ROYAL LONDON POLICY PAPER 29

What will be the impact of the April 2019 step-up in automatic enrolment contribution rates?

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What will be the impact of the April 2019 step-up in automatic enrolment contribution rates?

1. Introduction – Automatic Enrolment, staging and phasing

Since 2012, the UK has seen a transformation in the world of workplace pensions. More than one million employers have enrolled around ten million employees into a workplace pension with a legal duty on the employer to choose a scheme and to make a contribution. Rather than a 'big bang', this programme has been introduced gradually in two important respects;

A) Employers have been 'staged' into the programme according to their size, with the largest firms going first in 2012;
B) Contribution levels started low and are being 'phased' up; until April 2018 the minimum contribution rate was 2% of a band of 'qualifying earnings' with at least 1% of that having to come from the employer; in April 2018 the rate was stepped up to 5% (with 2% minimum from the employer) and in April 2019 the rate will rise again to 8% (with 3% minimum from the employer); no further increases are planned;

A crucial feature of the system of automatic enrolment is the ability of workers to 'opt out' of pension saving, but only after they have first been enrolled. This is sometimes described as a system of 'soft compulsion'.

When automatic enrolment was first being planned, government assumed that opt out rates could be up to one third of all those who had been enrolled. This was based largely on survey of people forecasting how they would behave if they were enrolled into a pension. But the outturn to date has been far more positive with opt-out rates of less than one in ten being quite typical.

One of the big concerns about the long-term success of automatic enrolment was whether these exceptionally low rates of opt-out could be sustained when contribution rates started to rise. Between April 2017 and April 2019 the employee contribution in a typical scheme rises *fivefold* from 1% to 5%. A big test for automatic enrolment would be whether significant increases in contribution rates would lead to large numbers of people deciding to leave pension saving altogether.

The purpose of this paper is to examine what is likely to happen in April 2019 when the final step-up in mandatory contributions takes place. We do this in two ways:

a) We review the available evidence from official sources and from pension providers into what happened in April 2018 when the first contribution increase took place

b) We look at what is likely to happen to disposable incomes in April 2019 when contribution rates rise, taking account of wage growth and changes to the income tax and National Insurance systems which will happen at the same time.

2. What happened when contributions rose in April 2018?

Some evidence for what might happen in April 2019 when mandatory pension contributions rise is to look at the data from April 2018 when the first step-up in contributions happened. For employees, the mandatory contribution rose in April 2018 rose from 1% to 3% which is the same absolute rise as will happen in April 2019 (when contributions rise from 3% to 5%), so the behavioural response in April 2018 should give us a good clue to potential reactions in 2019.

Prior to the April 2018 increases, opinions varied as to whether the contribution rise would trigger a big change in behaviour. One pension company issued a somewhat hysterical press release before the change entitled 'auto-enrolmageddon', suggesting that large-scale opt-outs could follow the change. By contrast, Royal London published a policy paper before the changes took place which was entitled 'Will Britain take the April pension contribution increase in its stride?' which argued that these changes would have relatively little impact on savings rates.

The most robust assessment of what actually happened in 2018 is provided by the DWP's annual 'automatic enrolment evaluation report'[1] which uses 'Real Time Information (RTI)' data from employers to track individual employees over time.

This analysis identifies two different ways in which people may stop saving into a pension and it is important to be clear what each means:

- "opt out" refers to people who are enrolled into a workplace pension under automatic enrolment and use their legal right to leave the pension scheme within the 'opt out window' (usually a month or so after they are enrolled); in this situation they are

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/764964/Automatic_Enrolment_Evaluation_Report_2018.pdf

treated as if they had never been in the pension and get a refund of their contributions;

- "cessation" refers to people who stop being a member of a particular workplace pension scheme at any time; this could be because they have now left the employer, but it could also be because they have actively decided that they no longer want to be in the pension scheme, perhaps because of affordability issues.

We consider each in turn.

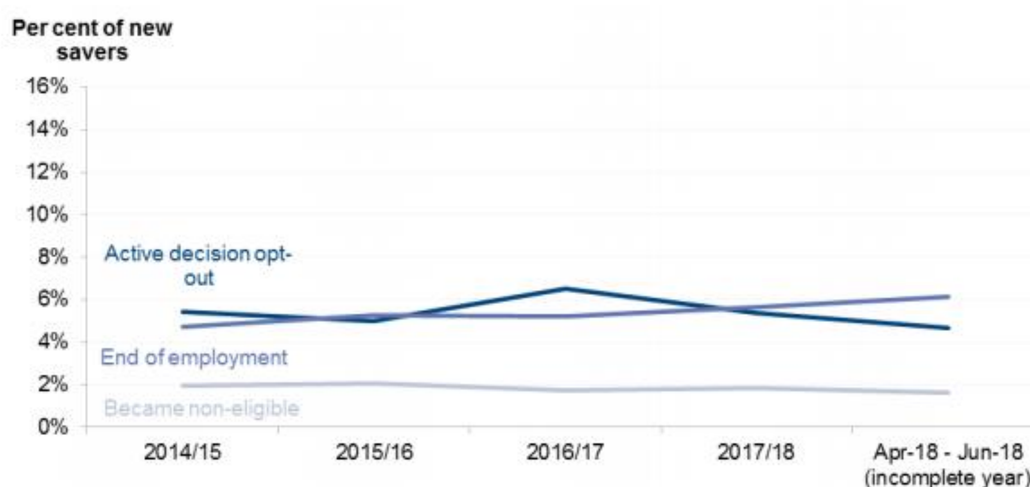
a) Opt out rates before and after the April 2018 step-up in contributions - DWP

As noted in the DWP's report, there are three main reasons why workers may show in the RTI data as paying their first pension contribution one month and then not contributing the next month:

- Leaving that employment
- Becoming ineligible (for example because of a change in their earnings)
- Actively choosing to opt out

In terms of assessing the impact of the step up in contributions it would be the third of these that would be of most interest.

The following chart, taken from the DWP report shows that there was absolutely no evidence of an increase in active opt-outs following the April 2018 contribution rise:



Source: DWP Automatic Enrolment Evaluation Report 2018

DWP also break this data down by gender, by age and by earnings level and with the sole exception of the highest earners (of which more below) they find no evidence of an up-tick in opt-out rates for any particular group off the back of the contribution rise.

However, if we were concerned that higher contributions were going to put people off saving for a pension, it seems likely that we will get a better picture by looking at cessation rates rather than opt-out rates. This is because those who opt out are largely those who have just joined a firm, are enrolled into a pension and immediately leave, or those who work for a firm which has just reached its 'staging date' and has enrolled all of its workforce. These workers are by definition the 'flow' into automatic enrolment.

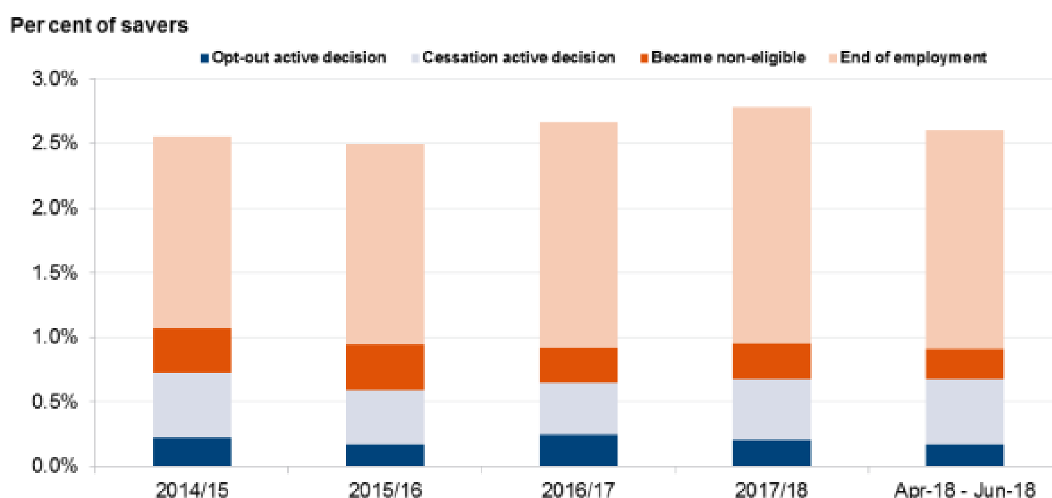
But a much larger group by 2018 would be the 'stock' of people (almost ten million workers) who had already been automatically enrolled. Many of these would have been paying at the minimum contribution rate of 1% and might have chosen to leave pension savings when their contribution rate was trebled. So in the next section we look at the proportion of workers who 'ceased' pension saving having previously been a member of a workplace pension beyond the initial opt out period.

b) Cessation rates before and after the April 2018 step-up in contributions - DWP

The DWP define the cessation rate as "...the proportion of all workplace pension savers who cease pension saving in a particular month". An important feature of this definition is that the month of cessation is defined as the month in which the final contribution was made, rather than the first month in which no contribution was made. This is important because people who ceased saving in a pension in April 2018 because of the April 2018 contribution rise would show up in the data as a March 2018 cessation.

The following chart shows cessation for the three main reasons described earlier – leaving employment, becoming ineligible and actively leaving the scheme – and also shows 'opt out' data for those who only ever made an initial pension contribution and then left.

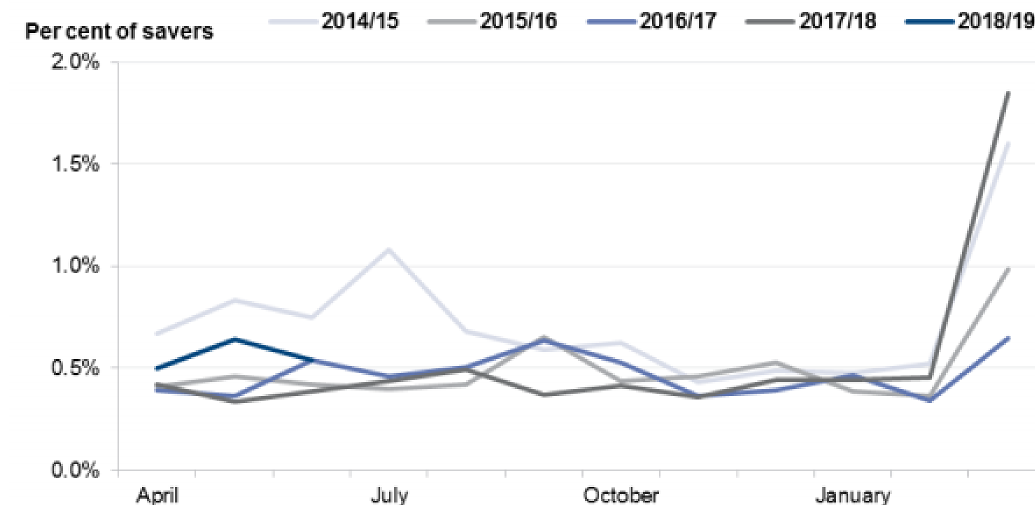
Figure 4.18 – Stopping saving: the average monthly proportion of workplace pension savers who stop saving each financial year, by reason.



Source: DWP Automatic Enrolment Evaluation Report 2018

On the face of it, the data offers little evidence that large numbers of people ceased to be members of pension schemes in the first quarter of the financial year 2018/19 in response to the step up in contributions. The only caveat to this is that if people reacted to the planned April contribution rise by making no pension saving in April, this would show up as a March 2018 cessation and therefore appear in the 2017/18 figures. Some evidence for this is shown in the following chart which gives month-by-month cessation rates:

Figure 4.19 – Stopping saving: the average monthly proportion of workplace pension savers who make an active decision to stop pension saving each month (including opt-outs and cessations)

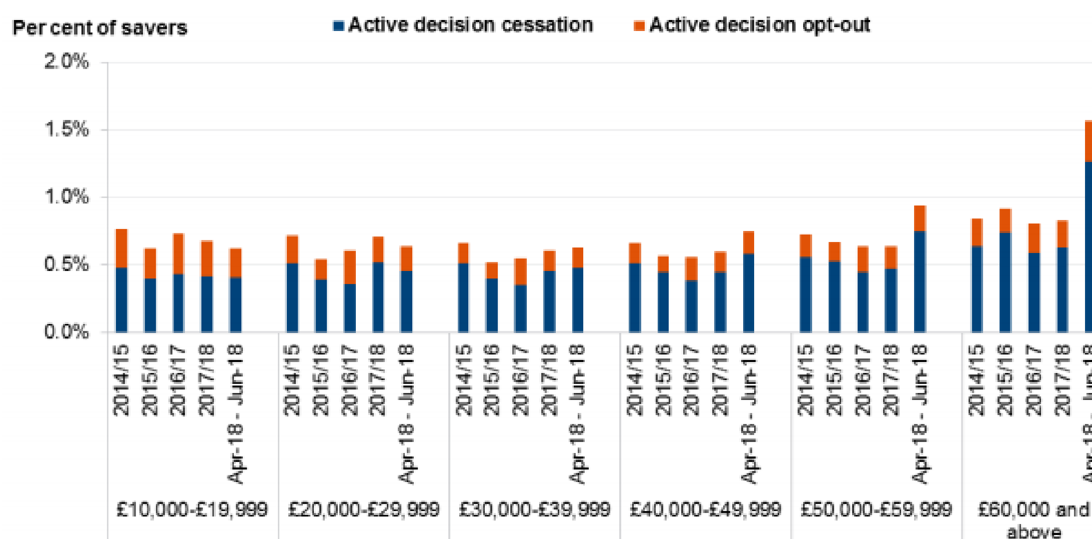


It is clear that in 2017/18 there was something of a March 'spike' in the rate of cessation into pension saving. However, a similar spike occurred in 2014/15 which suggests that this is unlikely to be purely a consequence of the step up in automatic enrolment contribution rates, as they were unchanged between 14/15 and 15/16.

It is therefore worth looking at more disaggregated data on cessations which suggests that one group did cease pension saving in larger numbers in the first quarter of 2018/19 – but probably not because of anything to do with automatic enrolment.

The next chart shows how cessation rates varied by earnings band in recent years:

Figure 4.22 – Stopping saving: the average monthly proportion of workplace pension savers who make an active decision to stop pension saving each financial year, by earnings level



The stand-out feature of DWP's Figure 4.22 is the final bar of the final group. This is the percentage of savers in the '£60,000 and above' earnings band who ceased pension saving around the start of the new financial year, which nearly doubled compared with previous years.

It is hard to believe that the jump in cessation rates is an affordability issue, as this is the highest earning group in the data and there is no evidence at all of a similar jump in the earnings groups under £40,000 who might be most likely to stop saving because of a contribution rise.

It seems reasonable to suppose that the cessations in April- June 2018 were primarily about factors which mainly affect higher earners, and changes to pension tax relief seems like a strong candidate. Whilst there were no specific changes to pension tax relief limits which applied from April 2018, it is possible that the cumulative effect of cuts to the Annual Allowance and the introduction in 2016 of the 'tapered' annual allowance of high earners was starting to bite by 2018/19. These limits do not prevent people making *any* tax-relieved pension saving in a given tax year, but they do seriously limit the amount that can be made. It is possible therefore that what higher earners are doing is saving relatively large amounts in the first month or two of the financial year and then ceasing pension saving by the end of Q1 because they have reached their annual limit.

In summary, whether it is opt-outs of newly enrolled workers or cessations by those already in pension saving, the aggregate data on the period pre and post the April 2018 contribution increase shows absolutely no evidence that the contribution increase drove people away from pension saving.

c) *Opt out rates before and after the April 2018 step-up in contributions – Industry estimates*

Whilst the DWP report, based on HMRC 'real time information' data, provides the most robust and comprehensive assessment of what happened in April 2018, it is also instructive to see if the data generated by individual pension providers and pension schemes tells the same story. Not all providers have published data, but of those that have, the pattern seems pretty consistent:

- Legal & General - Legal & General Investment Management (LGIM) analysed workplace pension schemes which it manages and said: "The experience across all our bundled clients has been similar, with opt-out rates showing no jump in April and May," it said. LGIM cited one employer with 30,000 workers enrolled, where only 40 have opted to reduce their contribution rate to 1%.[2]

- NOW: Pensions – Adrian Boulding, Director of Policy at NOW: Pensions told the Work and Pensions Select Committee that: "The numbers leaving increased by just 0.2% a month as we went through April but because it is inertia, it was taken from their pay packet and they found that they could afford it, they did not withdraw"[3]

- Royal London – data prepared for the Royal London Independent Governance Committee (IGC) showed that the opt out rate for automatic enrolment schemes rose by just 0.4% between the first quarter of 2018 and the second quarter of 2018; at 7% this was actually slightly below the 8% average for the whole of calendar 2017.

Whether it is aggregate data from HMRC or data from individual firms, it is very hard to see any significant impact of the April 2018 increase in contributions.

In principle, this finding should give us considerable confidence for 2019 that the power of inertia will be such that a further increase in contributions will have a limited effect on

[2] Source: Guardian newspaper report: https://www.theguardian.com/money/2018/aug/24/pension-opt-outs-have-not-jumped-since-auto-enrolment-rate-rise
[3] Oral evidence to Work and Pensions Select Committee: 23rd January 2019

pension scheme membership. But there is a possibility that whilst a 3% employee contribution rate is affordable for most, once contribution rates rise to 5% a rather higher proportion of workers will decide they can no longer afford to stay in their workplace pension.

A lot is likely to depend on how far a pension contribution increase in April 2019 has a big effect on the take-home pay of workers. To assess this, we move on in the next section to consider the other changes which will be happening in April 2019 and try to evaluate how this is likely to affect opt-out rates.

3. Take-home pay in April 2019

In addition to the increase in mandatory minimum pension contributions, take-home pay in April 2019 will be affected by changes in a number of other variables. These are summarised in Table 1.

Table 1. Income tax and national insurance thresholds and national living wage rates 2018/19 and 2019/20

	2018/19	2019/20
Income tax personal allowance (per year)	£11,850	£12,500
National Insurance floor (per year)	£8,424	£8,632
National Living wage (25s and over, per hour)	£7.83	£8.21

Each of the changes listed will tend to increase the take-home pay of some or all employees in April 2019:

- Although income tax personal allowances tend to rise each year, the April 2019 increase is a particularly large increase as it has deliberately been increased by more than the rate of inflation. This will provide a welcome income tax reduction to the vast majority of workers who earn above this amount.

- The increase in the point at which National Insurance Contributions start to be payable is simply in line with inflation but will give a cash boost to employed earners.

- The increase in the National Living wage is roughly double the rate of inflation and will provide a boost to over two million lower-paid workers; these are the workers who might be expected to have the greatest concerns about the affordability of pension contributions, so this increase is particularly relevant to our analysis.

In addition to these changes in the parameters of the tax and benefit system, the majority of workers receive an annual pay increase and this will often occur in April. Not everyone gets a pay rise but over the whole economy gross earnings are currently rising by around 3.2% per year.

A key question therefore is how far the rise in employee pension contributions due in April 2019 will be partly or fully offset by pay rises or a more generous income tax system.

To evaluate the combined impact of these changes, we have taken an illustrative worker on £20,000 per year in 2017/18 which is not far off the typical wage of the automatic enrolment population. In Table 2 we have worked out what his or her take-home pay would be assuming a 3.2% pay rise in April and an increase in pension contributions from 3% to 5%.

Table 2. Gross and net pay in 2017/18 and 2018/19 for illustrative worker on £20,000 per year who receives 3.2% pay rise in April 2019

	2017/18	2018/19
Gross pay	£20,000	£20,640
Minus income tax	-£1630	-£1628
Minus National Insurance	-£1389	-£1441
Minus pension[4]	-£480	-£826
Net Pay	**£16,501**	**£16,745**

As Table 2 shows, even though the mandatory pension contribution rate has increased from 3% gross (2.4% net of tax relief) to 5% gross (4% net of tax relief), the worker in this example still gets an increase in take-home pay in April of £244 per year or around 1.5%. Although this is below the rate of inflation and will represent a squeeze on living standards, it seems reasonable to suppose that the fact that pay is still going up in April is likely to dampen any drive to opt out of pension saving.

There is a further factor which will help to dampen the impact of the mandatory contribution rise. Although in our example above we have assumed that the new 5% rate (gross of tax relief) will apply to the whole of earnings, the mandatory minimum contribution is based only on a band of 'qualifying earnings'. In 2019/20, the floor for the band of qualifying earnings is £6,136, which means that contributions only have to be paid on the slice of earnings above this level. The effect of this on someone earning £20,000 will be to reduce the April 2019 step up by around one third, further reducing the impact on take-home pay.

As noted above, some workers will do better than shown in Table 2, particularly those who enjoy the 4.9% increase in the National Living Wage. But not every worker will get a pay rise

[4] We are assuming for this example that pension tax relief is delivered through the 'relief at source' method. In this approach, pension contributions are made out of take-home pay and then HMRC tops up the pension with tax relief at the basic rate. The worker therefore pays 4% of pay out of his/her take-home pay and this is grossed up to 5% by HMRC.

in April 2019 so we repeat the analysis in Table 2 for workers who have a pay freeze in April 2019. The results are shown in Table 3.

Table 3. Gross and net pay in 2017/18 and 2018/19 for illustrative worker on £20,000 per year who faces a pay freeze in April 2019

	2017/18	2018/19
Gross pay	£20,000	£20,000
Minus income tax	-£1630	-£1500
Minus National Insurance	-£1389	-£1364
Minus pension	-£480	-£800
Net Pay	**£16,501**	**£16,336**

In this case although the income tax cut provides a welcome boost to take-home pay, the lack of a pay rise means that the increase in pension contributions leaves the worker slightly down in 2018/19 compared with 2017/18, with a reduction of around 1% in take-home pay. It may be that workers who could absorb a gross contribution rate of 3% may struggle with a contribution rate of 5%, especially if they receive no pay rise at all in April 2019. The data from April 2018 provided no specific evidence that lower paid workers were more likely to opt out following the contribution rise than other groups of workers, but there is obviously no room for complacency on this point.

4. Conclusions

To date, automatic enrolment has been a huge success, with nearly ten million extra workers now saving into a workplace pension compared with when the programme began. But the big unknown has always been whether the remarkably low opt out rates observed when the programme first started would persist once contribution rates started to be increased to more meaningful levels.

We have reviewed the evidence of what happened in April 2018 and are greatly encouraged that there appears to be no sign that higher contribution rates created affordability issues and led to significantly more people opting out when enrolled or ceasing pension saving. Both official data and industry statistics suggest that April 2018 passed by with remarkably little impact on pension scheme membership levels.

For April 2019 our calculations suggest that there is again good reason to be optimistic about the impact of the next step-up in contributions. A very timely increase in the tax-free personal allowance, plus a large rise in the national living wage will all help to boost paypackets in April. For a typical worker who gets an average pay rise, we find that their take-home pay will still go up in April, even allowing for the increased pension contributions. Those who get no pay rise will find themselves around 1% down on average, but this is much smaller than would have been the case without the increase in the personal allowance.

Overall, our analysis suggests that we should be cautiously optimistic that the next step up in contributions in April 2019 will be implemented successfully, just as the first increase was successfully implemented in April 2018. The bigger challenge is likely to be getting those 8% total contributions up to more realistic levels in future, but that will be a matter for another paper.

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