8th Floor, Fleetbank House
2-6 Salisbury Square
EC4Y 8JX

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Dear Secretary of State,

NATIONAL MINIMUM WAGE RATES FOR 2018 INCLUDING THE NATIONAL LIVING WAGE

I enclose the executive summary of the Low Pay Commission's 2017 Report, which includes our recommendations for the rates of the National Living Wage (NLW) and National Minimum Wage (NMW) to apply from April 2018, as well as summarising the key evidence supporting the rationale for our recommendations.

Our remit sets different requirements in relation to the NLW, that is the rate for workers aged 25 and over, than for the four other rates, which cover workers aged under 25 and apprentices. For the NLW we are asked to make recommendations on the pace of increase towards a target: 'The ambition is that it should continue to increase to reach 60 per cent of median earnings by 2020, subject to sustained economic growth.' For the other rates we are asked to recommend rates which 'help as many low-paid workers as possible without damaging their employment prospects'.

National Living Wage

The core decision for our report was whether the most recent economic evidence met the condition of sustained economic growth to enable the NLW to be uprated in line with the path to 60 per cent of median earnings. Compared to when we last reported, fears of a recession following the decision to leave the European Union have abated and short-term confidence appears stronger. However, uncertainty about the medium-term is likely to remain high until there is greater clarity on the terms for leaving the EU.

The economy is growing and several indicators, notably business confidence, investment and employment intentions have improved. Last year we reported that GDP growth for 2017 was forecast to be around 1 per cent, but the outturn has surpassed this with growth now likely to be around 1.5-1.6 per cent for the year as a whole.

Importantly, jobs growth forecasts have been significantly revised upwards. Last year the Bank of England and the HM Treasury panel of independent forecasts forecast 0 per cent and -0.1 per cent respectively for 2017 while the outturn was 1.2 per cent or 420,000 jobs. For 2018, the Bank and HM Treasury panel forecast 0.4 per cent and 0.5 per cent respectively, which would mean an additional 125,000-175,000 jobs. The OBR's July 2015 forecast of 1.1 million additional jobs by 2020 has already been met and unemployment is at its lowest since the 1970s.

Performance of other indicators we reviewed however gave cause for concern. While economic growth has been sustained since 2010, it slowed in 2017. GDP per head has grown but only by some 2 per cent since 2008, reflecting weak productivity. Overall, productivity has remained relatively flat since 2007, despite the strong labour market. Investment as a whole remains about the same as in 2015. We also noted that inflation is growing, albeit expected to peak later this year. Consumer spending has weakened; as real incomes have fallen, net borrowing has increased, with likely increases in personal debt.

In our written and oral evidence employers remained concerned about the impact of the National Living Wage. Some sectors, notably hair and beauty and convenience retail remained very concerned. However, the evidence from stakeholders also suggested that employers have coped better with the NLW than they originally anticipated and few called for a move off the path. However, this was a greater challenge for small and medium-sized enterprises, compared to large companies with greater capacity to absorb the costs and planning adjustments necessitated by the introduction of the NLW and its subsequent uprating. Some employers also felt that the likelihood of a straight line path to 2020 enabled them to plan ahead for future increases, while others highlighted concerns about the challenge of future increases. To some extent, these responses reflect the lower than originally predicted upratings when the NLW was first introduced, an outcome of the flexible design of the NLW. Compared with our Autumn 2016 Report, many more employers have now factored the NLW into planning, and while the predicted cash value for 2020 has reduced, the likely large upratings still required to achieve the target of 60 per cent of median earnings by 2020 remain challenging.

Employee stakeholders were more positive, pointing to continued strong labour market performance, better than expected economic performance, and survey data suggesting that most employers had adapted to the NLW. They called for (at a minimum) a recommendation for an on-course rate as a fair outcome, given strong employment, low unemployment rates, and rising inflation.

Commissioners have weighed these considerations carefully and judged that the evidence available was consistent with the NLW remaining on its path to 60 per cent of median earnings by 2020. Having discussed whether to round to the nearest 5 pence, and deciding to neither frontload nor backload, our recommendation is that the NLW should increase to £7.83 an hour in April 2018, an uplift of 33 pence or 4.4 per cent. This approach fulfils our remit, while also taking into account the issues raised by both employers and workers.

In line with our original intention, this is the on-course rate using the median of available forecasts from the HM Treasury panel of independent forecasts (and adding the Bank of England). (We did not have access to the Office for Budget Responsibility's forthcoming November forecasts, though in recent years the HM Treasury panel forecasts have come somewhat closer to the out-turn.) It is also in line with the indicative on-course rate that we set out in our Autumn 2016 Report and thus supports employers in their forward planning.

For 2019, we estimate an indicative on-course rate of £8.20 an hour, with the HM Treasury panel and Bank of England forecasts implying a NLW within an interquartile range of £8.17 to £8.24. A material worsening in economic performance and prospects would lead us next year to consider whether to recommend that the NLW should not increase relative to median earnings, moving below a straight line path to 60 per cent in 2020, to safeguard employment.

Looking further forwards, using the available HM Treasury panel and Bank of England forecasts, we estimate that 60 per cent of median earnings in 2020 will equate in cash terms to an NLW of £8.61 an hour, within an interquartile range of £8.54 to £8.67. Again, this is the same as the estimate made in our Autumn 2016 Report, although it is lower than our estimate in Spring 2016 (£9.16) or when the policy was announced in July 2015 (£9.35).

While organisations have adapted through accepting lower profits, squeezing differentials and where possible increasing prices, Commissioners recognise that most will still find it a continuing challenge to accommodate the NLW. However, it was clear to us from oral and written evidence and visits, that the NLW was not the sole factor driving some of these behaviours, and employers had coped better with the NLW than they had thought when it was originally introduced. Some employers also highlighted their continuing concerns about managing continued upratings to achieve and then maintain the 2020 target of 60 per cent of median earnings. Continuing uncertainty about the outcome of negotiations for leaving the EU and long-term plans to change workforce structures were also important. We will continue to closely monitor the impacts of the NLW, bearing in mind the tolerance for some job loss built in to this policy.

National Minimum Wage

Last year we made recommendations that would take effect just six months after the previous uprating as the other rates of the NMW moved to synchronise with the April upratings of the NLW. We were concerned that two increases in a short space of time presented additional risks and so we have monitored the evidence carefully.

In the aftermath of the recession, we made recommendations for lower percentage increases to the youth rates in order to protect the employment position of younger workers, bearing in mind the particular risks of scarring effects for these workers. The evidence suggests that this was the right decision, but a necessary consequence was that these rates lost some of their relative value. In our reports from 2011 to 2014, we made a commitment to restore these differentials as soon as economic conditions had improved sufficiently to do so with minimum risk. This year the Commissioners judged that there was sufficiently strong evidence to be more ambitious for the rates for younger workers:

- Employment in the UK continues to grow more strongly than forecast and is at record levels.
- Unemployment has fallen to its lowest rate since 1975.
- There have been ongoing improvements in the employment and unemployment rates of 18-24 year olds, despite two increases in their NMW rates in quick succession in the last year.
- Wage growth for those aged 18-24 has been higher than those aged 25 and over for the last three years. As a result, the bite, which is the NMW as a percentage of median earnings and a key measure of pressure, has fallen for workers of these ages.

- Both employers and unions raised the importance of fairness and employee relations between age groups in the workforce.
- The concerns we raised in our Autumn 2016 Report about two increases to these rates over six months were not reflected in stakeholder evidence. Rather, analysis shows that the use of these rates for the two older age groups (21-24 and 18-20 year olds) has fallen because more employers are choosing to pay above those minimum rates.
- Finally, the evidence does not suggest a particular compliance problem in relation to these rates.

In weighing up this evidence, we also considered the risks of substitution and exploitation while keeping in mind that our objective for younger workers is to recommend a rate that should not reduce employment prospects.

Taking all the above into account, this year we have agreed percentage upratings which match or exceed that for the NLW for all NMW rates with the exception of the 16-17 Year Old Rate. For the 21-24 Year Old Rate, while the evidence shows that a majority of workers in this age bracket are paid above the minimum hourly rate, we noted the important protection it provides for the 120,000 workers paid at the rate. We recommend an increase of 4.7 per cent to £7.38 an hour from 1 April 2018. Assuming our recommendation of £7.83 an hour for the NLW is accepted, this recommendation, if also accepted, will maintain the penny gap of 45 pence between this rate and the NLW, something Commissioners considered important for transition to the higher rate.

Employment, unemployment and pay of 18-20 year olds have all continued to improve strongly. Our view is that this supports a significant increase for the pay floor for 18-20 year olds and a move towards restoring the relative value of this rate compared with the 21-24 Year Old Rate. Therefore, we recommend an increase in the 18-20 Year Old Rate of 5.4 per cent to £5.90 an hour from 1 April 2018. If accepted, this increase will restore the real value of the 18-20 Year Old Rate.

For 16-17 year olds, we noted that the evidence on employment was less positive than for the older age groups. Pay growth for this group was also less than half that seen by 18-24 year olds. A greater proportion of 16-17 year olds in work are paid at or just above the minimum rate for their age compared with the two older age groups, indicating that greater protection is afforded by the pay floor for this age group. We therefore considered it prudent to recommend a smaller increase for this group to £4.20 an hour. If accepted, this recommendation represents an increase of 3.7 per cent, balancing an above inflation increase for this group with their greater vulnerability in the labour market.

The Commissioners also noted the ongoing and welcome increase in the proportions of 16-17 year olds remaining in full-time education. This suggests that the original rationale for this rate – protecting 16-17 year olds in full-time work (with no training) from exploitation – has become less relevant over time.

Overall, it appeared to Commissioners that there is merit in looking more closely at the operation and effectiveness of the NMW rates, both in the light of the impact of the NLW as well as social and policy changes. We will continue to monitor this and consider what it might imply for the age-banded rates.

For apprentices we found that the group most affected by the Apprentice Rate – 16-18 year old apprentices – had seen high growth in their earnings, with a consequent fall in its bite. Furthermore, research into the 21 per cent increase in the Apprentice Rate in October 2015 found no evidence of an impact on the volumes or composition of apprenticeships. On that basis we recommend an increase to £3.70 an hour. This recommendation, if accepted, would deliver an increase of 5.7 per cent on the year. However, we also note that apprenticeship policy in England is in the midst of a significant transition and therefore we will look carefully at the function and impact of the Apprentice Rate next year when the new funding policy is bedded in and better evidence is available in the form of the biennial Apprenticeship Pay Survey.

Finally, we recommend a 60 pence increase in the accommodation offset to £7.00 in keeping with our aim to bring it up to the level of the 21-24 Year Old Rate as long as that rate is rising in real terms. This means the rate better reflects the costs of providing accommodation and helps the horticulture sector in particular.

Yours sincerely,

Bryan Sanderson
Chair, Low Pay Commission