Regulatory Policy Committee

National Minimum Wage Regulations 2017: increases in the national minimum wage and national living wage rates

Department for Business, Energy and Industrial Strategy

RPC rating: fit for purpose

Description of proposal

The national minimum wage (NMW) was introduced in April 1999. The national living wage (NLW) was introduced in April 2016. These set wages floors below which pay must not fall, protecting low-paid workers and providing incentives to work. The Low Pay Commission (LPC) reviews rates and makes recommendations to government annually.

The proposal would increase the NLW (for those aged 25 years and older), the NMW for workers aged 21-24 years and the development, youth and apprentice NMW rates in line with the LPC's recommendations. The Government propose to increase the NLW by 4.2% to £7.50, the 21-24 year old NMW rate by 1.4% to £7.05, the development rate by 0.9% to £5.60, the youth rate by 1.3% to £4.05 and the apprentice rate by 2.9% to £3.50. It is proposed that the new rates should come into force on 1 April 2017. NMW rates were last increased in October 2016. The date of changes to NLW and NMW rates have been aligned, moving NMW increases from October to April; from April 2017, NMW and NLW adjustments will occur at the same time each year.

The impact assessment (IA) appraises the impact of the current proposals. An addendum estimates the regulatory costs and benefits of NMW/NLW changes since the start of the current parliament. These estimates use the methodology employed in this IA, which has been reviewed and revised this year. The addendum is provided for the purposes of consistency and accurate business impact target (BIT) accounting.

Impacts of proposal

Direct labour costs

The introduction of the new NLW and NMW rates will impose costs on businesses by increasing the wages of employees who were paid less than the new statutory wage rates, and from associated non-wage labour costs. The IA models this cost to employers by estimating the difference between assumed rates of pay in the absence of an uprating of NLW/NMW rates and what they would have to pay in wages under the proposed NLW/NMW rates. To calculate the former, the Department has used a counterfactual in which the wages increase at a rate halfway between the CPI inflation forecast and average earnings increase forecast by the Office for Budget Responsibility (OBR). In its sensitivity analysis, the Department has also considered a counterfactual scenario in which employees who are currently paid the NLW/NMW rate would not receive any growth in pay in the absence of the proposed uprating.

The IA explains that the impact of the uprating is assessed over the period of time it would take for its counterfactual wage estimate to 'catch up' with the proposed NLW/NMW rates, dependent on the latest OBR forecasts. Based on this, the Department has used a two-year appraisal period, estimating that counterfactual wages would exceed the proposed NLW/NMW rates within two years for each category that it is proposed to increase. The IA assumes that, beyond that point, wages in the counterfactual would be higher than the new NMW rates in all categories.

The IA estimates that 2.2 million employees will be paid at or below the proposed NLW/NMW rates in March 2017. Of these, 1.74 million are estimated to be aged 25 years or over and, therefore, covered by the NLW. This is based on data from the 2016 Annual Survey of Hours and Earnings (ASHE), and is much higher than the corresponding figure used to estimate the impacts of the 2016 uprating because the appraisal now includes the NLW. The IA estimates the overall direct cost of the proposal to all (public and private sector) employers to be £306 million, in present value terms, over the two-year appraisal period.

The IA explains that impacts on the private and public sectors have been separated in order to calculate the equivalent annual net direct cost to business (EANDCB) figure. To estimate the cost to private sector employers only, the Department has used the proportion of workers affected by each of the NLW/NMW rates who work in the private sector – equivalent to 90% for the NLW, 93% for the main NMW rate, 95% for the development rate, 98% for the youth rate and 82% for the apprentice rate. These proportions have been applied to the overall cost figure, providing a total direct cost to private sector businesses of £275 million, in present value terms, over the appraisal period. All wage impacts have been uprated by 20.2% to account for non-wage labour costs, such as pensions and employer National Insurance contributions.

Spillover effects

The IA explains that some businesses may also raise wages for employees earning above the new NLW/NMW rates in order to maintain wage differentials. The Department has classified the increase in labour costs caused by this 'ripple effect' within the earnings distribution as an indirect effect, as the only regulatory requirement for businesses is to meet the increased pay floor. This is based on evidence from the LPC and other sources that there is no significant practice of maintenance of pay differentials being built into employment contracts (which would make it a direct impact). This was the approach adopted for the 2016 NMW IA. The IA estimates the ripple effect to cost employers £331 million over the two-year appraisal period. Combined with the direct cost to business of £306 million, the IA estimates the overall impact of the proposals on labour costs to be £637 million, which the Department describes as having a "…*net neutral economic impact as they are a transfer from employers to workers and the exchequer.*" (page 23)

Transition costs

The IA explains that businesses will incur transition costs of between £7.0 and £7.6 million as a result of the proposed NLW/NMW rates increases. This includes one-off familiarisation costs of between £0.9 and £1.2 million. This is based on employers taking five minutes of time to consult the government website to determine the new rates, and an estimate that between 460,000 and 675,000 employers will be affected by the uprating (using 2016 Business Population Estimates and external survey evidence). In addition, the IA estimates the implementation cost to employers of having to check the rates for which their workers are eligible and subsequently updating their payroll systems. This is calculated as between £5.9 and £6.0 million, based on the assumption that larger businesses with HR specialists would take 45 minutes to process the new wage rates using payroll software, and evidence that smaller businesses of six employees or fewer spend half a day of administrator time per month processing payroll. This assumption is based on information from business, payroll and HR specialists.

Legacy impacts

As indicated earlier, the Department has also estimated legacy costs for previous NMW increases during the current parliament, and for the introduction of the NLW. This is discussed in detail in the 'Quality' section below.

Quality of submission

During its scrutiny of previous IAs on these measures, the RPC raised two main concerns with the Department's methodological approach. These were assumptions about wage growth at the lower end of the wage distribution in the absence of changes to the NMW and the use of a one-year appraisal period. The present IA responds to these two concerns.

Counterfactual wage growth

The RPC set out a theoretical framework that indicated, in the absence of an uprating of the NMW, the average percentage wage increase at the lower end of the wage distribution would be below that across the whole economy, and that a zero per cent increase would be likely at the very low end of the wage distribution. This framework is presented on pages 47 and 73-74 of the IA. Under this framework, the assumption that the wages of employees at the NMW wage floor would – in the absence of uprating - increase in line with average earnings growth, which was used in the original submission on uprating NMW rates in 2016, would significantly underestimate the cost of the proposal to employers.

The Department has accepted that it is likely that some workers would not experience any wage growth over the short term in the absence of a minimum wage uprating, and that counterfactual wage growth for the low paid would accordingly be lower than average wage growth. The IA's central assumption is for growth to be at the mid-point between inflation and average wage growth. The Department has set out why it does not consider a lower assumption, in particular zero wage growth, to be realistic (pages 50-63) in the medium to long run. It should, however, be noted that the RPC has never suggested that an overall zero wage growth assumption was appropriate for all those affected by the NMW, or that zero wage growth for some low-paid workers would persist over the long-term.

The Department refers, in support of its approach, to advice from labour market experts, views of business stakeholders and analysis of historical data and trends, extended to include the period before the NMW was introduced and a longitudinal study of ASHE data. The IA would benefit strongly from a clearer exposition of the range of views of labour market experts and business stakeholders to support this assertion.

On the basis that the Department's approach appears to be supported by advice from labour market experts and business, the RPC can accept the assumption used in the IA. This assumption is more realistic than the average earnings growth figure used in the original IA on the 2016 upratings. However, the RPC remains concerned that counterfactual average earnings growth could be significantly lower than the rate assumed, for example because of the lower bargaining power of low-paid workers. The RPC recognises the difficulties presented by an unknowable counterfactual but would strongly encourage the Department to continue to consider ways to improve further its analysis and modelling of the counterfactual, including testing robustness using different scenarios, and to gather additional evidence to support its approach.

Whereas the NMW is aimed at reaching a competitive market equilibrium wage for low-paid workers, the NLW's policy intention explicitly goes beyond this in the interests of "…*rebalancing the economy from a low wage, high tax, high welfare society to a higher wage, lower tax, lower welfare society*" and equity (page 64). While the NMW is not expected to have negative impacts on employment, it has been anticipated (by the OBR) that the NLW is likely to do so. Given the different objectives and expected impacts of the NMW and the NLW, the Department should consider whether variations in the modelling approach may be appropriate to each policy and whether it fully captures the long-term effect of the NLW on wages and employment. In particular, the Department should address explicitly whether its methodology fully addresses the 'stickiness' effects of a step change in wages as a specific effect of the NLW. The RPC would expect the IA on the 2018 review to consider this point explicitly, and for any additional calculations to be undertaken as soon as the relevant data become available. The RPC remains of the view that best practice would be for the Department to provide an economic appraisal of the full policy ambition for NLW to 2020.

The areas where the IA should be strengthened in particular are listed below.

- Setting out more clearly the specific advice provided by individual labour market experts on the counterfactual and the evidence from stakeholders on wage-setting behaviour, similar to reporting in detail the design and results of a consultation exercise.

- Assessing the degree to which the introduction of the NMW may have 'permanently' changed wage-setting behaviour, resulting in real wage 'stickiness' and/or 'hysteresis'. This is potentially highly relevant to the analysis and could provide some support for the Department's assumptions on counterfactual wage growth. However, the IA provides very little consideration of this point. Evidence in relation to wages in general, or even low wages at a time when the NMW is being increased, is not relevant to establishing the counterfactual.

- Presenting the zero wage growth sensitivity (pages 28-29) alongside the central case and on a more like-for-like basis (i.e. in EANDCB terms).

- Discussing real vs. nominal wage growth, particularly increased divergence between the two as inflation increases.

- Providing a more integrated and detailed discussion of estimating equilibrium wage levels in the absence of an uprating of the NMW (e.g. a 'shadow wage curve'). This would potentially provide for a more effective assessment of how long zero wage growth could prevail (the question posed on page 49).

- Including greater acknowledgement of the difficulties and limitations of some of the historical data in informing a clean counterfactual, resulting from the presence of the NMW in this data.

It would be helpful if these points were addressed before publication of the IA. The RPC would expect them to be addressed for the IA of the 2018 review.

Legacy impacts

Most of the IAs covering previous upratings have used an appraisal period of one year. The RPC expressed concern that this approach was insufficient to capture the full impact of NMW and NLW increases over the course of the parliament. The present IA seeks to address this by re-estimating the costs to business of the 2015 and 2016 NMW upratings and the 2016 introduction of the NLW, using longer appraisal periods. These appraisal periods correspond to how long the impacts of the upratings are expected to last, based upon the length of time it would take counterfactual wages to reach the level of the new NMW or NLW rates. These estimates are presented as annex H to the IA.

The RPC previously validated EANDCB figures for the 2015 NMW apprentices uplift (a qualifying regulatory provision, as it went beyond the LPC recommendation) and the 2016 introduction of the NLW (a non-qualifying regulatory provision). These validations were in respect of the first-year impacts only. The Department has now used an appraisal period of ten and five years for these, respectively. Although the EANDCB figures are now lower than previously (reflecting the longer appraisal periods and the measures' diminishing impact over this period), the overall impact on business, as reflected in the BIT score (where the EANDCB is now multiplied by five rather than one), is much higher. This approach captures better the full impact of these measures on business. The table at the end of this opinion presents the previous and new validated figures. The IN (BIT score) for the 2015 NMW apprentices uplift has increased from £29.58 million to £56.0 million. The

Department's new estimate for the non-qualifying 2016 introduction of the NLW has increased from £820.97 million to £1,997.5 million (in 'BIT-equivalent' terms).

EANDCB figures for the (non-qualifying) 2015 NMW non-apprentices uplifts and (non-qualifying) 2016 NMW uplifts have not been validated previously by the RPC. The Department's submission would be improved by explaining why the estimated cost to business of these measures appears to be lower than in previous submissions. In addition, while the impacts of the 2015 NMW apprentices uplift last for ten years, the impacts of the 2015 NMW non-apprentices uplifts appear to last for only three years. Although it is not unreasonable for the Department to use a single (ten-year) appraisal period to cover all of the 2015 uplifts, the IA would benefit from including, at least as a sensitivity, an EANDCB figure for the (non-qualifying) 2015 NMW non-apprentices uplift using three years, noting that this would give a much higher figure.

Small and micro business assessment (SaMBA)

The SaMBA is sufficient. The IA explains why small firms should not be exempt from the proposal. The IA provides useful information to show that small and micro businesses are estimated to employ 38 per cent of those covered by the NMW/NLW and incur approximately 31 per cent of the cost. In that sense, small and micro businesses are not disproportionately affected and a significant part of the benefit of the policy to low-paid workers would be lost if small and micro firms were exempt. The IA discusses general measures that government is taking to support small businesses. However, this section of the assessment would be improved by drawing attention more clearly to mitigation measures that are more specific to the proposal, as in the 2015 IA.

Other comments

Employment and Exchequer impacts

As noted in previous opinions, the IA would benefit from a more extensive and integrated discussion of potential employment impacts and from providing greater detail around the size and nature of the Exchequer impacts. The 2015 IA included a box that helpfully described a potential framework for assessing possible employment impacts. The present IA would benefit from explaining more fully why this approach was not followed. The IA discusses briefly the impact of the proposals on labour productivity (pages 38-39). The IA would benefit from further discussion of these impacts and how they might arise, and from considering more generally the possible impact of the proposals on the 'quality' of employment as experienced by workers and employers.

Summary tables of assumptions and calculations

The IA would benefit from including summary tables showing the year by year assumptions (e.g. the forecast values for wage growth) and calculations, particularly where the impacts are estimated to last beyond the first few years.

Transition costs

To assess the processing cost for employers resulting from the NLW/NMW rate changes, the Department has split businesses into two groups: larger businesses that are likely to implement new rates automatically using dedicated payroll staff and software, and smaller businesses that may need to amend individual records manually. The Department has assumed that businesses with over 50 employees will incur this fixed cost of implementation. The IA would benefit from providing evidence to support this assumption, and addressing whether businesses smaller than this may be able to process new wage rates on an automatic basis. This may help refine the estimate of implementation costs, which the IA notes are '*likely to be significantly lower'* (paragraph 122).

Monitoring and evaluation

For major measures, such as these, the RPC would normally expect to see a detailed monitoring and evaluation plan. However, the RPC accepts the Department's position (page 42) that this process is already built into the system through the LPC reviews.

Proportionality and IA length

The Department's IA is exceptionally long. This is broadly justified in this case by the detailed presentation of the previously expressed RPC's concerns and by the inclusion of the legacy impacts. The RPC would not expect the Department to produce IAs of this length on subsequent upratings. In particular, the RPC notes that some of the evidence presented in the present IA, in particular on wage inequality and experience before the NMW was introduced, is of little relevance to demonstrating the appropriateness of the Department's assumptions. The additional analysis and evidence requested by the RPC should focus specifically on the points above, rather than expanding these areas of the IA. It should, therefore, be possible to accommodate this work in an IA of shorter length for the 2018 review.

Departmental assessment

Classification	Non-qualifying regulatory provision
Equivalent annual net direct cost to business (EANDCB)	£131.6 million
Business net present value	-£281.3 million
Societal net present value	-£7.3 million

RPC assessment

Classification	Non-qualifying regulatory provision (exclusions H and J– national minimum wage and national living wage)
EANDCB – RPC validated	£131.6 million
Business impact target score	£263.2 million
Small and micro business assessment	Sufficient

Re-validated and validated estimates relating to legacy measures

Measures with EANDCB previously validated by the RPC

	Appraisal period	Business NPV	EANDCB	BIT score/ NQRP 'BIT score equivalent'
2015 NMW apprentices (QRP)				
Previous	1	-38.76	29.58	29.58
New	10	-97.10	11.20	56.0
2016 NLW introduction (NQRP)				
Previous	1	-863.3	820.97	820.97
New	5	-1,940.2	399.5	1,997.5

Other measures

	Appraisal period	Business NPV	EANDCB	BIT score/ NQRP 'BIT score equivalent'
2015 NMW non-apprentices (NQRP)				
	10	-314.95	36.4	182.0
2016 NMW all (NQRP)				
	3	-86.3	28.3	84.9

Michael Gibbons CBE, Chairman