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What should be the contribution cap for Personal Accounts?

A contribution cap for Personal Accounts:

- The Pensions Commission proposed a contribution cap of £3,000 a year – 16% of band earnings for median earners.
- The Government has consulted on a proposal for a contribution cap of at least £5,000 a year, and £10,000 in the first year of Personal Accounts.
- PPI analysis shows that required contribution levels to meet target replacement rates will vary depending on people's earnings and work histories.
- The appropriate level for the contribution cap will depend on the Government's target market and policy intentions for Personal Accounts.

Introduction

There is currently much debate about whether a maximum annual limit should be placed on contributions to Personal Accounts, and if so, what that limit should be. This Briefing Note summarises the issues related to setting a contribution cap and presents PPI analysis of the required level of savings for different individuals to meet their target income replacement rates in retirement.

What is the context?

The White Paper ***Security in retirement***[1] describes the need for Government to intervene in the private pensions market to address inadequacy of retirement savings and to encourage and enable private pension saving for those without access to existing provision.

To address these issues, the Government has proposed reforms to state pensions and the introduction of a low-cost pensions saving scheme, called Personal Accounts. Although many details are yet to be finalised, the basic framework of Personal Accounts will be[2]:

- Auto-enrolment into a Personal Account (or an equivalent) for all employees aged over 22 and earning more than £5,035 a year, with the opportunity to opt out.
- A default combined contribution of 8% of band earnings (£5,035 to £33,540 a year), made up of 4% from the employee, 3% from the employer, and at least 1% from Government through tax relief.

The Government has been explicit that ***Personal Accounts should complement, rather than compete with, existing good-quality pension provision***[3]. But they have also stated that it is ***important to allow sufficient flexibility for those individuals who wish to save more [than the default level]***[4].

A contribution cap is one mechanism for achieving these two goals[5]: 1) to allow individuals sufficient flexibility to be able to reach their target replacement rates through saving in Personal Accounts, and 2) to minimise the potential negative impact of Personal Accounts on the savings market and on good quality existing pension provision.

The Pensions Commission's recommendation

According to the Pensions Commission many people say their target replacement rate for retirement is two-thirds of their pre-retirement income[6]. This means that people want to get two-thirds of their final salary each year after they stop working.

By saving in Personal Accounts, the Commission predicted that a median earner with default level combined contributions of 8% of band earnings will achieve a 45% replacement rate in retirement[7]. This means that when they stop working, they will receive less than half of their final salary each year, which is less than the two-thirds that people say they want.

On this basis, the Commission argued that employees and employers should be able to make additional contributions above the minimum default level.

However, the Commission also noted that ***there is a case for limiting the size of these additional contributions***[8]. In their view, ***if contributions were entirely uncapped, and if [Personal Accounts] were perceived as a highly cost-efficient investment vehicle, the aggregate size of [Personal Accounts] might conceivably grow to a level at which [concerns about impact on the UK***

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***savings system, consumer demand and rates of return] were valid*[9].**

Balancing these competing goals, the Pensions Commission proposed a limit on combined contributions to Personal Accounts of twice the annual default contributions for the median earner. This amounted to 16% combined contributions, or around £3,000 in 2005 earning terms. They argued that a contribution cap set at this level ***would mean that lower earners would effectively be free of any cap (since they would be unlikely to be able to use the full freedom) while limiting the extent to which higher earners could use [Personal Accounts] as a low-cost alternative for pension saving that is already in many cases occurring***[10].

The Government proposals

The Government has consulted on a proposal to set an annual contribution limit of £5,000, and £10,000 in the first year to promote long-term saving in the period before the launch of Personal Accounts[11]. A summary of responses to this and other questions is expected to be published by the Government in June 2007.

In their Personal Accounts White Paper, the Government agreed with the Pensions Commission that ***an annual limit on contributions to Personal Accounts could be an effective way of targeting the scheme at moderate and low earners who do not have access to an alternative good scheme***[12]. However, the Government concluded that a contribution limit of £3,000 ***would overly restrict the potential for voluntary saving***[13].

Table 1: DWP analysis of the effects of different contribution caps

Table 7.1: Effects of different contribution levels upon individuals at different income levels

Income level	Default contribution rate (8%)	Potential additional saving given contribution limit of: £3,000	£5,000	£8,000
£15,000	£800	£2,200	£4,200	£7,200
£23,000	£1,450	£1,550	£3,550	£6,550
£35,000	£2,300	£700	£2,700	£5,700

This table is reproduced from the DWP December White Paper ***Personal Accounts: a new way to save*** and does not represent PPI analysis

DWP analysis in the December White Paper explored the effects of different contribution levels upon individuals at three different income levels (Table 1). The Government concluded that[14]:

- for the lower earners on £15,000, reaching any of the illustrative contribution limits requires significant additional contributions;
- the median earner would be constrained by a limit of £3,000 if their total contribution is higher than the default rate of 8 per cent, for example if their employer contributes more than the minimum; and
- the higher earner would have very little opportunity to make additional contributions if a limit of £3,000 was imposed.

Who is the target group for Personal Accounts?

According to the Government, ***Personal Accounts are designed for the approximately 10 million people who are currently not participating in a pension scheme offering at least a 3 per cent employer contribution, are aged between 22 and State Pension age and earning over £5,000. This is the target group for Personal Accounts...We know that this group tends to be younger and on moderate to low incomes***[15].

They predict that while moderate to low earners are the particular focus for Personal Accounts, ***approximately 14 per cent of our target group for automatic enrolment into personal accounts earns above £30,000***[16].

Impact on individuals

The PPI has estimated the average annual contributions that individuals with different working and saving histories, and different earnings levels[17], will need to achieve an income in retirement of around two-thirds of their final salary (table 2). The analysis assumes that Personal Accounts achieve 3% real investment returns. It should be noted, however, that if returns turn out to be lower, individuals may need to make greater contributions each year to achieve a two-thirds replacement rate.

The analysis assumes that individuals' salaries vary over their lifetime, but that they remain in the same earnings decile for men or women at each age. So, while

table 2 presents the average annual contributions for different individuals, contribution levels will actually vary as income levels vary. This means that each individual has a range of contribution levels. Where an individuals' range takes them above £3,000 in some years this is indicated with an asterisk. Contribution levels above £3,000 in all years are indicated by two asterisks. Tables 5-8 of the PPI response to the Government's White Paper, ***Personal Accounts: a new way to save,*** has more detailed information and shows the contributions range for each individual[18].

The first example relates to a man aged 25 years in 2012 with a full NI history. He would need combined contributions of between £700 and £1,800 of his band earnings each year, depending on his income, to achieve a two-thirds replacement rate in retirement. The analysis shows that a £3,000 cap is sufficient for the median earning man, but may constrain higher earners with these characteristics. A £5,000 cap would be sufficient for earners up to the 7th decile, but 9th decile earners would be constrained in most years.

The second example is of a woman aged 25 in 2012 with two caring breaks. We assume that she receives NI credits for one caring break, but not for the other. The £3,000 cap is sufficient if she has low earnings, but if she is a median earner, the £3,000 cap may be restrictive in some years. This could mean she has limited flexibility to alter her saving patterns year by year. A £5,000 cap would be sufficient at the 7th decile but not for the highest earners.

The third example relates to a woman aged 40 years in 2012, with no previous saving history and two caring breaks (again she earns NI credits for one break but not the other). If she is a low earner, the £3,000 cap is sufficient, but as a median earner she would find it constrained her from reaching her target replacement rate. It is worth noting that as a median earner, however, she would need a combined contribution of around 32% of band earnings each year to achieve the desired replacement rate. As such, affordability issues may pose a greater restriction than a £3,000 contribution cap. A £5,000 cap would also pose a constraint for 7th and 9th decile earners with these characteristics.

The final example relates to a man aged 25 in 2012, and who is self-employed throughout his lifetime. Self-employed people will not be auto-enrolled into Personal Accounts, but they may choose to opt-in. Self-employed people will not benefit from an employer contribution, which means their individual contributions will need to be higher to reach the desired replacement rate. In this example, the £3,000 cap is sufficient for a low earner, but could be a constraint for median and higher earners. Self-employed people may experience greater fluctuations in earnings than other employees. As such, there may be a case for them to have greater flexibility to make higher contributions in some years to compensate for lower, or no, contributions in other years. Only the highest earning self-employed savers would be constrained by a

Table 2: Required saving to hit target replacement rates

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	Decile of earnings distribution				
	1st	3rd	median	7th	9th
Target replacement rate	*70%*	*70%*	*67%*	*67%*	*60%*
Man with full NI history - age 25 in 2012	£700 (7.7%)	£1,400 (9.9%)	£1,800 (9.5%)	£2,900* (11.4%)	£5,200** (18.4%)
Woman with caring breaks – age 25 in 2012	£200 (4.5%)	£1,600 (17.5%)	£2,900* (23.1%)	£4,700* (26.4%)	£7,900** (29.3%)
Woman with caring breaks and no prior saving – age 40 in 2012	£600 (12.4%)	£2,500 (26.9%)	£4,000** (31.9%)	£6,200** (34.1%)	£10,200** (36.8%)
Self-employed man – age 25 in 2012	£1,700 (19.6%)	£2,400 (17.6%)	£2,900* (15.3%)	£4,000* (15.8%)	£6,300** (22.4%)

Bold figures denote average annual savings (£s) required to reach the target replacement rate. * indicates contributions that exceed £3k in some* or all** years. Figures in brackets denote saving rates as % of band earnings.

£5,000 cap.

Overall, the analysis shows that a £3,000 contribution cap is sufficient for most people on low to median incomes to achieve a two-thirds replacement rate in retirement. People who are older in 2012 and who have no prior saving history are more likely to be constrained by a £3,000 contribution cap. If the cap were set higher, at £5,000 as the Government has proposed, it would be sufficient for many higher earning individuals also. However, this might have a larger negative impact on existing provision.

Impact on existing provision

It is difficult to predict what impact Personal Accounts will have on existing pension provision when they are introduced in 2012.

Many factors are likely to contribute to any potential impact. These include employer and employee behaviour, the ability of the existing market to provide low-cost pension products that are attractive to employers and are as good as or better than Personal Accounts, and the ultimate design of Personal Accounts, including elements like the level of the contribution cap.

Some commentators have suggested that the higher the contribution cap, the more likely it is that Personal Accounts will be a direct competitor for existing pensions schemes. For example, if the contribution cap is set at £5,000 a year, Personal Accounts could be a direct competitor for 9 out of 10 new business schemes. At £3,000 a year, Personal Accounts would still be a competitor, but for only 6 out of 10 new business schemes[19].

Alternatives to an annual contribution limit

There may be other ways to allow individuals flexibility in contributions to Personal Accounts while still going some way to limit (though not avoid completely) the potential detrimental impact on existing provision:

- A lifetime limit rather than an annual limit: this would be more in line with changes to the regime for the tax treatment of pensions introduced in April 2006, and would allow individuals/employers to decide when they are best able to make additional contributions.
- Allow unused annual allowances to be carried forward into future years.
- Allow one-off higher contributions from specific sources, such as divorce settlements or inheritances, for example.

Conclusions

This Briefing Note has explored some of the tensions that need to be balanced in deciding the appropriate level for a contribution cap in Personal Accounts. The analysis shows that:

- The level of contributions needed to achieve target replacement rates depends on individuals' earnings profiles and working histories.
- Most earners, other than very low earners, will need more than the minimum combined default contributions to hit their target replacement rate.
- The appropriate level of the contribution cap will depend on the Government's target market and policy intentions for Personal Accounts.
- If Personal Accounts are intended primarily as a product for low to median earners who do not have access to existing provision, then a £3,000 cap may be appropriate. If the Government intends Personal Accounts to be available to higher earners without access to existing provision, then a cap closer to £5,000 may be needed. However, a higher cap might have a larger negative impact on existing provision.
- A contribution cap is one way to enable flexibility in saving in a Personal Account, there may be other options.

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1 DWP (2006 SR) ***Security in retirement: towards a new pensions system***
2 See DWP (2006 PA) ***Personal Accounts: a new way to save*** for full details of the Government's proposals and consultation
3 DWP (2006 PA) pg 38 para 100
4 DWP (2006 PA) pg 141 para 7.24
5 Steps also include prohibiting transfers in and out of Personal Accounts from other schemes and allowing a waiting period before auto-enrolment to exempt schemes.
6 The Pensions Commission (2005) pg 7
7 The Pensions Commission (2005) pg 278
8 The Pensions Commission (2005) pg 278
9 The Pensions Commission (2005) pg 360
10 The Pensions Commission (2005) pg 360
11 DWP (2006 PA) pg 39 paras 105 and 107
12 DWP (2006 PA) pg 140 para 7.21
13 DWP (2006 PA) pg 141 para 7.24
14 DWP (2006 PA) pg 140-141 para 7.22
15 DWP (2006 PA) pg 27 para 62 and pg 48 para 1.1
16 DWP (2006) ***Regulatory impact assessment*** pg 114 para 5.21
17 The deciles are age and gender specific and based on UK earnings in 2006.
18 See PPI (2007) ***PPI's response to the Government's White Paper, Personal Accounts: a new way to save*** for more detail
19 Legal and General (2007) ***Submission to Work and Pensions Select Committee***