The impact of Insurance Premium Tax on UK households

2020 update report

Scott Corfe

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ABOUT THIS REPORT

This report was commissioned by the ABI and carried out by the Social Market Foundation (SMF). The scope of the research is to explore the fiscal facts of Insurance Premium Tax: how much it raises and who pays it. This report is an update of previous analysis presented in the SMF's 2017 report, "The impact of Insurance Premium Tax on UK households".

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 Insurance Premium Tax is the right way to raise revenue, relative to other fiscal choices, nor do we take a view on what the optimal rate of IPT should be. 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.

ABOUT THE AUTHOR

Scott Corfe

Scott Corfe is the Research Director of the SMF, he joined in June 2017 as Chief Economist. 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.

EXECUTIVE SUMMARY

Insurance Premium Tax (IPT) – covering most general insurance – has increased substantially since its inception in 1994. Since 2011 in particular, 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%. It has stood at this rate since June 2017.

IPT now raises more revenue than beer & cider duty or wine duty or spirits duty or betting & gaming duties. Since 1994, the standard rate of IPT has increased more rapidly than tobacco duty.

	Projected government revenue, 2019/20, £bn
Insurance Premium Tax	6.20
Wine duty	4.59
Beer & cider duty	4.05
Spirits duty	3.93
Betting and gaming duties	3.14

Source: OBR forecasts

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

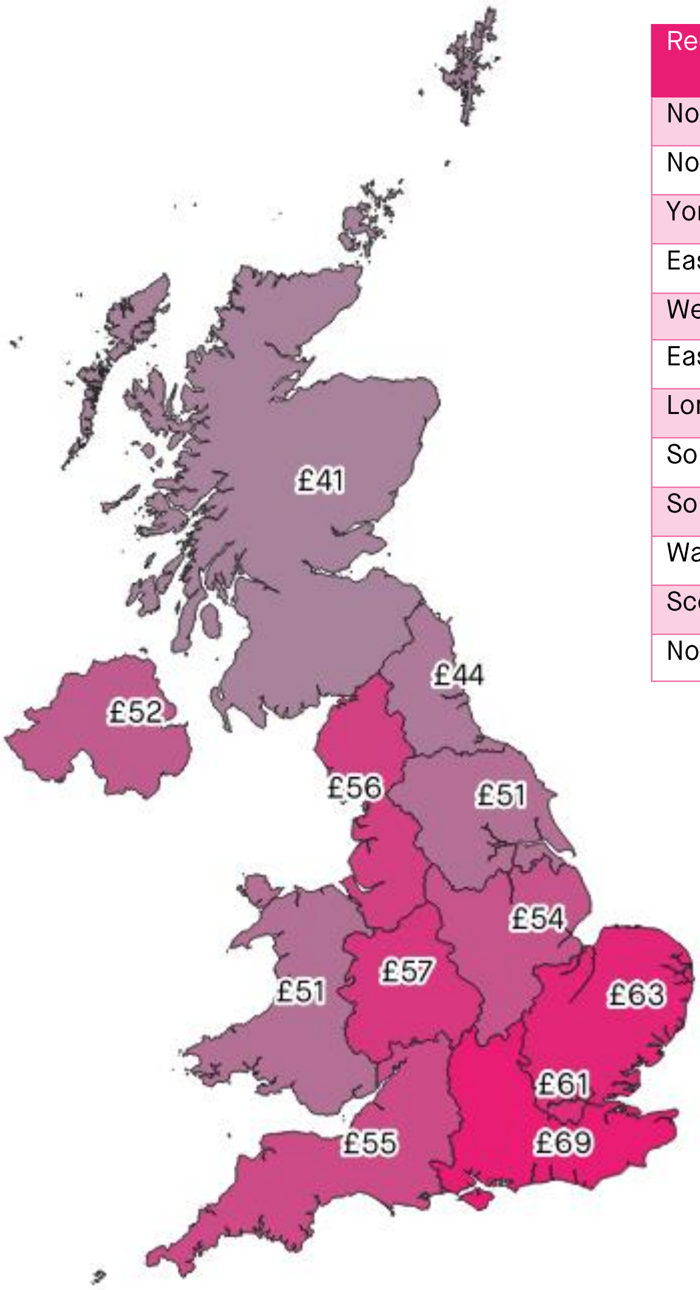
- The amount of revenue raised from IPT in the 2019/20 financial year is estimated to stand at £223 per UK household.
- About half (48%) of this is paid directly by households on insurance products, with the remainder paid by businesses. Business costs associated with IPT are likely, at least in part, to feed through into the finances of UK households – through higher consumer prices, lower dividends and reduced profits for business owners.
- 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, 2019/20, we estimate that households are directly paying about £58 per year more as a result of higher IPT.[1] 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 £123. Cumulatively, over the five years 2019/20 to 2023/24 inclusive, these costs are approximately £607 – some £17.1bn across all households. This comes on top of the £428 cumulative extra costs faced per household between 2010/11 and 2018/19 inclusive, compared with the standard rate of IPT remaining at 5%. This amounts to £11.6bn across all households.
- IPT is a regressive form of taxation. The lowest income 10% of households, in terms of post-tax income, spent 4.1% of their disposable income directly on insurance (except life insurance), compared with 1.6% for the highest income 10% of households. This is based on analysis of ONS Family Spending data covering the fiscal year ending 2018.

[1] 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.

- In the 2017/18 fiscal year – the latest year for which we have data split by income decile – the 12% standard rate of IPT is estimated to have cost those in the bottom half of the income distribution about half a billion pounds in extra spending, compared with a situation where the standard rate of IPT had remained at 5%.
- Average annual spending on insurance (excluding life insurance) is greatest in the South East of England, at about £1,140 per annum. Insurance spending is lowest in Scotland, at about £660 per annum per household. Despite such significant variation in cash spending on insurance, as a proportion of disposable income, the differences are less marked, ranging from 2.15% in Scotland to 2.82% in the North West of England. This reflects differences in household income at a regional level; while regions such as the North East spend a relatively low amount on insurance, they also have lower average incomes.
- Compared with a counterfactual situation where the standard rate of IPT had remained at 5%, extra annual costs to households ranged from £41 per household in Scotland to £69 per household in the South East of England in the fiscal year 2017/18. In the North West extra costs per household stood at £56.

The regressive nature of IPT 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 (IFS) 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.

Figure 1: Map of estimated extra per household spending on IPT by region in 2017/18, compared with a situation where the standard rate of IPT had remained at 5%. Table showing *total* spending on IPT per household.



Region	Total spending on IPT per household
North East	£77
North West	£100
Yorkshire & the Humber	£94
East Midlands	£94
West Midlands	£103
East of England	£112
London	£106
South East	£123
South West	£100
Wales	£89
Scotland	£72
Northern Ireland	£89

Source: ONS Family Spending dataset, Living Costs and Food Survey, SMF analysis

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 policies are 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 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 fill the hole in the public finances. IPT rate rises have seen government revenues from IPT rise significantly, more than doubling from £2.97bn in 2014/15 to £6.20bn in 2018/19.

Given the scale of the changes to IPT that have taken place, it is important to understand the 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 noted, IPT now appears to be excessively high 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.

> "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**

The structure of this report is as follows:

- **Chapter 2** examines recent trends in IPT and how this compares with other types of taxation.
- **Chapter 3** considers the financial impact of IPT increases on UK households and examines the extent to which this has offset some tax cuts.

[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).

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 was set at a rate equivalent to the VAT rate, and changed when the latter did.

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 standard rate of IPT was increased on four separate occasions since the financial crisis (in 2011, 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

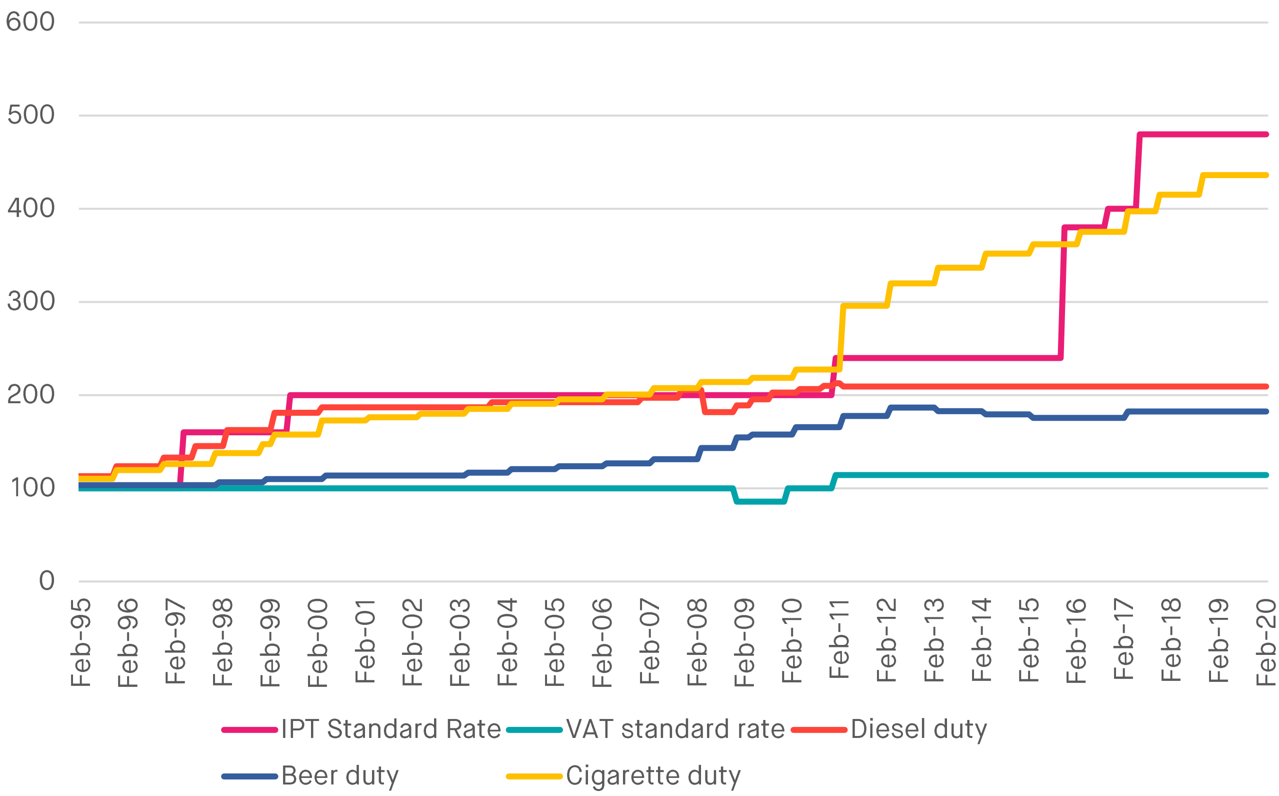
Source: HMRC

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, cigarette 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 duty or wine duty or spirits duty. In the 1999/00 fiscal year, more revenue was raised from betting & gaming duties than from insurance premium tax; IPT now raises about twice as much revenue. Further, as illustrated in Figure 2, IPT is expected to raise more revenue than spirits, or beer & cider, or wine and betting & gaming duties over the coming years, according to Office for Budget Responsibility (OBR) forecasts up to 2023/24.

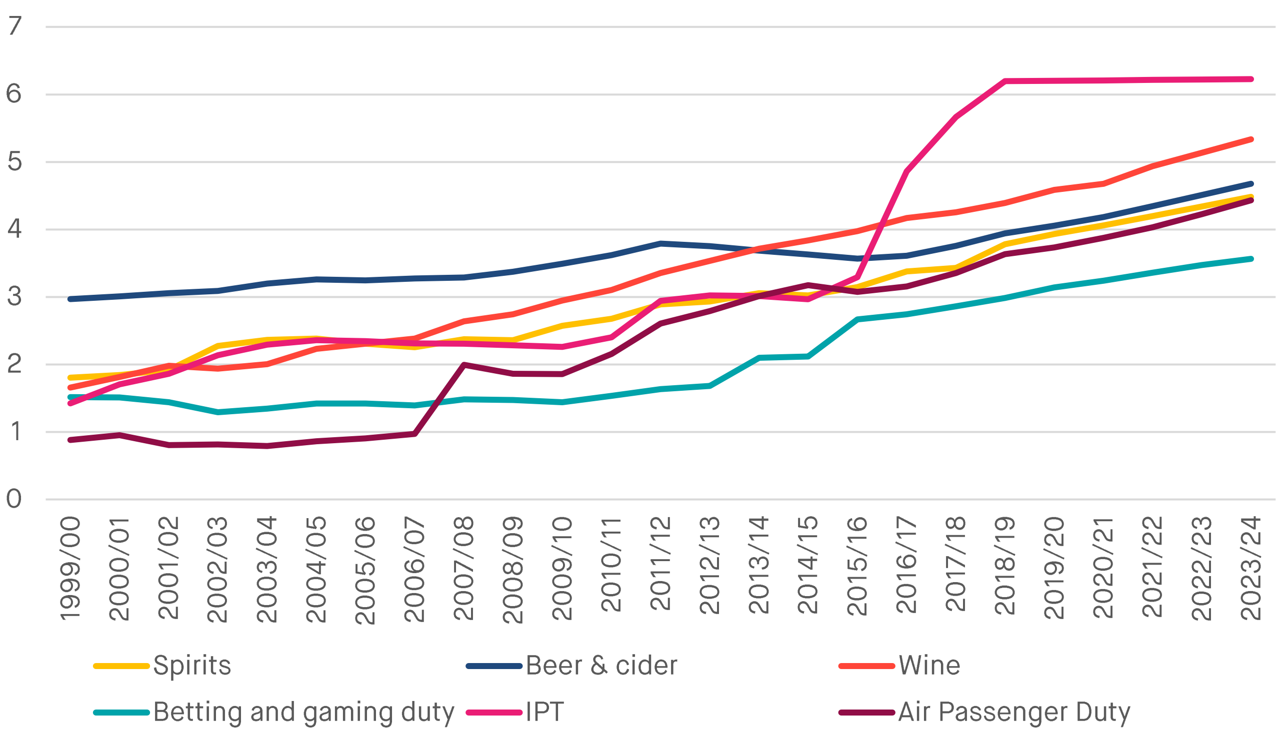
IPT accounted for 0.8% of government current receipts in the 2018/19 fiscal year, up from 0.4% in 1999/00.

Figure 2: Change in selected tax rates and duties since 1994. Index, October 1994 = 100



Sources: SMF analysis, HMRC

Figure 3: 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 have an impact on consumer behaviour and household finances. Most directly, higher rates of IPT translate into greater costs for households, which they either need to live with or mitigate through reducing their use of insurance products (if possible).

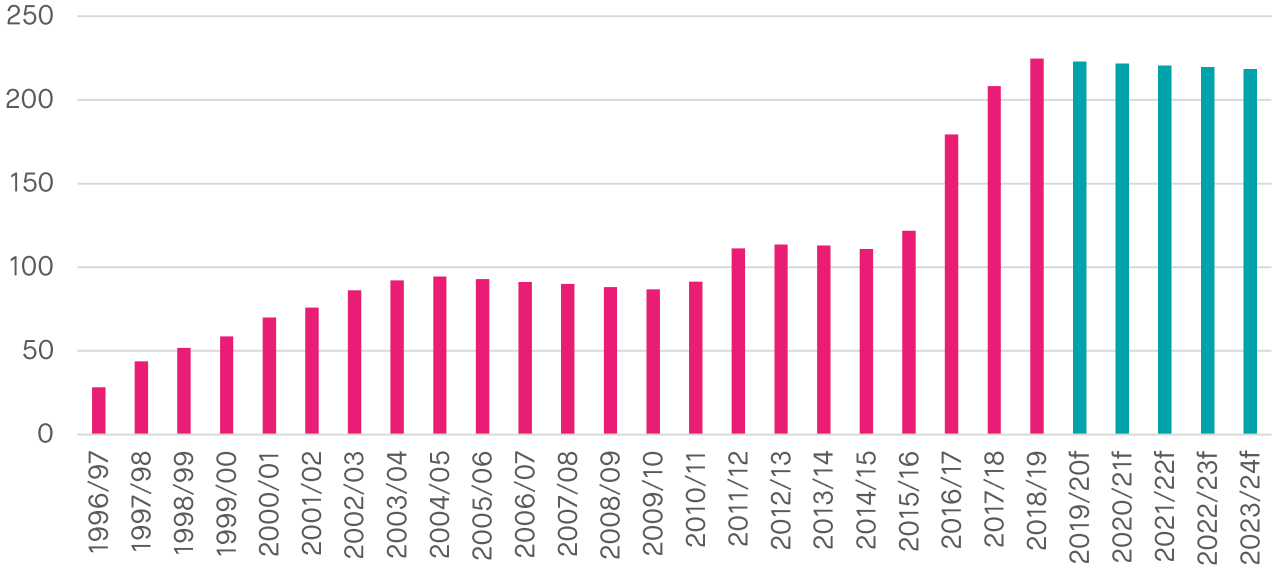
More indirectly, IPT affects households through its impact on businesses. Insurance products for businesses are also subject to IPT. Unlike VAT, the increase in insurance costs associated with IPT cannot be claimed back by businesses. Higher rates of IPT thus translate into lower net profits for businesses 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 to account for IPT, 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.[2] 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[3] – 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, is estimated to stand at £223 in the 2019/20 fiscal year – up from £87 in 2009/10. About half (48%) of this is paid directly by households on insurance products they buy, with the remainder paid by businesses (a significant portion of which is likely to be indirectly paid for by households). 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.

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 – such as the 'essential' nature of insurance products – we would expect a very high degree of pass-through for the tax.

Figure 4: IPT receipts (business and household) divided by the number of UK households



Sources: HMRC and OBR tax revenue data, ONS 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, 2019/20, we estimate that households are directly paying about £58 per year more as a result of higher IPT.[3] 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 £123. Cumulatively, over the five years 2019/20 to 2023/24 inclusive, these costs could be approximately £607 – some £17.1bn across all households.

This comes on top of the £428 cumulative extra costs faced per household between 2010/11 and 2018/19 inclusive, compared with the standard rate of IPT remaining at 5%. This amounts to £11.6bn across all households.

[3] 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.

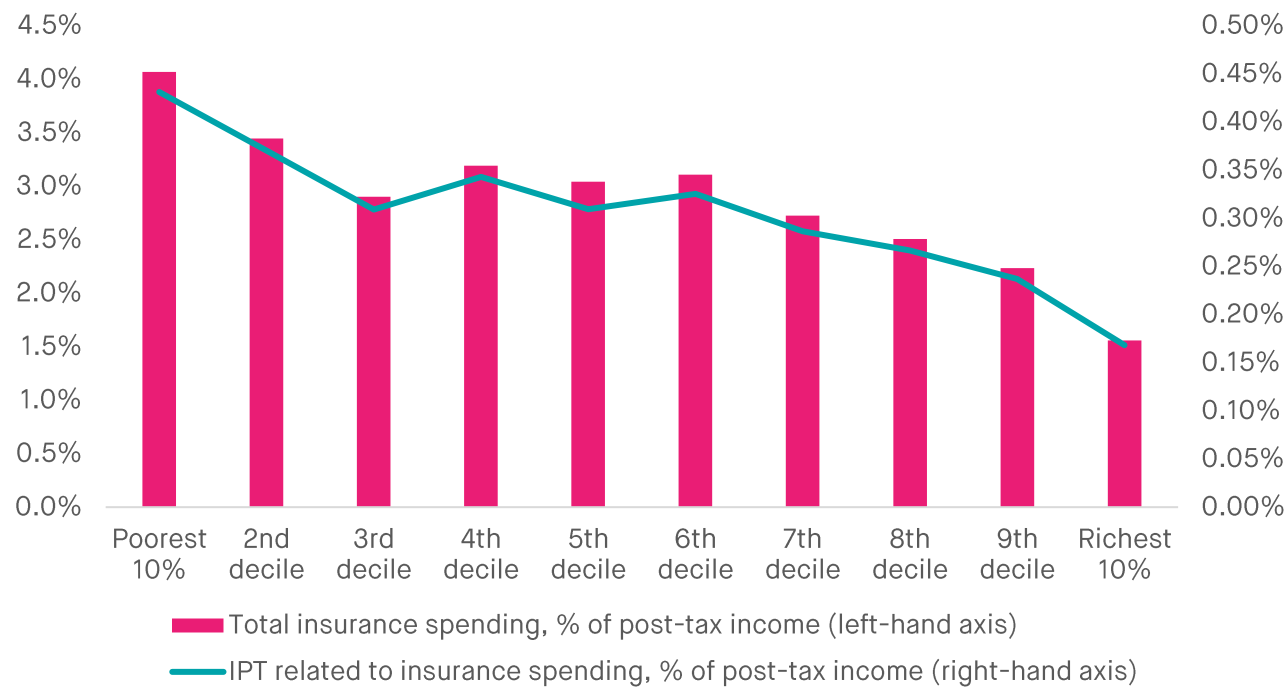
Distributional consequences of IPT

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.

By income group

Although higher income households spend more in absolute terms on insurance products than lower income households, our analysis of data from 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 income[4] on insurance (excluding life insurance, which is exempt from IPT) than the richest households. The lowest income 10% of households, in terms of disposable income, spent 4.1% of their post-tax income on insurance (except life insurance), compared with 1.6% for the highest income 10% of households. This is based on analysis of ONS Family Spending data covering the fiscal year ending 2018, and related to direct household spending on insurance (i.e. excluding business spending on insurance).

Figure 5: Proportion of household post-tax income spent on insurance (excluding life insurance) and IPT, by equivalised disposable income decile. Fiscal year ending 2018.



Source: ONS Family Spending dataset, Living Costs and Food Survey, SMF analysis

Table 3 below shows the extra spending on IPT directly paid by households, split by income decile – compared with a situation where the standard rate of IPT had remained at its pre-2011 rate of 5%. In the 2017/18 fiscal year – the latest year for which we have data split by income decile – the 12% standard rate of IPT is estimated to have cost the lowest income 50% of households about half a billion pounds in extra spending, compared with a situation where the standard rate of IPT had remained at 5%.

[4] Net of taxes and benefits

Table 2: Estimated direct household spending on IPT by equivalised disposable income decile in 2017/18

Income decile	Spending on IPT per household	Total spending on IPT by all households in group
1st (lowest income)	£40	£109mn
2nd	£63	£171mn
3rd	£64	£173mn
4th	£84	£229mn
5th	£90	£245mn
6th	£107	£290mn
7th	£108	£292mn
8th	£122	£331mn
9th	£135	£365mn
10th (highest income)	£160	£434mn

Source: ONS Family Spending dataset, Living Costs and Food Survey, SMF analysis

Table 3: Estimated extra spending on IPT by equivalised disposable income decile in 2017/18, compared with a situation where the standard rate of IPT had remained at 5%

Income decile	Extra spending on IPT per household	Total extra spending by all households in group
1st (lowest income)	£23	£63mn
2nd	£37	£99mn
3rd	£37	£100mn
4th	£49	£133mn
5th	£52	£142mn
6th	£62	£168mn
7th	£62	£169mn
8th	£70	£192mn
9th	£78	£211mn
10th (highest income)	£90	£244mn

Source: ONS Family Spending dataset, Living Costs and Food Survey, 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.[4] Having said that, some individuals might choose to be (illegally) uninsured in response to higher insurance costs. The Motor Insurers’ Bureau recorded over 26,000 personal injuries in 2018 involving uninsured drivers.[5]

ONS data suggests that expenditure on household insurance (appliances, contents and building) and motoring insurance – the two most “essential” types of insurance - accounted for 87% of total expenditure on insurance (excluding life insurance) among UK households in the 2017/18 fiscal year.

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.

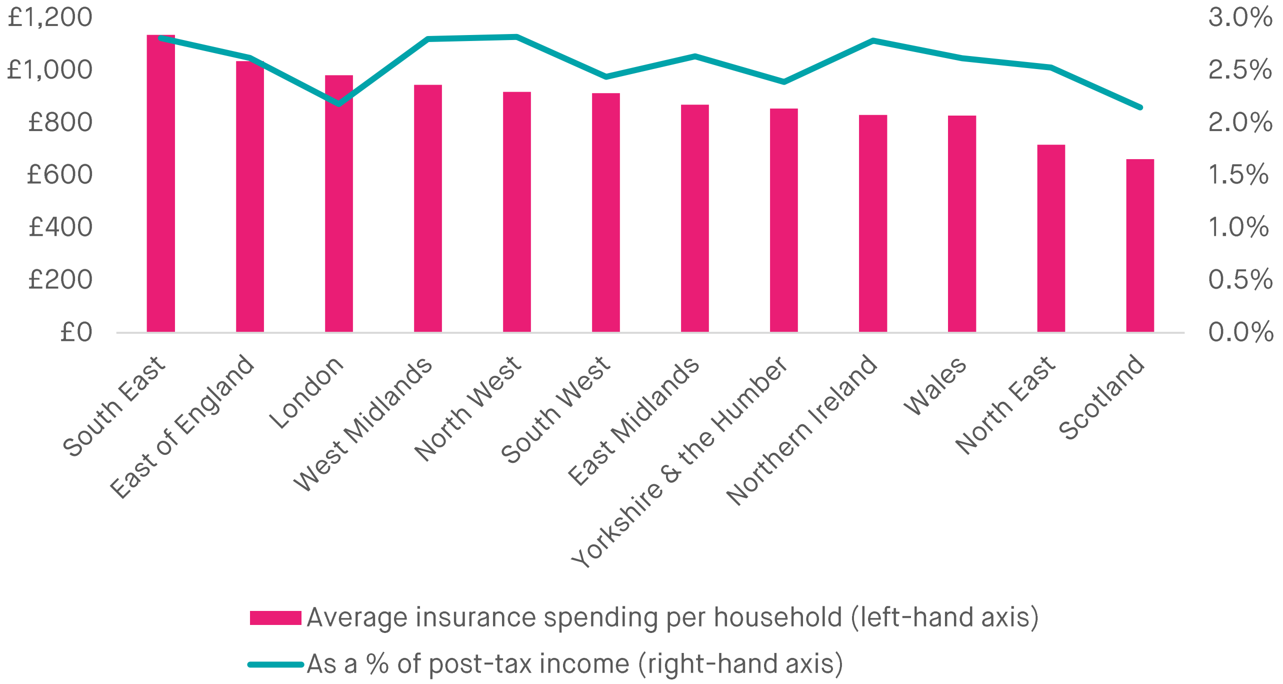
For example, those living in deprived areas may incur higher vehicle and housing insurance costs due to higher rates of crime. As the amount of IPT paid is a function of insurance costs, this can further contribute to a situation where those on lower incomes spend proportionately more on insurance.

By region

Another consideration is the impact of IPT across households in different regions of the UK.

Average annual household spending on insurance (excluding life insurance) is greatest in the South East of England, at about £1,140 per annum per household. Insurance spending is lowest in Scotland, at about £660 per annum. Despite such significant variation in cash spending on insurance, as a proportion of post-tax income difference are less marked, ranging from 2.15% in Scotland to 2.82% in the North West of England. This reflects differences in household income at a regional level; while regions such as the North East spend a relatively low amount on insurance, they also have lower average incomes.

Figure 6: Average household annual spending on insurance by region, cash terms and as a % of post-tax income



Source: ONS Family Spending dataset, Living Costs and Food Survey, SMF analysis

Tables 4 and 5 provide estimates of total spending on IPT by region, both in aggregate and compared with a counterfactual situation where the standard rate of IPT had remained at 5%. The extra annual costs, compared with a 5% standard rate of IPT, range from £41 per household in Scotland to £69 in the South East of England.

Table 4: Estimated household spending on IPT by region in 2017/18

Region	Spending on IPT per household	Total spending on IPT by all households in region
North East	£77	£88mn
North West	£100	£308mn
Yorkshire & the Humber	£94	£216mn
East Midlands	£94	£187mn
West Midlands	£103	£240mn
East of England	£112	£289mn
London	£106	£348mn
South East	£123	£448mn
South West	£100	£236mn
Wales	£89	£118mn
Scotland	£72	£173mn
Northern Ireland	£89	£70mn

Source: ONS Family Spending dataset, Living Costs and Food Survey, SMF analysis

Table 5: Estimated extra household spending on IPT by region in 2017/18, compared with a situation where the standard rate of IPT had remained at 5%

Region	Extra spending on IPT per household	Total extra spending by all housheolds in region (£ mn)
North East	£44	£50mn
North West	£56	£171mn
Yorkshire & the Humber	£51	£118mn
East Midlands	£54	£107mn
West Midlands	£57	£132mn
East of England	£63	£163mn
London	£61	£199mn
South East	£69	£251mn
South West	£55	£129mn
Wales	£51	£68mn
Scotland	£41	£98mn
Northern Ireland	£52	£41mn

Source: ONS Family Spending dataset, Living Costs and Food Survey, SMF analysis

APPENDIX: METHODOLOGY

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

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.

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 2019 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.

ENDNOTES

[1] https://www.ifs.org.uk/publications/8808
[2] https://www.gov.uk/guidance/insurance-premium-tax
[3] 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
[4] https://www.citizensadvice.org.uk/consumer/insurance/insurance/types-of-insurance/buildings-insurance/
[5] https://www.mib.org.uk/media-centre/news/2019/october/one-injured-every-20-minutes-police-launch-national-campaign-to-protect-the-public-from-uninsured-drivers/