

Deferring State Pension

PPI Briefing Note Number 4

Introduction

State pensions¹ become payable at age 65 for men and 60 for women. They can be deferred for up to 5 years, with an increment to the eventual income of one-seventh of 1% for every week deferred². From 2006, the option is planned to become more generous, with the enhancement increased to one-fifth of 1% for every week deferred. This means that after deferring for five years, someone who would otherwise receive a total state pension of £100 per week would receive instead £137 on the current basis and £152 on the proposed new basis³.

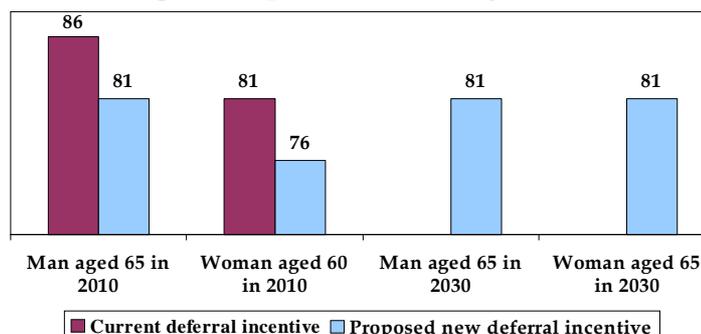
But how important is state pension deferral? Is the new option a good incentive? Will it work to encourage later, more flexible retirement?

How important is state pension deferral?

The deferral option is not widely publicised or recommended.

Fewer than 2% of new pensioners defer every year⁴. There is no available analysis on the characteristics of people who defer, but discussions with the Department for Work and Pensions (DWP) suggest that there are sub-groups with significantly higher rates of deferral, for example, 10% of women defer and 25% of pensioners living outside the UK.

Chart 1: Age to which a man age 65 or woman age 60/65 must live to gain from deferring state pension for 5 years



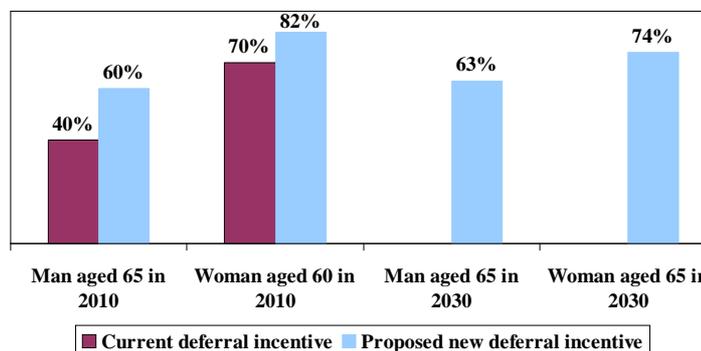
A surprisingly low number of people retire at the point when state pension becomes available. Only 10% of women and 17% of men stop work at state pension age (SPA)⁵, and after age 65 around 10% of people work.

There is no bar to earning while receiving state pension. Therefore, the only rational reason to defer would be that an individ-

ual thinks he or she is likely to live long enough for receiving the enhanced amount to be worthwhile.

There is no research on why people actually do defer. There is a strong hypothesis that people defer by accident, particularly women who assume that the start of their pension is linked to their husband's pen-

Chart 2: Probability of living to the age to which a man age 65 or woman age 60/65 must live to gain from deferring state pension for 5 years



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sion age, and overseas residents for whom the DWP may not have a correct address to send the notice about claiming pension at state pension age.

Are the proposed new deferral incentives attractive?

The PPI has analysed the deferral option from the point of view of an individual. The calculation identifies the breakeven age to which a person would have to live to make deferring the state pension, and then receiving the higher amount, more attractive than taking state pension at SPA and accumulating it in a building society account.

The analysis shows that the current deferral incentive is not particularly generous, especially for men. A man would have to live until age 86 and a woman to age 81 to benefit. The probability of doing so is 40% and 70% respectively (Charts 1 & 2⁶).

A man would have to live to 81 and a woman to age 76 for the proposed more generous deferral incentive to be worthwhile. This is obviously more likely, with probabilities 60% and 82% respectively. By the time the female SPA has equalised to age 65, say by 2030, a woman also has to live to age 81 and the probability of doing so is 74%. Although the probabilities are such that it is more likely than not that a person would live be-

yond the breakeven age, even the proposed more generous deferral incentive is not compelling.

Given that the benefit from deferring is small and depends on the unknowable of age at death, people may still prefer to take the pension at SPA, and bank it to secure some return, knowing that they can pass the money on if they die in the deferral period.

The deferral incentive gives an extra tax break to higher rate taxpayers who would like to carry on earning after SPA in a 40% tax band, but would prefer to take state pension later when in a lower tax band. On the proposed more generous basis, the breakeven age for men reduces to 79 (67% survival probability) and for women to age 74 (86%).

It is also proposed that the maximum period of deferral be removed. A longer deferral means a higher breakeven age is required which has a lower probability of being achieved. A lump-sum alternative is also suggested, which may sound more attractive. However, if the lump-sum simply reflected the value of pension payments foregone, an individual may still prefer to take the pension at normal age and invest it in case of death before claiming.

Encouraging later, flexible retirement

Making the deferral of state pen-

sion more generous does not give a particularly attractive incentive, and it does not give any more retirement flexibility. The state pension system puts no restriction on an individual's retirement age, and the restrictions from the private pension system will be removed by other proposals in the Green Paper.

As so few people know about the deferral option, it is no doubt intended to publicise the new incentives. The extra publicity could mean more people think about deferring.

However, it is not proven that even the enhanced deferral incentive will impact retirement behaviour. It is therefore questionable whether the extra publicity cost would be worthwhile as a way of encouraging working at older ages.

Raising state pension age for everyone would be a far more powerful signal that working later is expected. It would also release resources to improve state pensions for everyone; whereas only higher rate taxpayers gain most from the deferral proposals.

¹Someone reaching State Pension Age now could have state pensions from 4 sources: Basic State Pension, Graduated Retirement Scheme, State Earnings Related Pension and State Second Pension. All or none can be deferred.

²Department for Work and Pensions (2002) *Simplicity, security and choice: Working and saving for retirement* Green Paper

³DWP (2002) Green Paper p. 102

⁴HM Treasury (2002) *United Kingdom National Strategy Report on the Future of Pension Systems* p. 16

⁵Smeaton D, McKay S. (2003) *Working after State Pension Age: Quantitative Analysis* DWP Research Report 182. SPA is currently 60 for women and 65 for men.

⁶PPI analysis using the latest Government Actuary's Department cohort-based mortality rates and assuming deferral for 5 years, pension indexation at 2.5% per year and building society returns of 4% per year, which is around the best current rate for notice accounts.

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