## CBI SUBMISSION TO THE LOW PAY COMMISSION (LPC) - OCTOBER 2013

**Contents**




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**Determined by an independent LPC, the NMW must remain the UK's pay floor**

1. Pay minima exist to provide protection to the lowest paid, without distorting the wider labour market or economy by causing unemployment. The LPC was set up to recommend such a minimum. The Commission's business plan clearly states the LPC must recommend "levels for the minimum wage rates that help as many low-paid workers as possible without any significant adverse impact on employment or the economy."[1] This is a goal which the CBI continues to broadly support.

2. In setting the right minimum, a broad range of factors must be reviewed, including affordability, unemployment, productivity and the wider economic climate. The final recommendation can then balance the interests of both businesses and the unemployed – maintaining growth and encouraging job creation – and workers – providing a strong minimum standard. This is the hallmark of the success of the NMW – unlike the narrowly-based Living Wage (LW), which does not take into account the impact on the wider economy, and is based on a formula which lacks the rigour the LPC use.

3. For these reasons, CBI members support the work of the independent LPC. We are deeply concerned by the debate on minima that has formed this summer. Politicising the LPC by extending its remit beyond the NMW or changing its status as an independent body would risk damaging the hard-achieved consensus around minimum wage policy. More importantly, a move from the strongly economic approach of the LPC would put pressure on employment levels at the margins – in smaller firms, and those with thin margins, and for low-waged employees who may struggle to find work. This link between the NMW and the wider economy is now more perceptible than ever, with the Bank of England taking unemployment into account when setting interest rates.

4. Beyond maintaining independence, businesses also value a nationally-determined minimum wage. By providing a principal wage floor across and within sectors, business has come to know the NMW and expect compliance. It plays an important benchmarking role in the lower-paying sectors especially. A move away from this approach, for example through a return to wage councils or extending the remit of the LPC to consider sectoral or regional wages, is unworkable, as affordability varies as much within sectors as between them, and sectoral boundaries are blurred.

5. This has implications for competition too, with challengers, who tend to start off operating on a low margin, potentially unable to enter the market. Similarly, the Living Wage (LW), in absence of a voluntary approach, risks excluding challengers, with particular implications for the lower paying sectors, where margins are especially thin and the paybill represents a significant cost. While some businesses, including CBI members, pay the living wage, it is clear that not all businesses can afford to, and take-up has typically been in businesses where the vast majority of work is higher skilled, higher productivity and higher pay.

[1] Low Pay Commission, Business Plan 2013/14

6. With 2.5 million people currently unemployed, we cannot afford to play with fire. Our goal should be to set a robust, well-enforced statutory minimum that strikes the balance set out in the LPC business plan. Equally, we need to ensure that we address evidence or abuse where it is found. Flexible contracts, like zero-hours, are an important tool in maintaining and boosting employment levels, and should not be demonised. Indeed, a zero-hours arrangement often suits the preferences of both businesses and employees, shown by the fact that the majority of zero-hours workers are also not looking for an alternative job (approximately 80%) and only a quarter would like to work longer hours if given the option (approximately 25%).[2] Many of the examples of workers being dissatisfied with zero-hours contracts seem not to be problems with the zero-hours nature of the contract, but the insufficient enforcement of the existing regulations of the National Minimum Wage and the Working Time Regulations, and this should be addressed.

7. Businesses who do not comply with NMW regulations should feel the full force of the law. The relevant bodies, HMRC for the NMW, and organisations like the National Apprenticeship Service (NAS) and Skills Funding Agency (SFA) should work to boost awareness and ensure compliance.

[2] The Work Foundation, Flexibility or insecurity? Exploring the rise in zero hours contracts, August 2013

**<u>Unemployment and youth unemployment remain significant concerns in the UK labour market</u>**

8. The CBI's view is that high unemployment – especially youth unemployment – remains the key concern for the LPC in addressing the rate for 2014. While growth has returned, we expect progress on reducing unemployment to be slow. 2014 is not the year to consider any structural adjustment of the NMW, especially as regards the youth rates. It remains the case that the LPC's current approach has seen low-waged workers do better than average across the recession.

9. Progress in the labour market has been sluggish over the first half of the year. Despite an unusually robust labour market since 2010 and strong rises in employment in the second half of 2012, the unemployment rate remains high, with youth unemployment continuing to be a serious concern. As the nascent recovery takes hold, more and more people will enter the labour market, meaning some slack will continue well into 2014. In this context, the NMW has an important role to play in ensuring that people are not excluded when they are seeking opportunities to work.

10. Along with this, productivity remains near recession lows and unit labour costs have not eased. Accordingly, earnings growth has been subdued – far more subdued than NMW growth. There are some promising signs on job creation as employment intentions have picked up, but there is a long path ahead. A disproportionate rise in the NMW risks stifling much needed job creation, and being out of step with the wider pay and productivity picture.

    ***As we move slowly to economic growth, the labour market will gradually gain momentum. To ensure that the benefits are widely felt, the NMW needs to support people into work and be properly enforced. Equally, however, we need investment in skills by businesses and government, building on sustainable growth, to help individuals and the young especially, progress.***

    - ***The unemployment rate remains a cause for concern***
    - ***Youth and apprenticeship rates are important in safeguarding young people's job prospects***

**The unemployment rate remains a cause for concern**

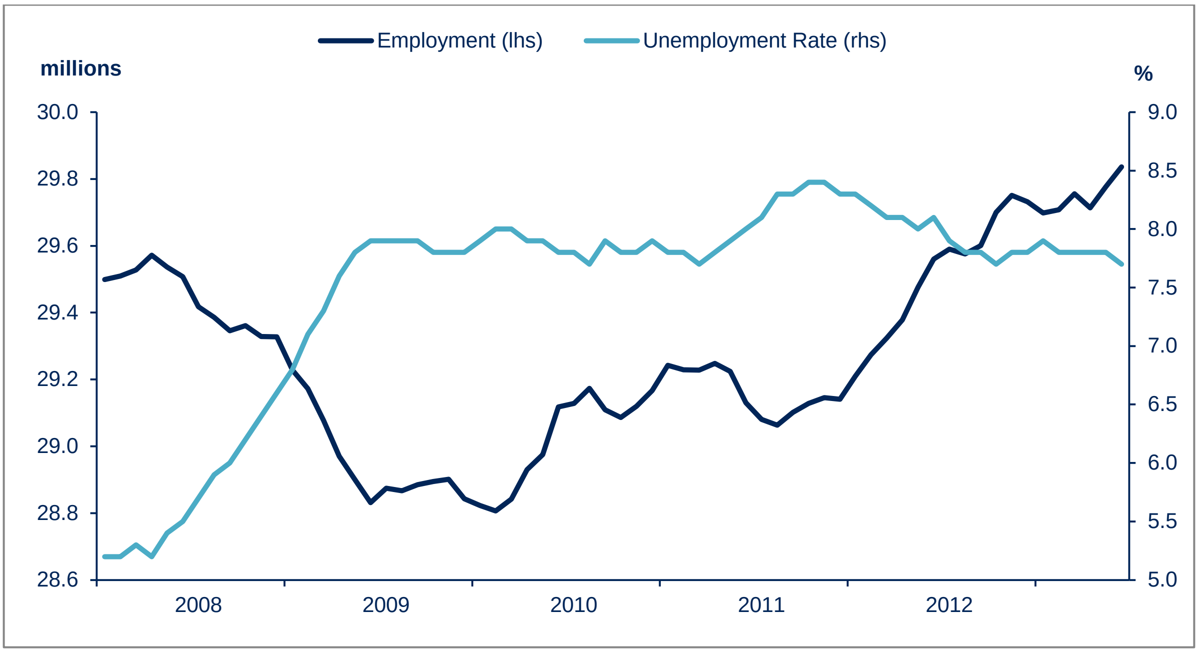
11. Despite gradual progress, the unemployment rate remains high. In the three months to July 2013, employment increased by 80,000 (0.3 per cent), the strongest rise since January 2013. There are now 29.84 million people in the UK in employment (see Exhibit 1). Unemployment fell by 24,000 (-1.0 per cent) in the three months to July, improving on a 4,000 fall in the three months to June. However, there are still 2.5 million people unemployed, an unemployment rate of 7.7 per cent (see Exhibit 1). The September data represented the first fall in the unemployment rate in almost a year (three months to October 2012). [3]

[3] ONS, Labour Market Statistics, September 2013

12. This slow progress is particularly important as it is expected to continue in the near term, affected by some of the underlying factors behind the recovery. The CBI forecasts that employment will rise by 1 per cent in 2013 as a whole, and by 1 per cent in 2014.[4] The fact that productivity grew more than employment in the second quarter of 2013 – 0.5% versus 0.2% respectively – illustrates that there is a long path to travel on productivity improvement before job creation takes off, especially as productivity remains no closer to pre-recession levels as at the beginning of 2013 (see Exhibit 9).[5] Some of the economic recovery will be through productivity rises rather than just through increases in employment. With employment levels robust even during the downturn, many businesses already have workforce capacity to face increases in demand, but this adds to expectations for slow progress on employment meaning that the minimum wage must be set in the context of a relatively flat labour market.

**Exhibit 1 – UK labour market: employment and unemployment**

Source: ONS, Labour market statistics



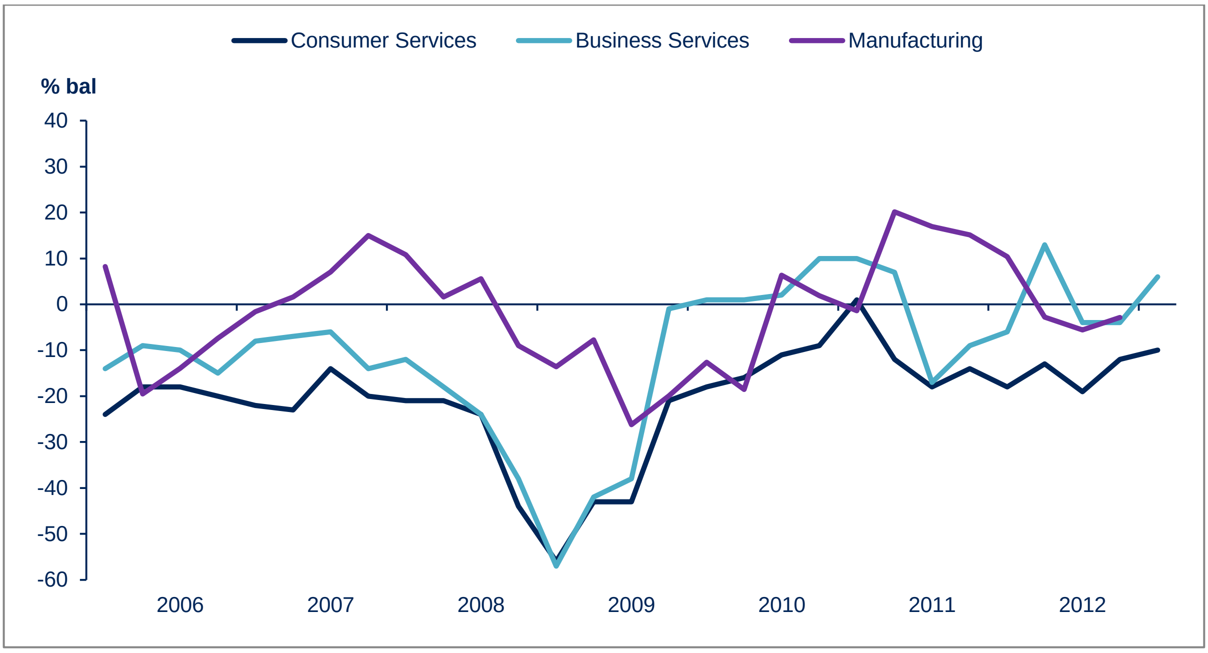

13. Slack will continue to characterise the labour market for some time as, encouragingly, the balance of employment continues to shift from part-time to full-time. There is also an emergent shift from inactivity to activity within the population. This too will hold back the rate of improvement in unemployment as the economy recovers. Specifically, full-time employment increased by 95,000 (0.4 per cent) in the three months to July 2013, while part-time employment decreased by 15,000 (-0.2 per cent). However, the proportion of those employed part-time that could not find a full-time job increased again from 18.0 per cent of the total to 18.4 per cent, returning to the series high recorded in the three months to May 2013. Inactivity is falling as the number of people who are not actively seeking work fell by 33,000 on the quarter, following a 10,000 fall in the three months to June 2013. Additionally, the number of people who want a job but are not looking for it fell by 69,000 over the same period.[6]

[4] CBI, Economic Forecast, September 2013
[5] ONS, Labour Productivity, September 2013; ONS, Labour Market Statistics, September 2013
[6] ONS, Labour Market Statistics, September 2013

14. Within the lower paying sectors, job creation – while encouraging – has not been uniform, so the risk remains that overambitious upratings of the NMW could serve as a barrier to job creation in some of these sectors. Accommodation and food services reported an increase in workforce jobs of 36,000 on the quarter in Q2 2013. On the other hand, businesses in the wholesale and retail trades reported the largest decline in workforce jobs in the economy (down 29,000), following strong job creation in the previous quarter. This supports CBI survey data from earlier in the year which showed, that numbers employed in consumer services fell slightly (balance of -5 per cent) in the first half of the year despite predictions of a rise (balance of +15 per cent).[7] From a lower base from earlier this year, employment intentions have picked up in retail. However with weak growth in workforce jobs overall – an increase of just 0.5 per cent in Q2 2013, and 1 per cent on the year – the NMW needs to strike a careful balance.[8]

15. More entrants into the labour market is encouraging news, but with spare capacity in the labour market, job creation must be the top priority to ensure they find work. Businesses are already maintaining robust employment levels next to current demand, meaning that business investment is the way forward on job creation. This requires caution on the wage bill if it is to be affordable.

**Exhibit 2 – Expected employment change over the next three months**
Source: CBI survey data




**Youth and apprenticeship rates are important in safeguarding young people's job prospects**

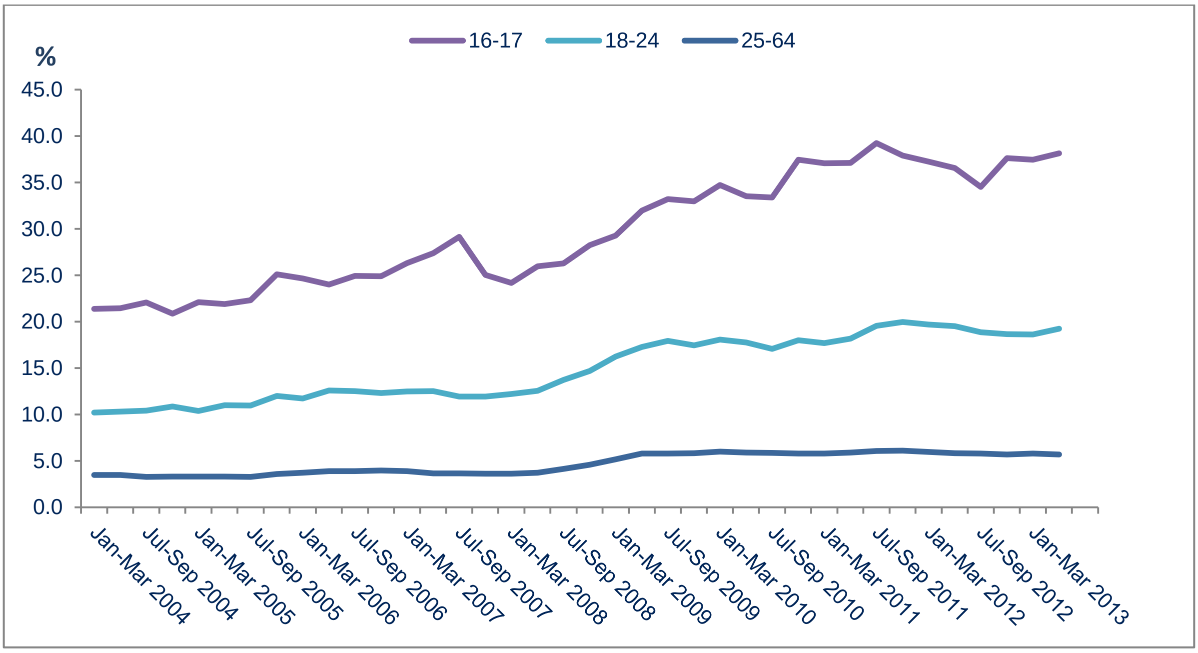
16. The position of young people has stabilised somewhat in the past year, with little change in their position. Youth employment remains high. With competition for jobs still intense and young people typically less skilled and less experienced than other age groups, they will continue to face a challenging labour market even as the economy

[7] CBI Service Sector Survey, May 2013
[8] ONS, Labour Market Statistics, September 2013

recovers. The youth rates remain an important incentive to businesses to hire from this group in this context. However, evidence over the long-term suggests that unemployment in the UK among this age group may be a structural as well as a cyclical problem. The LPC should view the youth rates as a part of an inter-related package of solutions needed to tackle youth unemployment. In particular, incentivising the greater provision of apprenticeships is vital, through the recommendations of the Richard Review. Making sure that our young people not only have academic but vocational rigour through a comprehensive package of measures including the youth rates, reforms to education, work incentives, apprenticeships and other forms of training will be necessary to build up the skills base of our young people, so that with higher productivity, young people can experience faster career progression as they break into the labour market.

17. In the three months to July 2013, there were 960,000 unemployed 16 to 24 year olds in the UK, a youth unemployment rate of 21.0 per cent (see Exhibit 3). This is up 9,000 from the three months to April 2013 and down only 0.6 percentage points from where the unemployment rate stood in our last submission. After removing full-time students, the youth unemployment rate stands at 19.4 per cent, up 9,000, to stand at 668,000.[9] The number of young people in unemployment is still 40 per cent higher than its pre-crisis level (Jan-Mar 2008). However, overall unemployment is 55 per cent higher than its pre-crisis level suggesting that young people's situation has not deteriorated in recent times and that there is some strength in the argument that this is a structural problem.[10]

**Exhibit 3 – Unemployment by age group**
Source: ONS, Labour Market Statistics, September 2013




18. Long spells of unemployment can have severe consequences. The longer someone stays out of work the more his or her skills deteriorate, lowering their chances of getting back into work. This has worse consequences for young people, as all the evidence

[9] ONS, Labour Market Statistics, August 2013
[10] ONS, Labour Market Statistics, August 2013

suggests that a failure to engage with the labour market early has a sustained scarring impact on individuals throughout their lives.[11] The percentage of young people not in employment, education or training (NEET), which can provide a better indication of the position of young people in the labour market remains high. In Q2 2013, the NEET rate was 15.5 per cent, up 0.4 percentage points on the quarter, though down 0.8 percentage points on the year.[12] The number of young people unemployed for at least 12 months is an alarming 24 per cent,[13] suggesting that young people continue to feel some effects of exposure to the negative impact of the recession.

19. With the LPC needing to strike a delicate balance in supporting income for young people, while recognising that their position remains somewhat fragile, the CBI welcomed the freeze in the youth rates in 2012 and the modest increase in 2013. This has supported the bites of the youth rates to fall slightly relative to median earnings over 2012 and into 2013 which will aid the attractiveness of young people in the labour market (see Exhibit 4). Nonetheless, the bites of the youth rates remain high relative to the median, with both rates still over 70 per cent of median wages for their respective age groups. In this context, the CBI believes the LPC should give primacy to ensuring that young people have the ability to enter the labour market and that constraining the youth rates is sensible. The corresponding challenge to government and business is to invest to facilitate individual skills, pay and productivity progression.

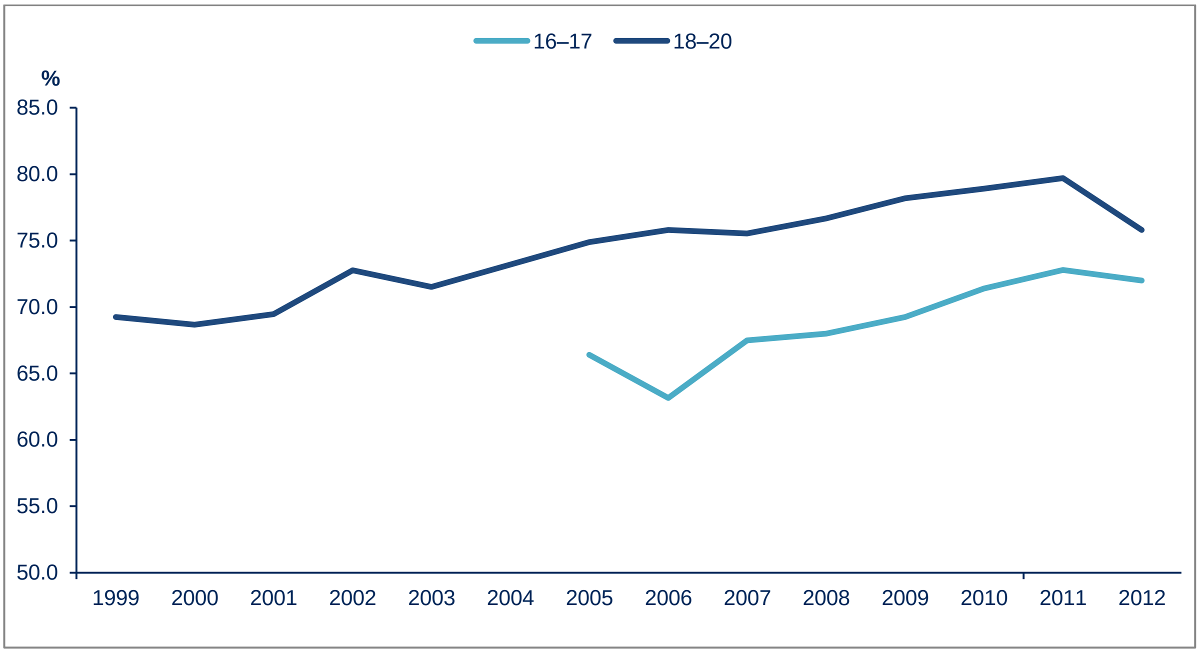
20. Apprenticeships are a valuable tool in helping young people break into the labour market, allowing them to build on their academic and workplace skills at the same time. The world of apprenticeships is changing fast as the demand for vocational skills and apprenticeship places increases. Businesses need to offer more apprenticeships, with the tripartite model of apprenticeship funding – whereby employers, government and the individual invest in the training for mutual return – being the right way to do this. Nonetheless, the investment required on the part of business, in terms of time and finance, is still substantial meaning that the apprenticeship rate has an important role to play in making apprenticeships an attractive option for business.

> *"The Government already sets a lower minimum wage rate for apprentices than for other workers, recognising that they have lower productivity while they are training, and are investing in themselves in the expectation of being paid more subsequently. This should continue."*
>
> – Doug Richard, Richard Review, November 2012

[11] Gregg and Tominey, The Wage Scar from Youth Unemployment, *CMPO working paper series* No. 04/097, 2004
[12] Department for Education, NEET Statistics – Quarterly Brief, Quarter 2, 2013
[13] ONS, Labour Market Statistics, August 2013

**Exhibit 4 – Bite of the youth rates by age, 1999-2012**

Source: ONS, ASHE



**<u>The underlying factors that will support long-term growth must be the focus in 2014 – not short-term steps on wages that may prove unsustainable</u>**

21. Our economy has been through a profound shock – one from which it is only now emerging. Growth so far this year has been stronger than expected, but there is a long path ahead. CBI forecasts are relatively optimistic for 2013 and 2014, but we must learn the lessons of the past. Now is the time to invest in future economic and pay growth, not risk destabilising what is a nascent recovery from a very serious illness.

22. The recovery is starting from a low base – output is still 3.3% below its pre-crisis peak, and unlikely to reach parity with its pre-recession level before the end of 2014. With this in mind, the impact of the NMW, which has risen ahead of wages across the recession, is greater in the economy now than in 2008.

23. The recovery also stands on relatively weak legs. So far, improvements in consumer confidence and spending have driven signs of recovery, but these are unlikely to be sustainable with household debt levels elevated and productivity remaining near recession lows. With improvements in business confidence not yet feeding through into business investment and the future health of the Eurozone still unclear, the recovery is not yet broad-based enough. We have an opportunity to build a strong, sustainable recovery – one is not inevitable.

***Caution must remain at the forefront of the LPC's mind this year. The Commission must set a NMW that supports the investment needed for a robust recovery.***

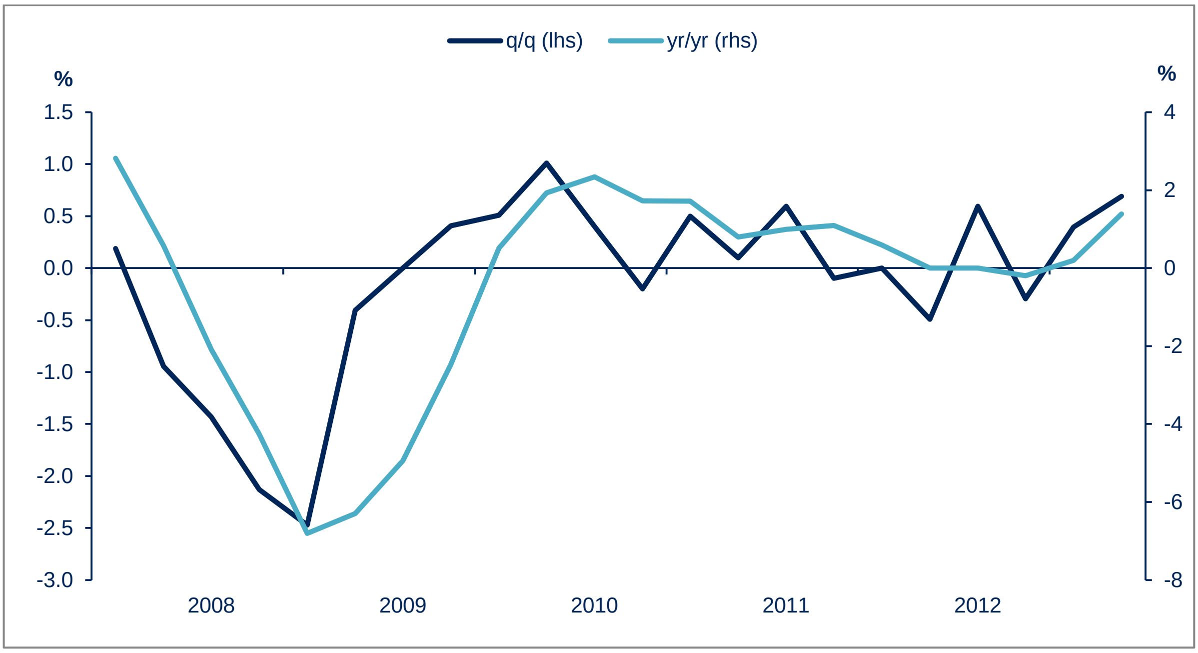
- ***Despite improved performance, there is a long way to go before the UK economy is back on its feet***
- ***The modest improvements in consumer spending are unsustainable without a broader-based recovery***
- ***Business investment has to pick up to contribute materially to growth***
- ***Productivity remains sluggish with earnings growth subdued as a result – this is a key concern***

**Despite improved performance, there is a long way to go before the UK economy is back on its feet**

24. The UK has been fairing better recently in 2013, but remains in the early stages of recovery. In Q2 2013, quarter on quarter growth was 0.7 per cent, up on the 0.4 per cent quarter on quarter growth in Q1 2013 (see Exhibit 5). This represents an improvement on Q4 2012 when growth over the year was relatively flat at -0.2 per cent. Going forward, we expect growth to continue to improve, although at a relatively slow pace. The CBI revised its forecasts for growth upwards in August 2013 from 1 per cent to 1.2 per cent in 2013 and from 2 per cent to 2.3 per cent in 2014. This is line with the consensus view of 1.2 per cent growth for 2013 and 1.9 per cent for 2014.[14]

[14] HM Treasury, Forecasts for the UK economy: a comparison of independent forecasts, August 2013

**Exhibit 5 – Real GDP growth**
Source: ONS




25. Encouragingly, growth has occurred across all parts of the economy, including services, which is home to many of the lower-paying sectors. In Q2 2013, just over 70 per cent of growth on the quarter was attributable to the services sector, with all four main services sectors under this grouping growing.[15] In comparison, output was still lower than a year ago in agriculture and in production, indicating that there is some way to go before the benefits of recent growth feed through materially into other sectors. This is important to remember, as the NMW does have a significant effect in some parts of these sectors.

26. The CBI currently forecasts that UK growth will not return to pre-recession levels until the end of 2014. The LPC must ensure the NMW remains in step with what is happening in the wider economy so not to jeopardise the recovery and business activity particularly in the lower-paying sectors where the NMW makes an impact. By achieving sustainable growth first, businesses will have the ability to increase wages faster, linked to productivity improvements. But key to achieving this are business investment and not having a NMW that locks smaller firms with high growth potential out.

> *"Although, we see evidence of economic recovery, it is too early to say if this is sustainable."*
>
> – CBI member, energy sector

**The modest improvements in consumer spending are unsustainable without a broader-based recovery**

27. While the economy seems to be picking up, it is worrying that this is to a large extent based on improvements in consumer spending – reflected in the strong performance of

[15] ONS, Second Estimate of GDP, Q2 2013

the services sector and the distribution, hotels and restaurants sub-sector in particular. Expenditure on consumption contributed 47.5 per cent to GDP growth between Q1 2013 and Q2 2013, more than triple that of gross fixed capital formation (15.9 per cent). This represents a substantial concern because these improvements in spending are unlikely to persist, without some more fundamental change in the economic picture.

28. Consumer confidence has picked up during 2013, and is now around the highest since 2010. However, this pickup should not be taken for granted as, on balance, consumer confidence remains negative as the proportion of consumers reporting their confidence as negative continues to outweigh those consumers reporting positive confidence, creating a stark balance of -22 per cent, as of September 2013.[16]

29. Troublingly, it is the recent upswing in confidence that seems to have been the main factor sustaining modest consumer spending growth, alongside the resilient employment levels that wage restraint has enabled, while household-debt levels have not improved materially.

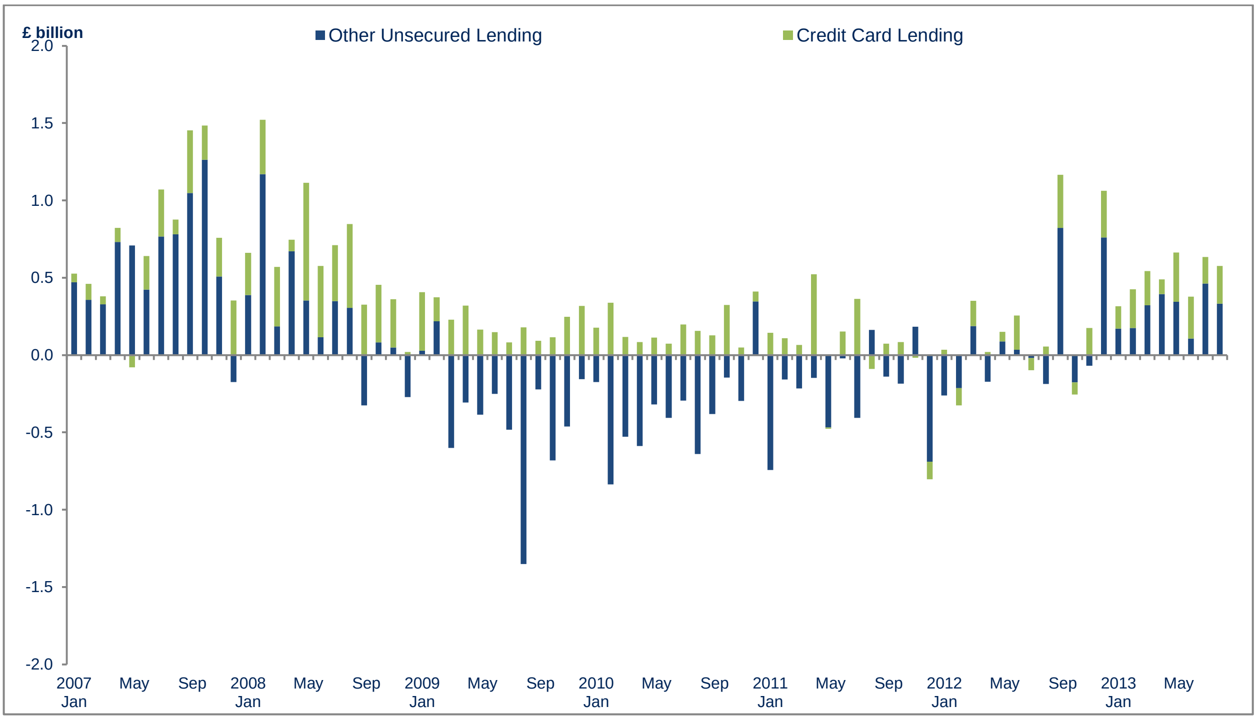
30. Consumer spending faces significant headwinds as further improvements are contingent on employment, earnings, inflation and credit conditions, with elevated household debt levels likely to drag on overall spending growth. Data from the Bank of England indicates that household borrowing has been increasing, albeit inconsistently, throughout 2013 (see Exhibit 6). While consumers continue to use their credit cards, there has been an increase in the quantity of credit derived from other forms of unsecured lending. For example, in the year to July 2013, households increased their unsecured borrowing by almost £5.4bn, a firm sign that the deleveraging trend witnessed between 2008 and 2011 is reversing (see Exhibit 6). This is worrying.

31. Businesses remain conscious of this puzzling development and recognise that the current momentum in consumer spending and pick-up in confidence will not be sustainable in the long-term without support from elsewhere. Businesses in the low-paying sectors especially are concerned because they are more affected by changing household circumstances than other sectors as more businesses are likely to be consumer facing, in this group. The level to which the NMW is uprated in 2014 will be crucial in determining whether these businesses can maintain employment levels should consumer confidence wane.

32. Recent CBI evidence from the high street in September 2013 indicates that while high-street sales continued to grow strongly to date,[17] consumer spending growth in restaurant and hotels was negative in Q1 2013, contributing to modest overall consumption growth of just 0.3 per cent in Q1 2013 (revised down from 0.4 per cent in September 2013).[18] Businesses in consumer services are somewhat optimistic about activity over the months ahead, but remain more cautious about the longer term.

[16] GfK, Consumer Confidence Barometer, September 2013
[17] CBI Monthly Distributive Trades Survey, September 2013
[18] ONS, Economic Review, August 2013

**Exhibit 6 – Change in net lending (£bn) and personal loan rates (%)**
Source: Bank of England




33. The underlying trends of the recent momentum in consumer spending reemphasise that the recovery is not yet secure with a reduction in consumer confidence potentially posing a significant headwind. With the NMW having a particular impact in the consumer facing sectors, the LPC must adopt a cautious approach.

## Business investment has to pick up to contribute materially to growth

34. Our analysis of the economic situation suggests rebalancing is still required, particularly greater contributions to growth from business investment and trade to ensure the recovery stands on firm legs and to deliver sustainable economic growth. This would provide a "vital to boost incomes and incomes expectations".[19] Unfortunately business investment has yet to pick up and contribute materially to growth. Getting corporate cash to work is essential – but longer term growth in wages requires it to be used for investment.

35. Overall, the UK business mood has improved. At our last submission, the uncertain economic backdrop continued to weigh on business confidence (see Exhibit 7). From this low base, business mood has since improved across the board. CBI business survey data indicates that optimism among manufacturers has risen for two quarters in 2013.[20] Within the services sector, the CBI's Quarterly Services Sector survey reported strong rises in confidence.[21]

[19] IMF United Kingdom 2013 Article IV consultation, July 2013
[20] CBI Quarterly Industrial Trends Survey, July 2013
[21] CBI Service Sector Survey, August 2013

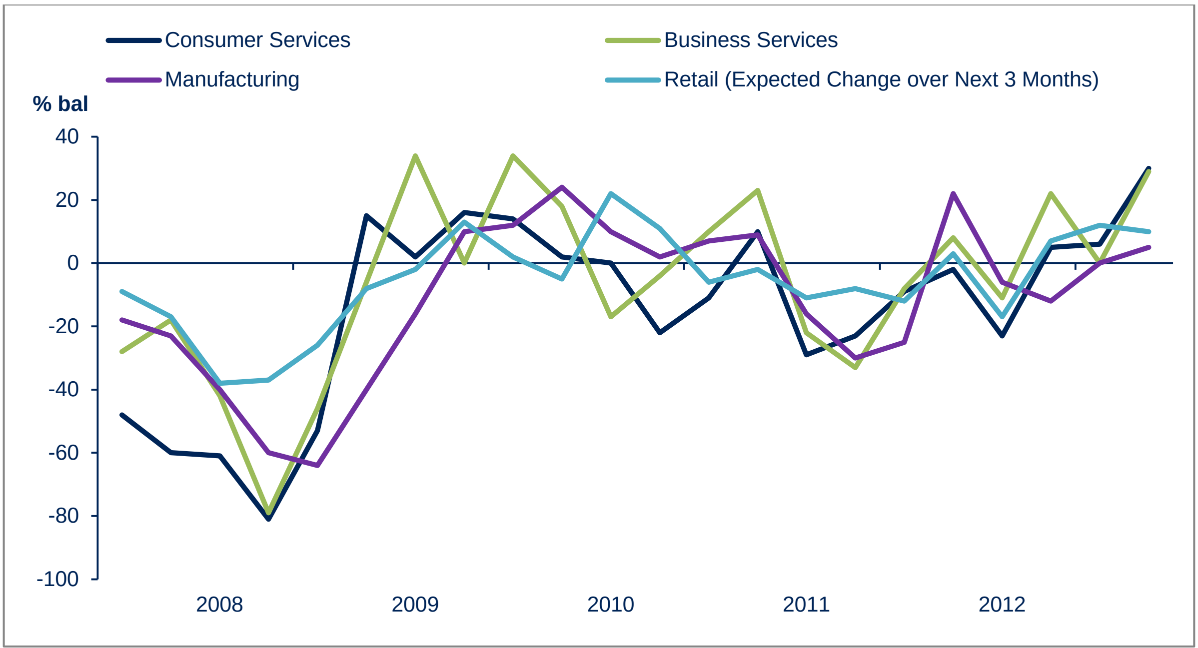
> *"Store owners are sacrificing their own wages by taking home less than the minimum wage to keep their stores open and pay staff…55% of shop owners believe that when compared to the number of hours they work, they currently earn less than the minimum wage from their business"*
>
> – The Voice of Local Shops Survey, Association of Convenience Stores

36. Both business and consumer services are optimistic about activity over the months ahead (see Exhibit 7), but it is worth noting that those in consumer services remain much more cautious about the longer term, again reflecting the potentially unsustainable nature of current consumer spending growth. Although they expect business volumes to grow, profitability is expected to fall again over the three months to November (particularly amongst hotels, bars and restaurants, and in telecoms and computing), headcount is expected to continue falling (at a faster pace), and demand uncertainty continues to constrain investment plans for the year ahead.[22] The prospects in these sectors could clearly weaken further if the NMW becomes an additional constraint on investment.

**Exhibit 7 – Business optimism compared to 3 months ago**

Source: CBI business survey data

A % balance is the difference between the percentage of respondents reporting an increase and those reporting a decrease




37. The improvement in business confidence has not yet fed through into business spending decisions and investment levels (see Exhibit 8), meaning the UK "remains a long way from strong and sustainable recovery".[23] Business investment declined by 2.7 per cent in Q2 2013 on the quarter (following growth of 1.7 per cent in Q1) (see Exhibit 8). Following recent revisions by the ONS, business investment is now much weaker than estimated, still 27 per cent below its pre-recession peak (in Q1 2008).[24]

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[22] CBI Service Sector Survey, August 2013

[23] IMF United Kingdom 2013 Article IV consultation, July 2013

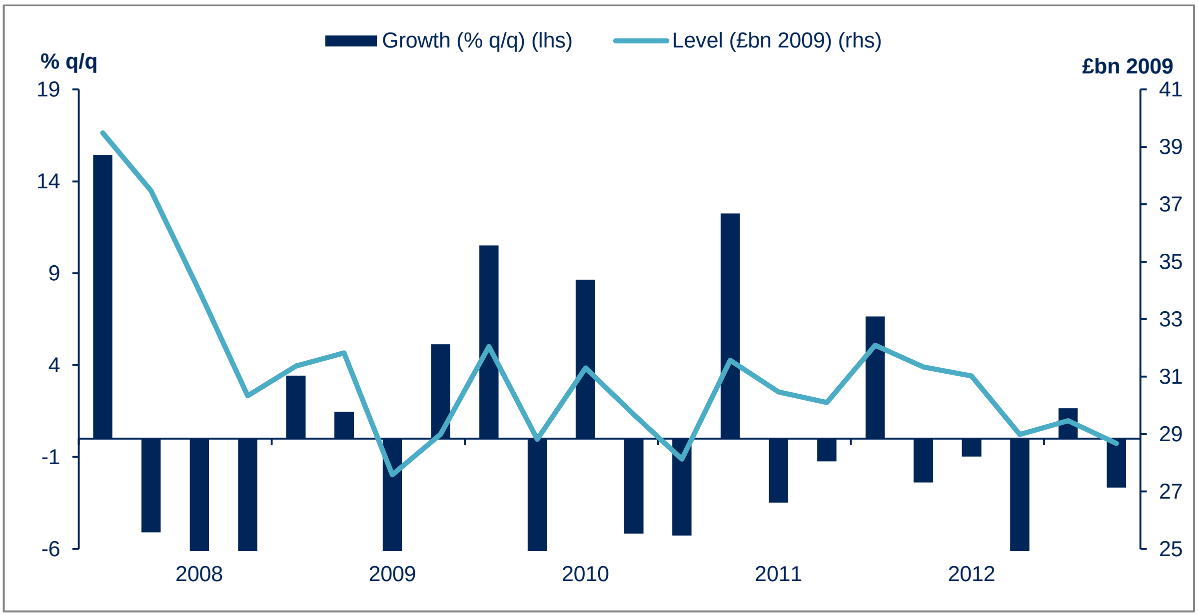
[24] ONS, Second Estimate of GDP, Q2 2013

38. Businesses remain concerned about demand uncertainty such that a "more sustained pickup in activity would be required before significant capacity-raising expenditures became necessary".[25] This is backed up by CBI surveys of investment intentions, which have yet to show a material improvement in capital spending plans for the year ahead. While some sectors have begun to show signs that demand uncertainty is waning as a constraint – namely business and professional services and financial services – this is not the case in the lower paying sectors. For example, business optimism in retail has still dipped slightly over 2013 (see Exhibit 7).

> *"Previous historical episodes of external rebalancing in the UK and OECD countries have been associated with increases in labor productivity growth—suggesting that it will be difficult for the UK to improve its external balance unless there is an improvement in productivity and competitiveness."*
>
> – International Monetary Fund

**Exhibit 8 – Business Investment**

Source: Bank of England




39. Until business investment picks up sustainably, the NMW must be cautiously increased to avoid contributions choking off a still fragile recovery. Only a broadening of the recovery through a rebalancing towards business investment and trade – and productivity improvements – can lead to wage growth that is sustainable. This is well illustrated by the fact that weak business investment levels are currently being cited as the main influence on modest levels of pay settlements in recent times.[26,27] In the lower-paying sectors, where the wage bill represents a substantial part of overall business operating costs, any rise in the NMW will have an amplified effect on investment intentions.

40. Globally, the economic picture is mixed, with businesses remaining concerned about the outlook. While advanced economies appear in somewhat better shape after sluggish performance over 2012, the future health of the Eurozone, the UK's key

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[25] Bank of England, Agents' summary of business conditions, August 2013
[26] IMF United Kingdom 2013 Article IV consultation, July 2013
[27] IDS, Pay Report, October 2013

trading partner, is by no means secure, with a considerable amount of work to be done to stabilise financial conditions, particularly in peripheral economies. Eurozone GDP is expected to contract marginally in 2013 as a whole, despite recent growth.[28] As the recovery gets underway in other advanced economies, the unwinding of monetary stimulus presents additional risks to financial market stability and confidence. The UK economy is exposed to these risks, and the materialisation of them would undermine confidence and growth. Downside risks to growth in emerging markets have also increased since early summer as economies face considerable structural hurdles to clear in order to move to a more sustainable footing. Recent developments in the United States, related to their fiscal position, are also expected to weigh on US GDP growth, with expected knock-on effects already occurring on business confidence in the UK, particularly in financial services.

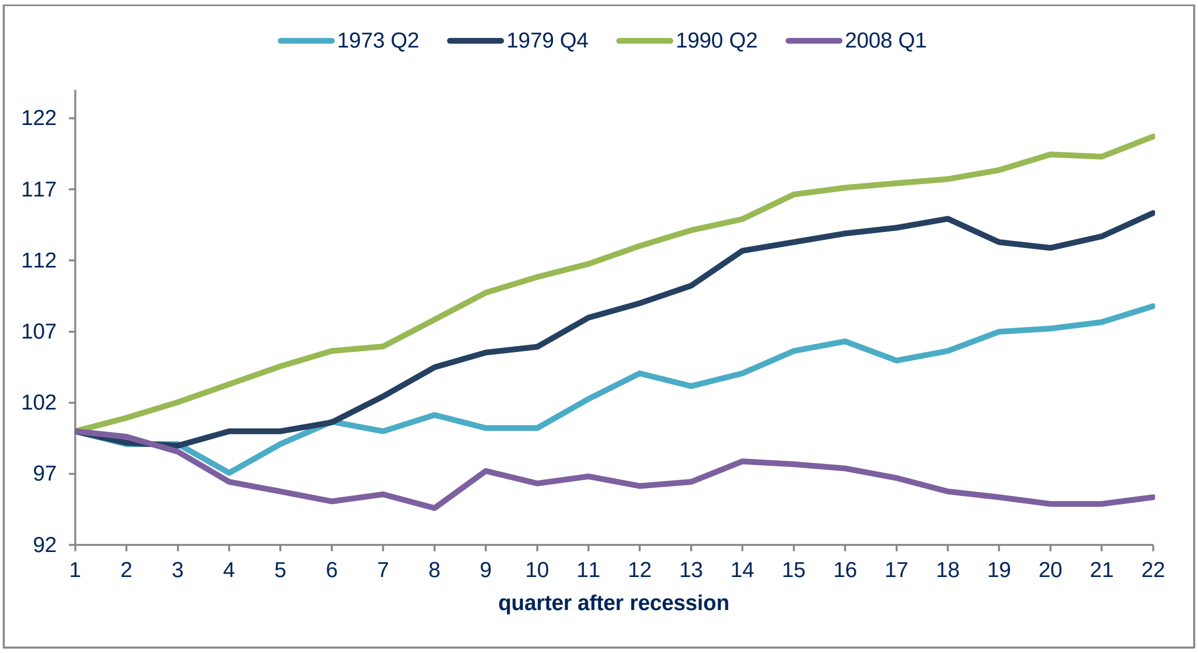
**Productivity remains sluggish with earnings growth subdued as a result – this is a key concern**

41. In spite of the recent improvement in growth, productivity has little improved. Material improvements in productivity will be key in facilitating faster pay progression as well as growth. This is another reason why boosting business investment has to be a priority. Recent data indicates that UK labour market productivity increased 0.5 per cent in the second quarter of 2013, on an output per hour basis, after stagnating near recession lows in the previous two quarters (see Exhibit 10).[29] After previous recessions, productivity recovered to its pre-recession peak within 9 to 18 months. However, nearly 5 years after the 2008 downturn, productivity still stands at 8 per cent below its pre-crisis peak (Q1 2008) or 5 percentage points, attributable mainly to minimal output growth (see Exhibit 9).[30]

42. The uncertainty over the extent to which productivity has been permanently impaired complicates the labour market outlook. Nonetheless the fact that hours worked and employment have recovered, while output has improved minimally demonstrates that growth will be crucial in any move to drive material productivity improvements and achieve sustainable wage growth.[31] Going forward, the CBI expects some recovery in productivity as business confidence rises and momentum continues to build. However, with modest growth expected, any productivity improvements will be subdued and probably be delivered by growth not feeding through to job creation as directly as has traditionally been the case.

[28] European Central Bank, Monthly Bulletin, September 2013
[29] ONS, Labour Productivity, September 2013
[30] ONS, Labour Productivity, September 2013
[31] Bank of England, Inflation Report, August 2013

**Exhibit 9 – Output per hour after recessions**
Source: ONS, Index (1973 Q2, 1974 Q4, 1990 Q2, 2008 Q1 = 100)




43. With no real productivity growth, businesses will need contained employment costs to generate sustainable jobs and drive recovery. Since the onset of the 2008/09 recession, unit labour costs have increased by 12 per cent (Q1 2008 - Q1 2013), driven predominantly by increasing total labour costs and falling output. Recent quarterly data indicates that unit labour costs have increased by 2.2 per cent in the second quarter of 2013, after changing little over the course of 2012 (see Exhibit 10). Similarly, on the year, costs increased by 2.2 per cent. Given that output per hour was broadly unchanged (an increase of 0.5 per cent, Q2 2012 – Q2 2013), upward change in unit labour costs reflects a rise in wages per hour. This is in line with the Bank of England's expectations that unit wage costs were expected to pick up in the second quarter of this year.[32]

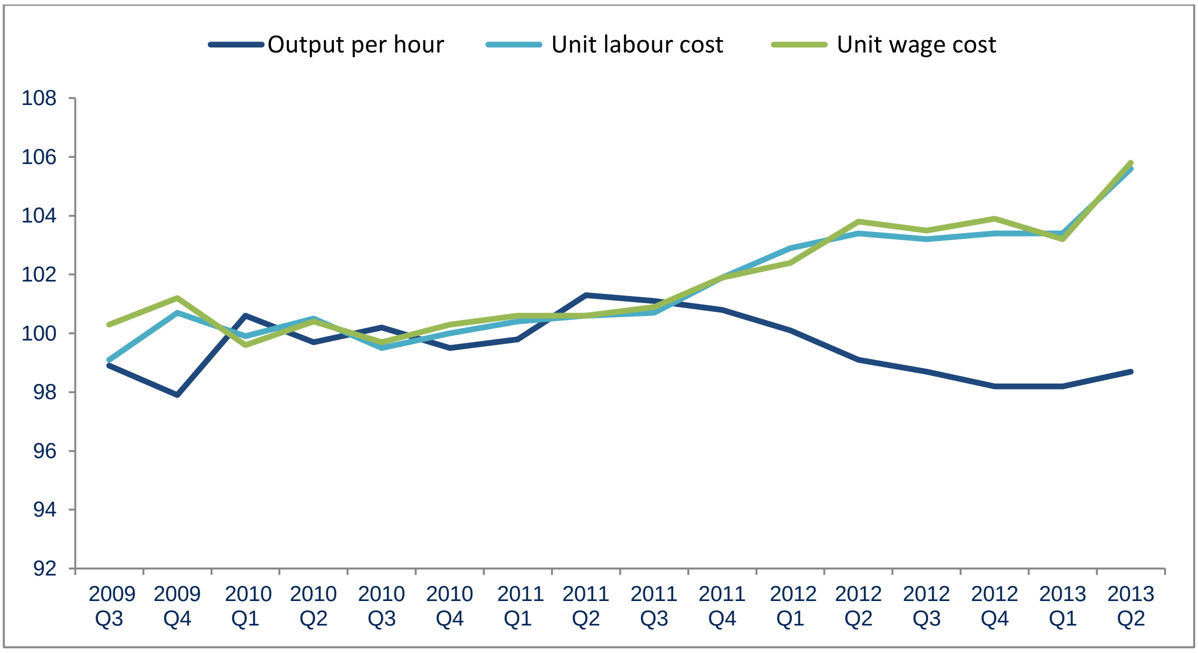
44. One factor driving the pick-up in employment costs in 2013 is the introduction of auto-enrolment. From October 2012, businesses have been enrolling their employees in workplace pensions scheme to which employers' contributions will rise from one to three per cent of qualifying earnings over the transitional period to 2018. Only just over 2,000 firms have so far entered the system, but almost 4 per cent of businesses in the country – representing a huge proportion of employees – will enter in the first half of 2014.

45. The CBI is supportive of this reform to build a sustainable pensions system, and it will have major benefits for businesses and individuals. However it has pushed up employment costs. Lower-paying industries are disproportionately impacted as employees within these sectors are currently less likely to already contribute to a pension, and with the lower-paying industries facing higher than average turnover, the administrative costs of auto-enrolment will be significant. Recent research indicates that the set-up costs for businesses alone are £15.4 billion, before contribution costs

[32] Bank of England, Inflation Report, August 2013

are even considered.[33] For these businesses unwise upratings of the NMW would limit the ability to absorb increased cost in the paybill, meaning that, in the short term, businesses would need to make sacrifices elsewhere.

**Exhibit 10 – Labour productivity**
Source: ONS, Index (2010=100)




46. Given minimal productivity improvements and continued growth in unit labour costs, earnings growth has naturally been subdued. This has been exacerbated by persistent spare capacity in the labour market. Earnings growth is now weaker than in our previous submission across most sectors owing to weak levels of business investment.[34] This again emphasises the need to prioritise business investment as a means to achieve pay growth.

47. Regular pay growth (excluding bonuses) remains well below CPI inflation (2.7 per cent in August) and has remained around the 1 per cent mark since February 2013. This is down from 1.9 per cent in our last submission to the LPC (see Exhibit 11) and emphasises the ongoing trend of above-wage–inflation rises in the NMW over previous years. Yet employment levels continue to be robust, indicating that pay restraint continues to be important in supporting employment.[35] With more people entering the labour market, and inflation forecasted to slowly come down in 2014, downward pressures remain on pay growth and it is crucial that the NMW is not out of step with these happenings in the wider labour market in order to protect employment at the lower-paying end of the pay distribution.

48. Within the lower paying sectors, the NMW typically acts as a benchmark for businesses, meaning that it has a greater impact than just on those earning the NMW rate. Given that the NMW has been uprated by more than average earnings in recent years, the lower-paying sectors have experienced more pay growth and fewer pay

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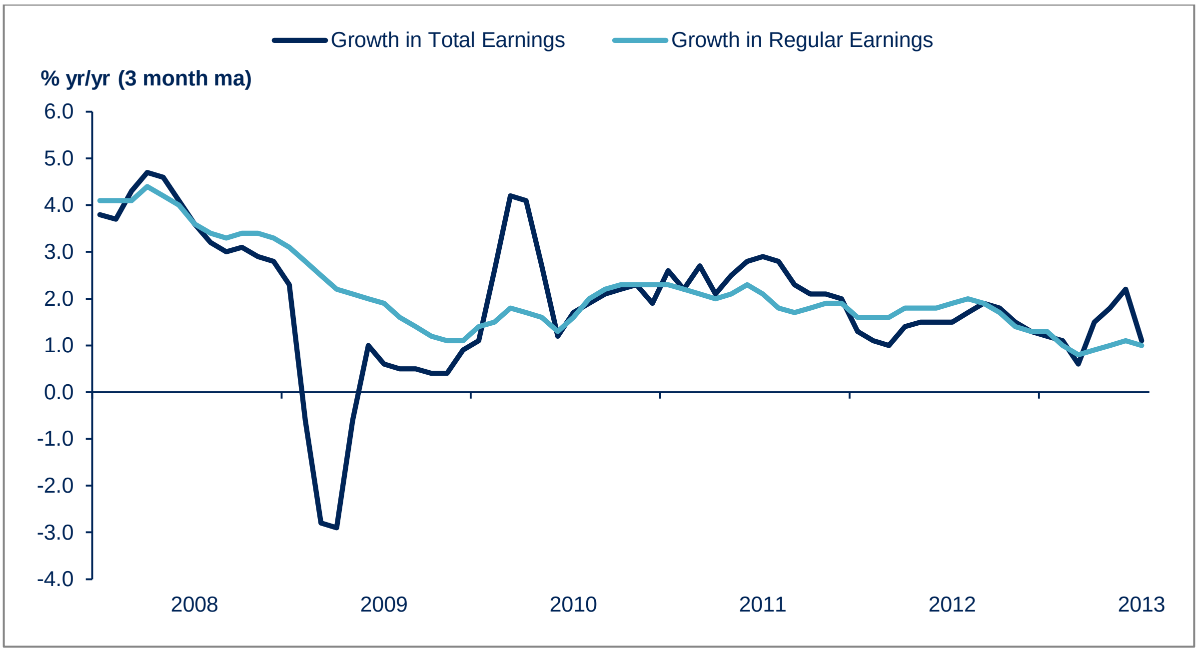
[33] Centre for Economic Business Research, Finding your way out of the auto enrolment maze, September 2013
[34] IDS, Pay Report, October 2013
[35] Low Pay Commission, Low Pay Commission Report 2013

freezes than other parts of the economy.[36] Average regular pay growth has been notably higher in the wholesale, retail and hotel and restaurant sectors – which have a large concentration of lower-paying sectors – at between 2 to 3 per cent throughout 2012, compared to between 1 and 2 per cent in the rest of the economy in 2012.[37] This has driven a reawakening of issues with pay differentials, as businesses face either passing on rises to a wider group of staff, or the erosion of pay structures and rewards for skills development.

**Exhibit 11 – Growth in Average Weekly Earnings**

Source: ONS

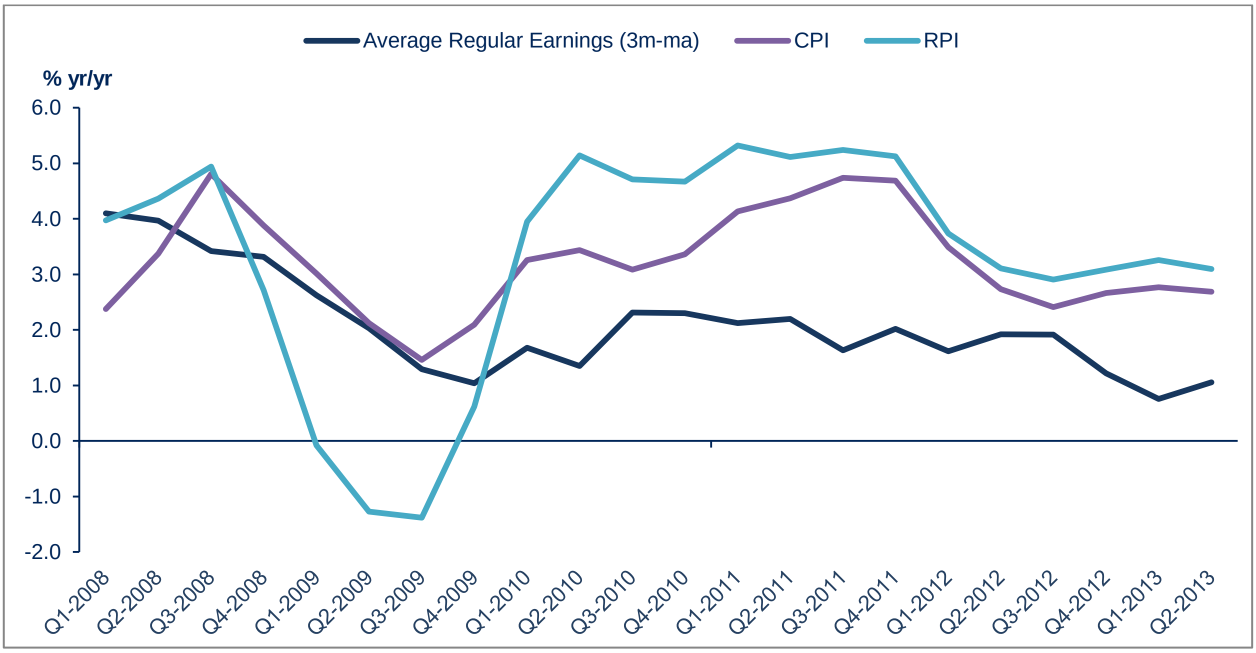



49. The CBI expects downward pressures on pay to continue in the near-term from the fragile economic recovery, above-target inflation (see Exhibit 12) and a sluggish labour market, and with the number of businesses to auto-enrol their employees into workplace pensions schemes set to peak twice next year, the entire business community will see a sharp increase in labour costs which may limit their capacity to offer significant pay awards in the near term. Accordingly, the affordability of pay increases remains a top priority for businesses, especially for those with thin margins.[38]

[36] IDS, Pay Report, October 2013
[37] ONS, Labour Market Statistics, September 2013
[38] IDS, Pay Report, October 2013

**Exhibit 12 – Inflation and Earnings Summary**

Source: ONS



**Businesses agree that the LPC should think about the longer-term – but this should be primarily economic**

50. As we move into economic recovery, it is understandable that questions on pay will arise. However, pay is a much more complex issue than recent calls on the living wage, minimum wage and wage councils would suggest. While falling real wages are undesirable, imprudent upratings in minimum pay are hollow if businesses are not able to sustain the increase in costs, or, equally, invest for growth. This is why achieving sustainable economic growth first must be the priority.

51. In this context, the CBI sees three essential economic outcomes that must be prioritised ahead of short-termist rises in the minimum wage. We believe addressing these would lead to a wider recovery in wage growth, with which – in line with our long-term stance – we would expect the NMW to keep step. The wage should never whither on the vine. These outcomes are: a broad-based economic recovery – including in sectors where the NMW makes an impact; evidence of material productivity improvements; and a significant reduction in the unemployment rate, not unlike the target adopted recently by the Bank of England.

52. In the near-term, provided global growth continues to recover, the drivers of UK growth should broaden. However, an expected modest improvement in productivity means that unemployment is expected to remain elevated. We need to see a more long-lived, broad-based improvement in domestic and global demand to deliver a recovery in investment and exports, which will pave the way for a lasting improvement in the prospects for employment and pay.

53. An underlying workforce issue that must be addressed as part of this, is skills – fundamental to any discussion around pay. At the individual level, investment in progression will improve individual prospects, and more broadly, ensuring businesses are equipped with the talent they need to succeed and grow will support the UK's economic future. The OECD's recent Survey of Adult Skills has shown that the low-skilled are more likely than others to be unemployed and earn much less.[39] This means that, as well as ensuring that our education system achieves academic rigour, we also need to ensure that, once in work, individuals maintain and develop the skills that support progression.

54. Businesses are already stepping up to the challenge by creating traineeships and apprenticeships to equip individuals, young people especially, with the skills needed for the workplace, but there much more to do. However, these offerings require significant investment of resources. Where businesses have thin margins, financial resource for skills investment could be crowded out by an overambitious NMW. Our *Tomorrow's Growth* report highlights the need to remove the barriers that currently exist to co-operation in skills development, around finance, information, and the lack of incentives in the education system to focus on employment outcomes.[40] Addressing this will not only support people in their transitions into work, but it will also aid faster career

[39] OECD, Survey of Adult Skills (PIAAC), September 2013
[40] CBI, Tomorrow's Growth, 2013

progression due to higher productivity. This in turn will give businesses the ability to pay more.

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