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Will Britain take the next pension contribution increase in its stride?

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WILL BRITAIN TAKE THE NEXT PENSION CONTRIBUTION INCREASE IN ITS STRIDE?

Executive Summary

The first phase of automatic enrolment has been a huge success. At time of writing (February 2018), nearly one million employers had automatically enrolled around nine million workers into a workplace pension. When the programme was first designed, the government expected that roughly one in three of those who had been enrolled would opt out, whereas it now appears that the opt out was only around one in ten.

However, this is only the beginning. Automatic enrolment has been phased in exceptionally slowly, both in terms of the gradual roll-on of firms, from largest to smallest, and also in terms of the required contribution rates. At present, the legally required contribution rate from employers and employees is just 1%, and that rate only applies to a band of 'qualifying earnings' in excess of a floor of £5,876 per year. A key test for automatic enrolment will come when the mandatory contribution rates rise in April 2018 to a combined 5% (with a minimum 2% from the employer) and in April 2019 to a combined 8% (with a minimum 3% from the employer). Will we see large-scale opt-outs which will mar the success of automatic enrolment and call into question the 'soft compulsion' on which the whole programme is based?

This paper argues that April 2018 and April 2019 will not see a rush to opt out of workplace pensions. Despite the fact that household budgets are stretched, with real wages having seen little increase in the last decade, we believe that a number of factors will combine to keep pension scheme membership at a high level:

- The national living wage, which covers more than two million of the lowest-paid workers in Britain will be increased by 4.4% in April 2018. As a result, the lowest paid workers, who might be thought to be most likely to opt out when contribution rates rise, will be guaranteed an increase in take-home pay *even allowing for the rise in pension contributions*

- Income tax thresholds and National Insurance thresholds are increased in April of each year. Although this is sometimes only to keep pace with inflation, such increases will reduce the number of people who suffer a fall in take-home pay in April following the contribution rises. It seems reasonable to assume that an absolute pay cut would be far more likely to stimulate an opt-out than a nominal increase in take-home pay that is simply 'lower than expected'

- Millions of people get an annual pay rise in April. A pension contribution increase of 2% for workers equates to 1.6% after tax relief, so even pay rises below the rate of inflation could still more than offset the increase in pension contributions, especially where workers are only contributing over a band of 'qualifying earnings'

Fundamentally, the power of inertia remains strong – individuals will still have to actively opt out and the amounts they are being asked to contribute are still relatively modest. Evidence from the US suggests that when contributions into 401(k) workplace pension schemes were gradually increased by a few percentage points from low single digit rates, opt-out rates were very low, and the same is likely to happen in the UK.

There will clearly come a point where opt-out rates do start to rise, but we believe that relatively modest increases in contributions, combined with pay rises, especially for the low-paid, are unlikely to fatally undermine the success of automatic enrolment.

1. Automatic Enrolment: The story and so far and what happens next

The process of automatic enrolment into workplace pensions began in the Autumn of 2012. Employers were allocated a 'staging date' based on their size, with the largest employers being required to undertake the process first, and the smallest having to complete the process by the Spring of 2018.

A total contribution rate of at least 2% was initially required, and this applied to a band of 'qualifying earnings' above a floor, currently standing at £5,876 per year[1]. At least 1% of this contribution had to come from the employer. As shown in Table 1, minimum contribution rates will rise in April 2018 and again in April 2019.

Table 1. Minimum contribution rates under automatic enrolment

	Minimum total contribution	Of which, minimum employer contribution
Initial phase	2%	1%
From April 2018	5%	2%
From April 2019	8%	3%

As at the end of 2017, the Pensions Regulator reports[2] that just over 983,000 employers had declared themselves 'compliant' with the legislation and nearly 9.2 million 'eligible jobholders' had been automatically enrolled.

Automatic enrolment is a form of 'soft compulsion', where firms are forced to enrol workers but workers are then free to opt out if they actively choose to do so. When the programme was originally designed, the working assumption was that around 1 in 3 people would exercise their right to opt out[3]. Significantly, this assumption was based on survey research in answer to a hypothetical question about whether people 'would' opt out if they were automatically enrolled.

The reality has been very different. The DWP's analytical report to accompany the 2017 review of automatic enrolment[4] estimated that the average opt-out rate had been just nine per cent, based on data from the 2017 Employer Pension Survey. The final opt-out rate may be slightly larger than this because this survey will not include some of the very smallest employers who were the last to stage and who tend to have slightly higher opt-out rates, but it would not be surprising if the final figure is much more like 1 in 10 than the 1 in 3 originally assumed.

The crucial question is whether this very low opt-out rate is explained mainly by the very low contribution rates currently required by law and whether opt-out rates will surge as contribution rates for employees rise five-fold over the next two years.

[1] Under proposals arising from the 2017 review of automatic enrolment, the government is planning to abolish the lower floor for the band of qualifying earnings.
[2] http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf
[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214440/rrep669.pdf
[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/668657/automatic-enrolment-review-2017-analytical-report.pdf

2. The April 2018 increase – how much will it cost?

As shown in Table 1 above, in April 2018 the mandatory contribution rate under automatic enrolment will rise from a total of 2% of qualifying earnings to 5%. The following table shows how much extra a typical employee will have to contribute (net of tax relief), assuming that the employer contributes 2% of the overall 5% figure. The first figure is where contributions are based only on a band of qualifying earnings, whilst the second assumes that contributions apply from the first pound.

Table 2. Increase in minimum mandatory employee contributions (before and after tax relief) in April 2018

Annual Salary	Increase in contributions (£ per week) – based on 'qualifying earnings'	Increase in contributions (£ per week) – contributions from the first pound
£15,000	£2.81	£4.62
£20,000	£4.34	£6.15
£25,000	£5.88	£7.69

In the next sections we consider the many other things that will be changing in April 2018 and how far these may mitigate against the contribution rises shown above.

3. Other changes in April 2018:

a. The National Living Wage

The present government has announced that it plans a series of above-inflation increases in the rate of the National Living Wage, and the next of these will take place in April 2018.

The National Living Wage (NLW) applies to those aged 25 and over and currently stands at £7.50 per hour. It will increase by 4.4% in April 2018 to £7.83 per hour, an increase significantly above the current inflation rate of around 3%.

Someone who works a 35 hour week on the NLW will see an increase of 35 times £0.33 per hour or £11.55 per week. Assuming that they pay income tax at 20% and employee NI contributions at 12%, they get to keep 68% of this increase or £7.85 per week.

Table 2 shows that a low-paid worker on £15,000 per year faces a maximum pension contribution increase of less than £5 per week, which is well below the amount that they would gain from the increase in the NLW. Crucially, this means that their take-home pay will rise in April, even after the effects of the increased pension contribution. Whilst this does not guarantee that they will not opt out, the fact that they still get a pay rise suggests that this will considerably reduce the risk that they will do so.

In terms of the number of people affected, the Low Pay Commission says[5] that in April 2017 there were around 1.5 million workers covered by the NLW, and that the planned above-inflation increases will take this number up to around 3.0 million by 2020. Workers covered

[5] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/671545/Short_report_December_2017.pdf

are particularly concentrated in retail, hospitality and cleaning/maintenance roles, though some are scattered through sectors which are not generally seen as 'low-paying'.

There can be little doubt that this series of increases in the National Living Wage could not have come at a better time from the point of view of the step up in pension contributions under automatic enrolment. DWP research[6] has found that "The most common reason workers gave for opting out was that they were concerned that they could not afford the worker contributions" (p86) , and it might be reasonable to assume that the lowest-paid workers are most likely to feel this pressure. The fact that this group are getting a series of annual above-inflation pay increases should help to reduce the risk that affordability issues drive up opt out rates.

b. Increases in tax and NIC thresholds

Thresholds for paying income tax and National Insurance Contributions are reviewed on an annual basis and tend to rise each April. Table 3 shows the level of the tax-free personal allowance and the Primary Threshold for National Insurance Contributions in April 2017 and April 2018.

Table 3. Income tax personal allowance and National Insurance Primary Threshold: April 2017 and April 2018

	April 2017	April 2018
Income tax personal allowance (per year)	£11,500	£11,850
NI Primary Threshold (per week)	£157	£162

Although each of these increases is broadly in line with inflation, each will produce a modest increases in take-home pay as follows:

- Income tax: an extra £350 per year on which no tax is levied rather than 20% tax will save £70 per year or £1.35 per week;
- National Insurance: an extra £5 per week on which no NICs are levied rather than 12% NICs will save £0.60 per week;

Taken together, these two changes will increase take-home pay by £1.95 per week. To put this in context, this is not far short of half the increase in pension contributions being asked of someone on £20,000 per year who is making contributions on the basis of qualifying earnings.

c. General Pay Increases

Whilst it is well know that 'real pay' (ie pay taking account of rising prices) has been stagnant for much of the last decade, this does not, of course, mean that people are not getting pay rises at all. The latest estimates available from the Office for National Statistics[7] show that in late 2017 'regular pay' was 2.4% higher than a year earlier. For someone who gets a pay

[6] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/391153/rr899-automatic-enrolment-employers-2014.pdf
[7] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/january2018#average-weekly-earnings

increase of that size in April 2018, this will be more than the 2% increase in pension contributions that they will be expected to make, and will again contribute to most people seeing a rise in take-home pay in April 2018.

The combined effect of an increase in pay of 2.4%, an increase in tax and NIC thresholds and an increase in pension contributions is shown in Table 4 for someone earning £20,000 per year in 2017/18 and paying pension contributions from the first pound of their earnings.

Table 4. Individual earning £20,000 in April 2017 – Net pay taking account of changes in pay, tax, NICs and pension contributions

	April 2017	**April 2018**
Gross Pay	**£20,000**	**£20,480**
Minus income tax	*-£1,700*	*-£1,726*
Minus NICs	*-£1,420*	*-£1,447*
Minus pension contributions	*-£160*	*-£492*
Take-home Pay (pa)	**£16,720**	**£16,815**
Take-home Pay (pw)	£321.54	£323.37

As Table 4 shows, even for a worker paying the extra pension contributions on the whole of their earnings, the combined effect of a modest pay rise and the increase in thresholds for tax and NICs means that they will still see a pay increase in April 2018, albeit a very small one.

In summary, well over 1.5 million of the lowest paid workers will get a pay rise in April 2018 which will comfortably absorb the increase in pension contributions, whilst for other workers even a more modest pay increase at levels currently being paid will be enough to make sure that few workers will suffer a reduction in take-home pay even taking account of the step up in pension contributions. Whilst we cannot be certain how people will behave, a small pay increase seems much less likely to induce an opt-out than a pay cut, however small.

4. Medium Term Effects

So far we have been considering only the potential for immediate opt-outs when the pension contribution rates under automatic enrolment rise in April 2018. But there are two further mitigating facts to consider which would be relevant *even if* there was significant opt out in April.

a) Re-enrolment

Under the automatic enrolment legislation, workers who opt out have to be 're-enrolled' three years later. Whilst it is too early to be certain exactly what impact re-enrolment will have, there is some indication that this will – as expected – help to claw back some of those who opted out in the first place. The Analytical report on the 2017 Automatic Enrolment review cited earlier says:

> *"Emerging findings suggest that opt-out rates following re-enrolment are around 38 per cent for medium employers and 55 per cent for large employers.32 This therefore means that 62 per cent of workers who were re-enrolled by medium employers and 45 per cent of workers re-enrolled by large employers remained in saving" (op cit p43).*

In other words, even if there were to be an uptick in opt-outs following an April contribution increase, the process of 're-enrolment' could plausibly bring about half of those who had opted out back in three years' time.

b) Job changes

So far, automatic enrolment has been a freestanding measure which, at point of introduction, resulted in a reduction in take-home pay for those who were enrolled (unless it happened to coincide with an annual pay rise). Even implemented in that way, opt out rates have been very small.

However, now that automatic enrolment is part of the landscape of employment, any individual starting a *new* job will be automatically enrolled within three months of starting, and are highly likely to regard the prevailing pension contribution rate as part of the overall employment package at their new employer. Consistent with this assumption, industry estimates suggest that opt out rates for those starting at a new workplace are currently standing at only around 5% (compared with the 10% rate for workers as a whole).

Taking together the impact of both re-enrolment and periodic job changes, the data suggests that even if there is significant opt out as a result of the step-up in contributions in April 2018 this may for many be only a transitional effect before they rejoin pension saving either at re-enrolment or at a job move.

5. Evidence from the US

Whilst the UK has been a pioneer in automatic enrolment, a number of other countries have similar systems of voluntary workplace pension provision and may be able to provide some indication as to whether modest contribution increases of the sort about to happen in the UK are likely to drive opt out rates.

The most obvious comparator would the US which has had a system of workplace 401(k) schemes for many years and where there is research data on the impact of increasing contribution rates on participation rates.

The whole automatic enrolment programme is based on the 'behavioural' insight that workers are more likely to end up in pensions if they have to actively opt out rather than if they have to actively opt in. A seminal book on behavioural economics is 'Nudge' by Thaler and Sunstein, which discusses the impact of increased contribution rates on pension scheme membership. It advocates a system known as 'save more tomorrow' where individuals pre-commit to gradually increased contribution rates in future, an approach which tends to be associated with low opt-out rates.

Another leading behavioural economist, Shlomo Bernartzi, worked with Thaler on 'save more tomorrow' and in his book of the same name (pp42-45) he describes a case study of a firm which moved from an opt-in pension arrangement to one where workers were auto-enrolled at a default contribution rate of 3%. A year later, the default contribution rate was set at 6%, though for new employees only.

As expected, the move to auto-enrolment dramatically increased pension scheme membership (from around 70% one year after joining the firm to around 95% almost immediately on joining). But even more striking was that defaulting people in at 6% rather than at 3% had *almost no* impact on opt out rates. Bernartzi writes:

> *"The company's case is especially interesting because it provides a natural experiment on the impact of the default savings rate on participation. Some observers had assumed that a relatively high initial savings rate (6 per cent in this case) might cause more employees to opt out than with a lower rate (3 per cent).* ***In fact, the opt-out rates were virtually identical in both cohorts****. The higher default savings rate (at least, in this range) did not prompt a greater number of people to opt out, so the participation rate was the same in both cases" (italics ours).*

Whilst this is just one example, there are others which reinforce the view that at relatively modest contribution rates, the power of inertia is likely to be as relevant in estimating opt out behaviour as it was when individuals were first automatically enrolled.

6. Conclusions

The huge success of automatic enrolment has always come with a nagging worry. Are we seeing such low opt our rates simply because the typical contribution rates are so low? And when employee contribution rates treble in April 2018 and rise again in April 2019, will this fatally undermine the delicate 'soft compulsion' which underlies automatic enrolment?

In this paper we have argued that there are considerable grounds for optimism that opt-out rates will remain low this April. In particular:

- Over 1.5 million lower-paid workers on the National Living Wage will see a 4.4% pay rise in April, more than enough to cover the planned pension increase;

- Annual increases in the personal tax allowance and the National Insurance floor take place in April and will help to cushion the pension contribution increase;

- Although real wages remain stagnant, average pay is currently around 2.4% above its level a year ago; an increase of 2.4% as an annual pay increase in April 2018 for someone on a typical wage of around £20,000 would enable them to absorb the pension increase without any reduction in take-home pay;

- Even where people do opt out in April, the process of re-enrolment and the low levels of pension opt-out when people subsequently change job should help to get many of these individuals back into pension saving before too long;

- The power of inertia remains strong, and international evidence suggests that modest increases in contribution rates from 'very low' to 'fairly low' is unlikely to trigger mass opt out. Although members of the public may tell interviewers hypothetically that they plan to opt out if their contribution rate increases, such responses have been a vey poor predictor of the actual behaviour of those individuals.

Whilst we cannot afford to be complacent, there is every reason to believe that the April 2018 and April 2019 automatic enrolment increases will pass off without incident and without undermining the fundamental viability of the automatic enrolment model. The much more challenging question of getting people beyond 8% should not be delayed whilst we 'wait and see' what happens over the next 18 months.