Automatic enrolment minimum contribution increases and pay

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PPI Briefing Note Number 112

Introduction

From April 2019, the minimum Automatic Enrolment (AE) pension contributions will increase from 5% to 8% of band earnings, altering the level of take-home pay and total remuneration to members in workplace pension schemes. This could potentially change employees' attitudes to AE and there is debate as to whether this could lead to a high number of employees stopping saving into a pension scheme, or conversely be of benefit to more adequate incomes in retirement.

Key results

- The 5.9 million eligible employees who are already contributing at a rate above the minimum level may not have an increase in their contributions or see any reduction in their take-home pay from March to April 2019 due to rises in minimum contribution rates.
- Increasing AE contributions in April 2019 across band earnings affects higher earning individuals proportionately more than those on lower pay.
- Individuals earning between £12,600 and £16,000 per year will see an increase in their take-home pay from April 2019 due to the combined positive impact of income tax and NI changes.
- Those on National Living Wage (NLW) will benefit greatly from the mandatory wage increase introduced in terms of take-home pay.
- While employee contributions will increase in April 2019 resulting in a reduction in take-home pay, overall remuneration will increase as a result of the corresponding rise in employer pension contributions.
- Overall, the cost to the employer will increase due to higher minimum employer contributions.

AE into pension schemes was introduced in 2012. Employers are required to automatically enrol employees who meet certain eligibility requirements into an appropriate pension scheme with a minimum level of pension contributions. The minimum contribution rate and thresholds increased in April 2018 and will do so again in April 2019.

The increase in AE minimum contribution rates will not be seen by all individuals since approximately 5.9 million eligible employees are already meeting the April 2019 minimum contribution requirements. About 6.1 million will see an increase in their total contributions in April 2019. This includes those who are contributing above the increased AE minimum employee contribution (5%) with their employer contributing under the increased minimum employer contribution (3%) and vice versa. Therefore, some of these individuals will see a reduction in their take-home pay and hence may be at risk of stopping saving.[1]

This Briefing Note investigates the minimum contribution rate, income and National Insurance (NI) increases, and assesses its implications on take-home pay and total remuneration, thereby determining which individuals are affected the most by the 2019/20 changes. The Briefing Note then looks into the potential cost to employers and the risk of more employees stopping saving into a pension scheme due to the changes.

Automatic Enrolment 2019/20 changes

In April 2019, the minimum contribution rate increases from a combined rate of 5% of band earnings (3% employee contribution, 2% employer contribution) to 8% of band earnings (5% and 3% respectively). The AE qualifying salary remains at £10,000 per annum. This is the minimum amount that an employee must earn in order to be automatically enrolled. As nominal average earnings growth is 2.6%,[2] more employees on lower earnings will now be eligible for AE. There are also other policy changes being implemented in April 2019 that will affect take-home pay such as increases to the annual personal allowance and changes in income tax and NI thresholds.

Changes to pension contributions have a greater impact on higher earners

The upper and lower salary bands have increased for 2019/20, to cover earnings between £6,136 and £50,000 per year. These bands represent the amount of earnings which would be pensionable. For example, an individual earning £10,000 would pay pension contributions on £3,864 of their earnings (= £10,000-£6,136). The upper band has increased by 8% in 2019 compared to a 2% increase in the lower band. With the wider band, higher earners could pay higher contributions where a larger portion of their income is subject to band earnings. However, this could reduce take-home pay.

Those on higher incomes (earning £40,000 - £50,000 per year) will see their take-home pay reduced by £50 a month in cash terms. This represents a reduction of 2% in take-home pay. For those earning less than £25,000, there is a 1% reduction in take-home pay. This is because a smaller proportion of a lower-paid employee's earnings is included in the band earnings so a lower proportion of their salary is affected by the increase in pension contributions.

When compared to the previous AE changes in 2018, the effect on take-home pay is similar for most salary levels (with those earning near the upper earnings limit being the exception).

Income tax and National Insurance threshold changes

Income tax on salary reduces take-home pay, but not all salary is subject to tax. Earnings below the personal allowance are not taxable. Increasing the personal allowance reduces the taxable income and therefore can increase take-home pay. The annual personal allowance will increase from £11,850 to £12,500 per year from April 2019. An additional £650 of earnings will be exempt from income tax, leading to a £130 per annum reduction in the tax paid at the basic rate level for those earning over £12,500.

National Insurance contributions NIcs) are also based on upper and lower thresholds. From April 2019, the primary (lower) threshold will increase from £8,424 to £8,632. The upper limit increases from £46,350 to £50,000. As with the personal allowance, the increase in the lower limit reduces the amount of NIcs payable. Unlike tax, NIcs are based on gross salary, so the increase in pension contributions doesn't itself reduce the income subject to NI contributions (Table 1).

Table 1: Changes to contributions and thresholds from April 2019

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Rates in 2018/19 and 2019/20 for the items considered in this Briefing Note

	2018/19	2019/20
Minimum total AE contribution (% of band earnings)	5%	8%
Minimum AE employer contribution (% of band earnings)	2%	3%
Employee contribution (% of band earnings)	3%	5%
Salary bands (lower/upper)	£6,032/£46,350	£6,136/£50,000
Income tax personal allowance	£11,850	£12,500
Higher rate tax earning threshold	£46,350	£50,000
NI primary and secondary thresholds	£8,424	£8,632
NI upper earnings limit	£46,350	£50,000
National Living Wage for people aged 25+ over (hourly rate)	£7.83	£8.21

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Table 2: Combined effect of all policy changes from April 2019

Cumulative effect on take-home pay of combined changes of increased contributions and tax and National Insurance thresholds (assuming no earnings growth)

Gross salary	Take-home pay with 2018	Take-home pay with 2019 AE contributions and bands only	Take-home pay with 2019 all policy changes	Difference arising from policy changes, £s a month
£10,000	£9,692	£9,618	£9,643	-£4.10 (-0.51%)
£15,000	£13,366	£13,226	£13,381	£1.30 (0.12%)
£25,000	£19,926	£19,626	£19,781	-£12.03 (-0.72%)
£35,000	£26,486	£26,026	£26,181	-£25.36 (-1.15%)
£45,000	£33,046	£32,426	£32,581	-£38.70 (-1.41%)
£50,000	£36,290	£35,700	£35,781	-£42.41 (-1.40%)

As a result of increases in tax and NIcs thresholds, the negative effect of AE contribution increases on take-home pay is offset (Table 2).

Individuals earning between £12,600 and £16,000 per year will see an increase in their take-home pay

By increasing the personal allowance to £12,500 per year, employees who would have paid tax in 2018 will now no longer reach the lower earnings band. This will have a positive impact on take-home pay for these individuals.

As a result, those earning between £12,600 and £16,000 will see an increase in their take-home pay after taking into account all of the policy changes. This is due to a reduction in income tax paid, offsetting increases to AE contributions.

Raising the NI upper earnings limit increases NI liability. Earnings above this limit are subject to NI contributions of 2% and those earning below this limit are subject to NI contributions of 12%.

Employees who would have paid the reduced higher NI contribution of 2% will now have a greater proportion of their income subject to the 12% NI contributions. The effect on take-home pay is greatest when income hits £47,600 where the effects of higher contributions and the shift in the NI upper earnings limit are compounded, resulting in an overall reduction of 1.9% in take-home pay (Chart 1).

The impact of tax thresholds then begin to take effect as those who would have paid a higher rate of tax of 40% in 2018 will now be under the basic tax level of 20%, and hence would not need to pay more tax. The curve flattens out

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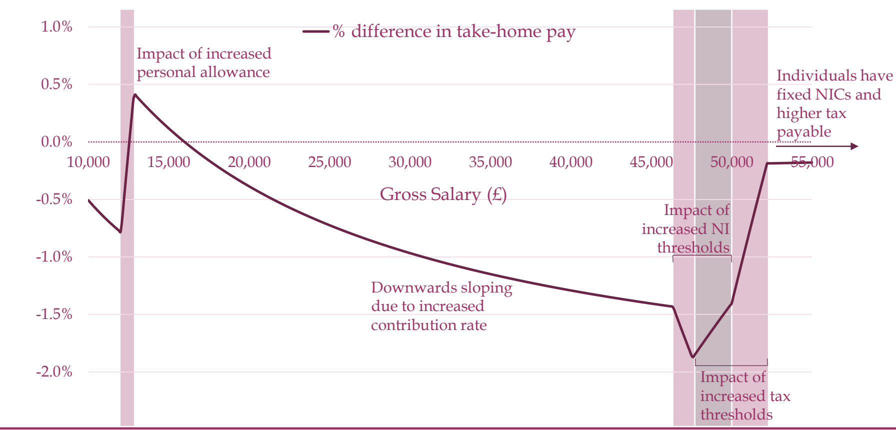
Chart 1: Higher earners lose out more from the policy changes

Net difference in take-home pay for different salary levels (assuming no earnings growth)



as those who earn more than £52,200 will have fixed NIcs, pension contributions and income tax payable.

The increases in both income tax and NI thresholds do not fully mitigate the increase in AE contribution rates. For those not earning between £12,600 and £16,000 per year, achieving the same take-home pay in 2019 as in 2018 would therefore require a pay increase.

Those on National Living Wage (NLW) will benefit greatly from the mandatory wage increases

The Office for Budget Responsibility (OBR) forecasts a 2.6% increase in earnings.[3]

Those on National Living Wage (NLW) will see their hourly pay increase from £7.83 to £8.21 in April, representing a 4.9% increase in salary. This is significantly higher than the average earnings growth and will offset the reduction in take-home pay due to the higher minimum AE contribution rate.

Those not on NLW and who have seen a fall in their take-home pay would require a pay rise in order to receive the same take-home pay after April 2019. This pay rise is less than the OBR's forecast nominal average earnings growth of 2.6%. Therefore, on average, an individual will see an increase in their take-home pay once pay rises has been taken into account (Table 3).

Total remuneration increases as a result of additional pension contributions

Total remuneration is the value of an individual's take-home pay and the total value of their pension contributions. Although the value of take-home pay will be reduced, the higher employee pension contribution is a redistribution of the components of total remuneration. Total remuneration will increase for all salary levels as employer pension contributions increase.

Take-home pay reflects the individual's purchasing power and so will exert the most influence on employee behaviour today.

However, money saved in a pension is not simply "lost money". Pension savings are a valuable part of the individual's earnings and therefore should be considered when looking at the AE changes in 2019/20. Considering total net remuneration as take-home pay plus the employer and employee pension contributions gives a perspective on the effect of AE pension contribution increases on the value of work.

While at most salary levels take-home pay falls, the sum of the increases in employee and employer contributions over compensates for this reduction and total remuneration increases at all salary levels, excluding any potential pay rises (Chart 2).

For example, although an individual earning £25,000 per year will see a decrease of £12 in his or her take-home pay each month, they will also see an increase of £31 in their employee contribution and a £16 increase in employer contribution, resulting in an increase of £35 in total remu-

Table 3: Maintaining take-home pay in nominal terms would need a pay rise less than average earnings growth

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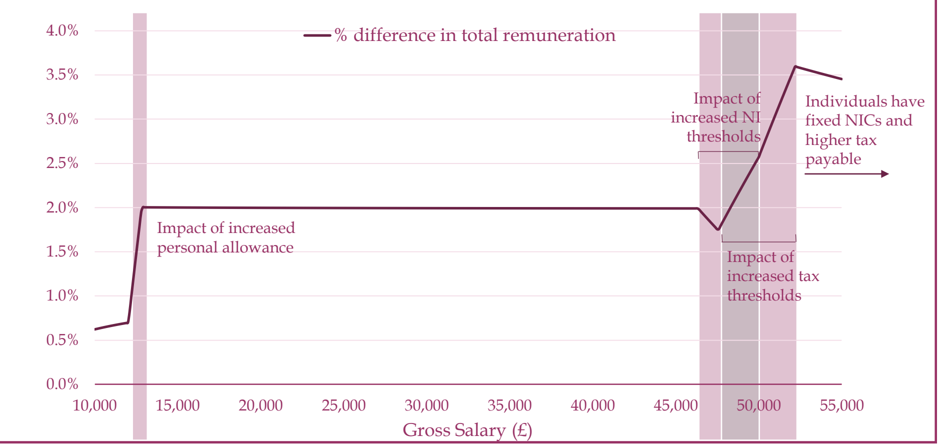
Required pay increases to maintain take-home pay from 2018 in 2019, in nominal terms

Gross salary	Take-home pay in 2018	Take-home pay in 2019	Difference (£s a month)	Pay increase required to maintain take-home pay in cash terms
£10,000	£9,692	£9,643	-£4.10	0.6%
£15,000	£13,366	£13,381	£1.30	-0.2%
£25,000	£19,926	£19,781	-£12.03	0.9%
£35,000	£26,486	£26,181	-£25.36	1.4%
£45,000	£33,046	£32,581	-£38.70	1.6%
£50,000	£36,290	£35,781	-£42.41	1.3%

Chart 2: Total remuneration increases for all employees (excluding any pay rises)

Net difference in total remuneration at different salary levels



neration (a 2% increase from last year). If their salary was to increase by average earnings growth of 2.6%, in line with OBR assumptions,[4] then the increase in total remuneration is greater.

The cost of employment also increases

An employer is interested in recruiting and retaining a workforce in a cost-effective manner. Modelling the effect of AE contribution increases from the employer's perspective is done by defining each employee's cost of employment as the salary paid plus employer NICs and employer pension contributions.

Since employer AE contributions have risen by 1% compared to 2018, the cost of employment will also rise (even if there isn't a pay increase). The increase in the NICs threshold will reduce the cost, but not completely offset it. Overall, there is an increase in cost to the employer.

Revisiting the individual earning £25,000 per year, an employer would need to fund an additional £158 a year per employee.

The increase in such costs could lead to employers seeking to reduce any pay rises to compensate the higher costs of employment. By reducing the size of a pay rise, employers are essentially passing on the cost of increases in AE minimum contributions to employees through lower pay increases. Restricting pay increases could lead to a reduction in employees' take-home pay. The OBR has accounted for this through their wage growth projections.

The risk of higher rates of stopping saving

The number of employees stopping saving (includes opt-outs and cessations) following the 2018/19 AE contribution changes remained stable at around 0.7%.[5]

Previous AE changes revealed that 69% of members had not considered changing their pension contributions with 28% actually considering to increase their pension contribution after the contribution rate rose from 2% to 5%.[6] This supports the idea that the number stopping saving may remain stable, despite the reduction in take-home pay.

The Real Time Information (RTI) reporting system focuses on earnings taxed through the Pay As You Go system. It collects information on employee pension contributions, although it does not catch employees with employer-only pension contributions and pension contributions made via salary sacrifice. These figures illustrate the trend over time, but do not represent the complete picture of all employees who have stopped saving.[7]

From 2016/17, the rate of those who have stopped saving into a pension scheme has remained stable around 0.7% per year. The latest in 2018/19 (June 2018) is 0.5%.[8] This trend has been stable over this period, which saw minimum pension contributions increase from 2% to 5%.[9] It is therefore possible that this trend could continue through the 2019/20 contribution changes.

Conclusions

Automatic Enrolment has been considered a success as it emphasises the importance of pension saving. Participation rates remain high despite increasing contributions in 2018/19. The increase in contribution rate for April 2019 may therefore have similar effects compared to changes in 2018/19, perhaps suggesting a similar reaction to the higher contribution rate.

The increased contribution rate will result in an increase in take-home pay for those earning between £12,600 and £16,000 per year.

For those auto enrolled at minimum levels and not earning between £12,600 and £16,000 per year, take-home pay will fall. Changes in income tax and National Insurance thresholds mitigate some of the effect of higher AE contributions, however it does not completely offset it. This is more evident for those on higher incomes, who are also disadvantaged by a large increase in the upper bands.

Those on the National Living Wage will receive a mandatory increase of 4.9% and will benefit from the increased contribution rate in April 2019. In order for others to see the same take-home pay after the changes, they will need a salary increase less than the OBR's 2.6% forecast increase in nominal average earnings.

When considered as a total remuneration package, the sum of the increases in employee and employer contributions offsets the reduction in take-home pay. Subsequently, at all salary levels, net remuneration is higher. This shows that everyone receives more money, but this money is distributed differently between the amount taken home and the amount invested in an individual's pension to provide for retirement.

The previous AE minimum contribution increases in 2018/19 and the increase in April 2019 both coincide with increases in personal allowance. This effectively dampened the impact the changes had on take-home pay. No political party advocates continuing increases in tax-free allowance. This raises a question on whether a future increase in minimum AE contributions will see an increase in personal allowance. If not, this could mean a larger impact on take-home pay and hence, potentially a higher number of employees stopping saving.

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1 Department for Work & Pensions (DWP) (2018), *Automatic Enrolment evaluation report*

2 Office for Budget Responsibility (OBR) (October 2018), *Economic and fiscal outlook*

3 Office for Budget Responsibility (OBR) (October 2018), *Economic and fiscal outlook*

4 Office for Budget Responsibility (OBR) (October 2018), *Economic and fiscal outlook*

5 Department for Work & Pensions (DWP) (2018), *Automatic Enrolment evaluation report*

6 NEST Insight (2019), *The auto enrolment experience over time*

7 Department for Work & Pensions (DWP) (2018), *Automatic Enrolment evaluation report*

8 An employee is inferred to have made an active decision to stop saving when their employment is still active and eligible, but they stop contributing to a workplace pension.

9 Department for Work & Pensions (DWP) (2018), *Automatic Enrolment evaluation report*

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