ROYAL LONDON POLICY PAPER 33

Are hundreds of thousands of people making a mistake by drawing their state pension too soon?

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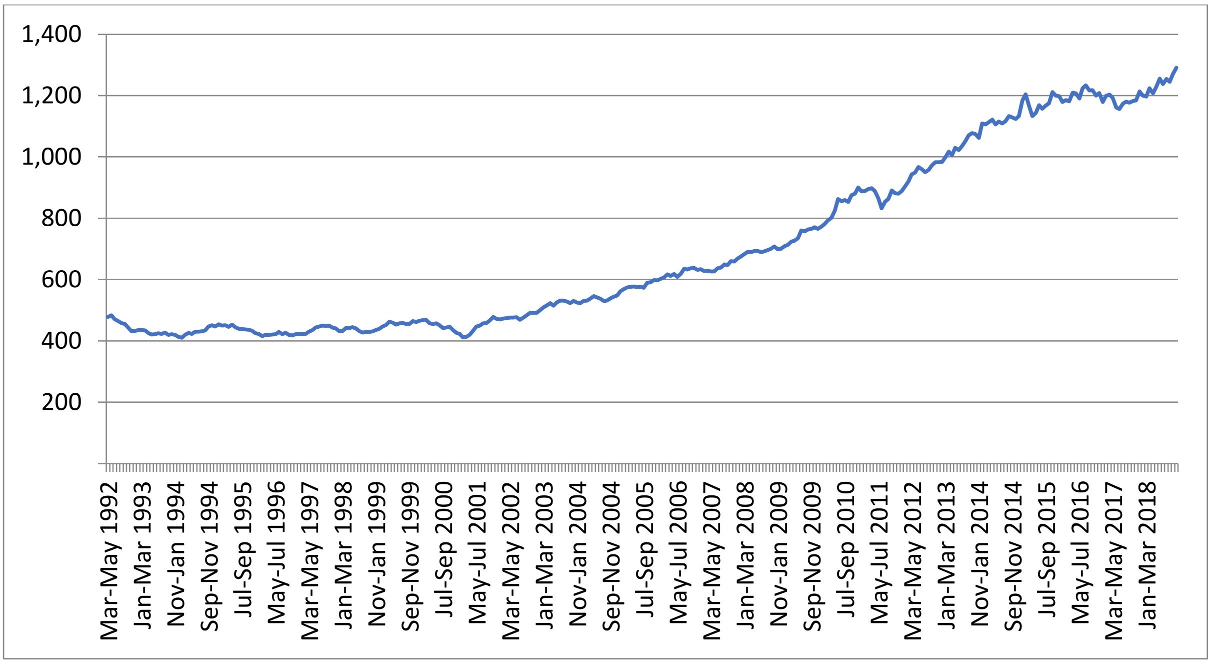
Are hundreds of thousands of people making a mistake by drawing their state pension too soon?

1. Introduction

One of the most dramatic trends in the UK Labour market in recent years has been the growth in the number of people working past traditional retirement ages. As Figure 1 shows, the number of people aged 65 in employment or self-employment has more than trebled since the turn of the century.

Figure 1. Number of people (thousands) aged 65 or over in employment / self-employment 1992-2018



Source: Labour Force Survey[1], successive quarters.

Throughout the 1990s, the number of over 65s in employment was relatively stable, fluctuating between around 400,00 and 500,000 at any point in time. But from the turn of the century the numbers started to rise dramatically, pausing only during the recession which followed the global economic crash in 2008. In the final quarter of 2018 there were 1.29m over 65s in work, compared with just 411,000 in the Spring of 1994, a threefold increase in a quarter of a century.

1 https://www.ons.gov.uk/file?uri=/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/employmentunemploymentandeconomicinactivitybyagegroupseasonallyadjusteda05sa/current/a05safeb2019.xls

What has been little studied to date however is the extent to which these workers are combining their income from employment or self-employment with receipt of a state pension. There is no requirement to be 'retired' to draw a state pension and it is therefore possible to draw a state pension as soon as you reach state pension age, whether or not you are also in paid work.

But it is not obligatory to draw a state pension as soon as you reach state pension age. In fact, it is possible to defer drawing a state pension and instead receive an enhanced state pension when you do start to take it. Although the reward for deferral is less generous than it was under the pre April 2016 state pension system, it remains the case that individuals who are considering working on past 65 can decide whether or not to combine their earnings and a state pension or to finish working first and then draw an enhanced state pension.

One of the main reasons for deferring taking a state pension would be taxation. In brief, both earned income and state pensions are taxable. Whilst each individual has an annual tax-free personal allowance, anyone combining earnings and a state pension will in most cases have income above the level of the personal allowance and will be paying income tax. This suggests that there may be a case for considering deferring taking a state pension for as long as you have significant earned income coming in, and then drawing a larger state pension when you actually retire, with more of that pension covered by your tax free personal allowance. But little research has so far been undertaken on whether people are in fact doing so or on whether it would be advisable for them to do so. This paper aims to shed light on this issue.

In the first part of this paper we use the Labour Force Survey to find out a bit more about the people who are working on past age 65. Next we combined this information with data from the Family Resources Survey to look at how far those in work past 65 are also drawing a state pension. Finally we look at the personal finance implications of combining a state pension with earnings compared with deferring taking a state pension.

2. Who are the people working past 65?

The largest, and most robust, survey of the working population is the Labour Force Survey. Here we examine data from the first quarter of 2017, which includes information on more than 88,000 people of all ages. We focus in particular on adults aged 65 or over who are still in work.

Table 1 shows the gender split of those in work aged 65 or above, dividing them into those working full-time and those working part-time.

Table 1. Workers aged 65 or over in Q1 2017, by sex and whether working full-time or part-time

Category	Number of people
Men – working full-time	306,000
Men – working part-time	389,000
Women – working full-time	99,000
Women – working part-time	338,000
All 65+ in work	**1,132,000**

Source: Royal London calculations based on 2017 Q1 Labour Force Survey

As Table 1 shows, in the first quarter of 2017 there were just over 1.1m people aged 65 or over who were in paid work, and just over three fifths of those were men. Amongst men there is a fairly even split between full-time and part-time work, though with a slight weight towards part-time work. But for women – who at this point would have been working well beyond the historic state pension age of sixty – the large majority are working part-time.

The split between full-time and part-time work is particularly relevant for our later discussion of the extent to which those who are working are likely to be in the income tax net and of the merits (or otherwise) of combining earnings with state pension.

Table 2 shows the age and gender split of those working past pension age.

Table 2. Workers aged 65 or over in Q1 2017 by sex and age group

Age Group	Male	Female	Total
65-69	413,000	280,000	694,000
70-74	200,000	121,000	321,000
75+	82,000	36,000	118,000
All 65+ in work	**696,000**	**437,000**	**1,132,000**

Source: Royal London calculations based on 2017 Q1 Labour Force Survey. Note that rows and columns may not sum exactly due to rounding

Given the historic differences in state pension ages between men and women, it is perhaps not surprising that there are more men than women still in work beyond the age of 65. But the table shows a surprising number of people aged 70 and above still in work – around 439,000 – and over a third of these are women. The relevance of this data is that one consideration in state pension deferral is how many years you expect to receive the pension when you do finally take it. We will not be suggesting that those who are working into their late 70s should defer taking their pension as it is unlikely they will be in receipt for long enough to recover the missing years of pension, even if they eventually receive a much higher amount.

3. Are people working past 65 taking their state pension?

Although the Labour Force Survey has the most robust data on the workforce, it has rather limited income information. The data source used by the DWP to construct income distribution statistics is the Family Resources Survey. Although this is a somewhat smaller survey, it does contain very detailed and reasonably robust data on sources of income, so it is to this survey that we turn to look at the interaction between later life working and state pensions.

The latest year of FRS data which is available at time of writing is for the financial year 2016/17. Note that the LFS data is for Q1 2017 whereas the FRS data is for the calendar year 2016/17. As employment rates amongst older workers have been rising steadily we would expect slightly higher figures in the LFS data than in the FRS data and that is indeed what we find. But in both cases we are estimating around 1.1m workers aged 65 or over.

Table 3 shows the number of workers aged 65 or over who are drawing a state pension, split by whether they are earning above the tax threshold or below.

Table 3. Workers aged 65 or over by a) receipt of state pension and b) taxpayer status – 2016/17

	Not on state pension	On state pension	Total
Over tax threshold	119,000	523,000	642,000
Under tax threshold	12,000	427,000	439,000
ALL workers aged 65+	131,000	950,000	1,081,000

Source: Royal London calculations based on 2016/17 Family Resources Survey. In 2016/17 the income tax threshold was £11,000 per year. Those over the tax threshold exceed this figure purely on the basis of their earnings, self-employment profits and/or occupational pension income. This does not include the value of their state pension.

The first column of results in Table 3 shows that there are 131,000 people aged 65 or over who were not drawing a state pension. In a small number of cases this could be because they do not qualify for a state pension, perhaps because of a seriously deficient record of National

Insurance Contributions. This might be the case if they entered the UK relatively late during their working life. But in the large majority of cases this is likely to be because they have chosen to defer taking a state pension.

The second column of results shows the perhaps surprising result that nearly one million people over state pension age, including more than half a million earning over the tax threshold, are also drawing a state pension. For reasons we discuss in the next section, this is a decision that they may wish to review.

4. Deferring the state pension – how does it work, and is it worthwhile?

It has been a longstanding feature of the state pension system that it is not obligatory to take your state pension as soon as you reach state pension age. Indeed, it is often not understood that state pension only starts to be paid when an active claim is made. Whilst individuals are generally warned around three months before state pension age that they may wish to make a claim, they are not required to do so.

Until the state pension reforms of April 2016, deferral was actively encouraged by the government. Individuals who deferred their state pension had two options when the time came to take their pension. The first was to take all of the pension payments that they had foregone in the form of a lump-sum, with a small amount of interest. The other alternative was to draw a regular state pension at a significantly enhanced rate. Under the old rules, each year of deferral meant that the pension would be paid at a rate 10.4% higher when it was finally drawn. This meant that even those with average life expectancies could expect to be net winners over their lifetime by deferring taking their state pension.

In April 2016, two major changes were made.

The first was to abolish the option of taking deferred pension as a lump sum. It was felt that this over-complicated the system (as the relative advantage of taking a lump sum over taking an enhanced pension could fluctuate over time depending on interest rates) and also that individuals who wanted a lump sum could simply take their pension and save it up for themselves if they could do without it for a period.

The second change was that the 'reward' for deferring was reduced. Rather than a 10.4% enhancement for each year of deferral, the increase is now 5.8%. This is regarded by the Government Actuary as being broadly 'neutral' in the sense that (ignoring taxation) the Exchequer is largely indifferent over time as to whether people take their pension at pension age or defer it.

However, because state pensions count as taxable income, it is important for those who are still in work past state pension age to consider carefully whether taking a state pension as soon as it is possible to do so is the best idea.

To illustrate this point, we consider two scenarios.

Case Study A: Individual with no other income in retirement except state pension

We consider first an individual who is currently in full-time work and who works on for one year past state pension age. Our data suggests that in 2016/17 the average full-timer aged 65 or over was earning a little over £24,000 per year. We assume that in round numbers this would now be around £25,000. In 2019/20 the tax-free personal allowance is £12,500 and the full flat rate state pension is £8,767.

This person has two options – to draw his/her state pension immediately at state pension age[2] or to defer taking their state pension until they stop work in a year's time. In the former case, the state pension will be added to their wages. Since the wage will more than exhaust the annual tax-free personal allowance, **the whole of the state pension will be subject to income tax at 20%**. In the latter case, a higher rate of state pension is payable (because of deferral) and no tax is paid (because the individual has no other taxable income once they stop work).

The impact on their total retirement will depend on how long they live, and on average this will be longer for women than for men. ONS estimates suggest that a typical 65 year-old male will live for 21 years and a typical female for 23 years[3].

The next two boxes show the outcome for a male and for a female with average life expectancy at 65. (To reduce complexity we ignore future indexation of the state pension and of the increment to the state pension for deferral).

Scenario A1. Male, takes state pension immediately, lives for 21 years

- Total state pension: Standard rate of £8,767 x 21 years = £184,107
- *Minus* Tax on state pension in year 1 = £8,767 @ 20% = (£1,753)
- Net income over retirement = £182,354

Scenario A2. Male, defers state pension one year, lives for further 20 years

- Total state pension: Enhanced rate of £8,767 x 1.058 x 20 years = £185,510
- Tax on state pension: Zero = £NIL
- Net income over retirement = £185,510

Gain from Deferral (Male) £3,156

[2] State pension ages for men and women are now gradually rising, but for simplicity we assume a pension age of 65. This does not affect the argument.
[3] See: https://www.ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/healthandlifeexpectancies/articles/whatismylifeexpectancyandhowmightitchange/2017-12-01

Scenario A3. Female, takes state pension immediately, lives for 23 years

- Total state pension: Standard rate of £8,767 x 23 years = £201,641
- Tax on state pension in year 1 = £8,767 @ 20% = £1,753
- Net income over retirement = £199,888

Scenario A4. Female, defers state pension one year, lives for further 22 years

- Total state pension: Enhanced rate of £8,767 x 1.058 x 22 years = £204,061
- Tax on state pension: Zero = £NIL
- Net income over retirement = £204,061

Gain from Deferral (Female) £4,173

In both cases, this person is several thousand pounds better off over the course of their retirement if they defer taking their pension for a year until they have stopped work. The man benefits to the tune of just over £3,000 and the woman by just over £4,000. In both cases there is a tax saving of £1,753 because the state pension is never subject to income tax (it is not drawn until there is no other taxable income and it falls beneath the personal allowance). However the woman gains more than the man because she has two extra years during which the enhanced rate of state pension for deferral is paid.

Case Study B: Individual with typical occupational pension of £8,000 pa

Next, we consider the case of someone who starts to draw an occupational pension at age 65. The DWP 'Pensioner Income Series' gives the median figure for those in receipt of an occupational pension as £161 per week, which we round to £8,000 per year. The significance of this is that the retired person will end up paying some tax on their retirement pension because the combination of their occupational pension and their state pension takes them above the £12,500 personal tax allowance. This means that the saving from deferral will be smaller than in the first case study.

We repeat our calculations from Case Study A, but now taking account of the occupational pension.

Scenario B1. Male, takes state pension immediately, lives for 21 years

- Total state pension: Standard rate of £8,767 x 21 years = £184,107
- *Minus* Tax on state pension in year 1 = £8,767 @ 20% = (£1,753)
- *Minus* Tax on state pension in years 2-21 = £4,267 @ 20% x 20 = (£17,068)
- Net income over retirement = £165,286

Scenario B2. Male, defers state pension one year, lives for further 20 years

- Total state pension: Enhanced rate of £8,767 x 1.058 x 20 years = £185,510
- *Minus* Tax on state pension in years 2-21 = £4,775 @ 20% x 20 = (£19,100)
- Net income over retirement = £166,410

Gain from Deferral (Male) £1,124

Scenario B3. Female, takes state pension immediately, lives for 23 years

- Total state pension: Standard rate of £8,767 x 23 years = £201,641
- *Minus* Tax on state pension in year 1 = £8,767 @ 20% = (£1,753)
- *Minus* Tax on state pension in years 2-23 = £4,267 @ 20% x 22 = (£18,775)
- Net income over retirement = £181,113

Scenario B4. Female, defers state pension one year, lives for further 22 years

- Total state pension: Enhanced rate of £8,767 x 1.058 x 22 years = £204,061
- *Minus* Tax on state pension in years 2-23 = £4,775 @ 20% x 22 = (£21,010)
- Net income over retirement = £183,051

Gain from Deferral (Female) £1,938

The key difference in Case Study B is that the individual is already using up £8,000 of their £12,500 tax-free personal allowance because of their occupational pension. This means that only the remaining £4,500 is available to shield their state pension against tax, so the potential upside to deferral is smaller. Nonetheless, by deferring, the individual still ends up £1,124 better off if they are a male with average life expectancy and £1,938 if they are a female.

Other factors affecting the size of the gain to deferral

a) High earners / low earners

The majority of people working past pension age will be standard rate taxpayers – if they pay tax at all. However, very roughly 1 in 10 appear to be paying tax at the higher rate. For these people, the case for deferral becomes much stronger. This is because if their wage exhausts not just the personal allowance but also the basic rate band, then the whole of their state pension in year one would be taxed at 40%. Avoiding this could save several thousand pounds in tax.

On the other hand, we noted earlier from the Labour Force Survey that around half of those working past pension age are doing so part-time. If they are earning a very low wage – less than around £3,700 per year – then even combining this income with a state pension will not draw them into the tax bracket overall. For these people, there is no tax advantage to deferring.

b) Length of deferral

To keep things simple, we have assumed that the individual works for one year past pension age and then stops work. Clearly, if they were to work for two years past pension age and defer their state pension for two years then the tax savings from deferral would double. However, they would have one less year after retiring in which to enjoy the benefits of deferral in terms of a higher pension rate, and this would partially offset the benefit from deferring for longer[4].

c) Health / life expectancy

Our worked examples so far have assumed average life expectancy for men and for women. But the actual benefit to someone from deferring will depend on their own individual life span. Someone who defers but then only draws their enhanced pension for a few years will never make up for the initial period when they drew no pension. Conversely, someone who has a long retirement will have extra years in which to benefit from the enhanced rate of pension and will win out overall. As we have seen, for this reason, on average women will tend to do better than men from deferral.

It is possible that – on average – the sort of person who is fit and healthy enough to go on working past state pension age will have a greater-than-average life expectancy, given that the average will also reflect people who were in poor health who had to drop out of work long

[4] In the extreme case, if someone were, hypothetically, to work on for 21 years after pension age (for a man) and defer their state pension for the whole period, they would save significantly on their income tax bill, but would on average never get to draw their state pension at all and so would lose out overall.

before pension age. But averages are only going to be a rough guide and each individual may wish to take account of information that they have about their own health before deciding whether or not to defer.

5. Conclusions

The growth in the number of people working past the age of 65 has been very dramatic in recent decades and shows no sign of abating. Indeed, as state pension ages increase for both men and women and as more people reach pension age with limited access to generous final salary pension schemes, we may see still more people working on into their late sixties and beyond.

This paper has highlighted the fact that these individuals face a choice as to whether or not to take their state pension as soon as possible, alongside their income from paid employment. As both sources of income are taxable, those with meaningful amounts of earned income could find that they pay extra tax on their state pension compared with those who defer taking their state pension until they have more unused tax free personal allowance to set against it.

Some individuals are clearly aware of this issue and have chosen to defer taking their state pension. But our analysis also finds that there are several hundred thousand full time workers who have not deferred taking their state pension and who appear to be paying more tax than they need to on their state pension.

For those who are already drawing their pension, all is not lost. It is possible to 'unretire' in the sense of telling the DWP that you no longer wish to draw your state pension. You can then resume taking your pension at a later stage with the benefit of an enhancement for deferral.

But perhaps more importantly, for those coming up to state pension age, DWP needs to do far more to alert people to their option to defer and the potential benefits to them of doing so. Without this, hundreds of thousands of people will continue to pay more tax on their hard-earned state pension than is necessary.