Regulatory Policy Committee

Amendment to the National Minimum Wage Regulations 2015 - introducing a national living wage

Department for Business, Innovation and Skills

RPC rating: fit for purpose

The IA is now fit for purpose as a result of the Department's response to the RPC's initial review. As first submitted, the IA was not fit for purpose.

Description of proposal

The proposal is to introduce, from April 2016, a national living wage into the existing national minimum wage framework. Initially, this will be set at £7.20 per hour and will apply to those aged over 25 years.

Impacts of proposal

Direct labour costs

The main impact of the proposal on businesses will be the cost of raising the pay of their affected employees to the national living wage. The Department estimates that approximately 1.7 million employees in the private sector will be affected, and that this will cost £804.4 million, consisting of £672.0 million in wages and £132.4million in associated non-wage labour costs, such as employers' National Insurance contributions. These costs are, for the most part, a transfer from employers to employees and the Exchequer. The estimates are calculated by uplifting wage data from the 2014 ONS Annual Survey of Hours and Earnings (ASHE) by the Office for Budget Responsibility's (OBR) forecasts for wage growth between 2014 and 2016.

'Wage spillover' costs

There will also be 'wage spillover' effects, whereby the wages of employees earning above £7.20 per hour also rise due to employers maintaining wage differentials between workers. The Department estimates, using Low Pay Commission (LPC) evidence and the ASHE wage distribution data, that this will cost £234.3 million. The majority of this cost is indirect because it results from the discretionary choice of employers to go beyond the requirements of the regulations. However, where wage differentials are stipulated in employment contracts or bargaining agreements with trade unions, maintaining wage differentials is not discretionary and constitutes a direct cost to business. Despite consultation with the LPC and businesses groups, the Department was unable to find data on these types of contracts or agreements. The Department has, instead, used the proportion of private sector workers covered by collective pay agreements (15.4 per cent) as the basis of its estimate that £37.7 million of the £234.3 million is a direct cost to business.

Transition costs

Businesses will also incur familiarisation costs and costs of updating the pay of employees to implement the measure. The Department estimates the former by assuming that, in 75 per cent of businesses, a senior manager will spend 30 minutes reading the national living wage (NLW) guidance. This is based upon survey evidence indicating that 26 per cent of employers are already fully aware of the NLW. This results in a cost of £12.1 million. For implementing changes to pay systems, the Department estimates that it will take an administrator 30 minutes to update the payroll record of each employee affected by the NLW. This is based on the CEBR-Federation of Small Businesses employment costs index. This results in a cost of £10.5 million, making a total transition cost of £22.6 million. The Department considers these to be cautious estimates because familiarisation will be assisted by an awareness campaign and payroll software may make the process more efficient for larger businesses.

Including costs to public sector employers, the total cost of the proposal is £1,139 million. This consists of £835.6 million direct labour cost, £280.5 million wage spillover effect, and £22.6 million in transition costs.

Wider impacts

The IA states that the policy will also have wider, macroeconomic effects. Using the same methodology as the OBR, the Department estimates that structural unemployment will increase, as a result of the 2016 uplift by approximately 9,000, or 0.03 percentage points, and hourly productivity will increase by 0.05 percentage points. Given the complexity of these effects, and their indirect nature, the RPC accepts that it is not possible to monetise them robustly.

Quality of submission

Issues addressed following RPC's initial review

As initially submitted, there were three problems with the IA that meant the RPC would have been likely to issue a red-rated (not fit for purpose) opinion. Following the RPC's initial review, the Department submitted a revised IA that responded to these points as below:

Transition costs

As indicated above, the IA now includes estimates of the cost to business of familiarisation with the proposal and of implementing changes to their payroll systems (pages 24-25). These costs add approximately £20 million to the estimated equivalent annual net cost to business (EANCB). The Department is unable to provide estimates of the potential cost to business of re-evaluating their pay structures in the light of the NLW. The Department includes a discussion of this and states that it will monitor the results of LPC-commissioned research, which may provide additional evidence. The RPC considers it important that this potential impact is covered by the evaluation of the introduction of the NLW.

Non-discretionary wage spillover effects

The RPC's initial review stated that the cost of maintaining wage differentials should be considered to be a direct cost to business where businesses have no choice, for example where it is set out in an employee's contract. The IA explains that there are no data on this and that the Department has made an estimate based upon the proportion of the wages of private sector employees that are subject to collective agreement (page15). This cost adds approximately £36 million to the EANCB.

Small and micro business assessment

The IA now provides a much fuller discussion of the impact of the proposal on small and micro businesses. The Department recognises that small and micro businesses will be more than proportionately affected, with 16.2% of employees in micro firms and 9.7% in small firms being covered by the NLW, as compared with 5.8% in large firms. The Department, however, argues, that, since 32.8 per cent of workers earning less than the NLW are employed in small and micro businesses (pages 27-28), any exemption would undermine the policy objective. The IA states, further, that an exemption would cause a competitive distortion and, given the large share of total costs accounted for by labour, create a significant disincentive for some small businesses to grow. The IA also includes details of how the effects on small businesses will, to an extent, be mitigated. There will be an increase in the employer allowance, a communications campaign and guidance for employers that will target small and micro businesses.

The Department has also addressed the following concerns raised in the initial review (which do not affect the RPC rating of an IA at the final stage), although there remain some issues, as detailed below.

Use of the NMW process, rationale and stakeholder engagement

It remains the RPC's view that the NLW should be seen as a new policy, rather than a particular uprating of the NMW, and should, therefore, have been supported by fuller analysis and a consultation stage impact assessment. That IA could have set out in detail the Department's rationale for this specific proposal and provided a basis for formal consultation on the Department's evidence and analysis.

However, the revised IA now includes details of informal consultation with stakeholders and explains how this has informed the Department's assumptions (pages 12-13). The IA now also includes more on the rationale for the proposal (pages 1-7). This section, however, largely replicates that in the IA for the national minimum wage (NMW). The Department should provide a stronger economic rationale for a proposal which appears to depart from previous LPC analysis and advice.

Assessment of further rises in the NLW

The IA covers the proposed change in regulation, which is a 50p rise in the minimum wage rate above the NMW rate for workers aged over 25 years, to be introduced in April 2016. The RPC accepts that the Department's one-year appraisal will, provided it is repeated consistently for each uprating of the NLW, produce a correct assessment of the direct impacts on business of the NLW over the course of the current parliament.

The Government have publicly declared an aspiration for the NLW to reach 60% of median earnings by 2020, expected to equate to a rate of over £9 an hour. The Department explains why its impact assessment does not cover this (pages 17-18). It argues that it would be inappropriate to do so because the 2020 target is not in regulation and setting out an assumed path to reach the target could undermine the independence of the LPC. The RPC is not persuaded by these two arguments. The announcement of the Government's 2020 target is, arguably, a much more significant constraint on the LPC than setting out an illustrative path of how to get there. The RPC remains of the view that best practice would be for the Department to provide an economic appraisal of the full policy ambition, as announced by the Chancellor, and not solely an assessment of the impact of the proposed first-year regulatory change.

Role of the Low Pay Commission

The Department now provides a fuller explanation of the remit of the LPC and what has changed with the introduction of the NLW (pages 13 and 47). The LPC will retain its role in recommending NMW uplifts, the adult rate of which will now apply to 21-24 year olds only, and will recommend the speed at which the Government should move towards their ambition of a NLW that is 60% of median earnings.

Macroeconomic impacts

The RPC's concern was that a rolling one-year appraisal of the NLW and subsequent uplifts would prevent adequate consideration of macroeconomic impacts, which will normally take effect over several years. The IA now provides some further discussion of these impacts and the difficulties in assessing them. It also includes some figures from the OBR analysis that was previously only referenced. Assessment of these impacts should form part of an ongoing evaluation of the NLW and should be included in the IAs for future uplifts of the NLW.

Equivalent annual net cost to business (EANCB) and business impact target

Following the adjustments made to the impact assessment by the Department, the RPC is able to validate the revised overall EANCB of £820.97 million. The Government have not yet decided the categories of non-qualifying regulatory provisions that will be excluded from the business impact target so the RPC is, at this stage, unable to determine the business impact target classification of the measure. An adjustment to the NMW, departing from LPC recommendations, would have been classified as an IN under the One-in, Two-out policy in the last parliament.

The RPC has consistently recommended that the Government approve as wide a scope as possible for the business impact target in order that it reflects the full, realistic experience of business and achieves maximum credibility.

Initial departmental assessment

Classification	Not yet decided by the Government
EANCB	£764.96 million (initial estimate) £820.97 million (final estimate)
Business net present value	-£863.3 million
Societal net present value	-£22.6 million

RPC assessment

Classification	Not yet decided by the Government
EANCB – RPC validated	£820.97 million
Small and micro business assessment	Sufficient
RPC rating (of IA as initially submitted)	Not fit for purpose

Michael Gibbons CBE, Chairman