CBI SUBMISSION TO THE LOW PAY COMMISSION – SEPTEMBER 2014

1. Since the recession began six years ago living standards have been consistently squeezed, leading to concerns about the incidence of low pay. This, combined with a general election being just around the corner, has meant that the political parties have been setting out their stalls, highlighting how they propose to tackle low pay through changes to the National Minimum Wage (NMW) and the role and remit of the Low Pay Commission (LPC).

2. Business is deeply concerned about any politicisation of the NMW. The independent, evidence-based approach taken to date by expert Low Pay Commissioners has proven its worth, managing to increase the NMW to the highest level possible without causing unemployment. Business is very concerned about any move away from this approach.

3. Politics aside, while economic growth has continued to strengthen this year, the broader health of the economy has not progressed in the way many were expecting a year ago. Productivity in particular is still a staggering 16% below where it would have been had the crisis not happened. This has impaired the ability of business to raise pay and means that the 2014/15 NMW award is now extremely stretching for business.

4. While business is keen to see pay rise in the future, and although the economy is improving, it is unlikely to pass our three tests for sustainable pay growth – productivity growth, a broad based recovery and low unemployment. First, while productivity will pick up next year there is still a significant amount of ground to be made up before ambitious increases in the NMW are affordable, especially as the NMW has increased faster than productivity this year. Second, the recovery is still on an uneven footing – although business investment will continue to rise, it has been a very low for a sustained period of time and export growth looks set to remain weak. Third, while unemployment has been falling, the number of jobseekers is still too high, particularly amongst the long term unemployed – those who the NMW aims to support the most. Given this, it is critical that the LPC recommends cautious upratings to the NMW in 2015/16.

5. Add into the mix uncertainties around the cost base for business and the limited scope for ambitious upratings becomes clear. Indeed, potential changes to the way holiday pay is calculated could add significant additional costs as well as millions of pounds in backdated claims. Similarly, as the 2015/16 rates come in, smaller firms will begin to auto-enrol their workers into workplace pensions. And whilst business is keen to help their employees to save for the future, this will reduce the amount of money left in the pot for pay rises.

6. Finally, with 747,000 young people unemployed it's vital that NMW rates help young people get their foot on the career ladder. Unaffordable upratings risk pricing them out of the market, which is the worst thing that could happen. Especially when you consider the scarring effects a period of unemployment early on in working life has on a young person.

1. The NMW must continue to be the UK's only wage floor, recommended by a politically independent LPC

7. The NMW, determined by an independent, evidence-based LPC, has been one of the most successful policies of recent times so there is no reason to change tack now.

The NMW, recommended by an independent evidence-based LPC, has been a success…

8. The remit of the LPC, clearly set out in its Business Plan, is to recommend NMW rates which *"help as many low paid workers as possible without any significant adverse impact on employment or the economy"*, a goal which the CBI continues to support.[1]

9. In fulfilling this remit, an independent LPC undertakes an evidence-based assessment considering a broad range of economic factors including unemployment, productivity and the wider economic climate, as well as potential effects on employment practices within firms – on differentials, the wider benefits package and on hiring. This process enables the final recommendations to strike the right balance between supporting jobs and growth whilst also maintaining strong pay minima.

10. Since its introduction in 1999, the NMW and the efforts of the LPC have enjoyed strong support from the business community. The independence of the LPC and the evidence-based approach it has always employed have been the cornerstones of business backing for this important policy.

11. And this is an approach which has proven its worth over time with a considerable body of evidence confirming that there have been little or no negative effects on employment as a result of the introduction of, and upratings to, the NMW. In short, over the last decade the LPC has consistently achieved its goal, increasing the NMW to the highest possible level without increasing the number of jobseekers.[2]

…and there is no need to meddle with such an effective policy…

12. Since the recession began there has been a significant squeeze on living standards which has ignited the debate about the role of the NMW in tackling low pay. Real pay is 7% below pre-recession levels and 20% behind where it would have been had pay continued to grow as it did before the crisis.[3] And, whilst the majority of people have felt the pinch, it has been those on the lowest incomes who have been hardest hit by inflation.

13. To tackle this challenge the political parties have proposed a number of changes to the NMW and the LPC. Business is clear that none of these are the right answer. They tackle the symptoms, not the causes of low pay and we are deeply concerned.

14. For example, the Labour Party has said that, should they win the general election, they would target the NMW to 58% of median earnings by the end of the next parliament and, earlier this year, the Chancellor of the Exchequer said that he would like to see the value of the NMW rise to £7 an hour by 2015, restoring it to its pre-recession value, adjusted for inflation. Both these suggestions are counterproductive. The LPC makes judgements based on the considerable independent expertise of its Commissioners, setting the NMW at the highest rate possible without putting jobs at risk. Raising the NMW in any other way would put serious strain on businesses, particularly hard-pressed smaller firms with tight margins, which would end up employing fewer people. The LPC has proven its effectiveness, so there is no reason to change tack now.

15. Sector NMWs have also been suggested as a tool for tackling low pay but this approach is flawed. Proposals for sector NMWs ignore the fact that in a modern economy businesses operate across sectors and fails to appreciate that the ability of business to afford higher pay varies within sectors as much as between them. For instance, the margins of a small shoe shop on Hackney high street, a retailer with multiple outlets across the country and a luxury online retailer are all likely to be very different. So, while this approach might improve pay rates for a few, where businesses are unable to afford a higher NMW they may be forced to cope by shedding staff or cutting back on the number of hours offered. Added to this, the simplicity of a single wage floor has been one of the major strengths of the NMW – changing this would only damage what is an extremely successful policy.

16. Elsewhere a move to mandatory living wages has been mooted as a way to tackle low pay, but this approach also puts jobs at risk. The methods used to calculate living wages are very narrow and fail to encompass a broader assessment of the health of the economy and the state of play in the labour market. This lack of rigour means that living wages are not an appropriate wage floor. The NMW

[1] *Business Plan 2014/15,* Low Pay Commission, 2014

[2] *Why has the British National Minimum Wage had no or little impact on employment?,* David Metcalf, 2007

[3] Office for National Statistics, Annual Survey of Hours and Earnings, deflated by CPI inflation

already maximises the wages of the lowest paid without causing unemployment and so pay levels over and above this must be left at the discretion of individual businesses. Illustrating this, while some firms (including CBI members) have chosen to pay living wages, for others this is not affordable and would put jobs at risk.

17. Finally, while a targeted NMW is not the way forward, greater certainty over future NMW rates would be helpful. It is the LPC that is best placed to do this. However, indications of the future path of the NMW must continue to be based on a balanced appraisal of a range of economic indicators. And, while understanding the future path would be helpful, this must only ever be an indication. Economic conditions can change and so to avoid any unintended consequences on jobs, hours and pay, the NMW must be responsive to any developments rather than an irreversible decision.

2. The 2014 award is likely to represent a significant rise above average wage growth and inflation

18. Although the LPC is concerned with the 2015/16 NMW rates, it is helpful to first look again at the impact of the upratings due to come into effect next month as this has significant implications for future increases.

19. In fact, conditions in the UK economy have not developed in the way many were expecting this time last year, which means that the forecasts the LPC took into account when recommending the 2014/15 NMW rates have not fully materialised. Productivity in particular remains 16% below where we would have been had the crisis not happened – a challenge which will only be partly resolved by future changes to the calculation of GDP – while wage growth has been sluggish at best.

20. This is very worrying. With productivity intrinsically linked to wages this has seriously impaired the capacity of business to raise pay and, as a result, a 3% increase in the NMW this October now represents a significant rise above average wage growth and inflation. So, to ensure businesses are not forced to cope with overambitious upratings by reducing employment, hours or the wider benefits package, it is critical that the LPC allows productivity to catch up by recommending only cautious upratings to the NMW rates for 2015/16.

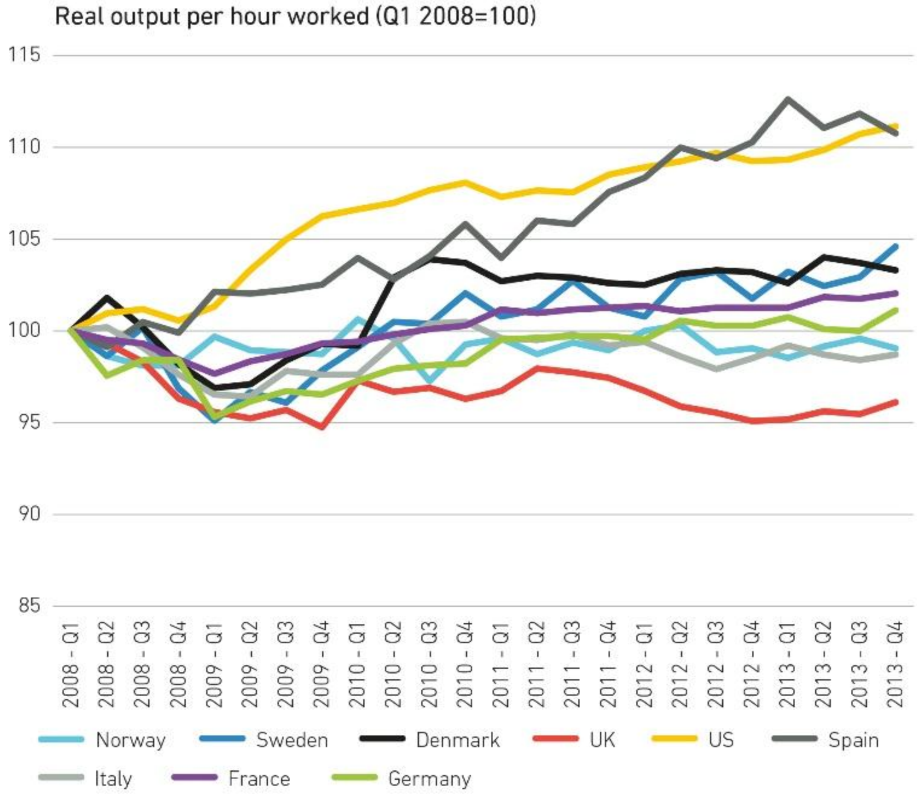
The economy is not where we thought it would be this time last year with productivity remaining worryingly low…

21. Although performance in the UK economy has continued to pick up as expected, productivity remains in the doldrums. Output has been rising since the beginning of 2013 and, very recently, surpassed its pre-crisis peak but at the same time productivity has remained worryingly weak.[4] Output per hour was up just 0.4% compared to a year ago so that by the first quarter of 2014 productivity was still a whole 4.3% lower than before the recession began and around a staggering 16% below where it would have been had the crisis not happened.[5]

22. This makes the UK stand out internationally as one of the few countries where productivity has failed to regain pre-recession levels. As Exhibit 1 shows, productivity has clearly recovered in the majority of countries including the US, Denmark and Sweden while the UK is still trailing behind.[6]

[4] Following the revisions to GDP data later this month, the pre-crisis peak is likely to have been reached by mid-2013
[5] Office for National Statistics, output per hour worked and *Making Britain work for everyone: Facing up to challenges in our labour market*, CBI, 2014
[6] *Making Britain work for everyone: Facing up to challenges in our labour market*, CBI, 2014

Exhibit 1: Productivity has recovered much faster in other countries



Source: CBI and Haver analytics

23. Drilling down further it's clear that the UK's low pay sectors have been particularly affected by the weakness in productivity. Take the 'other services' sector which includes the cleaning and hairdressing low pay sectors. While across the economy as a whole productivity is 4% below its pre-recession level, in this sector productivity is 11% below where it would have been had the crisis not happened. Likewise, in the accommodation and food services sector, which includes the hospitality low pay sector, productivity is still 5% below its pre-recession level.[7]

24. And the situation isn't likely to improve much during the rest of the year as increases in the NMW come into effect. In our forecasts we expect virtually non-existent productivity growth of 0.3% in 2014 while the Bank of England thinks that productivity will see only sluggish growth of just 0.5% in the second half of the year.[8] This unprecedented weakness has had serious implications for pay.

25. And, although changes to the way the ONS measures GDP are likely to revise down the size of the productivity gap, a significant shortfall will remain.[9] Indeed, although the changes due to be finalised at the end of the month are likely to show that productivity has been a little stronger than previously thought, it still fell significantly during the recession and, by the final quarter of 2012, remained 12% below its projected path had pre-crisis trends continued.[10,11]

…which has significantly impaired the capacity of business to raise pay…

26. Poor productivity performance matters because it has put a brake on the ability of business to boost pay. Pay is influenced by productivity both at the individual and firm level – and research by the CBI and the IFS has confirmed this, showing a positive relationship between productivity and wage growth in the UK's regions from 2007-11.[12]

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[7] Office for National Statistics, output per hour worked, Q1 2008 to Q1 2014

[8] CBI forecasts use output per workforce job to measure productivity and *Inflation report*, Bank of England, August 2014

[9] Analysis from the Bank of England shows that revisions could account for 2 percentage points (pp) of the 16% gap in productivity (relative to a continuation of its pre-crisis trend) and other measurement errors could account for a further 2pp. But, even accounting for this, a substantial gap remains

[10] *Economic Review,* Office for National Statistics, September 2014

[11] 2011 Census-based reweighting of the Labour Force Survey in October 2014 is likely to revise down the employment rate. However, the revisions will be relatively small (a fall of 0.1-0.2pp) and so do not solve the productivity puzzle

[12] *What can wages and employment tell us about the UK's productivity puzzle?*, IFS working paper W13/11 and *Making Britain work for everyone: Facing up to challenges in our labour market*, CBI, 2014

27. Such weak productivity has placed heavy downward pressure on wage growth this year. This has been compounded by the fact that – while unemployment has dropped quickly this year – levels are still high, meaning there is little upward pressure on wages when hiring, outside a few key skilled sectors.[13] Average weekly earnings in the three months to July showed regular pay was just 0.7% higher than the previous year. Looking across sectors, pay growth was slightly more sluggish in the service sector (0.6%), which includes many of the low pay industries, but very slightly stronger in the wholesale, retailing, hotels and restaurants sector (1.1%).[14]

…narrow margins and low inflation have also hampered pay growth…

28. On top of this, persistently narrow margins mean that for many businesses, including those in the low pay sectors, the money just hasn't been there to increase pay. Exhibit 2 shows how margins have changed relative to their average since 2000 and, while margins have seen a bit of a recovery very recently, they remain far below pre-recession levels. Echoing this, the Bank of England's regional agents recently found that for almost one third of businesses margins were below a sustainable level.[15] Clearly this is a factor which has limited the ability of business to increase wages as quickly as we had hoped this time last year (see Box 3).

Exhibit 2: Profit margins remain below pre-recession levels

Source: *Inflation Report, May 2014*, Bank of England

29. There is also very little scope for companies to fund wage rises by increasing prices. Producer prices, or the prices at the 'factory gate' fell by 0.3% in the year to August and are expected to rise to just 0.9% for 2014 as a whole. Similarly, GDP inflation, a slightly broader measure of prices, grew by just 1.6% in the first quarter of 2014 compared to a year earlier and will likely rise to just 2.4% for 2014 as a whole, according to the Office for Budget Responsibility.[16] Clearly this will hamper the ability of business to fund pay increases.

…putting hours, wider benefits and pay differentials under pressure…

30. Persistently low productivity and squeezed margins, combined with sluggish growth in the prices charged by business, leave us with a situation where a 3% increase in the NMW this October will now be a significant rise above growth in average wages. Indeed, this increase will be three times faster than our expectations for nominal average wage growth for 2014, at just 1%. And, with RPI inflation expected to average 2.6% this year, while wages for the average worker will have seen a significant decline in real terms, those on the adult NMW rate will again see their real earnings grow by comparison.[17] The likely result of this is explored in Box 1 – whereby firms will have to use a range of coping mechanisms.

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[13] 2011 Census-based reweighting of the Labour Force Survey is unlikely to change the unemployment picture
[14] Office for National Statistics, average weekly earnings, regular pay and RPI inflation
[15] *Agents' summary of business conditions*, Bank of England, June 2014
[16] Office for National Statistics, producer output prices and implied deflators, gross domestic product at market prices, *CBI economic forecasts*, CBI, September 2014 and *March 2014 forecasts*, Office for Budget Responsibility
[17] *CBI economic forecasts*, CBI, September 2014

31. Clearly, the 2014/15 award is now out of step with wider economic conditions and represents a very stretching increase for business. So to ensure recent employment growth (2.6% in the last year) is not eroded, and to minimise negative impacts on hours worked, the wider benefits package and differentials (see Box 1), it is absolutely critical that the LPC gives productivity time to catch up by recommending cautious upratings to the 2015/16 NMW rates.[18]

Box 1: Sharp upratings to the NMW risk negative impacts on hours, wider benefits and pay differentials

The approach taken by the LPC – to maximise the value of the NMW without causing unemployment – has, to date, been very successful. There is little evidence that the number of jobseekers has increased as a result of the annual upratings, because the LPC has taken an independent, evidence-based approach to recommending NMW rates which doesn't damage employment.

Yet it's important to remember that there are other ways in which employers have been forced to cope with increases in the NMW which have a negative impact on the people they employ:

- **A reduction in hours worked.** Evidence has shown that the introduction of the NMW led to a cut in hours of between one and two per week, an impact which was higher for women than for men. Confirming this, more recent research found that during the recession, instead of making employees redundant, firms absorbed the cost of an increase in the NMW through a reduction in hours worked.[19] Clearly, when employees work fewer hours this impacts negatively on their pay packets.

- **A reduction in the wider benefit package.** Wages are not the only way workers are rewarded for their efforts and evidence suggests that some businesses have, in the past, had to manage increases in the NMW by reducing the wider rewards they offer. Added to this, evidence from CBI members has revealed that increases in the NMW led them to re-evaluate the fringe benefits they have been able to offer their employees. This is also a risk as the 2014/15 NMW rates come into effect (see Box 2).

- **A squeeze on pay differentials.** Research has shown that in some workplaces, where pay is typically above the NMW but where settlements are still influenced by the NMW, the full upratings have not been passed on to staff therefore reducing pay differentials with firms that pay the NMW. Within firms, many CBI members report being unable to pass on the rate of uprating to staff on higher pay grades, causing a negative effect on firms' ability to reward staff development or those taking on a job with more responsibility.[20]

Box 2: Business views

"Competition is extremely high in the services sector and often based on price competitiveness. This means that margins are thin and businesses need to turn a lot of work to make a profit. This, combined with increasing costs and high volumes of staff on the NMW, means that any upratings have to reflect increases in productivity. There is a danger that employment will be negatively impacted if any increase is above inflation."
CBI member, public services sector

"Although we won't decrease the value of the total benefits package after this October's increase in the NMW, we'll be keeping a close eye on total costs – monitoring staff levels, the number of contracts that are extended, the number of new recruits and our capacity to offer a pension scheme which exceeds the market rate."
CBI member, retail sector

[18] Office for National Statistics, employment, May to July change on year. Note that 2011 Census-based reweighting of the Labour Force Survey due to be implemented in October this year may revise up employment levels slightly
[19] *Why has the British National Minimum Wage had no or little impact on employment?,* David Metcalf, 2007 and *The influence of the National Minimum Wage on pay settlements in Britain*, NISER, 2014
[20] *Employer strategies in the face of a National Minimum Wage: an analysis of the hotel sector,* Brown & Crossman, 2000 and *The influence of the National Minimum Wage on pay settlements in Britain,* NISER, 2014

3. Although the economic outlook has improved there are risks to its sustainability

32. As we've seen, challenges around productivity, narrow margins and inflation mean that this year's upratings to the NMW are more stretching than previously anticipated. This provides an important backdrop for the LPC when thinking about the potential for further rises in 2015/16 which we turn to now.

33. Our view is that while at the headline level the UK economy has continued to grow solidly, scratching beneath the surface reveals a less positive picture. For instance, growth hasn't been equally shared across the majority of low pay sectors and small firms continue to feel the pinch. Combine this with worryingly low productivity and subdued levels of business investment and it's clear that, to avoid job losses in sectors providing low paid employment, cautious upratings to the NMW in 2015/16 are necessary.

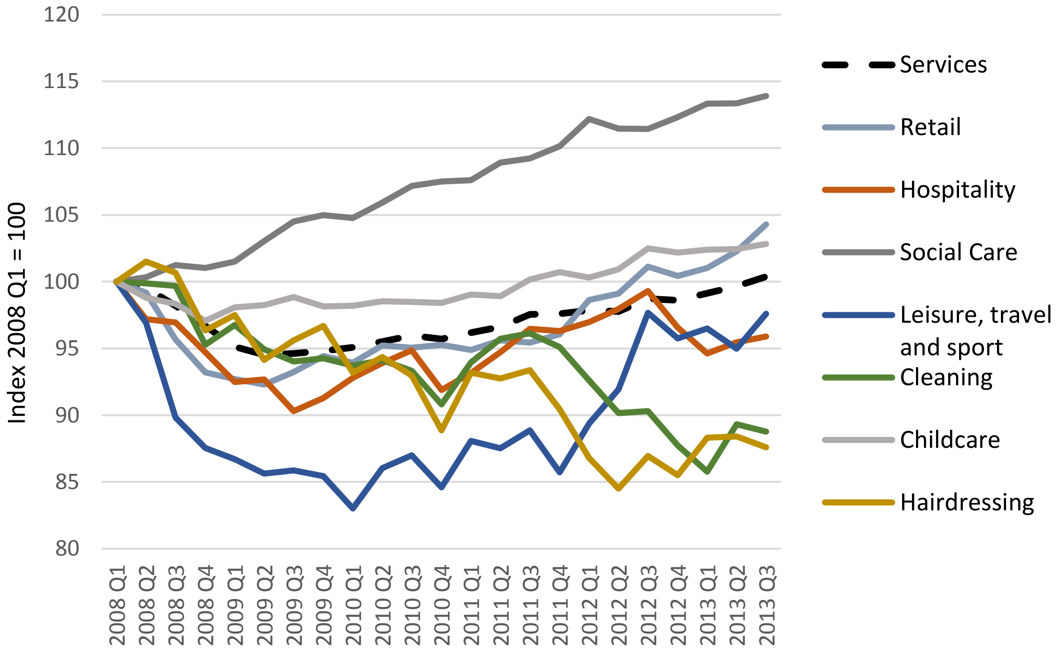
UK economic growth has continued, but the recovery is not yet equally shared across sectors or firm sizes

34. As this year draws to a close, we expect quarterly GDP growth to weaken slightly from 0.8% in the second quarter of 2014 to between 0.6% and 0.7% in each quarter for the rest of this year and 2015. This translates into GDP growth of 3.0% this year and 2.7% next year.[21]

35. However, while this is better performance than seen in many other economies this hasn't been shared equally across sectors. For example, while output in the service sector as a whole regained its pre-recession level in the third quarter of 2013, this was not the case in the hairdressing and cleaning sectors where output was still over 10% below pre-recession levels. Similarly, at this point in time output in hospitality and leisure, travel and sport was still 4% and 2% lower respectively than before the recession (see Exhibit 3).[22] And turning to the manufacturing sector, also a provider of some low paid employment, output has still not climbed back up to pre-recession levels. All this will be important for the LPC to bear in mind as changes in the NMW have a significant impact on these sectors.

36. And even in the retail sector where performance got back on track more quickly, strong sales growth has slowed slightly and is expected to continue to do so.[23] Further, and as Box 3 describes, some parts of the retail sector are still facing headwinds.

Exhibit 3: The recovery in output has been weak in many low pay service sectors[24]



Source: Office for National Statistics

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[21] *CBI economic forecasts*, CBI, September 2014

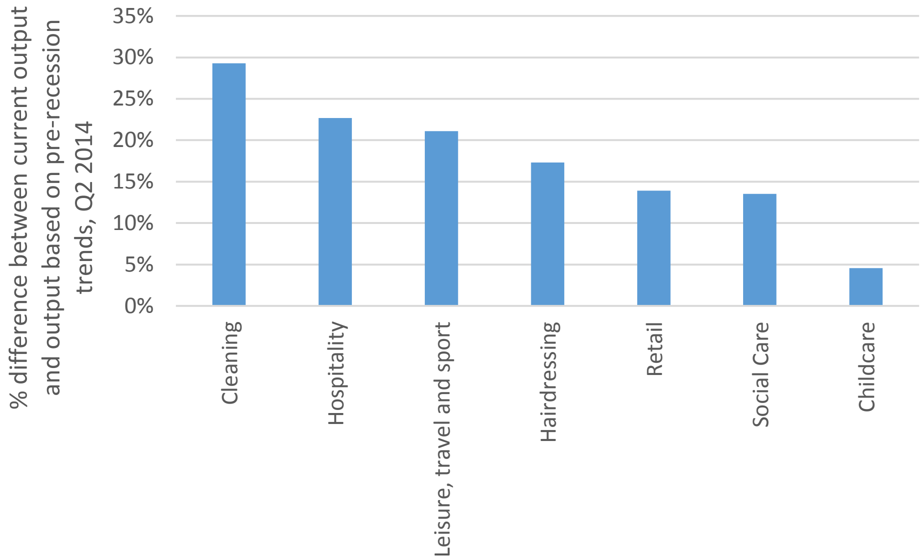
[22] Office for National Statistics, GVA chained volume measure

[23] *Distributive trades survey*, CBI, September 2014

[24] Low pay sectors have been approximated using SIC 2 digit GVA data so in some cases output may be overestimated

37. On top of this, we've lost a lot of ground compared to where we would have been had the economy continued to grow as it did before the crisis. For example, output in the cleaning, hospitality and leisure, travel and sport low pay sectors would have been at least 20% higher in the first quarter of 2014 had growth continued at pre-recession rates (see Exhibit 4).[25] The LPC must ensure that the NMW remains in step with conditions in these low pay sectors.

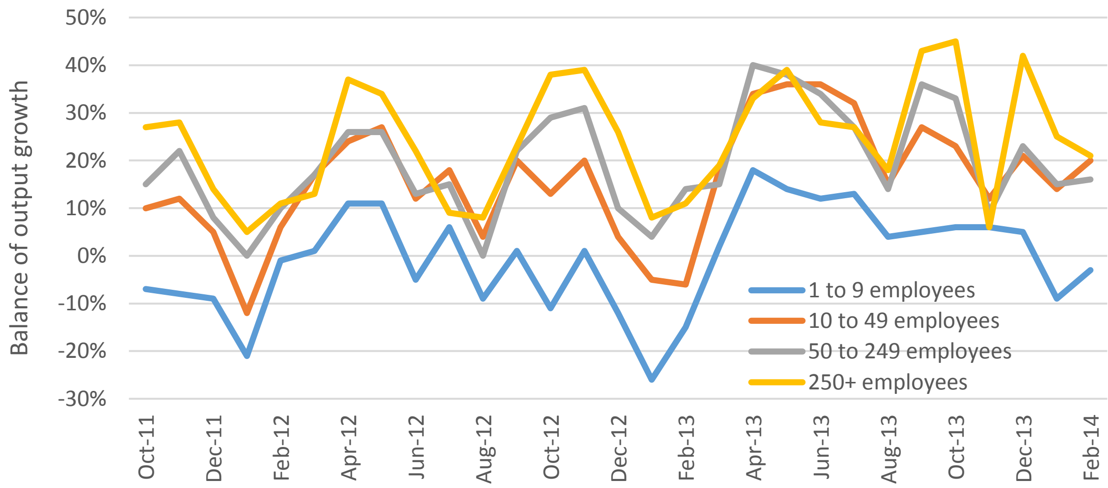
Exhibit 4: Output would be significantly higher today had pre-recession trends continued



Source: Office for National Statistics

38. And it's not just the low pay sectors that have continued to feel the pinch, small firms have seen a slower recovery too (see Box 3). We know that the effects of NMW rises are felt more acutely in small firms – a fact which is often lost in the public debate when, for instance, the retail sector is equated to only the big supermarkets. Illustrating this, evidence from the Bank of England's agents has shown that in July 2013 larger firms' margins were closer to normal levels than those of small firms.[26] And output growth for micro businesses – which employed 3.7 million people in 2013 – has been consistently lower than for larger businesses even turning negative at times (see Exhibit 5).[27] This evidence clearly indicates that small firms just can't afford overambitious upratings in the NMW and such moves risk derailing the recovery for smaller firms, jeopardising the positive employment growth of 2.6% we have seen over the past year.[28]

Exhibit 5: Output growth amongst micro businesses has been relatively slow



Source: *Growth dashboard July 2014*, Department for Business, Innovation and Skills, 2014

[25] Office for National Statistics, trend growth calculated using the compound annual growth rate between Q1 2000-08
[26] *Agent's Summary of Business Conditions,* Bank of England, July 2013
[27] Micro businesses have between one and nine employees. *Business population estimates for the UK and regions 2013*, Department for Business, Innovation and Skills, 2013
[28] Office for National Statistics, May to July change on year

Box 3: Business views

"When the NMW increases in October we won't be able to absorb this as our margins are already very thin and, as we need to keep investing in the upkeep of the hotel to remain competitive, the only alternative is to put our prices up. But price competition is so strong these days there's always a worry that consumers will simply go somewhere else which would clearly be bad for business and the amount of work we're able to offer our employees too."
- CBI small member, hospitality sector

"From our perspective it's still early days on the recovery. Some sectors have done better than others. Take the retail sector, some firms have been doing well, but other players are really struggling. And the recovery has been uneven in geographical terms too; London has steamed ahead while growth has been at a slower pace elsewhere and therefore customers are maintaining a high level of price sensitivity."
- CBI member, public services sector

The three tests we set out last year for faster rises are unlikely to be fully met next year, making cautious upratings a necessity

39. In our submission to the LPC last year we set out three tests – productivity growth, a broad based recovery and low unemployment – which the economy must pass before significant increases in the NMW are justifiable. Thinking about upratings for 2015/16, we've been pleased to see that some progress has been made but productivity remains worryingly low, consumer spending has continued to drive growth, business investment is weak and unemployment is still too high.

Upratings which move ahead of productivity risk damaging employment growth

Productivity will start to recover in 2015, feeding through into wage growth…

40. We know that productivity growth will remain weak this year, and we expect to see only a slow revival as we move into 2015. For example, as demand continues to pick up the resources firms may have put into 'business development' activities or winning new work during the crisis will increasingly generate returns while at the same time levels of business investment will rise, supporting improvements in productivity. As a result, we expect productivity growth of 1.5% in 2015, compared to growth of just 0.3% in 2014.[29]

41. More positive productivity performance will then start to provide the boost business needs to increase wages. Although the link between the two has been questioned, CBI research, described in Box 4, shows that this link is not broken. This suggests that improvements in productivity, which are discussed further below, will start to contribute materially to wage growth next year.[30]

Box 4: The link between pay and productivity is not broken

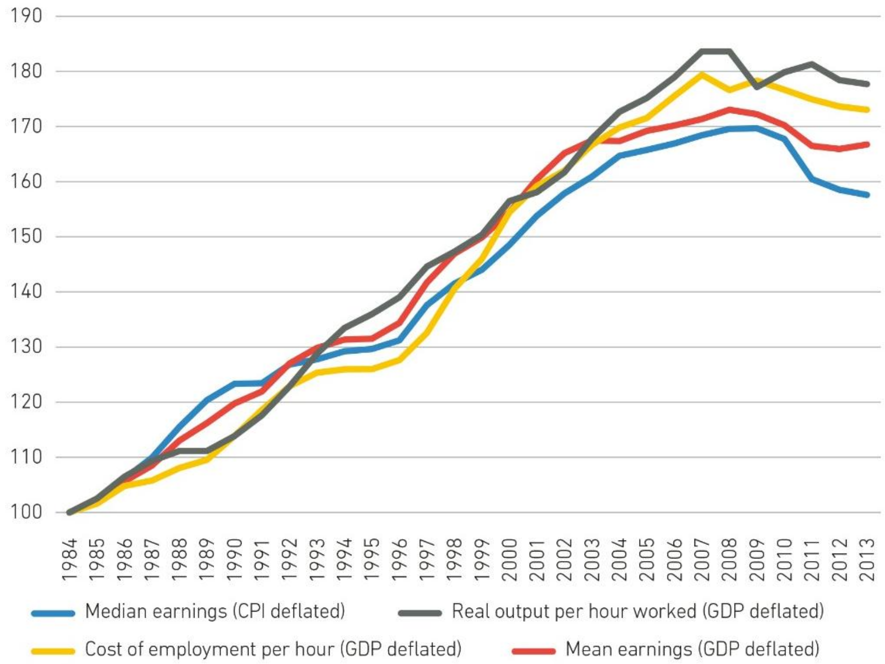
It has been observed that growth in the median wage has not kept pace with the growth in aggregate productivity in the last 30 years. But as we show below, this is not because the link between pay and productivity is broken. Productivity growth remains the ceiling for potential pay growth and the gap that can be seen as the result of three other factors.

- First, in recent years, the prices paid by consumers have been rising faster than the prices UK business have received. Reasons for this include relatively large increases in the cost of imported items like food and energy as well as increases in VAT. As a result, business income hasn't risen fast enough to afford pay rises that offset the rising cost of living. Comparing wages net of GDP inflation rather than net of CPI inflation narrows the decoupling observed (see Exhibit 6)
- Second, comparing wages and productivity does not account for non-wage labour costs. Employing a worker has become more expensive as non-wage costs – such as pensions and taxes – have risen. These additional costs have to be met out of the value created by productivity growth, but doesn't end up in a worker's take home earnings

[29] *Making Britain work for everyone: Facing up to challenges in our labour market*, CBI, 2014, *The UK productivity puzzle, quarterly bulletin 2014 Q2*, Bank of England, 2014 and *CBI economic forecast,* CBI, September 2014
[30] *CBI economic forecast,* CBI, September 2014

- Finally, a gap is observed because the median worker's wage is compared to aggregate productivity, yet productivity growth has been concentrated in higher paying sectors. This element of the gap highlights the importance of driving productivity growth in every sector, so that all workers benefit from higher productivity.

Exhibit 6: There is a strong link between the cost of employing workers and productivity



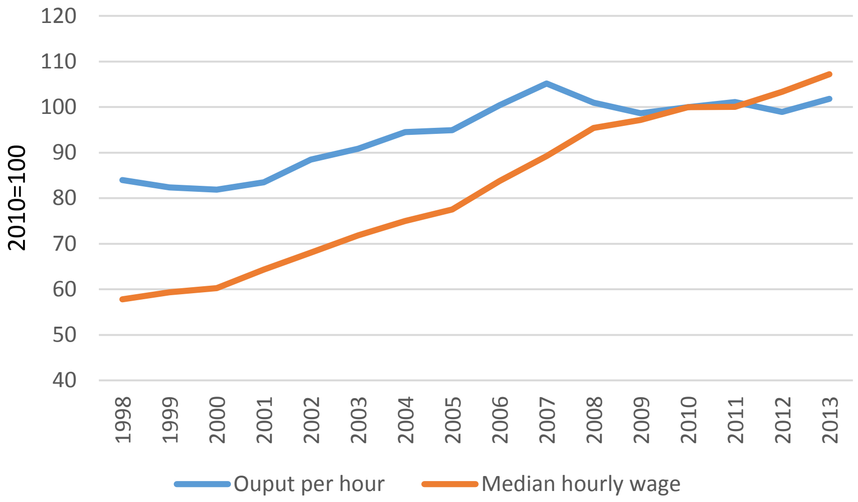
Source: *Making Britain work for everyone: Facing up to challenges in our labour market*, CBI, June 2014

…but productivity growth will still remain weak by historical standards and upratings to the NMW must reflect this

42. Yet while productivity will get better next year it will still be worryingly low by historical standards. In the decade prior to the downturn productivity grew on average by 2.4% per annum, a whole 0.9 percentage points (pp) faster than our forecast for 2015. Upratings which outpace productivity pose a real risk to employment and hours so the recommendations made by the LPC must be cautious to reflect the fact that productivity performance next year will not be on a par with conditions prior to the crisis.

43. This will be particularly important in some of the low pay sectors where there is some evidence that pay has started to outpace productivity. In particular, we see evidence of this 'positive decoupling' in sectors like retail trade & motor vehicle repair, textiles, wearing, apparel & leather, wholesale, and accommodation & food services. With jobs and hours offered in these sectors already at risk from substantial increases in the NMW this year, overambitious increases in 2015/16 will only add to this challenge. These sectors provide a large number of low paid jobs so, to avoid putting their jobs at risk, it is critical that future increases in the NMW do not outpace productivity.

Exhibit 7: Growth in pay has moved ahead of productivity in the wholesale, retail trade and motor vehicle repair sector



Source: Office for National Statistics, CBI analysis

44. Added to this, overambitious upratings will damage the prospects of the UK's small and medium sized firms – the lifeblood of the UK economy. These businesses make an important economic contribution accounting for 59% of private sector employment. Their importance also extends to the low pay sectors where, for example, 73% of employment in the human health and social work activities sector and 59% of employment in the accommodation and food services sector, which incorporates the childcare and hospitality low paying sectors, is provided by small and medium sized firms. [31]

45. Despite their importance to the UK economy, on average small and medium sized firms tend to be less productive than larger firms. Indeed, productivity is 18% lower in small firms and 11% lower in medium sized firms than in larger businesses. This pattern holds across most, but not all sectors. For example, in the accommodation and food services, information and communications and arts and leisure sectors (which incorporate the hospitality and leisure, travel and sport low pay sectors) productivity does increase with firm size. But, in the wholesale and retail and 'other services' sectors (which includes the hairdressing and cleaning low pay sectors), productivity performance is stronger in businesses with between 10 and 49 employees but weaker in those with between 50 and 249 employees.[32] However, because this data looks at the value added by each employee instead of per hour worked, larger firms in some service sectors can seems less productive. This is largely due to the fact that large firms in such sectors, like retail, often have many employees working part-time. Technical details aside, lower productivity on average amongst small and medium sized businesses means that, for the majority of these firms, scope to increase pay is low. As a result, cautious upratings to the NMW are necessary to avoid damaging prospects for these businesses and the people they employ.

46. Ultimately, improvements in productivity will be key to achieving sustainable wage growth which means challenging business to make changes and work smarter. This is a major topic of work for the CBI this year and our research project, *Ensuring growth makes a difference to everyone*, will be making recommendations to business and government around boosting productivity in November. Our team will share this with the LPC on publication.

The recovery is not yet broad enough based to support ambitious upratings in the NMW

Consumer spending continues to drive the recovery meaning growth remains unbalanced…

47. Consumer spending has continued to be a major source of the UK's growth. In 2013 GDP grew by 1.7% with the lion's share coming from household spending (1.3pp).[33] Looking to next year we expect strong levels of consumer spending to continue, accounting for around half of GDP growth.[34]

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[31] *Business population estimates for the UK and regions 2013*, Department for Business, Innovation and Skills, 2013
[32] Annual Business Survey, approximate GVA per employee, 2012 data
[33] Office for National Statistics. ONS GDP revisions show that in 2012, household final consumption expenditure contributed 0.9% to GDP growth, unchanged from previously published data
[34] *CBI economic forecast,* CBI, September 2014

48. This is a worry because, to be sustainable, the recovery must be fuelled by more than just consumer spending. Indeed, we've now seen spending increase for 10 consecutive quarters but, worryingly, this has been fuelled in part by consumers' savings – the saving ratio fell from 6.4% in the third quarter of 2011 to 4.9% in the first quarter of 2014.[35] And, despite the positive picture painted by retailers responding to our distributive trades survey, a decline in consumer spending would have a considerable negative impact on the health of this sector.[36]

49. As the next sub-section discusses, for a sustainable recovery we need to boost business investment as this will improve the productive potential of the economy, expand the ability of business to meet consumer demand from home and abroad and increase innovation. The LPC must therefore be mindful not to cut off business investment by recommending overambitious upratings to the NMW.

…and business investment remains below pre-recession levels…

50. Reviving levels of business investment is critical for improving productivity and enabling sustainable pay growth. But business investment took a massive hit during the recession with a peak to trough fall of 30% and it remains low today at a staggering 16% below its pre-crisis peak. Furthermore the UK doesn't perform well by international standards – total fixed investment as a share of nominal GDP has been the lowest amongst the G7 since the 1970s.[37] This is a worry given the key role the investment of corporate capital plays in driving up productivity and therefore in determining wage growth.

51. Although business investment will start to pick up next year it will still be a substantial 4% below its pre-crisis peak by the end of 2015. When considering upratings to the NMW the LPC will therefore need to be aware that over ambitious increases could reduce the amount of money in the pot for investment, hampering improvements in productivity. This is particularly important in low pay sectors where, because wages make up a large share of total costs, increases in the NMW can form a significant barrier to business investment.

52. It is worth noting that although ONS revisions are likely to revise up levels of business investment it has still been extremely low for a sustained period.[38] This has led to a deterioration in the amount of capital stock available per worker, a major determinant of productivity. This will reduce the propensity for growth to become broader based.

53. And finally, while it is positive to see access to finance, one key driver of investment, steadily improving there are growing risks ahead. Future interest rate rises will necessarily increase the cost of capital potentially putting a drag on businesses ability to invest, with small and medium sized firms particularly vulnerable here. When this is combined with heightened political risks and increased uncertainty at home and abroad it is vital that upratings to the NMW do not act as a further drag on business investment.

…and export growth looks set to remain weak

54. Exports are an important element of a balanced recovery but they've made little contribution to the recovery so far and this is a trend which, unfortunately, doesn't look set to change quickly. Reflecting this, firms responding to our industrial trends survey pointed out that new export orders were flat as were export deliveries.[39] And looking forward, while exports will pick up next year we expect that import growth, fuelled by stronger demand from consumers at home, will offset this. So the export growth of 3.9% we are predicting for 2015 will be almost completely cancelled out by import growth of 3.5%.[40]

55. On top of this, if the strength of the pound continues this will reduce the attractiveness of the UK's goods and services. In the past year Sterling has appreciated by 8% which has squeezed thin margins further.[41] And, because there is always a limit to what business can absorb, further strengthening could

[35] Office for National Statistics, consumer spending and household savings ratio
[36] *Distributive trades survey*, CBI, September 2014
[37] *Invested interest the long term investment challenge facing the UK economy,* CBI, 2014
[38] For example, the reclassification of R&D expenditure as fixed investment. *Economic review,* Office for National Statistics, September 2014
[39] *Industrial trends survey,* CBI, July 2014
[40] *CBI economic forecast,* CBI, September 2014
[41] Bank of England, Sterling effective exchange rate, monthly average between, Aug 2013-14 and *Inflation Report,* Bank of England, August 2014

to hit export volumes. Confirming this, a Bank of England survey found that a further 10% rise in the value of the pound would have an adverse effect on goods export volumes.[42] Declining volumes on top of thin margins would clearly restrict the affordability of pay rises.

56. And continued poor performance in the Eurozone poses a threat to export growth too. The Eurozone is the UK's most important trading partner so it is concerning to see that the recovery has continued to disappoint. Moreover, with the threat of deflation and the impact of sanctions on Russia hanging over the Eurozone prospects are less than positive.

57. More broadly, there are also risks to the health of the UK economy stemming from the ongoing Russia-Ukraine crisis. And although the UK's direct trade links with these countries are relatively small, there are broader risks from global contagion including upward pressure on commodity prices and instability in global financial markets.

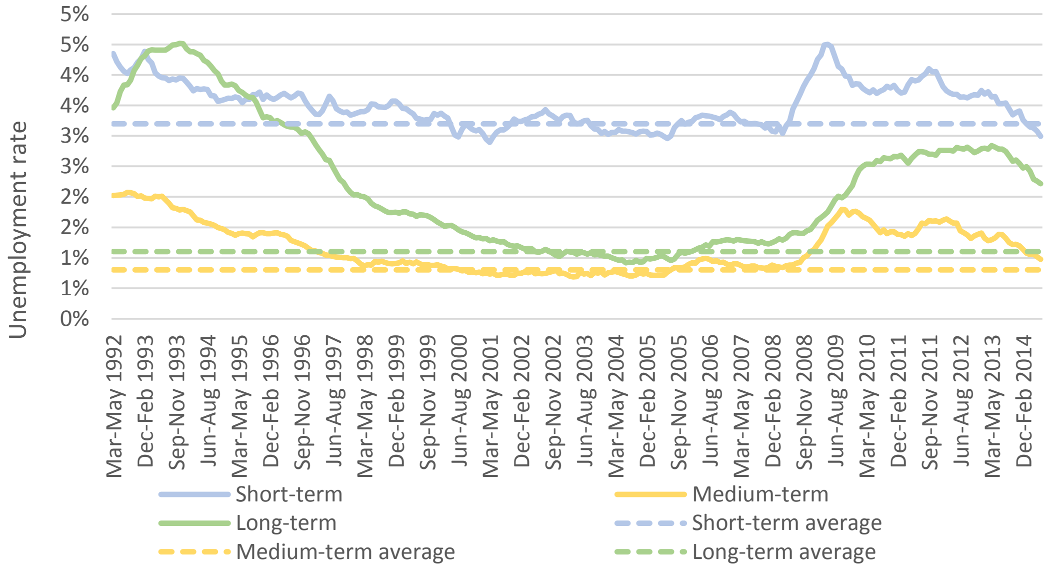
Increases to the NMW must not choke off employment prospects for jobseekers

58. The third and final test the economy needs to pass before ambitious upratings in the NMW are possible is low unemployment. But our analysis indicates that there is still some way to go on this front. First, unemployment has been falling but remains higher than before the crisis, particularly amongst the long term unemployed. And second, for those already in employment a significant share of part-time workers would like to take up full-time work. As a result, cautious upratings to the NMW are necessary to ensure the unemployed are not priced out of work and to avoid a reduction in the hours business are able to offer their employees.

59. Although unemployment has been falling, there are still more jobseekers today than before the crisis started. In the three months to July there were 400,364 more people unemployed compared to the first quarter of 2008.[43] And, with the unemployment rate at 6.2%, this is still 0.94pp above the long run unemployment rate.[44,45]

60. Added to this, it is concerning to see that unemployment remains stubbornly high for those who have been out of work for the longest period. As Exhibit 9 shows, while the rate of short and medium term unemployment has broadly fallen to pre-recession levels, unemployment remains worryingly high for those who have been out of work for over 12 months. These people will face particular barriers to getting into work, which is why a low NMW is so important to supporting them.

Exhibit 9: Long term unemployment remains substantially above pre-recession levels



Source: Office for National Statistics

[42] *Agents' summary of business conditions,* Bank of England, August 2014
[43] Office for National Statistics, September labour market statistics
[44] The OBR estimates the long run structural unemployment rate to be 5.25%
[45] Census-based reweighting of the Labour Force Survey in October is unlikely to change the unemployment picture

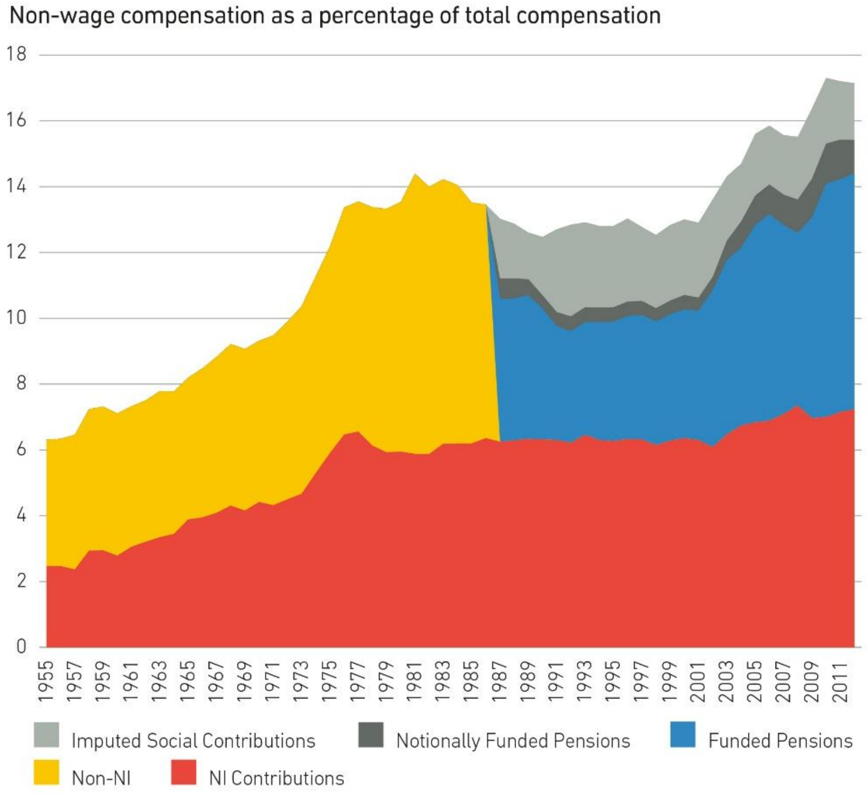
61. Looking forward, by the end of the year unemployment will still be higher than before the recession began. Our forecasts see unemployment reducing at a slower pace in 2015 which means that by the end of the year – around the time of the next award – the unemployment rate will remain 0.5pp above the pre-recession unemployment rate and 0.45pp above the long run full unemployment rate. So, to give the unemployed the best possible chance of finding work, it is critical that future upratings to the NMW are not overambitious.

62. But the NMW does not just have an impact on jobs, it also has an impact on the number of hours firms are able to offer. Looking at labour market data it is clear that demand for additional hours still exists amongst employees with the share of part-time workers who couldn't find a full-time job still standing 7pp higher than before the recession.[46] Given this, it will be important that future increases in the NMW are cautious and affordable to enable businesses to offer the additional hours their employees would like to work.

4. Uncertainties around the cost base have real potential to constrain companies' ability to pay more

63. Over time the share of company income transferred to employees as wages has decreased because spending on other costs of employment – driven by new regulations and legislative changes – have risen. Looking back over the past 50 years the cost of employment as a share of company income has remained broadly stable. However, within this total, wages taken as cash have fallen as a percentage of business income. This is because other costs of employment, like pensions and national insurance, have diverted spending away from pay (see Exhibit 10).

Exhibit 10: Pensions and taxes have risen as a proportion of the cost of employing workers



Source: Analysis by Oxford Economics System of National Accounts data

64. Further increases in these types of costs will reduce the money business has in the pot for pay rises. This is worrying given that two significant costs are on the horizon – potential changes to the way holiday pay is calculated and pensions auto-enrolment. These have the potential to increase the cost base business is facing and, as a result, cautious upratings to the NMW are necessary.

65. First, potential changes to the way holiday pay is calculated could add significantly to the cost base for business. Indeed, employers are facing the risk of significant additional costs – and potentially millions of pounds of backdated claims – from tribunal cases challenging the normal calculation of holiday pay.

[46] Office for National Statistics, September labour market statistics

Businesses face an uncertain wait to see how the Court of Justice of the European Union's ruling that commission payments fall within the concept of normal pay will be implemented in the UK, and for the outcome of related cases arguing that overtime payments should be included in holiday pay. If the existing UK calculation of holiday pay is struck down businesses face significant potential costs, including:

- The additional cost of including these parts of remuneration in holiday pay in the future – estimated by some affected CBI members at an ongoing cost of around 2-4% of labour costs
- The additional administrative burden of having to calculate holiday pay against a reference period
- If liabilities are backdated firms face major costs reaching tens of millions of pounds. Some of our mid-sized members have said this would push their otherwise profitable business into insolvency.

66. This means change to the existing definition of holiday pay will have stark implications on jobs, hours and pay as Box 5 illustrates.

Box 5: Business views

A CBI member in the logistics sector has postponed a planned 3% pay increase due to the risk of facing a £2.5m backdated liability and 2-3% increase in wages if overtime payments are deemed to be linked to basic pay.

Following the Court of Justice of the European Union's ruling on commission payments a CBI member in the food and drink sector has calculated that, if backdated payments were limited to three months, they would face a cost of £500,000 and an ongoing cost of around 3% extra on their pay bill, before accounting for administrative costs or any additional pension or tax contributions. This cost could not be passed on to customers and comes in the wake of other significant increases to employment costs such as auto-enrolment.

67. Second, the significant costs of pensions auto-enrolment are increasing the cost of employing staff, particularly for smaller firms who are often less able to absorb increases in the cost of employment. From April 2015 small businesses will start to enrol their employees in workplace pension schemes to which employers' contributions will rise from 1% to 3% of qualifying earnings over the transitional period to 2018. With private sector small businesses employing over seven million people this is a significant undertaking for these firms.[47]

68. Worryingly, a survey by the CIPD found that a quarter of small and medium sized firms anticipated that they would need to reduce pay growth to cope with this extra burden, while a fifth expected to freeze pay in order to absorb the additional costs associated with auto-enrolment. And it is not just wages that are likely to be affected with a quarter of small and medium sized firms highlighting that they would be forced to make reductions to the wider benefits package they offer such as bonus payments or overtime.[48]

69. While the CBI is supportive of this reform, which will help build a sustainable pensions system to the benefit of both employees and business, the evidence clearly shows that this makes it more expensive for business to employ workers. This will be particularly the case for low paying industries where employees are less likely to already be enrolled into a workplace pension scheme. For these businesses absorbing significant increases to the wage bill will be a challenge, so added costs from an increase to the NMW must be manageable. There are also substantial set-up costs in navigating the new system, which have concerned larger employers already. Indeed, the cost of preparing for auto-enrolment has been estimated at £8,900 per small business – a substantial cost which will fall on these firms in NMW year 2015/16.[49]

5. Youth rates must be competitive to help young people get their foot on the career ladder

70. A period of unemployment early on in working life has significant scarring effects which is why we must treat young people's futures carefully.

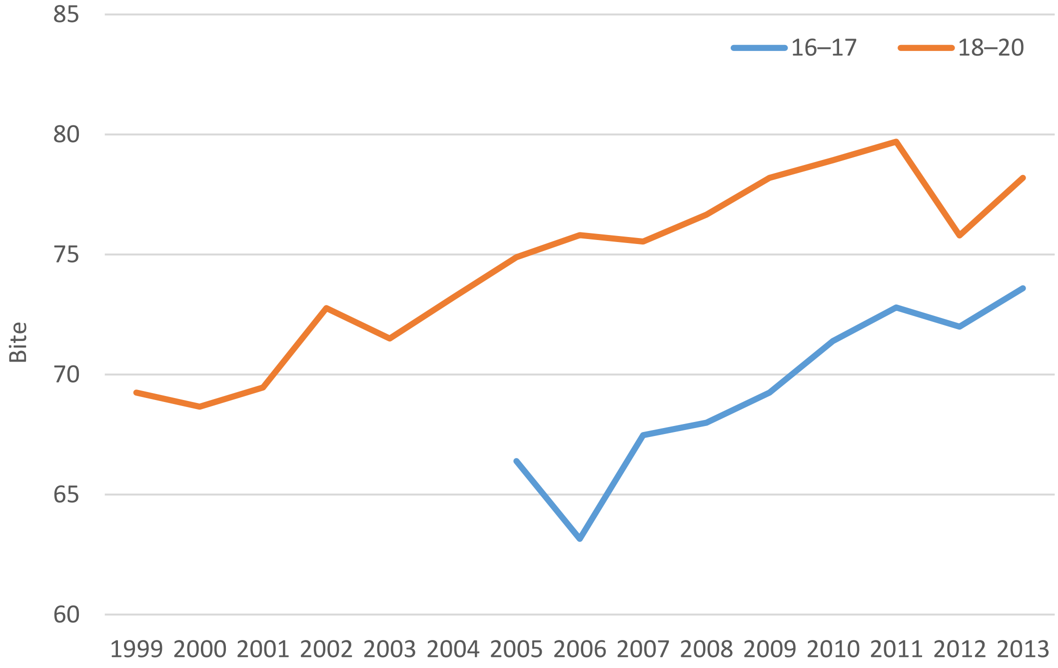
[47] *Business population estimates for the UK and regions 2013*, Department for Business, Innovation and Skills, 2013
[48] See: http://www.cipd.co.uk/pm/peoplemanagement/b/weblog/archive/2013/12/10/plan-now-for-pension-auto-enrolment-smes-warned.aspx
[49] Centre for Economic and Business Research

71. Although recent improvements in the labour market have benefited young people, high levels of youth unemployment remains a real concern. In the three months to July there were still 747,000 unemployed young people, 60,800 more than before the recession.[50,51] And, even as the recovery continues to strengthen, young people will still face a number of hurdles as they make their way in the labour market. More specifically, young people typically have less experience and lower skill levels compared to older people who have already spent a significant amount of time in the workplace.

72. This is why NMW rates, graduated by age, are so important. They help offset the additional costs – training, for example – that a business can incur when taking on a young person. Illustrating this, during the recession, anecdotal evidence from our members suggests greater use of the youth rates allowed increased flexibility to save cost but, importantly, still keep young people in employment. We would therefore encourage the LPC to retain this structure to support young people's competitiveness.

73. Added to this, when considering changes to NMW rates for young people the LPC should focus on ensuring young people are not priced out of a job as it is well known that a period of unemployment early on in working life is scarring – not only does it increase the risk of future spells of unemployment it also imposes a wage penalty.[52] This is why we called for a freeze in the youth rates during the worst of the downturn. With the 'bite' of the youth rate – the NMW as a proportion of median earnings – having increased steadily since the introduction of the NMW increasing this further would, quite simply, put jobs for young people at risk (see Exhibit 11).[53]

Exhibit 11: The bite of the youth rates have been increasing over time



Source: Office for National Statistics, before 2010 21 year olds were also covered by the youth development rate

6. To encourage quality apprenticeship provision those who reap the rewards must also share the costs

74. Apprenticeships are an important way to help young people prepare for the world of work and we need to encourage more employers to offer them. To do this a tripartite funding model – whereby employers and government invest in training and employees contribute through a lower wage – must continue to

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50 Office for National Statistics, September labour market statistics

51 Census-based reweighting of the Labour Force Survey in October is unlikely to change the unemployment picture

52 *Youth unemployment: the crisis we cannot afford*, ACEVO, 2012, and *The wage scar from youth unemployment*, Gregg & Tominey, 2005

53 *Final government evidence for the Low Pay Commission's 2014 report*, Department for Business, Innovation and Skills, 2014. Note the bite of the NMW for 16 to 17 year olds stands at 73% but the raising of the participation age means the relevance of this rate is somewhat reduced

operate. And second, a review of the structure of apprentice NMW rates should be postponed until the reforms currently underway are embedded.

75. Apprenticeships are a key way to help young people build the knowledge and practical experience they need to be successful in work and life as well as delivering the skills business needs to be competitive. Given this, we need to encourage more employers to offer high quality apprenticeship opportunities, particularly small and medium sized firms. The programme of reforms currently underway, if got right, have the potential to do this – by making apprenticeships more responsive to employer demand, businesses will see their value and really feel the benefit of offering more quality apprenticeship opportunities.

76. However, another way to increase quality provision is to ensure the cost of delivering apprenticeships is shared between those who reap the rewards. This means that the cost of the significant investment the employer makes in training and support is shared between the employer, government and the apprentice, through a lower wage. This is a reasonable ask when you consider that apprentices in Germany actually earn only about three quarters of pay received by their UK counterparts. Upratings to the apprentice NMW rate this year must maintain this balanced contribution (see Box 6).[54]

Box 6: Business views

"From our experience of working with, and advising, businesses on their apprenticeship offer our worry is that not all small and medium sized firms will be able to afford faster increases in the NMW apprentice rates. If rates increase by too much then our concern is that we'll see, in the first instance, a decline in the quality of the training given on the placements, then, over the longer term, a decrease in the number of places on offer."
- CBI member, education sector

77. On top of this, while compliance with the apprentice NMW rates is vital, and something the CBI fully supports, as there is little evidence to suggest this is a significant issue, a review of their structure should be postponed until the current reforms are embedded. This would also avoid adding additional layers of complexity thereby encouraging employers to offer more quality apprenticeships.

78. Although the structure of the apprentice NMW rate is relatively complex, anecdotally, we have not found this to be a challenge for CBI members. Added to this, while the 2012 apprentice pay survey did report concerns with noncompliance there are a number of reasons why this study may be misleading.[55] For instance, the survey took place around the time when the NMW rates changed so the pay data reported could easily have referred to previous pay packets. Given this, we believe the size of the noncompliance challenge has been overestimated. That said, as more and more businesses offer apprenticeships, it will be important for government to ensure awareness of the NMW rates that apply to apprenticeships is as high as possible.

79. Changes to the structure of the apprentice rate would also cause more confusion at a time when the way apprenticeships work is undergoing significant change. The current set of apprenticeship reforms are far reaching and need time to fully embed and we know that employers are already concerned about the pace of reform. As a result, changing the apprentice pay structure would simply lead to more confusion, ultimately putting businesses off engaging in apprenticeships.

80. Finally, it is important to note that NMW rates for both young people and apprentices should be seen as part of a broader package of solutions needed to help young people to get into, and stay in, work. On this topic we recently outlined the package of solution business believes is needed to support young people (see Box 7).

[54] *The environment for business in Germany, a commentary*, Civitas, 2014
[55] *Apprenticeship pay survey 2012: research findings*, Department for Business, Innovation and Skills, 2013

Box 7: *Future possible*: the business vision for young people

In our recent report, *Future possible*, we set out the support young people need to get into, and stay in, work:

- We need a structured programme of preparation for work in our schools. This means reforming the Ofsted framework, so that schools are incentivised to prioritise both academic progress and the development of "character"
- We need clear academic and vocational routes, which are equally valued, that young people can follow with confidence. This means developing a gold standard vocational equivalent to A-levels
- Business needs to step up to delivering the support young people need to get their foot on the career ladder. This means providing personalised feedback to candidates attending interviews or assessment centres and, for those that don't reach this stage, a list of general "top tips". It also means more high quality apprenticeships and a better careers system to help people find them
- And finally, young people need somewhere to turn when they find themselves out of work. This means introducing Back to Work Coordinators who can bring together all the support a young person might need and provide them with a single point of contact.[56]

7. Strong enforcement of the NMW is vital

81. The NMW is the UK's wage floor and it goes without saying that no business should ever pay its employees below this level. Reflecting this, high levels of compliance are vital to ensure low paid workers receive a wage which reflects their legal rights but also to reassure employers that they will not be undercut by other businesses paying less than the NMW.

82. The CBI fully supports strong enforcement where businesses have ignored the law and as such we have welcomed recent developments in this area. For instance, we welcome measures in the Small Business, Enterprise and Employment Bill which will allow employers to be fined up to £20,000 for every employee not being paid the NMW up from the previous £20,000 per business. More recently we were also pleased to hear the Deputy Prime Minister announce that *"the Government is upping the number of inspectors tasked, specifically, with identifying businesses hiring people, including migrants, for less than the minimum wage"*.

[56] *Future possible: the business vision for young people*, CBI, 2014