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31 October 2016

Dear Secretary of State,

NATIONAL MINIMUM WAGE RATES FOR 2017 INCLUDING THE NATIONAL LIVING WAGE

I summarise here the Low Pay Commission's recommendations for the rates of the National Minimum Wage and National Living Wage (NLW) to apply from April 2017. The enclosed chapter of our forthcoming report sets out the more detailed rationale.

Our remit gives us different requirements in relation to the NLW, the rate for workers aged 25 and over, than for the four other bands, which cover workers aged under 25 and apprentices.

For the NLW we are asked to make recommendations on the pace of increase towards a target: an 'ambition…that it should continue to increase to reach 60 per cent of median earnings by 2020, subject to sustained economic growth'. For the other rates we are asked to 'help as many low-paid workers as possible without damaging their employment prospects'.

The key challenge in fulfilling our remit has been risk and uncertainty in relation to the economic outlook following the decision to leave the EU. This sharply compounds pre-existing problems of limited data given the time it will take for any effects of the NLW, introduced in April, to emerge and be measured.

Future rates of the National Living Wage

We noted in our Spring 2016 Report that the NLW means substantial wage gains for many workers by 2020 but that it will be demanding for businesses, particularly those in certain industries and areas and for small businesses. It is set to give the UK one of the highest minimum wages in the developed world in relative terms.

We also noted that the 2020 path has a degree of flexibility: a target measured relative to average earnings is a more prudent way of raising the pay floor than a fixed goal because its cash level should to a degree adjust to reflect changes in economic circumstances. We thought a straight line to the target most likely.

The core decision for this report was whether the automatic adjustment in the rate as pay forecasts fell would be sufficient to manage economic risk and uncertainty following the vote for the UK to leave the European Union or whether we needed to recommend going more slowly in 2017 than our default.

Sustainable minimum wage increases depend on sustained growth in GDP, employment, and pay and productivity. Early concerns about an immediate recession have not come to pass, and a number of economic indicators are better than feared. However, the consensus of forecasters remains that the UK faces lower growth – around one per cent in 2017 – and higher unemployment. We note that the Government announced in July that it is no longer pursuing its fiscal surplus target, with GDP forecasts possibly meeting the definition of an economic shock set out in its fiscal framework.

Employers generally urged caution in view of economic uncertainty, with some arguing for lower increases now, or moving away from the 2020 target altogether. This would, they argued, provide more time to see what happens to the economy, make it easier for firms to adapt to higher wage costs by investing in productivity-raising measures, and help to manage pressures in April 2017 arising from other business costs such as pensions automatic enrolment (now covering small businesses) and the Apprenticeship Levy (affecting larger businesses).

By contrast, employee stakeholders urged ambition, pointing to continued strong labour market performance, limited hard evidence of economic harm post-Referendum, and survey data suggesting that most employers had coped with the introductory rate of the NLW. They called for (at a minimum) a recommendation for an on-course rate, adjusted no more than to reflect the changed pay forecasts. Some employers also saw risk in lower increases now because these would as a matter of simple arithmetic mean sharper increases towards 2020.

We have weighed these considerations carefully.

Overall, we recommend for April 2017 an increase in the National Living Wage of 30 pence or 4.2 per cent to £7.50 per hour. In line with our original intention, this is the on-course rate using the median of available forecasts from the Bank of England and the HM Treasury Panel of Independent Forecasts. (We did not have access to the Office for Budget Responsibility's forthcoming November forecasts, though in recent years the Treasury Panel forecasts have come somewhat closer to the out-turn.)

The recommendation represents a finely balanced decision in conditions of considerable uncertainty. On the one hand, it is a significant increase at a time of average pay growth of 2-3 per cent and should protect these low-paid workers from the higher inflation likely to result from the depreciation of sterling. On the other hand, as a consequence of the automatic adjustment designed into a moving target, it is substantially below the £7.64 we projected in our Spring 2016 Report, reflecting actual and forecast weaker pay growth.

Commissioners considered at length whether to recommend departing from the on-course rate bearing in mind the uncertainty of the economic prospects, with the real possibility of a significant downturn and consequent risks to employment. However, we judged that the limited evidence available at this early stage did not justify departing from the straight line path, particularly given the downward adjustment in value.

For 2018, the Treasury Panel and Bank of England forecasts imply a NLW within an interquartile range of £7.80 to £7.91. A material worsening in economic performance and prospects would lead us next year to consider whether to recommend that the NLW should not increase relative to median earnings, moving below a straight line path to 60 per cent in 2020, to safeguard employment.

Looking ahead, using the Panel forecast, we estimate that 60 per cent of median earnings in 2020 will equate in cash terms to an NLW of £8.61, within an interquartile range of £8.50 to £8.73. This is down from £9.16 in our Spring 2016 Report and £9.35 when the policy was announced in July 2015.

Impact of the introductory rate of the National Living Wage

Our Autumn 2016 Report includes further detailed analysis of the impact of the NLW, where there is now some early evidence on its effects on pay and employment. Around 1.6 million workers aged 25 and over – 6.7 per cent of the cohort - were covered by the introductory rate, with the large increase in April 2016 rippling some way up the pay distribution. This is reflected in hourly pay growth of nearly 6 per cent for the bottom quarter of workers, with women and part-timers particularly benefiting, and many workers aged under-25 also receiving the NLW rate. Low inflation meant real gains in pay were almost as large as nominal increases.

Pay increases were in some cases offset by reductions in benefits and premium pay as well as squeezing of differentials. Gains may also have been reduced by an increase in non-compliance, with recorded underpayment appearing to rise sharply, although this could be partly measuring higher non-compliance at the beginning of the NLW year. But it may also be a more sustained increase, and makes it more important to recognize that the demands on HMRC enforcement will rise in line with the NLW.

Surveys and stakeholder evidence suggest that firms used a wide range of measures to cope with the introductory rate, including higher prices and lower profits with a proportion reporting cuts in hours and jobs. The data do not as yet show clear evidence of effects on employment in low-paying sectors. However some specific sectors are reporting major concerns. Social care appears to have been helped by the Council Tax precept, but providers report that their medium-term sustainability remains at risk with many facing losses and some reports of withdrawal from contracts. The horticulture sector warns that high wage costs are a serious threat to the sector, risking viability towards 2020. The childcare sector in England is concerned about the interaction of higher wage costs with increased free hours. We shall continue to give these sectors close attention.

Looking towards 2020, most organisations have not yet got to grips with how they will accommodate the NLW. A lower cash figure by 2020 still means very substantial challenges from cost increases and compressed pay distributions, with the effect of that on

employee progression and motivation. We shall also want to investigate any effects on job mobility.

Other rates

Turning to the other rates we have, as in the spring, kept in mind that the Government designed the age structure on the basis that younger workers are more exposed than older workers to any employment risks of a higher pay floor. Our objective for younger workers is to recommend a rate that should not reduce employment (unlike for the NLW where our role is to advise Government on a path where some consequence for jobs has been accepted).

We drew attention in our last report to the evidence for differences in labour market performance that mean the pay floor for younger workers, including 21-24 year olds, cannot currently be set at the same level as that for workers aged 25 and over without risk to employment. We also said we would balance the risks of pricing younger workers out of employment were we to set the rate too high against the risks of encouraging employers to substitute younger workers for older ones were we to set the rate too low.

A new challenge in making recommendations for April 2017 is how to adjust them to reflect the fact that they will take effect just six months later. (Indeed we are making new recommendations only one month after our spring recommendations have taken effect.)

Recommendations for the under 25 year old rates and the Apprentice Rate also had to bear in mind increased economic uncertainty. On the one hand, backwards-looking data suggested continued improvement in the employment and pay position of younger workers. On the other, any economic slowdown would be likely to affect younger workers first.

Unemployment rates for the 21-24 year olds remain higher than for 25-30 year olds and the bite for 21-24 year olds is already the highest of any age group, with the current minimum wage set to be over 80 per cent of median earnings. However 21-24 year olds have continued to see both rapid recent improvement in unemployment rates and strong pay growth.

Balancing these considerations, we recommend that the 21-24 Year Old Rate should increase to £7.05 from 1 April 2017. This recommendation, if accepted, would deliver a cumulative increase since October 2015 of 5.2 per cent. It is equivalent to an increase at an annual rate of 3.2 per cent.

In our last report, we recommended a significant increase for the pay floor of 18-20 year olds reflecting their strengthening labour market position with a more modest increase for the 16-17 Year Old Rate in view of their weaker position. Since then, employment, unemployment and pay of 18-20 year olds has continued to improve strongly. Pay growth for 16-17 year olds has been similar to that of those aged 25 and over but weaker than for those aged 18-24, and there are possible signs of slowing employment and unemployment.

We recommend an increase in the 18-20 Year Old Rate to £5.60 from 1 April 2017. This recommendation, if accepted, would deliver a cumulative increase since October 2015 of 5.7 per cent. It is equivalent to an increase at an annual rate of 3.1 per cent.

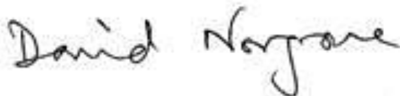
For 16-17 year olds, we recommend an increase to £4.05. This recommendation, if accepted, would deliver a cumulative increase since October 2015 of 4.7 per cent, equivalent to an increase at an annual rate of 2.8 per cent.

For apprentices we recommend an increase to £3.50. This recommendation, if accepted, would deliver a cumulative increase since October 2015 of 6.1 per cent. It represents an increase at an annual rate of 4.5 per cent. We remain concerned that the latest surveys continue to show very high levels of non-compliance.

Finally, we recommend a 40 pence increase in the accommodation offset £6.40 better to reflect the costs of providing accommodation and to help the horticulture sector in particular.

I am copying this letter to the Prime Minister.

Yours sincerely,



Sir David Norgrove