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Forced Savings as an Option to Improve Financing of Long-Term Care

James Knickman
New York State Health Foundation
New York, NY

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Health Policy Institute
Georgetown University
3300 Whitehaven Street, Suite 5000
Washington, DC 20057
(202) 687-0880
hpi.georgetown.edu

Preface

At the same time we invest over \$200 billion in public and private resources in long-term care, dissatisfaction with our current public-private financing partnership is widespread. To promote a better partnership for the future, the Georgetown University Long-Term Care Financing Project examined options to move us from a partnership that consists primarily of out-of-pocket financing and last-resort public financing toward a partnership that spreads risk, supports access to quality care, and shares financial responsibility fairly among taxpayers and affected individuals and families.

To identify options, we invited experts to develop their own proposals for new ways to finance long-term care. We sought innovative ideas that varied in the nature of the partnership between the public and private sectors. This working paper is one of a set of eight proposals written for the project. These eight, plus an additional four proposals from other sources, are summarized and assessed in an overview paper, *Long-Term Care Financing: Options for the Future*, written by Judith Feder, Harriet L. Komisar, and Robert B. Friedland. The working papers and the overview can be found at: ltc.georgetown.edu. The Georgetown University Long-Term Care Financing Project is funded by a grant from the Robert Wood Johnson Foundation.

Judith Feder and Sheila Burke

Project Directors

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Introduction

The central conundrum in paying for long-term care is that most elders are not wealthy enough to afford the high service cost at the point in life when they require the service. To make service costs affordable, a blend of strategies is probably required. First, an insurance approach makes the costs more affordable because it spreads the risk of needing large sums of money to pay for services across elders who in fact use the service and elders who are fortunate enough never to require services. However, since the discounted present value of a comprehensive long-term care insurance policy can exceed \$30,000 when purchased at age 65 (per person), even sharing risk leaves many elders unable to afford the expected costs of their long-term care.

The high costs lead naturally to a search for mechanisms to spread the costs of insurance across the lifespan. One approach to doing this lifetime cost spreading is through public insurance where the younger working age generation pays taxes to fund the services of the older generation. A second approach is through individual savings accounts where people of one generation can save each year to ensure adequate resources to afford their own long-term care costs later in life.

This paper considers the second approach to lifetime cost spreading: individual savings accounts. However, the approach considered includes a strong public sector involvement in that a forced savings program is the

James Knickman, Ph.D., is president and chief executive officer of the New York State Health Foundation in New York, NY. At the time he wrote this paper, he was vice president for research and evaluation at the Robert Wood Johnson Foundation. This paper was written in 2003.

approach to pre-funding analyzed here. A forced savings program blends some of the strengths of a private orientation with some of the advantages of a public approach to financing. Forced savings clearly is a form of taxation since the individual has no choice but to save. However, the revenues raised by this form of tax would not be blended into one shared pot; rather each individual would have a distinct, identifiable account that included the actual dollars saved as well as investment returns related to the savings accrued in the account.

The forced savings approach gets around the problem that most voluntary savings programs (such as individual retirement accounts or IRAs) are used disproportionately by the wealthy who wish to take advantage of the tax break. And, the approach gets around the political problem of coming to a consensus that the current elderly should be further subsidized with yet more intergenerational transfers. Finally, the forced savings approach would provide individuals with some amount of choice about how they used their accrued resources after turning 65. While the money would have to be earmarked towards some strategy to pay for long-term care, flexibility about the type of insurance policy purchased could be provided.

How the Program Would Work

The approach suggested would take the form of a 1.5% payroll tax. Each year, 1.5% of total wages would be collected through the tax system (most likely as an add-on to the social security tax collection mechanism) and this amount would be paid 100% by the employee. The money raised through the payroll tax would be credited to a savings account in the individual's name and an annual statement of revenues and earned interest would be provided to the individual.

There would be no maximum on the revenue collected annually for each individual. However, a standard for "required long-term care resources" would be set and would be inflated each year based on inflation rates in the long-term

care insurance market (which should reflect service costs). The standard would reflect the expected costs of a comprehensive long-term care insurance policy that has a single premium payment at age 65. When an individual's savings account reached this resource standard, no further payroll taxes would be assessed to the individual. However, if long-term care inflation exceeded annual returns on the revenues in the savings account, the forced savings might need to be restarted from time to time.

One serious complication of the proposed program would be the treatment of spouses in a family. The proposed approach is that the 1.5% forced savings rate be applied to each spouse in the household and that the savings be required to continue for each spouse until the "required long-term care resources" are in the savings account of each spouse. For example, savings would continue for both a husband and wife until the total amount in the combined accounts of the husband and wife reach twice the resource standard. However, if a spouse's savings account has not reached the standard, the payroll tax continues for the spouse who has reached the maximum savings amount; the additional savings go to the spouse's account. Once the standard is reached for both spouses, the person is not likely to ever have to pay into the savings account again unless long-term care inflation rates exceed rates of return on the accrued savings. One related complicating issue is how to divide savings in the event of a divorce. The approach proposed here is that a couple that divorces splits the combined current savings in both accounts equally.

What happens if the 1.5% savings rate does not result in enough resources for a specific individual to purchase a comprehensive insurance policy at age 65? In fact, this likely will happen in well over half of all American households. The proposed policy strategy is to have the federal government supplement an individual's savings account at age 65 to bring the total up to the required resource standard. The public dollars necessary to do this would come from the \$65 billion currently paid annually by Medicaid programs across

the country. In essence, the forced savings program would make Medicaid long-term care largely unnecessary. One issue is whether the federal government should restrict the choice of long-term care policies selected by individuals who receive federal subsidy.

How are the savings treated in terms of taxation? The proposed approach has the following elements: 1) the savings collected through the new 1.5% payroll tax are not deductible on other forms of income tax (just as currently is the case for social security payroll taxes), 2) investment income on savings in the accounts would not be taxed, and 3) dollars used after aged 65 for approved long-term care financing purposes would not be taxed. If a person dies before using the accumulated resources, the following occurs: 1) the savings are transferred to the surviving spouse's savings account, 2) any savings not needed in the spouse's account gets taxed and then put into the estate applying the same rules that apply to IRA funds of deceased people.

Three other important policy issues are crucial to the design of the initiative: How are the savings invested? How much influence does each individual have in making investment choices? What constraints are there on the use of the accrued savings at age 65?

Transition Considerations

This program idea has substantial transition challenges. Most importantly, for many individuals currently in their 40s or 50s or 60s, adequate savings standards will not be reached unless the individuals have high current wages.

Despite these concerns, there seems to be little choice other than to recognize that people currently in their middle to older work years will need to supplement the revenues in their savings accounts with other resources to pay for long-term care. It would make sense for the market to develop some less expensive, less comprehensive insurance packages for individuals who are not

able or willing to supplement their forced savings during the transition years. These policies might focus on back-end, catastrophic coverage or front-end assistance with home care.

The idea of allowing people to supplement their forced savings rate with voluntary contributions to the fund also could be considered. However, if incentives to make voluntary contributions were set in place, such as tax deductibility, the issue of regressive impacts of such tax subsidies would need to be addressed. Another transition approach would be for the federal government to subsidize the premium for a modest insurance policy during the transition years. The amount of subsidy could equal the difference between accrued savings at age 65 and the cost of the specified insurance policy. Such a subsidy would be more progressive in terms of impact across income groups than tax deductibility approaches. It is possible that the subsidies could be offset substantially by future savings in Medicaid costs due to services paid for by the private insurance.

Concerning the simulation analysis, it probably would be too ambitious to consider the federal costs of alternative transition strategies. It seems best to focus this paper on the longer-term equilibrium impacts of the forced savings strategy. I am not exactly sure how the Lewin model handles this type of situation. In essence, my sense is that the “equilibrium” case would be to simulate the distribution of total savings in the accounts at age 65 for a cohort of individuals who enter the workforce at the base year of the simulation.

In addition, it would be interesting to see how long it takes for the transition period to be “mostly” ended. This could be done by comparing the distribution of forced savings for cohorts of individuals who start the simulation at different ages. For example, the simulation might show that 60% of the cohort of 50 year olds in 2003 reaches the “required long-term care savings” standard by time they turn 65 compared to 40% of the cohort that is 55 years old in 2003. Simulation insights about the trajectory of the transition

period would be useful for thinking about public policies that might help during the transition period.



Georgetown University Long-Term Care Financing Project
Working Papers

- No. 1 **Medi-LTC: A New Medicare Long-Term Care Proposal**
John Cutler, Lisa M. Shulman, and Mark Litow
- No. 2 **The Life Care Annuity: A Proposal for an Insurance Product Innovation to Simultaneously Improve Financing and Benefit Provision for Long-Term Care and to Insure the Risk of Outliving Assets in Retirement**
Mark J. Warshawsky
- No. 3 **Forced Savings as an Option to Improve Financing of Long-Term Care**
James Knickman
- No. 4 **Long-Term Care Policy Option Proposal: Consumer Controlled Chronic, Home, and Community Care for the Elderly and Disabled**
Marty Lynch, Carroll Estes, and Mauro Hernandez
- No. 5 **A Federal Catastrophic Long-Term Care Insurance Program**
Christine E. Bishop
- No. 6 **Linking Medicare and Private Health Insurance for Long-Term Care**
Anne Tumlinson and Jeanne Lambrew
- No. 7 **A Trade-Off Proposal for Funding Long-Term Care**
Yung-Ping Chen
- No. 8 **A Proposal to Finance Long-Term Care Services Through Medicare With an Income Tax Surcharge**
Leonard E. Burman and Richard W. Johnson

About the Project

The *Georgetown University Long-Term Care Financing Project* pursues analysis designed to stimulate public policy discussion about current long-term care financing and ways to improve it. The project is funded by a grant from The Robert Wood Johnson Foundation. More information about the project and other publications can be found at <http://ltc.georgetown.edu>.