Regulatory Policy Committee

National Minimum Wage (Amendment) Regulations 2018: 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; all in line with the LPC's recommendations. The Government propose to increase the NLW by 4.4% to £7.83, the 21-24 year old NMW rate by 4.7% to £7.38, the development rate by 5.4% to £5.90, the youth rate by 3.7% to £4.20 and the apprentice rate by 5.7% to £3.70. It is proposed that the new rates should come into force on 1 April 2018. NMW and NLW rates were last increased in April 2017.

Impacts of proposal

Direct labour costs

The introduction of the new NLW and NMW rates would impose costs on businesses by increasing the wages of employees who were paid less than the new statutory wage rates, and associated non-wage labour costs. The impact assessment (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 counterfactual wage, the Department has used a counterfactual in which wages increase at a rate equal to the assumed increase at the 20th percentile of the wage distribution. This rate was recommended by the National Institute of Economic and Social Research (NIESR), which was commissioned by the Department to analyse counterfactual wage growth. This is the point in the pay distribution where NIESR estimate that there are no spillovers from the minimum wage 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, using an assumption for counterfactual wage growth recommended by NIESR. Based on this, the Department has used a three-year appraisal period.

The IA estimates two million employees would be paid at or below the proposed NLW/NMW rates in April 2018. Of these, 1.63 million are estimated to be aged 25 years or older and, therefore, covered by the NLW. This is based on data from the 2017 Annual Survey of Hours and Earnings (ASHE). The IA estimates the overall direct cost of the proposal to all (public and private sector) employers to be £264 million, in present value terms, over the three-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 and voluntary sector employers only, the Department has used the proportion of workers affected by each of the NLW/NMW rates who work in the private and voluntary sectors – equivalent to 96% for the NLW, 97% for the main NMW rate, 96% for the development rate, 100% for the youth rate and 92% for the apprentice rate. These proportions have been applied to the overall cost figure, providing a total direct cost to private and voluntary sector businesses of £254.3 million, in present value terms, over the appraisal period. All wage impacts have been uprated by 19.73% to account for non-wage labour costs, such as pensions and employer National Insurance contributions (NICs).

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 2017 NMW IA. The present IA estimates the ripple effect to cost employers £313.8 million over the three-year appraisal period. Combined with the direct cost to business of £264 million, the IA estimates the overall impact of the proposals on labour costs to be £577.7 million, which the Department says is a "transfer from firms to workers, with some benefits for the Exchequer (e.g. employer NICs) and therefore has a "net neutral economic impact" (page 25).

Transition costs

The IA estimates that businesses would incur familiarisation costs of between £2.0 million and £2.9 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 820,000 and 1,190,000 employers would be affected by the uprating (using 2017 Business Population Estimates and external survey evidence). Unlike last year's IA, the Department does not include implementation costs for this year's NMW uplifting. The IA explains that implementation costs were estimated because NMW and NLW were aligned for the first time last year. In addition, based on the evidence from the Bank of England Wage Dynamics Survey and the Workplace Employment Relation Study 2011, the IA assumes that most of the firms conduct pay reviews only once a year. NIESR also found that most pay reviews take place in April. The IA, therefore, suggests that the implementation costs, if any, are negligible.

Quality of submission

The RPC's opinion on the 2017 NMW/NLW upratings indicated areas where it would expect the Department to strengthen the analysis in the IA on the 2018 upratings.[1] In response, as noted above, the Department commissioned NIESR to carry out a study into counterfactual wage growth. This has had limited success but resulted in some improvements, such as a new estimate of the point in wage distribution where the effects of the NMW/NLW are no longer felt. The Department has also provided a quantitative assessment along the lines of the RPC's suggested 'shadow wage curve' framework (annex B of the IA). This is an important additional analysis, allowing for a period of zero wage growth at the lowest end of the wage distribution and, therefore, a longer period before which the counterfactual wage growth 'catches-up' with the minimum wage.

Given the improvements to the IA, the difficulties presented by an unknowable counterfactual and the recognition that the Department's approach appears to be supported by labour market experts, the RPC accepts the IA as fit for purpose. However, the RPC remains concerned with two key areas of the analysis, where the Department's approach seems likely to underestimate significantly the business impact of the NMW/NLW.

[1] RPC-3588(1)-BEIS 'National Minimum Wage Regulations 2017: increases in the national minimum wage and national living wage rates', 20 January 2017.

Counterfactual wage growth assumptions

NIESR attempted to estimate counterfactual wages based on changes in firm and worker characteristics but found that its model lacked sufficient explanatory power. NIESR, therefore, recommended instead a counterfactual assumption of wages at the low end of the pay distribution growing at the same rate as those at the 20th percentile. The rate recommended was that observed over 2011-2016, of 0.68 per cent per quarter (equivalent to just over 2.7 per cent annually). This approach has been used in the IA.

The RPC's concerns with this approach are:

a) That the wages of the lowest paid would rise at the same rate as the 20th percentile lacks an intuitive and theoretical basis. It would seem more likely, for example using a 'shadow wage curve' framework, that the NMW would be more binding at the lowest part of the wage distribution and that counterfactual wage growth there would, therefore, be lower or zero. The RPC had understood that NIESR considered its recommended approach to provide only a lower bound estimate of the cost to business, rather than a best or central estimate.
b) There appears to be significant support in the NIESR literature review (pages 17, 20, 21 and 27) and employers' survey (pages 40 and 45) for workers at the lower end of the pay distribution receiving lower wage increases in the absence of an NMW uprating. The IA's reference to the minimum wage having a "…*strong anchoring effect on wage setting*…" (paragraph 155, page 48) would also appear to be consistent with employees continuing to receive the old minimum wage and therefore getting zero or very low pay increases in the absence of an uprating.
c) It is not clear why 20th percentile wage growth over the period 2011-2016 is preferred over the latest OBR's forecast for average earnings growth (table 2, page 10 of the IA). The latter, at 2.3 per cent rather than NIESR's 2.7 per cent, would result in higher costs to business. The RPC does not, therefore, consider that the assumption could be described as "…*pessimistic*…" (paragraph 57, page 20 of the IA).
d) The potential bias in the Department's approach is considerable. Annex B presents an estimated additional cost of £2.6 billion (paragraph 158, page 49) for the NLW, over and above the Department's best estimate of £208.3 million (table 6, page 26), using an alternative approach to establishing the counterfactual.

The NIESR report does seek to address the RPC's concerns about counterfactual wage growth. First, NIESR tested data between 2001 and 2016 and found "no significant evidence" that wages in occupations at the lower end of the wage distribution had been growing historically at a slower rate (pages 76-79). Second, it presents the estimated counterfactual from NIESR's model and concludes there is no evidence for counterfactual wage growth being at, or close to zero, and that its recommended measure of counterfactual wage growth "…*neither consistently overestimates nor underestimates estimated wage growth.*" (pages 81-84; page 17 in the IA)

The RPC welcomes NIESR's attempt at addressing our concerns. However, we are not convinced that this provides strong evidence against wage growth being lower than that recommended by NIESR. On the first test, the RPC is unsure how the test allows for the existence of the NMW affecting the data. On the second test, the presentation of the model's results is welcome but its self-acknowledged lack of explanatory power limits the usefulness of this analysis, and we find it hard to see how wage growth of the low paid could ever be higher in the absence of the NMW as the range for the estimated model implies (figure 3, page 17 of the IA).

Omission of 'base-raising impacts from previous years' upratings

The second main RPC concern relates to the re-setting of the counterfactual each year to reflect that of the existing NMW/NLW. This potentially fails to capture the full ('base-raising') impact resulting from previous years' upratings, as illustrated in the NIESR report (figure 1, page 55). NIESR's report seeks to address the RPC's concerns at pages 56-59. The RPC accepts that long-term estimates of counterfactual wage growth would involve additional uncertainty. NIESR has also helpfully illustrated its argument that there would be a 'bias due to asymmetries arising from forecast errors' (figure 2, page 58).

Nevertheless, even if it is accepted that alternative approaches may have greater difficulties or drawbacks, it remains the case that re-setting the counterfactual each year results in costs being potentially omitted (represented by areas c and f in figure 1). The IA states that "*There is evidence that having had a minimum wage framework in the UK over a sustained period of time has had a significant impact on the wage setting behaviour of firms*" (page 15). If so, it is particularly important to acknowledge the 'base-raising' effect of NMW upratings. The RPC cannot recall any long-run impacts on the wage-setting behaviour of firms having been accounted for in previous NMW IAs.

The IA would benefit from making a clearer distinction between the NMW and the NLW. The IA would also benefit from recognising in its assessment the key difference between the introduction of a minimum wage, and its uprating. In the latter case the analysis is complicated by the distortions caused by the presence of a minimum wage. Appraising the full impacts of the NLW should be more straightforward given its much more recent introduction. 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. Failing that, the Department should at each annual uprating explicitly check that its assessment of the cumulative impact is soundly based.

Overall, the RPC recognises the difficulties presented by an unknowable counterfactual and is prepared this year to validate the Department's assessment. However, given the very significant potential impact on estimated costs to business, it strongly encourages the Department to continue to consider ways to improve further its analysis and evidence in this area. More specifically, the RPC suggests that the Department seeks comments and views from a range of labour market experts and stakeholders on the points raised in this opinion. The RPC would expect the Department to provide further support and evidence for its approach in the IA on the 2019 upratings.

Other comments

The IA would also be improved by addressing the following additional comments:

- Annex B: The IA would benefit from explaining further the basis for its assumption that counterfactual wages would catch up with the current minimum wage level in four years, and conduct sensitivity analysis on this period. The annex is hard to follow in places and the explanation could be improved (for example figure 9 is not explicitly referred to in the text). Given its importance, the RPC would like to see this analysis integrated more fully into the main body of the IA.
- Provide more information on "…*there may be other approaches which could be used*…" (paragraph 58).
- Explaining further the reasons for differences with LPC estimates, differences in employee coverage (page 25) and the LPC's conclusion that spillovers from the NLW in 2017 may have reached the 30th percentile of the wage distribution (paragraph 66).
- Implementation costs – presenting additional evidence for these being insignificant (page 31).

Small and micro business assessment (SaMBA)

The SaMBA is sufficient. Small and micro businesses are estimated to employ 31 per cent of those covered by the NMW/NLW and incur approximately 36 per cent of the cost. Although small and micro businesses are, on this basis, slightly disproportionately affected by the proposal, the IA explains why they should not be exempt from the proposal (paragraphs 130-132). The Department also states that the pre-announcement of the rates in November 2017 and the Government's communications campaigns would help small and micro businesses adjust to the new rates.

Departmental assessment

Classification	To be determined
Equivalent annual net direct cost to business (EANDCB)	£76.6 million
Business net present value	-£256.54 million
Societal net present value	-£2.9 million

RPC assessment

Classification	To be determined once the framework rules for the current parliament are set
Small and micro business assessment	Sufficient

Anthony Browne, Chairman