

14.6.3. Net burden of financing an income grant

In evaluating the costs of a Basic Income Grant financed by increasing income taxes or increases in the value added tax, it was argued in the presentations to the Committee that one should take note of the difference between “gross burden” and the “net burden” of the income grant. For example, although the additional costs of a R100 monthly Basic Income Grant to all (given existing grant obligations) could be R46 billion, evidence was given that R22 billion of this could be clawed back through the tax system, this means that the net additional funds needed would amount to a much reduced R24 billion.

Similarly, the Committee was presented with the argument that, if universal income grants should be funded out of increases in the VAT rate, the net additional burden of a R100 grant would be about R13,5 billion.

The Committee took note of these arguments, but since it is not within its brief to consider potential tax increases, the calculations in the rest of the chapter are based on gross additional costs.

14.7 The tax system and social security benefits

Reference has previously been made to the tax treatment of contributions to retirement funding. The tax structure related to retirement provision can be characterised as “exempt-tax-tax”, with contributions being tax exempt and investment incomes and benefits being taxed. This system of contribution deductibility provides a positive incentive to make private provision for retirement. Other issues related to taxation of retirement that need to be addressed are the taxation of investment and trading income of retirement funds and the current treatment of lump-sum benefits.

Current deductibility of a maximum of two-thirds of medical aid contributions in the hands of the employer provides an incentive for private provision as well as favouring those with higher incomes disproportionately. The appropriateness of this arrangement need to be reviewed along with issues related to the treatment of savings accounts.

14.8 Review of the current tax dispensation

User charges by Government and Government

agencies currently amount to 2 per cent of GDP. Some fees contribute to general Government revenue, some are retained in trading accounts or extra-budgetary entities, and some fees are not reflected in public sector accounts at all. They include departmental sales, registration and inspection fees, hospital fees and charges, motor licence fees, payments for research and other sales of research councils, road tolls, university and technikon tuition and residence fees, public school fees, state water scheme tariffs and sales of various other Government enterprises.

Dedicated levies not reflected in national and provincial budget appropriations currently amount to about 1,5 per cent of GDP or about 6 per cent of total tax revenue. International accounting standards count statutory levies as Government revenue and their spending as public expenditure. The largest of these are social security taxes, i.e. unemployment insurance contributions and workmen’s compensation levies (R4 billion), fuel levies for the RAF (R2 billion) and for the subsidisation of Sasol and Mossgas (R0,8 billion), and regional services councils levies on turnover and payroll for financing local infrastructure (R3 billion).

Levies also finance various industrial, research and regulatory bodies, such as the South African Tourism Board, Financial Services Board and South African Bureau of Standards. Television licence fees are assigned to the South African Broadcasting Corporation. Local property taxes and surpluses on municipal water and electricity trading accounts are earmarked for municipal services.

14.9 Review of principles underlying the classification and use of mixed financing options

This section reviews the current evaluation and principles underlying user-fees, earmarked taxes and levies and proposes a way of providing guidance on their use within public policy and the overall system of social security. This is done where appropriate with reference to views expressed by the Katz Commission and the Treasury Department. Extensive use has been made of the views of Herber (1975),

Fisher (1996) and Gildenhuys (1993) as part of the review.

14.9.1 General taxation

Broad-based taxes such as the personal income taxes such as personal income tax, value-added tax, and corporate taxes are most appropriate for financing those public goods for which considerable difficulty arises in applying the exclusion principle.

Earmarked taxes, user fees, and administrative revenues are all capable, at least to some extent of utilising or approximating the exclusion principle when used as financing techniques.

According to Herber it should be emphasised that the “presence” or “absence” of strong traits of “publicness,” whether deriving from some externality or from some other source, does provide a logical “tie-in” with the institutional sector, public or private, which is likely to be the more efficient in influencing the allocation of a particular economic good. None-the-less, a “case-by-case” approach is still; required.

If “Government” production and/or distribution of a quasi-public good is considered desirable, a variety of financing techniques are available to the unit of Government providing the good. Pure public goods, which are not subject to the exclusion principle, cannot be allocated by the commercial principle.

Quasi-public goods can be allocated according to at least a degree by utilising commercial principles as their benefits are often partially subject to the exclusion principle. Quasi-public goods can also be allocated and financed through general taxation. The choice between general taxation and the application of some commercial principle as financial allocative techniques is relevant for quasi-public goods but irrelevant for pure public goods.

The case for general taxation as a means of financing quasi-public goods rests upon several related points.

- General tax financing is preferred in those instances where the short-run marginal cost of an additional unit of output is very low or zero and the price elasticity of demand of the good is highly elastic. The low or zero marginal cost means that additional units of the good do not withdraw resources in any way from alternative uses. A very inelastic good

would imply little purpose in using price as a rationing technique.

- General tax financing would also be preferred in the case of quasi-public goods where important joint consumption characteristics exist that may cause a serious supply shortage of these goods (e.g. tuition costs).
- General tax financing of a quasi-public good would also be preferred in instances where the collection costs of user fees are substantial (administration costs). Severe inconvenience to users from the collection system would also be important (consumption disutility).
- General tax finance may also be preferred where certain distributional objectives are being pursued. For instance, medical services or school lunches may not be available in adequate quantities to certain low-income people if they are available only on a direct pricing basis.

Under certain conditions, mixed financing using both user prices and general tax revenues would constitute the most rational alternative for financing quasi-public goods. Under other circumstances, it may provide negative allocational and distributional non-neutralities. The use of mixed financing may be rational if the good possesses both substantial joint consumption effects, which benefit the society as a whole and which remain outside the exclusion principle, and also private benefits. Tax funds would finance the community or social benefits while user prices would finance the individual or private benefits.

The use of general fund financing to cover the losses associated with Government pricing, e.g. the case of optimum social output under conditions of decreasing production costs, is rational if it is collectively determined by the community that fiscal means of this sort should be used to redistribute real income by increasing the allocation of the quasi-public good in question. The combined use of general fund financing and user pricing to finance public university education meets this rationale since the benefits of education are both social and private in nature and, in addition, improving the education of the poor is an effective means of improving their long-term real income position.

The absence of sufficient joint consumption benefits to justify tax (or debt) subsidisation of any loss, or the absence of a sufficient community-approved redistribution objective, would make the mixed financing technique irrational. This could be true because private users would derive most or all of the benefits from the consumption of the good and few, if any, social benefits would result. Yet, general tax funds collected from society as a whole would subsidise part of the cost of the private consumption. The results would be both a redistribution of income in favour of private consumers of the quasi public good as well as an allocational distortion.

Herber also raises the issue about what he terms the size of the “relevant interacting group.” The term “relevant” here suggests the connotation of “inter-dependent” consumption. Essentially, it asks the question: is the group small enough to reach a market-type agreement without encountering a serious “free-rider” problem?

14.9.2 User charges

User charges should operate as benefit taxes with an individual’s charge depending both on benefit (use) and cost of provision. The principal rule for economic efficiency requires that marginal benefit equal marginal cost. For services that primarily benefit the direct consumer then, the price charged should equal marginal cost.

The arguments in favour of user charges are largely the converse of those used to motivate general taxes in the case of quasi-public goods. The argument for use of the commercial principle is found in those quasi-public goods whose *economic effects* are mostly subject to the exclusion principle. The following issues are important considerations:

- The absence of significant positive externalities may suggest that user pricing may be preferable. Significant negative externalities may, however, require high user prices to discourage consumption – to the extent that the exclusion principle can be applied to the good.
- Where the cost of collecting user fees is lower than general tax administration for the same revenue yield, user fees are preferred. (This was the case with primary care clinics in South Africa until 1996.)
- Distributional goals may be better met

through user fees than tax financing. This is particularly important for goods such as electricity or water where an approximation of the benefit principle is important.

The pricing of user-charges face a number of alternatives depending upon the nature of the good and the goals to be pursued. These will include:

- Profit maximising pricing
- Average cost pricing
- Marginal cost pricing.

Negative and distributional non-neutralities tend to be reduced as output is expanded toward marginal cost equals average revenue equality (the social welfare optimal allocation point). However, “isolated” examples of marginal cost pricing in a society where imperfect markets prevail do not necessarily constitute an optimal allocation solution, though in many cases they would constitute an improvement in allocation.

The strongest case for *marginal cost pricing* would likely centre around an important economic good possessing significant joint consumption characteristics over a *large group* and/or the presence of decreasing production costs at the relevant output scales. An administration problem of effectively applying the exclusion principle may nevertheless still occur. The implicit danger remains that pursuit of the marginal cost pricing rule for public-type goods, at a time when it is not being followed generally within the economy as a whole, will irrationally expand the supply of public versus private goods. Nevertheless, the use of the marginal cost pricing technique in the allocation of quasi-public goods may be considered, at times, as an acceptable “second-best” solution in a world inextricably associated with imperfect market structures, joint consumption, and externalities.

Use by Government of the *profit maximising price*, as determined by the intersection of marginal cost and marginal revenue, would best serve only the revenue goal unless society needs to reduce consumption of an undesirable good.

Average cost pricing is the preferred alternative to profit maximising pricing for governmental pricing of quasi-public goods as it helps to reduce negative allocational and distributional distortions.

Marginal cost pricing appears to be the most desirable apart from the problems already mentioned.

Gildenhuis draws attention to a common classification error in which user charges, levies and consumer tariffs are confused. In most of the literature a common term is used to describe all three, namely user charges. There are in fact fundamental differences.

User charges and consumer tariffs, however, have certain common characteristics, namely:

- The absence of compulsion – their payment is voluntary because the user or the consumer has a choice of buying the services.
- They are both based on the benefit-received principle, which means that the user charge or consumer tariff which has to be paid is based on the direct benefit of the service to the user or consumer; in other words there is a direct quid pro quo which means that the user or consumer receives actual value in services to the amount paid.
- The user charge or consumer tariff is established according to the costs for delivering the service. Consumer tariffs, therefore, are comparable to prices of goods traded in the private sector, while user charges are levied to recover additional operational (direct) costs incurred on behalf of a specific user of a service.

Gildenhuis proposes that consumer tariffs should be used in the case of quasi-collective services to pay for the extra operational costs incurred of quasi collective services. In this way there can be an efficient and effective allocation of the costs of public services. This also relieves the pressure on tax revenue because if consumer tariffs and user charges are not imposed, the cost of all particular and quasi-collective services has to be met from taxation.

User charges do not cover the full costs of quasi-collective services. If users were expected to pay the full cost of collective services they would in all probability be beyond the means of the larger part of the population.

User charges have the advantage of raising additional revenue. However, they also serve the important function of limiting the misuse of quasi-collective services and improved equity resulting from direct pricing (i.e. non-users do not subsidise users, e.g. toll roads, foreign users). Furthermore, user charges can register and record public demand for services. User charges can also serve to correct price signals in the

market. This is particularly important in conserving a resource which otherwise would appear free.

Fisher points out several general principles of efficient user charges:

- User charge financing becomes more attractive as the share of marginal benefits that accrues to direct users increases.
- User-charge financing requires that direct users can be easily identified and excluded (at reasonable cost) from consuming the service unless the charge is paid, assuming that most of the benefits of a service or facility go to direct users.
- The efficiency case for user-charge financing is stronger when demand is more price elastic. In the special case of a perfectly inelastic (vertical) demand, price does not matter. No inefficiency would result if consumers underestimate cost. Obviously, the more price elastic demand is, the greater the potential for inefficiency if consumers do not face true costs.
- Marginal benefits, not total benefits, matter for the determination of user charges.
- The costs for construction of a public facility should be paid by those groups in society who will benefit directly from the existence of the facility, which may be different from those who benefit from using the facility directly. Two reasons are given for this:
 - The existence of a facility provides individuals the option of use in the future, should their demands change.
 - Individuals who are not direct users also might benefit if the facility generates spillovers in the form of additional economic activity.

If all residents as well as users should pay all or part of the long-run production costs of public facilities, these charges should be independent of the amount of actual use of the facility. Some charges could be applied to everyone to cover that part of the capital cost that benefits all, and different charges could be applied to everyone to cover their share of the capital costs.

In practice, however, standard recommendations on the pricing policy guidelines prove quite difficult to implement. For instance, in the United Kingdom (UK) the following guide-