NI is the right way to pay for social care after COVID, but it needs to be made fairer

Improvements to the finance of social care will be paid for by a rise in National Insurance contributions. ***Nicholas Barr (LSE)*** *argues that NI can be the right way to finance this kind of risk, but the government can and should ensure that younger people do not have to shoulder an undue share of the new tax burden.*

The pandemic brutally exposed the long-known vulnerabilities of the care sector. As the UK emerges from a pandemic that overwhelmingly killed older people, it is good that the government is finally bringing forward practical proposals that have been promised for years. It is also good that – with the proposed modifications described below – the government is proposing to increase finance for social care through an increase in National Insurance contributions (NICs).

The right starting point: The purpose of insurance

The purpose of insurance is to provide cover against

- A bad thing that may happen to a person – or may not, and
- Which the person can't stop happening – and which, if it happens
- Is very expensive.

All three apply to the risk of needing social care at some stage in the future.

People value insurance, and so buy insurance voluntarily. For example, they routinely insure their homes against fire or theft. Private insurers offer policies that cover many such risks. So it is right that people should have access to insurance to cover the risk of paying for social care.

But private insurers cannot offer good cover against needing social care

The premium an insurance company charges is based on (a) the size of the risk involved and (b) the cost of addressing it. In the case of social care, these are the probability that someone will need social care, and the cost of providing care.

Neither of these is knowable for events that for a young person lie many decades ahead. What is therefore involved is not risk (where insurance companies have a reasonably good estimate of how likely a person is to need social care) but uncertainty (where the insurer knows that there is a risk, but cannot quantify it accurately). For further discussion of the central distinction between risk and uncertainty, see my earlier post Life after COVID-19: start planning now. Another important example of this distinction is over future levels of inflation. We know the risk of inflation is there, but have little idea of rates of inflation well into the future.

In the face of uncertainty, private insurers either offer no policies, or policies that are expensive and with significant restrictions. Similar problems apply to many of the main risks covered by the welfare state. This is why countries have some form of social insurance to fill the gap. For those reasons, in an earlier (2010) paper I argued that financing social care is a natural extension of the Beveridge arrangements for national insurance.

Who should pay?

Germany has an extra social insurance contribution of 1.525% paid by both workers and employers. Crucially, the contribution is paid also by pensioners. The arrangements integrate the contribution into social insurance in two additional ways: a person who has never had any children pays an additional 0.25 per cent, on the grounds that they do not bear the full cost of raising the next cohort of contributors; and though pensioners do not pay the main contribution because the risk (e.g.) of unemployment no longer applies, they continue to pay the long-term care contribution because they might still need social care

The system in Germany is a genuine strategy. It pays three levels of benefit, depending on the extent of incapacity, and offers three types of benefit: care at home; cash to allow a person to buy their own care at home; and residential care. There are additional benefits, for example for adapting a person's home or to cover the costs of respite care. (I discuss this further in my 2020 book, *The Economics of the Welfare State*.)

A nursing home in Bavaria, Germany. Photo: Michael Dr Gumtau

Many commentators worry that the burden of payment would fall on younger people and lower earners. Those concerns are right, but they can be fixed.

- The government has already indicated that the additional NICs should be paid by pensioners on income above some lower limit, as many continue to work past the state pension age. However, a good case can be made, as in Germany, for basing the contribution on pensions above some lower limit as well as earnings. The proposal to subject share dividends to the additional NIC is a step in this direction.

The government could do more to make the rise fairer, including:

- Raising the lower earnings limit at which NICs become payable;
- Raising the upper earnings limit, perhaps with no limit for the social care addition (potentially a substantial source of revenue); and/or
- Increasing child benefit and/or child tax credit.

Why National Insurance contributions rather than income tax?

Insurance market failures create an overwhelming argument for financing social care through taxation, but why NICs rather than income tax? The main reason (and my only difference in emphasis from the proposals in the 2011 Dilnot Report) is that a dedicated revenue source offers better protection both against short-term budgetary crises and longer-term trends. Consider how tax-financed benefits have been subjected to stringent budget cuts since 2010. The NHS, too, faced serious funding problems even before the pandemic because its budget was inadequately protected against inflation, since the costs of services rise faster than prices generally.

In sum:

- Private insurers cannot cover the costs of social care well, if at all. That is why the finance of social care has mainly to be through public finance.
- A dedicated revenue source like NICs gives greater protection than general tax finance against short-term budgetary crises.
- The government has several possible ways of making insurance cover via NICs more progressive.

This post represents the views of the author and not those of the COVID-19 blog, nor LSE.