

# Seminar Briefing 24

## Research

### Securing Funds for the Proposed NHS Multi-year Funding: The Feasibility of Using a Hypothecated Tax

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## 1. Introduction

The funding, or underfunding, of the NHS has again become a defining political issue. The Office for Budget Responsibility estimates that spending on the NHS must increase by about four percent per year to meet rising demand and costs. The Government has proposed a multi-year funding plan but has not yet explained how the funds will be raised.

The public is widely perceived by politicians to be tax resistant. Since 1979, it has become commonplace for both the Conservatives and Labour at general elections to promise not to raise all, or part of, the "big three" taxes: income tax, VAT and National Insurance which between them raise the bulk of government revenue. Instead, less "visible" taxes, for example the various forms of stamp duty, or the introduction of insurance premium tax, have been used to raise funds, leading to widely criticised distortions in the tax system.

To overcome tax resistance, and, in the eyes of some of its advocates, to give the National Health Service more stable funding, the idea of a "hypothecated" tax for the NHS has received a fresh airing. Hypothecation – the earmarking of a specific tax to be spent on a specific purpose (in this case the NHS) – can take essentially two forms. "Hard" hypothecation where the tax is intended to cover the whole of the cost of a service. Or "soft" hypothecation, where the tax is earmarked to be spent in a specific area but it only contributes to part of the cost rather than covering the whole of it. Hypothecation is not a new idea. It was, for example, debated with some fervour in the 1990s (see Jones and Duncan, 1995).

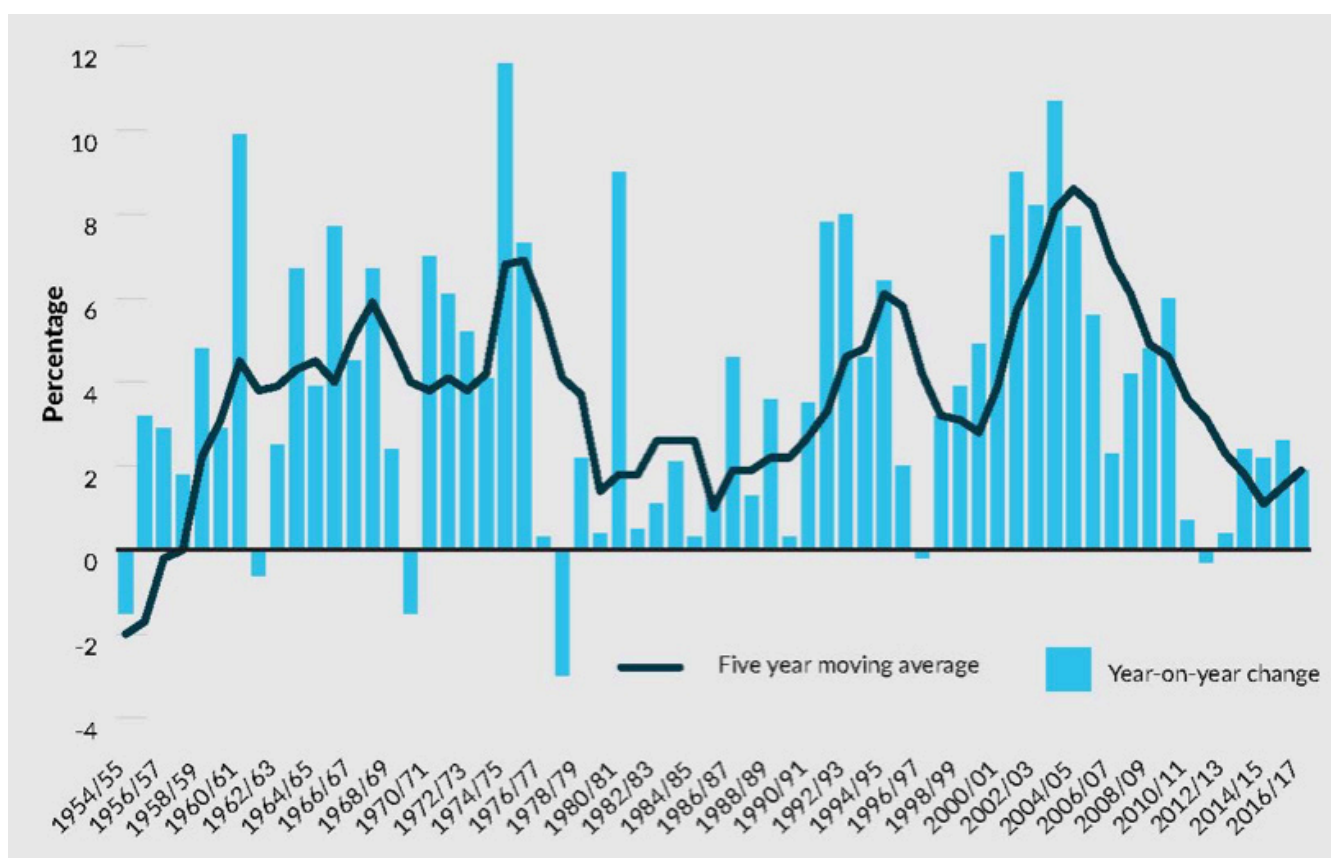
## 2. Arguments in favour of hypothecation

Proponents argue that hypothecation would increase transparency over taxation, might well increase support for NHS expenditure, and should provide the NHS with greater funding stability.

### 1. Greater funding stability

The graph below shows that health spending has shot up and down like a yo-yo, year to year. Even the five-year rolling average (black line) looks like an outline of the Pyrenean section of the Tour de France. This clearly is not sensible; capital spending decisions on construction take years, and lead times for training staff are three years for a newly qualified nurse and a dozen or so for a consultant. Indeed, a finance director of a FTSE company might well resign if faced with annual cash flow projections like this.

Figure 1. Volatile history of health spending in the UK



Note: Data are presented in real terms at 2016-17 prices, using GDP deflators published in March 2018.

Source: Murray, 2018, p3. The King's Fund reproduction of House of Commons Parliamentary Library data on NHS funding and expenditure

An earmarked tax might provide greater stability, making expenditure less subject to short-term decision making. The alternative, proponents argue, is to continue with alternating periods of famine and plenty. Under the present system the Treasury presses down on expenditure until the position becomes untenable and then allows a period of plenty, as there was ten years ago, for that only to be followed by another famine.

## 2. Transparency and public support

An earmarked tax, some argue, could overcome tax resistance by convincing the public that the money raised would be spent on the purpose intended. There is polling evidence that the public likes hypothecation. A properly administered hypothecated tax could increase citizen awareness of the actual cost of public services, both in general and personally.

Many proponents argue that because the NHS is held in such high esteem, the public will happily pay an earmarked tax that would produce higher spending. Others recognise that might not be the case – that the NHS might receive a nasty surprise when the implication of what is involved in raising the tax becomes clear to the public. They, nevertheless, believe that the greater transparency involved in hypothecation remains worthwhile – giving citizens, at least up to a point, a clearer view and potentially, more of a say, on how their taxes are spent.

## 3. Problems with defining “an NHS tax”

Just what should be included in “an NHS tax” is a matter of debate. Health expenditure in England is about £124 billion. But only around £110 billion of that is direct service expenditure, coming under the NHS England commissioning budget. The other £14 billion covers education, training, some capital, and R&D. Should that expenditure be included? And if not, why not - given that those other elements are key to sustaining the service? And what about social care, given the widely accepted argument that social care and the NHS are becoming ever more closely linked as the population ages? About £16 billion of public money is spent on social care, although that sum has been declining in real terms since at least 2010. The difference between covering only the “service element” of the NHS and the whole of health and social care spending is the difference between £100bn and a £140 billion per year, ahead of any increase in expenditure. The definition of what is included will have a bearing on which tax might be used.

## 4. Which tax might be used?

It would, of course, be possible to devise an entirely new health, or health and social care tax. It would probably make more sense, however, to use an existing tax – avoiding the need for major alterations to other taxes to allow for the introduction of an entirely new one. The obvious candidate would be National Insurance which raises around £136bn a year, although it should be noted that is a UK figure, not an English one. It would, nonetheless, need appreciable amendment. Those past state pension age, for example, do pay VAT and income tax. But they do not pay national insurance, despite elderly people being heavy users of NHS services.

## 5. Arguments against hypothecation

If there are strong proponents of hypothecation, there are equally strong opponents, with the Treasury having long been resistant, and opposed in particular to “hard” hypothecation. The arguments against include:

### 1. Flexibility in setting priorities in public spending

Hypothecation, by definition, reduces the flexibility of the public finances. The larger the share of public expenditure to which hypothecation applies, the more difficult it becomes to navigate the inevitable cyclical downturns in the economy and, indeed, structural ones of the sort that followed

the 2008 financial crash.

## 2. Hypothecation in one area will lead to pressure for hypothecation in others.

Once hypothecation is agreed for one area, there will be pressure for it to be extended to other parts of public expenditure. This is likely in the first instance to apply to what are perceived to be “popular” areas of public spending - schools, or other parts of education for example. Any extension, of course, would compound the problem of how to react to changing priorities, and the ability to respond to unexpected, and unexpectedly urgent, needs.

## 3. “Unpopular” programmes could lose out.

Hypothecation might lead to higher spending on “popular” causes – the NHS and education for example. But that may come at the price of greater public resistance to taxes for supporting essential, less popular causes—benefits expenditure, perhaps, or spending on prisons. Some regard this argument against hypothecation as unduly paternalistic, depriving citizens of choice and power. Others believe spending on unpopular causes is a part of responsible government: some spending is necessary in a civilised society even if significant parts of the electorate disapprove.

## 4. Distortion of spending across programmes.

Such distortions to public spending can, of course, happen even when spending areas are merely protected rather than formally hypothecated. For example, this Parliament and the prior one have protected NHS expenditure, overseas aid, pensions, and school spending for 5–16 year olds. This arguably resulted in less than optimal expenditure in other areas, notably criminal justice and local government. The cuts to local government expenditure have included social care expenditure, which indirectly affects demand in the NHS; the NHS, then, has been both protected and not protected.

## 5. Shortfalls and surpluses.

If spending is truly hypothecated, i.e. tied to the money raised by a particular tax, it becomes subject to the buoyancy of that tax. If the tax raises more than expected, there is no logical reason why the area to which it is hypothecated should receive higher expenditure than it would otherwise have received. If the tax raises less than expected, then one of two things has to happen: either spending must be cut, or the government will find it politically impossible not to top spending up to the level that had been anticipated, or is judged necessary - in which case the hypothecation is broken.

That, of course, could be mitigated by creating a specific fund, one that could accumulate surpluses that then could be used to even out spending in years of deficit. If surpluses were to occur for several years in a row, however, the temptation would be to reduce the tax rate, which might have undesirable consequences later on; increase spending with idea that the money is there to be used; or divert some of the surplus to other areas. Long run deficits would require an increase in the tax rate, or subsidy from more general taxation.

## 6. What has happened with hypothecation in the past?

The UK, despite Treasury resistance, has in the past used both hard and soft hypothecation. Examples of “soft” hypothecation include the introduction of a landfill tax by the Conservatives in 1996, with the promise that it would be “revenue neutral” – employer National Insurance contributions were reduced in return. By 1999, however, a change of government saw an increase in both the landfill tax rate and employer National Insurance contributions. In other words, the deal around this piece of hypothecation did not last.

In 1997, Labour introduced a “windfall tax” on the utilities, intended to fund new welfare-to-work programmes. Most of the £5.2 billion raised was used for that, but some £1.3 billion was allocated to backlog maintenance in schools, illustrating that money raised by hypothecation can easily be used for other purposes.

In the arena of health, Labour in 2002 increased National Insurance contributions to fund a generous five-year settlement for the NHS. The two were directly linked. But after the first year or two, due to the nature of government accounts, it is impossible to track how far the National Insurance increase in itself raised NHS spending – because there was, and is, no way to determine what would have been spent through general taxation in the absence of the NI increase.

More recently, a “sugar tax” was introduced on soft drinks, the proceeds of which were earmarked (hypothecated) to be spent on school sport. The tax was intended to reduce obesity both by reducing sugar intake as the price of soft drinks rose, and by providing encouragement for children to take more exercise. In practice the industry responded by reformulating many of its products to contain less sugar – a desirable aim of the tax. But, as a result, the take from the tax fell – from an anticipated £520 million a year when it was first announced in 2016, to what the Office for Budget Responsibility now estimates will be £275 million. As a result, some £245 million a year less will be available to spend on school sport.

Each of these illustrates the problems with “soft” hypothecation. The sugar tax illustrates not only that the amount raised is subject to the buoyancy of the tax, but also begs a question. “If an additional £520m needed to be spent on school sport, why should that fall to £275m just because the tax raised less than initially anticipated?” The landfill tax illustrates how promises around hypothecation often do not last. The windfall tax on the utilities shows how money raised for one primary purpose can often be spent elsewhere, while the national insurance hike to help pay for the NHS shows how, after an initial year or two, and when a hypothecated tax raises only part of the money for a service, it is impossible to demonstrate whether it is providing extra spending or not. These problems, not least the last of them, have led several economists to argue that – tempting though it may be politically to tie revenue raising to particular expenditure – soft hypothecation is essentially dishonest and a fraud. And the risk from is that as it becomes clear that the money raised is not really tied to the expenditure, or to extra expenditure, the repeated use of soft hypothecation will increase rather than decrease trust in politicians.

Perhaps the best known example of “hard” hypothecation is the Road Fund Licence (now Vehicle Excise Duty), originally levied to build and maintain roads. As the number of cars, vans and lorries exploded, however, the tax soon raised more than was needed for that and the money was diverted elsewhere.

The biggest single example of hard hypothecation is the tax that is often cited as the one that could be turned into a hypothecated health or health and social care tax: national insurance.

It has a long history. After the Second World War it entitled individuals to a range of non-means-tested benefits – the so-called “contributory” as opposed to means-tested benefits. These included unemployment benefit and the basic state pension – although a portion of National Insurance also has always made a highly variable contribution to NHS expenditure, from 6 percent at the low point to 22 percent at the high.

Over time, however, the link between contributions paid to National Insurance and the benefits received has become weaker and weaker. Some of the benefits that national insurance originally covered have disappeared entirely. Sickness benefit, for example, has been replaced by statutory sick pay. Others, such as the widow’s pension and invalidity benefit, were heavily cut in value or became entirely or partially means tested. Unemployment benefit used to be paid for a full year to those who had contributed enough to qualify, with no job search requirements. The replacement, the contributory based Jobseeker’s Allowance, is now paid without a means test for only six months and carries job search requirements. The number of years of contribution required to receive the full basic state pension was once as high as 49 years for men and 44 for women; it fell at one point to 30 years for both and is now 35 years. Parents, carers and others can be “credited in” – treated as though they have paid contributions without having done so.

The contributions are paid into a fund – the National Insurance Fund. But the fund is almost entirely notional - national insurance being a pay-as-you-go system, with contributions in any given year paid out in benefits, not invested. The fund has at times run surpluses and on other occasions deficits. It is essentially just a piece of government accounting. In 2017, national insurance raised some £35bn more than was spent on contributory benefits. The additional cash was spent elsewhere.

In other words, the UK’s longest and most sustained example of hard hypothecation has not in practice held. The benefits covered have shrunk. The money raised has at times been diverted elsewhere, and national insurance, from the employee’s point of view, has, in large measure, become just another tax on income.

Thus while it would of course in theory be possible to run a fund in which surpluses were retained for years when the tax take was less than anticipated, and in which deficits were plugged, either by hoping for and waiting for surplus years, or by filling the whole from general taxation, history seems to be against it.

## **7. But it works elsewhere?**

Perhaps the strongest counter-argument to this pessimistic, indeed hostile, view of hypothecation is that the social insurance systems used for health in France, Germany and elsewhere are effectively hypothecated taxes. But they are not without problems of their own. First, classic social insurance is a three-way deal between employee, employer and the state - ie the taxpayer - all of whom make contributions. Social insurance systems have their own collection and distribution systems, which create administrative costs beyond those of general taxation. But they also act as a tax on jobs, or are perceived as a tax on jobs. In a globalised world the sensible aim, surely, should be to make it as inexpensive as possible to create jobs, then tax the income and wealth that they produce to raise the money for public services. And it is notable that in so far as there has been a shift in funding in those countries that use social insurance, it has been to top up social insurance out of general taxation - in part because of worries about the impact on job creation.

## 8. Conclusion

So the conclusion here is that soft hypothecation is essentially dishonest, and hard hypothecation, certainly in the British context, has a distinct tendency to break down. My prime objection is that, in the long run, hypothecation is more likely to increase disillusion with politics rather than strengthen the political process. And as John Appleby has recently pointed out,

“Perhaps the most significant problem with an NHS tax is that it puts the (tax) cart before the (spending) horse. The key decision is how much we want to spend on the NHS; a secondary decision is then how we raise the funds to satisfy this decision. And in fact, we already have a reasonably fair and efficient system for doing this through the current tax system [i.e. general taxation].

In short, what’s required isn’t the bother and difficulty of creating a new tax, but rather the political decision to spend more on the NHS” (Appleby, 2018).

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