ECONEX 14

FUNDING THE NHI - EARMARKED TAX

1. Introduction:

There does not seem to be a strong argument for implementing earmarked tax to fund the NHI as it would represent only a small proportion of the NHI budget (and be a so-called weak earmarked tax). On the other hand an increase in taxes would be highly progressive and have severe implications for families paying personal income tax (i.e. largely medical schemes members).

Although **general taxation is intended to be the main source of funding for the NHI,** according to the Green Paper (GP), issued on 12 August as a discussion document, other options are also being examined.

These options include:

1. **A surcharge on taxable income;**
2. **Payroll taxes for employees and/or employers;**
3. **An increase in value-added tax (VAT); and**
4. **The removal of the existing tax subsidy for medical aids.**

The favoured option seems to be a progressive earmarked tax in the form of a mandatory payroll-related contribution. According to the GP this would establish a link between individual's contributions and the health benefits they receive.

2. Earmarked Taxes

Earmarked (or hypothecated) taxes are taxes of **which the revenues are reserved solely for a specific programme or purpose**.

This contrasts with funding from **general taxation, where expenditures are financed from consolidated receipts.** Examples of earmarked taxes include fuel taxes reserved for the transportation sector and carbon taxes reserved for environmental protection funds.

Proponents of earmarked taxes argue that it **may limit wasteful government spending**, while opponents argue that **they limit flexibility in expenditure in times of need**.

Earmarking can be used to constrain overall public spending as it provides an **accountability mechanism** that constrains public spending and can also work as a **commitment device** to solve time-inconsistency problems in tax policy.

As the level of spending is directly tied to the amount of taxes paid, earmarking **can inform taxpayers of the cost of particular services.**

Tax revenues are heavily dependent on the overall performance of the economy and tend to fluctuate with the business cycle. In this case earmarked tax to fund the **NHI could become hostage to economic cycles** with the threat of under-funding during economic downturns. Because general taxes fluctuate less in relation to the benefits promised, they are most efficient when benefits are not related to contributory status and liabilities must be financed regardless of the decrease in revenue.

2.1.2 Classification of earmarked taxes

There should be distinguished between **strong (or substantive) earmarking** and **weak (or nominal) earmarking** on the one hand, and **narrow and wide** earmarking on the other.

In the strong case, **tax revenues must equal public expenditure on the programme**, while **referendums may be held on the tax rate and the amount of spending**.

In the **weak** case, **earmarking** is **more transparent** and **informs the taxpayer of the cost** of the service, but expenditures do not match revenues.

Wide earmarking covers a whole spending programme, whereas **narrow earmarking covers a specific project** within a programme. According to this classification, **<u>the NHI's proposed earmarked tax would amount to weak, wide earmarking.</u>**

With **weak earmarking, taxpayers have no control over total expenditur**e on the public service and **governments could spend much more than earmarked taxes by increasing spending from general tax revenues**.

Weak earmarking would **only constrain public expenditure decisions in very narrow cases,** where earmarked funds contributed to some specific project within a general public service programme.

Earmarked tax could be supplemented from general taxation during times of recession, whereas **earmarked tax revenues could be raided for other types of spending in expansionary periods**. In either case, with weak earmarking, there would be **no real link between revenue and spending, undermining the argument in favour of earmarking.**
Over time many earmarked taxes have become less strong, and may be replaced by general taxation because these taxes often do not raise the exact amount needed.

2.1.3. Political support

Proponents claim that a move towards earmarking **will increase tax revenue by increasing taxpayers' willingness to pay**. Because earmarked taxes require the government to track and account for revenues separately, this usually **increases tax administration and compliance costs.**

2.1.4. Benefit principle

According to the GP the main rationale for a progressive earmarked tax would be **to establish a link between contributions that individuals make and the health benefits that they receive.** The **stronger the benefit principle** the **better the case for earmarked taxes**, in the form of payroll taxes or mandatory contributions, **since benefits are tied to contributions.**

In contrast, the **NHI will not have a strong benefit principl**e, especially if funded by highly progressive taxes. This is because the **taxpayers that fund an NHI system are unlikely to switch to the public sector on a large scale,** given the strong demand for private sector health care (see Note 11). Any tax to fund the NHI will have to be highly progressive, with the tax payer not receiving benefits to the same value as taxes paid.

Large redistributive taxes are typically associated **with targeted and universal benefits**, with the aim of poverty alleviation. **As vertical cross-subsidies increase there will be a decreasing willingness to pay.** In this case general taxes are most efficient, since benefits are not directly related to contributions.

2.1.5. Social solidarity

A further rationale put forward in the GP is that a **progressive earmarked tax would provide a mechanism for cementing social solidarity in the health system** through income-related contributions to a single pool of funds that will benefit all. In South Africa there are only 5,5m registered tax payers and they are all aware that a large component of their taxes is **redistributed to the poor.** Earmarking would therefore probably undermine social solidarity.

Hence, there **does not seem to be a strong argument for implementing earmarked rather than general taxation to fund additional expenditure on the NHI**. While general taxes are the **most efficient in this case, they are subject to macroeconomic constraints**.

3. Impact of an Increase in Earmarked Taxes

The **economic impact of an increase in earmarked taxes would be equivalent to an increase in general taxation**.

Unless the extra expenditure in healthcare comes at the cost of expenditures elsewhere, it will have to be raised by additional taxes and the relative size of government will increase. While fiscal substitution is unlikely, the political power of the Department of Health will be tested against the relative power of the other departments, with each appealing to the National Treasury to secure its own slice of the tax revenue for its political survival and prosperity.

3.1. SA NHI Tax Proposals

According to the recent Budget Review a range of possible funding sources are currently being considered.

These include:

1. **The removal of tax subsidies for medical scheme contributions;**
2. **A surcharge on taxable income; a mandatory payroll tax;**
3. **An increase in the VAT rate; and**
4. **Co-payments or user charges.**

Each of the potential revenue sources has its pros and cons. For example, VAT collections would be instantaneous to introduce, but would be regressive, affecting the poor more than the wealthy.

The favoured option seems to be a mandatory payroll-related contribution. According to the ANC proposal, this would be progressively structured, **from less than 1% for the lowest income earners to a maximum of between 7% and 8% for the highest income earners**. The **additional funding needs will to some extent be offset by the proposed removal of tax subsidies for medical scheme contributions.** According to the Budget Review, the revenue foregone from tax-deductions for medical scheme contributions was approximately R 6,7bn in 2008/09.

Personal Income Tax Brackets	Marginal Tax Rate	Increase in Marginal Rate for NHI
0 – 132,000	18%	0.5%
132,001 – 210,000	**25%**	**1%**
210,001 – 290,000	30%	2%
290,001 – 410,000	35%	3%
410,001 – 525,000	38%	4%
525,001	40%	6%

3.2. Impact of increased taxes on medical scheme members

The change in cost to members was investigated under three scenarios:

1. **The member remained on the same benefit option,**
2. **The member buys down to a cheaper plan; or**
3. **The member leaves the medical scheme.**

The results indicated that for a member earning R 40 000 per month, remaining on the same benefit option would cost around R 1 000 extra per month. This reflected the additional income tax and the removal of the tax subsidy. Members earning less than this would not be significantly affected. However, members earning more would be progressively disadvantaged. When dependents were added, the cost of remaining on the same option would increase because of the larger tax subsidy that would be lost.

If a member chose to **move to a cheaper plan**, part of the additional tax would be offset by the lower premiums. In this scenario the cheaper plan, e.g. a Hospital Plan, would cost around **R700 less per member per month**. Principal members earning more than R33 000 per month would pay more than they currently do, while those earning less would save money. If a single member chose to leave the scheme, the breakeven point would be a monthly salary of around R 50 000.

Importantly, these scenarios assume that the NHI contributions purchase the same value/volume of goods, but possibly offered in the public sector or an accredited private provider. However, it is most unlikely that current service levels (on average) in public institutions are comparable on a Rand for Rand basis to the levels currently offered in the private sector.

At the same time, it is clear that taxes will be highly progressive so that those that can contribute will do so and presumably their contributions will then be evenly spread across the populace. The taxpayers that pay for the additional health spending will probably not leave their medical schemes for the public sector. **As a consequence, the additional taxes will in all likelihood not generate an offset in the demand for private services and will amount to a substantial increase in their tax burden. While the majority of South Africans should theoretically be better off and have improved access to quality care, the people that pay for the NHI will receive very little benefits and be worse off.** This also **contradicts the ANC's main rationale for a progressive earmarked tax, namely to establish a link between contributions that individuals make and the health benefits that they receive.**

4. Conclusion

The proposed weak earmarking of taxes seems to negate most of the arguments in favour of earmarking. If government were to increase the budget for public health care it could do so **more efficiently through increases in general taxes**, as **benefits are not related to contributory status in an NHI**. **The additional taxes needed to fund the NHI are likely to be highly progressive and will probably amount to a substantial increase in the tax burden of medical scheme members.** However, revenue options are always dependent on macroeconomic performance and it is important to consider not just funding options for the NHI but balancing the entire fiscal equation. As Twine says, "discussing the apparent options available for funding the NHI is a little like contemplating the arrangement of deckchairs on an ocean liner instead of keeping an eye open for ice bergs."