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Amendment to the National Minimum Wage Regulations: increase in national minimum wage rates - 2016

Department for Business, Energy and Industrial Strategy

RPC rating: not fit for purpose

Description of proposal

The national minimum wage (NMW) is a statutory pay floor that provides protection to low-paid workers. The NMW came into force in April 1999; since when NMW rates have been reviewed annually by the Low Pay Commission (LPC).

The proposal would increase the 21-24 year old, development, youth and apprentice national minimum wage rates in line with the LPC's recommendations. The Government propose to increase the 21-24 year old rate by 3.7% to £6.95, the development rate by 4.7% to £5.55, the youth rate by 3.4% to £4.00 and the apprentice rate by 3% to £3.40. The new rates will come into force on 1 October 2016. Those aged 25 years and over are now covered by the national living wage (NLW), which was introduced in April 2016. The Government have announced their intention to synchronise the next increase in NMW rates with the next adjustment of the NLW rate in April 2017.

Impacts of proposal

There would be costs to employers from increasing the wages of employees who are paid less than the new statutory minimum wage and from associated non-wage labour costs. The impact assessment (IA) estimates the cost to employers by comparing the annual wage bills of affected employees under the new rates against a counterfactual in which the annual wage bill increases at half the rate of the average earnings forecast by the Office for Budget Responsibility (OBR). The use of this counterfactual is discussed further below. The IA explains that it uses a two-year appraisal period as the Department estimates that, for each NMW rate category that the Government propose to increase, the rates for wages in the counterfactual would exceed the new level of the NMW within two years. Beyond that point, wages in the counterfactual would be higher than the new NMW rates in all categories.

Using data from the 2015 Annual Survey of Hours and Earnings, and adjusting this based on an assumption that everyone is paid at least the latest October 2015 NMW rates, the IA estimates the number of employees paid at, or below, the proposed new NMW rate to be 575,000. This is much lower than in previous years because those aged 25 years and over are now covered by the NLW. The IA estimates the overall direct cost of the proposal to all (public and private sector) employers to be £206.4 million over the appraisal period in NPV terms.

To estimate the cost to business (private sector employers), this figure is adjusted by applying the proportion of employees working in the private sector who are affected by the proposal. The IA estimates the total direct cost to business to be £185 million over the appraisal period in NPV terms.

The IA explains that some businesses may also decide to raise wages for employees earning above the new NMW rate in order to maintain wage differentials. In response to comments from the RPC, the IA for the NLW classified a small proportion of these costs as direct impacts. However, the present IA explains that, based on further evidence and consultation with the LPC and representatives of employers and workers, it is considered highly unlikely that pay differentials are written into contracts. The IA, therefore, classifies all of these 'ripple effect' costs as discretionary and indirect. The IA estimates this to cost employers £86.8 million over the appraisal period.

Quality of submission

Following the RPC's initial review, the Department submitted a revised IA. However, this does not respond adequately to one of the two issues raised in the initial review notice:

Issue still to be addressed following the RPC's initial review

Using a one-year appraisal period

The RPC's opinion on the 2015 NMW increase[1] expressed concern that the Department's one-year appraisal period could mean that the impact of NMW increases over the course of the parliament would not be fully captured. This issue was brought into sharp relief last year by the significant increase in the apprentice rate, which exceeded the LPC recommendation and, therefore, was accounted for under the Government's business impact target. This concern was addressed by the Department in setting out its proposed approach for assessing the impact of the

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/454011/2015-07-09-RPC15-BIS-2382__Amendments_to_National_Minimum_Wage_rates_201....pdf

NLW. However, the Department's initial submission in relation to the present proposal on the NMW did not address this issue satisfactorily. The RPC's concern was that a one-year appraisal period is insufficient to capture the impacts of a proposal with an 'active life' longer than one year. Specifically the 2015 NMW increase raised the floor for future increases, including the 2016 proposal. This 'knock-on' effect has not been captured in either this IA or the IA for the 2015 NMW increase. This has resulted in estimates that understate the total costs to business for the period October 2015 to April 2017.

The RPC recognised that addressing the multi-year impacts of each round of increases is complicated, but the Committee was clear in its previous opinion[2] that there is a need to ensure that the business impact target and non-qualifying regulatory provision figures provide a complete account of the impacts of NMW changes during the current parliament.

In response to the RPC's initial review notice, the Department submitted a revised IA that states, " *For the purposes of the Business Impact Target, we will reassess whether it may be appropriate to estimate costs of NMW increases earlier in this parliament (October 2015) that may have extended beyond the single year appraisal period in future NMW impact assessments.*" (page11) At the same time, the Department sets out why it thinks a single-year appraisal may be justified. However, as the estimated costs in this IA do not satisfactorily capture the multi-year impacts of the 2015 adjustments, the RPC cannot validate the estimated EANDCB of this proposal. As indicated in the RPC's 2015 Opinion[3], the Department must address this in full at this stage and cover both increases that go beyond the LPC recommendation, such as last year's apprentices' increase (which will score against the BIT) and increases in line with LPC recommendations (which do not score).

Issues addressed following RPC's initial review

Counterfactual

In its initial submission, the Department assumed that, in the absence of the proposal, the wages of employees at the NMW wage floor would increase in line with the OBR's forecast for average earnings growth for all employees. The IA did not provide sufficient justification for this assumption, particularly as it seemed to cut across the rationale of the need for policy intervention at the bottom of the wage distribution. Following discussion with the RPC, the Department accepted this and said that it would consult the LPC and other labour market experts on the likely increase, if any, in earnings at the bottom of the wage distribution in the absence of

[2] *Ibid*. p.2
[3] *Ibid*. p.2

NMW uplifts. The revised IA states that, "…the balance of evidence suggests that counterfactual wages would likely grow at some rate between zero and average earnings growth." (page 13) The IA now provides scenario analysis where the central estimate uses a counterfactual in which the pay of employees at the NMW level increases at half the rate of the average earnings forecasts. The RPC is not confident that this is a robust estimate, given that there is more likely to be zero wage growth in the counterfactual for wages at the very bottom end of the wage distribution. However, in the absence of conclusive evidence and pending further research, the Department's approach is sufficient.

Small and micro business assessment (SaMBA)

The SaMBA is sufficient. The IA explains why small firms should not be exempt from the proposal. The IA provides useful information to show that small and micro businesses employ 39% of those covered by the NMW and will account for approximately 36% of the direct cost impact. In that sense, small and micro businesses are not disproportionately affected and a significant part of the benefit of the policy to low wage workers would be lost if small and micro firms were exempt. The IA discusses general measures that government is taking to support small businesses. However, this section of the assessment would be improved by listing mitigation measures that are more specific to the proposal, as in last year's IA.

Although the IA has addressed some of the RPC comments in its opinion on last year's uprating, there are still some areas where the IA could be improved:

Employment impacts

As in previous NMW IAs, the proposal is treated as a transfer from employers to employees and the Exchequer, with the net present value being zero. The IA explains why it expects no significant employment or efficiency impacts from the proposal. Although this assessment is not unreasonable, and seems to fit evidence regarding the impact of the NLW, the IA would benefit from a more extensive and integrated discussion of this issue. Last year's IA included a box that helpfully described a potential framework for assessing possible employment impacts. This box is not included in the present IA, and no explanation is presented as to why this approach was not followed.

Exchequer impacts

The IA explains that the Exchequer would benefit from the uprating of the NMW, for example, through higher pension and National Insurance contributions. Against this, there will be increased costs to the public sector through paying higher wages. The IA states *"…the Treasury estimates that there is no significant impact on public* *finances with changes in the NMW, and the net benefits on Public Sector Net Borrowing are very small, not significantly different from zero"* (page 29). It would be helpful if the IA provided greater detail around the size and nature of the Exchequer impacts.

Departmental assessment

Classification	Non-qualifying regulatory provision
Equivalent annual net direct cost to business (EANDCB)	£37.3 million (initial estimate) £90.2 million (final estimate)
Business net present value	-£184.1 million
Societal net present value	Zero

RPC assessment

Classification	Non-qualifying regulatory provision (exclusion H – national minimum wage)
EANDCB – RPC validated	Not validated
Business impact target score	Not validated
Small and micro business assessment	Sufficient
RPC rating (of initial submission)	Not fit for purpose

Michael Gibbons CBE, Chairman