5 Target group

Summary

In this chapter, we look at the proposed scope for automatic enrolment and consider a number of changes, analysing the impact on individuals and employers. We do not make specific recommendations at this stage, as the overall impacts and benefits can only be assessed when all the different areas of analysis in this report are brought together, including how changes in scope might impact on the regulatory burden, on profitability in the pensions market and on the need for NEST. Chapter 8 brings all these factors together.

The main areas for change that we have considered are:

- increasing the earnings threshold
- introducing a waiting period
- excluding some employers
- excluding older workers

Table 5.7 provides a summary of the impact on individuals, employers and industry for all options.

Consultation with stakeholders brought mixed views on the earnings levels at which individuals should be automatically enrolled. Concern was raised about including low earners for whom it may not pay to save. Some felt a small increase in the level was justified and that alignment with existing National Insurance or tax thresholds would ease administration burdens for employers. Analysis shows us that lower earners tend to achieve high replacement rates from the State alone. However, the dynamics of family and working life may mean that many lower earners may benefit from saving at a lower wage. Low earners are predominately women and therefore raising the threshold significantly is likely to have a particular

effect on women. Raising the threshold will reduce costs for employers and aligning thresholds with existing tax and national insurance is likely to ease the administration burden for employers.

The strongest call for waiting periods came from employers wanting to reduce the cost of enrolling short term and temporary workers. Consumer groups felt this would reduce overall saving and penalise those who change jobs frequently. Overall, the introduction of a waiting period has a largely negative impact on individuals, reducing overall saving for an average of 5.5 years with a 6 month waiting period. Employers save on both administration costs and contribution costs by not having to automatically enrol individuals who leave the company after a relatively short period of time.

We saw in Chapter 3 that the smallest employers would face high costs from automatic enrolment. However, whilst stakeholders recognised that the reforms would be most difficult for the very smallest employers, most felt that all employers should be covered by the reforms irrespective of size. Consumer and employee representative groups felt exempting small employers would be unfair to those individuals who worked for them. Analysis suggests that many individuals spend a relatively small part of their lives working for smaller employers before going on to work for larger employers. They would, therefore, be automatically enrolled at some future point in their working lives, but would lose out for the period of time that they are working for the smaller employer.

There were some concerns from stakeholders that it might not pay to save for those individuals who are close to retirement when the reforms are introduced, though there was limited appetite for excluding older workers amongst both employer and consumer groups. Analysis shows that many older workers already have past savings and would benefit from topping up these savings. Even those individuals who do not have past savings and who would only have time to build up a small pot could trivially commute their savings. They would, therefore, benefit from taking a lump sum with no negative impact on benefit entitlement. In the short term only, employers would see minimal contribution and administrative savings.

5.1 Introduction

We were asked to consider whether the proposed scope for automatic enrolment strikes an appropriate balance between the costs and benefits to both individuals and employers. The three main groups of options covered in this chapter that change this balance cover:

- Increasing the earnings threshold.
- Introducing a waiting period.
- Excluding some employers.
- Excluding early cohorts of older workers.

We have focussed primarily on the effects these options have on individuals and employers, but we have also considered the knock-on effects on industry, the Pensions Regulator, NEST and the Exchequer. Throughout the chapter, the discussion focuses on the effect of each change relative to the current approach and target group.

This chapter considers the various options separately. However, to some extent they affect the same individuals and employers. For example, micro employers are more likely to employ low earners and have a higher staff turnover.

In examining each option, the chapter looks at the case for change, stakeholder views expressed to us during the review consultation, options for change, and the key impacts of those options. The chapter starts by looking at options for changing the earnings threshold for automatic enrolment (Section 5.2); then considers waiting periods before automatic enrolment (Section 5.3); then looks at excluding smaller employers from the employer duties set out in the Pensions Act 2008 (Section 5.4); and finally looks at options for changing the age thresholds for automatic enrolment (Section 5.5). The comparative impacts of the changes are summarised in a table in the conclusions (Section 5.6).

5.2 The Earnings Threshold

5.2.1 Why consider change?

The Pensions Commission originally proposed that individuals would be automatically enrolled when they earn enough to pay National Insurance contributions. At this level of earnings an individual would accrue a Basic State Pension, which would give them a basic income in retirement on which to build through additional saving. They also recommended that pension contributions were calculated on earnings between the National Insurance contributions primary threshold and the National Insurance upper earnings limit. Therefore, in 2006/7 terms, individuals would be automatically enrolled when they earned at least £5,035, the then National Insurance contributions primary threshold, with contributions being calculated on all gross qualifying earnings between £5,035 and £33,540. The Pensions Act 2008 requires these thresholds to be up-rated in line with earnings, so consequent changes have caused them to become unaligned with the National Insurance thresholds, which have been up-rated in different ways.

The primary reason to consider changes to the earnings threshold for automatic enrolment is that there may be individuals who are consistently lower earners and find that the State, through pensions and benefits, provides them with a sufficiently high replacement rate without additional saving. For these individuals it may not be beneficial to redirect income during working life into pension saving. As discussed in Chapter 2, the Pensions Commission used the concept of the ‘replacement rate’ to measure the proportion of working-age income that is ‘replaced’ by income in retirement.

Another reason for change would be to re-align thresholds with other current earnings triggers, such as the National Insurance and tax thresholds. This would both simplify administration for employers and ensure that only those that earn enough to accrue a Basic State Pension are automatically enrolled into private pension saving.

5.2.2 Stakeholder views

In our consultation with stakeholders, there were mixed views on the earnings level at which individuals should be automatically enrolled. Industry, employer and consumer groups all expressed concern that the current policy included some low earners for whom it might not be worthwhile saving. Many thought there was a case for increasing the threshold at which an individual would be automatically enrolled, though there were different views on what level it should be. Stakeholders were clear, however, that while it may be appropriate to raise the threshold for automatic enrolment, the levels of earnings from which contributions are calculated once an individual is enrolled should not be increased.

Consumer and employee representatives generally supported as broad a scope for automatic enrolment as possible and wanted to ensure that key groups (especially women) were included. However, they had some concerns about the affordability of pension saving for lower earners, and that the interaction with means-tested benefits may reduce returns for some groups. There were different views on the policy implications of this dilemma. Some felt it justified a small increase in the earnings threshold, whilst others believed there was no case for change because individuals are already able to opt out of pension saving.

Employers supported a slight increase in the earnings threshold. This was predominantly driven by concerns about what they perceived as an unnecessary administrative burden, which they felt could be removed if the pension thresholds matched thresholds in the National Insurance system. Chapters 3 and 6 discuss employer concerns in relation to administrative burdens and de-regulatory measures to ease those burdens.

The strongest support for increasing the earnings threshold came from industry representatives, with many suggesting that £10,000 was an appropriate threshold.

Others suggested that the earnings threshold(s) could be linked to National Insurance thresholds, tax thresholds or National Minimum Wage levels.

5.2.3 Options

We start with the premise that we should take the opportunity to re-align the earnings threshold with existing earnings triggers for tax and National Insurance, provided there is a trigger within a sensible reach of the optimum triggers for automatic enrolment.

However, the critical issue for us is that the right balance of risk is achieved in setting the earnings threshold: a low earnings threshold has a greater risk of automatically enrolling an individual into pension savings who will not benefit from saving (relying on them to opt-out), while a higher threshold risks not automatically enrolling an individual who should be saving (relying on them to opt in).

In exploring the impact of changing thresholds and assessing the balance of risks involved, we have looked at four options for the threshold at which an individual becomes eligible for automatic enrolment:

- The National Insurance primary threshold – a small change, realigning the automatic enrolment threshold with the National Insurance primary thresholds (£5,715 in 2010/11).

- The income tax threshold – this raises the threshold slightly, aligning it with the threshold for income tax, removing the lowest earners from the scope of automatic enrolment. The Government have announced a real increase in this threshold to £7,475 in 2011/12 (£7,336 in 2010/11 terms).
- The Government aspiration for future income tax thresholds – removing a more significant proportion of lower earners from automatic enrolment (£10,000 in 2010/11).
- Setting a level above full-time work at the National Minimum Wage – to test the impact of removing a significant proportion of lower earners from automatic enrolment (£14,000 in 2010/11 prices).

For all options, we concluded:

- That the point at which contributions are deducted should be aligned with the National Insurance primary threshold. This ensures that, even with a higher entry threshold, individuals who are automatically enrolled have their pension contributions calculated on a significant portion of their income.
- Minimum contributions are calculated on earnings between £5,715 and £38,185 (the original £33,540 uprated to 2010/11 earnings levels). We do not recommend aligning the top end of the band with the National Insurance upper earnings limit (£43,875). This has moved significantly away from its level at the time of the original proposals and re-alignment may result in a significant increase in employer contributions for some employers with particular earnings profiles. We did not think is was an appropriate time to add further burdens on employers, but recognise that realignment may be appropriate in the future. We suggest that Government consider this as part of their review of the reforms in 2017.

5.2.4 Key findings

Impact on individuals

Increasing the earnings threshold will reduce the number of individuals who are automatically enrolled (see table 5.2), so it is important that we understand the characteristics of the groups affected and the impact that no longer being automatically enrolled at this point in their working lives would have on their income in retirement.

Increasing earnings thresholds disproportionately affects women. For example, setting the threshold at £7,336 would see 78 per cent of the group no longer captured being women, (or 76 per cent at £10,000 and 68 per cent at £14,000). This disproportionate impact on women is something we would wish to avoid if we believed that these people would benefit from saving.

There are a number of reasons to conclude that not automatically enrolling some low earners is the right thing to do:

- Persistent low earners get a high replacement rate from the State. As we saw in Chapter 2, individuals who are low earners throughout their lifetime receive relatively high income in retirement without private pension saving. For example, an individual earning £10,000 per year from the age of 22 would see a replacement rate of around 97 per cent from the State alone. For these individuals, it is questionable whether it is beneficial to redirect money into private saving.
- Individuals can opt in. Where the individual feels that they would benefit, they can opt in to pension saving if they wish. This means that employers would need to enrol voluntary savers into a pension scheme and pay employer contributions for those earning more than £5,715.
- Where earnings increase over time, the individual is brought in to pension saving when they have more money. The analysis in Chapter 2 showed how most individuals on low earnings subsequently go on to earn more. We can use this information to look at the impact of a higher earnings threshold on individuals whose earnings increase over time. Table 5.1 does this by increasing the age at which an individual is assumed to start making contributions, depending on the earnings threshold. It shows that, with higher earnings thresholds, the impact on weekly income in retirement is small, though there is also an impact on the lump sum the individual can take at retirement.

Table 5.1: Impact on low earner

Earnings threshold	**£5,715**	**£10,000**	**£14,000**
Contribution starting age	**25**	**29**	**36**
Private pension weekly income at retirement £	19.40	19.13	17.59
Lump sum at retirement *£000*	9.3	9.1	8.2
Net replacement rate at retirement *percentage*	62.3	62.2	61.8

Note: An individual with an earnings trajectory from £8,000 at age 25 to £20,000 by age 45.
Source: Department for Work and Pensions modelling.

In addition to the impact of increasing the earnings threshold, there is an impact on individuals from separating the threshold at which automatic enrolment occurs (£7,336, £10,000 or £14,000) and the band on which contributions are calculated and deducted (£5,715 to £38,185). Splitting the threshold and lower band in this way means that when individuals are enrolled, they start saving amounts of money that could more significantly increase their income in retirement. However, it also creates a potential cliff edge, where small increases in earnings could tip them over into making significant pension contributions. So they could see their take home pay fall. However, our analysis, in Annex C.4.2, suggests that this impact should be minimal.

Impact on employers

Increasing the threshold at which automatic enrolment occurs and separating the earnings threshold from the band on which contributions are deducted will have slightly different impacts on employers.

Increasing the automatic enrolment threshold means a reduction in the number of individuals automatically enrolled, leading to both administrative and contribution cost savings. Micro employers tend to benefit most from reduced administrative and contribution costs as they are more likely to employ low earners – around two thirds of individuals who work for micro employers earn less than £15,000, compared with around a third of individuals who work for employers with at least twenty workers (see Chapter 3).

Separating the earnings threshold from the lower earnings limit reduces the number of individuals who repeatedly start and then stop making contributions because of fluctuating earnings. It therefore reduces the administrative burden associated with such individuals. And where administration costs are incurred, they will be more proportionate because they will be incurred in making more significant amounts of contributions.

The administrative and contribution cost savings with each alternative earnings threshold is presented in Table 5.2.

Table 5.2: Impact on individuals and employers of different qualifying earnings

Qualifying earnings threshold	Individuals			Employer costs	
	Total coverage	% female	Other characteristics	Contribution costs	Administration costs
Current target group	10 - 11m	40%	12% BME 12% disabled	**£3,240m**	**£444m in Year 1** **£127m ongoing**
NICs Primary Threshold			Minimal change		
£7,336	-0.6m	78% (of the 0.6m) 38% in revised overall target group	No particular impacts by ethnicity, disability or age group. No disadvantage as individuals retain the right to opt in	-£20m	-£4m in Year 1 -£3m ongoing
£10,000	-1.4m	76% (of the 1.4m) 36% in revised overall target group		-£50m	-£8m in Year 1 -£6m ongoing
£14,000	-2.9m	68% (of the 2.9 m) 32% in revised overall target group		-£250m	-£22m in Year 1 -£12m ongoing

Source: Department for Work and Pensions modelling.
Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics.
Family Resources Survey, United Kingdom 2003-04, 2004-05, 2005-06, Department for Work and Pensions.

Impact on the pensions industry and the Exchequer

Separating the earnings threshold and the band on which contributions are paid will help reduce the number of small pots of pension savings which are disproportionately costly for industry to administer. The smallest contribution going into a pension pot would be £130 per year for an individual with earnings of £7,336 (£343 at £10,000 and £663 at £14,000). However, the size of the pension pot accumulated will also depend on the persistency of the individual's saving. An individual contributing a small amount over a long period of time could still build up an adequate size pot.

Savings for the Exchequer are relatively low with this option because overall savings levels do not change significantly. This is because those who are enrolled still make contributions from the lower earnings band. And those who are no longer enrolled would have been making small amounts of contributions in any case.

5.3 Introducing waiting periods prior to automatic enrolment

5.3.1 Why consider change?

Current policy is that all employees should be automatically enrolled on the first day of their employment or when they become eligible. Many employers have expressed concern that this could lead to costs associated with enrolling large numbers of employees working for short periods. The administrative burden may also be eased by allowing employers more time to complete all the processes involved in automatic enrolment and providing individuals with more time to consider whether they wish to stay in the scheme. It may also increase the opportunity for the individuals to return the opt out form prior to deductions being taken from their salary, reducing the risk that refunds will have to be paid.

On the other hand a significant waiting period will reduce the total amount of pension saving, especially for those with many jobs in their working life.

5.3.2 Stakeholder views

There were strong and consistent calls to introduce waiting periods from employers, and also from many in the pensions industry. On the other hand, employee and consumer groups were generally opposed.

Employer groups support the introduction of waiting periods because they reduce the administrative cost and burden of enrolling people who are only with the employer for a short period of time and also allow probationary periods to pass before automatically enrolling individuals. They believe that waiting periods will help employers to adjust to the additional cost of the duties; that it will minimise the need for refunds; and would help reduce the risk of levelling down. It was also suggested that a waiting period could align with the Agency Workers Regulations 2010 and hence could ease agency burdens. Most stakeholders had a waiting period of at least 12 weeks in mind.

Some pension industry members and representatives supported waiting periods for similar reasons (the reduction in administration associated with short-term workers and also to reduce the need to administer small pots of pension saving) and recommended a three month waiting period.

Consumer and employee representatives were concerned that introducing waiting periods will reduce overall pension saving, penalising those who change jobs frequently, and increasing the likelihood that individuals will opt out of pension saving.

5.3.3 Options

We have considered two options:

- Introducing a three month waiting period for all employees – suggested as an appropriate length by the majority of stakeholders who recommended a waiting period, and affecting around five per cent of employees (who have been with their current employer for less than three months).
- Introducing a six month waiting period for all employees – affecting around 10 per cent of employees (who have been with the current employer for less than six months).

In both of these options, we recommend retaining the option for the employer to automatically enrol staff at anytime during the waiting period. This is to ensure that flexibility is retained and that those employers who wish to automatically enrol staff straight away or sometime during the waiting period can do so.

5.3.4 Key findings

Impact on individuals

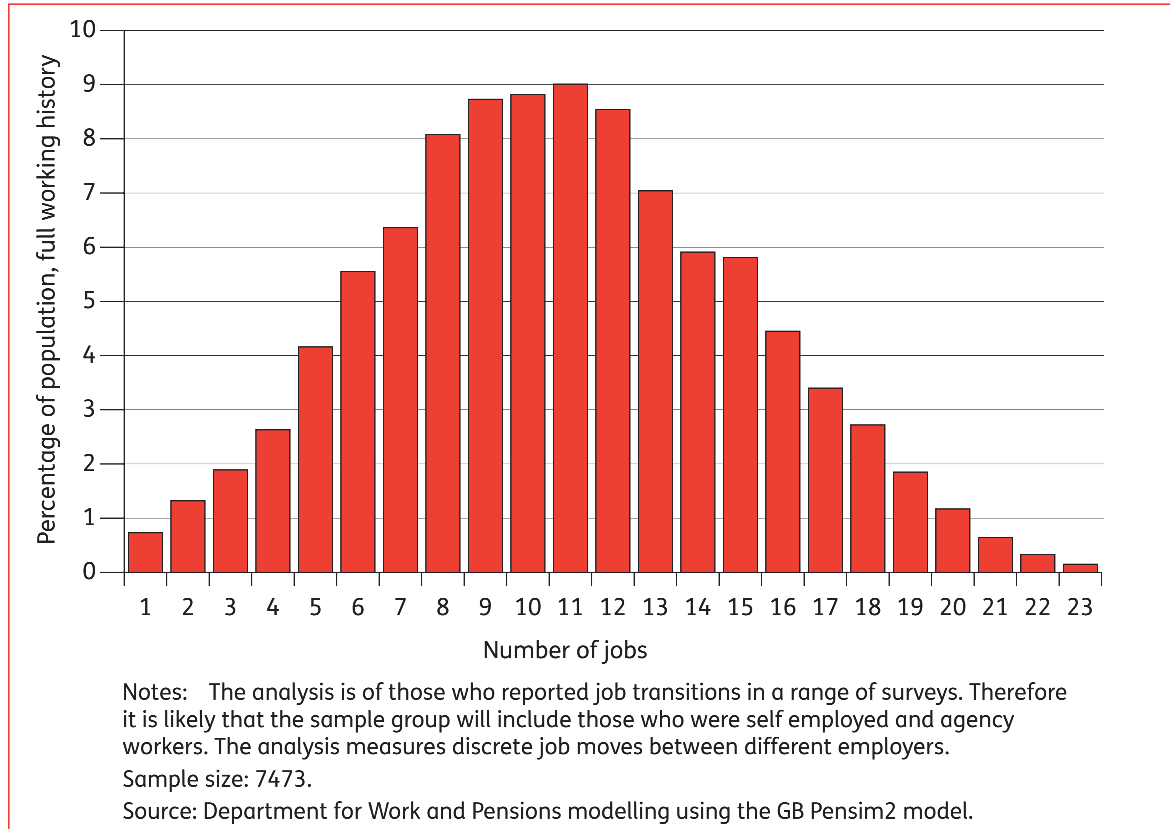
At any one time, an estimated 0.5 million or 0.9 million fewer individuals will be automatically enrolled into pension saving under these options and those that are automatically enrolled will not have contributed to a pension for the initial three months or six months they spend with any employer during their working life which will reduce their overall savings pot, unless they have opted in.

Chart 5.1 shows that, on average, an individual has 11 different labour market interactions during their lifetime[76] (the number of different jobs an individual has with different employers). Around 25 per cent of individuals have 14 or more employments. Therefore:

- A three month waiting period would have the effect, on average, of reducing an individuals accumulated years of saving by nearly 3 years (if all employers operate such a waiting period).
- Six month waiting period reducing years saved by 5-and-a-half years, on average.

76 The analysis in Chart 5.1 is based on individuals with full working histories, all individuals aged between 16 and 25 in 2007, the simulation start year.

Chart 5.1: Distribution of total number of jobs an individual will have over their lifetime, full working history



Notes: The analysis is of those who reported job transitions in a range of surveys. Therefore it is likely that the sample group will include those who were self employed and agency workers. The analysis measures discrete job moves between different employers.

Sample size: 7473.

Source: Department for Work and Pensions modelling using the GB Pensim2 model.

It is not possible to identify individuals who remain on short term contracts for the duration of their working life and so for whom this option would have the greatest impact. However, as a proxy, we can look at individuals with full working histories who have had over 20 different labour market interactions.

Of those individuals with a full working history, 2.4 per cent will have 20 or more jobs (which is an average job length of two years). A six month waiting period would reduce these individuals' accumulated savings by up to 10 years or more, whereas a three month waiting period would have impact of reducing these individuals' savings by up to five years or more[77]. So for those individuals that have the most frequent job changes, this may have a significant impact on their overall pension savings. (See Annex C.4.3 for further analysis on length of employment spells). Allowing individuals to opt into pension saving during the waiting period would, however, allow earlier access to those who particularly value it.

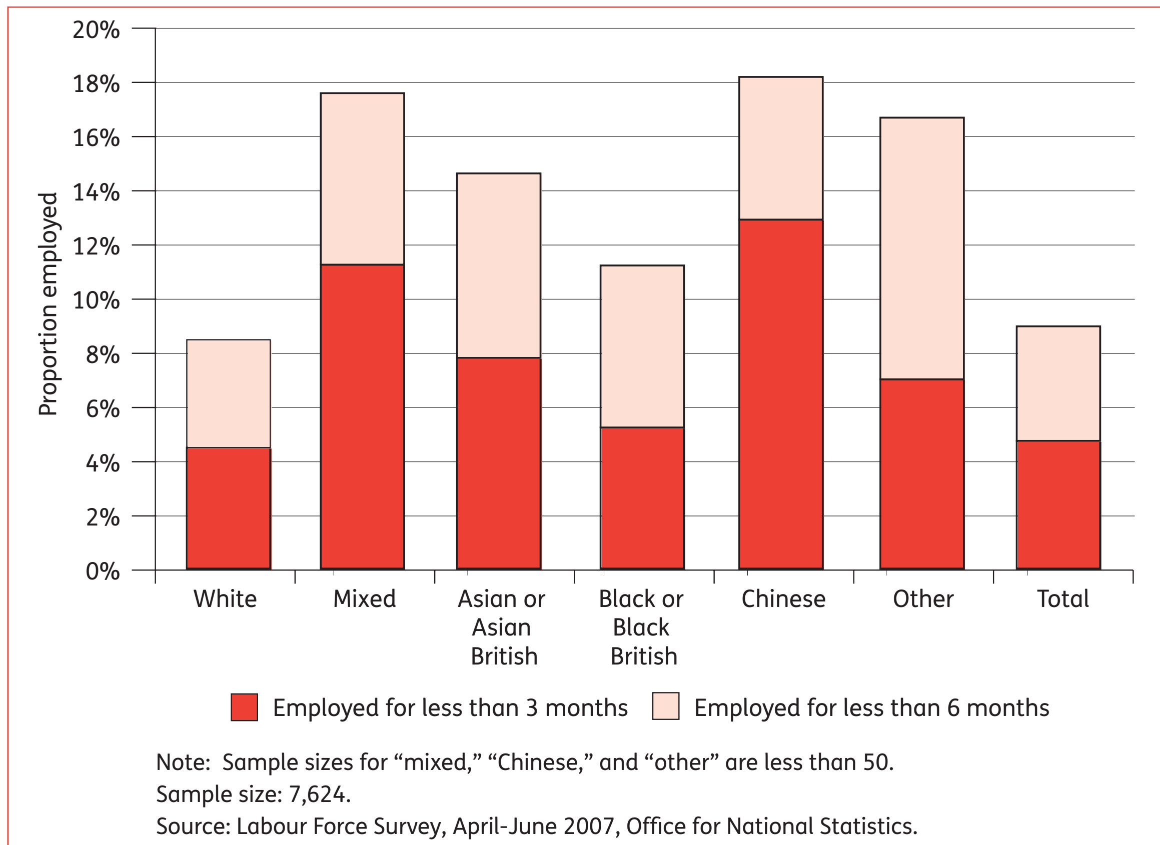
There appear to be minimal gender differences in rates of job churn. Nine per cent of employed men and nine per cent of employed women (in the target automatic enrolment population) had been in a current job for less than six months in 2007[78]. However, Chart 5.2 shows a greater proportion of non-White groups are employed for less than six months with eight per cent of employed White people having been in work for less than six months and 14 per cent of non-White individuals having been employed for less than six months.

77 Department for Work and Pensions modelling using the GB Pensim2 model.

78 Source: Labour Force Survey, United Kingdom 2007, Office for National Statistics. All figures relate to the current automatic enrolment target group.

On the other hand disabled people tend to have been in work for more time than non-disabled people. Only seven per cent of those employed and classified as disabled under the Disability Discrimination Act (2005) have been in work for less than six months, compared with nine per cent of the non-disabled population.

Chart 5.2 Proportion of eligible group in work for three and six months, by ethnicity



Note: Sample sizes for “mixed,” “Chinese,” and “other” are less than 50.
Sample size: 7,624.
Source: Labour Force Survey, April-June 2007, Office for National Statistics.

Young people are also likely to move jobs relatively frequently, whilst those starting a job aged 30-34 are likely to stay with that employer for longer. 24 per cent of 22 year olds have been in work for less than six months, which may reflect the large numbers starting their first job after leaving university. (See Annex C.4.3 for further analysis on job churn and age).

One potential concern is that introducing waiting periods might increase opt out rates as people become accustomed to receiving a wage without pension contribution deductions during a waiting period and feel a greater impact of pension contribution deductions once automatically enrolled. There is limited evidence available to help us understand the likely effect of waiting periods on opt out rates. What evidence there is from the US where schemes already operate waiting periods of up to 12 months shows that take up rates are still high and waiting periods do not seem to adversely affect opt out rates[79].

79 Fidelity International.

Impact on employers

The major benefits to employers of introducing waiting periods are the reduction in administrative burden and contributions costs (see Table 5.3). DWP modelling suggests ongoing annual savings on administration costs of at least £3m and £5m for three month and six months respectively (total administration costs are currently £127m) and an estimated £130m and £260m saving in contribution costs (total contribution costs are currently £3,240m). The administration cost savings do not seem all that high since employers are still having to meet the fixed costs associated with the duties, such as setting up a scheme, even though a waiting period will reduce the cost associated with other specific elements of the process.

The construction, distribution, hotel and restaurant industries exhibit a greater average job churn and so these industries are likely to benefit more from a waiting period. Micro employers in particular will benefit from having a waiting period because they have the highest levels of employee churn – 17 per cent of employees have less than one year's tenure (see Chapter 3). Employment agencies would also benefit from this with 11 per cent of workers temping for under two months and a further 21 per cent for two to six months[80].

Impact on the pensions industry and the Exchequer

The effects on the pensions industry are likely to be positive. There will be fewer small pots to administer, improved persistency of pension saving and a reduction in the administration of refunds where an individual would have opted out. The benefit of this to providers is reduced cost, which may result in increased profitability or a reduction in charges for members. This reduction in charges could offset the overall reduction in pension saving that a waiting period may create. The Exchequer saves an estimated £80m and £170m from reduced tax revenue foregone.

Table 5.3: Impact on employers and individuals of waiting periods

	Individuals			**Employer costs**	
Waiting period	**Total coverage**	**% female**	**Other characteristics**	**Contribution costs**	**Administration costs**
0 months (baseline)	10-11m	38%		£3,240m	£444m year 1 £127m ongoing
3 months	-0.5m	37% (of the 0.5m) No change to existing target group	Tend to be younger; no particular effect on disabled; slight adverse effect on ethnic minorities; no disadvantage as individuals retain right to opt in.	-£130m	-£5m in year 1 -£3m ongoing
6 months	-0.9m	39% (of the 0.9 m) No change to existing target group		-£260m	-£9m in Year 1 -£5m ongoing

Source: Department for Work and Pensions modelling.
Labour Force Survey, April-June 2007, Office for National Statistics.

80 REC Key Recruitment Trends 2007.

5.4 Excluding smaller employers

5.4.1 Why consider change?

The automatic enrolment duty currently applies to all employers who employ 1 or more individuals. Of the 1.2 million employers covered by the reforms, around 800,000 have fewer than five employees and 192,000 only have one employee. Very few of these currently offer any form of pension provision for their employees (five per cent and eight per cent respectively) and so will be undertaking new roles and processes in order to comply with the reforms.

Including smaller employers, therefore, involves engaging a very large number of employers in automatic enrolment for a comparatively smaller proportion of employees. The regulatory burden is proportionately higher for smaller employers than it is for larger employers. And the overall cost per worker enrolled is much higher, especially when the costs of the Pension Regulator are factored in.

Given these considerations, we have had to take seriously the case for change. Any case for change will, however, have to be set against the impact on those employed by small employers.

5.4.2 Stakeholder views

Most stakeholders suggested that all employers should be covered by the reforms irrespective of size. They felt that the existence of NEST meant that it would be possible for small and micro employers to automatically enrol their staff. Some were concerned that excluding certain groups of employers would lead to a distortion in competition. Concerns were also raised about creating disincentives for small employers to expand. Consumer groups generally felt that the scope for automatic enrolment was right and excluding particular groups of employers would be unfair to the individuals who work for them.

There was, however, some recognition that the reforms could be difficult for the very smallest employers. In particular, some employer groups representing small employers wanted the smallest employers to be excluded. One particular issue raised by consumer groups was that the duties will bring costs to disabled employers who employ carers.

5.4.3 Options

We have looked at the impact of removing three different groups of employers the automatic enrolment duties:

- Employers with one employee (for example those employing a nanny, cleaner or carer) – these employers are likely to face the greatest costs and difficulties complying with the duties.
- Employers with four or fewer employees – these employers will face higher costs-per-employee of automatic enrolment than larger employers.
- Employers with 19 or fewer employees – these employers are the least profitable employers for the pensions industry. Chapter 4 explains the very strong positive association between the number of employees in a company and the likelihood that a company scheme will be profitable at charge rates we feel are acceptable. There is some levelling off of this relationship for firms with around 20 employees.

The logic of any reform would be that employees of these small employers would not have the option to opt into pension saving in the same way as those who earn less than qualifying earnings. Otherwise much of the benefit to small employers and the Pensions Regulator could be lost.

5.4.4 Key findings

Impact on individuals

Excluding smaller employers under the three options outlined will see 0.3m, 1.5m and 3.4m fewer individuals being automatically enrolled at any one time (see Table 5.6). In general, people only spend part of their working life working for small firms and therefore will go onto work for larger employers and be automatically enrolled. Table 5.4 illustrates the overall movement of employees who work for smaller employers over a 10 year period. (See Annex C.4.4 for further details).

Table 5.4: Overall movement of employees working for a smaller employer over a 10 year period

			Column percentage
Moves between employers	**Employer size in 1997**		
	one employee	**4 or fewer**	**19 or fewer**
None	32	44	54
1	64	49	38
2	2	5	5
3 or more	2	2	3
Base	*1,466*	*6,170*	*20,500*

Source: Annual Survey of Hours and Earnings, Great Britain 1997-2006, Office for National Statistics.

However, for the period of time an individual works for a small employer, they will not contribute to pension saving or receive the benefit of having an employer contribution and tax relief towards their pension saving, which will affect their overall income in retirement.

If we consider a median earner who works for a micro employer from age 25-29 and then works for a larger employer until they retire, this individual will miss out on five years of private pension saving. This reduces their weekly pension income by £4 a week, from £225 to £221, and reduces their net replacement rate from 51.5 per cent to 50.7 per cent. This individual's lump sum would also be reduced by £2,200 from £18,800 to £16,600. The impact would obviously be greater for those spending more time working for a small employer.

Impact on employers

There are very different groups among micro employers. Some are self employed people employing just one or two additional staff. Some are simply people employing nannies or carers. Others are running more substantial small enterprises looking to grow.

The major benefit of this option is that it entirely removes the costs associated with automatic enrolment for the smallest employers – bringing annual contribution savings for the three options of £80m, £380m and £960m, and ongoing annual administrative savings of £16m, £63m and £93m respectively, as shown in Table 5.5.

However, exempting some employers from the duties based on their size can create three problems:

- There are likely to be practical implementation problems in identifying and keeping track of employers of very specific sizes, which may make it hard to get clear messages to employers and make ensuring compliance more difficult.
- There may be some distortions in competition if small employers face lower costs than their slightly larger competitors.
- There are possible perverse incentives which could inhibit business growth. Where an employer takes on extra staff they will face a cost 'cliff edge' of having to then automatically enrol all their staff. (See Box 5.1). Whilst we are not aware of evidence to suggest that the introduction of other regulations based on employer size, including health and safety risk assessments, and union recognition rights has stopped businesses from growing, the additional direct contribution and administration costs of this policy might well have such an effect[81]. As Box 5.1 shows the additional costs in moving from four employees to five could easily exceed £1,500 annually on top of the new employee's salary.

Box 5.1: Automatic enrolment costs associated with moving from having four to five employees

If employers with four employees or fewer are excluded:

- The cost to an employer of taking on a fifth employee would be the administrative cost of automatic enrolment and the cost of contributions for all five employees. The administrative cost would be around £420 in the first year and £230 per year in subsequent years. The three per cent employer contribution for the four employees assumed not to opt out would therefore cost the employer around £1,560 per year (given average qualifying earnings for individuals working for micro employers and not currently saving in a workplace pension are around £13,000).

If all employers are included:

- If the employer with four employees already had an automatic enrolment duty, taking on a fifth employee would have resulted in a marginal increase in administrative costs plus an increase in contributions of £390.

81 Information received from Department for Business Innovation and Skills.

Table 5.5: Costs and therefore potential savings to different sized employers

Excluding employers	Employer costs		
	Contribution costs	Admin costs	Admin costs per employee
Current employer scope	£3,240m	£444m in Year 1	£43 in Year 1
		£127m ongoing	£12 ongoing
1 employee	-£80m	-£41m in Year 1	-£140 in Year 1
		-£16m ongoing	-£53 ongoing
4 or fewer employees	-£380m	-£164m in Year 1	-£121 in Year 1
		-£63m ongoing	-£46 ongoing
19 or fewer employees	-£960m	-£278m in Year 1	-£86 in Year 1
		-£93m ongoing	-£29 ongoing

Source: Department for Work and Pensions modelling.

Table 5.6: Impact on Individuals

Excluding employers	Total coverage	% female	Other characteristics
Current employer scope	10-11 m	40%	
1 employee	-0.3m	39% (of the 0.3m) 42% in revised overall target group	No disproportionate impact
4 or fewer employees	-1.5m	41% (of the 1.5m) 42% in revised overall target group	
19 or fewer employees	-3.4m	41% (of the 3.4m) 42% in revised overall target group	

Source: Department for Work and Pensions modelling.
Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics.

Impact on the pensions industry and the Exchequer

The pensions industry currently has little engagement with the smallest employers and that is not expected to change a great deal in the face of automatic enrolment. We would expect the large majority to make use of NEST. Excluding micro employers means excluding the least profitable segments of the employer population, leaving the pensions industry better placed to meet the demand created by automatic enrolment. This is explained in more detail in Chapter 7. Annual steady-state savings to the Exchequer because of reduced tax revenue foregone is around £80m, £380m and £620m respectively.

The programme

About two thirds of employers are micro employers. So removing them from the scope of the programme would lead to a cost saving to the Pensions Regulator of over 45 per cent in operating the employer compliance regime.

Either option might create communication challenges as it would no longer be the case that all employers are being treated in the same way and, therefore, able to receive the same messages. It is possible that some employers would seek to evade the duties by setting up additional PAYE schemes or splitting in two once they reach a certain size. Exclusion of a particular band of employers may also increase both accidental and deliberate non-compliance.

Removing micro employers from the duty to automatically enrol would also generate short-term cost savings for NEST, although savings in steady state would be minimal.

5.5 Excluding older workers

5.5.1 Why consider change?

In the early years of the reforms some older workers, principally those without previous pension saving, who are automatically enrolled may receive a lower payback on contributions than younger workers due to the reduced time that they have before retirement to pay in contributions and receive growth on investments. Excluding those who are over 55 when the duties are first implemented may reduce the chances of some from losing out due to interactions with means-tested benefits in retirement.

5.5.2 Stakeholder views

In our recent consultation, views were mixed. Consumer and employee representative groups opposed exclusion saying it would not be aligned with the Government's intentions around extending working life and an increase in State Pension age. There was limited appetite for excluding older workers amongst employer groups. There was some support from industry with some calling for an exclusion of those that were 55 or over in 2012. All three groups expressed some concerns that it might not pay to save for those nearing retirement and that this could be addressed by providing targeted advice and information to these individuals to inform a decision to opt out of pension saving.

A number of consumer, employee and industry representative groups support the lowering of the age threshold to align with the National Minimum Wage, with several stating that the age could go lower to support greater savings throughout life. Employer representative bodies had mixed views, some support an alignment on simplicity grounds, but others are concerned about the increasing contribution costs and the need to enrol more individuals who only remain their workers for short periods of time. A similar number of stakeholders supported keeping the age threshold at 22. We concluded that the lower threshold is a balance between establishing patterns of saving earlier and avoiding automatically enrolling very young people with high labour market churn (e.g. those working in temporary jobs whilst in tertiary education), and that the current threshold of 22 strikes the right balance between these aims.

Some stakeholders also suggested that the upper age limit for automatic enrolment should be increased beyond State Pension age.

5.5.3 Key findings

Impact on individuals

Men dominate the group of eligible individuals who are over 55 in 2012. Analysis in Chapter 2 shows that 68 per cent of those aged 55 to State Pension age have some private pension wealth, rising to 79 per cent for those older people who are still in work and earning less than £40,000. The median pension wealth for these older individuals was found to be around £58,500. Chapter 2 also shows older people who are the lowest earners are least likely to have existing pension provision. An individual aged 55 in 2012 with median earnings is likely to receive a net replacement rate of approximately 48.7 per cent if automatically enrolled in 2012.

Unlike the other options discussed, excluding individuals aged over 55 in 2012 only has a temporary effect. This option will remove 1.1m individuals in 2012 from pension saving, but this number will fall during the following ten years, and there will be no effect on the eligible population beyond that.

The main benefit of excluding over 55s is to reduce their chances of losing out as a result of interaction with means tested benefits. However if we look at a median earner aged 55 in 2012 who contributes to a private pension until retirement, this individual will receive a private pension of £14.50 a week. He would lose income related benefits worth £2.50 due to this extra income, which therefore gives him an overall income that is £12 higher with pension saving. This saving increases his net replacement rate from 46.4 per cent to 48.8 per cent.

Many older workers will already have past savings and will benefit from topping up existing pension savings, which may take them above the thresholds for means tested benefits. Where older workers do not have past saving and only have time to build up a relatively small pension pot, they can trivially commute their pension pot, taking it all as a lump sum which, if it was under the capital limits, would have no negative impact on any benefit entitlement they have.

This option may see a disparity in approach between these reforms and the broader extending working lives agenda. The proposed phasing out of the default retirement age should see individuals working longer with more time available to build up pension saving.

Impact on employers

This option would see employers save £660m between 2012 and 2020 out of a total of £20,630m.

Impact on the pensions industry and Exchequer

There is a small beneficial impact on the pensions industry to the extent that some of the least profitable individuals are excluded temporarily, and that it prevents the build up of small pots. Total savings to the Exchequer are estimated at £370m up to 2020.

5.6 Conclusion

Table 5.7 outlines the impact on individuals, employers and industry for all options.

Table 5.7: The impact of target group options

Option	Individuals	Annual saving Employer	Industry
Earnings threshold			
£5,715	Minimal change	No change	Minimal change
£7,336	-0.6m	-£20m contribution -£3m ongoing	Benefits because least profitable individuals no longer saving
£10,000	-1.4m	-£50m contribution -£6m ongoing admin	
£14,000	-2.9m	-£250m contribution -£12m ongoing admin	
Waiting period			
3 months	-0.5m	-£130m contribution -£3m ongoing admin	Benefits – fewer small pots and improved persistency of pension saving
6 months	-0.9m	-£260m contribution -£5m ongoing admin	
Exclude some employers			
1 employee	-0.3m	-£80m contribution -£16m ongoing admin	Benefits – removes some of least profitable individuals
4 or fewer employees	-1.5m	-£380m contribution -£63m ongoing admin	
19 or fewer employees	-3.4m	-£960m contribution -£93m ongoing admin	High proportion of those automatically enrolled will be profitable
Exclude older workers			
Aged over 55 in 2012	-1.1m	-£660m (2012-2020)	Minimal change

Source: Department for Work and Pensions modelling.