



Institute for
Fiscal Studies



Options for raising revenue to pay for long-term care

James Browne and Paul Johnson

Institute for Fiscal Studies

Background: Dilnot Commission recommendations

- Dilnot Commission recommended increasing state spending on long-term care
 - Central recommendation puts cap on costs at £35,000 and would cost 0.14% of GDP (£1.7 billion per year) if introduced immediately
 - £1.4 billion is for long-term care for elderly, £0.3 billion for younger disabled
 - Cost increases over time to 0.22% of GDP
- Provision of social insurance against risk of large care costs
 - Private insurance market cannot insure with so much uncertainty
 - As individuals are risk averse, likely to be welfare-improving

How to pay for Dilnot

- Four possible routes:
 1. General tax revenue,
 2. Reduced spending on other programmes,
 3. A specific tax rise or benefit cut, or
 4. Could introduce a specific social insurance premium
- Here we focus on changes to existing tax and benefit system that could raise revenue
- With some focus on those who would benefit from the additional spending on long-term care paying
 - Approximating a social insurance premium
 - Mainly wealthier pensioners

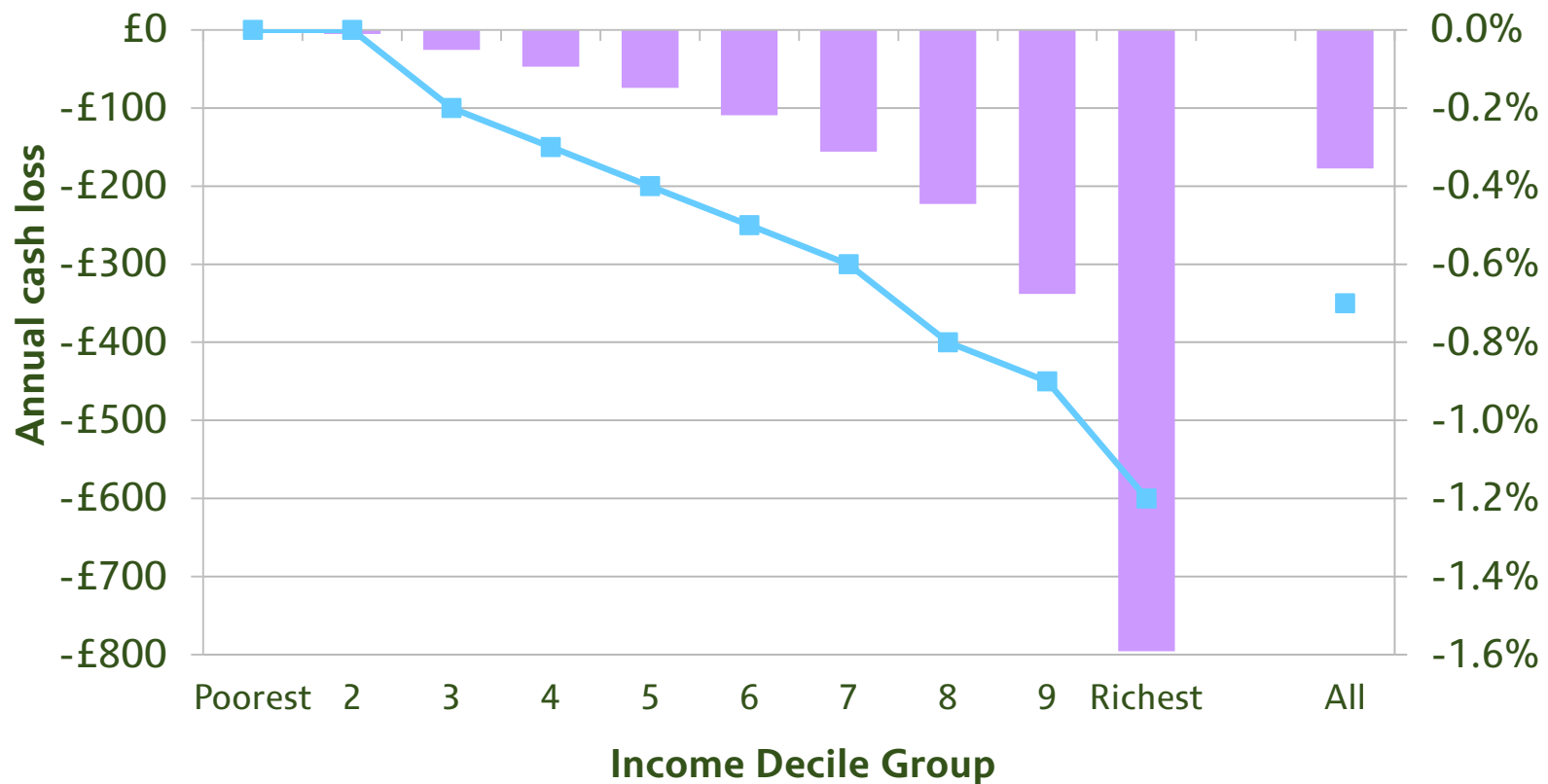
Options we consider

- General tax rises
 - Income tax and National Insurance rates
- Tax rises on pensioners specifically
 - Broadening the base of NICs
- Changes to the taxation of private pensions
 - Tax-free lump sums and higher-rate tax relief
- Reduce generosity of state pension
 - Increase State Pension Age, delay triple lock
- Means-test universal benefits for pensioners
 - Winter Fuel Payments and free TV licences
- Impose Capital Gains Tax at death

Increasing income tax and National Insurance rates

- Revenue raised:
 - Increasing all income tax rates by 1ppt raises £5.5 billion per year, raising all employee and self-employed NIC rates by 1ppt raises £4.5 billion per year
- Distributional impact
 - Rich pay more in cash terms and as a percentage of income

Distributional impact of increasing income tax rates



■ Annual cash loss (left axis) ■ Loss as a % of income (right axis)

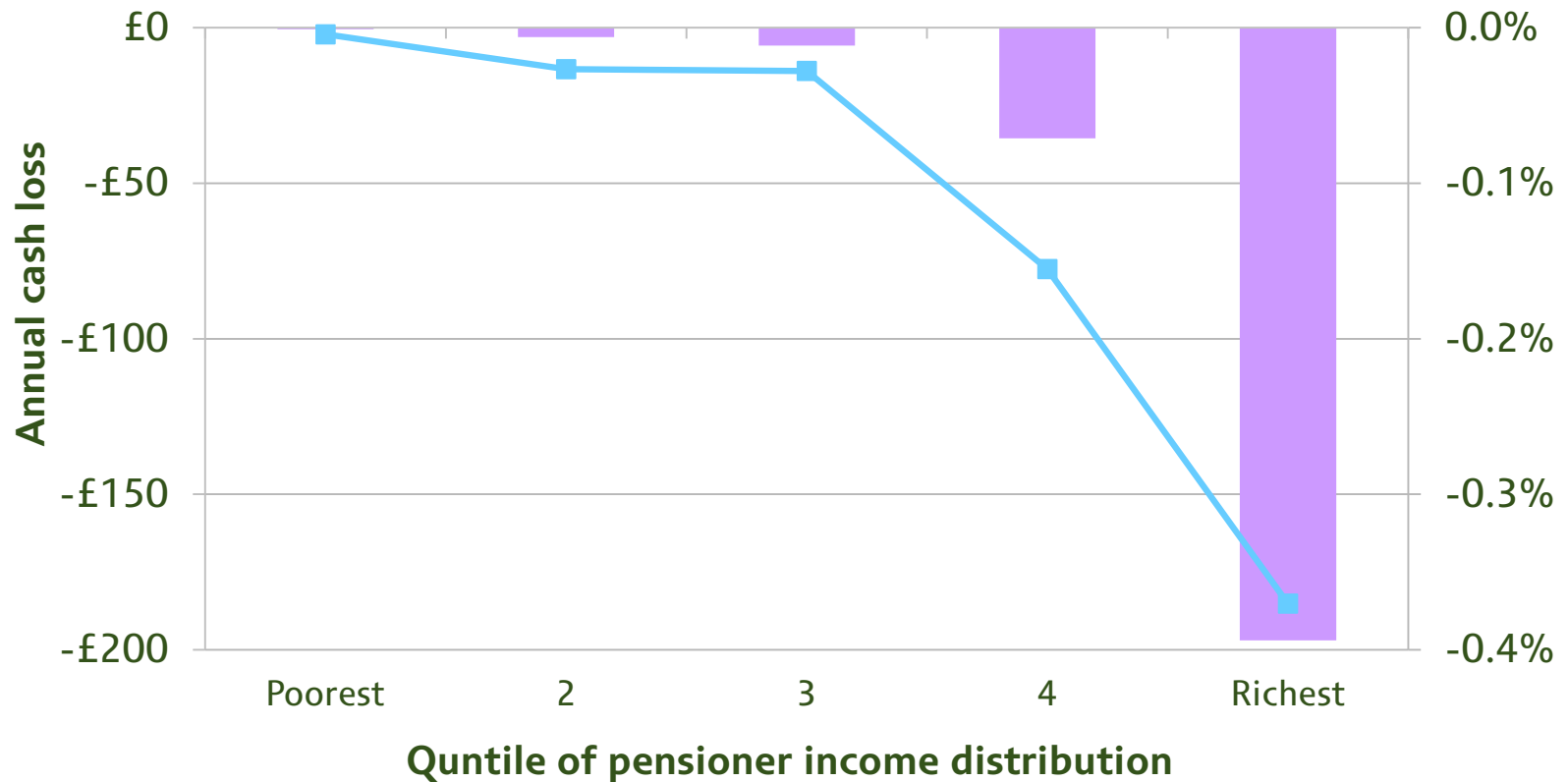
Increasing income tax and National Insurance Contribution rates

- Revenue raised:
 - Increasing all income tax rates by 1ppt raises £5.5 billion a year, raising all employee and self-employed NIC rates by 1ppt raises £4.5 billion a year
- Distributional impact:
 - Rich pay more in cash terms and as a percentage of income
 - Pensioners lose a little from higher income tax rate but do not pay employee's NICs
- Pros:
 - Straightforward tax rise
- Cons:
 - Weakens incentives to work
 - Income tax rise weakens incentive to save in non-favoured vehicles
 - Pensioners less affected than other groups

Imposing employee NICs on pensioners' earnings

- Currently those over State Pension Age don't pay employee and self-employed NICs
- Imposing them on this group would raise £400 million per year once SPA is 65 for men and women
- Only pensioners in paid work lose out: tend to be younger and with higher current incomes
 - Only richest quintile of pensioner families significantly affected: mean income among this group is £38k after taxes and benefits

Distributional impact of imposing employee NICs on earnings of pensioners



■ Average cash loss (left axis) — Average loss as a percentage of income (right axis)

Imposing employee NICs on pensioners' earnings

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 - Only richest quintile of pensioner families significantly affected: mean income among this group is £38k after taxes and benefits
- Pros:
 - Pensioners pay all additional tax
 - Ends (arguably) inequitable treatment by age
- Cons:
 - Weakens work incentives: literature suggests workers particularly responsive to incentives around retirement age

Taxation of private pensions

- Should always consider taxation of pension income and tax relief on pension contributions together
- Three points at which savings can be taxed:
 - Contributions
 - Returns
 - Withdrawals
- In the UK pensions are treated in the following way:

| | Income Tax | National Insurance |
|------------------------|---|--------------------|
| Employee contributions | Exempt | Taxed |
| Employer contributions | Exempt | Exempt |
| Returns | Exempt | Exempt |
| Withdrawals | Taxed, apart from 25% tax-free lump sum | Exempt |

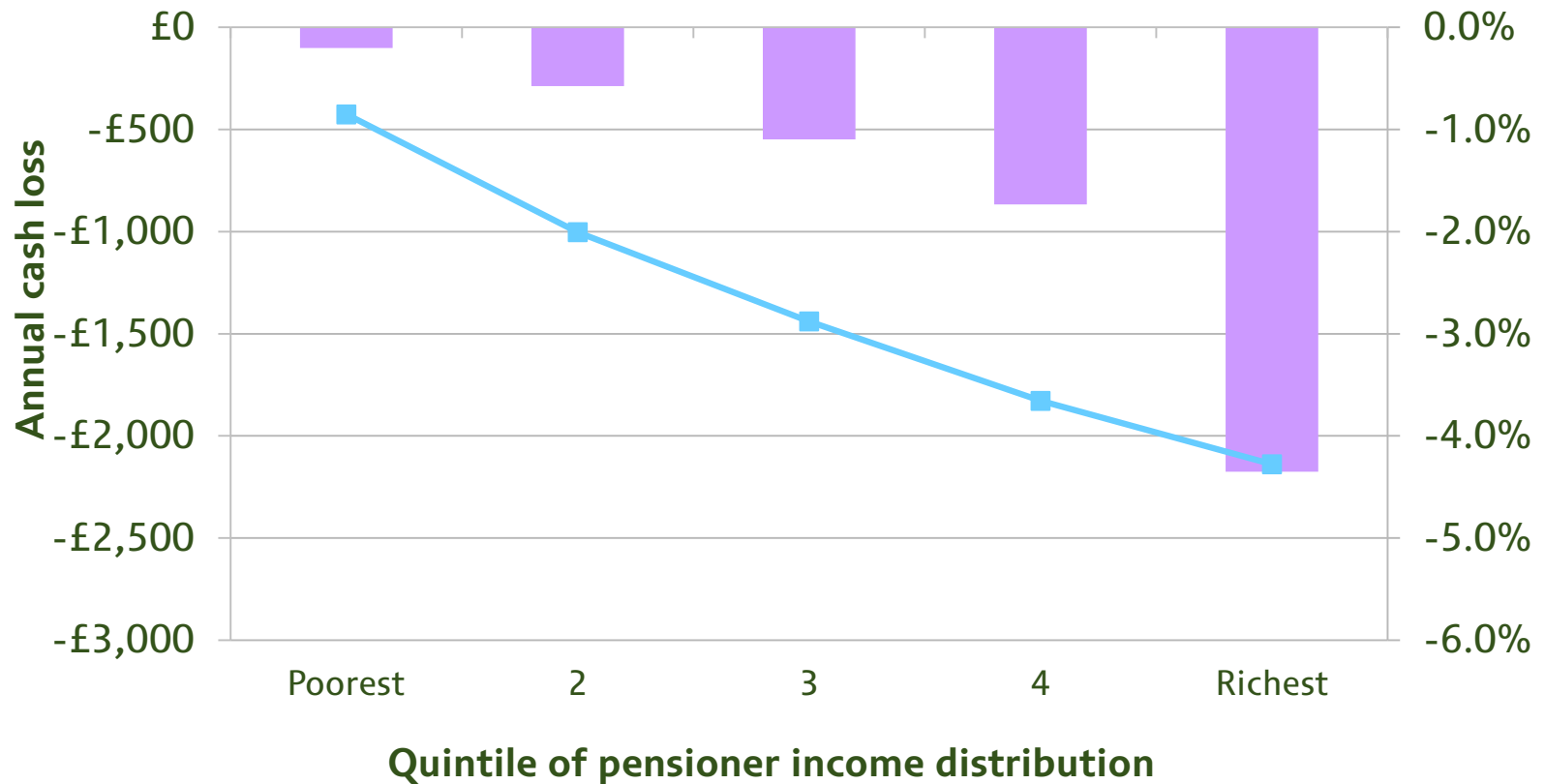
Anomalies in taxation of private pensions

- Mirrlees Review suggested tax-neutral treatment of saving optimal
 - This means EET or TEE treatment
- Treatment of private pensions deviates from this in a number of ways
 - Employer pension contributions not subject to NICs at all
 - 25% tax-free lump sum not subject to income tax at contribution or withdrawal stage
- Therefore, can raise revenue by subjecting pension income to NICs and removing tax-free lump sum without departing from neutrality
- Caveat: probably want to be more generous than tax-neutral for pensions. But maximum £437,500 tax-free lump sum going too far the other way?

Imposing NICs on pension income

- Applying both employee NICs on private and state pension income would raise £6.8 billion per year
- Only richer pensioners lose out

Distributional impact of imposing employee NICs on pension income



■ Average cash loss (left axis) —■ Average loss as a percentage of income (right axis)

Imposing NICs on pension income

- Applying both employee NICs on private and state pension income would raise £6.8 billion per year
- Only richer pensioners lose out
- Pros:
 - Hits group who benefit from Dilnot long-term care proposals
 - Ends exemption of employer contributions from NICs
- Cons:
 - Employee contributions already subject to NICs: double taxation
 - Mirrlees Review suggested giving NICs relief on employee contributions immediately and phasing in NICs on pension income over 40 year period
 - This would involve an up-front cost, but would raise revenue in the long run

Reducing generosity of tax-free lump sum

- HMRC estimate removing tax-free lump sum entirely would raise £2.5 billion per year
- Abolishing tax-free lump sum probably not desirable: need incentive to encourage people to tie up money and annuitize
 - But is lump sum best way of achieving this?
- Could place a limit on the amount that could be taken from current £437,500
 - But would not raise nearly as much: most lump sums small
- Would probably have to phase in over time to avoid disrupting plans of those approaching retirement
- Therefore could raise some revenue in long term, but not enough to pay for Dilnot proposals

Restricting tax relief on pension contributions

- Often argued that unfair to give rich more generous tax relief on pension contributions
- But must always consider tax treatment of pension contributions alongside tax treatment of pension income
 - Pension income taxed in retirement
- Is ‘tax smoothing’ unfair?
 - Way of avoiding paying higher rate of income tax?
 - Or is it undoing the unfairness of progressive income tax assessed on annual basis towards those with volatile incomes?
- Difficult to justify without also restricting tax rate on pension income to the basic rate
 - Relatively few pensioners higher rate taxpayers anyway, so would not reduce revenue significantly

Restricting tax relief on pension contributions

- Restricting tax relief to basic rate would raise £7 billion a year
- Current-higher rate taxpayers contributing to pensions lose out
 - Richest 8% of adults
- Pros:
 - Progressive tax change (but are probably better ways of raising revenue from the rich)
 - Removes (arguable) unfairness?
- Cons:
 - Current pensioners, some of whom benefited from higher-rate relief in the past, do not pay but do benefit from long-term care proposals
 - Weakens incentive to save for those affected
 - Administratively complicated for defined-benefit schemes: need to value contribution for each employee

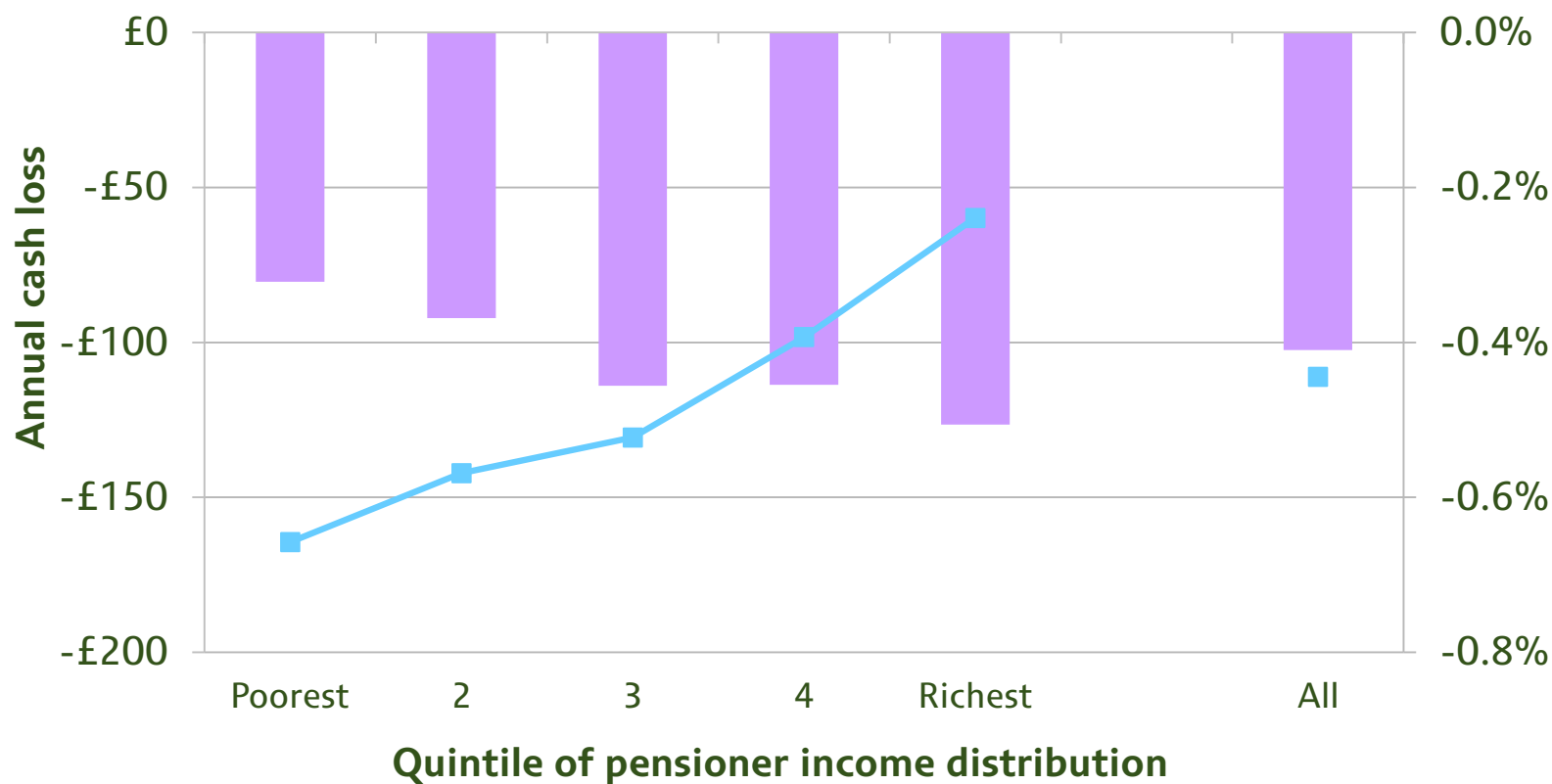
Increase State Pension Age

- Raising SPA and age for claiming Pension Credit by one year saves £2.5 billion in static model. If it led to one-year increase in effective retirement age would save £10 billion
- Those with short life expectancy and those who are more reliant on the state for their income lose the most: tend to be poorer pensioners
- Unlikely raising SPA could be accelerated in short run: already increasing quickly from now until 2020
- Chancellor announced consultation on raising SPA in line with life expectancy in Budget 2011
 - Need to think about how these would fit together

Defer Basic State Pension triple lock

- Coalition introduced triple lock in June 2010 Budget: BSP increases by greater of CPI inflation, earnings and 2.5%
- Previous government intended to introduce earnings-indexation from April 2012
- Reverting to earnings-indexation would mean BSP would increase by 1.7% rather than 5.2% in April 2012 and 2.2% rather than 2.5% in April 2013
- Poorest pensioners protected by Pension Credit, which rises to compensate for the fall in the BSP, but lose more on average than better-off pensioners as a proportion of income

Distributional impact among pensioners of postponing triple lock



Annual cash loss (left axis)

Loss as a % of income (right axis)

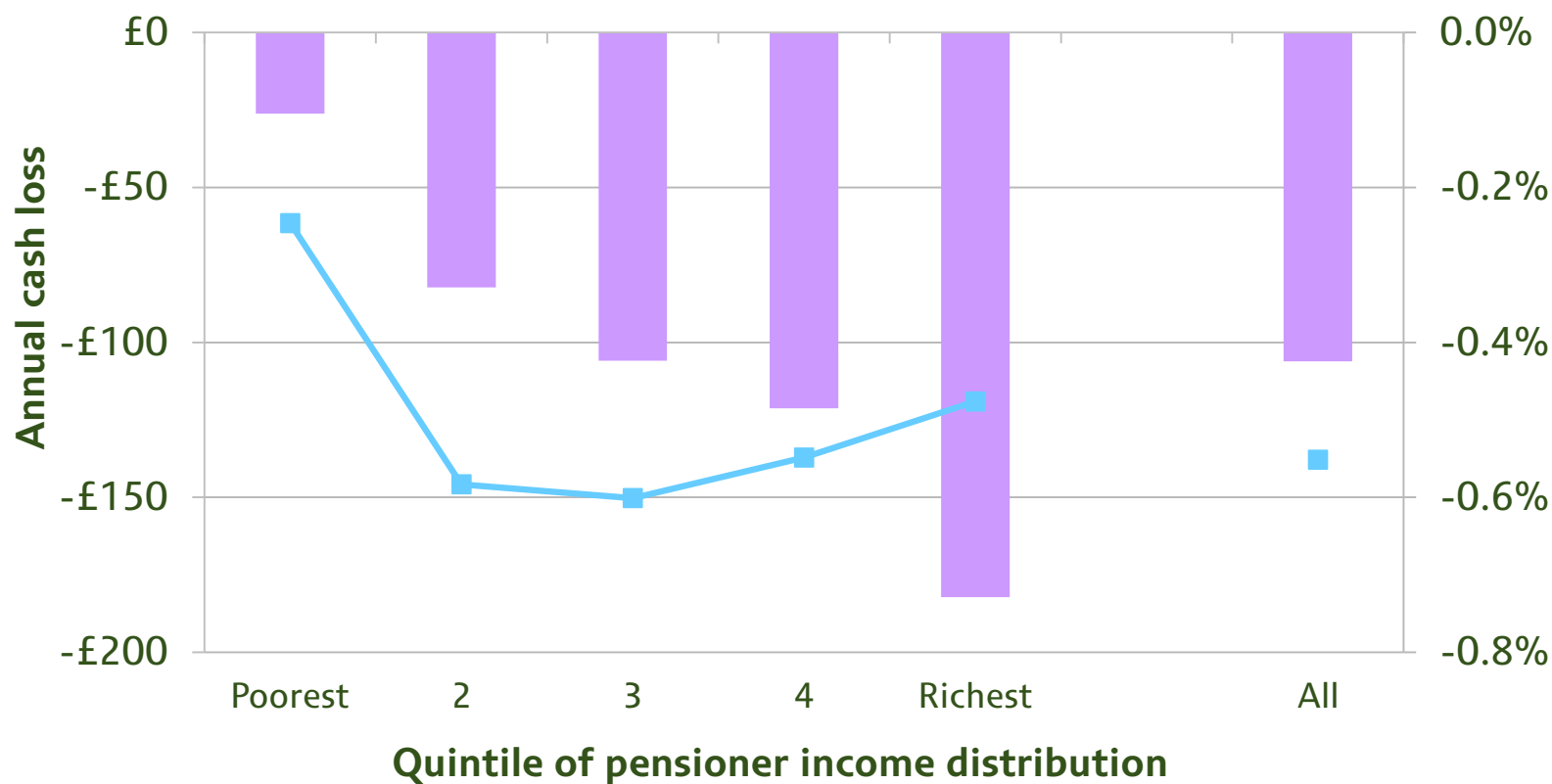
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- Poorest pensioners protected by Pension Credit, which rises to compensate for the fall in the BSP, but lose more on average than better-off pensioners
- This saves £1.5 billion per year in the long run
- Slightly weakens incentive to save for retirement as amount of private income required to escape means-testing increases

Means-testing existing universal benefits for pensioners

- Winter Fuel Payments and free TV licences
- Restricting to those on Pension Credit would save £1.4 billion per year
- Poorest pensioners protected, but those just too rich to qualify for Pension Credit lose most as a percentage of income

Distributional impact among pensioners of means-testing Winter Fuel Payments



■ Annual cash loss (left axis)

—■ Loss as a % of income (right axis)

Means-testing existing universal benefits for pensioners

- Winter Fuel Payments and free TV licences
- Restricting to those on Pension Credit would save £1.4 billion per year
- Poorest pensioners protected, but those just too rich to qualify for Pension Credit lose most as a percentage of income
- Pros:
 - Not clear what the justification for these benefits is in the first place
 - Those who benefit most from Dilnot proposals pay
- Cons:
 - IFS research has shown giving pensioners Winter Fuel Payments does increase their spending on fuel. If pensioners would otherwise spend a less than socially-optimal amount on fuel, may want to keep them
 - More means-testing: weakens incentive to save for retirement, increases complexity

Capital Gains Tax on death

- Imposing CGT on death would raise £670 million per year
- Only those with unrealised taxable gains of more than £10,600 would lose out
 - Note that ISAs, bank accounts and primary residence not subject to CGT so likely to only affect the wealthy
- Pros:
 - Mirrlees Review found no justification for forgiveness of capital gains at death: highly distortionary as encourages people to hold on to assets with unrealised gains until death when might otherwise reinvest elsewhere
 - Inheritance tax does not remove need for CGT: CGT exists to ensure capital gains taxed the same as other returns to capital (interest and dividends). Would just make double taxation imposed by IHT more obvious
- Cons:
 - Slightly weakens incentive to save

Summary

- Many suggestions of how to raise revenue to pay for Dilnot Commission proposals
 - Including others we haven't considered, e.g. means-testing AA & DLA
- Some of these would weaken incentives to work and save for retirement
 - e.g. increasing tax rates, imposing NICs on pension income
- Others remove distortions that currently exist
 - e.g. limits on tax-free lump sums, imposing capital gains at death
- Some are well targeted at the group that benefits the most from proposed reforms to funding of long-term care
 - e.g. means-testing Winter Fuel Payments, postponing triple lock
- Others less so
 - e.g. Removal of higher-rate tax relief on pension contributions, increase in employee NICs rate