Paying for Dilnot

James Browne and Paul Johnson
January 23, 2013
Paying for the Dilnot commission proposals

- Dilnot benefits higher-income pensioners and those with more wealth
  - Could raise taxes or cut spending very slightly across the board...
  - ...or go for approach that is distributionally neutral by increasing taxes or cutting benefits for those who would gain from proposals
Background: pensioners have become a relatively richer group over time
Paying for the Dilnot commission proposals

• Dilnot benefits higher-income pensioners and those with more wealth
  – Could raise taxes or cut spending very slightly across the board...
  – ...or go for approach that is distributionally neutral by increasing taxes or cutting benefits for those who would gain from proposals

• Focus on second of these. Key question:
  – Are there coherent ways of ensuring that better off pensioners as a group pay for more generous social care funding?

• Need to consider tax and benefit system as a whole:
  – What elements of the current tax and benefit system look less than coherent?
  – And how could they be reformed to raise money while enhancing coherence?
Principles for reform

• Look for where the current system deviates from a coherent structure for supporting pensioners
• Basic and earnings related pensions and pension credit represent a coherent system of support by themselves
• Other additional benefits and tax reliefs need to be justified
Additional benefits

- Winter fuel allowance and free TV licences
  - Go to all pensioners, not taxed or means-tested
  - Cost: £2.1 billion for WFPs and £0.6 billion for free TV licences
  - Just giving them to those on Pension Credit could save £1.5–£2 billion
  - Richer households lose, though biggest in percentage terms for those with incomes just above the cutoff for Pension Credit
Distributional impact among pensioners of means-testing Winter Fuel Payments

![Graph showing the annual cash loss and loss as a % of income among different quintiles of pensioner income distribution.](image)
Additional benefits

• Winter fuel allowance and free TV licences
  – Go to all pensioners, not taxed or means-tested
  – Cost: £2.1 billion for WFPs and £0.6 billion for free TV licences
  – Just giving them to those on Pension Credit could save £1.5–£2 billion
  – Richer households lose, though biggest in percentage terms for those with incomes just above the cutoff for Pension Credit

• Pros:
  – Why have separate benefit in the first place?
  – Those who benefit 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, take-up of Pension Credit fairly low
Also look at coherence of the tax system

• No NICs on earnings after state pension age – cost £800 million
  – Imposing NICs would take money away from higher income pensioners
  – But might want lower tax rates for older workers as more responsive to incentives

• Higher income tax personal allowances
  – Being phased out

• Single person discount for Council Tax
  – Particularly valuable to pensioners

• CGT is forgiven at death – cost £600 million
  – No justification for this: encourages people to hold onto assets when could be more profitably reinvested elsewhere
  – And IHT is probably in need of reform
Taxation of pensions

- Tax neutral treatment of saving generally appropriate
  - Though probably want more generous treatment for pensions
- Tax neutrality implies not taxing returns to saving, and either taxing contributions or pension income in retirement
- In the UK pensions are treated in the following way:

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>National Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee contributions</td>
<td>Exempt</td>
<td>Taxed</td>
</tr>
<tr>
<td>Employer contributions</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Returns</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Withdrawals</td>
<td>Taxed, apart from 25% tax-free lump sum</td>
<td>Exempt</td>
</tr>
</tbody>
</table>

- Two divergences from neutrality: tax free lump sum, and employer contributions escaping NICs altogether
Potential reforms to taxation of pensions

- Tax free lump sum costs £2.5 billion
  - Can get up to £312,500 tax free: limiting to higher rate threshold could save £500 million
- Employer pension contributions not subject to NI at any point
  - Which is both distorting/unfair to those whose employer does not contribute and extraordinarily generous
- Imposing NI on private pensions in payment could raise £350 million per 1p
  - Any such change would need to be phased in: would mean past employee contributions faced NICs on the way in and on the way out
  - Would also want offsetting NICs relief on employee contributions: overall cost in short run
  - Higher-income pensioners would lose the most from this...
Distributional effect of imposing full employee NI rate on private pension income

Annual cash loss

Income decile group

Poorest 2 3 4 5 6 7 8 9 Richest All

-£2,000 -£1,750 -£1,500 -£1,250 -£1,000 -£750 -£500 -£250 £0

-0.0% -0.5% -1.0% -1.5% -2.0% -2.5% -3.0% -3.5% -4.0%

in cash terms as a % of income

© Institute for Fiscal Studies
Conclusions

• The “Dilnot reforms” would benefit better off pensioners
• As a group, pensioners have done relatively well in recent years
  – Though their incomes are still below those of working age on average
• The current tax and benefit system is not wholly rational in its treatment of pensioners
  – If one wanted to find money from better off pensioners to fund the Dilnot proposals one could, and improve coherence of system at the same time
• Universal benefits like winter fuel allowances and free TV licences could be means-tested, abolished, or consolidated into the Basic State Pension or Pension Credit
• CGT at death, NICs and tax treatment of pensions could all be reformed in ways that raise money and increase coherence