Submission to the Davis Tax Committee
VAT Submission
Free Market Foundation

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Note: We attach the Free Market Foundation's submission on value added tax (VAT). These proposals should be viewed as a **second** best option and our proposal to introduce a Flat Tax remains our **first** preference. We are of the view that income tax ought to be simple, flat and low, with generous allowances that exempt the poor from paying tax. If the Flat Tax is not instituted, we propose alternatives for relieving the poor from the most onerous aspects of the tax system.

About the Free Market Foundation

The Free Market Foundation is an independent public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Executive Summary

The South African government has already deemed it necessary to zero VAT rate certain basic foodstuffs in order to increase access to these commodities for low income individuals. Considering the importance of essential medicines for the health and wellbeing of society, we propose that the government should thus also consider including medicines in its list of zero-rated VAT products. With the stroke of a statutory pen the South African government could increase access to medicines by zero-rating certain pharmaceutical products from VAT.

Introduction

According to the World Health Organisation's (WHO) *World Medicines Situation Report,* approximately one third of the world's population lacks access to essential medicines and proper medical treatment.[1] Although this figure represents approximately 2.3 billion people and is a serious cause for concern, access to medicines has actually increased in recent years since 1975, when less than half of the world's population had access to essential medicines. While the overall number of people without access to medicines has remained constant, the proportion of the world's population without access has shrunk.[2]

The primary reason for this increase in access to medicines is most likely the rising incomes and increased prosperity occurring in many developing countries. According to the World Bank's *World Development Indicators*, real income per capita (measured in constant 2005 international dollars) in low and lower-middle-income countries, increased from $517 in 1960 to $1,061 in 2012, which equates to an over two-fold increase.[3] Access to medicines is lowest in poor countries, which also have the lowest life expectancy and highest disease burdens. Life expectancy in low income countries averaged 59.2 years as opposed to 78.6 years in high income countries in 2012.

The reasons for inadequate access to medicines and to medical care are numerous and varied. This submission focuses on the extent to which VAT levied on essential medicines acts as a barrier to access to medicine. Governments impose import duties, either to protect local manufacturers from imports and competition, or to raise revenue, but charge VAT on completed pharmaceutical drugs and medical inputs purely to raise revenue. According to the WHO, "Countries at all income levels raise taxes from the sales of medicine. Yet some countries, including low-income countries, specifically exempt medicines from all taxes. The price-responsiveness of demand for medicines has been measured in several settings and shown to be positive but less than one, meaning that an increase in price, other things being equal, will reduce demand and vice-versa. Some groups of people – the poor and the elderly – are more sensitive to price changes than others".[4]

[1] WHO (2011) The World Medicines Situation Report, third edition. Available at: http://www.who.int/medicines/areas/policy/world_medicines_situation/en/. Accessed: 12-05-2014
[2] Bate, R., Tren, R. and J. Urbach (2006) Still Taxed to Death: An Analysis of Taxes and Tariffs on Medicines, Vaccines and Medical Devices. AEI-Brookings Joint Center
[3] World Bank (2014) World Databank – World Development Indicators. Accessed: 12-05-2014
[4] WHO/HAI (2011) WHO/HAI Project on Medicine Prices and Availability. Review Series on Pharmaceutical Pricing Policies and Interventions. Working Paper 5: Sales Taxes on Medicines.

Detailed Submission

The Davis Tax Committee's Terms of Reference states, "The following aspects should receive specific attention from the Committee: VAT with specific reference to efficiency and equity. In this examination, the advisability and effectiveness of dual rates, zero rating and exemptions must be considered".

VAT is a regressive tax, which means that it is "inequitable", since the amount paid on a certain product is a percentage of its price and is the same for rich and poor people. In other words, the tax burden for a given product forms a larger share of a poor person's income than that of a rich person. It is for this reason that it is proposed that medicines and inputs to manufacture medicines – or at least the medicines contained on the WHO's Essential Medicines List[5] – be exempted from VAT. Indeed, Bird (2005) states, "…many (developing and transitional economies) provide reduced VAT rates or exemptions for certain 'basic' items such as some foods, passenger transport, medical services, and cooking fuel".[6] Thus, some leading international tax policy advisers recognise the importance of exemptions – such as for medical care – from tax schedules.

The South African government has already recognised the importance of exempting certain basic foodstuffs from VAT and have introduced a zero-rated VAT status as a consequence (see Annex 1 for a list of certain basic foodstuffs that have been zero-rated for VAT purposes plus other products and services that are zero VAT rated). Very little literature exists on the taxation of medicines but several pieces of work provide some important insights in this area. Olcay and Laing's[7] work on taxes and tariffs on pharmaceuticals published in 2005 follows the work by the European Commission published in 2003. The European Commission examined trade duties and taxes in 57 low and middle income countries (LMICs)[8] and found VAT rates on all medicines varying from 0 per cent to more than 20 per cent. For the group of 17 least developed countries in the European Commission's study, average VAT rates on medicines were found to be 8.8 per cent. More recently, the WHO worked in partnership with Health Action International (HAI) to collect reliable data on medicine prices, availability, affordability and price components in low- and middle-income countries (see Table 1 below).

[5] The WHO Model Lists of Essential Medicines has been updated every two years since 1977. The current versions are the 18th WHO Essential Medicines List and the 4th WHO Essential Medicines List for Children. The WHO Model Lists of Essential Medicines are available at: http://www.who.int/medicines/publications/essentialmedicines/en/. Accessed: 13-05-2014

[6] Bird RM. Value-added taxes in developing and transitional countries: lessons and questions. International Tax Program Paper 0505, Rotman School of Management, University of Toronto, 2005. Accessed at http://www.rotman.utoronto.ca/iib/ITP0505.pdf.

[7] Olcay M and Laing R. Pharmaceutical tariffs: What is their effect on prices, protection of local industry and revenue generation? CIPIH study, The Commission on Intellectual Property Rights, Innovation and Public Health, World Health Organization, May 2005.

[8] European Commission Working Document: Developing countries' duties and taxes on essential medicines used in the treatment of the major communicable diseases. Brussels, European Commission, 2003.

Table 1: Domestic VAT (or sales tax) rates on medicines in selected low and middle income countries

Country and Survey Year	VAT or sales tax (%) on medicines
Armenia 2001	20%
Bolivia 2008	13%
Brazil 2001	18%
China 2006/6	17%
Colombia 2008	0%
Congo 2007	18%*
Dem. Rep. of Congo 2007	0%
El Salvador 2006	13%
Ethiopia 2004	0%
Ghana 2004	15% VAT + NHIL**
India 2003/04	5% (on most medicines)
Indonesia 2004	10%
Jordan 2007	4% sales tax
Kuwait 2004	0%
Kyrgyzstan 2005	4% sales tax
Malaysia 2004	0%
Mongolia 2004	15%
Morocco 2004	7% (some exceptions)
Nicaragua 2008	0%
Oman 2007	0%
Pakistan 2004	0%
Peru 2005	12% (some exceptions)
Philippines 2008	12%
South Africa 2004	14%
Tajikistan 2005	20%
Tanzania 2004	0%
Tunisia 2004	6% (locally manufactured medicines)
Uganda 2004	0%
Ukraine 2007	0%
Yemen 2006	5%
Average for sample countries	**7.6% (Range: 0% - 20%)**

**unclear if medicines are exempt*
*** National Health Insurance Levy*
Source: WHO/HAI, 2011

Table 1 reveals a great deal of variance in VAT rates applied in low- and middle-income countries represented in the sample. Where VAT is applied on medicines, the range is from 5 per cent to 20 per cent. But not all countries apply VAT. Over one-third (11 out of 30) of the countries in the sample do not impose VAT on medicines. Moreover, not all medicines are taxed in all countries. Imports and locally made medicines are sometimes taxed differently. For example, Tunisia adds a 6 per cent tax to locally produced medicines but not to imports. Medicines sold in the public and private sector are sometimes taxed differently. The average tax rate applied on medicines in the sample is 7.6 per cent. The WHO/HAI (2011) study concludes, "[For] the countries in which medicine price component data has been collected, it is clear that governments are indeed a contributor to the price of medicine and

thus a factor in restricting access to essential medicines".[9] For European high-income countries, all using VAT systems, data on medicines taxes has been assembled for 2013 and is summarised in Table 2 below.

Table 2: VAT rates on medicine in Europe, by country in 2013

		VAT Rates Applied to Medicines	
Country	**Standard VAT Rate (%)**	**Prescription (%)**	**OTC (%)**
Austria	20	10	10
Belgium	21	6	6
Bulgaria	20	20	20
Croatia	25	5	25
Cyprus	18	5	5
Czech Republic	21	15	15
Denmark	25	25	25
Estonia	20	9	9
Finland	24	10	10
France (1)	19.6	2.1	7
Germany	19	19	19
Greece	23	6.5	6.5
Hungary	27	5	5
Iceland	25.5	25.5	25.5
Ireland (2)	23	0 – 23	0 – 23
Italy	21	10	10
Latvia	21	12	12
Lithuania (3)	21	5 – 21	5 – 21
Luxembourg	15	3	3
Malta	18	0	0
Netherlands	21	6	6
Norway	25	25	25
Poland	23	8	8
Portugal	23	6	6
Romania	24	9	9
Serbia	20	8	8
Slovakia	20	10	10
Slovenia	20	8.5	8.5
Spain	21	4	4
Sweden	25	0	25
Switzerland	8	2.5	2.5
Turkey	18	8	8
United Kingdom	20	0	20

(1) France: reimbursable medicines 2.1%; non-reimbursable medicines 7.0%

(2) Ireland: oral medication 0%; other medication 23.0%

(3) Lithuania: reimbursable medicines 5.0%; non-reimbursable medicines 21.0%

This table shows the VAT rates applied to medicines in European countries as of 1 January 2013.

Source: http://www.pharmaboardroom.com/article/vat-rates-applicable-to-medicines. Accessed 08-05-2014

[9] WHO/HAI (2011) WHO/HAI Project on Medicine Prices and Availability. Review Series on Pharmaceutical Pricing Policies and Interventions. Working Paper 5: Sales Taxes on Medicines.

The above table from high-income countries in Europe also demonstrates a great deal of variation in tax policy with regards to medicines. One country in the sample, Malta, does not tax medicines at all, whether prescribed or over-the-counter (OTC), whilst Ireland has chosen to zero-rate oral medications. Some countries (Bulgaria, Denmark and Iceland) provide no exemption from existing and high (range 20 – 25.5 per cent) standard rates of tax for both categories of medicine. Yet others tax prescription medicines at a lower rate than the standard rate, while taxing OTC medicines at the standard rate (for example Croatia, Sweden and the United Kingdom). Some countries tax according to health insurance reimbursement practices and reward reimbursable medicines with a lower tax rate (France, Lithuania), whilst Sweden exempts prescribed medicines. The WHO/HAI also states, "In some other high-income countries [not included in the sample], medicines are tax-exempt (Australia, Japan, Korea)".[10]

Recommendations for South African policy makers

Despite eliminating all tariffs on pharmaceutical products entering South Africa, the government continues to impose VAT at a rate of 14 per cent on all medicines purchased in the private sector. The removal of all duties on pharmaceutical products is laudable but makes the retention of VAT on pharmaceutical products inexplicable. In 2010 the economic consulting division of Deloitte conducted a high-level analysis into the financial contribution of the Pharmaceutical Industry in South Africa. According to the report, "The findings of this survey indicate that the sampled pharmaceutical companies, which make up 74% of the total South African market, generated a total of R 26.34bn in revenue in FY08. This amount equates to 1.15% of the national GDP for that year".[11] More specifically, Deloitte reveals that the sampled pharmaceutical companies paid a total R548.81m in VAT[12] and estimate that the entire pharmaceutical industry contributed a total of R741.64m in VAT in financial year end 2008.[13] For the government, this revenue amounts to a relatively insignificant amount. Indeed the VTA collections on all pharmaceutical products amount to less than one per cent (0.48%) of the total VAT collections in the 2008/09 tax year (R154.343bn).[14] However, for individuals the VAT imposed on pharmaceutical products makes a significant difference (see Table 3 below).

According to the South African economic consulting firm Econex, South Africa suffers from a quadruple burden of disease. Econex states, "South Africa's burden of disease is on average four times larger than that of developed countries, and in most instances almost double that of developing countries".[15] South Africa's quadruple burden of disease is relatively unique and is primarily driven by the grave HIV/AIDS burden.

[10] WHO/HAI (2011) WHO/HAI Project on Medicine Prices and Availability. Review Series on Pharmaceutical Pricing Policies and Interventions. Working Paper 5: Sales Taxes on Medicines.
[11] Deloitte (2010) Insights into the high-level financial contribution of the Pharmaceutical Industry in South Africa
[12] The VAT is the net VAT payable by the entity at the financial year end which has occurred due to carrying out operating activities.
[13] Deloitte (2010) Insights into the high-level financial contribution of the Pharmaceutical Industry in South Africa
[14] National Treasury and South African Revenue Service (2013) Tax Statistics. A joint publication between National Treasury and the South African Revenue Service
[15] Econex (2009) South Africa's Burden of Disease. Available at: http://www.mediclinic.co.za/about/Documents/ECONEX%20NHI%20note%202.pdf

According to UNAIDS, South Africa has one of the highest rates of HIV infection in the world with approximately 17.9 per cent of the adult population (between the ages of 15 to 49 years) living with HIV/AIDS. This equates to approximately 6.1 million people living with HIV/AIDS in SA, making it the country with the greatest number of people infected with HIV/AIDS in the world. Moreover, the estimated ART coverage is approximately 80 per cent. This means that one-fifth (1.2 million people) of the infected population is not receiving ARTs.

The government's programme to provide anti-retroviral therapy through the state healthcare system has made significant progress in recent years but many South Africans infected with HIV/AIDS continue to seek treatment through the private sector. A month's supply of anti-retroviral triple therapy (Tribuss™) consisting of Tenofovir, Emtricitabine and Efavirenz is likely to cost R500.11 for the drugs alone.[16] Of this amount, R61.42 is paid directly to the South African government in the form of VAT. However, if the government were to waive VAT, not only will the quantity demanded of these drugs increase but patients would be able to afford more of the fresh fruit, vegetables and meat that they should consume in order to remain healthy and be able to maintain their anti-retroviral therapy.

Among the billions of Rand raised by the South African government, the R61 raised via VAT on each person's monthly anti-retroviral therapy makes little difference to the life of the government, but that money can make an enormous difference to the lives of ordinary South Africans living with HIV/AIDS. Table 3 below details the basket of goods that a patient could afford if the South African government did not impose VAT on medicines.

Table 3: Essential foodstuffs denied due to South Africa's VAT payment on anti-retroviral Triple Therapy

Item	Unit cost	Quantity	Total
Brown bread	R5.90	1	R5.90
Large eggs	R10.79 (6 eggs)	1	R10.79
Full cream milk	R8.99/litre	1	R8.99
Ace Super Maize Meal	R7.79/kg	1	R7.79
Bananas	R13.99/kg	0.5	R6.99
Chicken pieces	R39.99/kg	0.5	R19.99
Total			**R60.45**

Source: Dischem pharmacy and Pick 'n Pay supermarket. Prevailing prices 12-05-2014

[16] Prices quoted on 12-05-2014. Dischem pharmacy

Conclusion

The South African government needs to bear in mind that it should not prevent people improving their quality of life, especially the poorest members of society. Exempting medicines – or at least medicines contained on the WHO's Essential Medicines List – from VAT would have a number of beneficial outcomes. These include, but are not limited to, the following:

- Increase access to medicines by lowering the cost of pharmaceutical drugs
- Reduce the cost of self-medication, encouraging patients not to use their GP when it is not necessary.
- Reduce the administrative burden for community pharmacies (and the Treasury) who have to reclaim VAT.

Charging VAT on medicines, in general, and, particularly, on essential medicines, is counterintuitive. If government wants a healthy and productive workforce, it should not impose this tax on the sickest and most vulnerable members of society. Taxes on medicines are highly regressive and severely penalise the poorest and most vulnerable members of society. In a democratic state, removing these taxes should be both politically popular and feasible. The elimination of taxes that keep essential medicines out of the hands of the poorest of the poor should therefore be a priority for the South African government.

The FMF would like to thank the Davis Tax Committee for considering our proposal on VAT and we will be happy to assist the Committee wherever possible with any queries that may arise from this submission.

Annex 1: Zero-rated VAT products

According to the South African Revenue Service (SARS), "Zero-rated supplies are taxable supplies on which VAT is levied at a rate of 0%". Some examples of zero-rated supplies are briefly listed below:

Certain basic foodstuffs	
Brown bread	Dried mealies and mealie rice
Brown bread flour (excluding wheaten bran)	Samp
Hens eggs	Fresh fruit and vegetables
Dried beans	Lentils
Maize meal	Rice
Pilchards in tins or cans	Vegetable cooking oil (excluding olive oil)
Milk, cultured milk, milk powder blend	Edible legumes and pulses of leguminous plants (that is peas, beans, peanuts etc.)
Fuel levy goods	
Crude oil and certain petrol and diesel based products	
Going concern	
The sale of a business or part of a business which is capable of separate operation as a going concern	
Farming goods	
The supply of certain goods acquired and used for agricultural, pastoral or farming purposes may be zero-rated in certain circumstances. Some examples are animal feed, animal remedies, fertilizer, pesticide and plants and seeds in a form used for cultivation.	
Goods temporarily imported for repairs	
VAT is a tax on local consumption. Where consumption is outside of the RSA, the zero rate applies. Where goods are temporarily admitted into the RSA for processing, repair, cleaning or reconditioning, the services supplied directly in connection with those goods are zero-rated. Any goods which are consumed or permanently affixed to those goods as a consequence of the services being rendered will also be zero-rated.	
Exports	
The direct export of goods may be zero-rated. In certain instances, the indirect export of goods may also qualify for the zero rate.	
International transport	
The international transport of goods or passengers is zero-rated.	
Land situated in an export country	
Any service supplied directly in connection with land situated outside the RSA is zero-rated.	
Services physically performed outside the RSA	
The supply of services physically rendered or performed outside the RSA qualifies for the zero rate.	
Certain services provided to non-residents	
Where services are supplied to a non-resident who is not in the RSA at the time the services are rendered, the supply will qualify for the zero rate	
Municipal property rates	
With effect from 1 July 2006, any municipal property rates charged by a municipality are subject to the zero rate.	

Source: SARS, 2014