Pensions Policy Institute
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General Election 2024

Automatic Enrolment Contributions Briefing Paper

Introduction

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This Briefing Paper is part of a series of papers sponsored by People's Partnership, setting out some of the pensions policy areas that are likely to receive active discussion during the 2024 General Election campaign.

This second Paper deals with the minimum contributions made to pension schemes under automatic enrolment (AE). It sets out the current policy, the stakeholders in the policy, issues at stake, and other policy options that have been suggested.

The PPI was formed on 22 January 2001, so that a permanent expert organisation would undertake rigorous research from an independent, long-term perspective.

The retirement, pensions and later life market are undergoing fast-paced changes brought about by legislation, technology, and the economy. We do not lobby for any particular issue or reform solution.

Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative. We are proud that our research is used frequently by Government, Parliament, industry, consumers, academics, trade bodies, consumer groups and the media to improve policy and individual outcomes.

This Briefing Paper is authored by John Adams, Senior Policy Analyst.

The PPI is grateful for the input from Tim Gosling of People's Partnership, in the production of this paper.

Editing decisions remain with the author, who takes responsibility for any remaining errors or omissions.

This Briefing Paper is kindly sponsored by People's Partnership. Funding has been given to help fund the research, and does not necessarily imply agreement with, or support for, the analysis or findings from the project. The PPI does not make recommendations as to the appropriate direction of future policy, instead, our work provides INDEPENDENT evidence to allow policy development to be well informed

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The general view is that Automatic enrolment has been a great success in increasing participation in pension schemes

Automatic enrolment, introduced in 2012 requires employers to enrol their employees, who have a salary of £10,000 or over, and are aged between 22 and State Pension age, to be enrolled into a pension scheme, with the opportunity to opt out.

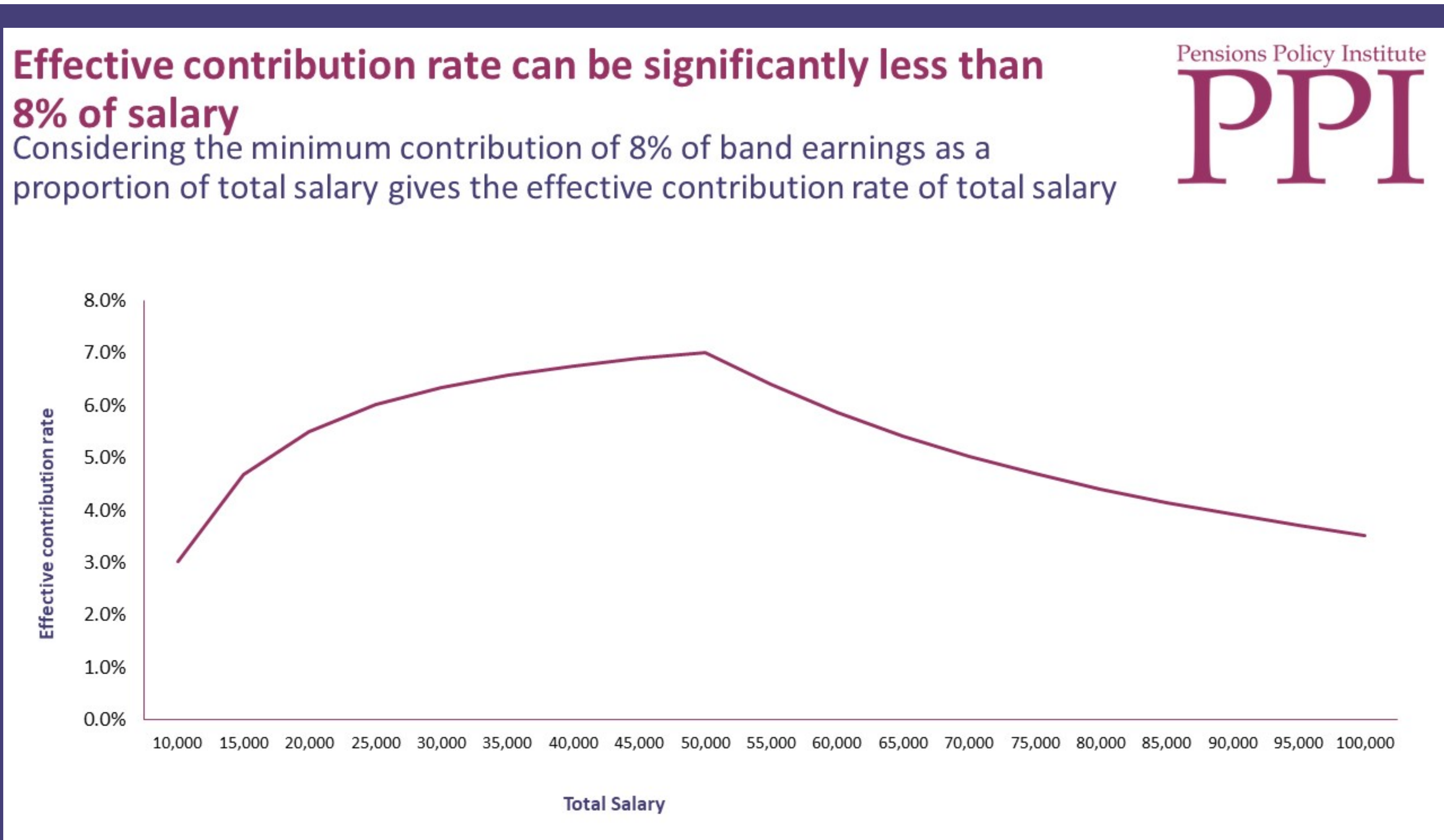
Moving the default action to participation with option to decline, rather than requiring active decision to participate, is described as harnessing inertia to bring millions of people into pension scheme saving. Pension participation in the private sector has increased from 42% of employees in 2011 before automatic enrolment to 86% of employees in 2022.[1] Opt-out rates have been low, typically around 10% of people automatically enrolled choosing to opt out. This has been widely regarded as a success in increasing pension scheme participation.

What are the minimum contributions to AE schemes?

Employer must automatically enrol their qualifying employees into a pension scheme. In order for that to be meaningful there are minimum standards that a pension has to achieve to be eligible to be used to fulfil automatic enrolment obligations.

One of these is the level of contributions. The employer and employee may both make contributions into the scheme but the minimum total contribution must be at least 8% of "band earnings", with at least 3% of that coming from the employer. Band earnings refers to earnings from the employer between a lower limit (currently £6,240 in 2024) and an upper limit (currently £50,000). The minimum contribution rate of 8% of band salary is not equal to 8% of total salary because some income is disregarded. The effective contribution rate of total salary varies by salary level.

Figure 1 - Effective contribution rate on total salary of 8% of band salary



[1] Department for Work and Pensions (2023) *Workplace pension participation and savings trends: 2009 to 2022*

The minimum income to be eligible for automatic enrolment is £10,000; for people earning at this level, 8% of band salary is equivalent to an effective contribution of 3% of total salary. The effective rate increases as salary increases and a higher proportion of total salary is included as band salary, up to a point where the effective contribution rate is 7% of total salary at the point where salary is equal to the upper band threshold of £50,000. For salaries over that level, the proportion of total salary that is included in band salary reduces, leading to a falling effective contribution rate at higher salary levels.

The AE review in 2017 recommended removing the lower limit so that contributions are based on the first pound of income. This would mean that for people earning below the upper band limit the effective rate of contributions would be the full 8% of salary. The Pensions (Extension of Automatic Enrolment) Act 2023 put in place the powers to remove the lower limit, however it has not yet been removed so we are still in a position of the 8% contribution not actually being 8% of salary.

8% contributions may not provide an adequate pension in retirement

With millions of people saving for retirement there is a risk that they believe that, by following the government's requirements and saving at the prescribed level, they are doing what they need to do to achieve a good retirement. However, the consensus in the industry is that 8% contributions are unlikely to provide an adequate pension in retirement to maintain a similar standard of living in retirement as in working life. Contributions of 12% have been suggested to give a better chance of giving an adequate pension. Increasing the minimum contribution could make being enrolled in a pension scheme less affordable for people with stretched incomes, leading to increased rates of opting out which could undo the success of the automatic enrolment and lead to people being worse off in retirement than they would under an 8% contribution.

There are a number of affected parties to an increase in AE pension contributions

The most obvious affected parties are the **employees** who would themselves be subject to the change in minimum contributions. The employees would receive more money into their pension savings, but may also be called upon to make higher contributions themselves. The additional money into their pension pot could significantly improve their likelihood of achieving an adequate income in retirement. However, there are age issues as while the increase could be of great benefit to younger workers, it could be too-little too-late for older workers. Employees with stretched finances could find the increase in contributions to be a breaking point, leading them to cease active membership of the pension scheme.

Employers are also affected. They must follow the automatic enrolment rules so are responsible for implementing the higher contribution rates and to communicate changes with employees. Employers would also be likely to shoulder some of the burden of higher contributions.

The **Government** set the rules and communicate what is required of employers. The success of the policy will achieve government aims of reducing pensioner poverty and reduce reliance on the government in retirement. Additionally pension schemes are investors in infrastructure projects, therefore more money in pension schemes can fulfil government aims to fund such projects.

Further stakeholders are the **Pension providers**, whose business is to invest and administrate the pension funds, making money through a management charge on the fund. Pension providers want a good perception of pension savings, to encourage confidence and willingness to save in pensions, so pension providers will in general want their members to be satisfied with their saving and the outcomes. The more money is invested in pension schemes the better for their business, therefore an increase in the contribution rate would seem initially appealing in that it increases the funds. However, if the increase were to lead to significant numbers of people ceasing their contributions, then there could be an overall fall in contributions made.

Adequacy and fairness are both at stake for employees

Adequacy Higher contributions are more likely to lead to better levels of adequacy in pension outcomes, but higher opt -outs reduce adequacy.

Fairness The employees that are most likely to opt out due to higher pension contributions are those with lower incomes. This causes an income-based gap in pension participation and leads to lower income people having less pension saving when they get to retirement. This could then exacerbate income inequality in retirement. This could have an impact on government spending on pensioner benefits.

How do suggested alternatives compare?

There are a number of options available, aside from maintaining the status quo. A selection of these are listed in **Box 1.**

Box 1. Possible policy options

Policy Option	Description	Notes
(1) Status quo	Maintain the minimum contribution of 8%.	8% total contribution with at least 3% from the employer.
(2) Increased minimum contribution	Increase minimum contribution to say 12%.	Would require contribution increase possibly on both employer and employee to make up to 12%.
(3) Additional contribution	Additional optional contribution up to 12%. Can opt out of increase before opting out of pension.	Being able to opt out of the contribution increase could reduce the incidence of people leaving the pension scheme altogether.
(4) Tiered contributions	Tiered contribution by income whereby people on lower incomes would have a lower minimum income.	Tiered contributions could reduce opt outs by leaving those more likely to opt out less affected. They may also not require pension saving to the same extent to achieve the same living standard in retirement.

Option 2: Increasing the minimum contribution for all employees who are automatically enrolled maintains a certain fairness within the system, no member is treated any different in their contribution level from any other level. However it could be argued that an all or nothing system with higher contribution is unfair on those who are unable to afford it and therefore find it difficult to remain in the pension scheme. The higher contributions produce a higher pension pot at retirement and consequently a better chance of adequacy in retirement.

Option 3: involves the employee being enrolled at an increased contribution level, but with the option to opt down to a lower contribution level, i.e. the current 8% contributions, before having to opt out of membership. This is intended to harness the inertia that has been successfully used in the automatic enrolment system to increase the contributions and give the benefits of a higher contribution, while allowing those who do not wish to make the full contributions to maintain the benefits of pension scheme membership at a level they can afford. However, it is possible that making the additional contribution non-compulsory could make it seem like an optional extra rather than necessary for improving adequacy.

Option 4: Tiered contributions would target the increase in contributions towards employees who are both able to afford them and likely to require additional savings to increase their chances of maintaining their standard of living in retirement. It may be that those who are on lower incomes are served by the State Pension with the current minimum level of contributions in meeting their standard of living. And that the increase that comes from the abolishing of the lower limit, meaning that contributions come from the first pound of income, will have a significant improvement on their pension saving, while not requiring them to have the additional impact of a further increase in contributions. Whereas people on average incomes would benefit from having higher contributions in meeting their adequacy requirements in retirement and may be better placed to afford any additional contribution falling on them as an employee. Fairness issues arise with the tiered contributions. If the higher tiers of contributions come with higher employer contributions, it may be unfair to deny additional employer contributions to lower income people. But without additional employer contributions the whole increase in contribution falls on the employee.

Different tiers of contributions by income level exists in Defined Benefit pension schemes. Many public sector schemes have had tiered contributions for many years, however the tier of contribution in that case does not give a different tier of benefit. This would be possible to replicate in Defined Contribution schemes if the overall contribution was the same for all employees and the tiers just affected how much fell on the employee. This could significantly affect employer costs and may affect decisions on staffing levels for some employers.

A change of policy could have many diverse impacts that have to be balanced

There are several issues that have to be balanced, including the need for higher contributions to achieve an adequate income in retirement; the squeeze on incomes and how an increase in pension contributions could affect behaviour, such as whether increasing contributions could lead to less saving; targeting saving where it needs to be; and balancing fairness. The political parties have not, at time of writing, set out their policies on any changes to automatic enrolment contributions.

This Briefing Paper is authored by:
John Adams, Senior Policy Analyst

For more information please contact John.
e: john@pensionspolicyinstitute.org.uk
w: www.pensionspolicyinstitute.org.uk

For general enquiries:
e: info@pensionspolicyinstitute.org.uk