Executive Summary

1 This is the 16th Low Pay Commission report. Our remit from Government said that "its aim is to have National Minimum Wage (NMW) rates that helped as many low-paid workers as possible, while making sure that we do not damage their employment prospects". It also said that, as the economy continues to recover, the Government's ambition is to increase the real value of the NMW. It asked us to monitor, evaluate and review the levels of each of the different NMW rates and make recommendations on the levels which should apply from October 2015. It also asked us to review the Apprentice Rate structure. Finally it asked us to consider whether, as we had hoped in our 2014 Report, the UK is entering a new phase where real increases in the NMW can be afforded. This report is provided in response to the remit request and, as in previous years, we set out in it the detailed evidence on which we have based our conclusions and recommendations.

Chapter 1: The Economic Context to the October 2014 Rates

2 Since we met to agree our recommendations in January 2014, the Office for National Statistics (ONS) has made substantial revisions to the data for economic output. These revisions showed that the recession was shallower than previously thought, with output falling by 6 per cent. The economy is recovering strongly with economic growth in 2014 around the level forecast, 2.6 per cent. However, the UK economy still underwent its longest and deepest recession since at least the Second World War and the recovery remains the slowest on record. Output is over 15 per cent below what it would have been had the long-run trend growth (1955-2008) continued from 2008 onwards. Thus, full economic recovery has a long way to go.

3 The labour market has continued to perform remarkably strongly in terms of jobs and hours, with job growth greater than forecast. Indeed, the number of jobs increased in the year to June 2014 faster than at any point since records began in 1959, and the increase in employment was its fastest since 1989. As a consequence, the reductions in unemployment and the claimant count have also been bigger than forecast. However, much of the increase in employment since the onset of recession has been in self-employment and the proportion of part-time workers who would like to work full-time remains almost double its pre-recession level. In conjunction with increasing labour supply from older workers, more women in work, greater conditionality for benefits claimants, and immigration, this means that strong employment growth appears to have put little pressure on wages. Higher employment combined with the sluggish recovery has had significant adverse consequences for the UK's productivity performance. Since 2011, productivity (whether measured by output per worker, per job or per hour) has stalled and remains below its level in the first quarter of 2008.

4 In the face of continued low productivity and spare capacity, forecasts for wage growth have turned out to be lower than expected. Average wage growth is expected to be around 1.1 per cent for 2014 with Consumer Price Index (CPI) inflation at 0.9 per cent and Retail Price Index (RPI) inflation at just 1.9 per cent in the fourth quarter of 2014. Low wage growth is likely partly to reflect the changing composition of the workforce. But the overall picture remains one of sluggish performance. Despite this, falling inflation means there may have been a modest increase in real pay – the first since 2009 – at the end of 2014.

5 The weak out-turn has important implications for the National Minimum Wage. The NMW increased by 3.0 per cent in October 2014. This was much higher than average wage growth, measured by the Annual Survey of Hours and Earnings (ASHE) or Average Weekly Earnings (AWE), suggesting an increase in the relative value of the NMW. It was also much higher than the increase in CPI or RPI inflation suggesting an increase in the real value of the NMW.

Chapter 2: the Impact of the National Minimum Wage

6 The adult rate of the NMW has increased by over 80 per cent since its introduction at £3.60 an hour in April 1999. This is greater than the increase in average earnings or prices over the same period. Over the course of the recession and recovery, the real value of the NMW fell as the increase in the NMW was lower than the increase in both CPI and RPI inflation – in line with trends in pay for other workers. But its value relative to typical earnings rose significantly, increasing the relative pay of the lowest paid – a marked difference from recessions going back to at least the 1970s, in which those at the bottom had tended to fall behind.

7 Using CPI to calculate the value of the NMW in real terms its value peaked in October 2007. By October 2013, it had fallen by 5.2 per cent, to below its value in 2005. The recent increase of 3.0 per cent in the NMW in October 2014 has since begun to restore some of that lost value, up by 1.7 per cent since October 2013. Against CPI, it has therefore recovered around a third of its lost value, and is now above its real value in the years 2005 and 2011.

8 By contrast, the value of the NMW relative to average earnings has never been higher than it was in October 2014. As a consequence, the bite of the NMW (its value relative to the median) – broadly stable in the economy as a whole between 2007 and 2010 – is now at its highest level since the NMW was introduced. For employees aged 21 and over it was 53.9 per cent. For those aged 22 and over – a measure comparable over time – the bite was 53.2 per cent. This compares with a bite of 45.7 per cent on introduction in April 1999 and 50.9 per cent in April 2010. The NMW has most impact on small firms and low-paying sectors. Here the bite has risen to 67.2 per cent for micro firms (those with fewer than 10 employees), and just under 80 per cent in the low-paying sectors as a whole.

9 Despite the increased level of the bite of the NMW, total employment has continued to grow in the economy as a whole and in the low-paying sectors with the year to September 2014 showing the highest annual (September-September) increases in employment and jobs since the introduction of the NMW, as well as strong growth in hours and vacancy levels. Indeed, although the bite has risen sharply in the low-paying sectors since 2007, the number of employee jobs in this part of the economy has grown more rapidly than those elsewhere – 4.3 per cent over the last year compared with 3.1 per cent for other sectors. Employment growth has generally been strong across all firm sizes, including small firms and across sectors though jobs and hours in retail have stagnated this year. Furthermore, the employment performance of most groups of workers particularly affected by the minimum wage – women, older workers, disabled workers, ethnic minorities, and migrants – has been better since 2008 than that of others not so affected by the NMW. The two groups whose experience has been worse are young people and those with no qualifications, although employment rates of those aged 18-20 not in full-time education and those with no qualifications have increased over the past twelve months.

10 Research we have commissioned to inform our decisions – now totalling around 140 projects – has generally shown that the NMW has led to higher than average wage increases for the lowest paid, with little evidence of adverse effects on employment or the economy. Firms appeared to have responded by: adjusting pay structures; reducing non-wage costs; making small reductions in hours; increasing productivity; increasing some prices; and some squeezing of profits (although insufficient to lead to an increase in business failure). Our most recent research has helped shed further light on these issues. Using one data source, ASHE, research on employment and hours found some strong negative effects on employment retention for female part-time employees and male full-time employees. However, this analysis using ASHE was limited to job outflow and did not investigate job entry, which would give a rounded picture of the impact of the NMW on employment. Furthermore, using an alternative data source – the Labour Force Survey (LFS) – no such evidence was found of negative retention effects although that analysis found some positive impacts on job entry for low-wage men in the period of economic recovery. Separate research found a positive association between the minimum wage and labour productivity, and that the increases in productivity had not resulted from reductions in employment. It found little evidence of the impact of the NMW on profits or firm exit.

Chapter 3: Young People and Apprentices

11 Earnings growth for young people varied sharply by age this year. Those aged 18-20 saw strong wage growth of 2.5 per cent between April 2013 and April 2014, more than double last year’s increase in the Youth Development Rate. This resulted in a fall in the bite. By contrast, 16-17 year olds experienced very little earnings growth, just 0.6 per cent over the year and, as a consequence, the bite rose. Indeed, the typical earnings of 16-17 year olds have remained stuck at around the £5.00 an hour mark since 2008. Wage growth across the 16-20 group was far stronger for young men than for young women.

12 Change in the labour market position of young people was more similar between ages, modestly improving over the year. There were small reductions in unemployment and increases in employment, but there was more striking change for young people not in full-time education, where the unemployment rate fell by 5.7 percentage points for 16-17 year olds and by 3.2 percentage points for 18-20 year olds. The proportion of 18-20 year olds and 16-17 year olds not in employment, education or training (NEET) also fell over the year. Overall, the picture was one of encouraging stabilisation, albeit with a long way to go to recover lost ground.

13 Wage improvements for 18-20 year olds and a stabilising labour market position for both them and 16-17 year olds come against the backdrop of several years when we have reluctantly recommended lower increases for the youth rates of the NMW in order to protect employment opportunities. New research for this report found this approach may indeed have helped to protect younger workers' employment prospects.

14 This year – in contrast to our 2014 Report, which had found greater use of the adult rate of the NMW – more employers appeared to be paying young workers at their respective youth rates. Excluding apprentices from the data (for whom a lower minimum wage often applies) lifted median earnings for other young people slightly but very substantially reduced the proportions of young people recorded as being paid below their applicable NMW. This analysis, which we were able to carry out for the first time this year, helps allay previous fears of much higher non-compliance for the youth rates than the adult rate.

15 Turning to apprenticeships, starts fell again over the last year, driven by the reduction in apprentices aged 25 and over outweighing the effects of a modest increase for apprentices aged under 19. New data – including the first Apprentice Pay Survey since 2012 – revealed that median gross pay was significantly above the Apprentice Rate on average, but much lower for younger workers and those in low-paying frameworks. The new data also shed fresh light on non-compliance, recording levels of between 9 and 14 per cent, much lower than previous estimates, but still unacceptably high and more prevalent in some frameworks, particularly Hairdressing, Construction and Childcare.

Chapter 4: Review of the Structure of the Apprentice Rate

16 The Government asked us to consider whether any changes can be made to the Apprentice Rate to simplify the structure and improve compliance, including the option of combining it with the 16-17 Year Old Rate. It further asked us to consider whether the structure and level of the Apprentice Rate should continue to be applied to all levels of apprenticeship, including higher levels.

17 At the moment the Apprentice Rate, £2.73 per hour from October 2014, is applicable in the first year for all apprentices. For those aged 19 and over, the age-appropriate rate applies after this point – the same as for any other minimum wage worker. For those aged 16-18, the Apprentice Rate remains due.

18 Having reviewed the evidence carefully, evaluating options for structural change for their effect on apprentice pay, compliance and apprentice numbers, we recommend clarifying in regulations that the Apprentice Rate should not apply to Higher Apprenticeships. But we have found no other structural change that we feel able to recommend.

19 We judge that there would be significant risks in a merger between the Apprentice Rate and the 16-17 Year Old Rate. It increases the value of the rate by between 39 and 88 per cent, affecting between 90,000 and 200,000 apprentices – up to about a quarter of the cohort. The increased cost could reduce provision, particularly in low-paying sectors that have been important in providing starts to low-skilled young people. We estimate a direct cost to employers of at least £160 million each year – around half the total cost of this year's recommended increase in the adult rate. The risks to provision are amplified by other funding uncertainties in relation to mandatory cash contributions for training for employers in England.

20 We are particularly concerned about possible effects on disadvantaged 16 and 17 year olds. The bite is already over 80 per cent for this group. There would no longer be a wage difference for 16-17 year old apprentices compared with peers for whom no training was being provided. Older apprentices would still attract a wage discount relative to their peers to cover training costs, so 16-17 year olds seeking an apprenticeship would be both more expensive than their contemporaries, and worse 'value' than those somewhat older than them. This cohort remains the group where successive governments have struggled to expand provision. Phased introduction would not remedy these issues.

21 The benefits of such a change are also uncertain. The proposal has the potential to worsen non-compliance because of greater complexity for 18 year olds and if employers struggle to pay the new higher rate. It is focused where evidence is weakest that non-compliance has a relationship to structure. To the extent that greater generosity is a driver of the proposal, the current level of the rate was originally designed to be equivalent to what students could receive in full-time education and had broadly tracked this level since. There are significantly more applications for apprenticeships than places – suggesting a weak 'market' case for change on this scale. Research for our 2014 Report showed that relative to countries like Germany, apprentice pay is higher in the UK, with a smaller discount and lower training quality. This evidence suggests that the status of apprenticeships is more related to training quality and wages on completion than the applicable wage floor.

22 On the broader question, we agree with the Government that apprentice pay non-compliance is far too high at up to 14 per cent according to the 2014 Apprentice Pay Survey. However, the argument that structural change is the solution to this has at least two limitations.

23 First, our analysis shows that main reform options are a zero sum game: they either lead to lower pay for apprentices or higher costs to employers with consequent risks to training quality and the supply of apprenticeships. The key complexity that evidence suggests has a relationship with non-compliance – a rate that changes with both experience and age – is inherent if policy-makers wish to keep current employer incentives to provide apprenticeships <u>and</u> the higher pay that rewards experienced apprentices while seeking to protect the relative attractiveness of offering apprenticeships to young people.

24 Second, the evidence further suggests that high non-compliance is in any event not simply, and possibly not primarily, a problem of a complex structure. Though the evidence is not conclusive, it appears substantially to reflect a mixture of a lack of understanding and awareness (as well as some deliberate evasion). This is reflected in high non-compliance at the point where the structure is a simple flat rate, namely for 16-18 year olds, and preliminary analysis suggesting that up to half of non-compliance could be explained by non-payment of training hours or reporting error rather than problems complying with the hourly rate.

25 Communication and enforcement are the proportionate response to lack of awareness or deliberate non-compliance. Welcome efforts by the Government to strengthen publicity, guidance and enforcement following a recommendation by us in 2013 are recent and small scale relative to need. They have not yet addressed weak incentives for training providers to communicate the rate.

26 Despite this analysis, we present a range of possibilities for structural reform with the advantages and disadvantages of each, rather than a specific recommendation. We are conscious that reform needs to fit with broader government policies that lie outside our competence and scope, for example on training subsidies, higher contributions by employers and decisions about whether apprenticeships should be re-focused away from entry to the labour market for disadvantaged young people and more towards occupations that demand higher skills.

27 Overall, we believe that the evidence available to us does not support a case for structural change. However, we recommend that if the Government decides to make a change it should do so only after further consultation. Of course any change risks an increase in non-compliance unless accompanied by the major communication effort that is anyway needed.

Chapter 5: Compliance and Operation of the National Minimum Wage

28 The past year has seen a range of encouraging developments in the compliance and enforcement regime. This includes the naming of non-compliant employers under the revised Naming Scheme and higher penalties for those employers found in breach of the minimum wage. We strongly welcome the increase in the resources available to HMRC, whose budget is due to increase by a further £3 million in the next financial year; though this needs to be sustained to make a lasting difference. There has also been renewed focus on case handling times, where we see a need for improvement.

29 However, in other areas further action is needed. There has been a marked rise in the number of complaints to HMRC concerning the NMW. But demand-led work has affected risk-based targeted enforcement. The latter is critical to ensuring the compliance regime has a systemic effect, helping individuals who do not or cannot complain. Resources for pro-active work need to be protected. Other priorities for government include: the depth of official guidance; the need for more awareness-raising; publicity for confidentiality rules; and the use of prosecutions for the most serious infringers.

30 The evidence continues to suggest that some groups are at greater risk than others of not receiving their entitlement to the NMW. We remain concerned about social care, where reports continue of non-payment for travel time leading to non-compliance. We are also concerned about non-compliance among employers of apprentices; inappropriate use of unpaid interns; the application of the NMW to seafarers on ships working between UK ports; and abuse of the Family Worker Exemption for migrant domestic workers.

31 We urge the Government to consider further action in all of these areas including: more targeted compliance work, focused on social care; raising awareness of the Apprentice Rate including targeted enforcement action guided by data, and exploring strengthening the responsibilities or incentives of training providers to communicate the NMW; developing the NMW guidance further in partnership with stakeholders; encouraging further enforcement activities in relation to interns and voluntary workers; looking again at the application of the Family Worker Exemption to migrant domestic workers; and reviewing how the NMW should apply to seafarers on ships working between UK ports.

Chapter 6: The Rates

32 Last year we were pleased to recommend the first real terms increase in the value of the minimum wage since the recession. We said that, provided the economy continued to recover, we expected to recommend further progressive improvements, restoring and then surpassing the previous highest level of the minimum wage.

33 This year, strong performance on employment and unemployment has continued, beating expectations. Growth has been sustained while inflation and the oil price have fallen. Nominal pay growth has remained sluggish. Overall we judge that excessively sharp increases in the minimum wage would put jobs at risk – not least bearing in mind pressure on low-paying sectors and small firms. The bite is at its highest level ever: overall; for low-paying sectors; and in firms of all sizes.

34 We do believe however that continued recovery, and in particular the impressive growth in employment of the low paid, should this year allow a further increase in the real and relative value of the minimum wage. We recommend that the adult rate of the National Minimum Wage be increased by 3 per cent to £6.70 from 1 October 2015. Forecast inflation at the time we met to agree our recommendations was 1.0-1.5 per cent, so this is likely to be a larger real terms increase than last year and should restore two-thirds of the fall in the real value of the NMW relative to its peak in 2007.[1]

1 The Bank of England's latest CPI forecast, released on 12 February 2015, after we met and agreed our recommendations, was 0.5 per cent for the fourth quarter of 2015. On this basis, the recommended increase would restore three-quarters of the fall in the real value of the NMW relative to its peak in 2007.

35 Over two years the NMW will have increased by more than 6 per cent. Because of the improved economic and labour market conditions we believe once again that employers will be able to respond in a way that supports employment. However, our recommendation this year is predicated on a forecast which foresees lower input costs for business in fuel and energy, a strong economic performance, significant recovery in earnings across the economy and rising productivity. If these expectations are not borne out over the year we will take this into account when considering next year's recommendation. We also remain concerned about the pressures the increase will place on social care. We urge the Government to ensure funding is available to meet the extra burden the NMW rise will place on the sector.

36 Overall our recommendations for the adult rate may increase the number of jobs covered by the minimum wage significantly – to 1.43 million in October 2015 compared with some 1.2 million in April 2014, albeit this analysis is sensitive to what happens to earnings growth and pay structures. When the ASHE surveys become available to validate this estimate, the 2014 and 2015 NMW increases may each be seen to have added about 115,000 jobs to the total, together expanding the coverage of the NMW by 20 per cent. For comparison, around 900,000 jobs were covered at the start of the downturn in 2008. The increase reflects the fact that the minimum wage has risen in relation to median earnings.

37 In 2013 we conducted a review of the accommodation offset. As a result we said that it was our intention to recommend staged increases towards the level of the adult rate of the NMW when its real value is tending to rise – a condition met by our above-inflation adult rate recommendation this year. We recommend that the accommodation offset be increased by 27 pence to £5.35 a day from 1 October 2015.

38 In recent years we have recommended smaller increases for young people than for adults because their labour market position has been worse, and the damaging consequences of unemployment even more serious. We have also said that we expected to be able to recommend larger increases when economic conditions have eased. This year wages for workers aged 18-20 have significantly outperformed those of adults, their employment position has improved, and the bite has fallen. The abolition of employer National Insurance contributions for workers aged under 21 from April 2015 should modestly reduce employment costs for about two-fifths of this age group on the minimum wage. These factors mean we see scope to take a step towards bigger increases for this cohort. We recommend an increase of 3.3 per cent in the Youth Development Rate to £5.30 an hour from 1 October 2015. This should increase its real and relative value. For 16-17 year olds, whose position is also improving, though more slowly, we recommend an increase in the minimum wage of 2.2 per cent, taking it to £3.87 an hour.

39 Over the past year apprenticeship starts have fallen overall, driven by those aged 25 and over, but have increased for those aged under 19. The new Apprentice Pay Survey has shown non-compliance remains unacceptably high. Overall, we judge that large increases in the level of the Apprentice Rate could pose risks to provision. However, we do believe there is scope for a more cautious step. We recommend an increase in the Apprentice Rate of 2.6 per cent to £2.80 an hour from 1 October 2015. We encourage the Government to redouble its efforts in actively publicising the existence and level of the rate, which the evidence suggests is poorly understood. This rate would apply unless the Government decides to proceed with

stuctural change, for example the option set out in its evidence, merging the Apprentice Rate with the 16-17 Year Old Rate.

40 This year we have again been asked to review the conditions that need to be in place to allow the value of the minimum wage to increase in real terms including updating our advice on the future path of the NMW.

41 Last year we said 2014 could mark the start of a new fourth phase for the minimum wage, of bigger increases than in recent years, following previous phases of: cautious initial increase from the late 1990s; bolder above-inflation increases in the early 2000s; and increases above average earnings growth but below inflation during the recession and its aftermath. However, to achieve our shared aim of faster increases in the minimum wage without risk to the employment of the low paid, we believed it would be necessary to see: rising real wages in the economy; stable or rising employment, particularly in low-paying industries and small firms; and an expectation of sustained economic growth.

42 A year on, our analysis of the basic considerations necessary for rises are unchanged: growth, jobs, productivity and earnings remain critical – especially trends in low-paying sectors. In relation to where the UK stands against those considerations, we judge that employment is strong and rising, with impressive performance in low-paying industries and small firms. Economic growth has also been solid and is somewhat more balanced than last year. The area where there is least certainty is wage growth and productivity, where 2014 saw limited progress. While this year we believe that there is scope for another real increase, further evidence of improvement in average pay, and productivity will be important to the future trajectory.

43 We remain of the view that policy action can help to support a higher minimum wage, including via advocacy. As we argued last year, one in four NMW workers are not in low-paying sectors and for many it may be affordable for employers to raise wages without adverse impacts. This should be encouraged.

Recommendations

National Minimum Wage Rates

We recommend that the adult rate of the National Minimum Wage be increased by 3 per cent, to £6.70 an hour, from 1 October 2015.

We recommend an increase of 3.3 per cent in the Youth Development Rate to £5.30 an hour from 1 October 2015

We recommend an increase of 2.2 per cent in the 16-17 Year Old Rate to £3.87 an hour from 1 October 2015.

We recommend an increase of 2.6 per cent in the Apprentice Rate to £2.80 an hour from 1 October 2015. (This rate would apply unless Government decides to proceed in this timescale with structural change, for example the option to combine the Apprentice Rate and 16-17 Year Old Rate set out in its evidence).

Accommodation Offset

We recommend that the accommodation offset be increased by 27 pence to £5.35 a day, from 1 October 2015.

Structure of the Apprentice Rate

We recommend amending regulations to exempt Higher Apprenticeships from the scope of the Apprentice Rate. These apprentices should be entitled to the age-related rate of the NMW.

We believe that the evidence available to us does not support a case for structural change. However, we recommend that if the Government decides to make a change it should do so only after further consultation.