, \delta)\), functions depend on explanatory variables, \(z\) and associated parameters, \(\delta\). Elasticities estimates, by consequence need to premultiplied by the distribution function.

6. Empirical Analysis and Results

In order to understand the effects on households showing different level of wine consumption estimation has been carried out for quartiles of consumption having the following classification: occasional consumers (0.5-6 liter/sample period), infrequent (6.1-16.75 liter), frequent (16.76-50 liter) and heavy consumers (50.1-1351 liter). The division concerns the quartiles for volume consumption, thus the number of consumers included in each group diminishes proportionally from the first to the last group. Finally, average prices across segments results similar.

Estimation has been conducted obtaining a good variability explained by the model, more than 22% for every equation, in line with the existent empirical demand literature. Demand own- and cross-price effect are used to proxy the effect of excise and to better understand consumers’ preferences and quality switch in case of price changes.

Own-price elasticities at each quartile show that going from occasional to heavy consumers, price effects are generally smaller. Own-price elasticities show high values in the first two quartiles. Looking at price effects relative to the wine typologies it is possible to notice a certain degree of substitution between foreign and DOCG wines, both for red and

\(^1\) The model used is an heteroscedasticity consistent probit.
white wines. DOCG Italian wines, therefore, seem to be the most vulnerable category to foreign competition; in fact, they compete in the same price segment, as show by average prices in tab. 2. This effect is stronger and more significant in the first two quartiles. A certain degree of substitution has been found also between white IGT and white Table wines. When white Table wine price increase, consumers might switch to higher quality wines such as white IGT. This result is valid at all quartiles. Households of the first three quartiles could substitute for almost any other wine typology when Table wines are sold to higher prices.

Estimated price effects give useful indications relative to the consequence of excises on wine consumption and on composition of households’ wine bundles.

**TAB. 5 - Compensated Price Effects**, evaluated for reference type household with mean expenditure at base prices (Bold face are significant at 95%).

<table>
<thead>
<tr>
<th>Consumers' segment</th>
<th>Wine Typology</th>
<th>Red Foreign</th>
<th>Red DOC</th>
<th>Red DOCG</th>
<th>Red IGT</th>
<th>Red Table</th>
<th>White Foreign</th>
<th>White DOC</th>
<th>White DOCG</th>
<th>White IGT</th>
<th>White Table</th>
</tr>
</thead>
<tbody>
<tr>
<td>Light consumers</td>
<td>Red Foreign</td>
<td>-1.171</td>
<td>0.417</td>
<td>1.390</td>
<td>-2.009</td>
<td>0.534</td>
<td>0.209</td>
<td>0.105</td>
<td>-2.298</td>
<td>0.143</td>
<td>0.075</td>
</tr>
<tr>
<td></td>
<td>Red DOC</td>
<td>-0.056</td>
<td>0.678</td>
<td>0.007</td>
<td>-0.036</td>
<td>0.624</td>
<td>0.154</td>
<td>-0.278</td>
<td>-0.09</td>
<td>0.163</td>
<td>0.236</td>
</tr>
<tr>
<td></td>
<td>Red DOCG</td>
<td>0.139</td>
<td>0.101</td>
<td>0.008</td>
<td>0.144</td>
<td>0.144</td>
<td>0.059</td>
<td>0.500</td>
<td>0.147</td>
<td>0.729</td>
<td>0.221</td>
</tr>
<tr>
<td></td>
<td>Red IGT</td>
<td>-0.044</td>
<td>0.016</td>
<td>0.190</td>
<td>0.188</td>
<td>-0.044</td>
<td>0.155</td>
<td>0.097</td>
<td>0.489</td>
<td>0.729</td>
<td>0.150</td>
</tr>
<tr>
<td></td>
<td>Red Table</td>
<td>-0.036</td>
<td>-0.025</td>
<td>0.056</td>
<td>-0.519</td>
<td>-0.051</td>
<td>0.059</td>
<td>-0.172</td>
<td>-0.428</td>
<td>0.284</td>
<td>0.408</td>
</tr>
<tr>
<td></td>
<td>White Foreign</td>
<td>0.150</td>
<td>0.255</td>
<td>0.359</td>
<td>-0.537</td>
<td>0.0405</td>
<td>0.059</td>
<td>0.607</td>
<td>0.304</td>
<td>0.141</td>
<td>0.290</td>
</tr>
<tr>
<td></td>
<td>White DOC</td>
<td>-0.172</td>
<td>-0.272</td>
<td>0.263</td>
<td>-0.385</td>
<td>-0.001</td>
<td>0.093</td>
<td>0.093</td>
<td>0.014</td>
<td>0.273</td>
<td>0.263</td>
</tr>
<tr>
<td></td>
<td>White DOCG</td>
<td>-0.126</td>
<td>-0.126</td>
<td>0.250</td>
<td>-0.849</td>
<td>0.370</td>
<td>0.379</td>
<td>0.007</td>
<td>-0.004</td>
<td>0.141</td>
<td>0.290</td>
</tr>
<tr>
<td></td>
<td>White IGT</td>
<td>-0.085</td>
<td>0.137</td>
<td>0.007</td>
<td>-0.339</td>
<td>0.028</td>
<td>0.016</td>
<td>0.142</td>
<td>-0.028</td>
<td>0.273</td>
<td>0.443</td>
</tr>
<tr>
<td></td>
<td>White Table</td>
<td>-0.016</td>
<td>0.093</td>
<td>-0.126</td>
<td>-1.094</td>
<td>0.093</td>
<td>0.032</td>
<td>0.250</td>
<td>-0.014</td>
<td>0.273</td>
<td>0.443</td>
</tr>
</tbody>
</table>

Looking at the magnitude of price effects a first deduction concerns the fact that occasional and infrequent consumers would be the most affected, in terms of volume of wine consumed. In terms of expenditure on wine, frequent but especially heavy consumers would be seriously affected. Their demand is almost inelastic, thus, a price increase would generate a reduction in consumption. When imposing excise duties the objective of the government is reducing volumes of alcohol consumed and avoiding abuses. Given the price effects information obtained in this research we conclude that excise imposition would reduce wine consumption.
mostly for occasional and infrequent consumers, not much for frequent and heavy consumers. Therefore, the government taxation could not be highly effective, by contrast, would affect consumers’ welfare, in monetary terms.

Another consideration concerns the fact that excises are per volume duties. Consequently, lower price wines would receive a higher price increase in percentage terms, the opposite for expensive wines. We deduce that this rationale allows forming expectations on Italians’ wine bundle composition changes.

7. CONCLUSIONS

The hot debate about excise imposition on wine consumption in Italy has reasons to exist. Justifying taxation with a lower consumption is not entirely true because infrequent consumers would be those that will be affected the most. Producers that are going to be affected the most are table and DOCG wine producers, because less wine of these categories is going to be consumed on the market. While the reduction of lower quality wine could be an incentive to producer to move up to the next quality level with their production, a different situation stands for DOCG consumption. Those wines are the most traditional and reflect the cultural background of a specific wine production in a given area. The decrease in consumption of those wines will truly affect traditional producers, as stated by national government in the debate. This result could, in fact, be used as support to the statement.

Imposing taxes on a beverage which consumption has cultural roots, on the other hand, will increase governmental revenues, but the reduction in wine consumption especially for infrequent consumers, does not reduces the abuse of alcohol.

The effect of excises in terms of a harmonization of intra-European trades is a question we procrastinate the answer to further studies.

The dataset used is rather far away in time. We do not expect great differences in terms of estimates although during the last decade wine bundles have been changing. Foreign wine results, on the other hand, are expected to be different as more wine from new world countries has been consumed into Italian market.
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