Regulatory Policy Committee

National Minimum Wage (Amendment) Regulations 2020: increases in the national minimum wage and national living wage rates

Department for Business, Energy and Industrial Strategy

RPC rating: fit for purpose

Description of proposal

The national minimum wage (NMW) was introduced in April 1999. The national living wage (NLW) was introduced in April 2016. These measures set floors below which hourly wages must not fall, protecting low-paid workers and providing incentives to work. The Low Pay Commission (LPC) reviews rates and makes recommendations to government annually.

The proposal would increase the NLW (for those aged 25 years and older) and the four NMW rates; the main (21-24 years), development (18-20 years), youth (16-17 years) and apprentice rates. All changes are in line with the LPC's recommendations:

Low Pay Commission NMW/NLW rate recommendations for April 2020

	LPC recommendation	Current rate	Annual percent increase
National living wage rate	£8.72	£8.21	6.2%
21-24 year old rate	£8.20	£7.70	6.5%
18-20 year old rate	£6.45	£6.15	4.9%
16-17 year old rate	£4.55	£4.35	4.6%
Apprentice rate	£4.15	£3.90	6.4%
Accommodation offset (day rate)	£8.20	£7.55	8.6%

It is proposed that the new rates should come into force on 1 April 2020. NMW and NLW rates were last increased in April 2019. The latest proposed increase in the NLW rate would mean that it would reach the Government's target of 60 per cent of median earnings by 2020.

Impacts of proposal

Direct labour costs

The new NLW and NMW rates would impose costs on employers by increasing the wages of employees who were paid less than the new statutory wage rates, and through associated non-wage labour costs. The impact assessment (IA) models these costs by estimating the difference between assumed rates of pay in the absence of uprating and what employers would have to pay in wages under the proposed NLW/NMW rates. To calculate the counterfactual wage, the Department has assumed that wages paid to employees currently receiving NLW/NMW would increase at a rate equal to the assumed increase at the 30th percentile of the wage distribution. This is the point in the pay distribution above which recent research[1] by the LPC indicates that there are no more spillovers ((businesses raising wages for employees earning above the new NLW/NMW rates in order to maintain wage differentials) from the minimum wage uprating. Last year's IA used a counterfactual based on assumed wage growth at the 20th percentile, based upon research by the National Institute of Economic and Social Research (NIESR).

The IA explains that the impact of the uprating is assessed over the period it would take for this counterfactual wage estimate to 'catch up with' the proposed NLW/NMW rates. The basis for the assumption is that expected counterfactual wage growth (what would be predicted without the uprating) has changed from the average for the post-financial crisis period (from 2010) to a long-term average (from 2001). The Department judges that this reflects best the business cycle in which the UK is currently. This approach results in an annualised figure for earnings growth of about half a percentage point higher than would have been the case if the approach for last year's IA had been used. Based upon this, the Department has used a three-year appraisal period. The Department undertakes sensitivity analysis using alternative growth rates to form high and low-cost scenarios.

The IA estimates that 2.4 million employees would benefit directly because they would otherwise be paid less than the proposed NLW/NMW rates in April 2020. It is estimated that, based on data from the 2019 Annual Survey of Hours and Earnings, 2 million of these employees are aged 25 years or older and are, therefore, covered by the NLW. All wage impacts have been increased by 21.78 per cent to account for non-wage labour costs (employer pension and National Insurance contributions). The IA estimates the overall direct increase in labour costs to all (public and private sectors) employers to be around £0.7 billion in present value terms.

[1] Available at: https://www.gov.uk/government/publications/low-pay-commission-report-2019

Spillover effects

The IA explains that some businesses may also raise wages for employees earning above the new NLW/NMW rates in order to maintain wage differentials. The Department has classified the increase in labour costs caused by this spillover (sometimes known as ripple effect) within the earnings distribution as an indirect effect, because the only regulatory requirement for businesses is to meet the increased pay floor. This is based on evidence from the LPC and other sources that there is no significant evidence of pay differentials being built into employment contracts (which the RPC considers would be required to make it a direct impact). This was the approach adopted for the 2019 NMW/NLW IA. This year, however, the Department has estimated that spillovers extend to the 30th percentile, as noted above. The present IA estimates this spillover or ripple effect to cost employers around £1 billion in present value terms. Combining this cost with the additional direct labour costs to employers of £0.7 billion, the IA estimates the overall impact of the proposals on labour costs to be around £1.7 billion in present value terms.

Transition costs

The IA estimates that businesses would incur familiarisation costs of between £2.7 million and £6.4 million. This estimate is based on ten minutes of employers' time to consult the government website to determine the new rates, and an estimate that between approximately 1.1 million and 1.3 million employers would be affected by the uprating. The IA relies on 2019 business population estimates and external survey evidence and accounts for the proportion of businesses with workers paid in ranges affected by the current and proposed NMW/NLW rates. This is a higher familiarisation cost assumption than estimated in last year's IA, taking account of the delayed announcement of the uprating this year (paragraph 106, page 29). As in last year's IA, the Department explains that it does not expect any other significant implementation costs associated with this year's NMW/NLW upratings, drawing upon qualitative evidence from NIESR.

Overall cost and cost to business

The upper estimate of the transition cost (£6.4 million) is added to the labour cost estimate of £730.1 million to provide an overall cost to employers of £736.5 million, in present value terms. In order to arrive at a direct cost to business for business impact target (BIT) purposes, the Department makes two further adjustments. First, it applies the proportion of workers paid at each of the NLW/NMW rates who work in the private and voluntary sectors (as opposed to the public sector) – equivalent to 95 per cent for the NLW, 98 per cent for the main NMW rate, 99 per cent for the development rate, 99 per cent for the youth rate and 89 per cent for the apprentice rate (annex E, pages 52-54). Second, it excludes the indirect spillover cost of around £1 billion referred to above. These adjustments result in an equivalent annual net direct cost to business (EANDCB) of £205.6 million in present value terms over the three-year appraisal period (based on 2016 prices; 2017 base year for discounting). Under the better regulation framework rules for the 2017-19 parliament, this measure would have been a qualifying regulatory provision that would count towards the BIT. Its status for BIT purposes will need to be determined once the framework for the current parliament is set.

Wider impacts

As noted above, the Department's IA also provides monetised assessments of the impact of the measures on public sector employers, employees and HM Treasury. The £1.7 billion direct labour cost to employers is matched by a combined benefit to employees through increased wages (£1.4 billion), and to HM Treasury primarily through increased pension and National Insurance contributions (£0.3 billion). The net present value (NPV) of -£6.4 million (-£5.5 million in 2016 prices; 2017 base year for discounting) measures additional costs (not transfers) driven by the transitional resource costs to employers.

The IA provides a discussion of macroeconomic impacts, including potential impacts on employment, prices and productivity (pages 30-34). Due to the nature of the LPC's remit and the lack of definitive evidence from numerous past evaluations and studies, the Department sees no reason to expect adverse employment effects from the proposed increase in the NMW and NLW rates. For the NLW, the Department notes that it may have macroeconomic impacts in the long run, which could include negative employment impacts. It notes that the Office for Budget Responsibility (OBR) previously estimated 60,000 fewer people in employment by 2020 due to the NLW, but that the OBR acknowledges that this has not materialised.

Quality of submission

The Department's estimate of overall cost to business of around £1.7 billion in present value terms is around three times the figure used in the IA for the 2019 upratings. This figure includes the indirect spillover effects, which are now assumed to ripple further up the wage distribution, to the 30th percentile. The EANDCB of £205.6 million is around a third higher than last time; although a better measure of the increase in direct cost to business compared to last year's upratings is the BIT score (under the better regulation framework rules for the 2017-19 parliament), since costs are now assessed over three rather than two years. The BIT score, at £616.7 million, is around twice that of the 2019 upratings. As the Department's sensitivity analysis shows, these costs would be significantly higher but for the Department's revised assumptions for counterfactual earnings growth. The business NPV, EANDCB and BIT score figures all reflect the significantly-higher percentage increases in the minimum wage rates in 2020 compared to last year's increases.

The RPC's opinion on the IA for the 2018 NMW/NLW upratings[2] set out in detail two main concerns with the Department's analysis. In summary, the first was that counterfactual wage growth at the lowest part of the wage distribution seemed likely to be much lower than that assumed by the Department, possibly even at, or close to, zero. The second was the omission of potentially-significant 'base-raising' impacts from previous years' NMW uprating, arising from re-setting the counterfactual in each IA to the level of the existing NMW. Both factors suggested that costs to business could be much higher than those estimated by the Department. The RPC encouraged the Department strongly to continue to consider ways to improve further its analysis and evidence in these areas and suggested, specifically, that the Department should seek comments and views from a range of labour market experts and stakeholders on the points raised in its opinion.

In response, for the IA on the 2019 upratings, the Department undertook a survey of labour market academic experts. On the basis that the majority of the respondents supported the Department's approach, the Department's overall analysis remained fundamentally unchanged and this has been carried forward to the present IA. However, useful developments within this overall approach include:

- incorporation of new work by the LPC, resulting in the shift to using the 30th percentile noted above, and further liaison with the secretariat to the LPC to identify alternative methods to estimate the counterfactual;

- an updated literature review, desk-based research and academic work supporting the *Dube Review*, to check that the Department's approach is still valid; and

- consideration of an auto-regressive integrated moving average model (paragraph 56, page 17) to improve its estimation of wage growth.

[2] https://www.gov.uk/government/publications/national-minimum-wage-amendment-regulations-2018-rpc-opinion

The Department also updated its illustrative alternative quantitative assessment (annex D, pages 46-51). This shows that estimated costs would be very much higher if one were to allow for a period of zero wage growth at the lowest end of the wage distribution, since this would imply a longer period before counterfactual wage growth caught up with the uplifted minimum wage.

Given the improvement in the evidence base for the present IA, the difficulties presented by an unknowable counterfactual and continuing academic support for the Department's approach, the RPC accepts the IA as fit for purpose.

The RPC expects the Department to continue to strengthen the evidence and analysis for its approach in IAs of future upratings. This is particularly important with a new policy objective for the NLW to reach two-thirds of median earnings within the next five years (if economic conditions allow). As indicated in the opinion on the 2019 IA, in view of the small number of responses to the previous survey of academics, this could involve seeking views of more labour market experts. The Department could also explore further, minority views in the survey for last year's IA that recognised the issues raised by the RPC. These included the suggestion that a lower counterfactual wage growth assumption might be appropriate and potential omission of the base-raising effect of previous years' NMW upratings.

The Department could also consider tracking more-detailed longitudinal micro-economic evidence in order to test its assumptions. This work could, potentially, also give a better sense of indirect, and wider, impacts such as substitution among different types of labour, impacts on labour productivity, promotion rates, retention, duration/churn of employment and interaction with in-work benefits.

The current IA would benefit from addressing the following comments:

- *Making a clearer distinction between the feasibility of different analytical approaches to assess the NMW and the NLW*. Appraising the full impacts of the NLW should be more-straightforward given its much more recent introduction. The RPC remains of the view that the Department should provide an economic appraisal of the full policy ambition for the NLW, which is now the aim to reach two-thirds of median earnings within the next five years (paragraph 159, page 39), including the base-raising effect of earlier years. Failing that, the Department should, at each annual uprating, check explicitly the validity of its assessment of cumulative impacts.

- *A clearer explanation of the method used in Annex D*. This annex provides an illustrative cost estimate under a period of zero counterfactual wage growth. The Department has helpfully elaborated its method, including a new graph (figure 11, page 50). However, the text at paragraphs 193-194 is particularly difficult to follow and it is not clear how figure 11 relates to the RPC's shadow wage curve graph (figure 9, page 45). In particular, given what is stated at paragraph 196, it would be useful if the Department explained how the Annex D cost estimate proxies the blue shaded area in figure 9 (and confirming that it does not incorrectly include part of the general increase in wages in the counterfactual, i.e. the area immediately to the right of the blue-shaded area).

- *International trade impacts.* The IA would benefit significantly from an assessment of the impact of the proposal on trade. In particular, the impact on the competitiveness of UK businesses in the upcoming trade negotiations with the European Union. The IA states that *"…evidence from stakeholders suggests their preferential mechanisms to cope with the increased wage bill are to raise prices"* (paragraph 123, page 31). The higher prices used to offset the increased labour costs may have an impact on the trade balance; and in turn, on trade negotiations.

- *Annex B – previous cost estimates from minimum wage upratings*. This helpful new annex would benefit from additional information, or explanation, in places. For example, the table might include the BIT or non-qualifying regulatory provision-equivalent scores and clarify that the high 2016 estimates covered the *introduction* (rather than uprating) of the NLW.

- *Employment effects resulting from NLW*. The IA reports that the Department will remain vigilant for 'negative employment effects' (paragraph 178). The IA would benefit significantly from providing further information on how these potential effects will be monitored and tested, especially in the sectors reported as 'particularly exposed' such as social care, convenience and wholesale (paragraph 119). The Department should also address explicitly the consistency of its approach to counterfactual wage growth with the OBR's (at least previous) expectation of an increase in unemployment rate over the medium term resulting from the NLW.

- As noted above, the IA's discussion of employment effects would benefit from further consideration of substitution among workers earning different wages, and shifts between capital and labour. It could also consider whether such effects could be stronger in the future as competitive pressures and the advance of automation/artificial intelligence increase incentives to reduce wage bills.

- *Counterfactual wage growth and appraisal period.* The IA would benefit from discussing the 'stickiness' of employee pay progression under the uprating and its potential implication for comparison against the counterfactual and choice of appraisal period. For example, in the counterfactual, some of those currently on the minimum wage would be promoted as their performance warranted while, under the uprating, such promotions might be delayed until the marginal product of labour exceeded the new NMW/NLW.

- *Justification of the switch to using long-term average earnings growth for the counterfactual*. The IA would benefit from providing further justification for the change to using long-term (compared to post-financial crisis) average earnings growth in its counterfactual. Views of labour market experts would be particularly useful, as well as discussion around whether the prolonged departure from trend since 2007-8 might have depressed the calculation of the long-term trend.

- *Stakeholder evidence of wider business impacts*. The IA includes evidence from stakeholders, e.g. in relation to prices on page 31. The assessment would benefit from further development and/or reporting of stakeholder evidence as to how businesses have been affected by increases in the minimum wage rates, including impacts on their staffing etc. practices.

- *Transition costs*. The Department monetises familiarisation costs but the IA would benefit from further discussion of why other transition costs, such as updating employee contracts, pay tables and tax codes, are not expected to be significant.

- *Spillover effects*. The IA would benefit from a wider consideration of spillover effects. These effects could include the possibility of some employers reducing headcount, reducing minimum wage workers or substituting between minimum-wage, better-paid workers and non-employees, and the effect that displaced workers could have on wages. The discussion around there being no significant evidence of pay differentials being built into employment contracts would benefit from considering negotiated or collectively bargained pay scales, which will apply to many public sector workers.

Small and micro business assessment (SaMBA)

The SaMBA is sufficient. Small and micro businesses are estimated to employ 22 per cent of those covered by the NMW/NLW and incur approximately 31 per cent of the total direct cost to business of the uprating. Although small and micro businesses are thereby disproportionately affected by the proposal, the IA explains clearly why they should not be exempt from the proposal (paragraphs 152-154, page 38). The Department refers to the success of previous communications campaigns (paragraph 154, page 38) and employer-targeted communications activity/guidance to ensure small and micro businesses are aware of the NMW/NLW changes. In line with the comments in the RPC opinion on the IA for the 2019 upratings, the Department also refers to other mitigation, such as small and micro businesses being exempt from the Apprentice Levy. The IA would be improved further by discussing briefly the possible competitive effects of these mitigations.

Monitoring and evaluation

The Department explains how the LPC will continue to monitor, evaluate and review the levels of the various minimum wage rates and that future recommendations by the LPC will be based on extensive monitoring and evaluation of the current rates. The Department notes further that monitoring and evaluation requirements for the LPC with regard to the new policy objective of NLW reaching two-thirds of median earnings will be included in the LPC's remit for 2020/2021 (page 39).

Departmental assessment

Classification	Qualifying regulatory provision (IN)
Equivalent annual net direct cost to business (EANDCB)	£205.6 million
Business net present value	-£1,364.7 million (includes indirect costs)
Societal net present value	-£5.5 million

RPC assessment

Classification	Under the framework rules for the 2017-19 parliament: qualifying regulatory provision (IN) To be determined once the framework rules for the current parliament are set
EANDCB	£205.6 million (2016 prices; 2017 present value base year) - subject to validation once the framework rules for the current parliament are set
Business impact target score	£616.8 million (over three years) - subject to validation once the framework rules for the current parliament are set
Small and micro business assessment	Sufficient

Regulatory Policy Committee