Alternative Approaches to Long-term Care Financing. Distributive Implications and Sustainability for Italy

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During the last decade, many countries have adopted tax schemes specifically aimed at financing programs for Long Term Care (LTC). These mechanisms have important distributional implications both within and across generations. Given the process of demographic ageing, the issue of inter and intra-generational fairness is deeply linked with the problem of the long-term financial equilibrium of an LTC fund.

In this paper we first compare, on a microdata sample of the Italian population, the distributive effects (both on current income and across generations) of six alternative approaches to finance an LTC scheme. In particular, we consider a hypothetical LTC scheme (with a size equivalent to that of the German one) to be introduced in Italy and analyse the distributive implications of the following tax options, taken from the financing mechanisms implemented or under discussion in Germany, Luxembourg, Japan and Italy: i) "Germany 1": a 1.7% tax on income with a ceiling; ii) "Germany 2": a differentiated tax rate for people with and without children; iii) "Germany 3": a flat rate; iv) "Luxembourg": a tax on income with no ceiling; v) "Japan": a tax on people aged more than 40 with a fixed co-payment; vi) "Ise Tax": a tax proportional to an indicator of the economic situation of the household that depends on both income and wealth. This last option, in particular, allows to reach two different aims: a) since the profile of wealth over the life cycle is steeper than that of income, the "Ise tax" increases the contribution of the elderly, i.e. of those persons who are subject to higher disability risk; b) if we accept the idea that the living standard of a person depends not only on his income but also on his wealth holdings, then the increase in the average contribution of the elderly is motivated also by the fact that they are "richer" than the younger taxpayers.

Of course, we do not claim to offer a full description of the institutional framework of any specific country: our aim is to highlight the distributive implications

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of few stylised policy options. Even if we discuss these alternatives with reference to Italy, we believe that our analysis can offer a contribution to the international debate by discussing the general properties of alternative financing approaches.

The distributive impacts of the various alternatives, all raising the same revenue, have been evaluated across different income and age classes. The poorest decile of the equivalent income distribution would be exempt from all alternative taxes, and in the "Japanese" case, with an age limit of 40 years, more than one third of households would be exempted. On average, these taxes would have an incidence of about 1–1.5% of disposable income and would be slightly progressive due to the presence of a taxable minimum. The flat tax case, of course, would be regressive in favour of the richest half of the population. The distributive analysis across age classes confirms that the "Japanese" tax and the tax on Ise shift the distribution of total burden towards the elderly: the share of total revenue paid by taxpayers aged more than 65 goes from 16.5% in the "Germany 1" case to 22.3% for the "Japanese" tax, and to 23% in the case of the Ise tax.

In the second part of the paper we move from a static to a dynamic perspective: we study the long-term sustainability of an hypothetical Pay as You Go (Payg) LTC scheme operating in Italy (that is, assuming the Italian projected demographic trends) under scenarios that consider alternative indexation rules, growth rates of GNP, future incidence of disability among age groups.

Given the impossibility for a pure Payg scheme to jointly deliver financial sustainability and inter-generational fairness, we discuss the possibility of introducing a trust fund for the first years of the life of the program in order to "smooth" across generations the effects of ageing. We consider the fact that, when a country starts a Payg scheme, it can benefit from a *una tantum* "free lunch" to distribute;, we suggest that the solution in which all the windfall is unselectively given to the members of the first generation is not the fairest possibility. In the case of LCT insurance, it can be argued that the principle that everybody contributes to the financing of the scheme according to his/her economic capacity while receives benefits according to the level of individual need is acceptable in the steady state regime while it may be not in the transition to steady state. In particular, we argue that people who are jointly rich and old when the LTC program is started should face a means tested co-payment when they receive benefits in the first years of functioning of the scheme. This temporary co-payment could allow the accumulation of a trust fund during the first period of working of the program. This could make it possible to drain from it in the subsequent period in order to keep both the contribution and benefits constant in real terms for all generations. Of course, this kind of approach implies important problems of public accountability and transparency: the operation of efficient regulatory

bodies is necessary in order to insulate the fund management from political interference. Furthermore, the portfolio policies of the trust fund are crucial: the trust fund can add to credibility and sustainability only if its operating is associated with an increase in aggregate saving (see Munnell 2005). As far as LTC is concerned, the collective accumulation of assets is consistent with the principle, at the individual level, that the right to benefits depends only on the size of need, not on past individual contributions.

Our numerical example enables us to discuss the issue of financial sustainability from different perspectives. Indexation to (2%) inflation plays an important role: no indexation implies financial sustainability even with modest GDP growth (about 1% per year on average) since such growth together with the erosion of the real value of the benefit fully offsets the rise in the number of beneficiaries. With indexation to inflation we need to double GDP growth in order to keep the scheme in balance. If we consider the need to provide full indexation not only with respect to inflation but also with respect to a 1.5% increase in unit cost of care, then the picture becomes darker: even a robust GNP growth (about 3% per year on average) cannot deliver financial sustainability. The accumulation of an "LTC trust fund" during the first years of operation of the program significantly improves global sustainability: with full indexation (inflation and unit cost) and a 3% GDP growth a 10 year 20% average co-payment allows sustainability for 23 or 27 years under the assumption of constant or decreasing incidence of disability, respectively. Under a poorer GDP dynamics (1.5% per year on average) the scheme is at higher risk: even with a 30% co-payment for 20 years financial sustainability is to last for about 25 years (for both scenarios of disability incidence). Of course, if we rule out any indexation to unit costs the situation improves even in the low GDP growth scenario (1.5%): under the constant scenario of incidence of disability,, financial sustainability is achieved for almost the whole considered period (2005–2051), provided a 25% average co-payment is introduced for the first 15 years; the scenario of decreasing disability sustainability "only" requires a 10% average co-payment for the first 12 years.

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