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The gain from deferring state pensions

Introduction

Deferring state pensions was the subject of PPI Briefing Note Number 4 in September 2003 (BN4). Since then, the Pensions Bill 2004 has passed the proposed improvement in deferral into law.

This Briefing Note updates the analysis in BN4 on the benefit of deferring state pensions: not the actual lump sum promised by government, but that amount compared to building up a lump sum yourself.

How deferral works

State pensions become payable at age 65 for men and 60 for women. They can be deferred, with some restrictions.

The changes from April 2005 make deferral more generous, and give more options:

1. Pension can be deferred for as long as the individual wishes.
2. When the pension starts to be paid again, the amount will be the then prevailing level of pension enhanced by one-fifth of 1% for every week deferred.
3. Instead of taking an enhanced pension later, a lump sum can be chosen. The lump sum will be paid when pension payments start to be made again (at the then prevailing level of pension). The lump sum will be calculated as if the pension not taken was invested in an account earning interest at the Bank of England Base Rate plus 2% pa.

Likely gain from lump sum deferral option before tax

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State pension £ per week (average for new pensioners)	Years deferred	Lump Sum from Government (current base rate 4.75% plus 2%)	Lump sum from taking the pension and saving it (at 5.25%)	Actual gain
£71 (women)	5	£21,841	£21,040	£801
£105 (men)	1	£5,646	£5,603	£43
	2	£11,673	£11,500	£173
	5	£32,306	£31,115	£1,191
	10	£77,090	£71,301	£5,789

How much is deferral worth?

Government literature focuses on the amount of the lump sum obtainable, or the level of the enhanced pension available.

For example, Government figures suggest under the heading *Benefits of deferring State Pension* that *...a typical person who delays their State Pension for five years could receive a payment of £20,000 to £30,000.*[1]

But this is only one half of the equation. Instead of deferring, the pension could instead be taken and put in a savings account, where the pension payments would accumulate to a lump sum. The actual benefit of deferring is the lump sum available from the government less the amount accumulated by taking the pension and saving it.

Take the example of someone with a state pension of £105 a week who defers for five years. Ignoring tax, the government's lump sum would be £32,306. If instead the pension was taken and invested in not quite the best current rates for an internet no-notice account, the accumulation would be £31,115. The actual gain before tax would therefore be £1,191 (Chart 1).

The lump sum option has an incentive built in the interest margin in addition to the Base Rate. There is no such obvious incentive for the option of deferring and then taking an enhanced pension. Whether it turns out to be a good deal depends on whether an individual lives long enough to receive more in deferred, enhanced pension than he or she would have done taking an unenhanced pension immediately (as BN 4 explained). Taking the pension and saving at a good rate of interest can be better, and more flexible.

The tax advantage
People who want to carry on working after state pension age do not have to defer. State pension can be taken from state pension age (SPA) whether or not the individual is working. Deferral is linked to working because of the potential tax advantage.

Whenever the state pension is taken, it is taxed at the appropriate rate for the individual in the year in which it is received. Tax can be saved if an individual's tax rate was higher while the person was working (and earning) than it is after stopping work. A deferred pension, or lump sum, taken after stopping work and dropping down a tax band will then attract a lower rate of tax.

The likely tax advantage from the deferral lump sum option is for those who would pay tax at 40% before SPA but who would pay tax at 22% on the deferred lump sum from the government (Chart 2). In this case, the actual net gain from the average pension of £105 deferred for 5 years would be £7,477.

Possible tax-advantaged gain from deferral

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State pension £ per week (average for new pensioners)	Years deferred	Lump Sum from Government (current base rate 4.75% plus 2%; taxed at 22%)	Lump sum from taking the pension (taxed at 40%) and saving it (at 5.25% taxed at 40%)	Actual gain
£71 (women)	5	£17,036	£11,980	£5,056
£105 (men)	1	£4,403	£3,327	£1,076
	2	£9,103	£6,759	£2,344
	5	£25,194	£17,717	£7,477
	10	£60,118	£38,406	£21,712

Other factors
Other issues to allow for in assessing the value of deferral include how big the pension is and what might happen on death while the pension is deferred.

Amount of pension
£105 is around the average weekly state pension (basic plus additional) received by men aged 65 currently. The average state pension among women aged 60 is £71 a week[2]. The net gain from deferring will be proportional to the amount of state pension; so the average woman can gain around £801 from the lump sum option with no tax advantage if she defers 5 years, or £5,056 with the likely tax advantage.

Risk of dying
If someone deferring their state pension dies, the widow or widower may receive the enhanced pension or the lump sum. The rules depend on how long the pension had been deferred. But for someone with no spouse, the deferred pension does not form part of the estate. If instead, the pension is accumulated by the individual in a savings account, it would fall into his or her estate.

Conclusion
The deferral option may be attractive to some individuals who can afford to receive their state pension later.

It is not necessarily linked to carrying on working after state pension age, but it is more valuable for those who go into a lower tax bracket after they finish work a year or more after state pension age.

The potential net gain from the lump sum option is around £800-£1,000 with no tax advantage or £5,000-£7,500 with the likely tax advantage.

1 Department for Work and Pensions (DWP), *Five Year Strategy*, February 2005; DWP Press Release 2 February 2005; Advice pages on Pensions Service website. These Government examples of the deferred lump sum ignore the inflation-linked increase in state pension from year to year. For consistent comparison, all the worked examples in this note also ignore inflation.
2 DWP *State Pension Summary of Statistics*, September 2004

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