



Tim Butcher
Chief Economist and Deputy Secretary to the Low Pay Commission
6th Floor, Victoria House
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Dear Mr Butcher

Re: FSB response to Low Pay Commission's Consultation on the National Minimum Wage

The Federation of Small Businesses (FSB) welcomes the opportunity to respond to the above named consultation.

The FSB is the UK's leading business organisation. It exists to protect and promote the interests of the self-employed and all those who run their own business. The FSB is non-party political, and with approximately 200,000 members, it is the largest organisation representing small and medium sized businesses in the UK.

Small businesses make up 99.3 per cent of all businesses in the UK, and make a huge contribution to the UK economy. They contribute 50 per cent of GDP and employ 59 per cent of the private sector workforce.

The FSB welcomed the National Minimum Wage when it was introduced and continues to support the measure, provided that the rates set do not harm employment and business competitiveness. After several years of pay restraint, the FSB agrees that it is important that we start to see real wage growth across the economy. Small firms are starting to raise wages, with nearly 7 in 10 members expecting to increase wages over the next 12 months. It is right that the lowest paid also benefit as wages start to grow in real terms, which is why, at this stage in the economic recovery, we support gradual increases in the Minimum Wage.

Nevertheless, despite further positive signs of rising output, employment and business confidence, some sectors are still struggling and growth in business profitability is not widely shared. In sectors such as retail and hospitality, firms are still running tight margins and the impact of other non-labour costs – particularly utilities, rents and business rates - continues to be felt. We would again call on Commissioners to pay particular attention to these sectors when thinking about what rates the economy could afford next October.

In terms of the rates themselves, the FSB recommends a further increase across each of the NMW rates in October 2015 in line with the forecast rate of CPI inflation (which according to the latest Office for Budget Responsibility estimates will be approximately 2 per cent¹ between Q4 2015 - Q4 2016). This we feel would be affordable across all sectors, and would strike the right balance between helping to boosting earnings of the lowest paid on the one hand, and protecting businesses and jobs in sectors where low pay is concentrated, such as those described above.

In addition to addressing the questions posed by Commissioners, we provide further analysis in our response based on two recent surveys conducted by the FSB of its members. We trust that you will find our comments useful and that they will be taken into account.

Yours sincerely,

¹ OBR, Economic and Fiscal Forecasts, March 2014

A handwritten signature in dark ink, reading "Michael Mealing". The signature is fluid and cursive, with a long horizontal stroke at the end.

Michael Mealing
Chairman, Employment Committee
Federation of Small Businesses



FSB response to the Low Pay Commission's consultation on the National Minimum Wage 2014-2015

September 2014

1. Overview: small businesses, wages and the economy

Small businesses continue to report growing confidence in their short to mid-term outlook. In the third quarter of 2014, the headline rate of confidence among small business rose to +41 points, as measured by the FSB's Small Business Index – a quarterly indicator of business owner confidence². This is up from +39.7 in Q2 2014 and compares to +33.5 reported in the third quarter of last year. As it stands, the SBI is at the highest level since the series began in 2010.

The latest SBI also finds that:

- 48 per cent of firms surveyed expect conditions to improve over the next three months – the highest proportion recorded so far, compared to 14 per cent expecting to see a deterioration.
- The proportion of firms expecting to grow during the next twelve months stands at 61 per cent, with 11 per cent expecting to grow rapidly. Key factors cited by firms as barriers to growth include weak consumer demand and skills shortages.
- A net balance of 7 per cent of firms expect to increase headcounts, up from 1 per cent in the same quarter last year. A net balance of 20 per cent of firms reported turnover growth during the past three months, while a third expect turnover growth over the next three months.
- The most optimistic sectors of the economy are financial, business and personal services. Agriculture, automotive and real estate have seen declines in confidence compared to the same period a year ago.

The generally bright outlook described above combined with increased reporting of skills shortages appear to be slowly translating into higher pay and remuneration. According to our survey, **54 per cent of FSB members have increased wages over the past 12 months, compared to 6 per cent who have reduced wages and 40 per cent reporting no change to their average salary award**. Taken together, members estimate the average (mean) wage settlement for their business over the last 12 months to be +1.59 per cent.

Furthermore, seven in 10 (65 per cent) FSB members expect to increase wages over the next 12 months, with the average wage settlement over the coming 12 months expected to come in at +2.06 per cent. This tallies with other recent employer surveys on pay and while salaries in the public sector are unlikely to rise for some time, we may see a return to real wage growth in 2015 thanks to wage increases in the private sector.

Despite these important signs, there remain a number of challenges for wage growth. Firstly, only 8 per cent of firms are seeing profits rising. This is testament to the continuing economic difficulties and is preventing firms from increasing their margins. Despite low inflation, weak profitability means that the cost of doing business continues to be a pressure burden, particularly in sectors such as hospitality, retail and wholesale. It is in these sectors where utilities, rents and business rates continue to be most strongly felt.

Secondly, while businesses in every region and nation have seen a significant improvement in their outlook over the past year, regional disparities remain. For a long term recovery that is balanced between the South and the rest of the UK, a sustained uptick in business confidence in the North will be needed. However, regions in the North of England and the devolved nations may be disproportionately affected by government cutbacks in the coming years, making the task of reducing unemployment more difficult and inhibiting consumer demand in the medium term – both of which could keep wages contained.

² FSB Small Business (SBI) Index, Centre for Economics and Business Research and FSB, August 2014

Finally, we remain concerned about the underlying weakness in productivity and agree with the view that productivity levels need to improve before wages can increase exponentially. A net balance of 46 per cent of small firms reported that they were running below capacity in Q3 2014. While this is down from 49 per cent a year earlier, and a net balance of 42 per cent expect to be operating below capacity over the next quarter, there is still plenty of spare capacity in the small firm sector, which is likely to be acting as a drag on productivity growth and therefore wages.

2. Impact of the October 2014 Minimum Wage increase on small businesses

In September 2014, the FSB ran a survey of its members looking at pay and workplace benefits. A total number of 1,129 members responded to the survey. Respondents were asked a series of questions on the National Minimum Wage.

Question A1 asked what impact the increase in the National Minimum Wage due to take effect on 1st October 2014 would have on their business. In answering this question, respondents were asked to consider changes to the main adult rate, which will increase by 19p to £6.50 per hour, the 18-20 rate (an increase of 10p to £5.13 per hour), the 16-27 rate (up 7p to £3.79 per hour), and finally the apprenticeship rate (up 5p to £2.73 per hour).

Among those respondents that currently employ staff (base: 822), the survey found that:

- 18 per cent estimate that the rise in the Minimum Wage will have no or only marginal impact on their business.
- A further 63 per cent of respondents will not be affected, as they do not employ staff on the minimum wage. **A total of 81 per cent of small employers therefore expect the October 2014 rise to have no impact or only marginal impact on their business.**
- 13 per cent of respondents expect the rise to have a moderately negative impact on their business, while 3 per cent said it will have a significantly negative impact – **a total of 16 per cent therefore anticipate a negative impact.**
- 2 per cent of respondents said the increase would have a moderately positive impact on their business, while 1 per cent said it would have a significantly positive impact.
- Businesses in Scotland (23 per cent) and the North West (21 per cent) were more likely to cite a negative impact ('moderately' and 'significantly' negative combined)³. Businesses in East England, the South East and Yorkshire and Humber⁴ were less likely to cite a negative impact.
- Businesses in hospitality (hotels, bars, restaurants and catering) (39 per cent) and retail (26 per cent) were more likely to cite a negative impact ('moderately' and 'significantly' negative combined). Businesses in construction, financial services⁵ and computing/IT and related services were the least likely to cite a negative impact.

³ Businesses in Wales and Northern Ireland were also more likely to report a negative impact, but the base sample sizes in both cases are small and should be treated with caution when making inferences.

⁴ Businesses in London were also less likely to report a negative impact, but as with the above the base sample size is small.

⁵ Ibid

Among those businesses that currently employ one or more member of staff on the NMW (base: 302), the survey found that:

- **50 per cent expect the increase in the Minimum Wage on October 1st 2014 to have no impact or only a marginal impact on their business.**
- 35 per cent of respondents said the increase would have a moderately negative impact on their business, while 7 per cent said it would have a significantly negative impact – **a total of 42 per cent of small businesses with staff on NMW therefore anticipate that the October 2014 rise will have a negative impact on their business**
- 5 per cent of respondents said the increase would have a moderately positive impact on their business, while 2 per cent said it would have a significantly positive impact
- Respondents expect to manage the increase in the NMW in a number of ways. 24 per cent said they would absorb the extra cost, 19 per cent would put off hiring new staff, 17 per cent said they would reduce staff hours, while 14 per cent said they would raise prices. In addition, 12 per cent stated they may have to freeze or reduce the pay of higher paid staff, while 9 per cent suggested that they would reduce staff numbers.

4. Scenarios for 2015/16 NMW rates

Question A3 in our survey asked respondents to consider a range of scenarios for the Minimum Wage in October 2015, and the impact on their business of each scenario.

The full responses to this question weighted a) to all employer respondents and b) to respondents with one or more members of staff on NMW can be found in annex 1 and 2 of this submission. However, several key findings are worth considering here, across each of the scenarios:

Scenario 1: An increase in National Minimum Wage below the rate of inflation⁶

- Only 13 per cent of employer respondents feel that this scenario would have a negative impact on their business.
- 16 per cent say it would have no impact or only a minimal impact, while 63 per cent are not likely to be affected as they do not employ staff on NMW⁷.
- 43 per cent of respondents with at least one staff member on NMW said this scenario would have no impact or minimal impact, while 16 per cent cite a *positive* impact.
- A minority of respondents employing NMW earners (30 per cent) feel this scenario would have a moderately negative impact, with only 6 per cent expecting it to have a significantly negative impact.

Scenario 2: An increase in National Minimum Wage in line with the rate of inflation

- A slightly higher share (16 per cent) of employer respondents suggest that this scenario would have a negative impact on their business.

⁶ Respondents were informed that the OBR's latest official projection for the CPI inflation rate for the period in question is 'approximately 2%'.

⁷ For each of these scenarios, questions were only asked of members employing one or more members of staff on NMW. The responses were re-weighted to include all employer respondents, most of whom are unlikely to be affected/not applicable, hence we see a recurrence of the 63 per cent of respondents marked as unlikely to be affected across the scenarios.

- As with scenario 1, 16 per cent of employer respondents suggest this scenario would have no impact or only a minimal impact, and a further 63 per cent are unlikely to be affected.
- Also identical to scenario 1, 43 per cent of respondents with staff on NMW estimate the impact of this scenario to be zero or minimal on their business, while 10 per cent suggest it would have a positive impact.
- A slightly higher percentage of respondents employing staff on NMW cite a moderately negative impact (34 per cent) and a significantly negative impact (7 per cent) from this scenario respectively.

Scenario 3: An increase in the National Minimum Wage above the rate of inflation but below the Living Wage (currently £8.80 an hour in London and £7.65 in the rest of the UK)

- 23 cent of employer respondents suggest that this scenario would have a negative impact on their business. 8 per cent suggest it would have no impact or only a minimal impact.
- A net majority of respondents with staff on NMW believe that this scenario would have a negative impact on their business with 30 per cent citing a moderately negative impact, and 32 per cent a significantly negative impact⁸.
- 21 per cent of respondents with staff on NMW believe this scenario would have no impact, while interestingly 11 per cent cite a positive impact (higher than under scenario 2).

Scenario 4: An increase in the National Minimum Wage up to the level of the Living Wage

- 26 cent of employer respondents suggest that this scenario would have a negative impact on their business. Only 5 per cent suggest it would have no impact or only a minimal impact.
- Unsurprisingly, 45 per cent of respondents with staff on NMW suggest this scenario would have a significantly negative effect, while 24 per cent cite a moderately negative impact.
- 15 per cent of respondents employing NMW earners feel that an increase from NMW to the Living Wage next year would have no or minimal impact to their business, while 10 per cent believe this would have a positive impact.

5. Recommendations for the 2015/16 NMW rates

In light of the findings presented in section 3 and 4 above, and previous FSB research on wages, we believe that at this stage in the recovery, small increases in the NMW are affordable.

However, the Government and the Low Pay Commission must remain prudent when setting the NMW and any increases must be gradual. It should be acknowledged that the NMW has risen faster than median earnings since 2008, despite its value falling in real terms. On this evidence, raising the NMW alone is unlikely to generate sustained real terms wage increases in the medium term. Average wage growth in turn needs to mirror productivity growth in order to be sustainable.

As in previous submissions, we believe that Commissioners need to be particularly mindful of the effect of their recommendations on firms in sectors where low pay is concentrated, such as retail, care and hospitality. In these sectors, labour typically represents the highest share of running costs and firms tend to operate on fine margins, meaning that they can be particularly sensitive to adjustments in the Minimum Wage. Our survey suggests that firms in these sectors are understandably more concerned by the impact on their business of increases in the NMW.

⁸ This may partly be explained by the broad range within the scenario

With regard to the level of the NMW commencing October 2015, and based on our analysis, we recommend further rises across each of the NMW rates. The FSB's preference, following our submission last year, would be for NMW rates to increase in line with the forecast rate of CPI inflation, which the Office for Budget Responsibility estimates will be at or approaching 2% during the period Q4 2015-Q4 2016. This we feel would be affordable for the vast majority of businesses.

As we have said in previous submissions, the Government cannot simply rely on incremental increases to the National Minimum Wage as a means of supporting real earnings growth. The FSB believes that Government must set out a long-term strategy to grow enterprise and encourage investment in productive capacity, which in turn will enable small firms to expand their headcounts and boost wages.

5. The Apprenticeship rate: level and structure

In previous submissions, we have argued that the gap between the apprenticeship rate and the under 18 rate should progressively narrow over time. In a previous survey, 82 per cent of FSB members supported an increase in the minimum wage for apprentices from £95⁹ to £123 per week, which would have taken it roughly in line with the youth (under 18) rate at that time.

Our rationale for the above has always been that a higher AMW will help to boost the attractiveness of apprenticeships among young people and their parents. This is necessary if we are to build parity of esteem for apprenticeships, where vocational education is seen by a greater number of capable youngsters as a valuable and worthwhile alternative to academic routes.

With rates of youth unemployment falling, the FSB again believes there is a case for increasing the Apprenticeship Minimum Wage (AMW) rate in 2015/2016. However, as we stated in our 2014 submission, our support for significantly higher increases to the AMW is dependent on the outcome of wider apprenticeship reforms. While we support the Government's vision to place employers in charge of apprenticeship funding, we are concerned that the proposed funding models may lead in some cases to small businesses incurring higher training costs. **Consequently, we would recommend against increasing the AMW by a significantly faster rate relative to the youth rate until after the Government's reforms have taken effect and the impact on employer take up of apprentices can be appraised.**

Regarding the structure of the Apprenticeship rate, the FSB believes that the current system is relatively straightforward, however improvements could be made as there is scope for confusion. Our survey found that 38 per cent of FSB members feel that the rate is complicated and confusing (rising to 49 per cent of those who currently employ apprentices), compared to 16 per cent who disagree, and 14 per cent who neither disagree nor agree. Of those that currently employ apprentices, 54 per cent feel the rules are straightforward and that they 'have no problem complying'.

In order to support businesses to comply, guidance on the AMW tailored specifically to employers should be promoted more widely, including on the Apprenticeships.org.uk website. The Government should also work with the payroll industry to explore what changes, if any, could be made to payroll software to alert employers to their apprentices' birthdays alongside the duration of their employment to date. Some employers may inadvertently fail to up-rate their apprentice's pay to their age rate once they turn 19 and are studying beyond their first year.

⁹ Based on the 2010-11 rate of £2.50 p/hour

At this stage, and without further evidence, the FSB does not believe that substantial changes need to be made to the AMW structure. Applying the AMW to all levels of an apprenticeship would risk discouraging young people from becoming apprentices, if – as may happen as a result – they are paid the AMW in every year of their apprenticeship. Similarly, removing the AMW altogether (and thereby requiring employers to pay the relevant age rate of their apprentice) could discourage employers from taking apprentices, particularly those aged 18 or over.

On balance, the FSB would prefer a narrowing of the gap between the AMW and the youth rate, however this should not proceed too quickly for the reasons outlined above.

4. Effect of the NMW on the employment prospects of young people

As we have said in the past, there are multiple reasons for why small businesses can sometimes be reluctant to hire young people. However, our members tell us that the NMW is rarely a major barrier to employing a young person. Instead, small businesses can be reluctant to hire young people because they often find that many lack the right skills to do the job. This includes functional skills, such as numeracy and literacy, but also employability skills – such as the ability to communicate effectively and having the right attitude to work - that are so crucial to employers.

Since employability skills are essential to getting and keeping a job, the FSB believes that employability skills should be embedded within the curriculum. Furthermore, young people need good careers advice and careers education, covering a wide range of potential career options and routes into careers. This guidance should also promote vocational training as a valuable and equal alternative to university. Schools also need to be incentivised to engage more with local businesses, turning to them for careers guidance, work experience and mentoring.

6. The LPC's 'additional assessment' on the future path of the NMW.

The FSB largely agrees with the LPC's 'additional assessment' made in its 2014 report, regarding what economic and business conditions needed to be in place to allow a faster increase in the minimum wage .

In the FSB's view, a number of developments must take place before a significant deviation from the current trajectory of the NMW can be contemplated. Building on current trends, we need a sustained period of GDP growth, further falls in unemployment, and rising confidence in the small business sector. We also need to see a pick-up in productivity levels if significant wage increases across the economy are to be sustainable and affordable.

The FSB welcomes the LPC's recognition of the additional cost constraints under which many firms are operating. This relates not only to the external environment, but also Government policy – and we welcome the LPC's emphasis on this in its report. We agree with a number of the concerns affecting specific sectors, such as social care, where low pay is in large part a result of local authority commissioning practices, exacerbated in recent years by the efficiency savings councils are being required to make. On a more general level, the introduction of automatic enrolment into workplace pensions, which all businesses will have to comply with over coming years, will increase wage costs from 1-3%. These and other costs need to be borne in mind when considering the level at which the NMW should increase.

As we have previously stated, Government also has a critical role to play in supporting real wage growth, by supporting firms to grow and invest in productive capacity. It can also help to address regional pay

disparities (and by extension, the variable impact of NMW increases on employers according to their geographic location) for instance, by supporting infrastructure investment, opening up the public procurement process to small companies, and improving the governance of Local Enterprise Partnerships in England. This in turn will allow small firms to grow, adding significant value to their local economies, and over time should help to reduce pay differentials that exist between the UK regions.

7. Further comments: the LPC's remit

The FSB has continually supported the work of the LPC and champions its independent status. Nevertheless, we believe that several changes could be made to its remit.

The LPC currently advises the Government on NMW rises one year (or 'NMW period') at a time. In the past, employers have only been given six months' notice before NMW increases come into effect. Both the short notice given to employers and the short-term horizon makes it hard for small firms to plan, affecting their investment and hiring decisions. It can also have a particularly adverse effect on small firms with pre-existing contracts that run through separate NMW periods, many of whom find they effectively have to predict the following year's NMW rates when bidding for contracts.

In order to address these concerns, we believe that the LPC should work with the Office for Budget Responsibility (OBR) to publish a five-year indicative forecast for future NMW rates. The LPC would reserve the right to revise these rates annually, in line with economic conditions. However, providing an indication would give firms far greater certainty over the future trajectory of the Minimum Wage aiding planning and investment.

The FSB appreciates the LPC's concern regarding available data, but would urge it to work closely with the OBR, the Bank of England and other independent forecasters and experts. We would welcome the opportunity to discuss this suggestion further with Commissioners.

Annex 1: Impact of NMW increases in October 2015 by scenario (all with employees)

All with employees (S1=2-5) FSB weighting	An increase in the national minimum wage below the rate of inflation	An increase in the national minimum wage in line with the rate of inflation	An increase in the national minimum wage above the rate of inflation but below the Living Wage ¹⁰	An increase in the national minimum wage up to the level of the Living Wage
	A	B	C	D
Weighted Base	822	822	822	822
Unweighted Base	816	816	816	816
Total	100%	100%	100%	100%
Significantly positive impact	2%	1%	2%	2%
Moderately positive impact	4%	2%	3%	2%
No impact / marginal impact	16%	16%	8%	5%
Moderately negative impact	11%	13%	11%	9%
Significantly negative impact	2%	3%	12%	16%
NET: Positive impact	6%	3%	4%	4%
NET: Negative impact	13%	15%	23%	25%
Don't know / too early to tell	2%	2%	2%	2%
N/A	63%	63%	63%	63%

¹⁰ Currently £8.80 an hour in London, £7.65 for rest of UK

Annex 2: Impact of NMW increases in October 2015 by scenario (businesses with one or more employees on NMW)

Employees on national minimum wage (S1=4,5) FSB weighting	An increase in the national minimum wage below the rate of inflation	An increase in the national minimum wage in line with the rate of inflation	An increase in the national minimum wage above the rate of inflation but below the Living Wage (currently £8.80 an hour in London, £7.65 for rest of UK)	An increase in the national minimum wage up to the level of the Living Wage (currently £8.80 an hour in London, £7.65 for rest of UK)
	A	B	C	D
Weighted Base	302	302	302	302
Unweighted Base	291	291	291	291
Total	100%	100%	100%	100%
Significantly positive impact (5)	5%	3%	4%	5%
Moderately positive impact (4)	11%	7%	7%	5%
No impact / marginal impact (3)	43%	43%	21%	15%
Moderately negative impact (2)	30%	34%	30%	24%
Significantly negative impact (1)	6%	7%	32%	45%
NET: Positive impact	16%	9%	11%	10%
NET: Negative impact	36%	41%	61%	68%
Don't know / too early to tell	6%	6%	6%	6%
N/A				