



The Future Path of the National Minimum Wage

Low Pay Commission
2014



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Low Pay Commission 2014

Presented to Parliament
by the Secretary of State for
Business, Innovation and Skills
by Command of Her Majesty

March 2014



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The Future Path of the National Minimum Wage

In September 2013 the Secretary of State for Business, Innovation and Skills wrote to our Chair requesting that we undertake a task in addition to recommending the rates of the National Minimum Wage from 1 October 2014. He said that: “alongside signs of an emerging recovery, I am keen to ask the Commission to take a longer term view of the minimum wage and the necessary conditions for higher increases in the National Minimum Wage. In addition to the remit that I sent you in June, I would like you to:

- consider the conditions that need to be in place in order to allow a faster increase in the minimum wage taking into account the implications on employment.

Included amongst these conditions, I would be keen to understand how government policies that affect the labour costs and take-home pay of people on the National Minimum Wage have influenced your conclusions.”

We welcome this request. Since our 2013 Report there has been an upsurge of interest in the part the National Minimum Wage (NMW) may play in supporting the incomes of the lowest paid, often in the context of wider discussion of living standards. In this short report we set out the Commission’s view of the contribution that the NMW has made, particularly during the period of generally falling real wages since the economic downturn began in 2008, and our view on the conditions needed for the minimum wage to increase faster in future.

Introduction

- 1** This report comprises three parts as well as this introduction, and a conclusion. The remainder of the Introduction outlines the roles of the National Minimum Wage (paragraphs 9-14) and of the Low Pay Commission (paragraphs 15-19).
- 2** Part 1, The National Minimum Wage to Date, covers:
 - the path of the NMW since its introduction, outlining the different policy phases in the Commission's approach to recommending rates (paragraphs 21-23);
 - the impact of the recommended increases on employment and the real value of the NMW, including:
 - what it has meant for the pay of the lowest earners in periods of recession and recovery (paragraphs 24-28);
 - measures of the impact of the NMW, including the minimum wage as a proportion of median earnings, and numbers of workers covered by it (paragraphs 29-33); and
 - the findings of research investigating evidence of adverse employment effects (paragraphs 34-35).
 - the general context we judge important for understanding the impact of our recommendations, including:
 - the decline over time in the wage share of national income experienced in the UK and other developed countries (paragraphs 36-38); and
 - movements in labour costs and take-home pay, and their place in Low Pay Commission deliberations (paragraphs 39-48).
- 3** Part 2, Conditions Needed for Faster Increases in the National Minimum Wage, covers:
 - stakeholders' views on the conditions needed for faster NMW increases (paragraphs 53-62);
 - the general conditions in the economy conducive to faster NMW increases, including:
 - inflation and the role of the Monetary Policy Committee of the Bank of England in determining the real value of the NMW (paragraph 66);
 - the importance of productivity (paragraphs 67-72);
 - the role of increased demand in the economy (paragraph 73); and
 - previous experiences of faster increases in the National Minimum Wage (paragraphs 74-76).
- 4** The next section, from paragraph 79, discusses the sectoral conditions for faster increases in the NMW, which focuses on the low-paying sectors and includes the significance of:
 - labour costs (paragraphs 80-83);

- short-term market adjustments (paragraphs 84-85);
 - market characteristics (paragraphs 86-89);
 - impact on differentials (paragraph 90);
 - non-labour costs (paragraphs 91-92) and
 - statutory requirements (paragraphs 93-94).
- 5** Part 2 ends with comments on implications of a higher bite for the low-paying sectors (paragraphs 95-99).
- 6** Part 3, Scope to Affect the Conditions Needed for Faster Increases in the National Minimum Wage, examines:
- the scope to influence general economic conditions which would enable a faster NMW increase (paragraphs 102-105);
 - conditions directly affected by government policies, including tax and National Insurance contributions (paragraphs 106-108);
 - productivity in the low-paying sectors (paragraphs 109-113);
 - small firms and the NMW (paragraphs 114-118);
 - other considerations, including the living wage (paragraphs 119-120);
 - young people (paragraphs 121-125); and
 - apprentices (paragraph 126).
- 7** Part 3 ends by discussing options for clarifying the forward path of the NMW, including the idea of forward guidance from the Commission on the minimum wage (paragraphs 127-134).
- 8** The Conclusion (paragraphs 135-149) then summarises the conditions which would enable the Commission to recommend faster increases in the minimum wage. For significantly faster increases in the minimum wage to be achievable without significant risk to the low paid we believe it would be necessary to see:
- rising real wages in the economy generally;
 - stable or rising employment, particularly in low-paying industries; and
 - an expectation of sustained economic growth.

The Role of the National Minimum Wage

- 9** The purpose of the NMW is to provide a wage floor, in order to protect low-paid workers against exploitation, without causing job losses. Many economists have been wary of statutory minimum wages: unless they raise the price of labour at the bottom of the wage distribution above what it would otherwise be they are pointless; but if they raise it then the fear is that they will curb demand for labour, and curb it to the particular detriment of the least skilled – those whom a wage floor is intended to help.

National Minimum Wage

- 10** However, others have pointed out that labour markets are not perfectly competitive. There are costs and risks for workers who want to change jobs, and some employers enjoy a degree of monopsony power in local labour markets. As a result workers may be paid at levels below the market-clearing rate. The implication is that a statutory wage floor may raise the pay of the lowest earners without adverse employment effects. Of course, even under these conditions, if the minimum wage is set too high then adverse effects on employment will appear. So the challenge is to set the level as high as possible short of causing people to lose jobs.
- 11** The minimum wage is not a living wage: a living wage aims to assess needs and to provide enough for an employee and their dependants to live on, whereas the NMW aims to provide a wage floor which is affordable for business. It may need to be supplemented by other policy measures, principally in the tax and benefits fields, to produce enough for a family or household to live on. The tax and benefits systems, unlike wages (whether the NMW itself or indeed a living wage that is set across family types), are able to take into account household characteristics such as number of children, family size and number of earners in the household, all of which are closely correlated with household need.
- 12** The UK minimum wage is relatively simple. There are only four rates: three age-related rates, and a rate for apprentices. It is a single hourly rate across the UK for all industries, occupations, sizes of firm and regions. It is cash, and does not include benefits-in-kind, apart from accommodation. It is comprehensive as it covers nearly all workers and types of employment, with few exemptions. We regard this simplicity as a strength because it makes the NMW easily understandable for employers and workers, which promotes support for it and compliance with it; it makes enforcement easier; it minimises the regulatory costs of compliance for business; it avoids the 'boundary issues' regional or sectoral rates would entail; and it simplifies the process of determining the rates.
- 13** The Low Pay Commission's founding principles have been unchanged since the Commission was created in 1997. The First Report set out the Commission's intentions for the minimum wage: that it should support a competitive economy; be set at a prudent level; be simple and straightforward; and make a difference to the low paid. We continue to support these guiding principles, underpinned by a strong, evidence-based, analytical approach.
- 14** Accordingly our overarching aim in recommending minimum wage levels has, like our predecessors on the Commission, been to help as many workers as possible, without adversely impacting employment prospects. In its interim evidence to us in September 2013 and in its final evidence in January the Government encouraged us to retain this focus in making our minimum wage recommendations for 2014.

The Low Pay Commission

- 15** This overarching aim embodies the objectives of both employers, that the minimum wage should be affordable for business, and of unions, that as many workers as possible should benefit from as generous an NMW as is achievable. As such it reflects the composition of the Low Pay Commission, which includes three Commissioners from employer backgrounds, three from employee representative backgrounds, and three independents (the Chair, and two labour market experts).
- 16** To date all the recommendations made by the Commission have been unanimous. This is central to the effectiveness of the Commission: what the Government receives are not competing arguments from different standpoints but recommendations which are supported by business, by unions and by independent experts.
- 17** The Commission's recommendations are shared judgements rather than the mechanistic products of an economic model. They are strongly based in evidence, gathered through: commissioned research; visits to low-paying employers and employees around the country; extensive analysis of labour market and economic data, written and oral evidence from representative organisations and review of international comparisons. They involve careful assessment of the past impact of the NMW, and of the future prospects for the economy. However, despite this grounding in substantial evidence and analysis, in the end the Commission's recommendations necessarily remain judgements, and are not the arithmetical output of a formula.
- 18** This has proved a successful model. In 2010 members of the Political Studies Association voted the minimum wage the most successful government policy of the preceding 30 years. It is supported by all the main political parties, and has survived a change of government, and a prolonged economic slowdown which has put acute pressures on both the living standards of the lowest paid and the margins of many businesses. In our view simplicity and universality are key to this success.
- 19** Of course it is important that we examine factors which are not universal in arriving at rate recommendations, and later in this report we consider the role of constraints on increasing wages which operate at sectoral level. Each year the Commission looks closely at the different low-paying sectors and occupations in order to understand the actual and likely impact of previous and possible future increases in the minimum wage. Alongside our recommendations for minimum wage rates we have from time to time made recommendations calling for changes to policy or practice relating to specific sectors. However, while we take account of sectoral features and differences in arriving at our rate recommendations we cannot, and should not, react to each industry and occupation. In this sense it is fair to say that the attributes that have contributed to the success of the minimum wage – particularly its simplicity and universality – mean that it is by necessity a blunt instrument.

Part 1: The National Minimum Wage to Date

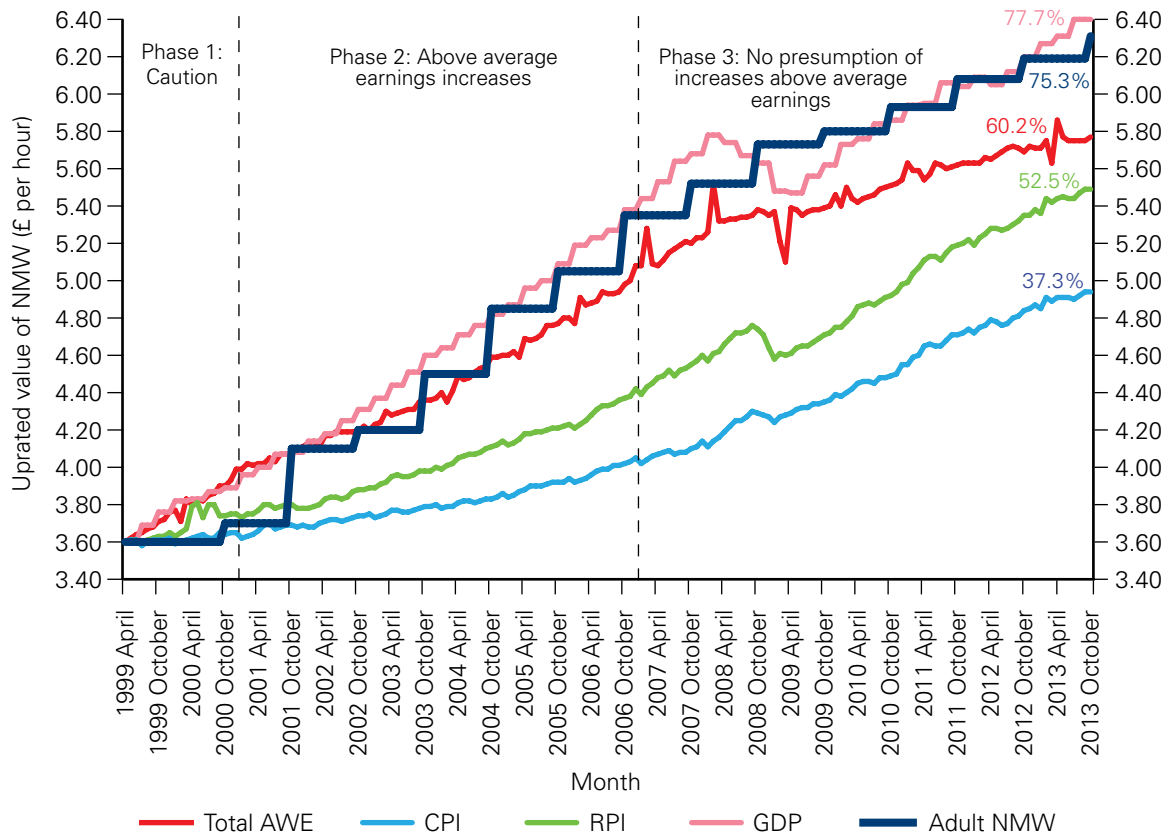
20 This part covers:

- the path of the NMW since its introduction, outlining the different policy phases in the Commission's approach to recommending rates (paragraphs 21-23);
- the impact of the recommended increases on employment and the real value of the NMW, including:
 - what it has meant for the pay of the lowest earners in periods of recession and recovery (paragraphs 24-28);
 - measures of the impact of the NMW, including the minimum wage as a proportion of median earnings, and numbers of workers covered by it (paragraphs 29-33);
 - the findings of research investigating evidence of adverse employment effects (paragraphs 34-35);
- the general context we judge important for understanding the impact of our recommendations, including:
 - the decline over time in the wage share of national income experienced in the UK and other developed countries (paragraphs 36-38); and
 - movements in labour costs and take-home pay, and their place in Low Pay Commission deliberations (paragraphs 39-48).

The Path of the National Minimum Wage Since its Introduction

21 The NMW was introduced in April 1999 at £3.60 an hour for those aged 22 and over. Figure 1 shows that it has increased in nominal value each year, reaching its current £6.31 an hour in October 2013, an increase of 75.3 per cent since 1999. This increase is similar to the increase in nominal gross domestic product (GDP) over the period, and significantly more than the increases in average earnings (around 60 per cent) and in prices, which have risen by about 52 per cent measured using the Retail Price Index (RPI) and by around 37 per cent using the Consumer Price Index (CPI). In other words the minimum wage is worth more now than when it was introduced and, while its relationship to average earnings has shifted from time to time with changes in economic conditions and in the policy of the Commission (see below), the hourly earnings of workers receiving it are a substantially higher percentage of average earnings than they were in 1999.

Figure 1: Increases in the Real and Relative Value of the Adult National Minimum Wage, UK, 1999-2013



Source: LPC estimates based on ONS data, AEI including bonuses (LNMQ), 1999, AWE total pay (KAB9), 2000-13, RPI (CHAW), 1999-2013, and CPI (D7BT), 1999-2013, monthly; and GDP (YBHA), 1999-2013, quarterly, seasonally adjusted (AWE, AEI and GDP only), UK (GB for AWE and AEI).

22 Figure 1 also shows the three distinct phases in the Low Pay Commission’s approach to recommending the rate since the NMW was introduced in 1999. It was initially set at a cautious level and was then raised in line with price inflation, while the Commission awaited the outcome of research investigating the impact on employment and wages. The Commission reviewed its approach in the light of those early research studies which suggested that the minimum wage had raised the wages of many workers, but that it had not covered as many workers as expected and it had not greatly affected differentials or led to an adverse impact on employment or hours worked.

“... revised statistics show that the number of workers directly affected by the minimum wage are smaller than the Commission originally forecast ... All the signs are therefore that the minimum wage can now be increased as a percentage of average earnings – benefiting more workers – without producing damaging economic effects.”

Chairman’s Foreword to the Fourth Report of the Low Pay Commission, 2003.

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23 Informed by these findings and in a climate of continuing economic growth the Commission followed a policy of recommending increases that were above average earnings growth and inflation between 2001 and 2007. The Commission adjusted its approach again after 2007, with the arrival of more uncertain economic conditions. Since then, increases in the adult rate of the NMW have been much closer to average earnings growth.

“... we do now consider that the phase in which the Commission is committed to increases in the minimum wage above average earnings is complete and, looking forward, we have no presumption that further increases above average earnings are required.”

**Low Pay Commission
Report, 2006**

The Impact of the National Minimum Wage

The Level of Low Pay

24 Table 1 shows relative changes in the hourly wages of the lowest-paid since 1975, broken down into phases of the economic cycle. In the earlier recessions of 1979-82 and 1989-92 the wages of the lowest paid fell relative to the median. In the 1979-82 recession the pay of those at the median rose by 6 percentage points more than that of workers in the lowest 5th and 10th percentiles. Table 1 also shows that during the recoveries of the 1980s and 1990s the pay of those at or above the median rose faster than that of the lowest paid.

25 Since the introduction of the NMW the picture has changed radically. The lowest paid have received the largest increases in earnings relative to the median. The strongest relative growth was between 1997 and 2004 (although that growth was not shared by those in the second quartile, particularly those between the 25th and 40th percentiles – not shown).

Table 1: Earnings Growth by Selected Percentile, UK, 1975-2013

Hourly wage growth relative to the median (percentage point difference)	Mean	Percentile					Median total hourly wage growth (%)
		5th	10th	25th	70th	90th	
1975-79	0.1	5.0	-3.0	-0.7	0.8	2.5	65.7
1979-82	1.0	-6.3	-6.0	-3.6	4.3	7.7	53.0
1982-89	0.8	-9.1	-8.7	-6.3	5.1	12.1	67.7
1989-92	0.7	-3.0	-1.0	-0.4	2.2	4.2	27.2
1992-97	-0.1	-4.6	-2.8	-2.4	1.8	2.7	17.3
1997-04	5.3	12.4	6.3	-0.1	1.3	5.9	27.2
2004-08	1.2	2.9	0.5	0.3	0.2	-1.0	19.8
2008-13	-0.2	1.9	0.1	-0.1	-0.3	-2.6	7.6

Source: LPC estimates based on NES and ASHE, UK, 1975-2013.

Notes:

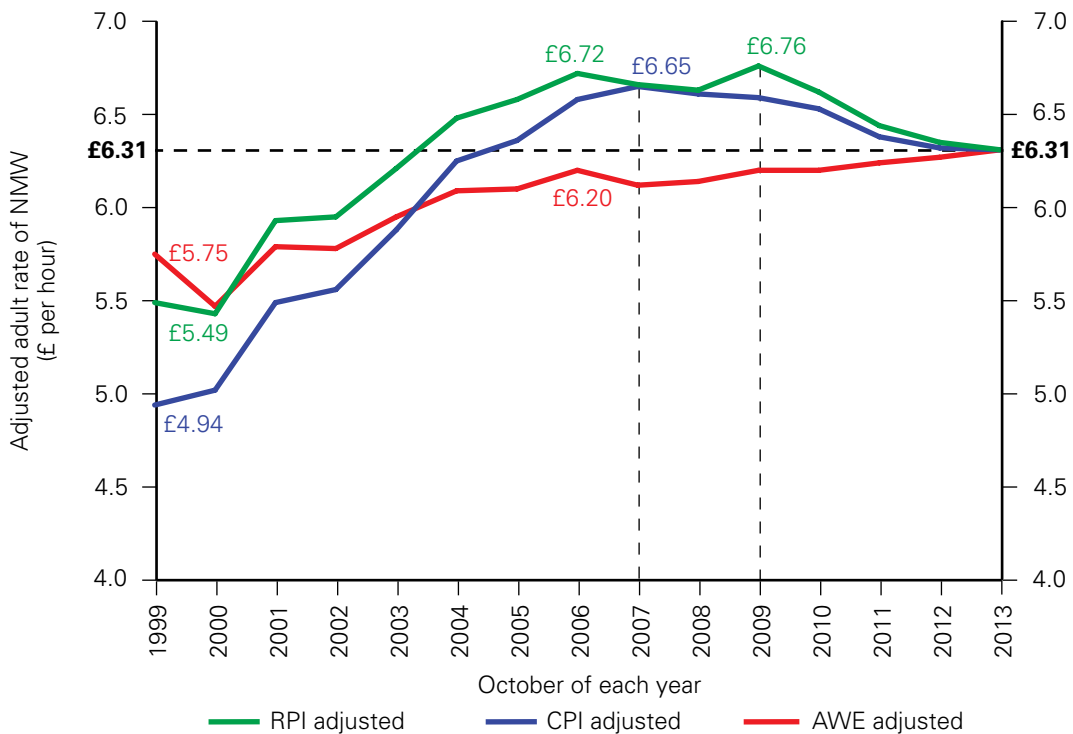
a. Shaded periods are recessions.

b. The 5th percentile generally has covered those on the NMW since 1999.

26 Since the onset of recession in 2008 the lowest paid have again made the greatest relative gains. In other words the trend whereby the wages of the lowest paid used to rise slowest has been reversed since the introduction of the NMW, and they have fared relatively better than their peers. Figure 2 below shows that the value of the NMW was at its highest ever level relative to Average Weekly Earnings (AWE) in October 2013.

27 However, although NMW increases have kept pace with the growth in average earnings since 2007, along with wages in general they have failed to keep up with price inflation. Figure 2 shows that using the RPI, the real value of the NMW peaked in 2009 (at £6.76 in 2013 prices), and in 2007 using the CPI (at £6.65 in 2013 prices). Thus, in October 2013, the NMW was 45 pence an hour lower in real RPI terms than it was in October 2009 and 34 pence lower than it was in October 2007 in real CPI terms. Were it decided to recover the lost value of the minimum wage through one uprating in October 2014, it would need to increase by 10.3 per cent in RPI terms (from £6.31 to £6.96) or by 7.8 per cent in CPI terms (to £6.80).

Figure 2: Real and Relative Value of the Adult National Minimum Wage, UK, 1999-2013



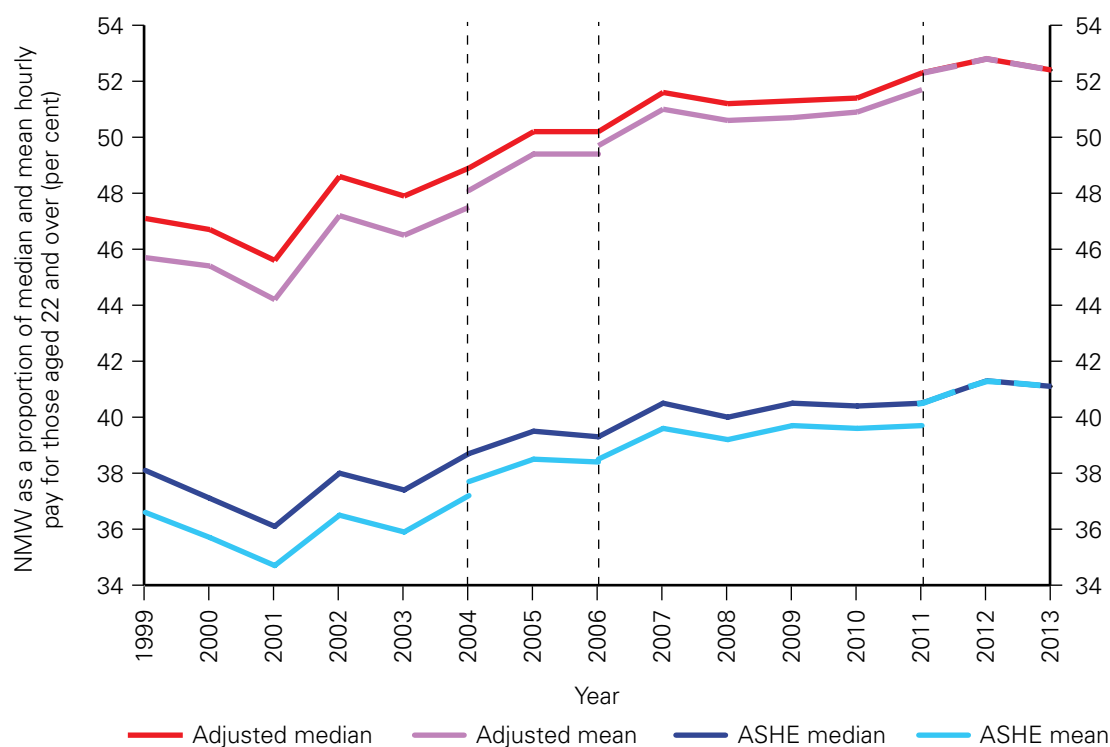
Source: LPC estimates based on ONS data, AEI including bonuses (LNMQ), 1999, AWE total pay (KAB9), 2000-13, RPI (CHAW), 1999-2013, and CPI (D7BT), 1999-2013, quarterly, seasonally adjusted (AWE and AEI only), UK (GB for AWE and AEI).

28 To put the trends another way, while the real value of the minimum wage has declined in this period, the real value of wages generally has declined faster. But this is little consolation to low wage workers, who are often those least able to absorb reductions in income. On our visits around the UK low-paid workers have told us about growing difficulties in making ends meet, and their struggles to afford what many people would regard as necessities.

Measures of the Impact of the National Minimum Wage

29 The increase in the value of the NMW, relative to average earnings, is often expressed in terms of the bite – the minimum wage as a proportion of median earnings.¹ We closely monitor the bite because a high or growing bite means that employers are more likely to be affected by the NMW. It may indicate an increased risk that the minimum wage will reduce demand for labour – that it will cost jobs – because of wage bill impacts on employers. Figure 3 shows that in 1999 when the NMW was introduced the bite was 45.7 per cent (or 47.1 per cent using an adjusted-ASHE series). Since 2007 it has increased from 51.6 per cent to 52.4 per cent in 2013 on the adjusted-ASHE basis (or 53.0 per cent if 21 year-olds, who were not entitled to the adult rate until 2010, are included). If average earnings grow as much as the OBR forecast for the year to the first quarter of 2014 (2.4 per cent), we would expect the bite to fall, to around 52.1 per cent when the 2014 ASHE data become available.

Figure 3: Bite of the Minimum Wage, UK, 1999-2013



Source: LPC estimates based on ASHE: without supplementary information, April 1997-2004; with supplementary information, April 2004-06; 2007 methodology, April 2006-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK.

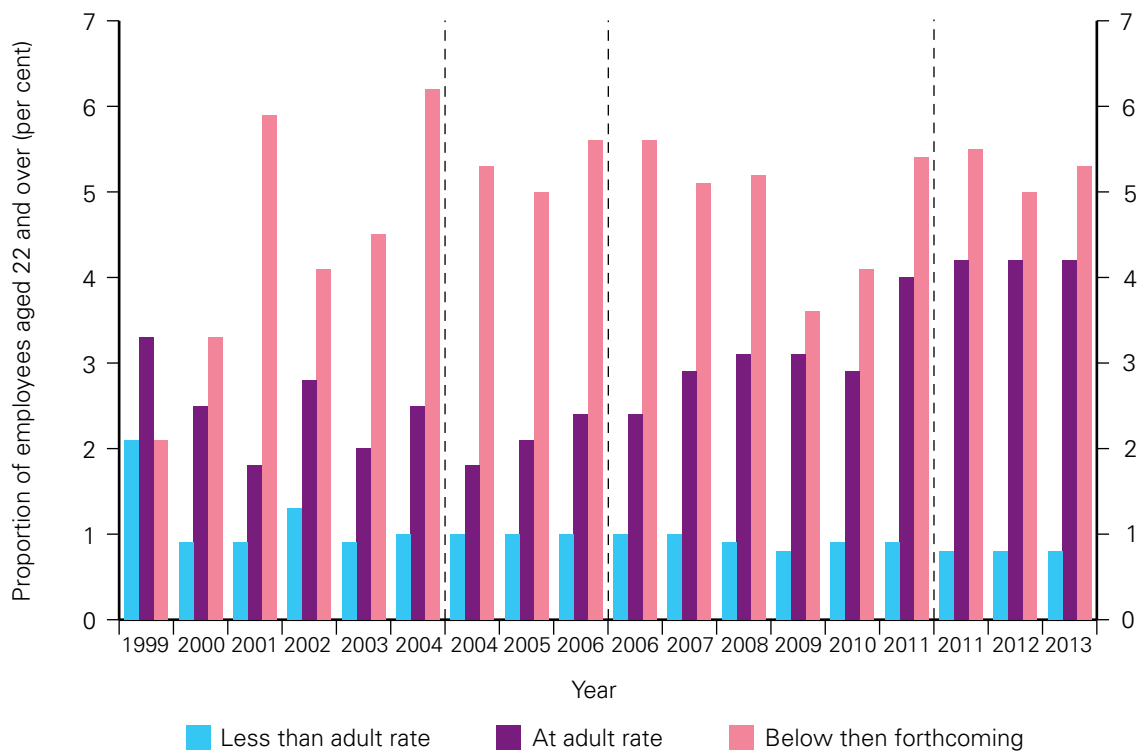
Note: ASHE data have been adjusted to take account of methodology changes to provide a consistent time series. The raw data are shown with distinct breaks to show the discontinuities in the four ASHE series.

30 The bite can be expressed sectorally, being the minimum wage as a proportion of median earnings for a given sector or group of sectors. For the low-paying sectors as a whole it is just under 80 per cent. The data, and evidence we have received through our consultations and visits, suggest that in some areas, such as cleaning and hairdressing, the minimum wage is increasingly often the going rate for the job. (See Annex A for details of the bite in low-paying sectors over time.)

¹ The bite is defined as the National Minimum Wage as a proportion of a particular point on the earnings distribution. In our reports, we tend to focus on the bite in terms of median earnings or average (mean) earnings, although we also consider the bite at the lowest decile, lowest quartile, upper quartile and upper decile. The bite can only range from 0-100 per cent.

31 In its evidence to us for this additional assessment the Government asked us what other measures of the impact of the NMW we take into account, besides the bite. As well as considering the bite at the median we examine the bite at the lowest decile, lowest quartile and mean. We also review the number of jobs covered by the minimum wage. Figure 4 shows how many jobs have been covered since 1999. We expect our recommended 2014 rate rise to increase the number of jobs covered by the NMW by over a third, to around one and a quarter million, partly because the new rate would be at a round number – £6.50 an hour – which is already paid to many workers. All of these measures indicate that the impact of the NMW on earnings is at or near its highest point to date.

Figure 4: Coverage of the Minimum Wage, UK, 1999-2013



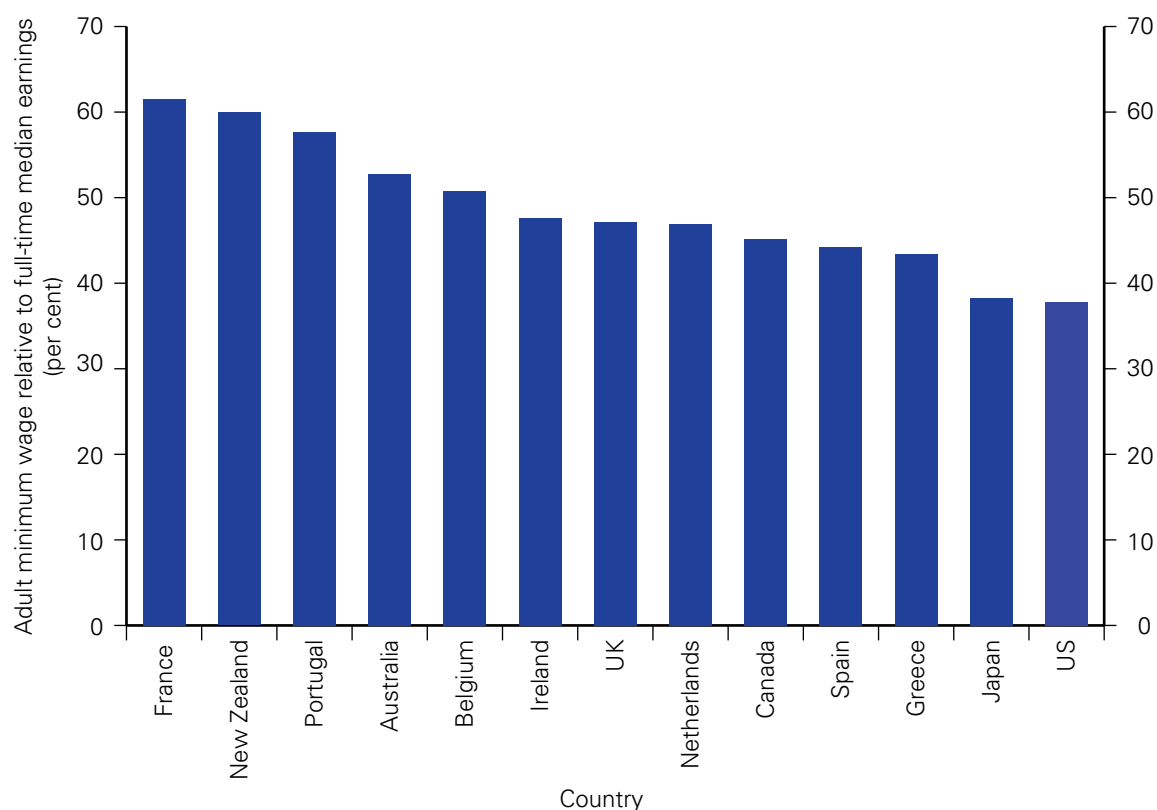
Source: ONS. Source: ONS central estimates using ASHE without supplementary information and LFS, UK, 1999-2004; LPC estimates based on ASHE: with supplementary information, April 2004-06; 2007 methodology, April 2006-11; 2010 methodology, April 2011-13, low-pay weights, including those not on adult rates of pay, UK.

Notes:

a. Direct comparisons before and after 2004; those before and after 2006; and those before and after 2011, should be made with care due to changes in the data series.

32 We also consider the relationship of the NMW to median earnings in an international context. Figure 5 shows that the UK bite sits broadly in the middle of the bites in the OECD comparator countries that we have tracked since 1999.

Figure 5: Adult Minimum Wages Relative to Full-time Median Earnings, by Country, 2012



Source: OECD estimates based on OECD minimum wage database and median earnings for full-time workers, 2012.
 Note: Average value of minimum wage in each year.

33 To summarise the changing value of the NMW, two trends – superficially though not actually divergent – have occurred during the economic slowdown of recent years: on the one hand the worth of the minimum wage to those receiving it has fallen, even as, on the other hand, the minimum wage has risen faster than other wages. The Commission is concerned by both of these trends. Neither of them is sustainable indefinitely, but one or both is inevitable for as long as inflation exceeds average earnings growth.

Employment Impacts of the National Minimum Wage

34 Since 1999 the Low Pay Commission has commissioned over 130 research projects that have covered various aspects of the impact of the National Minimum Wage on the economy. In that period the low paid have received higher than average wage increases but the research has, in general, found little adverse effect on aggregate employment; the relative employment shares of the low-paying sectors; individual employment or unemployment probabilities; or regional employment or unemployment differences. The research suggests that employers have coped with the minimum wage by adopting a combination of strategies. Pay structures may have been adjusted or non-wage costs reduced. There may have been small reductions in hours worked and increases in productivity. We monitor hours worked in order to understand how rises in the hourly NMW rate feed into weekly wages. To the extent that there may have been small reductions in hours worked these have not been enough to leave affected NMW workers no better off.

35 In addition some prices may have been increased and profits squeezed but these reductions in profits have not been sufficient to lead to an increase in business failure. Business creation may also have slowed. Our most recent research has not altered these findings although it has refined our understanding, for example of the propensity of some employers to set wage rates at round numbers. However, adverse employment effects have been found by research into the experiences of other countries (such as Neumark and Wascher, 2008), where minimum wages have represented a higher proportion of median earnings than here; or where they have not had separate rates for young people.

The Wage Share of Income

36 Part of the context for these changes is a longer-term fall in the share of national income which goes in wages. At around 54 per cent the wage share of GDP, shown in Figure 6, is lower now than it was in the 1960s and 1970s, when it averaged around 59 per cent. It rose sharply in the mid-1970s, reaching over 65 per cent, before falling back. It then fell sharply to just above 50 per cent before rebounding after 1997. It has fluctuated at around 54 per cent since 1999.

Figure 6: Wage Share of GDP, UK, 1955-2013



Source: LPC estimates of the wage share calculated using ONS data: Total compensation of employees (DTWM) as a proportion of GDP (YBHA), seasonally adjusted, quarterly, UK, 1955-2013.

37 The decline in the wage share is not restricted to the UK. It is a common feature across most economically advanced countries. The TUC (2013) showed that the wage share had generally fallen across many countries between 1970 and 2007. Using available data from the OECD, we estimate that the labour share across OECD countries fell from an average of over 70 per cent in the 1970s to around 67 per cent in the 1980s, 64 per cent in the 1990s and under 62

National Minimum Wage

per cent in the 2000s. It has slightly increased since the global downturn in 2008 to around 63 per cent.

- 38** Within that falling wage share, there have been significant differences across earnings groups. Between 1975 and 2000 those in the bottom decile saw their wages rise much more slowly than those at the median, who in turn had smaller increases than those in the top decile. The introduction of the NMW has helped stabilise the gap between the top and bottom deciles since that period. It should be noted that it is the top 1 per cent, or more specifically, the top 0.1 per cent, that have had the greatest increases in earnings and income over the last twenty years.

Labour Costs and Take-Home Pay

- 39** The Secretary of State has asked us to consider in our assessment government policies that affect the labour costs and take-home pay of people on the National Minimum Wage. Impacts on take-home pay are complex and we set out in Annex B our analysis of the effect that these have had since 2001 as context for the role they might play in future, which we consider later in this report. Our findings are below, before our examination of the impacts on labour costs for employers.

Take-Home Pay

- 40** Take-home pay represents an employee's net pay – what is left after deductions for income tax and National Insurance contributions (NICs). On average, NMW workers worked around 26 hours per week in April 2013. The hourly distribution of minimum wage workers is very different to that of more highly-paid workers. It has a bimodal structure with 23 per cent of minimum wage workers working 9-16 hours and about 19 per cent working 36-40 hours per week. In contrast, over 52 per cent of non-minimum wage workers work 36-40 hours a week with only 21 per cent working 25 hours or fewer. This influences the extent to which changes in income tax and NICs thresholds affect minimum wage workers.
- 41** Around a third of minimum wage workers work 16 hours or fewer. Those working these hours do not earn enough to pay income tax or make National Insurance contributions. Another 10-11 per cent of workers, working around 20 hours a week, were drawn into the income tax and NI system between 2004/05 and 2010/11. The raising of the personal tax and NI thresholds since 2010/11 means that those now working up to around 25 hours a week no longer pay income tax but those working 25 hours a week do make small contributions to NI. Thus, by the 2013/14 financial year, around 54 per cent of NMW workers no longer paid any income tax or National Insurance. Our analysis assumes that all NMW workers work 52 weeks a year, which means that it may overstate to a degree the impact of income tax on NMW workers.
- 42** Take-home pay (cash in the pocket) is likely to matter most to workers. Between 2001/02 and 2006/07 the increase in the hourly take-home pay of NMW workers rose faster than both measures of inflation (RPI and CPI) but was generally similar from 2006/07 to 2009/10, except for the anomaly produced when RPI inflation was briefly negative. Although recent increases in the NMW have been below inflation, the changes in income tax and National

Insurance since 2010 have resulted in the effective take-home pay of many NMW workers (those working more than 25 hours a week) increasing faster than inflation. However, 45 per cent of NMW workers have not benefited from income tax and NI changes because they work 20 hours or fewer a week. Another 11 per cent do not work enough hours to have benefited from the most recent increases in personal tax allowances in 2013/14. Therefore around 56 per cent of NMW workers received a cut in real take-home pay in 2013/14, but for around 44 per cent it maintained or increased its value.

- 43** However, real take-home pay is not the same as real disposable income, which may be affected by tax credits and other in-work benefits as well as the impact of changes in other forms of taxation and regulated prices. Benefits are generally assessed at the household level, whereas our analysis above has been limited to individuals. An assessment of the impact of changes including those to in-work Tax Credits, eligibility for Council Tax and Housing Benefit, and indirect taxes such as VAT would be necessary to draw conclusions about changes in the real disposable income of the lowest paid. The complexity of the tax and benefits system and the availability of appropriate data sources make it very difficult to assess the impact of these changes on NMW households. Research from the Joyce (2012), Joyce and Phillips (2013) and Brewer and De Agostini (2013) tends to suggest that for those at the bottom of the income distribution such changes have negatively affected real disposable income. This is also indicated by analysis that supplemented the Autumn Statement. HM Treasury (2013b) showed that the cumulative impact of the tax and benefit changes would have a net negative effect on the bottom four deciles of household income. Brewer and De Agostini (2013) concluded that, after the changes to Universal Credit and personal tax allowances had been included, a ten per cent rise in the minimum wage would lead on average to a 3 per cent increase in net income.
- 44** We aim to understand the effect of government measures on take-home pay to improve our overall understanding of the position of the low paid. These measures may also affect incentives to find work, and hence labour supply. However, we do not take account of the effect of employees' tax and National Insurance on take-home pay in recommending minimum wage rates, because they do not alter what employers can afford to pay or the level of the minimum wage the economy can bear without employment impacts.

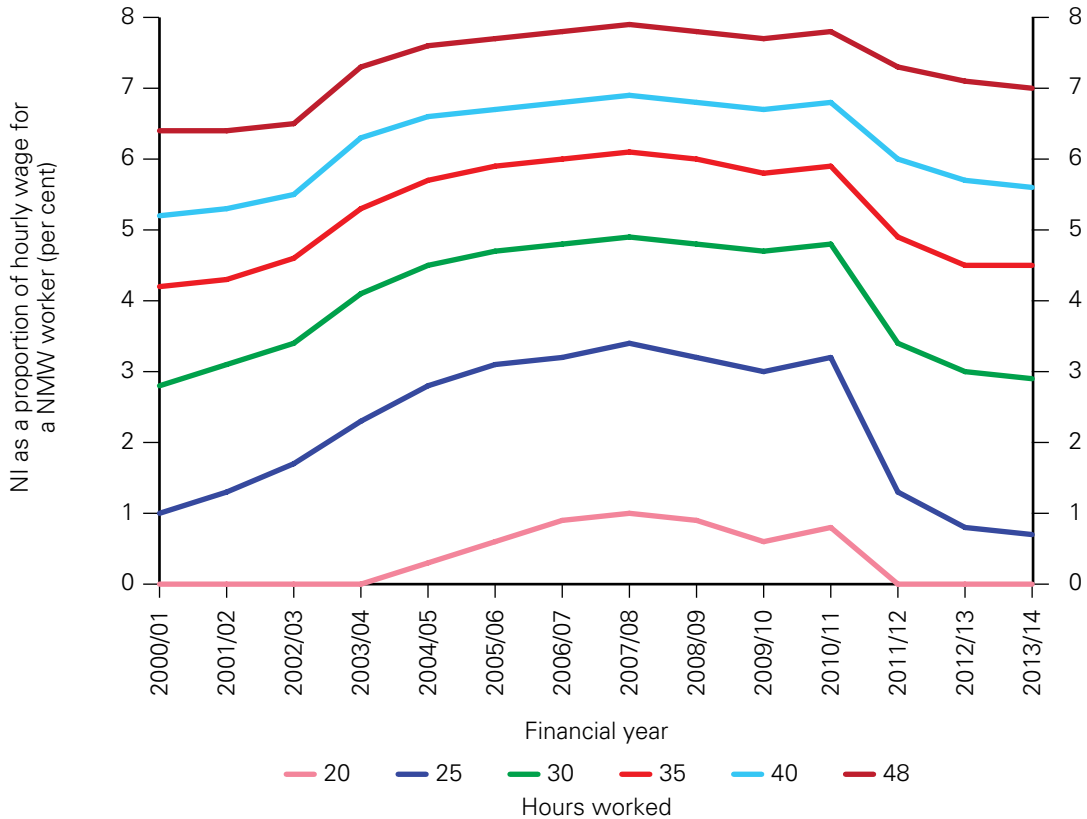
Labour Costs

- 45** We are, however, concerned about labour costs. National Insurance is levied on workers and employers. The thresholds have a similar structure but the rates differ. They are higher for employers. Figure 7 shows that the direct costs to employers of employing a NMW worker rose during the mid-2000s but have fallen back since 2010/11. It also shows that, in terms of National Insurance, it is more costly per hour to an employer to employ a full-time NMW worker than a part-time one. Recent changes to the NI thresholds have taken those working 20 hours or fewer out of the system and reduced the cost of employing those working between 25 and 35 hours a week back to similar rates as in 2000/01. The recent reductions in NI for full-time NMW workers have not been sufficient to reduce the costs back to those experienced in 2000/01. They may however have had some positive impact on the employment of lower-paid workers. It should be noted that this analysis does not take

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account of indirect costs such as annual leave entitlement and pension contributions. However, these indirect costs are not trivial and appear to have increased over time.

Figure 7: Labour Costs for Minimum Wage Workers by Hours Worked, UK, 2000-14

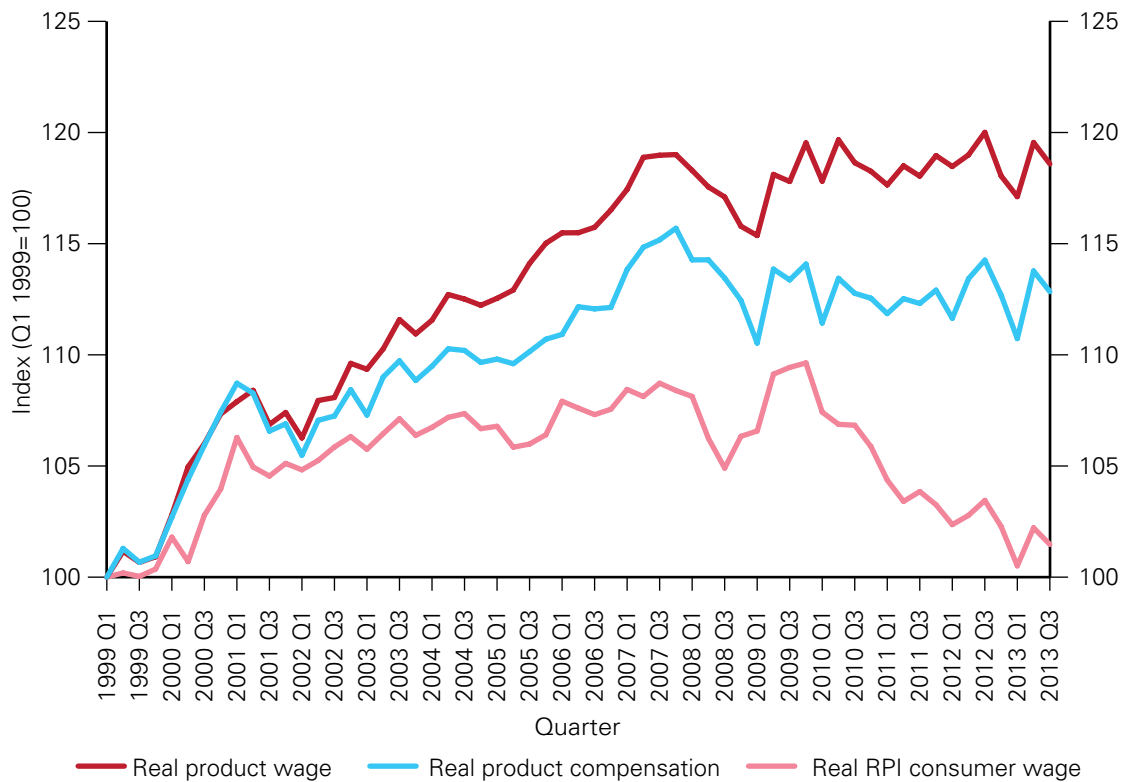


Source: LPC calculations based on Employer NI thresholds and rates, in nominal terms, UK, 2000-14.

- 46** Government measures that affect employer costs are of interest to the Commission in that they affect affordability. They are, however, exceedingly difficult to assess in aggregate, and in terms of how they bear on or support businesses in different sectors or by size of firm.
- 47** The employer is concerned about real as well as nominal costs. For an employee, the real wage should be considered in terms of consumer inflation, measured using the CPI or RPI. This will determine what the wage earner can buy with their wage. We call this the real consumer wage. However, consumer prices are not necessarily the appropriate prices to consider for an employer. Not all firms sell direct to consumers. Employers are concerned about the price of their outputs, and they are concerned about how these costs are changing relative to the costs of the output produced by the labour employed. Changes in the price of output can be measured using the GDP or gross value added (GVA) deflators, and used to express the wage in real terms for the employer, the real product wage. It makes little difference to this analysis which deflator we use. For the section that follows we use the GDP deflator.

48 As well as the wage, employers will also consider the non-wage costs of labour. This can be measured using compensation of employees (that includes other labour costs such as NICs and pensions). Figure 8 shows how consumer and product wages have changed over the last 14 years. Since the introduction of the NMW in 1999, the real product wage has generally increased faster than the real consumer wage. Both the product and consumer wage increased up to the end of 2007, but since the onset of recession, the real product wage has remained around 13 per cent higher than it was in 1999. In contrast the real consumer wage increased by around 10 per cent between 1999 and 2009 but has since fallen back and is now only 1.5 per cent above its level in 1999. Over the same period, real product compensation (taking account of employers’ social contributions as well as wages) has risen by nearly 20 per cent. This shows that although the real consumer wage has fallen since 2009, the real product wage has been relatively constant and real product compensation has risen slightly, which would tend to reduce the scope to increase wages.

Figure 8: Real Consumer and Product Wages, UK, 1999-2013



Source: LPC estimates based on ONS data: Real RPI consumer wage is Wages and Salaries (ROYJ) per employee job (BCAJ) deflated by RPI (CHAW), the real product wage is Wages and Salaries (ROYJ) per employee job (BCAJ) deflated by the GDP deflator (YBGB), and the real product compensation is total compensation of employees derived from wages and salaries (ROYJ) and employers’ social contributions (ROYK) per employee job (BCAJ) deflated by the GDP deflator (YBGB), UK, 1999-2013.

Note: The product wage and product compensation are deflated by the GDP deflator.

Part 2: Conditions Needed for Faster Increases in the National Minimum Wage

49 Part 2 covers:

- stakeholders' views on the conditions needed for faster NMW increases (paragraphs 53-62);
- the general conditions in the economy conducive to faster NMW increases, including:
 - inflation and the role of the Monetary Policy Committee of the Bank of England in determining the real value of the NMW (paragraph 66);
 - the importance of productivity (paragraphs 67-72);
 - the role of increased demand in the economy (paragraph 73); and
- previous experiences of faster increases in the National Minimum Wage (paragraphs 74-76).

50 The next section, from paragraph 79, discusses the sectoral conditions for faster increases in the NMW, which focuses on the low-paying sectors and includes the significance of:

- labour costs (paragraphs 80-83);
- short-term market adjustments (paragraphs 84-85);
- market characteristics (paragraphs 86-89);
- impact on differentials (paragraph 90);
- non-labour costs (paragraphs 91-92); and
- statutory requirements (paragraphs 93-94).

51 Part 2 ends with comments on implications of a higher bite for the low-paying sectors (paragraphs 95-99).

52 First we set out below the views we have received from stakeholders. When we received the Secretary of State's request that we carry out this additional assessment we extended the deadline for responses to our consultation on the 2014 minimum wage to allow stakeholders to let us have their views on the request. We are grateful to all who commented.

Stakeholder Views

53 A number of business representatives commented on the additional assessment and several common themes emerged. Businesses were clear that there would have to be a real and sustained recovery of both productivity and employment across the economy, including within the sectors most affected by the minimum wage. Some argued that there were other policies which should be brought into play to help increase living standards, not just increases in the minimum wage.

- 54** The CBI said there were three essential economic outcomes which had to be prioritised ahead of increases in the NMW. Addressing these would lead to a wider recovery in wage growth and it would expect the NMW to keep in step with this. The three outcomes were: a broad-based economic recovery; evidence of material productivity improvements; and a significant reduction in the unemployment rate. UK Fashion and Textiles also said unemployment should be falling dramatically (to well below 7 per cent) and it also wanted to see strong evidence that average earnings were rising faster than basic rate earnings.
- 55** British Chambers of Commerce said stronger growth and faster falls in unemployment were needed – and not just falls in unemployment driven primarily by increases in inactivity. The Textiles Services Association said there would have to be consistently higher levels of economic growth and consistently lower levels of RPI inflation. EEF, the manufacturers’ organisation, said the NMW should be increased in line with basic rates of pay across the economy. It said there may be occasions when businesses could afford a stronger increase, but for this to happen, there would need to be broad-based sustainable growth in both employment and productivity.
- 56** EEF also said there should be a broad-based approach to improving living standards and that government policy should take steps to create a more productive and more flexible workforce. The CBI said that skills needed to be addressed. It said the low skilled were more likely to be unemployed and earn less and it wanted to see the education system achieve academic rigour and once in work, individuals maintain and develop skills that supported progression.
- 57** Representatives from the hospitality sector said there had to be a clear and stable trend in the economy over at least a year; there had to be confidence about economic circumstances two years ahead; and job creation in the low-paying sectors attributable to increased business activity. The Association of Convenience Stores said wages were determined by the profitability of businesses and general performance and retention of staff. Attempting to set them by any external monetary indicator did not meaningfully reflect the performance of a business and the wage rates they could afford. Those representing businesses in sectors which rely on public funding (e.g. social care and childcare) said increases in the fees paid to service providers would be necessary to enable wages to be increased.
- 58** There was a degree of overlap between employer and union representatives in the key economic indicators each thought we should take into account when judging the scale and pace of recommended future NMW upratings. However, unions generally interpreted these data as indicating there was more room than employer groups saw for higher increases in the NMW. In addition, unions thought our assessment should be more responsive to recent

The owner believed the recent recession was worse than in the 1990s... he wanted to give more to staff but the business couldn't afford to in difficult times.

Meeting with hospitality business, Commission visit, 2013

They reiterated the fragility of the recovery and that they could not accommodate sharp increases in the NMW.

Meeting with hospitality businesses, Commission visit, 2013

changes in household needs, which had been increased by falling real wages. They also thought the exchequer saving from a higher minimum wage, resulting from a reduced subsidy to low-paying employers, should be considered.

59 The Union of Shop, Distributive and Allied Workers (Usdaw), in line with evidence we received from other union bodies, thought the case for significant improvements in the NMW was currently supported by improvements in key economic indicators, referring to forecasts of employment growth, the level of unemployment and GDP growth. It suggested that we focus on these and then we may well agree that the NMW could rise by more than current conditions allow. Usdaw suggested that as the economy picked up our cautious approach could be lifted.

60 The Trades Union Congress (TUC) also thought the strength of the existing recovery already provided significant scope for the NMW to increase more quickly than in recent years, and that the additional assessment task aimed to allow us to consider the conditions which would allow a faster increase than would currently be feasible within the current terms of our remit, i.e. than would be possible even as a strong recovery unfolds. The TUC looked at ways which could enable higher NMW rises, and would like to see the Government take a more proactive role in supporting low-paid industry to secure productivity

gains by, for example, helping to raise skill levels. In sectors where increases in productivity were neither attainable nor desirable (care provision for example), the Government could help in other ways, by identifying new sources of public funding or taking new approaches to public sector contracting. The TUC did not accept that take-home pay should be taken into account when considering the scope for faster increases in the NMW, because it did not capture the impact of other factors like rises in indirect taxes or benefit reductions, and so was not an appropriate measure of household incomes. However, it thought some sectors could already pay a higher NMW and that there may be a case for charging the Low Pay Commission with overseeing a process for setting additional NMW premia (to apply to particular sectors), or for us consulting on the pros and cons of introducing an appropriate London weighting to the NMW.

61 A number of unions thought we should take into account the effect of relatively small upratings, in the context of rising prices, leading to falls in real income. GMB's call for fair wages in order to close the gap between pay and the cost of living was typical of the approach of many unions. UNISON told us that the current level of the NMW was failing workers across the UK and a significantly higher NMW, raised in stages towards the living wage, was the right thing to do in moral terms, and to boost the economy. It was affordable and would produce savings to the Treasury. Unite supported such a move towards the living wage level, better reflecting real living costs.

"They explained that for people receiving the NMW it was important that their pay should not lose real value as they have less scope to accommodate that."

Meeting with trade union members, Commission visit, 2013

- 62** The Communication Workers Union also called for the NMW to be transformed into a living wage. In examining which longer-term conditions would allow for further increases in the NMW, it believed we should look not only to sector profitability and medium and longer-term economic forecasts, but also to projections for in-work poverty rates, the real value of the NMW in relation to inflation and qualitative evidence of the experiences of families living on low wages.

He thought the Commission should be bold. The NMW had started at a low level and now was the time to 'experiment upwards'. Companies in his sector were making large profits but paying staff low wages 'because they can'.

**Meeting with union officer,
Commission visit, 2013**

General Economic Conditions for Faster Minimum Wage Increases

- 63** We distinguish between increases in the real value of the NMW which take place when the NMW and wages generally are rising faster than inflation, but broadly in line (and when the bite remains more or less constant); and increases in the real value of the NMW greater than increases in average wages, so that the bite rises. In this section of the report we focus on increases that would not raise the bite, and examine the general economic conditions conducive to such increases.
- 64** We start by noting the significance of inflation, and then outlining the conceptual framework within which we consider the scope for real increases in the minimum wage. Productivity, i.e. how much workers produce, is central to this assessment and we set out our approach to that below. Of course we also take into account factors affecting the supply and demand for labour since movements in either of these may tend to put upward or downward pressure on wages.
- 65** We consider demand factors later in the section. Those affecting the supply of labour include: population growth influencing the working age population (which also increases demand for goods and services); changes in inward and outward migration; and alterations to the ages at which workers enter or leave the labour market, for example through changes in the ages at which younger workers leave education, or at which older ones retire. We take account of all of these, through consideration of the employment rate, in arriving at our recommendation for the rate of the NMW.

Inflation and the Monetary Policy Committee

- 66** The real value of the minimum wage is a function of inflation as well as of the level of the NMW. Therefore an objective of supporting real increases in the NMW engages both minimum wage policy and policy towards the management of inflation. The Bank of England's Monetary Policy Committee (MPC) has responsibility for managing inflation. The MPC has published forward guidance outlining the circumstances in which it may raise the Bank Rate. The forward guidance has only an indirect relationship to our recommendations for future NMW rates, as a factor bearing on expectations for inflation. We discuss the scope for forward guidance in relation to the minimum wage at paragraphs 127-134 below.

Productivity

- 67** We share the widely held view, expressed by many stakeholders from both employer and worker standpoints, that a sustained increase in workers' compensation depends on increased productivity – for increases in compensation to be sustainable they must be affordable, which generally requires an increase in overall output (and revenue) per head at a given level of employment.

Wages and Productivity

"...The MPC's November Inflation Report reiterates the link between wages and productivity, and the Governor of the Bank of England has stated that "ultimately the growth in real wages is going to be determined by recovery in productivity in this economy" ... The OBR in their Economic and Fiscal Outlook December 2013 also state that "productivity growth is the only sustainable source of real income growth in the long term"..."

The Chancellor's Autumn Statement, 5 December 2013, paragraph 1.27

- 68** The theory of labour demand underpinning this view states that the number of workers in a firm will be determined by the point where the value of additional output produced by workers (the value of their marginal productivity) equals their wage. In competitive labour and product markets, when wages equal the value of marginal productivity firms would not want to adjust employment and the labour market will be in equilibrium (labour supply equals labour demand). If wages are lower than the value of marginal productivity, firms can make profits from hiring additional workers and so would take on more workers until the point where there is no gap between wages and the additional value of output. Conversely, when wages are above the value of marginal productivity, they will shed labour until they return to the point where wages equal the value of what the marginal worker can produce.
- 69** Of course, this theoretical relationship between productivity and workers' compensation carries several caveats. It assumes perfectly competitive labour and product markets, which in practice are imperfect. Indeed the NMW itself represents a recognition of this, as we noted at paragraph 8 above, and while productivity determines what an employer can pay, market power may enable him or her to retain an excess share. Moreover, while it may be generally true that productivity increases are necessary for sustainable rises in compensation, exceptions are not hard to find and behaviours may follow different patterns in the short term. It is however the case that, at the level of the economy and viewed over the long term, a sustainable increase in real compensation in the economy depends on productivity gains – as the Bank of England and Office of Budget Responsibility observe, in the box above.

The company had a number of concerns if the NMW was increased in 2014 ... it would reduce further the level of spare cash for investment.

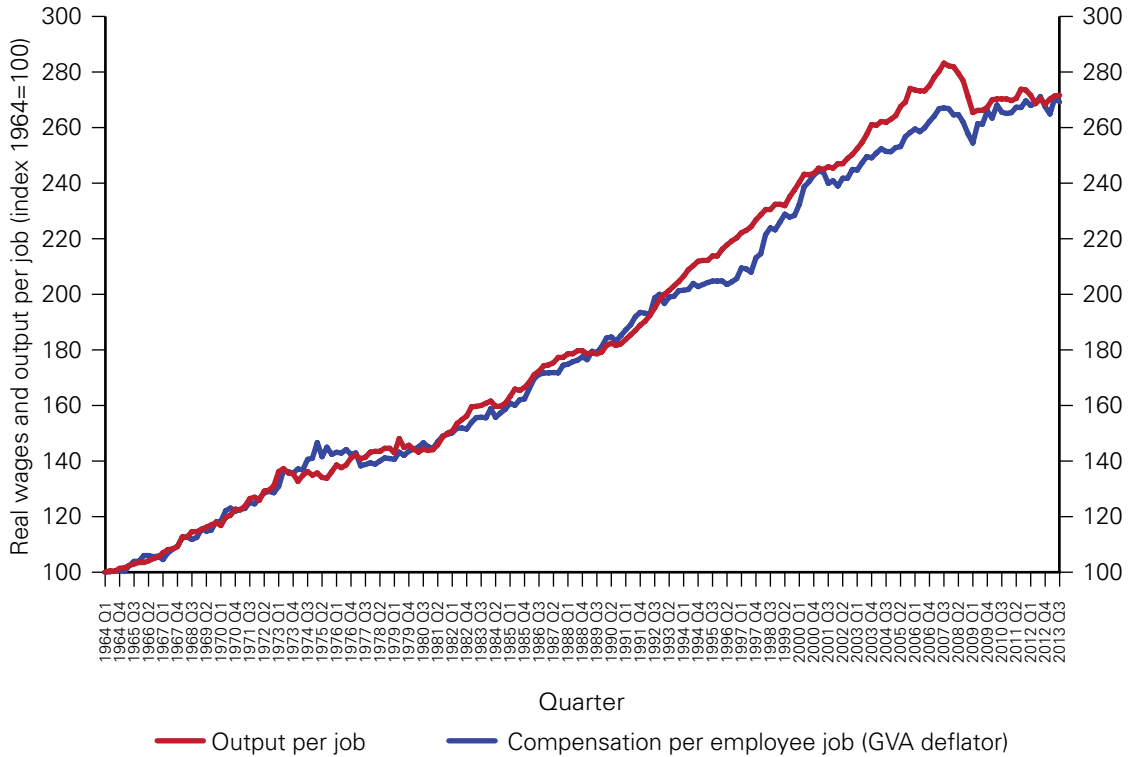
Meeting with manufacturing business, Commission visit, 2013

- 70** Over the long run it is therefore important to monitor changes to wages in seeking to understand changes in productivity in the economy. Moreover a key consideration in recommending the level of the minimum wage is the relationship between the NMW and wages elsewhere in the economy. By giving close attention to the path of average wages we gain insight into labour productivity across the economy, while also placing the minimum wage in the context of wages more broadly.
- 71** However, while increased productivity (properly measured or recognised) is a necessary condition for sustained increases in the real value of the minimum wage, it is not a sufficient condition. As indicated above, our aim is to help as many workers as possible without an adverse impact on employment prospects. It is possible for firms to increase productivity per worker by shedding less productive workers – the ‘batting-average effect’ whereby output is lower and fewer people have jobs, albeit that those in jobs have higher productivity. Gains in productivity per worker of this sort would not prompt us to recommend corresponding increases in the minimum wage because we would not thereby meet our aim of helping as many workers as possible, or of avoiding adverse employment effects.
- 72** In other words it is increases in productivity in the context of stable or rising employment that matter. Data on and forecasts of employment are central to our judgement of the optimal NMW rate. We examine not only headline data, but those relating to the employment performance of the low-paying sectors to understand the labour market affecting the lowest paid, and we pay close attention to forecasts for changes in employment.

Productivity and Wages: Recent History

We have suggested that over the longer term and at the level of the economy wages are determined by productivity. While productivity increases are a prerequisite for sustained real wage growth, some economists have argued that wages have failed to match rises in productivity in recent years. Our assessment is that much of the difference disappears when total employee compensation, i.e. all elements of remuneration including non-wage items such as pension contributions, are included, as Figure 9 shows. However, workers have not seen their real wages increase proportionately with productivity, for several reasons. One is that an increase in the non-wage component of compensation, principally increased employer pension contributions, is not received in the current pay packet. A second is that consumer price inflation, which determines the real spending value of wages, has exceeded product price inflation, which is used to determine the real cost of wages to employers. Third, increased inequality means that although average (i.e. mean) compensation in the economy has tracked productivity, over the life of the NMW a bigger share of the overall growth in compensation has gone to the highest earners. The implication is that average compensation for the economy as a whole has risen more than the compensation of lower-paid workers.

Figure 9: Employee Compensation and Productivity Growth, UK, 1964-2013



Source: LPC estimates based on ONS data: Output per job (LNNN); and compensation per employee job (DTWM divided by BCAJ) and deflated by the GVA deflator (CGBV), quarterly, seasonally adjusted, UK, 1964-2013.

Increased Economic Demand

73 We of course pay close attention to the prospects for overall growth in the economy, which depend critically on the stage of the business cycle, and also on world economic conditions. A general increase in the level of demand in the economy will likely necessitate an increase in domestic output to meet that demand. In turn, firms will utilise more inputs to generate that output. One of those inputs will be labour. An increase in the demand for labour will put upward pressure on wages. Similarly, increased demand in certain sectors can lead to increased demand for labour and thus increases in wages in these sectors.

Previous Experience of Faster Increases in the National Minimum Wage

74 In the preceding paragraphs we have summarised the conceptual framework which we have in mind when assessing the scope for real increases in the minimum wage. Here we briefly set the above-inflation increases in the NMW between 1999 and 2007 in the context of these considerations.

75 Many of the factors we have highlighted above as conducive to real increases in the NMW were in place between 1999 and 2007, a period when the NMW not only rose in real terms, it also grew faster than median wages so that it was a period when the bite increased:

- average labour productivity rose: output per filled job increased 2.2 per cent a year between 1999 and 2008 (see Figure 9 above), while output per hour increased at 2.5 per cent a year;

- real wages rose, as pay settlements and average earnings growth in general exceeded inflation over the period. Between 1999 and 2006, the median of pay settlements was around 3 per cent, picking up to 3.5 per cent between 2006 and mid-2008. Positive pay drift saw average earnings growing at around 4-4.5 per cent between 2000 and mid-2008. Price inflation rose on average by 1.4 per cent (CPI) and 2.5 per cent (RPI) between 1999 and the end of 2006. Although inflation picked up in 2007 it remained below the increases in average earnings. Thus 1999 to 2007 was characterised by a period of real wage growth, an average of 2.8 per cent a year (in CPI terms) and 1.7 per cent (in RPI terms). Moreover pay growth was similar across different sectors, sizes of firms and age groups;
- employment rose – employment increased by over 2.5 million (around 9.4 per cent) between April 1999 and May 2008. Over the same period the working age employment rate increased from 71.8 to 73.0 per cent – growth in employment outstripped the growth that took place in labour supply; and
- GDP grew relatively strongly. Growth averaged 3.1 per cent a year between the second quarter of 1999 and the first quarter of 2008.

76 In this section we have commented on the general economic conditions conducive to increases in the real value of the NMW which take place when wages generally are rising faster than inflation, emphasising the centrality of productivity gains to sustainable real wage increases. The presence of many of these conditions enabled the Commission to follow a policy of recommending increases above inflation in the period up to 2007, which meant that the lowest paid shared in the gains of economic growth at the time.

Sectoral Conditions for Faster Minimum Wage Increases

77 We distinguished above between the minimum wage increasing alongside other wages, and increases in the real value of the NMW which exceed any increases in average wages, so that the bite rises.

78 Sector-specific factors are an important dimension in considering the conditions which need to be in place for the minimum wage to increase faster in both senses. Some of the constraints on increasing wages reflect the characteristics of particular sectors, their markets, and their low-paying occupations. These constraints vary in significance from one sector to another, and also in the extent to which they might be eased by government policy measures. Taken together they are critical to the capacity and potential of the low-paying sectors – on which the majority of low-paid workers depend for employment – to accommodate faster rises in the NMW without adverse employment effects.

79 In this part of the report we examine the nature of these constraints, focusing on those affecting low-paying industry sectors which employ 4 per cent or more of minimum wage workers (childcare, cleaning, hospitality, retail, social care) or where minimum wage workers account for a third of the employees in a sector (hairdressing). We recognise that other low-paying sectors may also be affected by

Paying above the NMW was important to the business to help retain staff.

Meeting with day nursery, Commission visit, 2012

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specific constraints. Furthermore, it should be noted that around a quarter of minimum wage workers do not work in the low-paying sectors but are distributed across the whole economy. In addition, there are parts of the public sector, in particular local government, where several years of pay restraint has meant the minimum wage has now started to meet the bottom points on pay scales. Without employer action, the NMW would have recently caught up with the lowest hourly rates paid by some local authorities.

Significance of Labour Costs

80 Other things being equal, sectors where labour costs account for a larger share of business turnover will tend to be proportionately more affected by increases in those costs than other sectors. The data shown in Table 2 below are indicative rather than definitive because the composition of costs varies from firm to firm within a sector according to factors such as the extent of automation, and because there are no authoritative official data on the share of turnover spent on labour costs. Nonetheless they do illuminate the importance of labour costs, and by extension the minimum wage, in these low-paying sectors. Other data for these costs are available from other sources, in particular from trade associations, and these may differ from the ONS Annual Business Survey figures given in the table, and are often higher.

Table 2: Labour Costs in Low-paying Sectors, UK, 2013

	Labour costs as share of turnover (ABS) (%)	Proportion of total minimum wage jobs (%)	Minimum wage jobs in sector (000s)	Proportion of jobs in sector paid at minimum wage (%)
Hospitality	29	25	331	25
Retail	11	21	278	10
Cleaning	48	7	88	31
Social Care	61	7	87	9
Childcare	62	2	24	15
Hairdressing	37	2	26	30

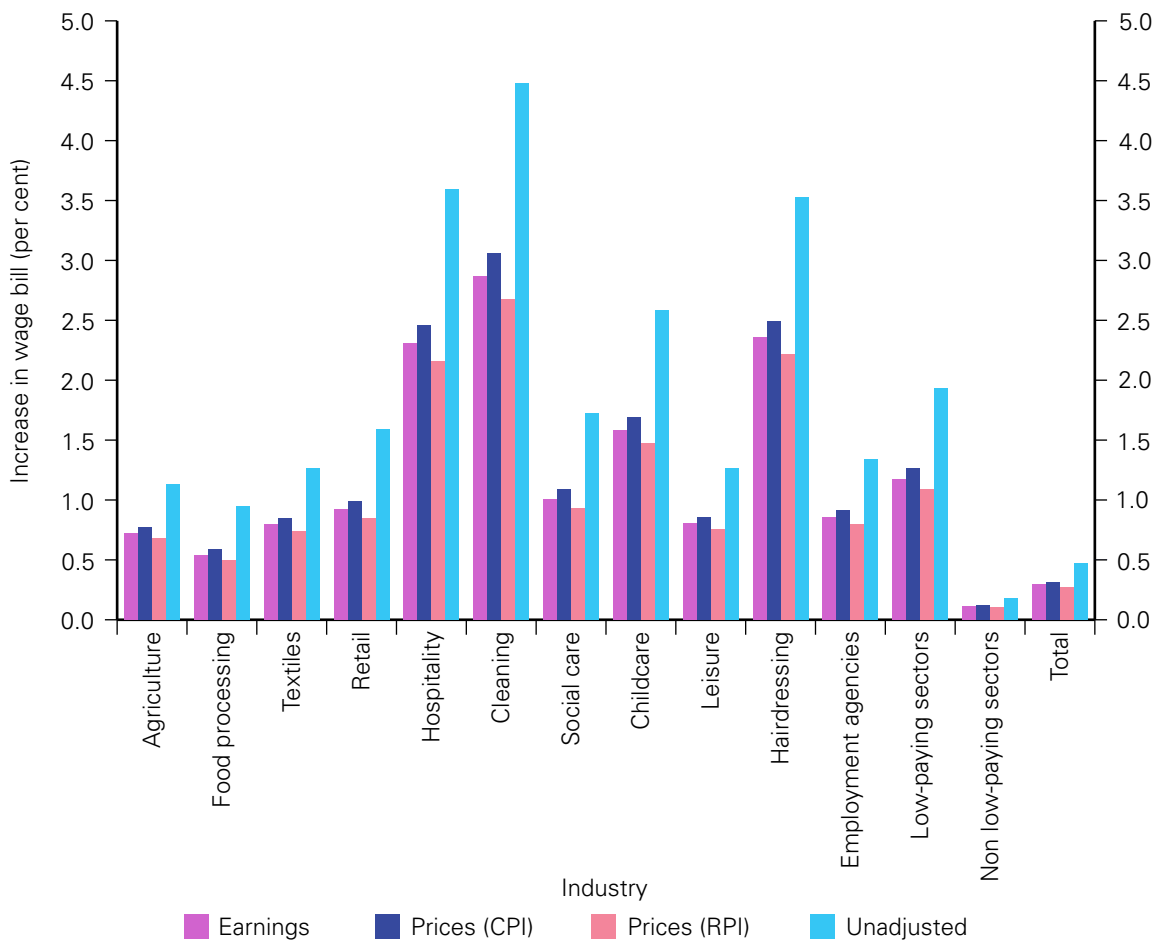
Source: LPC estimates are based on the ONS Annual Business Survey (ABS), 2012, UK; and ASHE 2010 methodology, low-pay weights, including those not on adult rates of pay, UK, April 2013

81 In all the sectors discussed here minimum wage jobs account for at least 10 per cent of jobs (with the exception of social care at 9 per cent, which may be subject to reporting error² – estimates derived from other data sets put the figure considerably higher and our own internal Low Pay Commission estimate is that it could be up to 12 per cent). This means that, in general, minimum wage jobs are likely to be too large a part of the cost base for wage rises to be affordable without material increases in a firm's revenue, particularly as such increases are likely to create pressures to increase the pay of other workers in order to protect differentials (see paragraph 90 below).

² Domiciliary care workers are typically paid an hourly rate for client contact time, which employers may report in the Annual Business Survey as the hourly rate they pay to employ their carers. However the unpaid time these carers spend travelling between clients needs to be factored in to determine their actual hourly pay, and this will be closer to the NMW (or below it) for many of these workers.

82 We can estimate the impact of restoring the real value of the NMW on changes in the wage bill for each sector. In order to do this, we need to make an assumption about the counterfactual – how wages might change in the absence of any increase in the NMW. To provide a range of estimates we use the median of HM Treasury Panel of Independent Forecasts for CPI, RPI and average earnings growth. We set this alongside an assumption that wages have not changed since April 2013. As shown in Figure 10, irrespective of our counterfactual wage assumption, the estimated impact of the restoration of the real NMW is, not surprisingly, greater for the low-paying sectors (over 1 per cent of the wage bill) than the rest of the economy (around 0.1 per cent). The increase in wage bills would be particularly large in cleaning, hospitality, hairdressing and childcare. Further, these estimates do not include any impact on differentials and thus may underestimate the full impact.

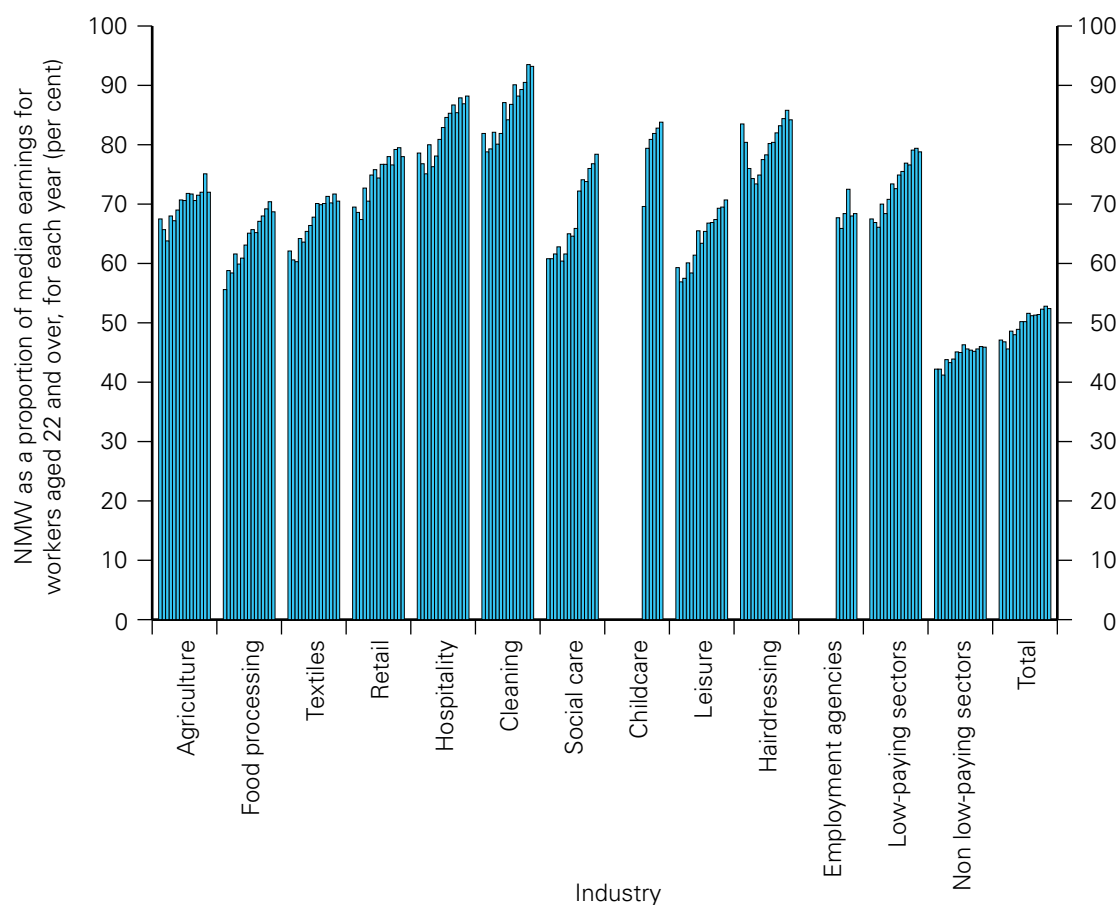
Figure 10: Estimated Impact on Wage Bills of Restoring Real Value of the National Minimum Wage, UK, 2013



Source: LPC estimates based on ONS ASHE 2010 methodology data, UK, April 2013 and HM Treasury Panel of Independent Forecasts for CPI, RPI and average earnings growth (January, 2014).

83 The size of the sectoral bite – the NMW as a proportion of the median wage for each sector – is one way to understand the impact of the minimum wage in these sectors. This is shown in Figure 11. The bite in low-paying sectors has increased steadily in recent years, with a small fall in 2013 for some.

Figure 11: Bite of the Adult Minimum Wage for Workers Aged 22 and Over, by Low-paying Industry, UK, 1999-2013



Source: LPC estimates based on ASHE: adjusted earnings without supplementary information, April 1997-2004; with supplementary information, April 2004-06; 2007 methodology, April 2006-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK.

Notes:

- a. Definitions for the low-paying industries are based on Standard Industrial Classification (SIC) codes. Data from 1999-2007 are based on SIC 2003 codes. Data from 2008-12 are based on SIC 2007 codes.
- b. Data on childcare and employment agencies industries were not available before 2008.
- c. ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

Short-term Market Adjustments

- 84** Hospitality, retail and hairdressing are heavily reliant on consumer spending, and sensitive to shocks affecting consumers. They experience an immediate impact when consumers curtail discretionary spending as a result of factors that reduce, or consumers fear will reduce, their income. For example, ONS data for the wholesale and retail sectors indicate that between the second and fourth quarters of 2008, Gross Value Added for the sectors fell almost 8 per cent. The next biggest change across two quarters in the period since 2008 was an increase of 3.9 per cent between the fourth quarter of 2012 and the second quarter of 2013.
- 85** The cleaning sector is vulnerable to shocks which also affect businesses, or are transmitted to businesses by reduced consumer spending. It is affected when businesses cut back on non-core activity. Since the onset of recession in 2008 we have heard repeated accounts from firms in the cleaning sector of reduced demand from clients, or the re-negotiating of contracts, responding to reductions in income. In childcare, the economic downturn has affected parents' use of childcare and ability to afford fees.

Market Characteristics

- 86** Hairdressing is characterised by low barriers to entry, so that competition is intense, inhibiting the scope to raise prices and create headroom for wage increases. In the four years from 2008 the number of hairdressing enterprises increased 8 per cent, while industry turnover increased by only 4 per cent. This means that over the industry as a whole income per business fell. Further, the employed workforce is only around 100,000 but the industry trains 28,000 apprentices a year, a much higher proportion of the workforce than any other comparable industry.
- 87** The markets for provision of social care (4 per cent of minimum wage jobs, accounting for 7-12 per cent of jobs in the sector) and childcare (4 per cent of minimum wage jobs, and 14 per cent of jobs in the sector) services are distinctive in that providers are heavily dependent on public sector purchasers, who exercise a degree of monopsony power. Social care providers have faced static or falling prices paid by local authority commissioners, and have been unable to pass on higher costs. Laing & Buisson (2013), found councils giving an average uplift of 1.8 per cent, compared with the 2.0 per cent it estimated was needed to keep pace with care home inflation. For 2012/13 it gave figures of 1.6 per cent and 2.5 per cent respectively. These averages concealed significant variations between local authorities (for further details see Chapter 4 of the Low Pay Commission 2014 Report).
- 88** The Association of Directors of Adult Social Services (ADASS) in England told us that around £2.8 billion of savings had been taken out of local authority social care spending over the past three years. In its Children's Nurseries UK Market Report, Laing & Buisson (2011) showed that the average local authority early years (3 and 4 year old) funding per hour was £3.68. Nearly two-thirds of nurseries said that this level of funding did not cover the cost of providing care (although we might note that most continue to provide this care).
- 89** As well as strength of competition and power of purchasers, the ability to raise prices (in order to afford wage rises), is affected by increased costs of other inputs such as rent, rates, fuel, energy, transport and raw materials. It will also be affected by the sensitivity of consumers to changes in prices.

The care business was struggling because care was no longer an attractive industry to finance. The collapse of Southern Cross had made it even more difficult to raise finance, banks were reluctant to lend, and as a result some care homes were struggling to survive or had gone to the wall.

Meeting with social care business, Commission visit, 2013

Impact on Differentials

- 90** The implications for the pay of those above the NMW – the cost of pay rises for them consequent on minimum wage increases, and/or the erosion of differentials between these workers and those on the minimum wage – are significant considerations in a number of low-paying sectors. Around a third of all jobs in the low-paying sectors are paid less than

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£7.00 an hour. In some sectors much more of the workforce is paid less than £7.00 an hour, including: childcare (41 per cent); hairdressing (42 per cent); hospitality (48 per cent); and cleaning (58 per cent). Evidence since the introduction of the minimum wage, from official and independent research, showed how during certain periods differentials in the low-paying sectors narrowed, particularly at times of relatively larger increases in the NMW (2002-06), and how higher NMW increases were also accommodated through changes to pay structures (merging of grades in retail), changes to pay premia, and restrictions on non-wage benefits (IDS 2011a, Cronin and Thewlis 2004, Denvir and Loukas 2006). Later research found evidence of a restoration of differentials when there were relatively smaller increases in the NMW between 2008 and 2010 (IDS 2011b, Dickens, Riley and Wilkinson 2012). Further detail about each low-paying sector is provided in Annex A.

Non-labour Costs

91 Non-labour costs can be a significant component of firms' overall costs, but there can be limited scope for controlling them, or mitigating increases. The widely publicised increases in utility costs (gas, electricity, water) over recent years will have affected industries for which premises are an important factor for their business, for example hospitality (pubs, restaurants), retail and hairdressing (shops), and manufacturing (factories). Many firms have had to fund making good deficits on their pension obligations – not strictly a non-labour cost, but nonetheless a cost reducing scope to fund wage rises. The Input Price Indices produced by the ONS measure the changes in the prices of materials and fuels bought by UK manufacturers. These showed fuel prices increased by 4.7 per cent and imported food prices by 7.8 per cent, in the year to October 2013.

Increased costs included not just the NMW, but also building costs, energy costs, taxes ... it was difficult for the company to pass additional costs onto customers.

Meeting with wholesale distribution company, Commission visit, 2013

92 Increases in business rates are linked to RPI and in 2012 they increased by 5.6 per cent (following a 4.6 per cent increase in 2011). In addition, significant increases in food inflation over the last few years have increased the input costs for hospitality businesses and general increases in inflation will have affected input costs for the retail and non-food processing industries. The British Furniture Manufacturers reported that between 2009 and 2012, direct labour and material costs as a proportion of turnover increased from 53 per cent to 61 per cent. The ability to control, or reduce, these costs (and therefore allocate funds to wage increases) may be limited.

The cost of raw materials had increased significantly over the past two years, impacting on profitability.

Meeting with knitwear manufacturers, Commission visit, 2012

Statutory Requirements

93 A number of the low-paying sectors are subject to requirements for particular levels and/or age of staff, minimum qualifications and service standards. In the security sector regulatory

requirements have contributed to raising wages (see case study in ‘Sector Productivity’ section below). However, statutory requirements can limit firms’ room for manoeuvre in coping with minimum wage rises. Care homes are required under statutory regulations to meet minimum staffing requirements so that at all times there are sufficient numbers of suitably qualified, skilled and experienced workers. In the childcare sector, nurseries need to conform to statutory staff:child ratios (and staff have to be of at least a certain age to count towards the ratio). Providers in both sectors are currently being asked to raise qualification levels and service standards in their workforce. These place limits on the scope to change staffing level or mix, or alter service standards, in order to find savings to fund higher minimum wages.

- 94** In hospitality and retail, requirements include alcohol-licensing regulations (including minimum staff age), health and safety rules (e.g. food hygiene) in restaurants, and costs of licences for provision of, and limits on operating, facilities for gambling.

Implications of a Higher Bite for Low-paying Sectors

- 95** In this section, together with Annex A, we have drawn attention to the significance of the NMW as a component of the cost base in the low-paying sectors, to the bites in these sectors, and we have discussed the constraints and pressures on wages in them. As we noted at paragraph 30 above, in areas such as cleaning and hairdressing the minimum wage is increasingly often the going rate for the job.

- 96** We have outlined the pressures affecting each sector. The key considerations are:

- labour costs as a share of turnover, which varies by sector but is significant in all of the sectors and means that (partly through impact via differentials on staff paid above the NMW) the minimum wage is a material cost;
- sensitivity to short-term market adjustments, particularly through shocks affecting consumers (notably in retail, hospitality and hairdressing, and also in cleaning and childcare);
- market characteristics such as low barriers to entry (which has given rise to intensified competition in hairdressing) or dependence on public sector contracts (which have left many social care and childcare providers struggling to afford to pay the NMW);
- the cost implications of particular statutory requirements in care, in hospitality and in retailing; and
- intensifying pressures from other costs, such as utilities (affecting all sectors, but especially retailing, hospitality and hairdressing) and making good pension deficits.

- 97** The bite is at or near its highest ever level in these sectors. Against that background our view is that in these conditions an increase in the NMW such as to cause a large rise in the bite would run a high risk of adverse employment effects.

- 98** That risk would be more acute if an increase were to take place very quickly: the evidence from past increases in the NMW is that time to adjust business practice in order to manage additional wage costs has been important in enabling employers to cope. We continue to

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receive advice from employers that a very big rise that takes place in one go would be the hardest for them to absorb.

- 99** We say this on the basis of the existing relative productivity of the low-paying sectors and other parts of the economy. Earlier in the report we emphasised the centrality of productivity to sustainable real increases in the minimum wage. It follows that, were the productivity of the low-paying sectors to increase relative to others, then that would help to create the conditions in which a significant increase in the bite could take place without material adverse employment effects. We discuss the considerations affecting this productivity gain in the next part of the report, which addresses the scope to influence conditions needed for faster increases in the minimum wage.

Part 3: Scope to Affect the Conditions Needed for Faster Increases in the National Minimum Wage

100 Part 3 examines:

- the scope to influence general economic conditions which would enable a faster NMW increase (paragraphs 102-105);
- conditions directly affected by government policies, including tax and National Insurance contributions (paragraphs 106-108);
- productivity in the low-paying sectors (paragraphs 109-113);
- small firms and the NMW (paragraphs 114-118);
- other considerations, including the living wage (paragraphs 119-121);
- young people (paragraphs 121-125); and
- apprentices (paragraph 126).

101 Part 3 ends by commenting on options for clarifying the forward path of the NMW, including the idea of forward guidance from the Commission on the minimum wage (paragraphs 127-134).

Scope to Influence General Economic Conditions

102 We have commented above on the general economic conditions which would enable a faster increase in the NMW. The Government has a significant influence on these framework conditions, although some of the timescales for impact are longer term, and where it may influence them many other considerations besides the minimum wage typically come into play, meaning that weighing the benefits of different policy objectives is necessary.

103 We have highlighted higher productivity as a central issue. The strategic challenge for employers, employees and government in achieving a sustainable longer term increase in real wages is to support the creation of a high productivity economy. For government, key policy fields include skills development, infrastructure, and supporting access to finance for capital investment. We consider below the scope to support productivity improvements in the low-paying sectors in particular.

104 We have also emphasised the importance of economic growth. Important public policy levers include those affecting interest rates, inflation and fiscal conditions, as well as establishing regulatory frameworks which are conducive to growth.

105 In paragraph 65 above we noted the role of labour supply factors. Some of these, such as the legal frameworks governing educational participation, migration and the retirement age, are shaped to some extent by government policy, and would thus need to be considered if a comprehensive examination of policy affecting wages were undertaken.

Conditions Directly Created by Government Policies

Tax and National Insurance Contributions

- 106** Paragraphs 39-48 above and Annex B present the impact of changes in the income tax and NICs regimes since 2000. They show that around half of NMW workers, those working fewer than 25 hours a week, have not been affected by recent income tax and NI changes but that the other half had experienced real increases in take-home pay as a result of these changes. They also show that the relative costs of employing NMW workers had fallen but the hourly costs of full-time NMW workers were higher than for those working fewer than 30 hours a week.
- 107** Changes already made mean that for over half of NMW workers there is limited scope for further improvement in take-home pay through adjustments to the income tax and NI regimes. We estimate that 56 per cent of NMW workers already earn less than the appropriate thresholds and would thus experience no benefit from their going up (unless it is argued that increasing employer NI thresholds would make it more likely that employers would offer more hours to part-time minimum wage workers, thereby increasing their weekly pay although not their hourly rates). The Government has already announced an increase in the personal tax allowance to £10,000 in 2014/15. This would currently take all those working 30 hours or fewer out of the income tax system. That would be around 65 per cent of NMW workers. However, the increase in the NI threshold is only sufficient to take those working 24 hours or fewer out of the NI system. Scope therefore remains to adjust the income tax and NI regimes so as to increase the take-home pay of a substantial minority of the lowest paid, and also to remove disincentives to employers to offer full-time work to minimum wage workers. In relation to young people (discussed at paragraphs 121-125 below) the Government has recently announced that it will reduce National Insurance payments for under 21 year olds.

Other Statutorily Determined Parts of the Reward Package

- 108** We have noted already that as well as tax and National Insurance, a number of other statutory provisions apply to all employers and affect labour costs and the value of the reward package to the worker. These include minimum annual, and maternity and paternity, leave entitlements, and pension auto-enrolment. Although significant in their own terms these are not central to the terms of the Secretary of State's request, and for the purposes of our assessment we have assumed that they are currently out of scope.

Sector Productivity

- 109** If improvements in the productivity of workers in low-paying sectors exceed those of workers elsewhere in the economy then, as we noted at paragraph 99, prospects for increasing the minimum wage faster than average wages are enhanced. The constraints on increasing wages in the low-paying sectors which we have described above in the section on 'Sectoral Conditions for Faster Minimum Wage Increases' help to illuminate some of the challenges involved in achieving increases in productivity in these sectors.

- 110** These challenges differ from sector to sector, and a multi-strand approach would be necessary if action was to be taken to increase productivity across the low-paying sectors. Measures could be expected to include raising the skill levels of managers and workers, developing and utilising technology (and facilitating the access to finance to invest in it), introducing new business methods and practices, and so on, but the balance between them, and the specific challenge, will vary in each case.
- 111** In sectors such as social care and childcare it may be difficult to raise productivity within statutory constraints without an unwanted adverse effect on services. The scope to substitute technology appears limited, and statutory requirements (for example, in relation to staff:child ratios in childcare) limit freedom to alter delivery models. Unless desirable productivity improvements can be identified within these parameters it would be necessary to increase funding for care, specifically for financing wage rises for the lowest paid, if these sectors were to be included in a programme of sectoral measures to support increases in the minimum wage.
- 112** In evidence provided to us and on our visits around the country we have heard the argument that in social care in particular there is an issue not so much of productivity as of the value society attaches to providing care, and of a failure to reward the skills that are required. A policy objective of funding higher wages for the lowest-paid care roles might need to be accompanied by other measures, formally recognising the skills involved, and requiring carers to demonstrate possession of them, for such a policy objective to be attained. The experience of raising wages in the security sector may offer some pointers (see box below).
- 113** It is beyond the scope of this report to rehearse the detailed circumstances of each sector, but the general point is that an agenda of raising productivity to help enable increases in the minimum wage would require action targeted at each sector and differentiated to reflect the challenges of each sector.

Case Study: the Security Sector

Following a review of the characteristics of the low-paying (minimum wage) sectors in 2012, we ceased to classify the security sector as low-paying because of the small proportion of workers in the sector who were paid at or near the NMW. The actual number of workers in the sector had increased since the introduction of the NMW; in June 2012 there were 179,000 employee jobs in the security industry (an increase of 57,000 compared with June 1998), but the proportion (in April 2011) paid at or below the adult NMW rate then in force was just over 5 per cent.

The security sector has changed over a number of years, with the impact of the minimum wage lessening, mainly driven by the introduction of a statutory licensing system. Security guarding is the part of the sector where jobs are more commonly paid at or around the NMW. The compulsory licensing of individuals undertaking designated activities within the private security industry came into being from 2003. This has increased the training and professionalism within the industry, and raised wages. At the same time, there has been a switch by companies to make better use of electronic technology. In 2006, we were told that the earnings within the sector had risen strongly, largely because of the introduction of the statutory licensing system. At that time, when the adult rate of the NMW was £5.35, official data showed a clear spike in the earnings distribution at £6.00 and stakeholders told us the 'going rate' for the industry was around £6.40. Over time upskilling and training brought about by compulsory licensing, and increased use of technology, has increased wages in the sector, shrinking the proportion of security workers paid at or near the NMW.

Small Firms and the National Minimum Wage

114 Any programme of measures intended to create conditions conducive to faster increases in the NMW would need to address constraints on small firms.

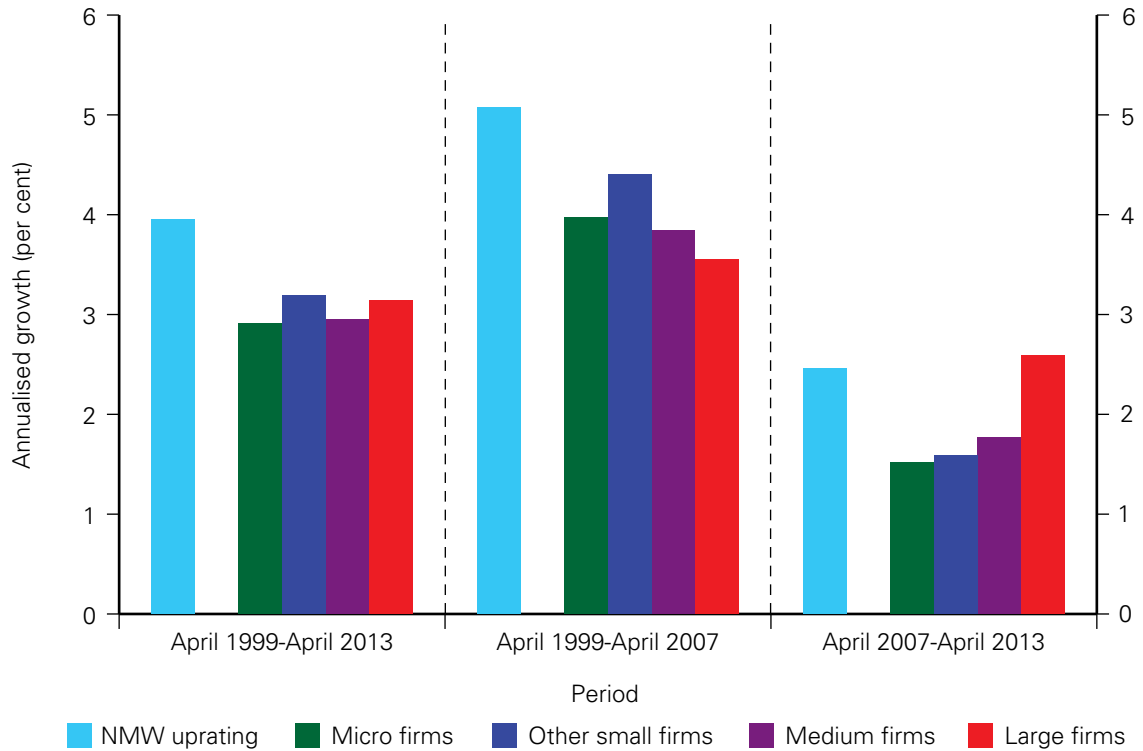
In our 2013 Report we noted, as we had in our previous reports, that there was a clear relationship between the proportion of minimum wage jobs and the size of firm. In April 2013, minimum wage jobs accounted for fewer than 4 per cent of jobs in large firms (with 250 or more employees), about 6 per cent of jobs in medium-sized firms (those with 50-249 employees), 7 per cent of jobs in other small firms (10-49 employees), and 12 per cent of jobs in micro firms (1-9 employees). Small and micro firms employ 20 per cent of the adult workforce, but employ around 35 per cent of minimum wage workers.

With labour costs 45 per cent of turnover, the NMW made it very difficult for the company to compete with low-wage countries.

Meeting with small manufacturer, Commission visit, 2012

115 Figure 12 shows that employees in smaller firms have also experienced lower earnings growth since 2007. The positive relationship between size of firm and annualised earnings growth is clear. Over the whole period from 1999 to 2013, earnings growth across firms of different sizes was similar, at around 3.0 per cent. But this disguises two distinct periods.

Figure 12: Annualised Growth in the Adult National Minimum Wage and Median Earnings for Those Aged 22 and Over, by Firm Size, UK, 1999-2013



Source: LPC estimates based on ASHE: adjusted earnings without supplementary information, April 1997-2004; with supplementary information, April 2004-06; 2007 methodology, April 2006-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK.

Note: Earnings data have been adjusted to account for discontinuities in the data sets.

116 Between 1999 and 2007, employees in micro and other small firms saw higher earnings growth than medium-sized and large firms, although still below the average upratings in the NMW of 5.1 per cent. However, since 2007, smaller firms have seen lower earnings growth than larger firms, and the smaller the firm, the lower the growth in employee earnings. Between 2007 and 2013 workers saw an annualised growth in median earnings of just 1.5 per cent a year in micro firms, 1.6 per cent in other small firms, 1.8 per cent in medium-sized firms, and 2.6 per cent in large firms. The minimum wage increased by an average of 2.5 per cent a year over the same period.

The family business owner highlighted the long hours the family worked ... it was likely as the self-employed owner he earned below the NMW.

Meeting with rural business, Commission visit, 2013

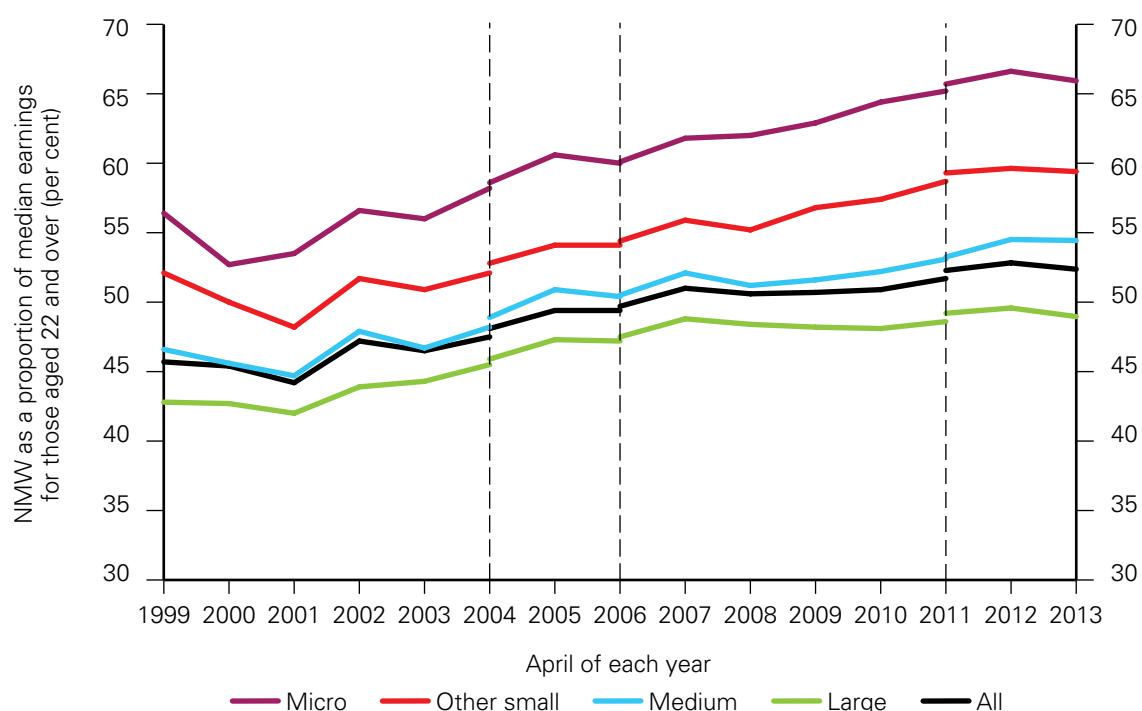
117 This pattern of earnings growth in small firms has increased the bite of the NMW in these firms since 2001. Figure 13 shows that the bite in micro firms had increased more or less continuously since 2000 from 52.7 per cent to 67.0 per cent in 2012 and 66.0 per cent in 2013. Similarly, other small firms experienced an increase in the bite from 48.2 per cent in

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2001 to 59.4 per cent in 2013. Although the bites for medium-sized and large firms increased at a similar pace to that for small firms between 2001 and 2007, there has been a noticeable difference since then.

- 118** From 2007 to 2010, median wage growth in medium-sized and large firms was similar to that of the minimum wage, and hence the bite remained at around 52 per cent for medium-sized firms and 48 per cent for large firms. Since then wage growth in these larger firms has not matched increases in the NMW and the bite has again risen. In April 2013, the bite for large firms had risen to 49.0 per cent and for medium-sized firms to 54.4 per cent. These were, however, considerably below those for micro firms (66.0 per cent) and for other small firms (59.4 per cent).

Figure 13: Bite of the Adult National Minimum Wage at the Median for Those Aged 22 and Over, by Firm Size, UK, 1999-2013



Source: LPC estimates based on ASHE: without supplementary information, April 1997-2004; with supplementary information, April 2004-06; 2007 methodology, April 2006-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK.

Notes:

- Direct comparisons before and after 2004, before and after 2006, and before and after 2011 should be made with care due to changes in the data series.
- There were fewer responses to the question on size of firm in the 2002 ASHE than in other years.

Other Considerations

- 119** The discussion above has explored the role of national and sectoral economic and business conditions, and the scope for government to affect these. These factors have an important bearing on what workers can be paid, but ultimately the actual decisions as to specific rates of pay are taken by employers. Depending on their circumstances employers retain more or less room for manoeuvre in adjusting the wages of their lowest-paid employees.

The Living Wage

120 The Living Wage Foundation campaigns to persuade employers who can afford to do so to pay at least the wage rates specified by the Foundation. These are calculated by estimating the needs of each of a range of household types, and then arriving at a single number by taking an average of the estimates for the different household types. A number of employers have increased the pay of their lowest-paid employees as a result. We noted at the start of this report that the NMW is a pay floor for individual workers, which is not the same as a living wage. We believe that employers who are not driven by business pressures to pay the minimum wage should be encouraged to pay more. Around a quarter of minimum wage workers are not employed in the low-paying sectors, and may be working for employers for whom their wages are a relatively small element in their cost base.

A housing group advised that at the beginning of 2013 it had taken the decision to make the living wage its lowest pay point. This decision affected fewer than 30 employees (mainly cleaners) and the impact on its pay bill was around £10,000, which the Group described as "minimal" when looked at as a proportion of its total wage bill.

Meeting with a housing group, Commission Visit 2013

Young People

121 So far this report has concentrated on the adult rate of the NMW. We have noted in previous reports that employment of young people is more sensitive than that of adults to the economic cycle, and during the economic slowdown the labour market position of young people deteriorated more than that of adults. In addition there is evidence of change in the structure of the labour market for young people. This means that recommending the youth rates involves a judgement year-by-year which assesses both these factors. In 2011 and 2013 we recommended lower increases for young people than for adults, and in 2012 we recommended freezing the youth rates.

122 As the youth rates have risen less than the adult rate since the onset of recession in 2008 they have also undergone a larger fall in real value. Using the RPI, the real value of the youth rates of the NMW peaked in 2009 (at £5.63 and £4.16 in 2013 prices), and in 2007 using the CPI (at £5.54 and £4.10 in 2013 prices). Thus the youth rates of the NMW today are 60 and 44 pence an hour, or 10.7 and 10.6 per cent, lower in real RPI terms than they were in October 2009 (and 51 and 38 pence, or 9.2 and 9.3 per cent, lower than they were in October 2007 in real CPI terms).

123 However the value of the youth rates compared with median earnings for 16-17, and 18-20 year olds has increased significantly over the period 2007-13. The annualised increase in the 16-17 Year Old Rate (1.8 per cent) and Youth Development Rate (1.9 per cent) exceeded the annualised increase in median earnings over the period, for both 16-17 year olds and 18-20 year olds (0.4 and 1.4 per cent respectively). The bite of the Youth Development Rate has however fallen slightly in the last two years partly as a result of our cautious youth rate recommendations already mentioned, though the bite of the 16-17 Year Old Rate increased in April 2013 as median earnings for this age group fell.

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- 124** The general conditions necessary for us to recommend faster rises in the adult rate in future also apply to the youth and apprentice rates. However the greater sensitivity of young people's employment to the economic cycle means we would expect to be able to recommend larger increases for young people when economic conditions have eased.
- 125** That recommendation would also of course be influenced by our view of the characteristics of the labour market for young people at the time. There are reasons to believe these characteristics may be changing. In its evidence to us the Government noted that the number of young workless people that have never had a paid job has been increasing since the early 2000s, and that there appears to be a structural issue in the youth labour market relating to the transition between education and employment. If the Government wishes us to conduct a fuller examination of the conditions necessary for faster increases in the youth rates we would expect to include that in our 2015 Report, informed by an up-to-date assessment of how far the labour market for young people has experienced structural as well as cyclical change.

Apprentices

- 126** The Apprentice Rate was introduced in 2010 and has risen more than any other rate of the NMW since then. While, as noted above, the general economic conditions which inform our recommendation for the adult rate are also the context for recommending youth and apprentice rates, the labour market for apprentices has a number of distinct features. It is shaped to a significant extent by the evolution of the learning and qualifications frameworks, and of government support for training apprentices. The apprentice framework is continuing to evolve as the Government implements the recommendations of the Richard Review of Apprenticeships. Moreover it is clear that the impact of the Apprentice Rate differs greatly from sector to sector (its bite by sector ranges from 98 per cent in hairdressing in England, to 25 per cent in management in Wales). We have been very concerned by the widespread non-compliance with the Apprentice Rate suggested by the Department for Business, Innovation and Skills' Apprentice Pay Survey 2012 (BIS, 2013a). We understand that in 2014 the Government intends to conduct another apprentice pay survey, the third since the rate was introduced. This should provide an important data source for a fuller assessment of the conditions needed for us to recommend a faster increase in the Apprentice Rate, should the Government wish us to include that in our 2015 Report.

Clarifying the Forward Path of the National Minimum Wage

- 127** The Secretary of State has asked us to take a longer-term view of the minimum wage, and in its evidence to us the Government said that it wanted us to provide forward guidance on the NMW. It also asked us for our views on phasing planned increases over two or more years to ease adjustment, and on whether we would be looking to restore the relative position of NMW workers, i.e. to restore the fall in the bite that took place in 2013.
- 128** To an extent the Commission already provides forward guidance. We meet in January to agree recommended rates for the year beginning 9 months, and ending 21 months, after our decision. This contrasts with the Monetary Policy Committee, whose decisions take immediate effect.

- 129** In taking our decision this year we have considered the outlook for the minimum wage. We believe an abrupt increase at this stage of the recovery would put employment at risk. But we will aim to recommend progressive real increases in the value of the NMW, restoring and then surpassing its previous highest level. The Conclusion below summarises the conditions that will be needed to achieve this.
- 130** The scope to give greater clarity on future levels of the minimum wage, including the option of two-year recommendations, was something we examined in our 2012 Report. Our conclusion then was as follows.

"...We previously gave two-year recommendations in our Third, Fourth and 2005 Reports for the upratings of the minimum wage between 2001 and 2006. We moved to annual recommendations in our 2007 Report as we felt the increasing bite of the minimum wage and greater economic uncertainty meant it was important that our recommendations were based on the most timely data.

Some stakeholders supported two-year recommendations in their responses to our consultation. The FSB thought that two-year recommendations would aid business planning, and the Association of Convenience Stores (ACS) reported that two-year recommendations would allow retailers to budget further ahead and restructure staff with a longer-term perspective in mind. Some stakeholders in favour of two-year rates, including the ACS and Scottish Licensed Trade Association (SLTA) felt it was important that we retain an ability to review and change the second year rates to reflect the economic climate.

A few stakeholders called for even longer-term recommendations. The Cinema Exhibitors' Association felt that knowing the increases three to five years ahead would help planning of financial and human resources, while members of the Cleaning and Support Services Association reported that they would be able to factor the increases into their tenders if they were known up to three years in advance.

However, most stakeholders thought that we should continue to make annual recommendations, particularly given the current economic conditions. These stakeholders included the TUC, Unite, CBI, the BCC, and other representative organisations of both employers and employees. Many of these stakeholders cited the importance of basing the recommendations on timely information, and a need for us to retain flexibility to respond to volatile economic conditions.

We have examined a number of ways of indicating what rate recommendations might be expected in the second year. A substantial majority of consultees, from across the spectrum of employers and workers, opposed these ideas. We agree with them that the disadvantage of constraining the Commission to a position which by definition cannot be based on timely evidence outweighs any benefit in increased clarity, particularly in the present uncertain business environment. We have also considered whether the implementation date for our recommendations could be moved in order to give increased notice of upratings, but again this would mean the data informing our recommendations would be less timely than at present."

Low Pay Commission Report, 2012

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- 131** This remains our view. We have also considered the Government's question about restoring the fall in the bite, which might imply making an intended level of the bite an explicit goal, which could be another way to provide stakeholders with greater certainty about the future path of the NMW.
- 132** However, we do not favour this. The Commission reviews all the evidence and weights it according to our assessment of it. Targeting a given level for the bite would make the Commission's task more formulaic, and less a weighing of all the evidence, than it has been to date. In addition we see serious practical difficulties:
- it would mean making assumptions at our January meeting about median earnings in the April, 15 months later – further into the future than any available forecasts of median earnings, and two years forward from the starting point in the most recent ASHE;
 - given the poor record of past independent forecasts of earnings any assumed median earnings figure would be highly likely to be inaccurate;
 - even when forecasts of average earnings are available, they are prone to error, and they forecast the Average Weekly Earnings series (AWE) which is liable to diverge from ASHE in a given year (in two of the past three years there has been a marked difference between the increases in earnings measured by ASHE and AWE);
 - the year-on-year volatility of the principal data series, and their tendency to diverge in a given year would make it very risky to treat the most recent ASHE or AWE as a baseline from which to take a formulaic approach to recommending the NMW.
- 133** None of this is to say that we do not take best estimates of the impact on the bite into account in recommending rates. We do. Our 2014 recommendation will bring the bite back to around its 2012 peak if median earnings increase 2 per cent per year between April 2013 and April 2015, which is plausible. But we would not favour making a given level of the bite a target because the numbers are not robust enough for the purpose.
- 134** For the reasons given above we think that – while we can and do give our view on prospects for a faster increase in the minimum wage – there is no numerical indicator available which would go further forward than the 21-month time period of our recommendations, while being reliable enough to be useful. However it is possible to set out the conditions for a faster increase in the National Minimum Wage, as the Secretary of State has requested, and we do this in the Conclusion of this report below.

Conclusion

- 135** There have been three phases in the Low Pay Commission's approach to recommending the adult rate since the NMW was introduced in 1999: initial caution (1999-2001); increases above average earnings growth and inflation (2001-07); and rises closer to average earnings (2007-13).
- 136** The minimum wage has done its job well. Before its introduction the lowest paid fared worse than other workers; since 1999 they have done better, including since the onset of recession in 2008. This has happened without evidence of adverse employment effects.
- 137** But since 2007 the NMW has not kept pace with inflation. It is worth less now than it was then. At the same time the NMW has continued to increase as a proportion of average earnings, since wages generally have experienced an even larger loss of real value.
- 138** This year however we have recommended an increase which should start to restore the real value of the NMW. Provided economic circumstances continue to improve we expect that process to continue, so that 2014 will mark the start of a new, fourth phase – of bigger increases than in recent years – in the work of the Commission.

Conditions for Faster Increases in the National Minimum Wage

- 139** We set out below the general economic conditions we believe are needed for faster increases in the NMW which would materially increase its real value.
- 140** We share the widely held view that a sustained increase in real wages depends on increased productivity. We look closely at movements in average wages because over the longer term they are a guide to changes in productivity at the level of the economy, and because of the importance of the relationship between the NMW and other wages.
- 141** However, because we aim to help as many workers as possible without an adverse impact on employment prospects we also require a context of stable or rising employment, and an expectation of economic growth, so that there is likely to be steady or growing demand for labour. At the macro level the key considerations that would lead to recommendations for higher increases are:
- an expectation that real wages generally will rise and continue to do so in a sustainable way;
 - stable or rising employment; and
 - an expectation of sustained economic growth (itself the basis for the first two conditions).

We would also take into account evidence of conditions affecting the low-paying sectors, such as the level of and outlook for consumer spending.

- 142** Even without these conditions being met we have, since the downturn began, recommended increases in the minimum wage that were modestly larger than the increases in median earnings in the economy as a whole. This has led to an increase in the bite for the economy generally, but so far without evidence of an adverse effect on employment.

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- 143** The bite faced by low-paying sectors and small firms, where minimum wage workers are employed disproportionately, has increased faster than for the wider economy. By definition, wages of low-paid workers tend to be a material part of the cost base of firms in the low-paying sectors so this is particularly relevant to our recommendations. And in some sectors the bite has risen to an extent that the minimum wage has become the wage determinant for the industry.
- 144** We have however judged that these increases, necessary to limit the erosion of the incomes of the lowest paid, could be accommodated without an adverse effect on employment when introduced in regular steady increments, and this appears to have been true.
- 145** But because of the increased pressure the NMW now places on small firms and low-paying sectors we believe that a dramatic increase (for example to recover most of its lost value in one uprating) would be very risky in current conditions. For the same reason we would expect to recommend any rises that would cause further longer-run increases in the bite only in gradual steps, and only where the evidence shows that the low-paying sectors have accommodated preceding steps without material employment effects.
- 146** These are necessarily matters of judgement: the effects of NMW increases cannot be known in advance, though they can be estimated. Rate recommendations are also judgements in the sense that they are shared assessments of the evidence, written, oral, and from our discussions around the country with employers and employees, rather than the outcomes of a mechanistic formula. Setting the level of the minimum wage can never be wholly a science. It means working with economic forecasts that are always uncertain, and – at least in recent years – more often wrong than right. Moreover expectations themselves, and the climate of economic confidence, affect what the economy will bear.
- 147** The Government influences the employment of the low paid and the value of their wages. It has an influence on general economic conditions including through the management of inflation, and economic management and policy in support of growth. Government also has a direct impact on the cost of employing low-paid workers through the National Insurance framework, and through regulatory requirements such as pension obligations.
- 148** We take these into account in arriving at our recommendations. We do not take account of the effect of tax and National Insurance on take-home pay because these do not alter what employers can afford to pay or the level of the minimum wage the economy can bear without employment impacts. We do though note here that 44 per cent or so of NMW earners work enough hours to incur deductions from pay, and it is open to the Government to raise their take-home pay by increasing these thresholds.
- 149** Lastly, we have noted that around a quarter of minimum wage workers are not employed in the low-paying sectors. For many of them it may be affordable for employers to raise their wages without adverse impacts on their businesses as a whole. We believe that employers who are not driven by business pressures to pay the minimum wage should be encouraged to pay more.

Annex A

The Bite of the National Minimum Wage in Low-paying Sectors

- 1 The bite is the National Minimum Wage (NMW) as a proportion of a particular point on the earnings distribution. In this annex we look at the bite of the minimum wage (the NMW against median earnings) from 2007 onwards. We focus on six low-paying sectors – those which employ 4 per cent or more of minimum wage workers (childcare, cleaning, hospitality, retail, social care) or where minimum wage workers account for a third of the employees in a sector (hairdressing). We compare the bite in each with that for all low-paying and all non low-paying sectors. We also look at what the bite would have been if the NMW had been uprated in line with inflation (both Consumer Price Index (CPI) and Retail Price Index (RPI)) and consider what stakeholders have told us about the impact of the NMW in these sectors, in particular on differentials.

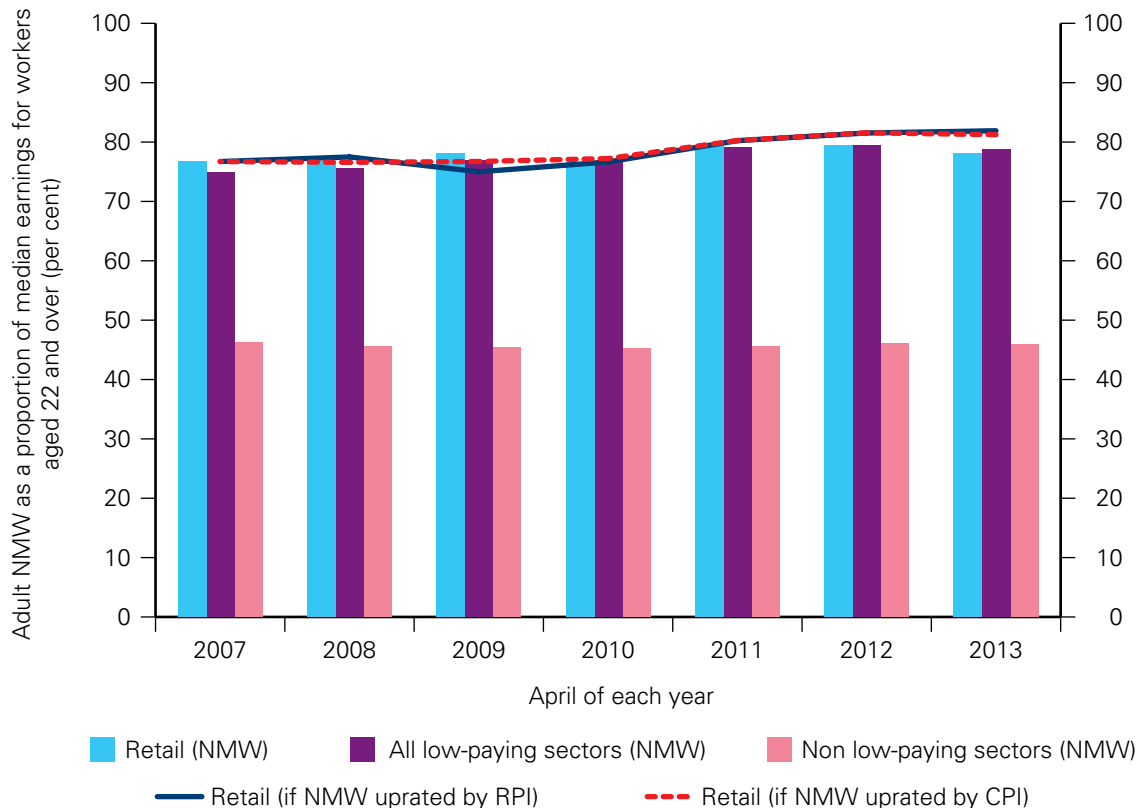
Retail

- 2 Figure A.1 shows how the bite of the NMW in the retail sector had reached 78 per cent by 2013, up from around 75 per cent in 2007. However, if the value of the NMW had been maintained in real terms between these years the bite would have been higher by 2013, at just over 81 per cent (if uprated in line with CPI) or nearly 82 per cent (if uprated in line with RPI). Retail is a very differentiated sector in terms of pay. While in the major supermarkets in 2013, sales assistants' basic hourly rates at age 18 were well above the adult NMW (ranging from around £6.60 to £7.28 an hour) we are told by those representing small rural retailers that the cost pressures mean that proprietors often pay themselves considerably less than the minimum wage.
- 3 Jobs in retail paid at or around the NMW include retail assistants, cashiers, and other basic sales occupations. Over the years we have often heard from retailers and organisations representing them that a consequence of increases in the NMW has been to narrow differentials between grades, particularly between basic retail and supervisory roles, with implications for the motivation, and recruitment and retention, of staff. The response to this has varied across the sector. In some parts this has meant a compression of points on pay scales as retailers cannot afford to or choose not to restore the wage differential. For example, the British Retail Consortium informed us that the proportion of employees in non-food retailers earning within 20 pence of the NMW almost trebled to 9 per cent in 2012 compared with 2011, and in 2013 rose again to 16 per cent. The British Independent Retailers Association also told us that some parts of the sector in particular face wage compression from NMW upratings, such as in department stores and certain geographical regions. The Association of Convenience Stores has often raised with us the squeezing of differentials between average wage rates paid by its members and the NMW. In addition,

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research has found that employers have sometimes absorbed NMW upratings by reducing pay premia or restricting non-wage benefits.

Figure A.1: Bite of the National Minimum Wage, Retail, Low-paying and Non Low-paying Sectors, Actual and If Uprated in Line with CPI or RPI, UK, 2007-13



Source: LPC estimates based on ASHE: 2007 methodology, April 2007-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK; and ONS data: CPI (D7BT) and RPI (CHAW), monthly, UK, 2007-13.

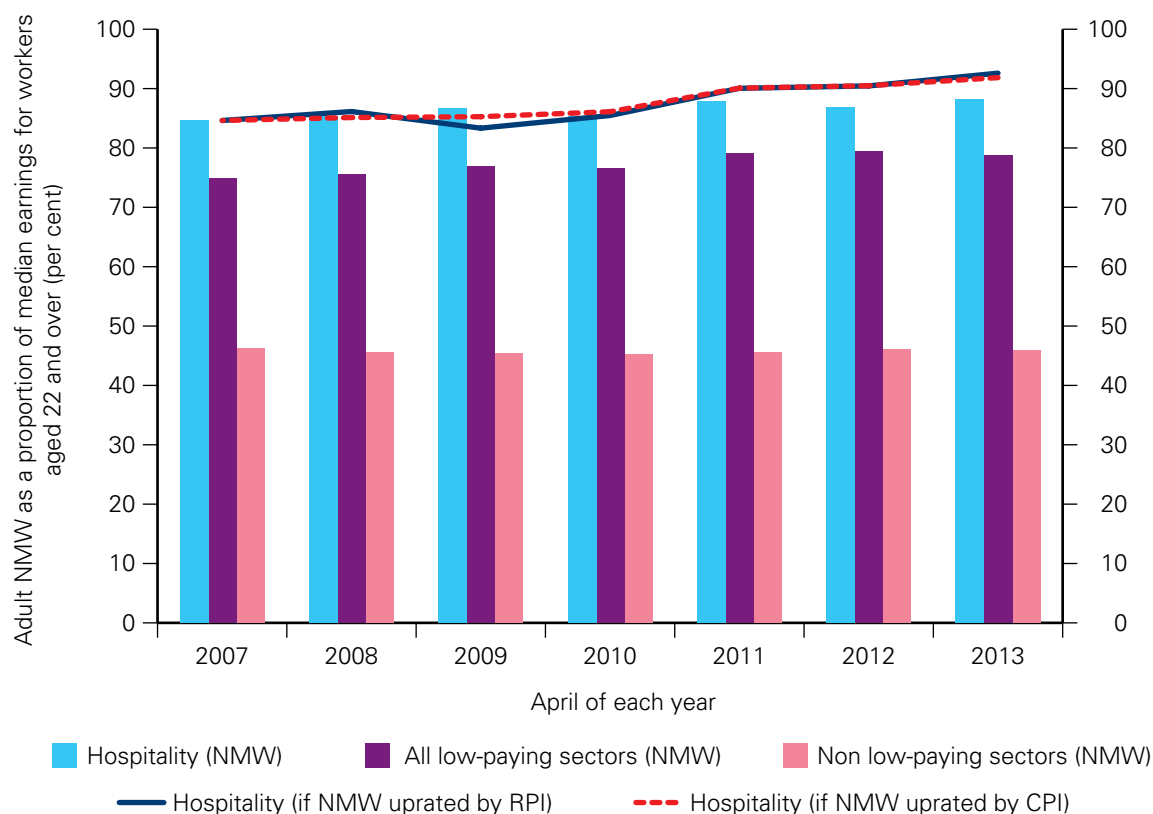
Note: ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

- 4 We have, however, also heard that in some parts of the retail sector the NMW has either had less effect, or has led to what might be regarded as a more positive development in pay structures. For example, our commissioned research has told us that the impact from a squeezing of differentials has sometimes prompted sector employers to revise their pay and grading structures: instead of separate grades for trolley-collecting, shelf-stacking and cashiering these were often merged into one grade. Usdaw, which represents retail workers, told us that the increase in the NMW in October 2013 was lower than the level of sector settlements Usdaw was achieving (2.0-2.5 per cent, with some at 2.8 per cent). The NMW, it maintained, was not reducing differentials, but allowing the lowest paid to fall further behind the rest of the labour market.

Hospitality

- 5 The bite of the NMW in the hospitality sector, as shown in Figure A.2, reached just over 88 per cent by 2013, an increase from just over 84 per cent in 2007. However, if the value of the NMW had been maintained in real terms in this period the bite would have been just under 92 per cent (if updated in line with CPI) or just over 92 percent (if updated in line with RPI).

Figure A.2: Bite of the National Minimum Wage, Hospitality, Low-paying and Non Low-paying Sectors, Actual and If Updated in Line with CPI or RPI, UK, 2007-13



Source: LPC estimates based on ASHE: 2007 methodology, April 2007-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK; and ONS data: CPI (D7BT) and RPI (CHAW), monthly, UK, 2007-13.

Note: ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

- 6 A large proportion of jobs in hospitality are paid at or around the minimum wage. These include waiting staff, bar staff, hotel cleaners, etc. In hospitality, unlike retail, there is an increasing use of the Youth Development Rate, i.e. the minimum wage for 18-20 year olds. Employees aged under 21 make up around 22 per cent of the sector's workforce.
- 7 Sector representatives tell us that the main impacts of the minimum wage are on the compression of differentials and the scope for employers to maintain non-pay benefits. Over recent years these concerns have grown as input prices (food, utilities, etc) have increased substantially. As a result of this compression, job layers have gradually been removed, causing disgruntlement among those affected (reducing opportunities for promotion and squeezing differential pay for those with greater responsibilities). They expect this situation to carry on if the minimum wage continues to increase. In recent years the pub sector has advised us that the adult rate of the National Minimum Wage has become the average wage in the sector.

Cleaning

- 8 The cleaning sector has the highest bite of all low-paying sectors. Figure A.3 shows it reached just over 93 per cent in 2013, an increase from just under 87 per cent in 2007. However, if the value of the NMW had been maintained in real terms between these years the bite would have been nearly 97 per cent (if uprated in line with CPI) or just under 98 per cent (if uprated in line with RPI).
- 9 The majority of the jobs in this sector could be described as cleaning operatives. Although official data show that around a third are paid at the minimum wage, an industry survey in 2012 reported that 62 per cent of cleaners were paid at the NMW (then £6.08) with a pay rate of £6.25 proving an effective ceiling. Around 76 per cent of workers were paid less than this.
- 10 Business representatives report that successive increases in the minimum wage have forced employers to reduce hours and the quality of the service they provide, as they have little scope to renegotiate contract prices (and during the recent economic downturn service users have tried to renegotiate prices down to reflect pressures they were under). Consequently differentials continue to be squeezed and further minimum wage increases would only exacerbate this situation and flatten pay structures. We have been told by business representatives that the squeezing of differentials reduces the incentive for workers to take on extra responsibilities, for example by becoming supervisors.

Figure A.3: Bite of the National Minimum Wage, Cleaning, Low-paying and Non Low-paying Sectors, Actual and If Uprated in Line with CPI or RPI, UK, 2007-13



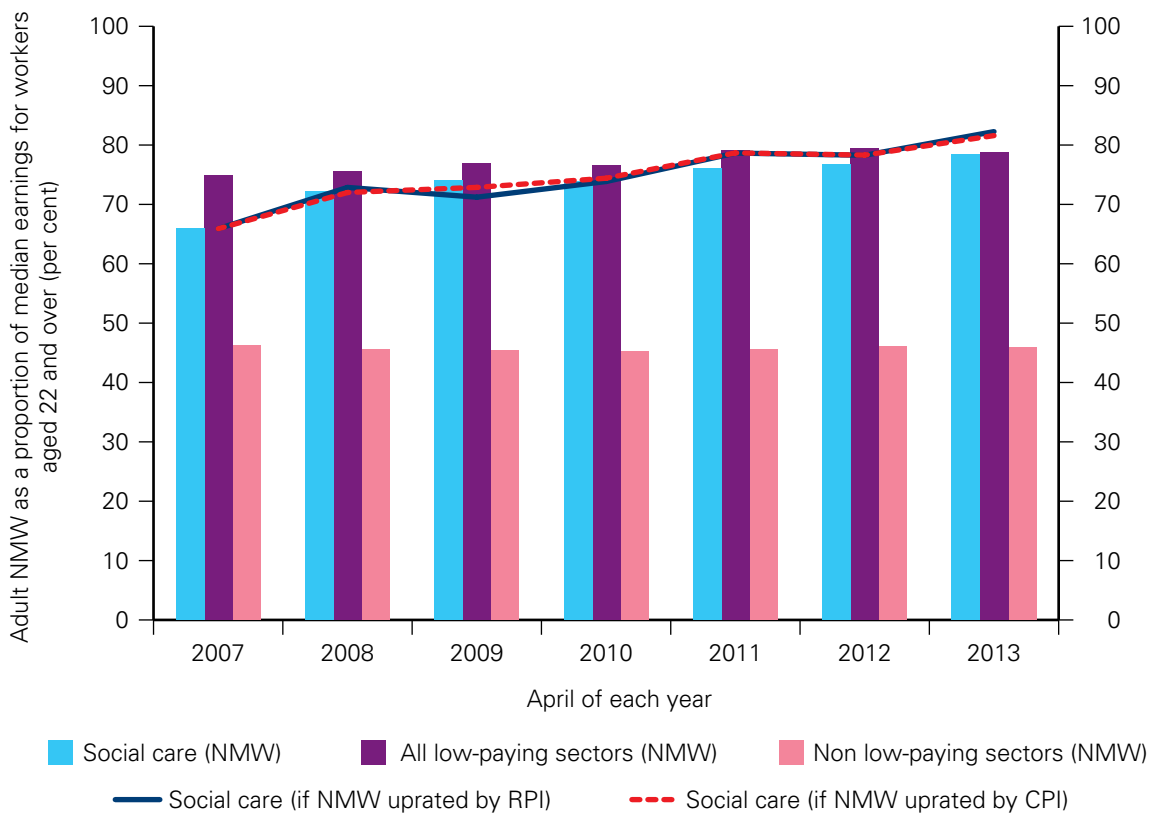
Source: LPC estimates based on ASHE: 2007 methodology, April 2007-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK; and ONS data: CPI (D7BT) and RPI (CHAW), monthly, UK, 2007-13.
 Note: ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

- 11** But Asset Skills (2013) found that while pressures on cleaning businesses remained significant, a number of businesses were managing these challenges effectively and a significant number of respondents reported relatively healthy profitability. Asset Skills reported that even though challenges remain, businesses had put in place structures which allowed them to operate more effectively and efficiently.

Social Care

- 12** Figure A.4 shows that the increase in the bite of the NMW in the social care sector was one of the sharpest in the low-paying sectors, rising from 66 per cent in 2007 to reach over 78 per cent by 2013. However, if the value of the NMW had been maintained in real terms between these years the bite would have been even higher, at nearly 82 per cent (if uprated in line with CPI) or just over 82 per cent (if uprated in line with RPI).
- 13** Independent providers in the social care sector tell us that the key factor they face in affording increases in the minimum wage, and in managing the impact of the NMW on their pay structures, is whether local authorities (LAs) pay care fees at a level which reflects the actual cost of care – providers are often heavily dependent on LA purchasing of their services. Care associations have advised us that NMW upratings add significant financial pressure to providers with a substantial proportion of provider expenditure on staff costs.

Figure A.4: Bite of the National Minimum Wage, Social Care, Low-paying and Non Low-paying Sectors, Actual and If Uprated in Line with CPI or RPI, UK, 2007-13



Source: LPC estimates based on ASHE: 2007 methodology, April 2007-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK; and ONS data: CPI (D7BT) and RPI (CHAW), monthly, UK, 2007-13.

Note: ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

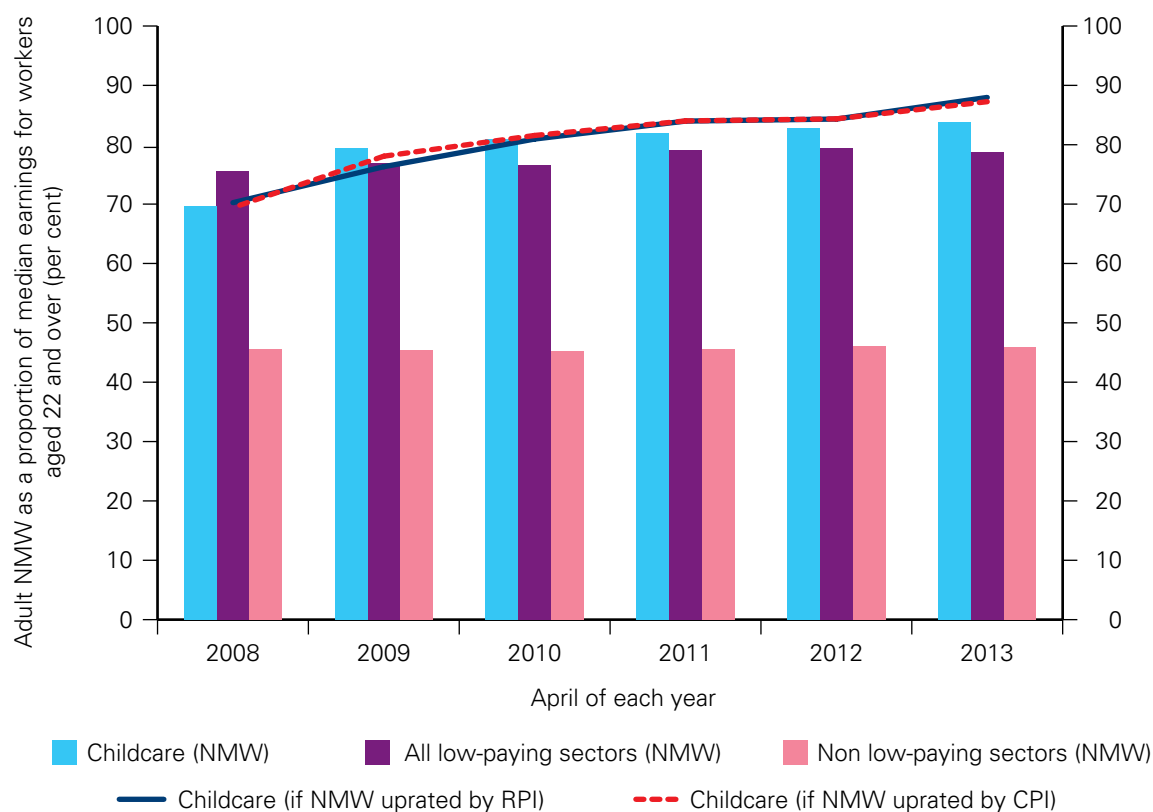
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- 14** Jobs in social care paid at or around the level of the minimum wage include care assistants in residential care and home care workers, as well as those in support service functions. Although ASHE data suggest that social care, compared with some other low-paying sectors, does not appear to have a very high proportion of jobs paid at the NMW, we have found from our own analysis (supported by other research) that unpaid time (such as for travel) and failure to factor in deductions (such as for accommodation) may mean a far higher proportion are actually paid at or near to the NMW. In addition, care sector representatives tell us that without care fees reflecting care costs, an increase in the NMW has an impact on recruitment and retention of more senior workers. Available monies would be used to pay increases for those on the NMW rather than reward higher-paid staff. This also affects incentives for existing staff to train and take on higher responsibilities. As it gets harder to retain and recruit permanent staff, more use would be made of expensive agency staff, which would add further pressure to the pay bill.

Childcare

- 15** The bite of the NMW in the childcare sector has grown even more sharply than the bite in social care. Figure A.5 shows that the bite reached nearly 84 per cent in 2013, a substantial increase from just over 69 per cent in 2008. However, if the value of the NMW had been maintained in real terms between these years the bite would have been just over 87 per cent (if uprated in line with CPI) or just under 88 per cent (if uprated in line with RPI).
- 16** Many nurseries pay their unqualified staff, such as nursery assistants and support staff, at or around the NMW and structure pay scales to reflect qualifications and responsibility. The body representing day nurseries reported that the average increase in nursery fees in 2013 was 1.5 per cent and fee increases had moderated, or been frozen, in response to pressure on parents to afford them. A key concern for the sector is funding, whether it be from parents (many of whom are struggling to pay) or from government for free nursery places (where the majority of nurseries claim that this funding does not cover the cost of provision).
- 17** Businesses report that increases in the NMW have affected the sustainability of many nurseries. Increases in the NMW mean a review of pay for the entire workforce if they are to: maintain differentials; incentivise staff; and reward attainment. Continued increases in the NMW, and funding pressures, have reduced the discretion owners have to set their own pay structures. Many nurseries report that any increase in budgets is predominantly spent on responding to NMW increases, thus limiting discretionary awards. This will affect the sector's ability to maintain qualified and motivated staff, who may look for alternative careers.

Figure A.5: Bite of the National Minimum Wage, Childcare, Low-paying and Non Low-paying Sectors, Actual and If Updated in Line with CPI or RPI, UK, 2008-13



Source: LPC estimates based on ASHE: 2007 methodology, April 2008-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK; and ONS data: CPI (D7BT) and RPI (CHAW), monthly, UK, 2007-13.

Notes:

a. ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

b. Data in childcare were not available before 2008.

Hairdressing

18 Figure A.6 shows that the bite of the NMW in the hairdressing sector had increased to just over 84 per cent by 2013 from below 80 per cent in 2007. However, if the value of the NMW had been maintained in real terms between these years the bite would have been even higher at just under 88 per cent (if updated in line with CPI) or just over 88 per cent (if updated in line with RPI).

19 Hairdressing is a labour-intensive industry. It has the sector workforce with the largest proportion of apprentices and it has the highest proportion of workers paid at or below the age-related minimum wage. The industry reports that increases in the minimum wage have continued to erode pay differentials. This is mainly an issue between trainees and junior staff (as senior staff are more likely to earn commission (tips) or benefit from incentives or performance-related pay). Businesses in the sector have limited scope for dealing with increases in the NMW if they want to maintain differentials. Managing increasing costs in a highly competitive market is very difficult.

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20 However, Habia (2012) reported that 60 per cent of owners had said that the NMW had not affected their business, with only 20 per cent saying it had. Habia reported that the reason fewer businesses were being affected was because they were now used to the legislation and were factoring it into their budgets.

Figure A.6: Bite of the National Minimum Wage, Hairdressing, Low-paying and Non Low-paying Sectors, Actual and If Updated in Line with CPI or RPI, UK, 2007-13



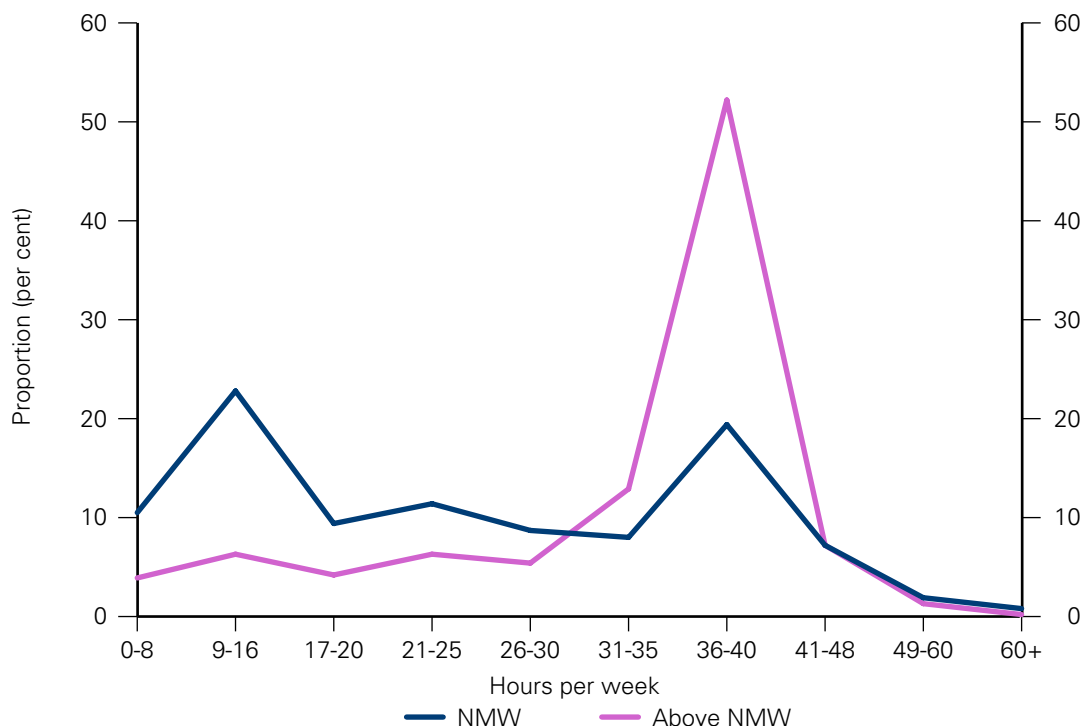
Source: LPC estimates based on ASHE: 2007 methodology, April 2007-11; and 2010 methodology April 2011-13, standard weights, including those not on adult rates of pay, UK; and ONS data: CPI (D7BT) and RPI (CHAW), monthly, UK, 2007-13.
 Note: ASHE data have been adjusted to take account of methodology changes to provide a consistent time series.

Annex B

Take-home Pay

- 1 Several steps are necessary in order to reach a judgement about the effects of changes to the income tax and National Insurance regimes on the take-home pay of minimum wage workers. This is mainly because the minimum wage is an hourly rate whereas National Insurance contributions (NICs) are payable on weekly or monthly earnings and income tax is payable on annual income. It is therefore necessary to divide the population of NMW earners into bands according to how many hours they work in order to derive estimates of the weekly and annual earnings of minimum wage workers, to which NICs and income tax apply. Since these factors may vary over time we have made these calculations separately for each of the financial years since 2000/01. Further, income tax and NI thresholds and rates are set for financial years (April-March) but the NMW changes on 1 October each year. Thus, we need to take account of the change in the NMW in the middle of each tax year.
- 2 On average, NMW workers worked around 26 hours per week in April 2013 (the latest available data). Figure B.1 shows that the hourly distribution of minimum wage workers is very different to that of more highly-paid workers. It has a bimodal structure with two peaks, at 9-16 hours per week (23 per cent of minimum wage workers) and 36-40 hours per week (19 per cent). In contrast, the hours worked by non-minimum wage workers have only one peak, at 36-40 hours a week (over 52 per cent of non-minimum wage workers), with only 7 per cent working 9-16 hours or fewer.

Figure B.1: Distribution of Hours Worked for Minimum Wage Workers, UK, 2013



Source: LPC estimates based on ASHE: 2010 methodology April 2013, low-pay weights, including those not on adult rates of pay, UK.

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- 3** We now turn to look at the take-home pay of an average NMW worker. We should note that the Annual Survey of Hours and Earnings (ASHE) is conducted after the start of the new financial year and yields information on gross hourly and weekly pay in the latest pay period as well as gross annual earnings but the latter will cover the previous financial year, whereas the former is likely to relate to the current financial year.
- 4** Tables B.1 and B.2, and Figure B.2 below, show how government policies regarding income tax and NI have affected the take-home pay of minimum wage earners and the labour costs of their employers since 2000/01, differentiating these effects to take account of the factors mentioned above. Table B.2 shows that the average weekly wage for a minimum wage worker in 2013 was about £158.50, with the median minimum wage worker earning £146.60 per week. Over the year to April 2013, the average annual wage for a minimum wage worker was £7,233, with the median wage at £6,342. The NI threshold was £149 a week in the 2012/13 financial year. That means that an average NMW worker would pay 52 pence a week in NI and, if they earn on average £7,233 a year, they would not have paid any income tax (as the threshold in the 2012/13 financial year was £8,105). A median NMW worker would not have paid any income tax or NI. In order to assess weekly and annual take-home pay, we have taken some account of the fact that many NMW workers work fewer than 52 weeks a year on average, by dividing average annual earnings by average weekly earnings.

Table B.1: Gross and Net Earnings of Minimum Wage Workers Aged 22 and Over, UK, 2001-13

ASHE Year	Gross weekly earnings		Gross annual earnings		Take-home (net) weekly earnings		Take-home (net) annual earnings	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
2001	90.0	81.4	4,784	4,150	87.6	80.5	4,768	4,150
2002	98.3	88.4	5,277	4,565	89.7	81.4	5,160	4,565
2003	107.6	98.4	5,587	4,785	96.2	88.4	5,383	4,717
2004	114.9	104.0	5,381	4,618	103.7	97.0	5,194	4,554
2004	116.7	107.5	5,576	4,745	110.9	102.5	5,358	4,666
2005	123.0	114.1	5,758	4,727	112.2	105.6	5,522	4,635
2006	128.9	116.2	5,799	4,780	118.0	111.8	5,565	4,693
2006	128.5	115.5	6,238	5,334	123.7	114.0	5,949	5,240
2007	138.7	127.3	6,450	5,408	122.6	113.5	6,129	5,280
2008	143.3	129.7	6,854	5,700	131.8	124.3	6,488	5,581
2009	146.4	131.8	6,951	5,988	135.7	127.0	6,666	5,879
2010	147.3	133.4	6,740	5,767	140.4	129.4	6,499	5,656
2011	149.5	134.9	6,833	5,815	142.0	130.8	6,776	5,815
2011	151.1	136.4	7,134	6,032	148.2	134.9	7,065	6,032
2012	153.4	140.0	7,233	6,342	149.7	136.4	7,191	6,342
2013	158.5	148.6			152.5	140.0		

Source: LPC calculations based on ONS ASHE data: without supplementary information, April 1997-2004; with supplementary information, April 2004-06; 2007 methodology, April 2006-11; and 2010 methodology April 2011-13, low-pay weights, including those not on adult rates of pay, UK.

- 5 Figure B.1 showed that around a third of minimum wage workers work 16 hours or fewer. Table B.2 shows that these workers have never earned enough money to pay income tax or make National Insurance contributions. Another 9 per cent of workers, working around 20 hours a week, were drawn into the income tax and NI system between 2004/5 and 2010/11. The raising of the personal tax and NI thresholds since 2010/11 means that those working up to around 25 hours a week in 2013/14 no longer pay income tax but those working around 25 hours a week do make small contributions to NI. Thus, by the 2012/13 financial year, around 53 per cent of NMW workers no longer paid any income tax or National Insurance. The analysis in Table B.2 assumes that all NMW workers work 52 weeks a year, which means that the analysis is likely to overstate the extent of the impact of income tax on NMW workers.

Table B.2: Effective Hourly Take-home Pay for Minimum Wage Workers Aged 22 and Over, UK, 2000-14

ASHE Year	Financial Year NMW	16 or fewer hours	20 hours	25 hours	30 hours	35 hours	40 hours	48 or more hours
	Approximate Share (%)	33	9	11	9	8	27	3
	2000/01	3.65	3.65	3.65	3.56	3.45	3.33	3.10
	2001/02	3.90	3.90	3.90	3.82	3.70	3.57	3.32
	2002/03	4.15	4.15	4.15	4.03	3.91	3.76	3.51
	2003/04	4.35	4.35	4.35	4.18	4.04	3.88	3.62
	2004/05	4.68	4.68	4.65	4.46	4.29	4.12	3.85
	2005/06	4.95	4.95	4.90	4.70	4.51	4.34	4.06
	2006/07	5.20	5.20	5.12	4.92	4.71	4.54	4.25
	2007/08	5.44	5.44	5.34	5.13	4.91	4.73	4.44
	2008/09	5.63	5.63	5.58	5.27	5.04	4.87	4.60
	2009/10	5.77	5.77	5.74	5.46	5.21	5.03	4.75
	2010/11	5.87	5.87	5.83	5.52	5.28	5.10	4.82
	2011/12	6.01	6.01	6.01	5.90	5.60	5.38	5.03
	2012/13	6.14	6.14	6.14	6.10	5.79	5.56	5.18
	2013/14	6.25	6.25	6.25	6.22	6.05	5.80	5.38

Source: LPC calculations based on income tax and NI thresholds and rates, UK, 2000-14.

Notes:

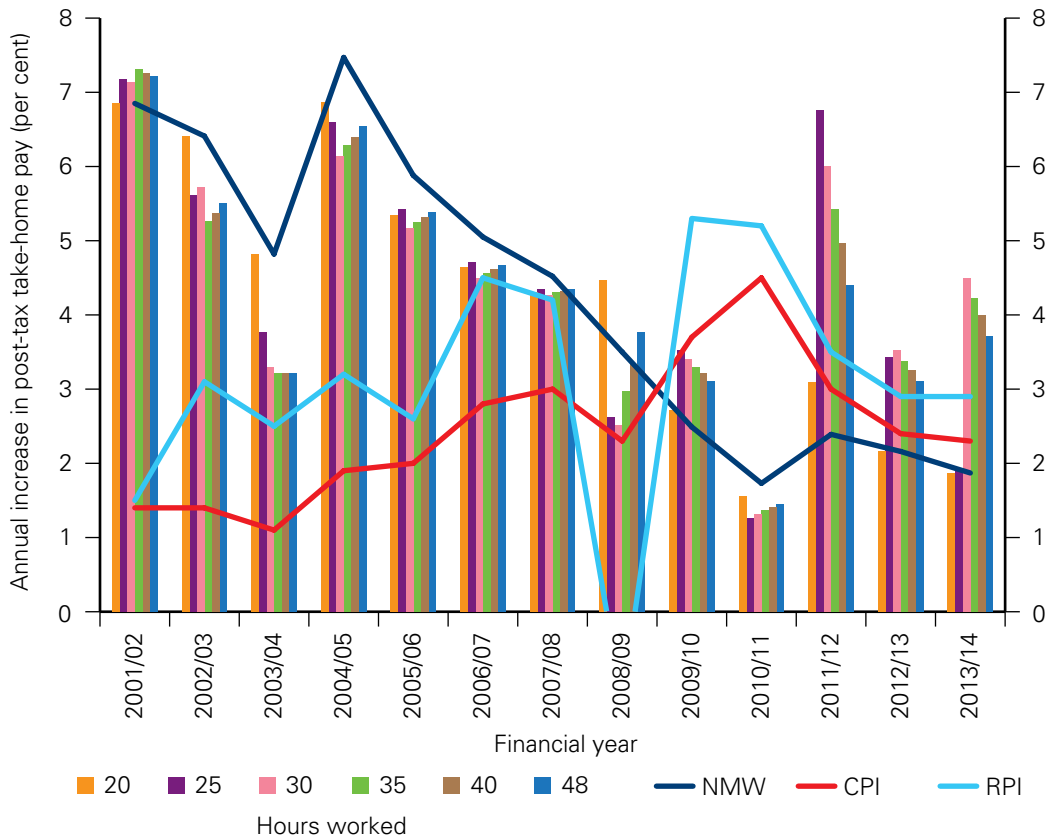
- a. The financial year NMW is the average of the adult rates of minimum wages in the Octobers before and after the start of the financial year.
 b. Approximate shares are 17-20 for 20 hours; 21-25 for 25 hours; 26-30 for 30 hours; 31-35 for 35 hours; and 36-47 for 40 hours.

- 6 It is take-home pay (cash in the pocket) that is likely to matter most to workers. Table B.2 suggests and Figure B.2 shows that between 2001/02 and 2006/07 the increase in the hourly take-home pay of NMW workers increased faster than both measures of inflation (RPI and CPI) but was generally flat from 2006/07 to 2009/10, except for the anomaly produced when RPI inflation was briefly negative. Although recent increases in the NMW have been below inflation, we can see that the changes in income tax and National Insurance have resulted in the effective take-home pay of many NMW workers (those working more than 25 hours a week) increasing faster than inflation. However, 42 per cent of NMW workers work 20 hours or fewer a week and have thus not benefited from those recent income tax and NI changes.

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Further, those who work around 25 hours (around 11 per cent) did not benefit from the most recent changes in the increase in personal tax allowances. Around 53 per cent of NMW workers received a cut in real take-home pay in 2013/14, and for around 47 per cent it maintained or increased its value.

Figure B.2: Annual Increase in Take-home Pay for Minimum Wage Workers, by Hours Worked, UK, 2001-14



Source: LPC calculations based on income tax and N1 thresholds and rates, UK, 2001/02-21013/14 and ONS data: CPI(D7BT) and RPI (CHAW), monthly, UK, 2001-13.

- 7 However, real take-home pay is not the same as real disposable income, which may be affected by tax credits and other in-work benefits as well as the impact of changes in other forms of taxation and regulated prices. Benefits are generally assessed at the household level, whereas our analysis above has been limited to individuals. An assessment of the impact of changes including those to in-work Tax Credits, eligibility for Council Tax and Housing Benefit, and indirect taxes such as VAT would be necessary to draw conclusions about changes in the real disposable income of the lowest paid. The complexity of the tax and benefits system and the availability of appropriate data sources make it very difficult to assess the impact of these changes on NMW households. Research from the Joyce (2012), Joyce and Phillips (2013) and Brewer and De Agostini (2013) tends to suggest that for those at the bottom of the income distribution such changes have negatively affected real disposable income. This is also indicated by analysis that supplemented the Chancellor's Autumn Statement. HM Treasury (2013b) showed that the cumulative impact of the tax and benefit changes would have a net negative effect on the bottom four deciles of household income. Brewer and De Agostini (2013) concluded that, after the changes to Universal Credit and personal tax allowances had been included, a ten per cent rise in the minimum wage would lead on average to a 3 per cent increase in net income.

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