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29 February 2016

Dear Secretary of State,

THE 2016 NATIONAL MINIMUM WAGE RATES FOR WORKERS AGED UNDER 25 AND APPRENTICES, AND THE NATIONAL LIVING WAGE

I enclose the Low Pay Commission's first report of 2016. This sets out our recommendations for the three rates of the National Minimum Wage to apply to workers under 25, and the rate for apprentices, from October of this year. We will report again this autumn on the level of the National Living Wage to apply from April 2017. We have made an initial assessment of its impact for this report.

National Minimum Wage

The introduction of the National Living Wage (NLW) for people aged 25 and over has in effect created a new age band of the National Minimum Wage (NMW) for 21 to 24 year olds, in addition to the 16-17 and 18-20 age bands. Stakeholders took different views in our consultation on how to approach this group.

On one side we received considerable evidence highlighting the fairness, legal and employment relations risks of a lower minimum wage for workers aged between 21 and 24 than for workers aged 25 and over. A significant gap in the pay floor could lead to substitution of younger workers for older, and disadvantage those near the age boundary between rates.

On the other, we heard concerns that the rate should not add to costs for employers arising from the NLW. A wage floor set too close to the NLW would mean very high coverage and bite, potentially pricing 21-24 year olds from employment, and risking substitution by workers aged 25 and over, or under 21.

In reaching our own view we bore in mind that the Government designed this age structure on the basis that younger workers are more exposed than older workers to employment risks of a higher pay floor. We also reflected that 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 the Government on a path where some consequences for jobs have been accepted). Labour market evidence remains our test of what is affordable.

Unemployment rates for 21-24 year olds are twice as high as those for 25-30 year olds and the bite for 21-24 year olds is already the highest for any age group, with the current minimum wage now 79 per cent of median earnings. However 21-24 year olds have seen rapid recent improvement in unemployment rates, pay growth in 2015 was twice as fast as for workers aged 25 and above, and – a new consideration for this group – NLW workers are set to become relatively more expensive, so the pay floor for workers aged 21-24 may be able to be higher than it otherwise would be.

Balancing these considerations, we recommend that the adult rate (21-24 year olds) should increase by 3.7 per cent or 25 pence to £6.95 an hour from 1 October 2016. This is a higher increase than last year in both cash and percentage terms and means both the real and relative value of the NMW for this age group is likely to reach its highest ever level.

Our recommendation is made against the backdrop of mixed evidence on the economic outlook. Economic forecasts and evidence from the Government and others see good growth in the economy and employment in the next two years, with further recovery in the rate of pay increases to levels not seen persistently since the recession. We note, however, a slowing in the rate of pay increases and a number of downside risks to growth and employment. Should economic and pay performance prove weaker than anticipated, we will take this into account in future recommendations.

Youth Development Rate, 16-17 Year Old Rate and the Apprentice Rate

In recent years we have generally recommended smaller increases for workers under 21 than for older workers because their labour market position has been worse and the damaging consequences of unemployment more serious. However, last year we were able to recommend an improvement in the relative position of 18-20 year olds to reflect their encouraging wage and employment growth. We recommended a higher percentage increase in their pay floor than for workers aged 21 and over. We were more cautious for 16-17 year olds, whose jobs and pay growth were weaker.

This year the labour market position of 18-20 year olds has improved further, including sharply falling unemployment, solid median pay growth for a third successive year, and a falling bite. The position of 16-17 year olds has also begun to improve, though still lagging that of 18-20 year olds. In view of the strength and duration of the labour market improvement of 18-20 year olds we recommend a further significant step to recover their position, with an increase of 4.7 per cent or 25 pence in the Youth Development Rate to £5.55 an hour. For the 16-17 Rate, we recommend an increase of 3.4 per cent to £4.00 an hour.

The Apprentice Rate last year saw a 21 per cent increase, as well as a number of policy developments. Little information is available to assess the effect of these changes, with most growth in new starts coming from age groups with limited exposure to the higher pay floor. In view of the uncertain effect of the very large increase last year we recommend a 3 per cent increase in the Apprentice Rate to £3.40 an hour, raising its value broadly in line with expected pay growth elsewhere in the economy.

Indicative rates

Our remit asked for guidance on the future level of the minimum wage. In response, we have provided an indication of direction of travel, rather than particular numbers. There are no specific pay forecasts for the younger age groups, and their pay is more volatile than older workers’, so precise figures could very well mislead businesses. (We illustrate this in our report.)

On the direction of travel, the evidence suggests that there are genuine 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. In the absence of changes in relative performance, our view is that it may increase less rapidly for younger workers than that of workers aged 25 and over to 2020. Equally, there are countervailing concerns that will also play an important role in our recommendations: that, if too large a gap opens between the pay floor for different ages, there will be disincentives to hire or retain employees near the boundary and substitution by younger workers will be encouraged. We will balance these considerations in future recommendations.

National Living Wage

One area where we can give more detailed forward guidance is the NLW, where our report sets out further analysis, building on findings we published soon after its announcement. Around 1.8 million people are likely to be covered by the introductory rate of £7.20, with nominal gains of £680 a year for a typical (26 hours per week) worker.

This is a substantial increase that will help many low paid people. We are not of course at this stage able to comment on estimates of possible job losses by 2020 included in July 2015 analysis by the Office for Budget Responsibility (OBR). As one would expect, most firms in low-paying sectors have told us that they expect to be able to cope with the initial rate through a mixture of reduced premium payments, higher prices, lower profits and by offering fewer hours. The main areas of concern are smaller businesses in more marginal sectors and places, and the longstanding issue of the social care sector. Here providers warn that many were already vulnerable and that even the introductory rate of NLW presents a major risk to the viability of some businesses. The response of local authorities will be critical, though we heard real concerns about their ability to meet the costs of the sector even with extra flexibility on council tax, particularly in poorer areas with high need but a weaker tax base.

The wider challenge is the 2020 NLW goal of 60 per cent of median earnings, which currently equates in cash terms to £9.16. This number is likely to change when the OBR publishes its next forecasts at the Budget.

But wherever the cash figure ends up, the relative earnings goal is a stretching one. The bite for minimum wage workers under 25 is over 70 per cent. Taken together the weighted average figure for all the minimum wage rates could be around 62 per cent of median earnings in 2020, putting the UK among the countries of the OECD with the highest minimum wage relative to earnings. It would be somewhat above this level if the minimum wages for those aged under 25 increase faster than average earnings.

Both gains to employees and risks to employment will depend on the performance of the economy and how well business responds to the challenge. The main message from our consultation with employers and workers is that most organisations are still working out how they will accommodate the NLW, and have not yet looked beyond this year. Significant change in many business models is likely to be needed.

The role of the LPC itself is also changing. We are asked to continue to recommend rates for those under 25 that will not damage employment. For people aged 25 and over we will advise on the path to 60 per cent of average earnings, a target that is subject to sustained economic growth.

Our report sets out our preliminary thoughts on our approach. We note that the nature of the evidence on pay and its effects and measurement time lags mean we will probably be making our recommendations ahead of a clear understanding of the consequences of NLW increases. We will endeavour each year to consider the best possible trajectory. In the absence of economic shocks or other strong evidence, the default is likely to be a straight line bite path to 60 per cent.

On this basis, and to help guide business planning, we project the rate for April 2017 to be £7.64 though this could well be on the high side in view of recent data showing slower growth in pay (and again is likely to change when the OBR publishes new forecasts at the time of the 2016 Budget). We will make our recommendations in the autumn taking into account early responses to the NLW and the outlook for pay and the economy.

I am copying this letter to the Prime Minister.

Yours sincerely,

David Norgrove

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