Evidence from New Zealand suggests that the government's plan for auto-enrolment into workplace pensions may substantially affect participation rates and total savings.

Jan 20 2012

As the government plans to unroll its automatic enrolment in workplace pensions, **Leandro Carrera** *argues that while the legislation is likely to increase the number of savers, policy design and evidence from New Zealand shows that uncertainty about the future and increased costs for employers could paint a more complex picture on the future of pensions.*

In a recent inquiry, the Work and Pensions Select Committee focused on the introduction of automatic enrolment into workplace pensions from 2012. The previous Labour Government, acting on the recommendations of the Pensions Commission's 2005 report, legislated in the Pensions Act 2008 that from 2012, employers would be required to automatically enrol eligible employees into their own pension scheme, or into another pension arrangement, provided it meets the certification criteria. Automatically enrolled employees will have the right to opt out at any time. The Pensions Commission's original intention in recommending automatic enrolment was to overcome people's inertia and tendency not to save into a pension.

ONS statistics show that in 2010 only around 6 million people in the private sector were either contributing or accruing rights to a workplace pension. Automatic enrolment into workplace pensions could then significantly increase both the total number of people saving into a pension and the total amount of pension savings. The Government has recently estimated that there could be between 5 and 8 million new savers in workplace pensions as a consequence of these reforms.

How will the system be implemented?

Employers will have to start automatically enrolling their eligible employees into a workplace pension in a series of stages, with large employers starting in October 2012. Employers will be required to automatically enrol every employee aged 22 to State Pension Age (SPA) with earnings above the National Insurance Threshold of £7,475 per year (in 2011/12 earnings terms).

The legislation stipulates a total minimum contribution of 8 per cent, with at least 3 per cent from the employer. Contributions will be calculated on a band of earnings that ranges from £5,715 to £38,185 in terms of 2010/11 earnings, but will be uprated to 2012/13 terms according to earnings evolution. This means that an auto-enrolled employee on, for example, a £10,000 salary will need to make a minimum contribution of 8 per cent of £10,000 minus the £5,715 minimum. The band earnings system was designed so that employees who are automatically enrolled but on low earnings experience a lower reduction in their net pay than if they contributed based on their full earnings.

The self-employed and employees aged 16 to 22 and those between the SPA and 75 can opt-in to the system. Employees who are automatically enrolled will have the right to opt-out at any time.

The Government has set up the National Employment Savings Trust (NEST) as an option for those employers who do not provide a qualifying occupational pension scheme or who do not sponsor a group or stakeholder personal pension. NEST will provide a system of individualised accounts with a low-charging structure of 0.3 per cent of the fund per year. However, for the first few years of operation NEST members will also pay a 1.8 per cent charge on contributions in order to fund NEST's start-up costs.

Will the system achieve the goal of increasing both the number of people saving into a pension and total pension saving?

While automatic enrolment could significant change the current pensions landscape, there are some uncertainties regarding how employers and employees will react. Whether employees contribute the legal minimum of 3 per cent or whether they will contribute more will impact on the total amount of pension saving.

Automatic enrolment will increase employers' costs as they will have to enrol and pay contributions of at least 3 per cent of band earnings for their eligible employees. As a result, employers may decide to pass on this cost increase either by increasing prices or reducing profits – in this case consumers or shareholders would lose out from the reforms. Employers could also reduce wage settlements or reduce the generosity of their pension scheme to try to offset some of the extra costs related to the increased participation in pension schemes following auto-enrolment – in this case employees may be affected. For example, if employers with existing good schemes started reducing the generosity of their contributions to those schemes to the legal minimum of 3 per cent of band earnings, then we could see a substantial reduction in the total amount of private pension saving in the UK.

It was estimated in 2009 that only 10 per cent of employers were making pension contributions of 3 per cent or more. However, they accounted for more than half of all private sector employees, as large employers are more likely to offer generous pension schemes. Thus, decisions made by this small number of employers could have a significant effect on total pension savings. Also, employees' decisions on whether to opt-out once automatically enrolled, or to opt-in will impact on the total number of people saving into a workplace pension.

It is difficult to anticipate the expected opt-out rates as the UK will be only the second country in the world, after New Zealand, to incorporate a national system of auto-enrolment into private pension saving with the option to opt-out.

Evidence from New Zealand

New Zealand implemented auto-enrolment into a national saving scheme called KiwiSaver in July 2007. Unlike the UK, individuals are auto-enrolled when starting work for the first time or when changing jobs. Also, auto-enrolled individuals can only opt-out within 8 weeks of being automatically enrolled. After this period, they can apply for an unlimited number of contribution holidays of up to five years. In NZ, members have a unique KiwiSaver account throughout their working life. By contrast, in the UK auto-enrolled members may end up accumulating different pension pots, depending in the scheme selected by their different employers throughout their working life: an occupational pension, a personal pension or NEST.

Recent estimates from New Zealand's Inland Revenue show that the opt-out rate, calculated as the number of people who opted-out divided by the number of people who were auto-enrolled, has been around 30 per cent in the first three years from 2007/08 to 2010/11. As of 30 June 2011, participation in the scheme represented around 51 per cent of New Zealand's working-age population. Total assets in KiwiSaver accounts represent around 14 per cent of New Zealand's life and insurance market.

Notwithstanding the policy design differences between the NZ and the UK, the NZ experience with auto-enrolment and KiwiSaver suggests that participation rates and total pension savings could be substantial in the UK once auto-enrolment is fully implemented.

A recent evaluation survey has found that New Zealanders' decision to participate in the system could be affected by a number of reasons. For example, the survey found that around 30 per cent of those surveyed decided not to participate in the system because of fear that the Government would implement changes in the future. KiwiSaver has indeed undergone through a number of changes since its implementation in 2007 which included changes to the minimum contribution rates and a reduction in the Government tax credit for those who participate in the system. The current centre-right Government led by the National Party proposed further changes to KiwiSaver in the recent electoral campaign, suggesting further changes could be explored in the future.

The changes and uncertainties about the future could explain why some eligible people in NZ have decided not to join KiwiSaver. There may be an implication for the UK in that continuous change before, during and after the system is fully rolled-out could affect people's trust in the system.

In sum, automatic enrolment is likely to significantly change the current pensions landscape. But policy design and the evidence from New Zealand highlight different factors that could affect the goals and outcomes of the policy.

This post is based on a recent Pension Policy Institute briefing note available here.

Please read our comments policy before posting.

You may also be interested in the following posts (automatically generated):

1. Employer contributions have a significant impact on encouraging pension savings. Policy-makers seeking ways to increase contribution rates and take-up should focus on this lever.
2. Policy interventions designed to increase household savings rates should be based on high quality evidence of saving behaviour
3. How are pensions changing in the UK?
4. Budget 2011: The new flat rate pension will reduce poverty among the retired, but employers who offer good pensions may be penalised financially as a result