The impact of Insurance Premium Tax on UK households

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SMF Social Market Foundation

Acknowledgements

This report was commissioned by the Association of British Insurers (ABI) and was produced independently by the Social Market Foundation, which retains full editorial independence, using publicly available information and sources. Any views expressed the report do not necessarily reflect those of the ABI.

About the author

Scott Corfe joined the SMF as Chief Economist in June 2017. Before joining, he was Head of Macroeconomics and a Director at the economics consultancy Cebr, where he led much of the consultancy's thought leadership and public policy research. His expert insights are frequently sought after in publications including the Financial Times, the Sunday Times, the Guardian and the Daily Telegraph. Scott has appeared on BBC News, Sky News, Radio 4 and a range of other broadcast media. Scott was voted one of the top three forecasters of UK GDP by Focus Economics in 2016.

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About this report

This report was commissioned by the ABI and carried out by SMF, which retains editorial independence. The scope of the research is twofold: to explore the fiscal facts of IPT: how much it raises and who pays it; and to explore public understanding of the tax – do people know what it is and how it works?

The SMF undertook this work because we are a charity with a remit to improve public understanding of public policy and economics. Our purpose here is to set out the facts about a significant tax and to help inform the public about the size and operation of that tax, relative to household finances, and relative to other taxes and the wider public finances. The SMF does not, in this paper, take a view on whether IPT is a fair or unfair tax, or about the level and application of that tax, relative to other fiscal choices. Our intention is simply to inform the debate around taxation and the public finances, so that voters and those who make decisions on their behalf can have a more honest conversation about these issues.

Executive Summary

Insurance Premium Tax (IPT) – covering most general insurance – has increased substantially since its inception in 1994. In particular, since 2011 IPT has climbed rapidly as policymakers have sought additional revenue to reduce the deficit in the public finances. At present the standard rate of IPT stands at 12%, about five times its initial rate of 2.5%.

IPT now raises more revenue than beer & cider duties, wine duties and spirits duties. It is set to raise more revenue than inheritance tax over the next three years, according to Office for Budget Responsibility projections. Since 1994 the standard rate of IPT has increased more rapidly than tobacco duty.

Such large hikes in IPT have taken place despite a lack of published evidence around its impact on consumer behaviour and household finances, especially with respect to the distributional consequences of changes in IPT. This Social Market Foundation report presents new analysis into the impact of IPT on households and shows that:

- The amount of revenue raised from IPT in the 2016/17 financial year was equal to £179 for every British household.
- About half of this is paid directly by households on insurance products, with the remainder paid by businesses. Business costs associated with IPT are likely, at least in part, to feed through into the finances of UK households – through higher consumer prices, lower dividends and reduced profits for business owners.
- Forecasts suggest that the per-household annual costs of IPT are set to increase and rise above £200 from 2018.
- If the standard rate of IPT had remained at 5%, its rate prior to 2011, then the savings per UK household could be significant. For the current fiscal year, 2017/18, we estimate that households are directly paying about £50 per year more as a result of higher IPT. If the business costs associated with higher IPT are ultimately borne by households, then the per household cost could be as high as £105.

- To put this into context, costs of over £100 associated with higher IPT could, for a typical income taxpaying worker, offset the financial benefits of the April 2017 increase in personal allowances from £11,000 to £11,500.
- IPT is a regressive form of taxation; lower income households spend a greater proportion of their disposable income on insurance (excluding IPT-exempt life insurance) than the richest households.

Survey research undertaken as part of this study suggest a widespread lack of awareness of IPT's existence or the extent to which it has changed in recent years. About half of the 2,000 adults surveyed were unaware of the existence of IPT before taking part in the survey – notably higher than the other taxes and duties we asked them about. IPT might therefore be described a "stealth tax", a term that captures public cynicism about the honesty and transparency of the tax system.

The regressive nature of IPT, lack of awareness of the tax and the fact that it has increased significantly should be key considerations for policymakers making decisions on this form of taxation. As the Institute for Fiscal Studies has noted, recent increases in IPT have been made by government without deep consideration of what the economically optimal rate of the tax should be. The IFS has suggested that a low single-digit rate for consumers would be appropriate[1], suggesting that the current rate of 12% is excessive.

[1] https://www.ifs.org.uk/publications/8808

Chapter 1: Introduction

Insurance Premium Tax (IPT) is charged on insurance premiums and covers most general insurance (such as motor and household insurance) as well as health insurance and cash-plan policies. Life insurance and most other long-term insurance is exempt[2].

Since coming into effect in 1994, the rate of IPT has increased significantly. The standard rate stood at 2.5% when it was first introduced. Since then, it has increased by about fivefold, standing at 12% since June 2017. Much of this increase has occurred since the financial crisis as government has used the tax to try to contribute towards deficit reduction targets. IPT rate rises have seen government revenues from IPT more than double over the past decade, from £2.3bn in the 2006/07 fiscal year to £4.8bn in 2016/17.

Given the scale of the changes to IPT that have taken place, it is important to understand their implications for UK households. This report aims to shed new light on the economic impact of IPT on consumers in the UK. Despite numerous increases in the tax in recent years, the government has not published a detailed assessment of its impact on the financial position and behaviour of UK households, including an assessment of the distributional consequences of the tax for households at different points on the income spectrum.

Indeed, the government appears to have done little in the way of detailed economic analysis on what the optimal rate of insurance taxation should be. As the Institute for Fiscal Studies (IFS) has recently noted, IPT now appears to be excessively high[3] from an economic perspective, and the tax has deviated far away from its original goal of compensating for the VAT exemption of financial services such as insurance.

As we show in this report, IPT is a regressive tax, impacting lower income households disproportionately, and this is something that ought to be borne in mind with respect to any future changes in the rate.

This report also considers the extent to which IPT is a "stealth tax", where households are largely unaware of changes in the tax or even the very existence of the tax. We also examine consumers' views on the tax treatment of insurance products and the extent to which this aligns with the current stance of government.

The structure of this report is as follows:

- Chapter 2 examines recent trends in IPT and how this compares with other types of taxation.

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[2] Other areas exempt from IPT include re-insurance, insurance for commercial ships and aircraft, insurance for commercial goods of international transit and premiums for risks located outside the UK (which may be liable to similar taxes imposed by other countries).

[3] "IPT was introduced to compensate for the VAT exemption of insurance. Without IPT households would be paying too little for insurance and firms too much. Broadly, the "correct" tax on insurance for households would be 20 per cent of the difference between premiums and payouts. Since IPT is levied on premiums alone, that would roughly equate to a low single-digit tax rate. So a 12 per cent tax on premiums is much higher than the appropriate rate on households, let alone on businesses which were being overtaxed on their use of insurance even before IPT was introduced." Paul Johnson, IFS, December 2016

- Chapter 3 considers the financial impact of IPT increases on UK households and examines the extent to which this has offset some tax cuts.
- Chapter 4 presents findings from new survey research examining public awareness of IPT, and the extent to which it can be considered a “stealth tax”.
- Chapter 5 draws conclusions from the preceding analysis.

Chapter 2: Trends in IPT

Rates of IPT have increased significantly and on a number of occasions since the tax was first introduced in 1994. Originally, there was a single rate of IPT, which stood at 2.5%. In 1997, a higher rate of IPT, which initially stood at 17.5%, was introduced. The higher rate applies for travel insurance, mechanical or electrical appliances insurance and vehicle hire or sale insurance. In these sectors businesses had historically ascribed excess value to the insurance and depressed it on the goods (or holiday) insured in order to reduce the liability to VAT ("value-shifting"). This is why it is an IPT rate equivalent to the VAT rate and changes when the latter does so.

By the turn of the millennium, the standard rate of IPT had doubled from its initial rate, rising to 5%. It remained at this level until 2011, when the rate increased to 6%. Furthermore, the higher rate of IPT increased at the start of 2011 from 17.5% to 20.0%, alongside the increase in the standard rate of VAT in that year.

The past three years have seen three increases to the standard rate, which rose in 2015, 2016 and 2017 to stand at its current level of 12%.

Table 1: Changes to IPT rates

Date of change	Standard rate, %	Higher rate, %
01.10.94	2.5	-
01.04.97	4.0	17.5
01.07.99	5.0	17.5
04.01.11	6.0	20.0
01.11.15	9.5	20.0
01.10.16	10.0	20.0
01.06.17	12.0	20.0

Source: HMRC

The standard rate of IPT has increased much more rapidly than a number of other taxes, including "sin taxes" such as tobacco and alcohol duties. For example, as Figure 1 shows, while the standard rate of IPT has increased by about fivefold since 1994, tobacco duty increased by about fourfold and beer duty increased by a factor of less than two.

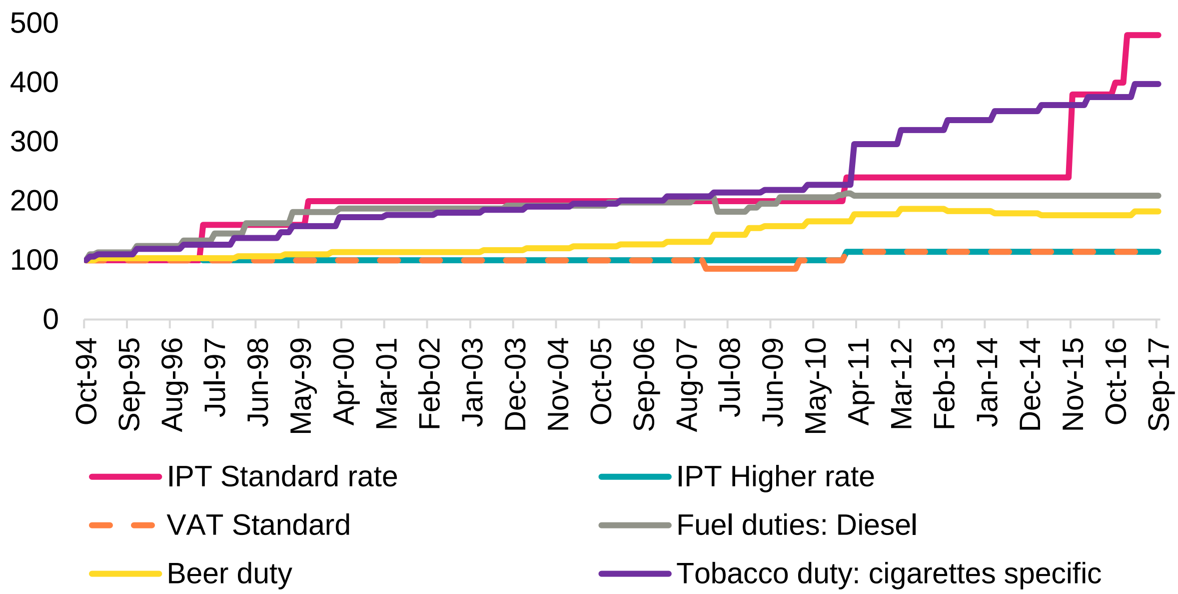
The increase in the rate of IPT has, in turn, increased its relative importance as a source of revenue for the exchequer. As Figure 2 shows, the tax now raises more revenue than beer & cider duties, wine duties and spirits duties. In the 1999/00 fiscal year, more revenue was raised from betting & gambling duties than on insurance premiums; IPT now raises significantly more revenue. The tax is expected to raise more revenue than inheritance tax over the years to 2020/21, according to OBR projections shown in Figure 2.

IPT accounted for 0.8% of HMRC tax receipts in the 2016/17 fiscal year, up from 0.5% at the start of the millennium.

The amount of IPT paid by households and businesses is influenced by changes in the underlying (pre-tax) price of insurance. This is because IPT is applied as a percentage rate of premiums rather than a fixed value per premium (as is the case with say beer duty and road fuel duty). As such, increases in underlying insurance premiums lead to higher tax revenues.

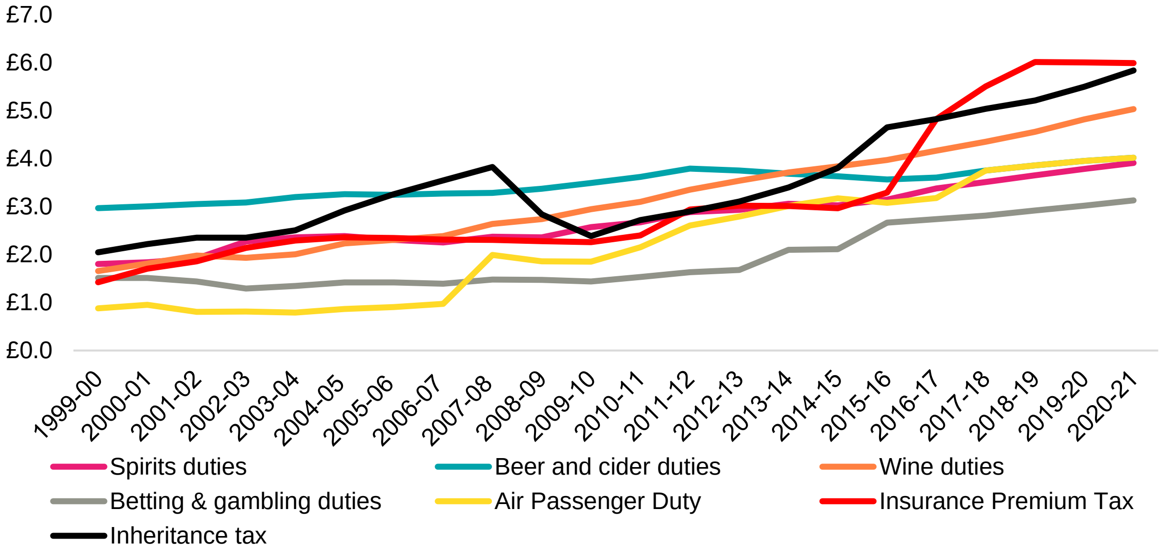
Future trends in IPT policy remain unclear, though it is conceivable that the government could increase the standard rate further as it seeks new sources of revenue to reduce the fiscal deficit. This is particularly likely to be the case given the political constraints associated with increasing either income taxes or VAT, and declining tax revenues from sources such as tobacco duty. The challenges associated with raising revenue from these sources means that governments may be tempted to continue using more "subtle" tax changes such as IPT hikes to raise revenue.

Figure 1: Change in selected tax rates and duties since 1994. Index, October 1994 = 100



Sources: SMF analysis, HMRC

Figure 2: Government revenues from selected taxes and duties, £bn



Sources: SMF analysis, HMRC, OBR forecasts

Chapter 3: The financial impact and distributional consequences of IPT

Increases in IPT clearly have an impact on consumer behaviour and household finances. Most directly, higher rates of IPT translate into greater insurance costs for households, which they either need to live with or mitigate through reducing their use of insurance products (if possible).

More indirectly, IPT affects households through its impact on businesses. Insurance products for businesses are also subject to IPT. Unlike VAT, the increase in insurance costs associated with IPT cannot be claimed back by businesses. Higher rates of IPT thus translate into lower net profits for businesses and in turn lower incomes and dividend payments for UK households. Alternatively, businesses may pass on the costs associated with higher rates of IPT to households, in the form of higher consumer prices. Through these channels a significant proportion of the business costs associated with IPT are likely to fall into the hands of UK households.

Although insurers are technically liable for IPT[4], we believe that, as with many other indirect taxes such as alcohol duty and VAT, purchasers of insurance are likely to bear the brunt of the tax as it is passed on to them. As has been widely reported, insurers have faced a challenging economic environment in recent years amid a prolonged period of very low interest rates[5]. Many are likely to struggle to absorb IPT increases and accept lower profit margins. Furthermore, as economic literature on the incidence of indirect taxes notes, consumers are particularly likely to bear the brunt of taxes when demand for a product is relatively insensitive to changes in price[6] – as is the case with "essential" types of insurance such as building and vehicle insurance.

As Figure 3 below shows, the amount of revenue raised from IPT, on a per household basis, stood at £179 in the 2016/17 fiscal year. About half of this is paid by households on insurance products, with the remainder paid by businesses. As we have argued a significant proportion of the business costs are likely to be passed on to UK households, or translate into lower incomes for UK-based entrepreneurs and shareholders. The per household cost of IPT is close to double the £91 seen in 2006/07. Social Market Foundation calculations based on Office for Budget Responsibility forecasts suggest that the per household costs of IPT are set to increase and rise above £200 from 2018.

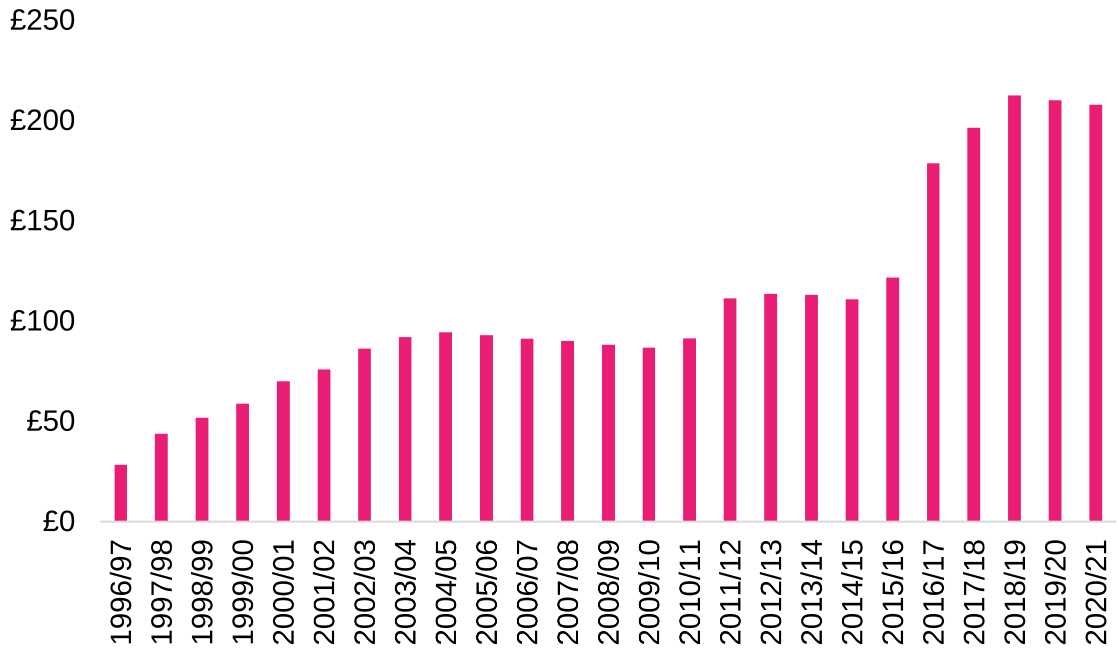
Our calculations are made on the basis that there is full pass-through of IPT from insurers to households and businesses. For reasons set out above, we believe this is a reasonable assumption to make to approximate the impact of IPT on consumers. Given the characteristics of the market – the 'essential' nature of insurance products and the squeeze on the profits of insurers in the prevailing economic environment – we would expect a very high degree of pass-through for the tax.

[4] https://www.gov.uk/guidance/insurance-premium-tax

[5] See, for example, Financial Times (28 June 2016), "Insurance industry faces daunting list of challenges"

[6] For a brief overview of the economic theory around the incidence of taxation see, for example, http://www.homepages.ucl.ac.uk/~uctpmwc/www/TEACHING/PPEA/9_Tax%20Incidence%20and%20the%20Efficiency%20Cost%20of%20Taxation.ppt

Figure 3: IPT receipts (business and household) divided by the number of UK households



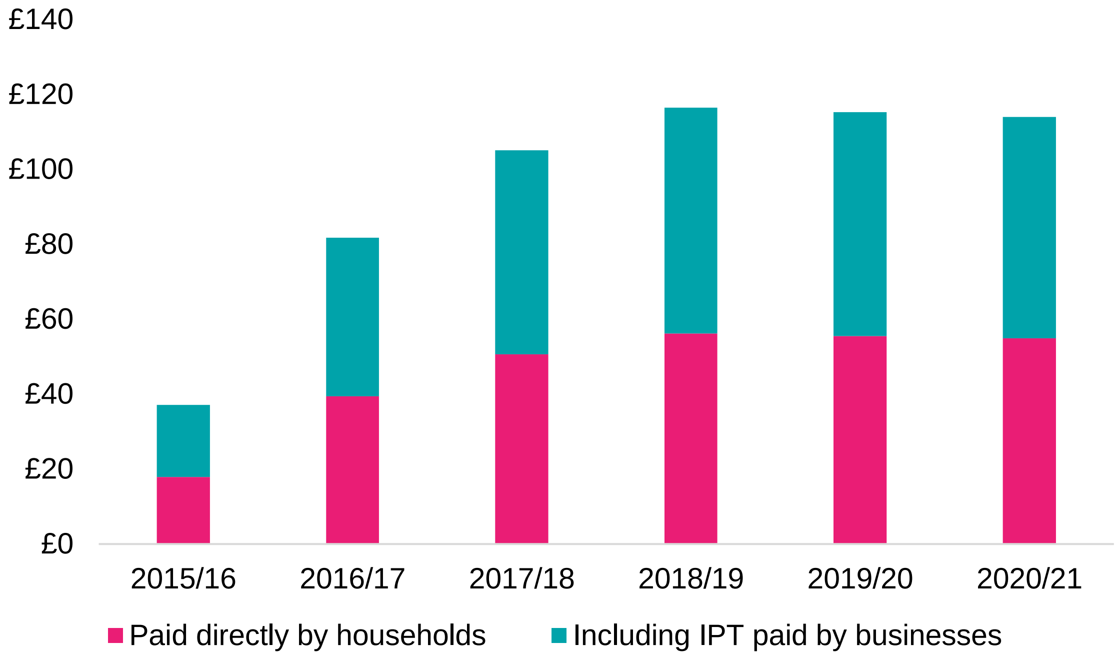
Sources: HMRC and OBR tax revenue data, ONS and DCLG household data, SMF analysis

We estimate that, if the standard rate of IPT had remained at 5%, its rate prior to 2011, then the savings per UK household could be significant. For the current fiscal year, 2017/18, we estimate that households are directly paying about £50 per year more as a result of higher IPT[7]. If the business costs associated with higher IPT are ultimately borne by households (either through higher prices or lower incomes/dividends), then the additional cost per household could be as high as £105.

To put this into context, an IPT-related cost of £50, would, for a typical income taxpaying worker, offset half the financial benefits of the April 2017 increase in personal allowances from £11,000 to £11,500. If the cost is as high as £105, then all of the financial benefits of the recent rise in personal allowances would be offset Much of a tax cut that is given significant promotion and publicity – by politicians and the media alike – may be being absorbed by a tax that gets much less attention.

[7] This assumes no change in the volume on insurance products purchased in response to IPT changes, reflecting the "essential" nature of key insurance products such as motor and building insurance.

Figure 4: Extra spending on IPT compared with the standard rate remaining at the pre-2011 rate of 5%, on a per-household basis.



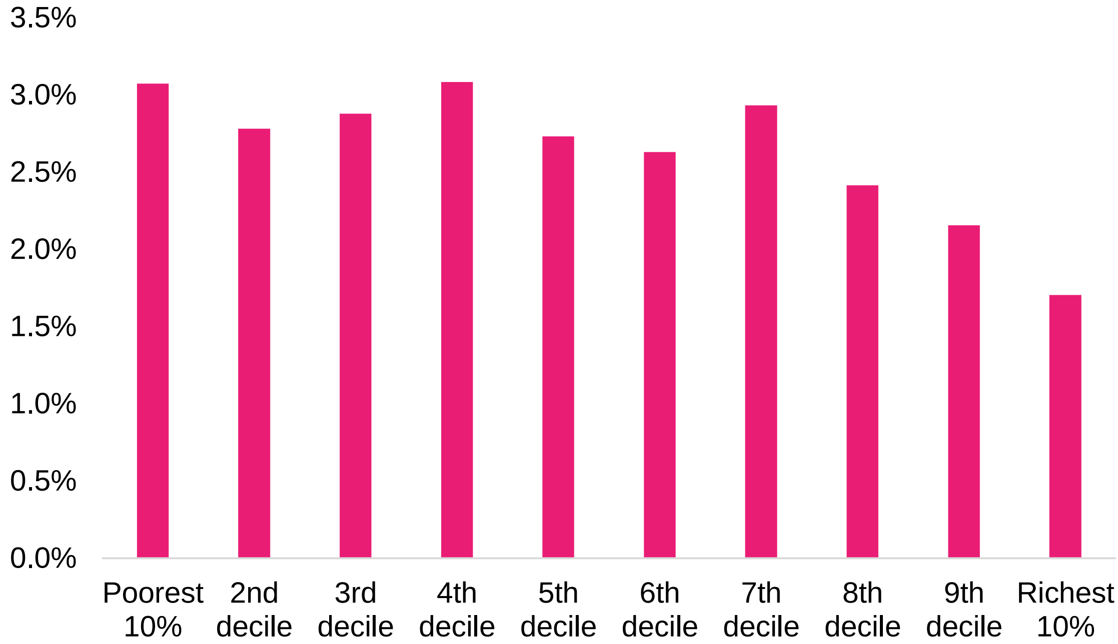
Source: DCLG and HMRC data, SMF analysis

Distributional consequences of IPT

As well as the implications of IPT for the average UK household, it is important for policymakers to consider the *distributional* consequences of higher rates of IPT.

Although higher income households spend more in absolute terms on insurance products than lower income households, our analysis of data in the ONS Living Costs and Food Survey suggests that IPT is a regressive form of taxation; lower income households spend a greater proportion of their disposable[8] income on insurance (excluding life insurance, which is exempt from IPT) than the richest households. The poorest 10% of households, in terms of disposable income, spent 3.1% of their disposable income on insurance (except life insurance), compared with 1.7% for the richest 10% of households. This is shown in Figure 5.

Figure 5: Proportion of household disposable income spent on insurance (excluding life insurance), by equivalised disposable income decile



Source: ONS, SMF analysis

The regressive nature of IPT is likely to reflect the fact that a significant proportion of expenditure on insurance is what would commonly be regarded as "essential" rather than "discretionary", meaning that it is required by households on all parts of the income spectrum.

The potential to cut back on building insurance and vehicle insurance is, for example, often limited. Indeed, possessing motor insurance is a legal requirement for drivers and building insurance is usually a requirement for mortgage holders[9].

[8] Net of taxes and benefits
[9] https://www.citizensadvice.org.uk/consumer/insurance/insurance/types-of-insurance/buildings-insurance/

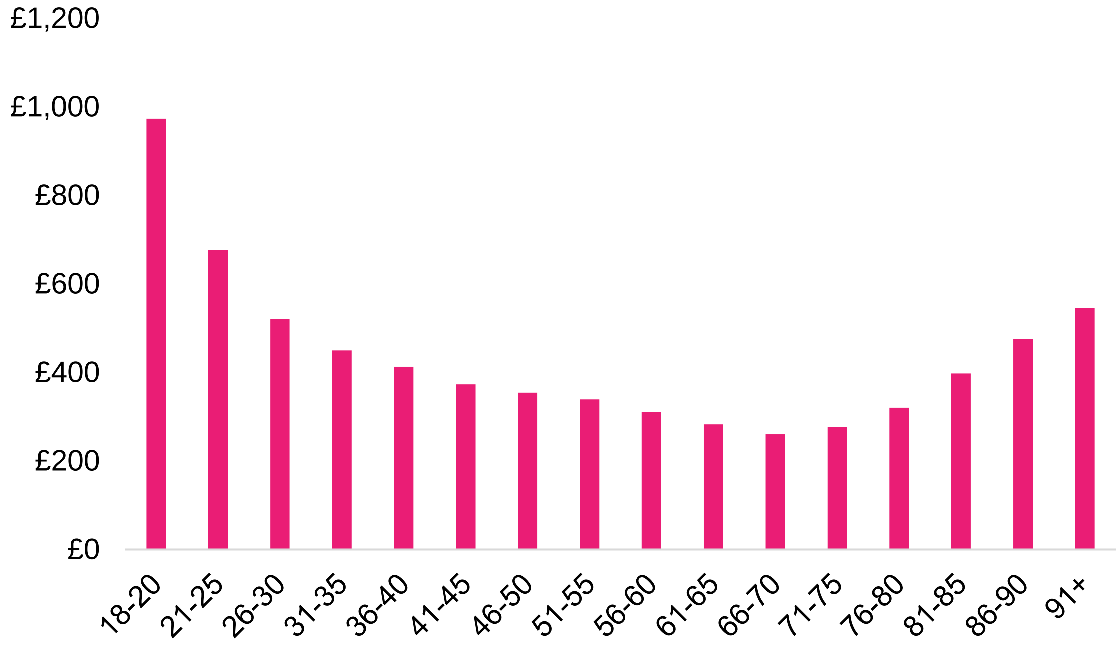
ONS data suggests that expenditure on household insurance (appliances, contents and building) and motoring insurance – the two most "essential" types of insurance - accounted for 89% of total expenditure on insurance (excluding life insurance) among UK households in the 2015/16 fiscal year.

The essential nature of insurance products to many UK households is also clear in Opinium consumer survey research commissioned as part of this study. Most (58%) of those surveyed felt that either all types of insurance are essential (13%) or most types are essential (45%). Only 7% believe that no type of insurance is an essential service. A clear majority of households felt that building insurance (76%), contents insurance (74%) and motor insurance (86%) are essential services.

Another factor which may contribute to the regressive nature of insurance premium taxation is that in some instances underlying insurance costs can be higher for lower income households. For example, those living in deprived areas may incur higher vehicle and housing insurance costs due to higher rates of crime. As the amount of IPT paid is a function of insurance costs, this can further contribute to a situation where those on lower incomes spend proportionately more on insurance . Most policymakers consider "poverty premiums" on purchases by low-income households to be a bad thing, but IPT can effectively amplify the problem in home and motor insurance.

Another distributional consequence of IPT relates to its impacts on individuals in different age groups. For example, data from the Association of British Insurers show that drivers under the age of 26 spend significantly more on car insurance premiums than older drivers. As such, they will be disproportionately impacted by an increase in motor insurance costs related to higher rates of IPT.

Figure 6: Average motor insurance premium by age of policyholder



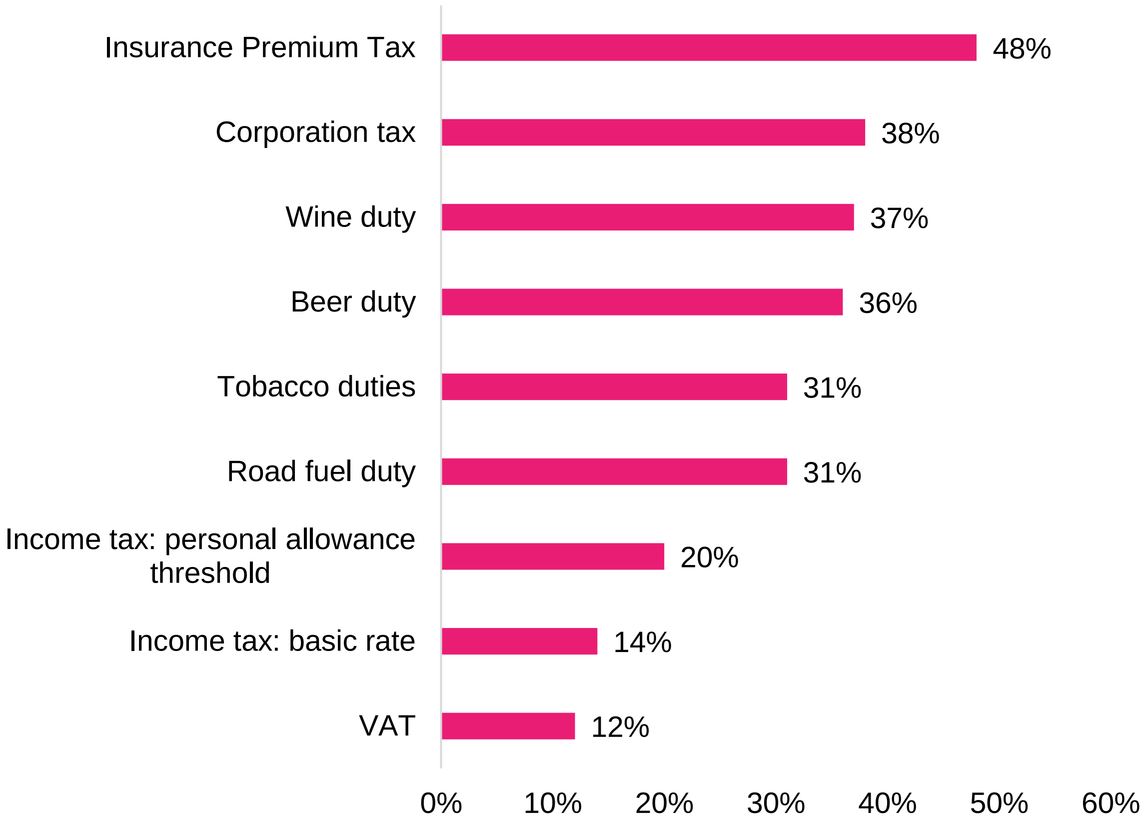
Source: ABI website

Chapter 4: Public awareness of IPT – is it a stealth tax?

The previous two chapters of this report have highlighted the significant increases in IPT in recent years and examined the distributional consequences of the tax. Our analysis suggests that IPT, at least in terms of the tax burden falling directly on households, is a regressive form of taxation, accounting for a higher proportion of the disposable income of poorer households.

Yet, despite the scale of the increases in IPT observed, survey analysis undertaken as part of this research suggests a significant lack of awareness about the existence of the tax. The Opinium survey of 2,000 adults showed about half (48%) of individuals unaware of the existence of IPT – significantly higher than any of the other taxes and duties we asked them about. Figure 7 illustrates the results.

Figure 7: Prior to completing this survey, were you aware of the existence of the following tax rates, duties and tax thresholds? Proportion of respondents who were not aware of the existence of tax



Source: Opinium

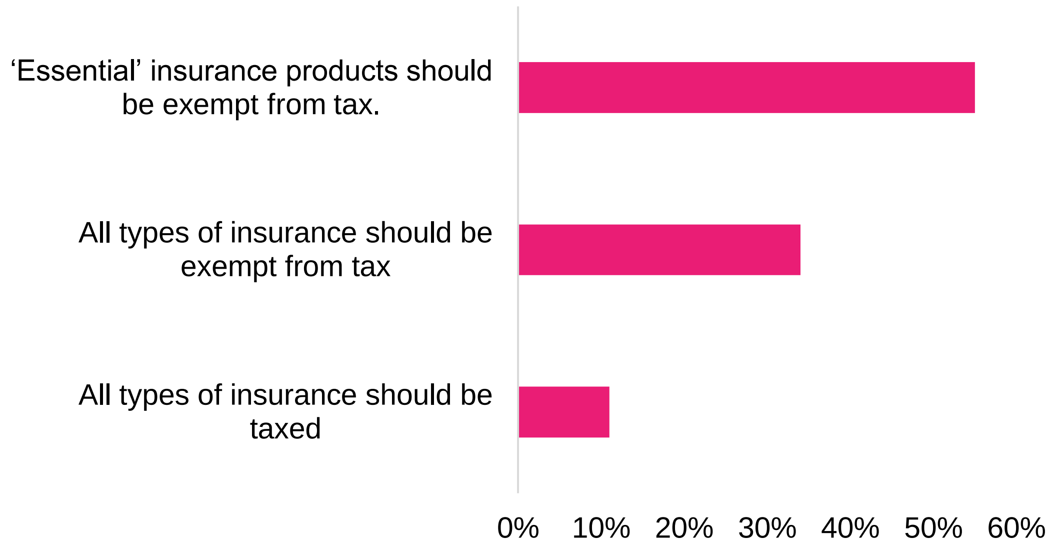
The lack of awareness about IPT and the extent to which it has changed over time suggests that recent hikes can are liable to be regarded as a "stealth tax" – raising money from households in a way that many people are unaware of.

Views about the taxation of insurance

Our survey suggests that, if there were broader public knowledge about the existence of IPT and the extent to which it has increased in recent years, there would probably be more negative sentiment expressed towards the tax.

We explained in the previous chapter that a majority of UK households believe that at least some types of insurance are "essential". Widespread belief that insurance is at least partly essential is reflected in households' views about the tax treatment of insurance. A third (34%) of survey respondents felt that all types of insurance should be exempt from tax while over half (55%) felt that "essential" insurance products should be exempt from tax. Only one in ten (11%) thought that all types of insurance should be taxed.

Figure 8: How do you think insurance should be taxed?



Source: Opinium

While the survey does not show a majority of respondents favouring outright abolition of taxation on insurance - possibly because respondents believe the government would seek revenue from elsewhere - it does suggest that a majority of households would prefer a situation where IPT is applied in a similar way to VAT – with "essential" areas excluded from taxation or subject to a lower rate.

Chapter 5: Conclusions

Any government will undoubtedly have a significant fiscal challenge over the coming years, as it tries to reduce the UK's fiscal deficit. Pressures to increase spending in a range of areas – from healthcare to public sector pay – are significant. At the same time, there is a reluctance among policymakers to raise unpopular and well-known taxes such as income tax, VAT and road fuel duty.

Against such a backdrop, the government has had to use some of the smaller sources of tax revenue in an effort to raise additional funding and narrow the gap in the public finances. In this context, Insurance Premium Tax stands out as a tax which has increased substantially since the financial crisis. The standard rate of IPT has increased by close to a factor of five since the tax was originally introduced, with the majority of this increase occurring since 2011.

The nature of insurance products such as building and motor insurance means that it is difficult for households to avoid IPT. In economic terms, the price elasticity of demand for these insurance products is likely to be low, meaning consumer spending does not change significantly in response to price changes.

Lack of sensitivity to price changes may be good from the government's perspective in terms of maximising tax revenues. However, the essential nature of many insurance products contributes to negative distributional consequences associated with raising revenue from IPT. Our analysis of official data shows that those on lower incomes spend a higher proportion of their disposable income on insurance products (excluding IPT-exempt life insurance) than the richest households. IPT is a regressive tax, with the poorest taking the biggest financial hit in proportion to their disposable incomes.

Furthermore, widespread lack of awareness of IPT means that it is likely to be regarded by some as a "stealth tax" where some of those paying it feel that they were not fully informed or consulted about that tax by those responsible for taxation. That feeling can be corrosive to public trust in the tax system, and the political process more widely.

The regressive nature of IPT, the "stealthy" nature of the tax and the fact that it has increased significantly more than many other types of tax in recent years should all be key considerations for any policymaker considering the future of IPT.

In addition, recent increases in IPT have been made by government without obvious public consideration about what the *economically optimal* rate of the tax should be and the tax has deviated far from its original purpose of offsetting the fact that insurance is not subject to VAT. Such issues should be given much greater public consideration by HM Treasury in future decisions relating to taxation in general and IPT in particular.

Appendix: Methodology and information about the survey

Methodology

All the data used in this report are publicly available and previously published by HM Treasury, the OBR, HMRC or the ABI.

Historic tax rates and duties are recorded in HMRC bulletins. October 1994 is used as a baseline as it corresponds to IPT being introduced for the first time. Further changes in taxes and duties reflect the month in which the change was implemented.

HMRC bulletins were also used to obtain government revenue raised by the selected taxes and duties. Projections of future revenue are taken from the March 2017 edition of the OBR's Economic and Fiscal Outlook report.

Calculations of IPT revenue per household are derived by dividing past revenue collected and future predictions of IPT revenue by the total number of households in the UK.

Spending on insurance as a proportion of average weekly household disposable income is calculated for each equivalised income decile group using ONS data from the Living Costs and Food Survey.

About the survey

As part of this research, we commissioned a consumer survey from Opinium in order to better understand consumer awareness of Insurance Premium Tax and consumers' views on the appropriate tax treatment of insurance.

2,001 online interviews with UK adults were undertaken as part of the survey. The survey was in the field from 22 September to 26 September 2017, inclusive. In the survey findings shown in this report, the survey sample has been weighted to reflect a nationally representative audience

Full survey data are available from Opinium, a member of the British Polling Council, upon request.