UK Allows State Pension “Top Up”

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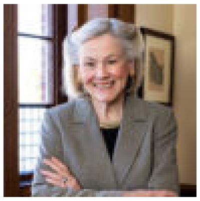

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Allowing people to buy additional Social Security benefits might be a good use of modest 401(k) balances.

The United Kingdom (UK) recently increased the Basic State Pension, but only for those born after April 6, 1951 (for men) and April 6, 1953 (for women). It has introduced a small, time-limited initiative that allows those born before the cut-off to “top up” their basic state pension by buying additional units of income with lump-sum payments. While the program is small, the notion is interesting. Should our Social Security system get into the annuity business?

Here’s my understanding of the story. The current State pension has two tiers. The *Basic State Pension* historically has provided £113.10 per week for those who have paid their required contributions. This amount has historically fallen below the poverty line, so many people were eligible for a means-tested top-up to the poverty line. The second tier is the *Additional State Pension*, which is partly earnings-related.

Policymakers were concerned that the top-up to the Basic State Pension discouraged saving, so in 2013 the government introduced a new pension of

£144 per week for those reaching pensionable age after April 6, 2016 and who had contributed 35 years.

Those born before April 6, 1951 (for men) and April 6, 1953 (for women) will not be eligible for the new pension. Concern for these excluded workers led the government to introduce a new program whereby individuals could add as much as £25 per week – inflation-proofed and 50 percent to the surviving spouse – to their pension by making lump-sum payments to the state. The window for buying this extra pension will start October 2015 and run for 18 months.

To avoid placing a burden on today's national insurance contributors, the cost of the top-up will be calculated on an actuarially fair basis. As such, the cost will decline with the age of the contributor. For example, the cost of an additional pound per week for those age 65 is £890, for those age 70 £779, and for those age 75 £674.

On the other hand, pension experts say these rates are about half the cost of buying an inflation-linked, joint-and-survivor annuity in the private market. For a 65-year-old, buying £25 a week would cost around £44,500, instead of £22,250 (£890 x 25) through the new government offer; the comparable annuity rates are 2.9 percent for the private market and 5.8 percent for the new government offer.

The government says that these top-ups could be very beneficial for women and for the self- employed who have not done well under the Additional State Pension and have not previously been able to top these up. The offer also should be more attractive to women than to men because prices are gender neutral and women on average live longer than men.

An online poll of 2,000 people at or close to the pensionable age showed that 20 percent were either "very" or "fairly interested" in taking up this offer, with those age 65-70 more interested than those over 70. It will be fascinating to see what the actual take-up turns out to be, given that people are generally very reluctant to turn over piles of cash for streams of income. Also, many people don't have a spare £22,250 laying around. I think that the primary purchasers may turn out to be wives in high-income couples.

The UK government denies it is getting into the annuity business. In an answer to a question on this topic, the UK Pensions Minister said: "I have been asked to stress that this is not an annuity; this is national insurance paying for an additional state pension." But it's pretty hard to get around the fact that the government is providing the opportunity to purchase an inflation-adjusted joint and survivor annuity.

The question this initiative raises in my mind is whether the U.S. Social Security Administration should be allowed to provide actuarially fair annuities. That is, SSA could allow individuals to purchase (perhaps up to some limit, such as $250,000) larger Social Security benefits, which would be equivalent to providing inflation-adjusted annuities. Such an arrangement might be a great way for people to apply their modest 401(k) balances.