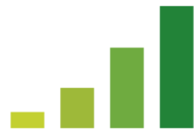

Options for raising revenue to pay for long-term care

James Browne and Paul Johnson

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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

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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

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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

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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

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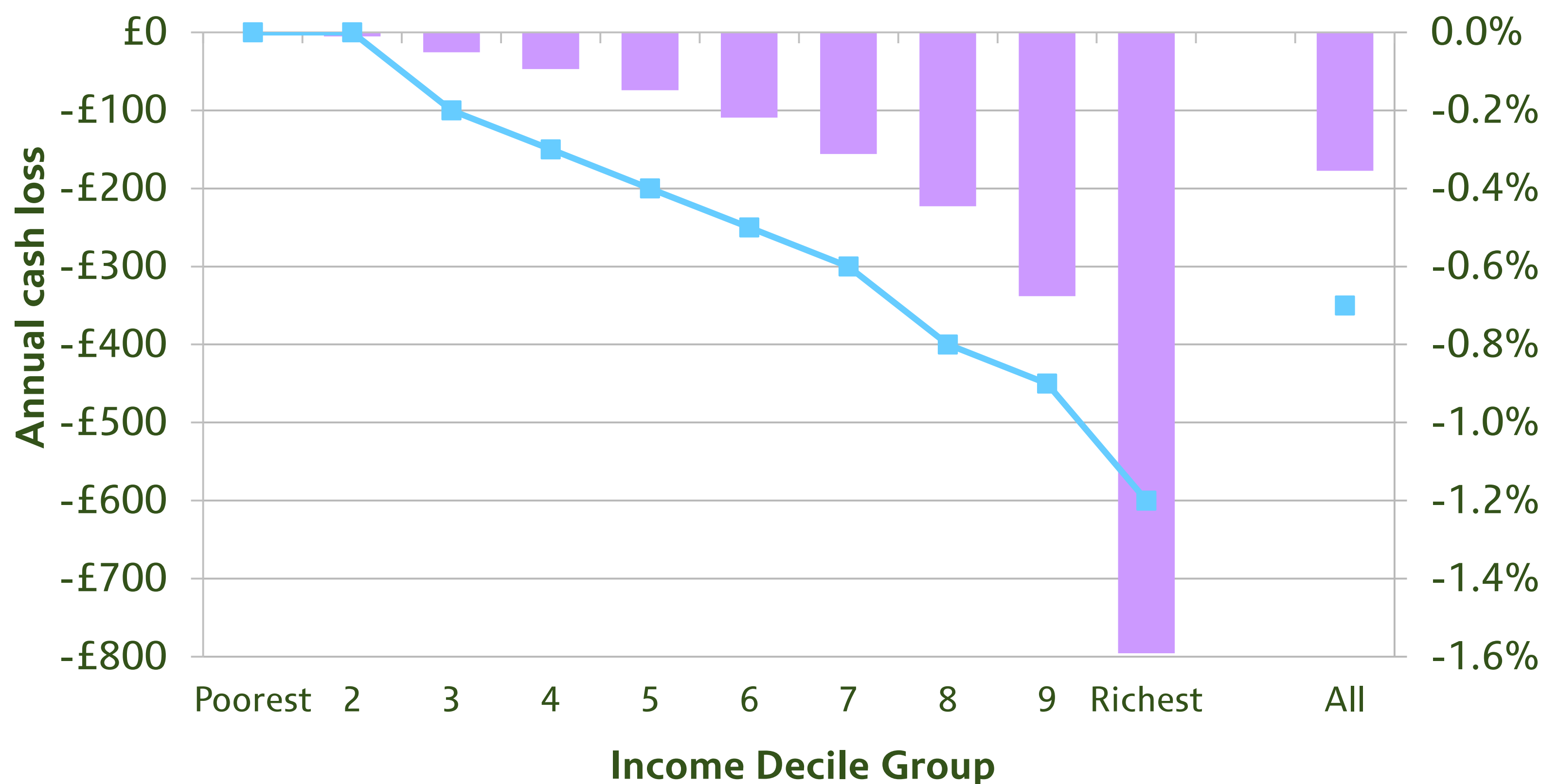
Distributional impact of increasing income tax rates



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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

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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

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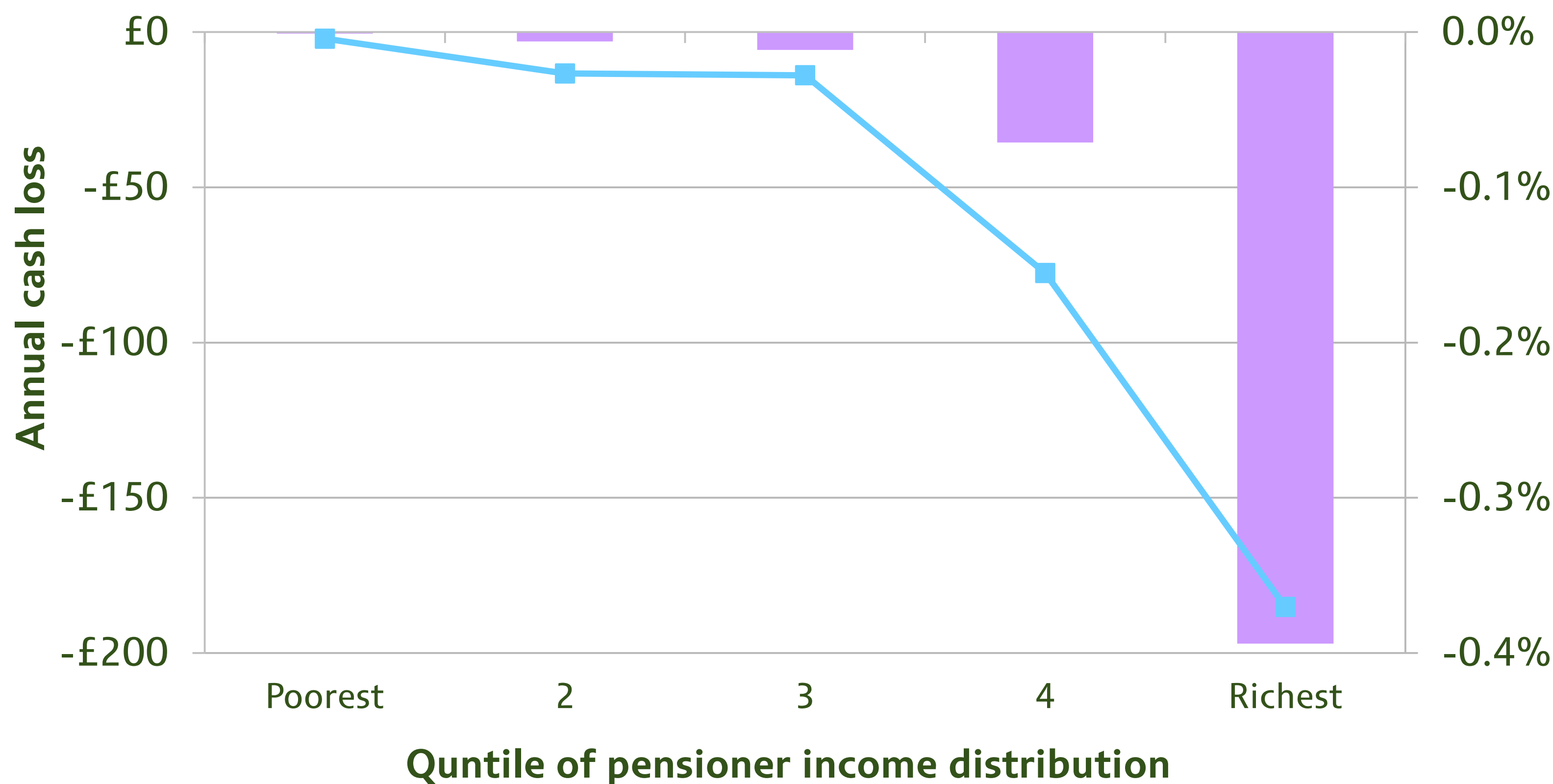
Distributional impact of imposing employee NICs on earnings of pensioners



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

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- 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
- 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

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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

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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?

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Imposing NICs on private pension income

- Applying both employee and employer NICs would raise £6.8 billion per year
- Only richer pensioners lose out

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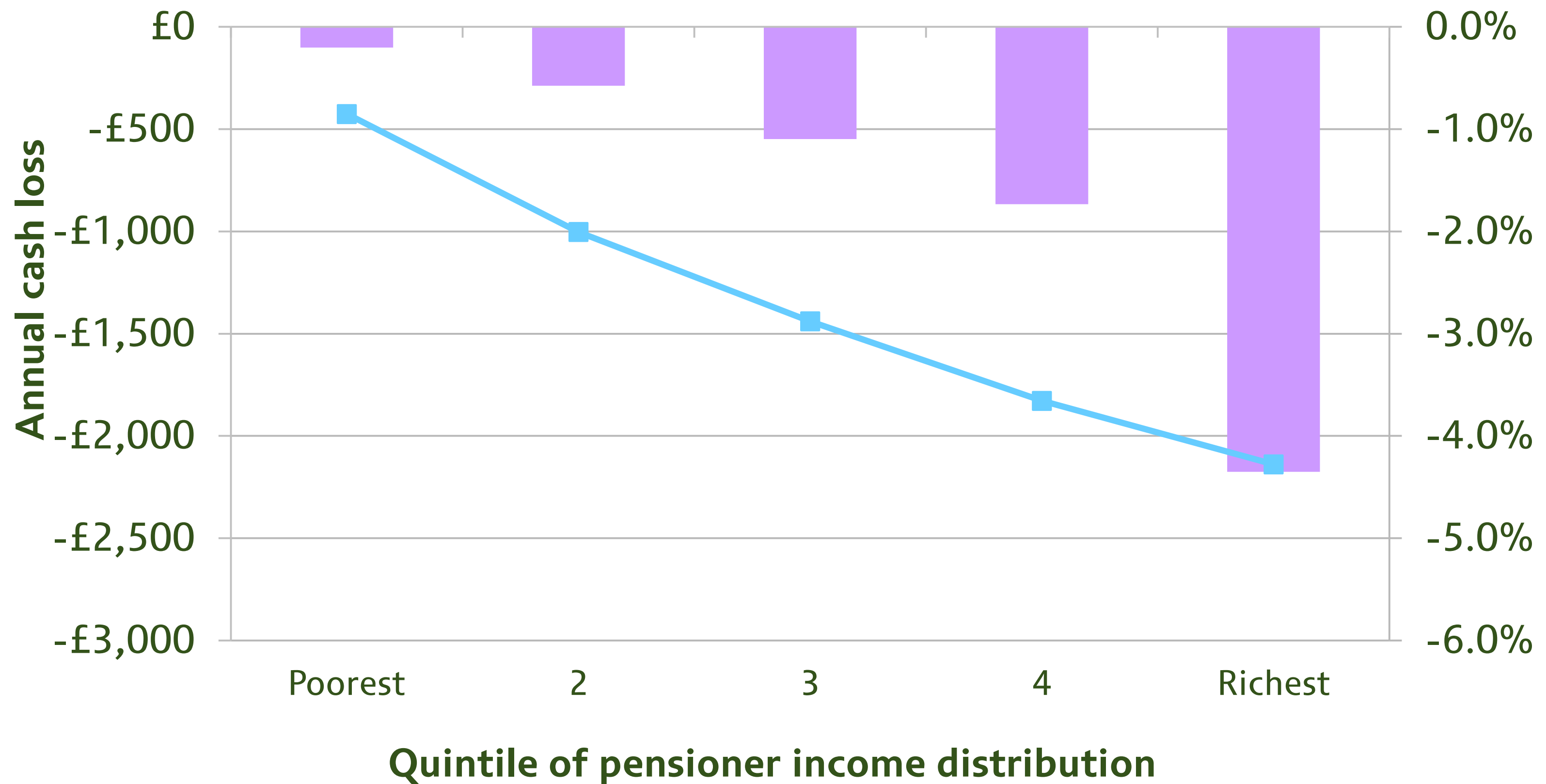
Distributional impact of imposing employee NICs on pension income



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Imposing NICs on private pension income

- Applying both employee and employer NICs 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

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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

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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

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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

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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

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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

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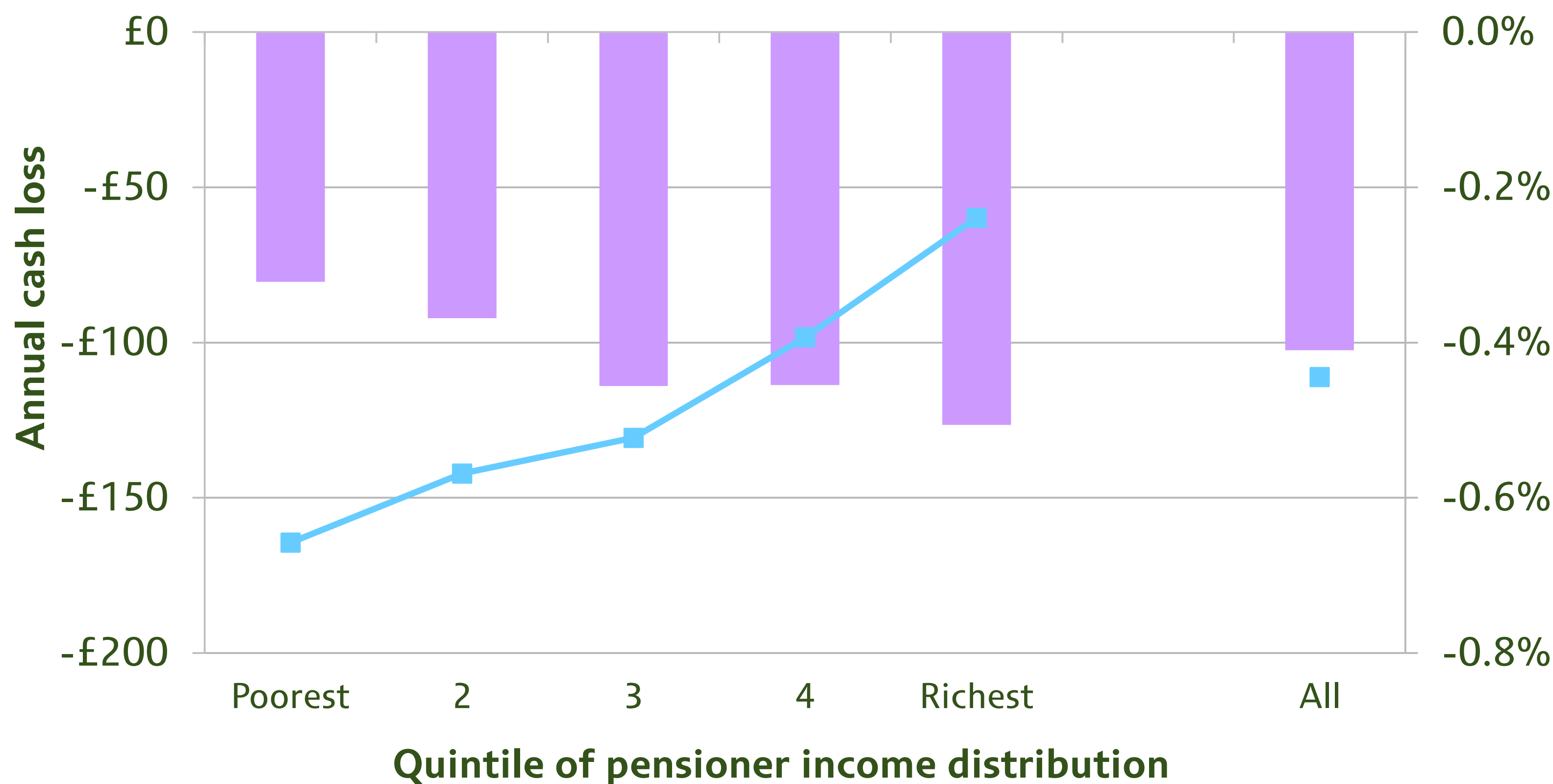
Distributional impact among pensioners of postponing triple lock



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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

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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

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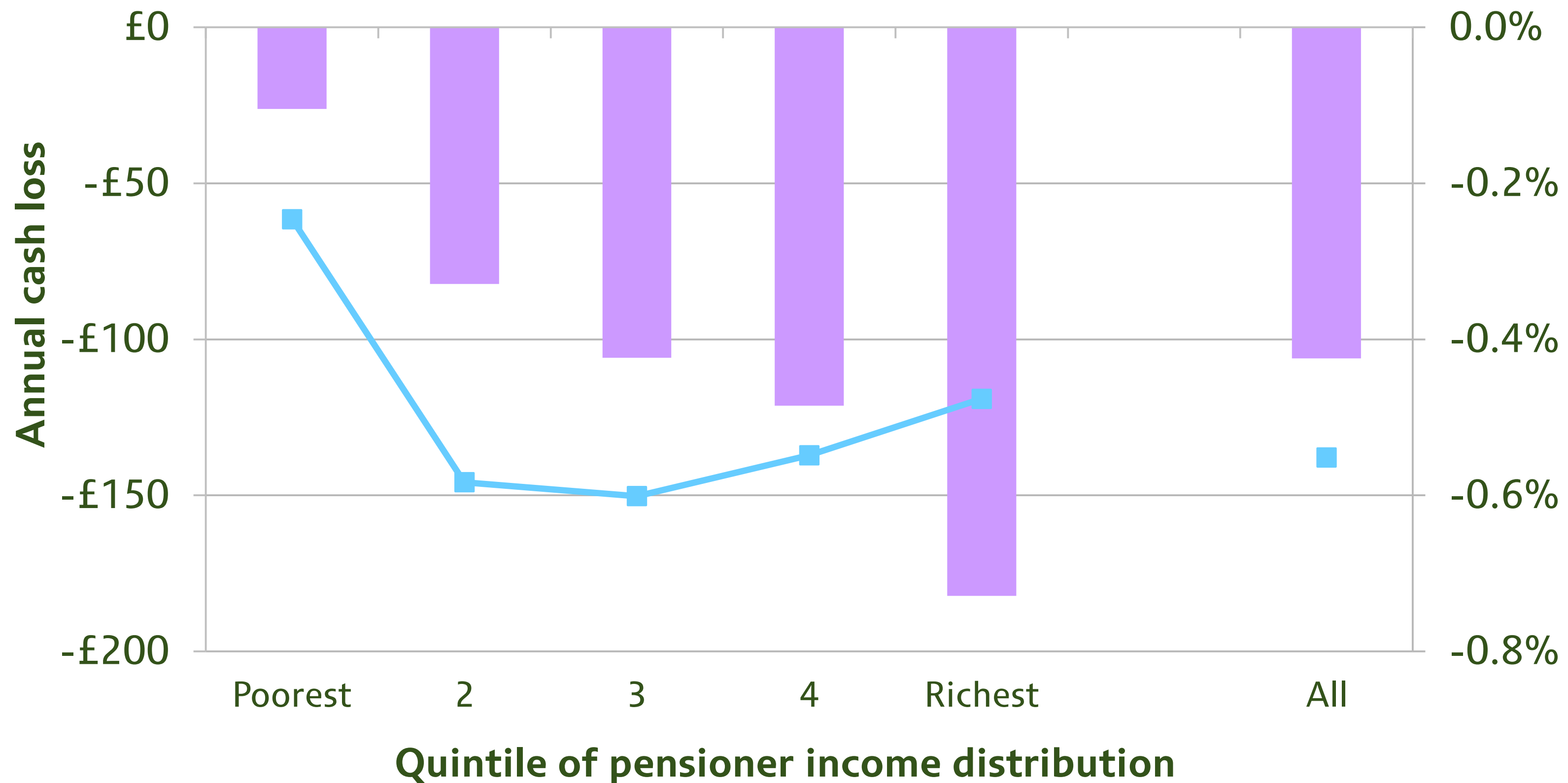
Distributional impact among pensioners of means-testing Winter Fuel Payments



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

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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

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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

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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

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