



The National Living Wage Beyond 2020

November 2019
Low Pay Commission

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Introduction

Publication note

This report was submitted to the Government in early September 2019 as part of the consultation concerning the future of the NLW. It has not been updated following any subsequent announcements or policy changes.

1 It is now over 20 years since the National Minimum Wage (NMW) was introduced across the UK, with the aim of ending exploitative low pay and redressing power imbalances between employers and workers at the lower end of the labour market. Throughout that period we, the Low Pay Commission (LPC), have been responsible for recommending each year to the Government the annual increases applied to the different NMW rates; and for reviewing the impact of the minimum wage on the UK economy. In 2016, the Government introduced a new top rate, the National Living Wage (NLW), and asked the LPC to take responsibility for increasing the rate to a target level of 60 per cent of median earnings by 2020. With the caveat that our recommendations are always subject to a full review of the economic evidence, it is likely the Government's target will be met by April 2020.

2 In October 2018, addressing the House of Commons in his Autumn Budget, the then Chancellor set out his ambitions for the future of the NLW and the LPC: 'Next year we will need to give the LPC a new remit beyond 2020. We will want to be ambitious with the ultimate objective of ending low pay in the UK but we will also want to be careful – protecting employment for lower paid workers. So we will engage responsibly with employers, the TUC, and the LPC itself over the coming months gathering evidence and views to ensure we get this right – and I will confirm the final remit at the Budget next year.'

3 Whatever the Government's decision on the next phase of the NLW, it will have a significant impact on the economy and labour market in the coming years. It will have an equally deep effect on the role of the LPC, a long standing and widely respected social partnership; and on the status of the minimum wage more broadly, which over a long period has raised workers' pay without harming employment and won the support of employers and businesses alike. Since the Chancellor's statement, we have thought about the significance of the ambition to end low pay in the UK, the role of the NLW in this challenge and the conditions required to achieve this. We have considered the evidence on the NLW's impact to date and spoken to a wide range of stakeholders across the low-paying sectors and

beyond about the pressures and opportunities which would be created by a higher NLW target. This report sets out our response to the Government's stated ambition to end low pay.

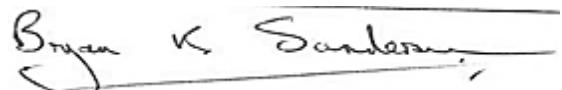
4 Throughout this report, we have focused on the role of the minimum wage, although we believe strongly that despite having a role to play it cannot end low pay by itself. We have interpreted the Government's ambition in light of HM Treasury's own reference (HM Treasury, 2018) to the OECD's definition of low pay, which sets the relevant cut-off point at two-thirds of median earnings. We have also started from the assumption that the default model for the minimum wage after 2020 will be that used for the NLW since 2016, that is, a time-bound target set as a percentage of median hourly earnings. These are necessary starting assumptions only and we recognise that the Government has the freedom to set policy as it sees fit. They are also assumptions about, rather than endorsements of, a given approach. To comment on the general ambition to end low pay, we have had to start from specific assumptions; but much of what we say in this report is of broader relevance to the Government's ambition and to the future of the minimum wage.

5 The NMW has been one of the outstanding policy successes of the past 20 years. It has reversed historic trends which dictated that the lowest-paid members of society saw the weakest growth in earnings; and it has done so without causing jobs to be lost. Alongside this, the LPC itself has been a success in building consensus over minimum wage increases and keeping the confidence of workers and employers alike. It will be essential to maintain this confidence in the future; to preserve the institutional strengths of the LPC; and to ensure the minimum wage continues to improve the position of as many individuals as possible. We look forward to continuing our work in the next phase of this vital agenda.

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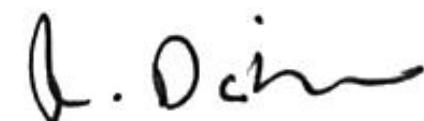
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Executive summary

1 We, the Low Pay Commission, set out in this document our advice to the Government on the future of the National Living Wage (NLW) beyond 2020. We do this in the context of the Government's announcements in the 2018 Budget and the 2019 Spring Statement on its ambition to end low pay. We share and support this ambition. But it is important to carefully consider what this general ambition means for the NLW specifically – and whether the NLW is the sole means to achieve it.

2 As already set out in the Introduction, our work is informed by a number of assumptions about what the Government's ambition entails. By low pay, we understand the Government to mean the percentage of workers paid below two-thirds of the median hourly rate. We have taken the Government's statements to signal a further target for the NLW, set at two-thirds, or 66.7 per cent, of median hourly earnings. The decision over the appropriate level and timescales for any NLW target is a political one – although we assume it will be our role to set a pathway towards that end-date, using our model of social partnership to build consensus over increases. As we go on to discuss, we should have flexibility each year to take account of economic conditions in making its recommendations, which may require it to vary this pathway.

3 As part of this advice, we have looked at the implications of a target set at this level and the conditions needed to support it. Crucially, we have also looked at the design of the policy framework around the NLW as well.

4 Since its introduction in 2016, the NLW has raised wages for the low paid without strong evidence of overall job losses. But in making our recommendations, we note that we only have evidence of the effects of three of the total five NLW upratings. The fourth uprating to £8.21 came into force in April 2019, so evidence of its impact is very limited and, at the time of submitting this report to Government (September 2019), we have not yet made a final recommendation on the rate for April 2020 that attains the target of 60 per cent of median earnings.

Low pay and the National Living Wage

5 The extent of low pay varies depending on how it is defined, with the crucial distinction being whether it is measured on the basis of hourly or weekly pay. Weekly pay is the basis for international comparisons of low pay and is, arguably, more relevant when considering the relationship with living standards more generally, while low pay defined on an hourly basis is more analogous to the UK's

National Minimum Wage

hourly National Minimum Wage (NMW). But on all measures, there is a relatively high degree of low pay in the UK. We calculate that there are 4.7 million workers aged 21 and over in the UK who are low-paid on an hourly basis, or just under 18 per cent of the workforce. But looking at weekly pay, this figure rises considerably to 7.2 million individuals, or over 27 per cent of the workforce, because of the UK's relative abundance of part-time work. We would expect the NLW, as a minimum hourly rate, to have a more direct impact on hourly measures of low pay, and a weaker impact on weekly low pay measures because weekly pay is at least as dependent on the number of hours worked as the hourly rate of pay.

6 In the course of its 20-year history, the NMW has substantially increased pay for the lowest-paid, without harming overall employment, and reversed historic trends whereby the lowest-paid would see the lowest growth in their earnings. Despite this it is only relatively recently (since 2014) that the overall rate of low pay on either weekly or hourly measures has begun to fall noticeably. This is most likely because only the more ambitious NLW rate increases and their spillover effects further up the pay distribution have been high enough to have any effect. This finding – that the relationship between low pay and minimum wages is not straightforward – holds internationally as well. Evidence from other countries shows that a high bite (the ratio between the minimum wage and median pay) does not automatically mean less low pay – though countries where the bite of the minimum wage has increased have seen a reduction in the prevalence of low pay.

7 Ending low pay is a substantial commitment – and one that is arguably more ambitious than anything the NMW has achieved to date. There are many countries with a lower rate of low-paid workers than the UK. But fewer countries combine a low incidence of low pay with equal or higher rates of employment, and some of these do not have a minimum wage at all. There are no countries without any low-paid workers. According to the OECD's bite data, no European Union or G7 country has a minimum wage approaching two-thirds of median earnings.

8 Raising the NLW further is likely to reduce the number of low-paid workers based on an hourly definition, but, for a number of reasons, we should not expect increases in hourly minimum wage rates to 'end' low pay or in-work poverty in the broader sense. Rather than being concentrated in the lowest-income households, workers earning the NLW are in fact spread through the household income distribution. This means that the NLW is not as well-targeted at low-income households as might be assumed. Further, those in low-income households will gain less from NLW increases than their counterparts in higher-income households, as they are more likely to be in receipt of in-work benefits, which are withdrawn as their pay rises. There is also the distinction between weekly and hourly pay. Increases in hourly pay do not automatically translate into higher weekly pay, which is what matters for living standards.

9 To be clear, this is not an argument against raising the NLW. Instead we are simply stating that the minimum wage is a specific policy tool which raises the hourly pay of the lowest-paid workers. This is not the same as raising an individual's total weekly, monthly or annual salary and not the same as raising their total household income.

10 Employer and employee stakeholders alike have told us that they support the ambition to abolish low pay, but there is less consensus on the approach to reaching this ambition. However, all agreed that the LPC's role was central to this process. While worker representatives argued strongly for the wider economic and social benefits this would bring, employers were concerned about whether the NLW was the most effective means to achieve the stated aim. Worker representatives said they would prefer a quick transition, perhaps along similar lines to the NLW pathway so far, while employer representatives urged a more cautious approach, perhaps taking between 8 and 10 years. Some employer representatives did not agree with the target-based approach and called for a return to the previous remit of the LPC.

Impacts of a higher NLW target

11 It is challenging to predict which workers would be affected by a higher NLW target, and to what extent, without certainty over the proposed target level and end date. However, by looking at the group of workers most likely to be affected – those paid less than two-thirds of median earnings now – we can shed some light on this. As with the introduction of the NLW, a new group of employers and workers will be affected by the higher target, with implications for how those employers currently set pay and comply with the minimum wage regime. For example, there could be up to one million more workers covered by the NLW who currently work in non-low paying occupations. This in turn will have implications for the Government's efforts around communications, guidance and enforcement.

12 Even if the scale and pace of future increases were known, it would still be challenging to predict the impact of future increases on the labour market. We only have evidence on the impacts of the first three of the five NLW upratings, but the research to date tells us that the NLW has not, so far, had any significant negative effect on overall employment. However, this does not mean future increases are without risk to employment or other potential negative impacts on other measures.

13 It is also important to consider the tax and benefit implications of any changes. Under present arrangements, if the NLW were increased to two-thirds of median earnings and assuming no other changes to hours of work or the tax and benefits system, then low-paid workers will pay a greater share of their pay in tax. This is because there are many NLW workers who currently earn below the National Insurance and Income Tax thresholds, but will move above them as their earnings increase.

Conditions for a higher National Living Wage

14 A higher NLW must be supported by economic conditions, including strong employment, economic growth, increasing pay, productivity growth, the affordability of increases to firms and the quality of jobs for workers. In recent years the labour market has seemed to diverge from broader economic performance. We have seen significant increases in employment alongside weak GDP and productivity growth. However, it remains our position that a strong economy is necessary to support the ambition to reduce low pay in the long term. We will continue to examine a range of indicators in assessing whether the economy has capacity for minimum wage increases – but will not restrict ourselves to particular thresholds of these indicators. The evidence base for the LPC's recommendations will remain the combination of economic data, research and qualitative evidence from workers, employers and their representatives.

The policy framework for the National Living Wage

15 The question as to how high and how fast the NLW can increase is clearly of significant importance, but just as important is the design of the policy framework that supports it. The NLW framework in place since 2016 differs from the previous NMW framework in a few important respects. It has a target, set as a percentage of median earnings, and an end-date, which together result in a predicted path of NLW rates based on earnings forecasts. Employers tell us these are valuable in planning ahead.

16 In addition, currently there are specific conditions whereby the LPC can depart from the target. Firstly, the Government has told us that our recommendations should be 'subject to sustained economic growth', which we have interpreted as annual GDP growth of 1 per cent. Secondly, in setting the target, the Government signalled some tolerance for job losses caused by NLW increases (at the time, the OBR forecast substantial job growth across the economy, compensating for any jobs lost). Were we to find employment effects greater than this tolerance, then this too may be grounds to come off the path.

17 The sources of evidence these conditions depend on are subject to lags and are potentially inaccurate. This tends to limit our ability to respond to changes in economic circumstances. And the earnings growth forecasts, which are fundamental in setting the rate, may also be slow to respond to changing economic conditions and are subject to considerable uncertainty.

18 We need the flexibility to respond to changes in economic circumstances. During the financial crisis of 2008 and 2009 we made recommendations to slow the growth of the NMW and our research evidence suggests that these upratings did not damage employment, despite the backdrop of the UK's deepest post-war recession and findings that employment is more sensitive to minimum wages in recessions. This serves as an example of the success of the LPC's social partnership model;

Commissioners were able to achieve consensus on the appropriate rate despite both unfavourable economic circumstances and an uncertain evidence base. But these recommendations may not have been possible under the NLW framework, with its dependence on GDP data and forecasts of earnings growth. It is now known that GDP data in the second quarter of 2008 was incorrect, and earnings forecasts were overstated. At the time the LPC was able to take into account persistent inaccuracies in earnings growth forecasts; and when looking at factors which merited caution, to take into account broader factors than just the rate of GDP growth. This has implications for the design of the policy framework for the NLW.

19 Given these limitations, and the ambition of a potential two-thirds target, we think there is a case for reassessing the design of the NLW framework to make sure we have the appropriate flexibility to respond to circumstances. Specifically, the condition of 'sustained economic growth' should be broadened so we have the freedom to take a wide-ranging view of economic conditions and whether they support continued progress along a set pathway to the NLW target. In practice this may not involve us considering a significantly different set of indicators to those we currently do; but will give us the freedom to base our decisions on a wider range of indicators. It is important to establish the principle of the LPC's autonomy in assessing the evidence, and to avoid tying this to any specific thresholds.

20 Recommending departing from the target could take several forms, either adjusting the pathway without altering the target's end-date, or moving the end-date. In either case, the variability of the target should be symmetrical; it should be possible for the LPC to recommend faster increases if evidence suggests these are achievable.

21 In our consultation, stakeholders uniformly backed the importance of the LPC as an independent, evidence-led body in setting the NLW each year, taking into account a wide range of indicators. But there was greater diversity of opinion over the framework itself, with trade unions supporting an ambitious target, but many employer representatives opposed to a prescribed NLW target.

22 In setting any future NLW target, the Government should consider carefully what supporting policies are needed to ensure its success. For individuals, the tax and benefits system influences how far they feel the benefit of NLW increases. For employers, the minimum wage is one cost among many which must be managed. In the sectors which Government itself funds – social care and childcare – sufficient funding is necessary to meet the cost of the rising NLW. And the expansion and development of HMRC's enforcement capabilities must continue if the NLW is not to be undermined by growing non-compliance.

Conclusions and recommendations

23 Ending low pay is a worthy ambition. We hear too often from workers about the debilitating effects of low pay. But we should be under no illusions: a two-thirds target is ambitious and will be very stretching for businesses in low-paying sectors. Equally, a higher NLW target by itself will not end low pay under the most common measures, and will need to be accompanied by a broad slate of supporting policies if the Government's stated aim is to be met.

24 The Government's ambition to eradicate low pay should be matched by ambition for the evidence base that supports it and allows us to track the emerging effects of the policy. The Government has been making promising steps in using administrative data as part of its evidence base. We believe there is potential in the Government's Real Time Information (RTI) system, which collects information for the purposes of collecting tax, to provide a key information source. **We recommend that Government takes steps to provide both timelier and more detailed estimates of employment using RTI than currently provided. In addition, we recommend that the Government explores the potential to collect information on hours of work in RTI.** At the same time, access to existing data sources is often slow for researchers, limiting our ability to respond to economic conditions. **We recommend that the Government takes steps to facilitate faster access for researchers to primary data sources on employment, hours and earnings.**

25 To ensure the ongoing credibility of the NLW, the LPC's independence and discretion to depart from a target must be safeguarded. And we must be free to look at the full range of available evidence in reaching a judgement on whether the target is achievable. **If economic conditions are not favourable, we must have the flexibility to recommend varying the path and end date of any target.**

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Chapter 1

Low pay and the National Living Wage

Definitions of low pay

1.1 The Government has announced an ambition to end low pay and has signalled that this will drive the next phase of the National Living Wage (NLW). But the relationship between minimum wages, low pay and living standards more generally are not straightforward. In this chapter we set out these relationships, to better understand the extent to which the NLW can contribute to the Government's overall ambition. In order to do this, we need to first define what we mean by low pay.

Existing definitions of low pay

1.2 When the Government announced its intention to 'end low pay' in the 2018 Budget, the associated documents (HM Treasury, 2018) cited the Organisation for Economic Co-operation and Development (OECD) definition of low pay, which states that individuals who earn less than two-thirds of median earnings are low-paid. Two-thirds of median earnings/income is widely used as a definition for poverty analysis in the sociological and economic literature. The OECD measure is based on weekly pay for full-time workers on adult rates of pay and the OECD defines full-time employees as those who work more than 30 paid hours per week or those in teaching professions working 25 paid hours or more per week. Excluding part-time workers from the measure in this way enables easier comparisons across countries with different levels of part-time working. Using this definition, the UK currently has 19 per cent of full-time workers in low pay.

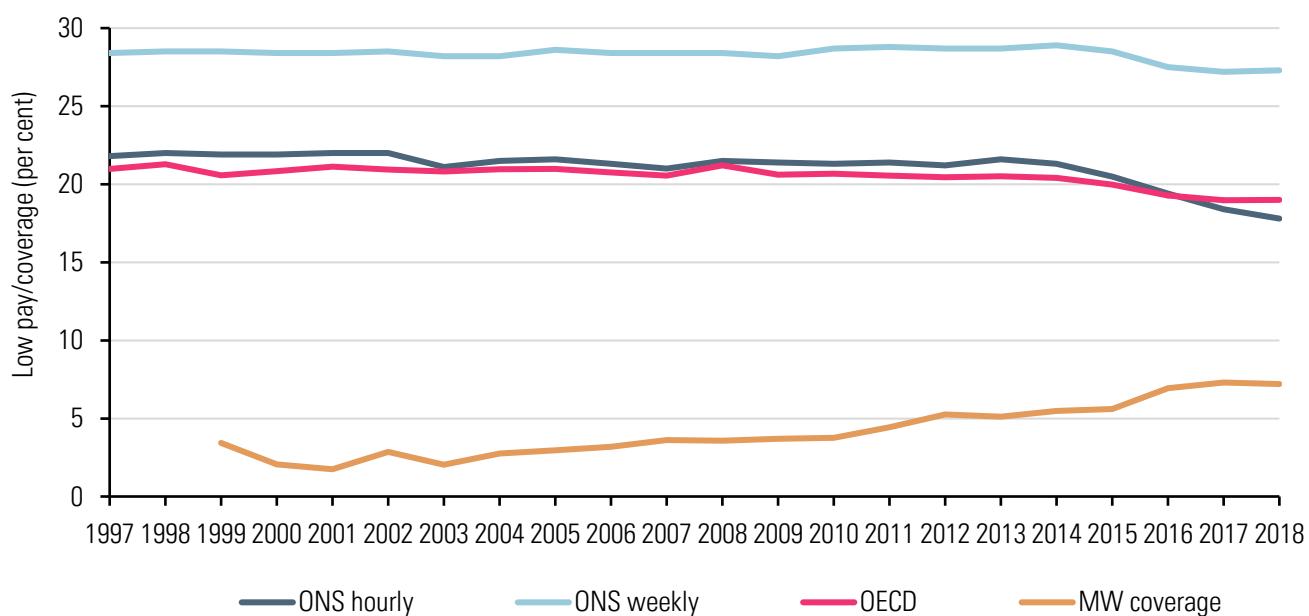
1.3 The Office for National Statistics (ONS) also produce estimates of low pay in the UK (Office for National Statistics, 2018b). They also use the two-thirds threshold but apply it to the entire workforce (i.e. not excluding part-timers) and produce separate estimates for those who are low-paid on an hourly basis and those who are low-paid on a weekly basis. As the ONS include part-time workers, their estimate of weekly low pay is significantly higher than the OECD estimate, with over 27 per cent of workers underpaid on this definition. Looking at hourly pay only, the ONS estimate that almost 18 per cent of workers are low-paid.

1.4 Understanding the differences between these ways of thinking about low pay is vital for understanding the impact that changes to the NLW might have on them. We explore this below.

Low-pay and the NMW

1.5 The National Minimum Wage (NMW) has been in place since 1999. Since its introduction, it has always taken the form of an hourly, rather than weekly or monthly minimum wage. This is also the case for the NLW, introduced in 2016 and on course to reach a target of 60 per cent of median hourly wages for those aged 25 and over by 2020; as well as for the four other rates that make up the NMW framework¹. Figure 1.1 shows how low pay – whether defined using the ONS or OECD methodologies – and minimum wage coverage² have changed in the UK since 1997. This shows that, despite the minimum wage's twenty-year existence, the prevalence of low pay has only started to fall appreciably since 2014. While this change appears to pre-date the NLW's introduction, it is reasonable to assume that the faster increases in the level and coverage of the rate since 2016 have contributed to this fall.

Figure 1.1: Low-pay rates under various definitions, 1997-2018



Source: ONS hourly and ONS weekly from Office for National Statistics (2018b), OECD from Organisation for Economic Co-operation and Development (2019a) and MW coverage LPC estimates using ASHE 2010 methodology, standard weights, UK, 1999-2018.

¹ The exception to this is the Accommodation Offset, which is an allowable deduction from wages for accommodation, set as a daily amount.

² We define the coverage of the minimum wage as the number of individuals who are paid within 5 pence of the rate.

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1.6 The first thing to note is that (using comparable ONS definitions), low pay measured on a weekly basis is significantly more widespread than on an hourly basis, with over 27 per cent of the workforce counted as low-paid on the former measure. This compares with under 18 per cent of the workforce on the hourly measure.

1.7 The second point to note is that as an hourly minimum wage, the NLW's relationship with low pay varies depending on the measure used. As an hourly measure we would expect the NLW to have a stronger relationship with hourly low pay than weekly, and this appears to be borne out by the data presented in Figure 1.1. The relationship between the NLW and weekly low pay is less direct. The UK has one of the highest rates of part-time working among economically developed countries, with around a quarter of UK employees and two-thirds of NLW workers in part-time roles. In consequence, even with a higher minimum wage, many NLW workers will work too few hours to earn enough to escape from low pay on a weekly measure. The prevalence of part-time working is the main reason for the much higher number of low-paid jobs on a weekly basis. Just over 80 per cent of part-time jobs are low-paid on a weekly basis, but this is largely a function of hours worked rather than hourly pay.

Low pay thresholds

This box sets out the different thresholds for low pay, as measured by weekly pay, hourly pay, across all workers and for full-time workers only. To keep a degree of consistency across the definitions we use the same age group – employees aged 21 and over, who are not in the first year of an apprenticeship. This means that the thresholds here may be slightly different to those used to define the low pay measures shown in Figure 1.1. All figures are based on earnings in 2018.

The median hourly pay rate for this group of employees was £12.90. Therefore, **any worker earning less than £8.60 per hour would be classed as low-paid**.

Median gross weekly pay for this group of workers was £477.67, **meaning those earning less than £318.44 per week would be classed as low-paid**.

A minimum wage worker would therefore have needed to work 41 hours a week to earn enough to be above the threshold for low pay. Less than 15 per cent of minimum wage workers did so in 2018.

Excluding part-time workers (as defined by the OECD and set out in paragraph 1.2), the median pay figures increase to £14.28 an hour and £574.95 a week. Therefore, for a minimum wage worker to earn two-thirds of median weekly full-time earnings (£383.30), they would have needed to work 49 hours a week.

1.8 The NLW's relationship with the OECD's definition of low pay is likely to be weaker still. This is because median hourly pay for full-time workers is around 50 per cent higher than for part-time workers. Excluding the latter group raises the median and with it the threshold for low pay, and effectively lowers the NLW's bite. This makes it less likely that the NLW pushes up hourly pay enough to cut low pay amongst full-time workers.

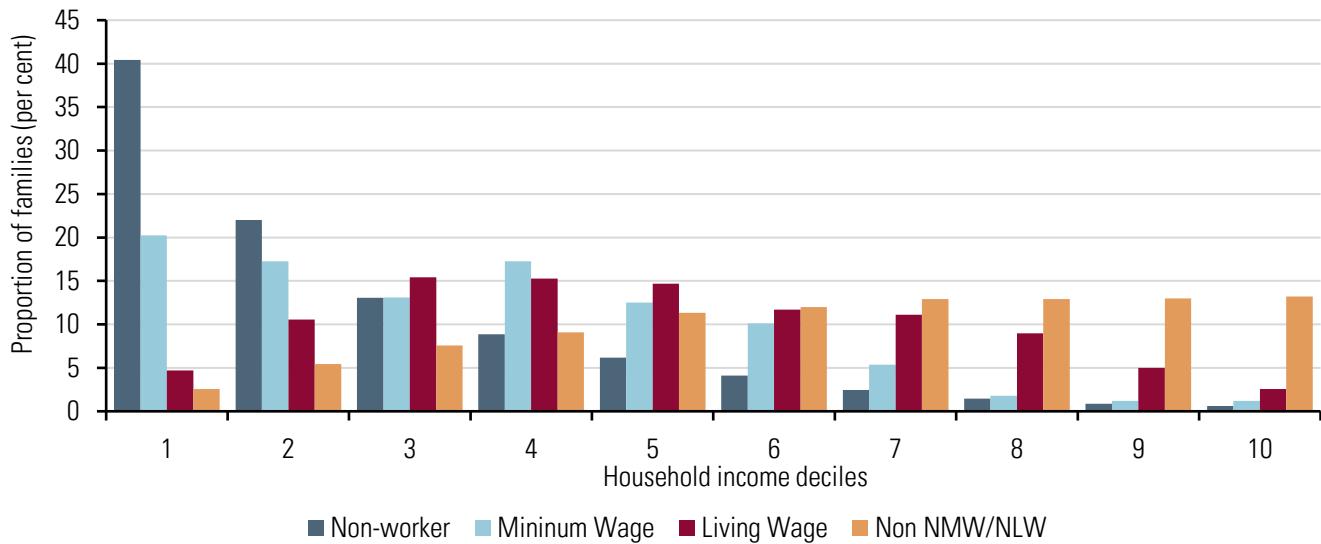
1.9 It is important to note that workers who are low-paid using a weekly measure may not be low-paid when using an hourly one (and vice-versa). Our analysis shows that around 80 per cent of those who are low-paid on an hourly basis are also low-paid on a weekly one, but only around half of those low-paid on a weekly basis are low-paid on an hourly one. In fact, when looking at weekly pay, minimum wage employees are spread across the bottom 30 per cent of the pay distribution rather than concentrated at the bottom. Six-in-ten minimum wage employees earn more each week than the lowest-paid 10 per cent of employees, and a third of these earn more each week than the bottom 20 per cent. This is explored in more detail in the 'Who are the low paid?' section on page 5.

Low pay and living standards

1.10 All the measures previously discussed focus on gross pay at an individual worker level. However, what matters for living standards is the total income to the whole household. Therefore, it is important to understand firstly where low-paid workers are in the household income distribution and secondly the impact of other factors on household income, particularly the tax and benefit system.

1.11 It is not unreasonable to assume that low-paid or NLW workers live in low-income households, but while there is a correlation it is not as strong as might be expected. For example, a low-paid or minimum wage worker may be the partner or dependent of someone with a higher income. The lowest-income households often contain no individuals in work, but even amongst working households, minimum wage employees are spread across the income distribution. A recent study Cribb, Norris Keiller and Waters (2018) found that lower-paid workers were distributed across the household net income distribution for working households, with similar fractions of low-paid employees in the bottom five household deciles. Overall, they found that the lowest-paid 20 per cent of employees made up around 9 per cent of the bottom household income decile, and around 11 per cent of the 2nd to 5th income deciles. A separate study Brewer and Agostini (2017) examined the link between the NMW, the NLW and the tax and benefit system. They also found only a minor overlap between minimum wages and low-income households, with very few of the poorest working-age households containing NMW or NLW workers, but with fairly consistent distribution of minimum wage workers across the 2nd to 7th household income deciles as shown in Figure 1.2.

Figure 1.2: Working-age families across the working-age income distribution, by employment and NMW/NLW status, UK, 2017-18



Source: From Brewer and Agostini (2017) using Family Resources Survey, 2014/15.

1.12 The effects of higher pay for some of these workers are moderated by the tax and benefit system. The Universal Credit (UC) taper rate is 63 per cent, suggesting that workers on UC will keep at most 37 percent of a pay increase (for those working enough hours to earn beyond the work allowance³). Paragraphs 2.24 to 2.33 examine the tax and benefit impacts of higher minimum wages in more detail.

1.13 Overall, the extent of low pay in the UK, and who is counted as low-paid, varies depending on the definition we use. However, all measures find significant levels of low pay in the UK. The ambition to end low pay completely implies a substantial change to the UK labour market, and will require a range of interventions of which the NLW can only be one.

Who are the low paid?

1.14 In this section we compare the characteristics of workers who are hourly low-paid with those that are weekly low-paid. We focus our analysis on those aged 21 and over, consistent with our recommendation to Government in our recent review of the youth rates of the NMW (Low Pay Commission, 2019c), which set out proposals to lower the age of eligibility for the NLW to 21.

³ The work allowance is the amount that workers on Universal Credit can earn without facing benefit withdrawal

1.15 As set out above, there are 4.7m UK workers who are low-paid on hourly measures and 7.2m who are low-paid on weekly ones, and these two groups do not overlap completely. Around 3.7m workers are both hourly low-paid and weekly low-paid – this is three quarters of hourly low-paid and half of weekly low-paid workers.

1.16 Table 1.1 shows the distributions of workers' hourly pay relative to their weekly pay. The relationship between weekly and hourly low pay is simpler and more direct at top of the pay distribution: 82 per cent of the highest-paid hourly workers are also in the highest decile for weekly pay. The relationship is more direct here because at this end of the distribution most workers work full-time. But the relationship between hourly and weekly low pay weakens as we move down the pay distribution (from the bottom-right corner to the top-left one). At the bottom just over a third of the lowest-paid hourly workers are also in the lowest-paid weekly decile. The lowest-paid hourly are mostly found in the bottom three deciles of weekly pay. However, the lowest decile for weekly pay contains a large share of workers who are not among the lowest-paid in hourly terms.

Table 1.1: Relationship between weekly and hourly pay distribution, employees aged 21 and over, UK, 2018

	Gross weekly pay									
	Lowest paid	2 nd decile	3 rd decile	4 th decile	5 th decile	6 th decile	7 th decile	8 th decile	9 th decile	Highest paid
Hourly pay	37%	28%	24%	7%	2%	1%	0%	0%	0%	0%
	23%	25%	30%	15%	5%	2%	1%	0%	0%	0%
	13%	18%	20%	33%	11%	4%	2%	1%	0%	0%
	9%	12%	10%	28%	25%	10%	4%	1%	0%	0%
	4%	7%	6%	7%	38%	24%	9%	3%	1%	0%
	2%	4%	4%	3%	9%	44%	22%	8%	3%	0%
	3%	2%	3%	3%	3%	9%	49%	21%	6%	1%
	3%	2%	2%	2%	3%	4%	9%	53%	20%	2%
	2%	2%	1%	1%	2%	2%	3%	11%	62%	14%
	2%	2%	1%	1%	1%	1%	1%	2%	6%	82%

Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

1.17 Table 1.2 looks at some characteristics of low-paid workers, using both the ONS weekly and hourly definitions of low pay. It shows the number and proportion of each group who are low-paid and the share they make up of all low-paid workers. Women are more likely to be low-paid than men, and even more so when looking at weekly pay rather than hourly, because they are more likely to work part-time. Younger workers aged 21-29 are more likely to be hourly low-paid than those aged 30 and over, whilst there is little difference by age for weekly low-paid workers.

National Minimum Wage

Table 1.2: Low-paid employees by worker characteristics, 21 and over, UK, 2018

Characteristic	Number	Hourly low-paid		Number	Weekly low-paid	
		Share of low-paid (per cent)	Proportion of group low-paid (per cent)		Share of low-paid (per cent)	Proportion of group low-paid (per cent)
Female	2,940,000	62.1	22.2	5,230,000	72.9	39.5
Male	1,790,000	37.9	13.4	1,940,000	27.1	14.5
Full-time	2,190,000	46.3	11.3	1,430,000	20.0	7.4
Part-time	2,540,000	53.7	35.4	5,740,000	80.0	80.1
21-29	1,360,000	28.7	26.0	1,540,000	21.5	29.4
30-39	970,000	20.4	14.6	1,450,000	20.2	22.0
40-49	930,000	19.6	14.1	1,540,000	21.5	23.5
50-59	970,000	20.4	16.3	1,620,000	22.6	27.3
60-64	320,000	6.8	20.5	590,000	8.2	37.5
65+	190,000	4.1	26.7	440,000	6.1	60.5
Total	4,730,000	100.0	17.8	7,180,000	100.0	27.0

Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

1.18 Table 1.2 shows as well that the likelihood of weekly low pay is largely determined by the number of hours worked: just over half of hourly low-paid employees work part-time but this increases to eighty per cent for weekly low-paid employees. Figure 1.3 highlights the difference in the distribution of hours worked for hourly and weekly low-paid workers, and the greater share of weekly low-paid workers who work on a part-time basis. For those identified as hourly low-paid there is more of an even split between full-time and part-time work.

Figure 1.3: Distribution of hours worked for hourly and weekly low-paid employees, 21 and over, UK, 2018



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

1.19 Table 1.3 sets out the employment characteristics of the different groups of low-paid workers. Overall, the majority of low-paid employees are employed on permanent contracts, have been in the same job for more than one year, have one job only and are paid by the hour. However, there are some less common characteristics with disproportionately high shares of low-paid workers. Over half of temporary workers are low-paid on weekly measures, as are over 60 per cent of workers with multiple jobs, and almost half of workers paid by the hour rather than salaried (compared with 27 per cent for all workers).

1.20 Being paid by the hour is also strongly associated with low pay on hourly measures: more than one-third are hourly low-paid compared with around one in six of all workers. While less than eight per cent of all salaried workers are hourly low-paid, over a quarter of hourly low-paid workers are now salaried workers. Many of these salaried workers may previously have been outside the hourly low-pay universe, but recent increases to the NLW have seen them begin to be caught up in increasing numbers as the minimum wage spillover effect compresses the bottom quartile of the pay distribution. This group of workers are also increasingly at risk of underpayment of minimum wage and we will be paying close attention to them in future consultations.

Table 1.3: Low-paid employees by employment characteristics, 21 and over, UK, 2018

Characteristic	Number	Hourly low-paid		Number	Weekly low-paid	
		Share of low-paid per cent	Share of group low-paid per cent		Share of low-paid per cent	Share of group low-paid per cent
Permanent	4,250,000	89.8	17.2	6,200,000	86.4	25.2
Temporary	450,000	9.5	24.6	930,000	12.9	50.8
Same job	3,480,000	73.5	16.0	5,560,000	77.5	25.6
Not same job	1,250,000	26.5	25.5	1,620,000	22.5	32.8
One job	4,380,000	92.5	17.3	6,320,000	88.1	25.1
More than	360,000	7.5	25.9	850,000	11.9	61.9
Paid hourly	3,450,000	72.9	34.7	4,520,000	63.0	45.5
Salaried	1,280,000	27.1	7.7	2,650,000	37.0	15.9
Total	4,730,000	100.0	17.8	7,180,000	100.0	27.0

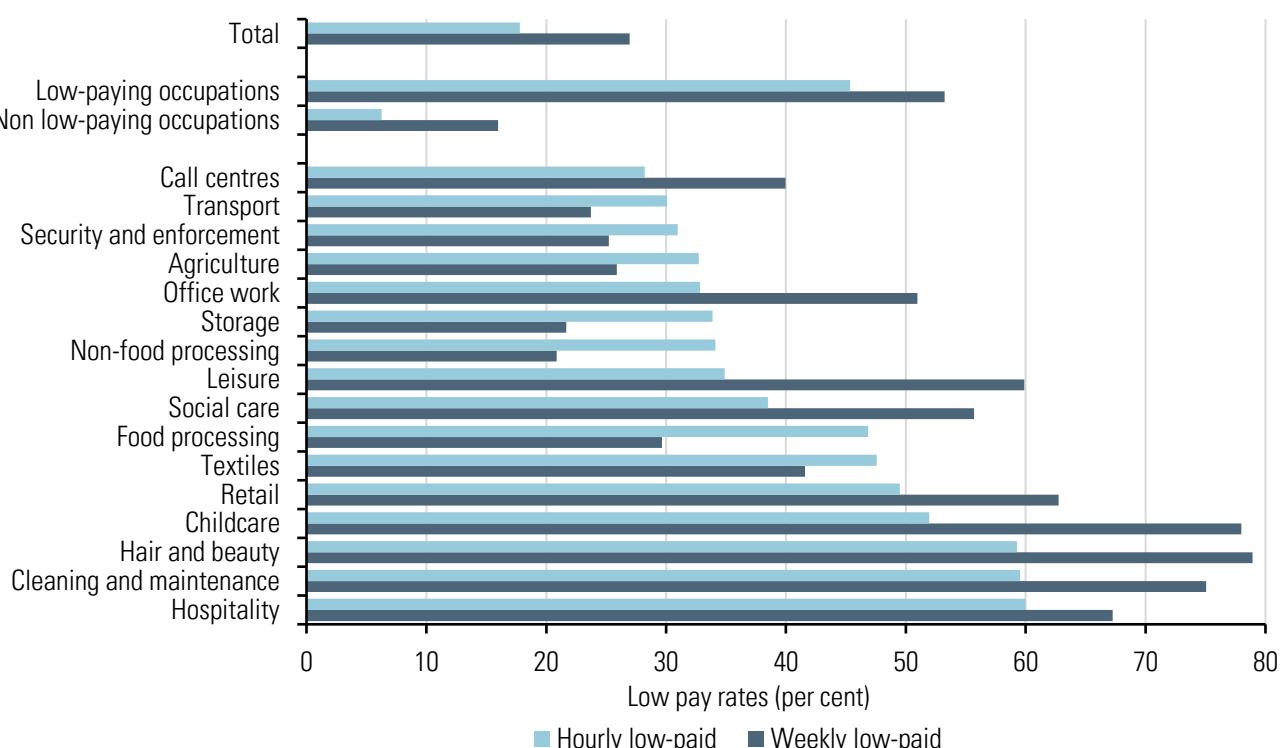
Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

National Minimum Wage

1.21 Most low-paid workers are concentrated in a number of low-paying occupations. Figure 1.4 looks at the shares of hourly and weekly low-paid workers in these low-paying occupations, where the incidence of low pay is 53 and 45 per cent respectively. The highest numbers of hourly low-paid workers are found in retail (930,000), hospitality (600,000), cleaning (480,000) and social care (310,000). On an hourly basis, all the low-paying occupations have an above-average rate of low pay, ranging from 28 per cent for call centre workers up to 60 per cent for those in hospitality.

1.22 The picture for weekly pay is slightly different. Overall, low pay on a weekly basis is more prevalent than on an hourly basis, but there are a number of occupations where the opposite is true. These include the manufacturing-based occupations of food processing, textiles and non-food processing as well as agriculture, security and transport. These are all occupations where hours worked tend to be higher. Only around one in five workers in non-food processing and storage are weekly low-paid, less than the national average. But the proportion rises to two-thirds of workers in retail and hospitality, and over three-quarters of workers in cleaning and maintenance, childcare and hair and beauty.

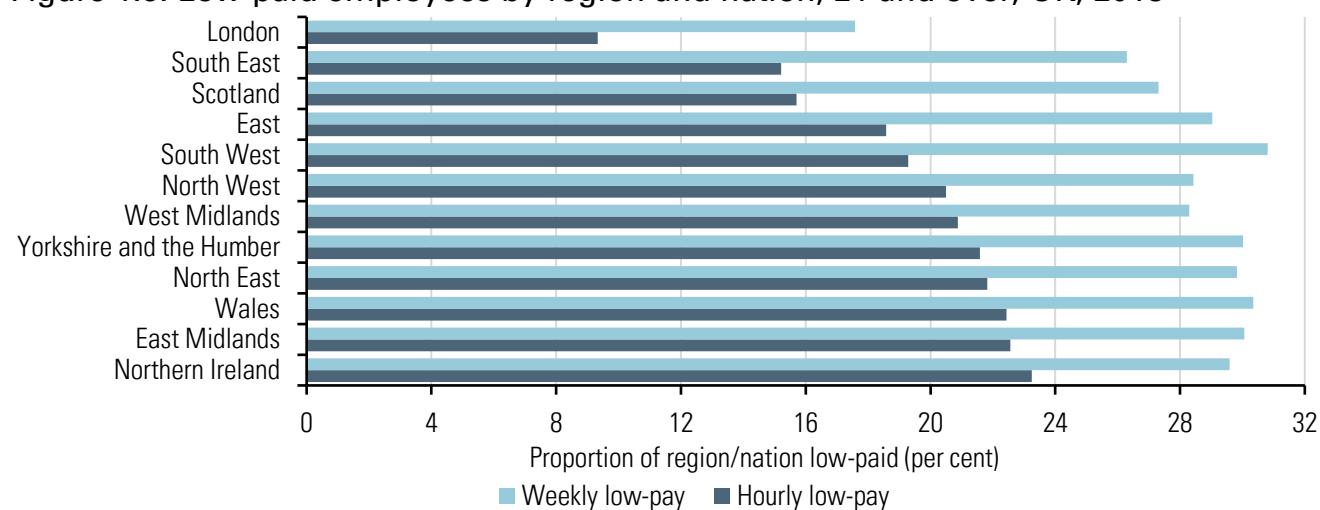
Figure 1.4: Low-paid employees by occupation, 21 and over, UK, 2018



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

1.23 Figure 1.5 looks at the regional variation in the proportion of workers by the two low pay measures. London has the lowest share of low-paid workers on both definitions, with fewer than one in ten workers low-paid on an hourly measure and around 18 per cent that are weekly low-paid. The South East and Scotland are the only other regions and nations below the UK average of 17.8 per cent on an hourly measure. There is less geographical variation (excluding London) in the proportion of workers that are weekly low-paid. The South West has the highest share with 31 per cent – London and the South East are the only areas with less than the national weekly low pay average of 27 per cent.

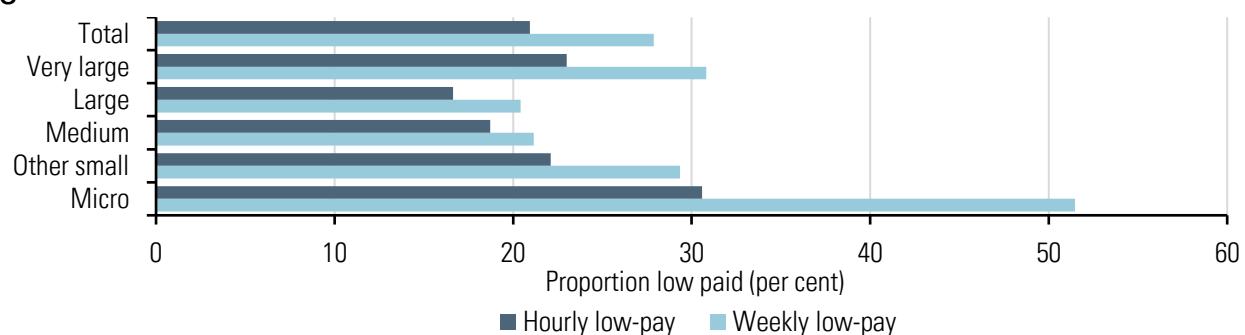
Figure 1.5: Low-paid employees by region and nation, 21 and over, UK, 2018



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

1.24 Figure 1.6 examines both low pay measures by size of employer. It excludes public sector workers as they can have a disproportionate impact on the very large size band. It shows that more than half of workers in micro firms are likely to be affected by weekly low pay, almost double the UK average. Workers in micro firms are more likely to be working fewer hours, and we have shown that 80 per cent of part-time workers are weekly low-paid. Micro firm workers are also the most likely group to be affected by hourly low pay, but the spread across firm sizes is much narrower than for those who are weekly low-paid, ranging from 17 per cent for large firms up to 31 per cent for micro firms.

Figure 1.6: Low-paid private sector employees by employer size, 21 and over, UK, 2018

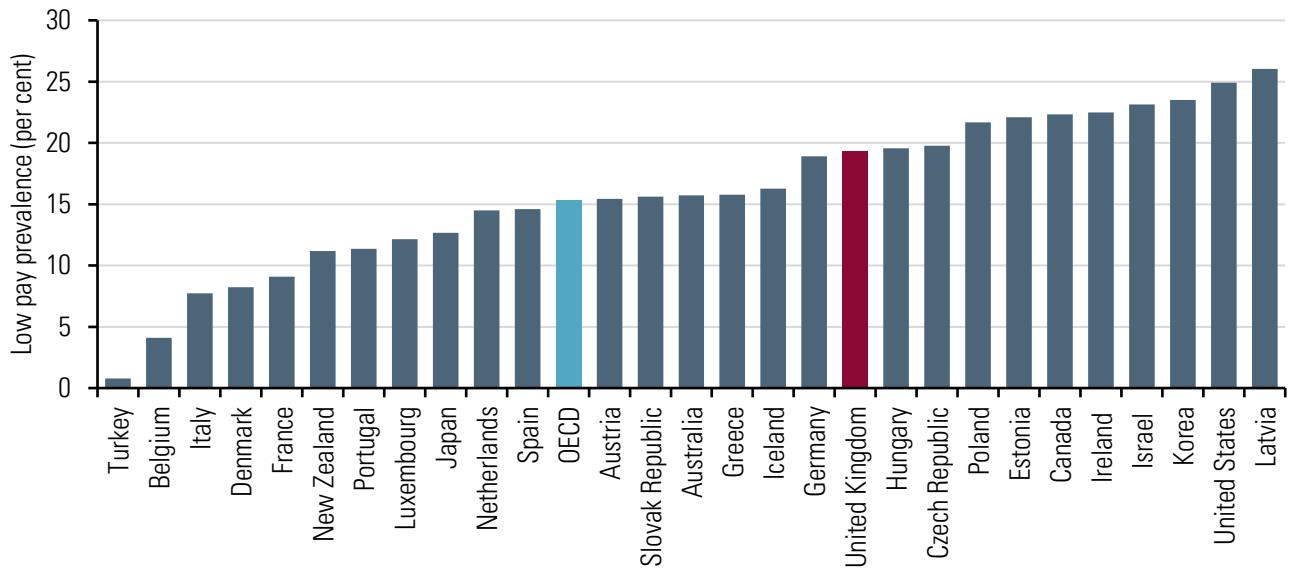


Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

International comparisons

1.25 Using the OECD's definition of low pay, in 2016 the UK, at 19 per cent, had a higher level of low pay than the OECD average of 15.3 per cent. Figure 1.7 shows that despite recent signs of a fall in low pay in the UK (see Figure 1.1), its prevalence was some way above the group of countries with rates at or below the OECD average. While the data are lagged – 2016 is the most recent year for which OECD data is available in many countries – under this definition, low pay in the UK has fallen only very slightly since 2016.

Figure 1.7: Low pay prevalence, weekly earnings of full-time workers in OECD countries, 2016

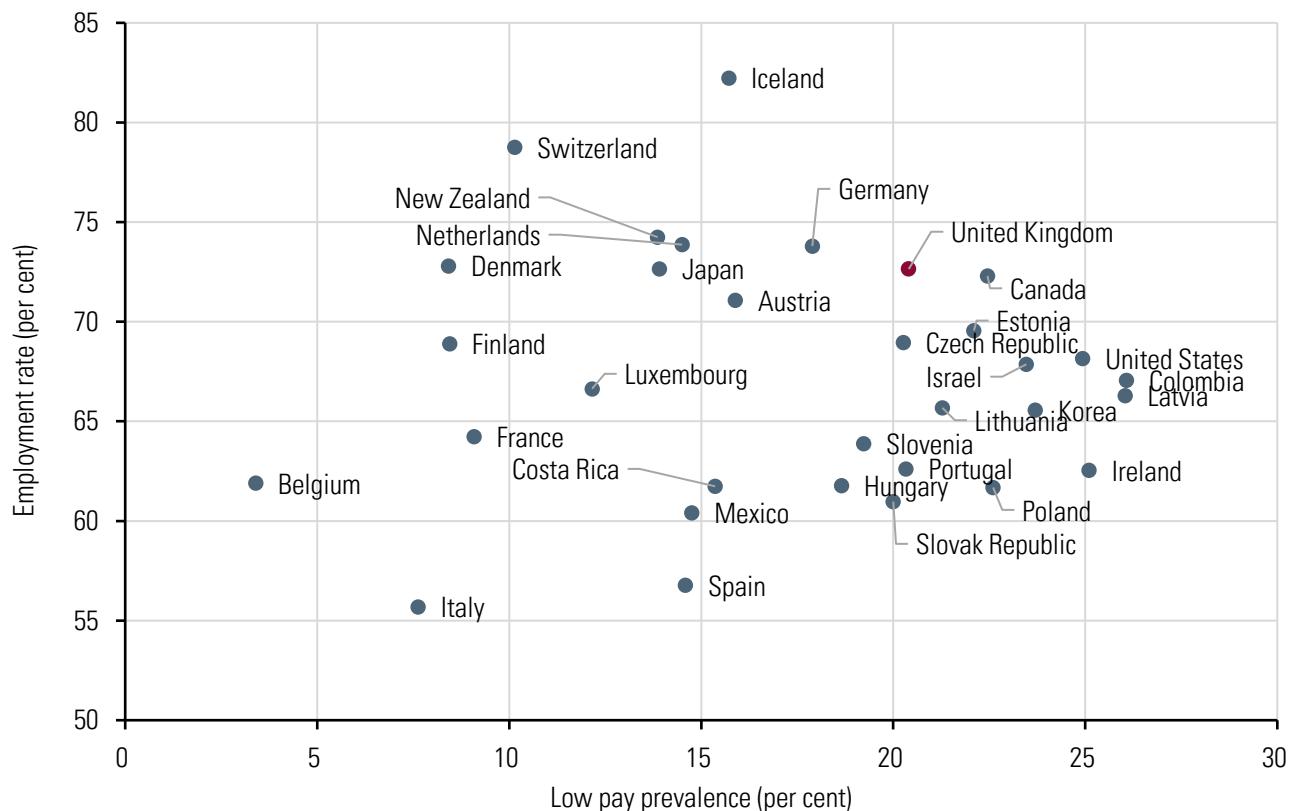


Source: Organisation for Economic Co-Operation and Development (2019a)

Note: Data for Estonia, France, Latvia, Luxembourg and Spain are from 2014.

1.26 There is evidence, presented below, that minimum wages can help reduce low pay, of which the UK has a relatively high level. However, most of the countries with lower levels of low pay than the UK also have lower employment rates. Those that have less low pay combined with higher employment are shown in Figure 1.8. They are Denmark, Germany, Iceland, Japan, the Netherlands, New Zealand, and Switzerland. Minimum wages and other factors affecting low pay in these comparators, especially relevant to the countries with lower levels but no statutory minimum wage, are examined in Chapter 4.

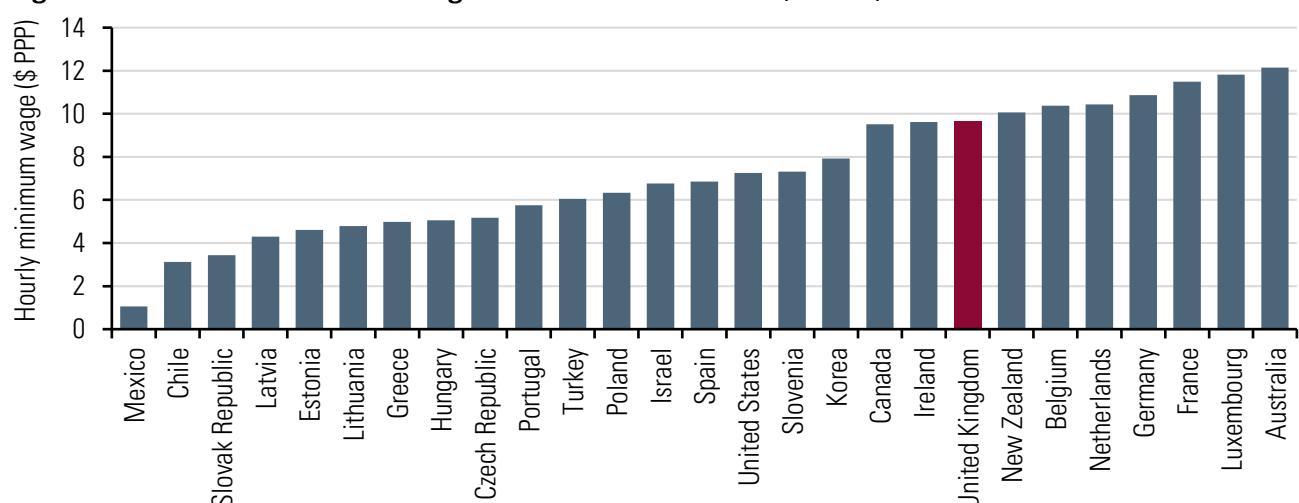
Figure 1.8: Low pay prevalence and employment rate, OECD, 2014



Source: Organisation for Economic Co-Operation and Development (2019a). Organisation for Economic Co-Operation and Development (2019d)

1.27 Many OECD countries have some form of statutory minimum wage. In nominal terms and adjusted for purchasing power, the UK's minimum wage is relatively high, but still towards the bottom of the group of high minimum wage countries. Figure 1.9 shows the real value in dollars of minimum wages across a number of OECD countries – the picture when looking at nominal minimum wages is similar but with slightly greater dispersion.

Figure 1.9: Real minimum wages in OECD countries, \$ US, 2018

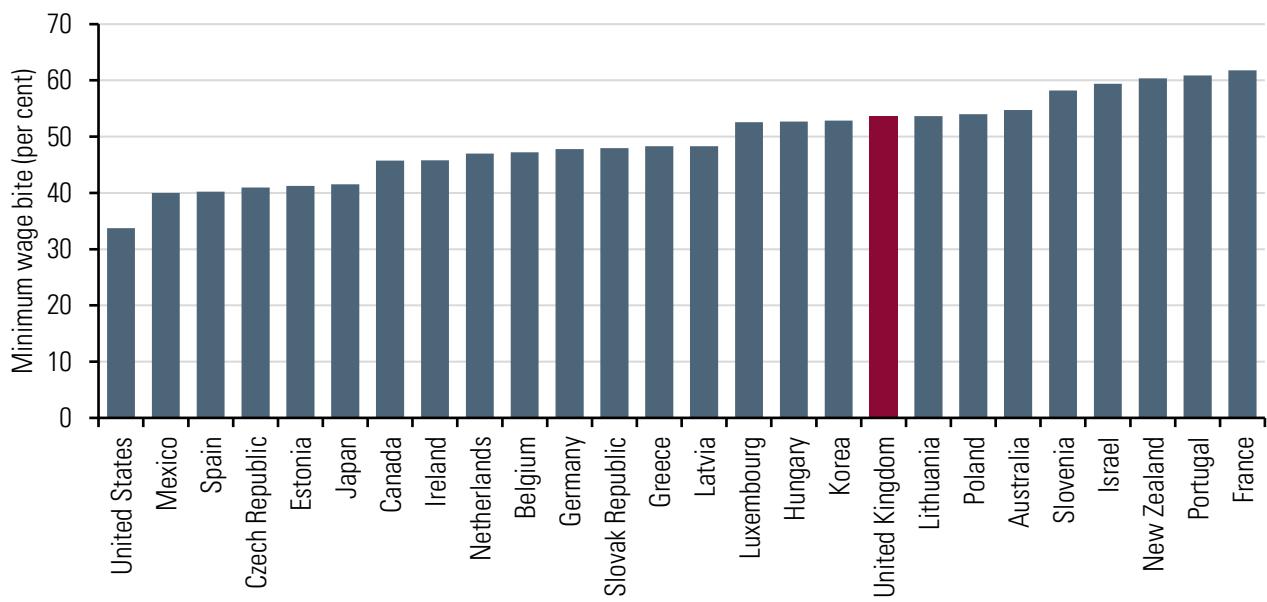


Source: Organisation for Economic Co-Operation and Development (2019c)

National Minimum Wage

1.28 Comparisons of minimum wages, even with purchasing power parity adjustments, are heavily affected by exchange rate fluctuations, so it is also necessary to take into account other measures such as bite, on which the OECD also produces data. Figure 1.10 compares the bite in different countries, although there are some caveats to bear in mind. For comparability across countries, the OECD calculates the level of the bite against the pay of full-time workers, as it does with its measure of low pay. This results in a lower bite estimate – 53.6 per cent – than that calculated by the LPC for the purpose of advising on the NLW (57.6 per cent in April 2017, calculated against all workers aged 25 and over using ASHE data, including part-time workers who are more likely to be lower-paid). The UK has a higher proportion of part-time workers than in many of the countries with higher indicated bites. Further, the OECD only uses the age group that the main rate of the minimum wage covers in each country. That will also give the UK a lower estimate of the bite compared with other countries (the median wage for those aged 25 and over will be higher than for those aged 18 or 21 and over). Other countries, such as France with a bite of over 60 per cent, have minimum wages that are applicable from age 18. If the UK's NLW applied from 18, its bite would be approximately 2.5 percentage points higher. Nevertheless, a bite of two-thirds in the UK based on any age group would give the UK one of the highest nominal or relative minimum wages in the world.

Figure 1.10: Minimum wage bite in OECD countries, 2017

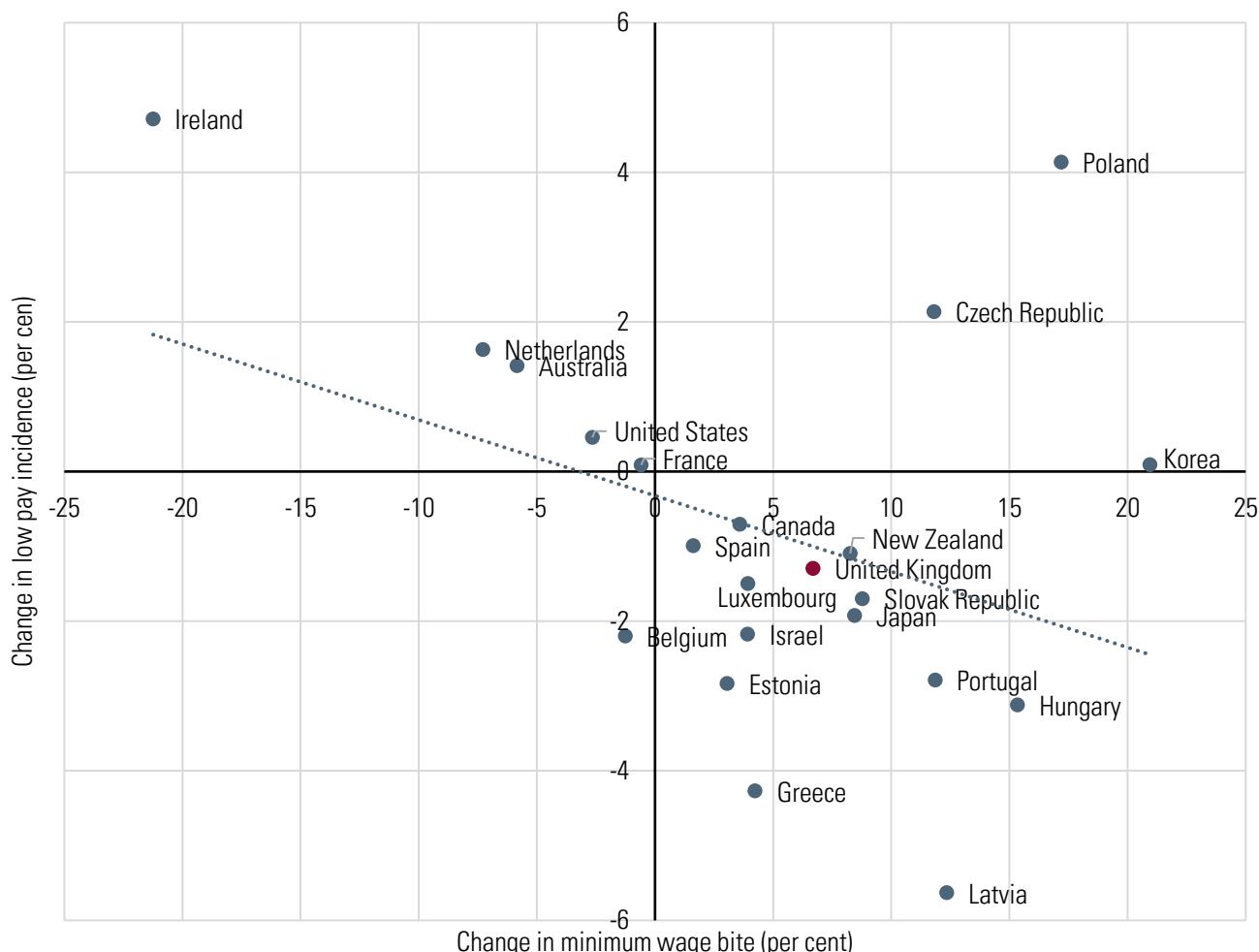


Source: Organisation for Economic Co-Operation and Development (2019b)

1.29 As described in paragraphs 1.2 to 1.9, the effect of the minimum wage may have only a limited effect on the prevalence of low pay, and depending on how low pay is defined there can even be no clear relationship between the two measures overall. Based on the OECD's figures, few minimum wages have reached a level where they would have a direct effect on low pay. Any impact would depend on the extent of spillover effects from minimum wage increases.

1.30 That being said, we can identify a relationship between changes in minimum wage bite and change in low pay across the OECD in the period 1999-2016. Figure 1.11 shows that, in general, countries that saw growth in their minimum wage bite between 1999 and 2016 also saw a fall in low pay prevalence, and vice versa. There are some clear outliers, but it should be noted that these are countries in which the minimum wage was set at a particularly low bite at the start of the period. This is reinforced by the fact that recent minimum wage increases in New Zealand, which already had one of the highest bites according to the OECD, led to a reduction in low pay, with a 1.5 percentage point fall in the OECD's measure from 2017 to 2018. Conversely, it is also worth noting that minimum wage bite actually fell in Belgium over the period, so the fall in low pay there – and low absolute level – must be explained by other factors.

Figure 1.11: Relationship between change in minimum wage bite and change in low pay incidence, OECD countries, 1999-2016



Source: Organisation for Economic Co-Operation and Development (2019b). Organisation for Economic Co-Operation and Development 2019a)

Note: Data not available for full time period for all countries. Estonia, France, Latvia, Luxembourg, New Zealand and Spain are 2002-2014, Belgium, Greece and Portugal are 2004-2016, Ireland is 2000-2016, Israel is 2001-2016.

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1.31 While most OECD countries have minimum wages, there are some notable exceptions: Austria, Denmark, Iceland, Italy, Norway, Switzerland and Sweden. Among these are countries with some of the lowest rates of low pay. Equally, some countries with low relative minimum wages have low levels of low pay. For example, Spain has a minimum wage bite of just 40 per cent but low pay prevalence below the OECD average; Belgium's minimum wage bite of 47 per cent is accompanied by a low pay prevalence of just 4 per cent. All of this evidence indicates that the minimum wage is just one of a range of factors that can influence low pay. In Chapter 4 we examine further the role of minimum wages and other factors, and establish which international examples can provide useful evidence for the future of the NLW. We assess recent developments in minimum wages across the OECD and touch on the research evidence emerging from these examples. We also examine low pay in a broader context, accounting for demographic and labour market differences, to identify possible lessons for the UK.

Stakeholder views on the ambition to end low pay

1.32 In the course of our consultation, stakeholders from all sides told us about their responses to the Government's ambition to end low pay. The worker representatives that we spoke to were united in their support for the ambition to end low pay. Most reiterated their desire for the NLW to reach £10 as soon as possible. For example, the Trades Union Congress (TUC) told us that "The TUC target is that the rate should reach £10 as quickly as possible. We therefore support increasing the target as progress.... The LPC should set the shortest timescale possible for achieving the proposed target of two thirds of median earnings".

1.33 Worker representatives were of the view that there would be clear economic benefits to further rises in the NLW. Unite commissioned research which suggested that workers would see substantial increases in their incomes with little negative effects on employment. The research also concludes that there would be exchequer benefits through increased tax receipts and reduced in work benefit claims.

1.34 Worker representatives also told us that the current economic conditions support the ambition. For example, UNISON noted that, while they were subject to uncertainty, economic forecasts for GDP, employment and earnings "provide a sound basis for pushing toward the two-thirds target". They also pointed out that "the numerous studies commissioned by the Low Pay Commission have never found any substantial evidence of the wage rises causing unemployment".

1.35 Some employer groups made it clear that they backed the ambition to end low pay: the Institute of Directors (IoD) refer to it as an "honourable goal" and the Confederation of British Industry (CBI) said "Government's intention to end low pay is shared by businesses". However, employer representatives were far more cautious about the increasing the NLW. The IoD went on to say, "we would urge the

LPC to proceed cautiously with further hikes, rather than implementing them automatically simply to reach the target." The CBI told us that "government must recognise that while ending low pay is an objective that business can sign-up to, the path to this goal must be very carefully monitored. ... The unprecedented nature of further increases should not be a barrier to ambition, but the NLW's future trajectory beyond 2020 needs to be evidence-led." Others were explicit that a target set at two-thirds of the median would be too high. The Federation of Wholesale Distributors (FWD) told us that "pegging the NLW to the OECD definition of 66 per cent of median earnings for over 25s would be unsustainable for the wholesale sector" and Make UK said "there is no appetite amongst manufacturers to increase the trajectory of the NLW above the metric of 60 per cent of median earnings."

Conclusions:

The UK has a relatively high level of low pay, with almost a fifth of the workforce low-paid on a weekly measure. The UK has a higher rate of low pay than the OECD average, and sits above the other high minimum wage countries. There is no simple relationship between minimum wage bite and low pay prevalence – indeed some of the countries with the lowest prevalence do not have statutory minimum wages – but there is some evidence that increasing the minimum wage's bite can reduce low pay.

If we were to raise the NLW further, we would likely reduce the number of low-paid workers based on an hourly definition, but, for a number of reasons, we should not expect increases in hourly minimum wage rates to end weekly low pay or in-work poverty in the broader sense. Firstly, there is the distinction between weekly and hourly pay. Increases in the hourly pay floor will not automatically translate into higher weekly pay for those that earn the least in a week, which matters more for living standards. Moreover, NLW workers are spread through the household income distribution, meaning that the minimum wage is not targeted at the lowest-income households. Finally, under the current benefit policy, those within low-income households will likely not gain the full benefit from increases in the NLW as they are likely to be on benefits which would be withdrawn as their pay rises.

To be clear, this is not an argument against raising the NLW. Instead we are simply stating that the minimum wage is a narrow and specific policy tool – it raises the hourly pay of the lowest-paid workers. But this is not the same as raising an individual's total weekly, monthly or annual salary and not the same as raising their total household income.

Any decision to implement a higher NLW target should take this into account – so the effectiveness of the policy can be clearly understood, and so an appropriate range of supporting policies can be put in place to help Government achieve its stated ambition.

Chapter 2

The impact of a two-thirds target

2.1 As discussed in the Introduction to this report, we have interpreted the Government’s statements to date on their ambition to end low pay as indicating that they are considering a new target for the National Living Wage (NLW) for the period beyond 2020. We also assume that any target will once again be expressed as a proportion of median hourly earnings. As set out in the previous chapter, the definition of low pay used by both the ONS and OECD is two-thirds, or 66.7 per cent, of median earnings, and so we have also assumed that a further NLW target would be set at this level. We recognise that these are only assumptions, and the final decisions on the future of the NLW remain to be taken by Ministers. Nevertheless, in this chapter we consider some of the potential implications of an NLW target set at this level.

NLW trajectories to two-thirds of median earnings

2.2 Assuming the existence and level of a target for the NLW, the main policy variable in setting such a target is the timescale over which it will be achieved. Choosing a timescale to get to a two-thirds target involves balancing the risks from moving too quickly for employers to cope against the benefits for workers of higher wages. The choice of end date will be influenced by how Government chooses to balance the various risks and benefits from each date. Paragraphs 2.7 and 2.8 set out stakeholders’ views on appropriate timescales for the NLW to move towards two-thirds of median earnings.

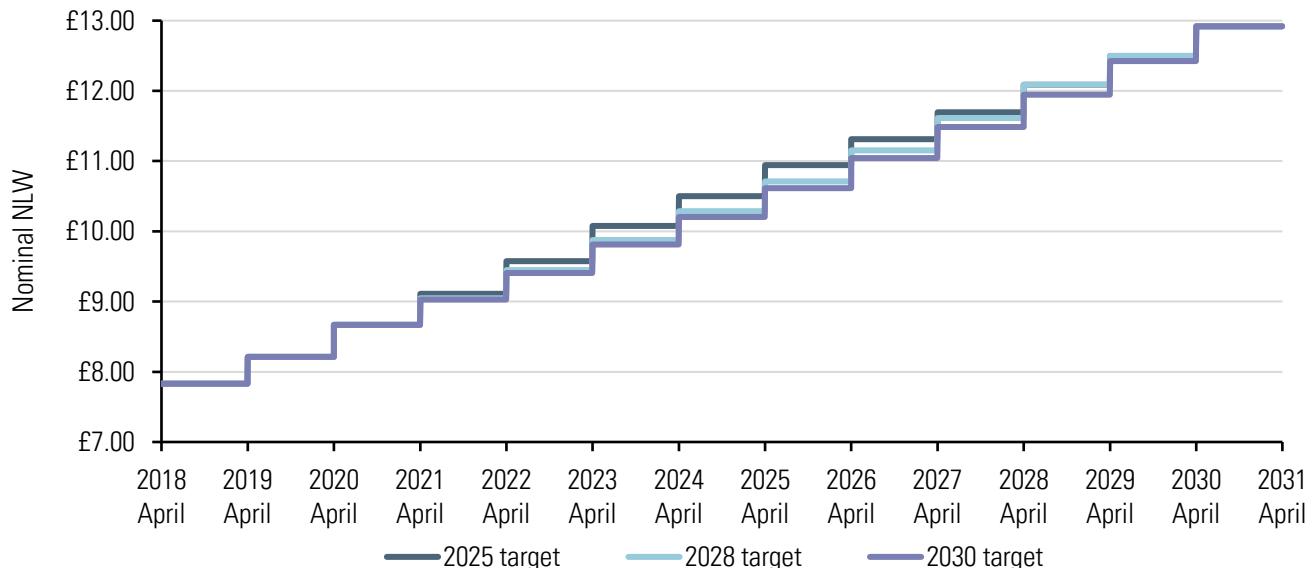
2.3 The age groups for whom the NLW acts as a pay floor will also influence the path towards the target. This is because younger workers typically earn less than workers aged over 25 and so including them in the NLW calculation will bring down the median wage of the affected group, and therefore the nominal value of any target. We have recently concluded a review of the structure of the youth rates of the NMW (Low Pay Commission, 2019c), in which we recommended to the Government that the age of eligibility for the NLW should be reduced to 23 from April 2021, along with a commitment to reduce the threshold to 21 at a later date. These changes will have an effect on the trajectory and value of the NLW as it moves towards a target.

2.4 For the paths set out in this report we have assumed that the NLW age threshold is reduced to 23 in April 2021 (in line with our recommendation to Government in Low Pay Commission [2019c]) and then to 21 in April 2024. We have also assumed that we take a straight-line bite path to the target, in line with our approach so far for the NLW.

2.5 Figure 2.1 and Table 2.1 show three separate forecasts the NLW under three different target end dates⁴. These are a five-year path, an eight-year path and a ten-year path (that is, reaching the target in 2025, 2028 and 2030 respectively). Table 2.1 shows the NLW level, annual percentage increase and mid-year bite under the three end dates. The data suggest that in any of these scenarios the NLW would need to grow by over 4 per cent a year to hit the target against forecast growth in average earnings of between 3.1 and 3.5 per cent throughout the period. This also illustrates one of the difficulties of using forecasts – they are subject to uncertainty, and the further we look into the future the more uncertain the forecast becomes.

2.6 Figure 2.1 shows the trajectory of the NLW in each scenario. The maximum divergence between the level of the NLW in the different scenarios occurs in 2025, with a 32p difference between the 2025-target scenario and the 2030-target scenario (a 3 per cent difference in the level of the NLW).

Figure 2.1: Comparison of paths to two-thirds bite with different end-date assumptions



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2015-18 and HM Treasury panel of economic forecasters HM Treasury (2019).

⁴ These figures are based on the available data at the time of writing and so do not include the 2019 ASHE data on median pay. Instead they are based on the 2018 median level, and forecasts.

Table 2.1: NLW level, increase and bite, under various end-date assumptions

Year	Age covered	2025 target			2028 target			2030 target		
		NLW	Increase per cent	Bite mid-year	NLW	Increase per cent	Bite mid-year	NLW	Increase per cent	Bite mid-year
2020	25+	£8.67	5.6	60.0	£8.67	5.6	60.0	£8.67	5.6	60.0
2021	23+	£9.11	5.1	62.2	£9.05	4.3	61.7	£9.03	4.1	61.6
2022	23+	£9.58	5.1	63.3	£9.45	4.4	62.4	£9.41	4.2	62.2
2023	23+	£10.08	5.2	64.4	£9.88	4.5	63.1	£9.81	4.3	62.7
2024	21+	£10.50	4.2	66.1	£10.29	4.1	64.8	£10.21	4.0	64.3
2025	21+	£10.94	4.2	66.7	£10.71	4.1	65.2	£10.62	4.0	64.7
2026	21+	£11.31	3.4	66.7	£11.15	4.1	65.7	£11.04	4.0	65.1
2027	21+	£11.69	3.4	66.7	£11.61	4.1	66.2	£11.48	4.0	65.5
2028	21+	£12.09	3.4	66.7	£12.09	4.1	66.7	£11.94	4.0	65.9
2029	21+	£12.50	3.4	66.7	£12.50	3.4	66.7	£12.42	4.0	66.3
2030	21+	£12.92	3.4	66.7	£12.92	3.4	66.7	£12.92	4.0	66.7

Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2015-18 and HM Treasury panel of economic forecasters HM Treasury (2019).

Note: These figures are based on the available data at time of writing and do not include the 2019 ASHE data on median pay and are based on the 2018 median level, and forecasts.

Stakeholder views on timeframe

2.7 In the course of our consultation, we heard stakeholders' views on the appropriate timescale for reaching a two-thirds target. Worker representatives generally supported moving towards the target as quickly as possible, with a five-year target mentioned by several. The Trades Union Congress (TUC) told us that a long-term timeframe for a target risked being 'pretty vague' and difficult for Government to communicate to workers. On the other hand, employer representatives urged caution. Several employer representatives were of the view that the two-thirds target would require a 10 year path, particularly smaller employers (Federation of Small Businesses, British Independent Retailers Association, British Retail Consortium).

2.8 A number of stakeholders were concerned about the combined impact of a higher NLW with the UK's exit from the EU and other factors. For example, the British Chambers of Commerce (BCC) said: 'In light of Brexit and other factors, the government should reconsider the proposed LPC remit. We believe the 5-year timeframe should be extended to 8-10 years or the 66% median earnings target be reduced in line with our European competitors'. The National Hairdresser's Federation (NHF) told us that "66% of median earnings would make the UK's rates the highest in the world, yet other countries are not facing the same economic challenges as the UK and its departure from the EU. We are about to enter uncharted territory with Brexit, at a time when employers have had two successive years of pension contribution increases as well as above-inflation rises to minimum wages."

2.9 There was discussion with some stakeholders about whether a target end-date was required at all. The Confederation of British Industry (CBI) told us that although they supported the aspiration to end low pay, they did not think it was appropriate to attach a definite timescale to this – but rather that the Government should have ‘a medium-term indicative path so that employers can plan for the future, but do so free from a politically set, rather than evidence-led timetable. As the evidence base for future increases shrinks, the need for flexibility to respond to emerging evidence grows’. Others, however, thought that such an approach would not be practical; the TUC worried about a target becoming a ‘vague aspiration’ rather than a binding commitment.

Who would be affected?

2.10 This section looks at employees the workers whose pay is most likely to be directly affected by a two-thirds target. This analysis uses the distribution of pay in 2018. This should not be confused with a prediction for the numbers of workers who will be paid the NLW if it were to reach a two-thirds target. Employers choose to increase pay for some workers by more than they would be required to by the wage floor, and for workers higher up the wage distribution. They choose to do this for a variety of reasons: to maintain differentials between different job grades, to recognise skills and to help recruitment. These ‘spillovers’ from the minimum wage mean that workers higher up the pay distribution benefit from increases in the floor, and that increases in the minimum wage do not cause all workers between the previous wage floor and the incoming one to be paid exactly the new minimum wage (see Figure 4.2 for more detail on spillovers under the NLW).

2.11 Therefore, we instead look at the employees we think will be directly affected by a two-thirds target. These are the employees who currently earn less than two-thirds of the median wage. This is likely to be an underestimate of the number of workers who will experience pay growth due to the NLW, but as we do not know how employers will choose to change their pay structures we cannot model the number who will be ‘indirectly’ affected. Similarly, it is likely that the pay of the median worker in some industries will rise faster than it would otherwise have if the new wage floor gets close to it. Therefore, some of the modelling around bite in this section should be viewed as a measure of the size of impact on these occupations/industries and not necessarily a forecast of what the bite would look like if we achieved a two-thirds minimum wage.

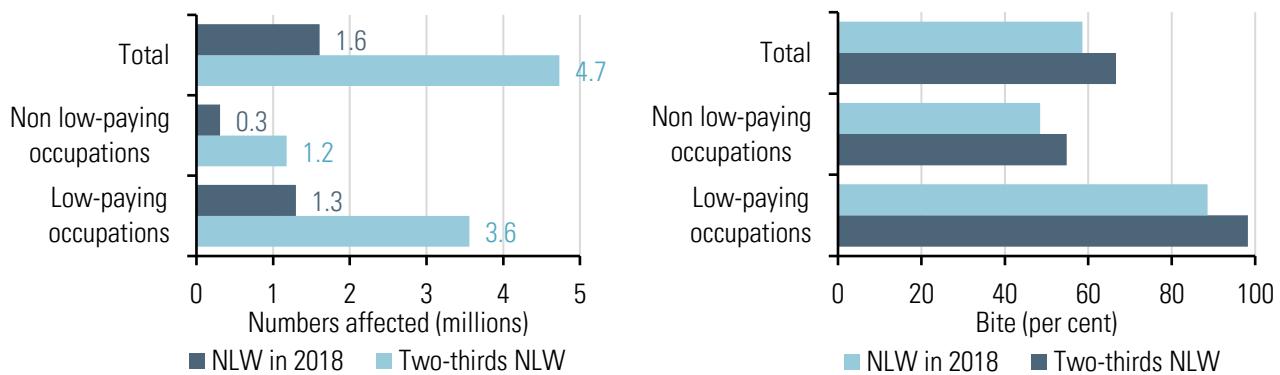
2.12 We use 2018 Annual Survey of Hours and Earnings (ASHE) data to estimate the bite of the proposed two-thirds NLW and the number of workers likely to be affected by it, including those aged 21 and over. We compare this with the 2018 NLW population across a range of characteristics. The bite is the ratio between the minimum wage and a given point on the earnings distribution, in this case the median. It is often used as an indicator of the toughness of the wage floor.

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2.13 Figure 2.2 shows that the number of workers paid below the low pay threshold (4.7m in 2018) is far larger than current minimum wage coverage (1.6m in 2018). Most of the difference is for workers in low-paying occupations, with 3.5m below two-thirds compared with 1.3m covered by the minimum wage. However, there are many low-paid workers in non low-paying occupations (1.2m compared with 0.3m covered by the minimum wage). They include large numbers of teaching assistants, educational support assistants and nursing auxiliaries and assistants.

2.14 If all of these workers were affected by the higher target, substantial numbers of workers currently outside the minimum wage would be drawn in, with consequences for their employers. Had the two-thirds target been introduced in 2018, and assuming no wage spillovers, we would see an increase in the bite for low-paying sectors from 89 per cent to 98 per cent, meaning the new NLW would apply to almost half of all low-paid workers. For those in non low-paying occupations the bite would rise from 48 per cent to 55 per cent.

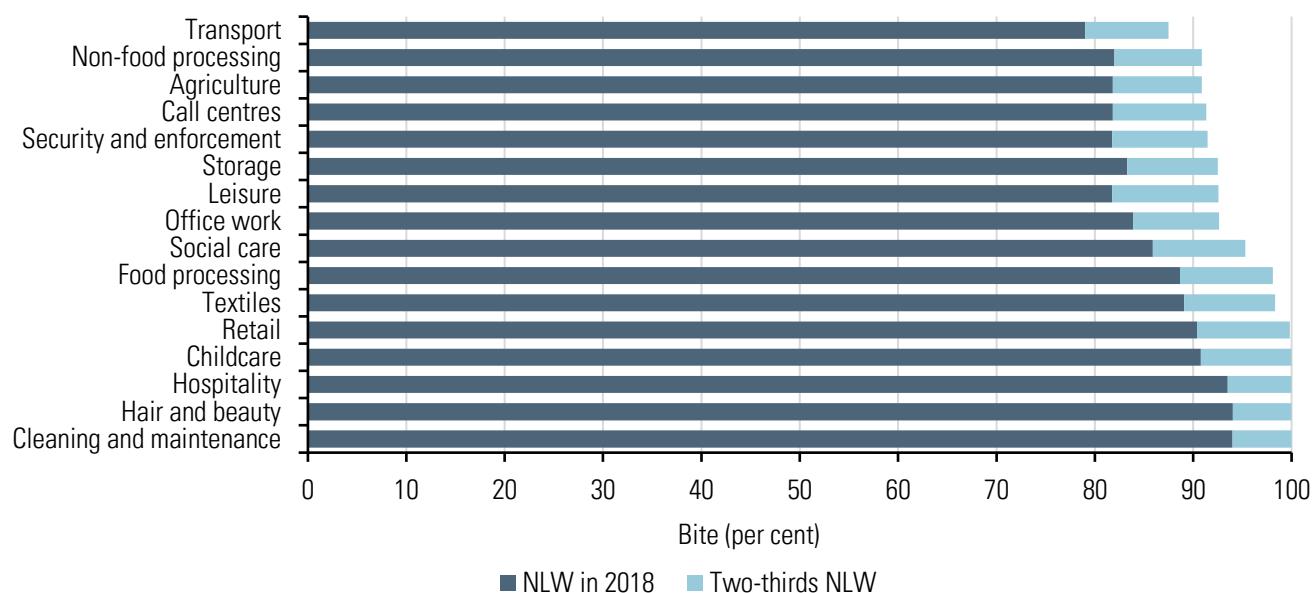
Figure 2.2: Numbers affected and bite of a two-thirds NLW target for workers aged 21 and over, by low-paying and non low-paying occupations, UK



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

2.15 Figure 2.3 looks more closely at the impact of the two-thirds target on the bite for workers in low-paying occupations. Estimating what the bite might be in the future for individual low-paying occupations is challenging without knowing how employers will respond, what the spillovers will be and how they may vary across sectors. This is because spillover effects are likely to move the medians for many of these occupations and so lower the bite. In short, these figures are likely to be over-estimates of what the bites will be in the future. Nevertheless, Figure 2.3 shows that the bites in some low-paying occupations are likely to reach high levels. In retail, childcare, hospitality, hair and beauty and cleaning and maintenance the bite could rise to up to 100 per cent. This effectively means the NLW would become the 'going rate' for the job for at least half of workers in these occupations. Even transport, which has the lowest projected bite at 87 per cent, is significantly above the target bite. All other low-paying occupations may have bites in excess of 90 per cent.

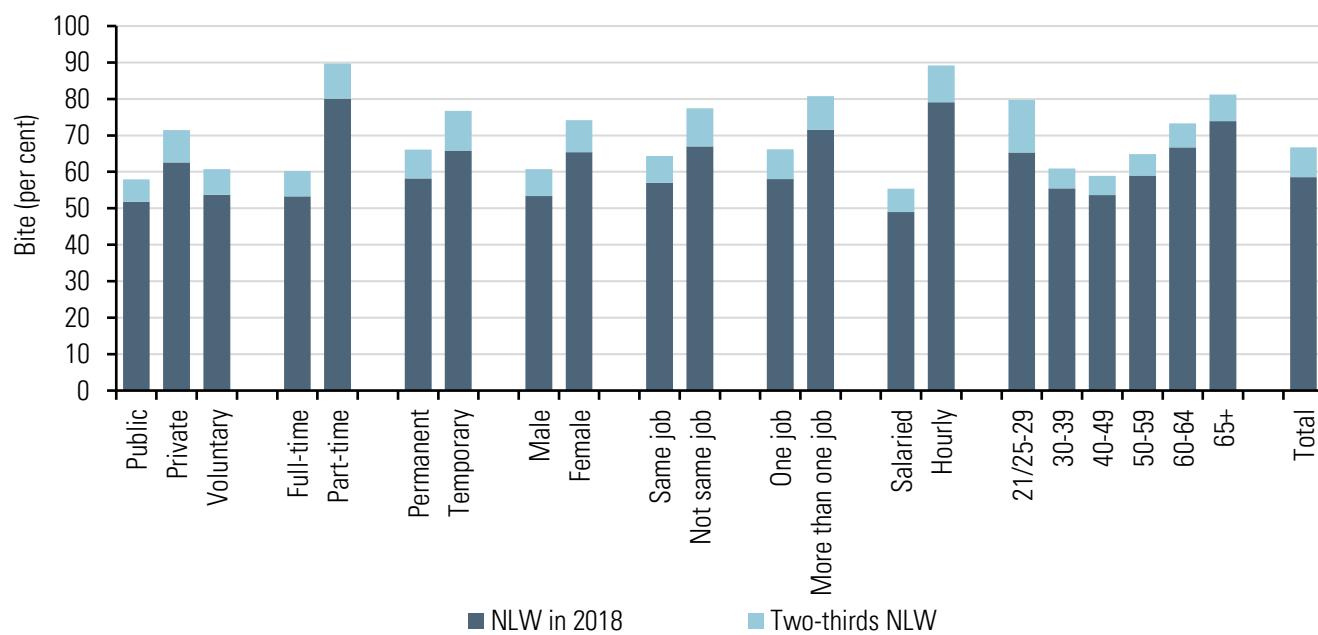
Figure 2.3: Projected bite of a two-thirds NLW target for workers aged 21 and over, by occupation, UK



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

2.16 Figure 2.4 shows what effect a two-thirds target would have on bite for various job characteristics. The bite would be particularly high, at around 90 per cent, for part-time jobs and hourly-paid jobs. The bite would also be above 80 per cent for workers age 21-29 and 65 and over.

Figure 2.4: Projected bite of a two-thirds NLW target for workers aged 21 and over, by job characteristics, UK



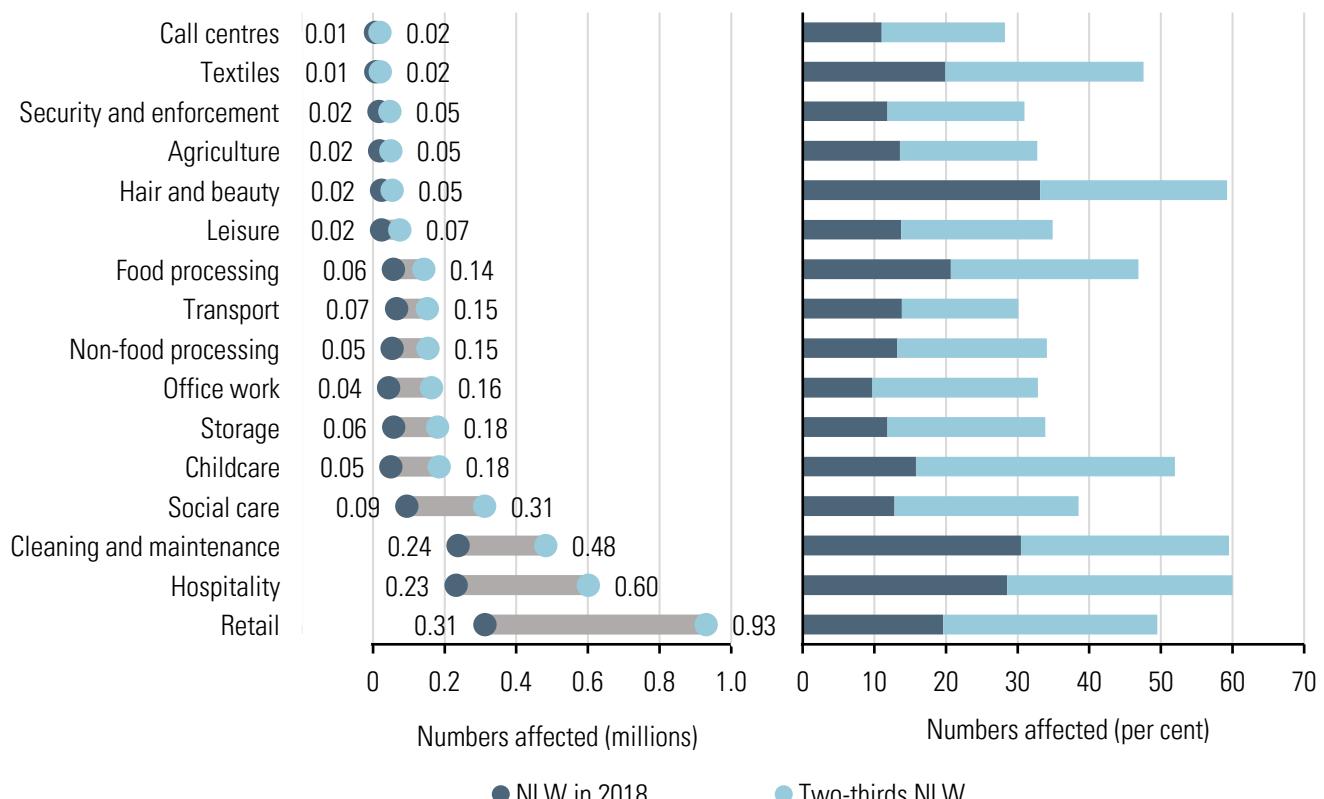
Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

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2.17 A move to a two-thirds target would result in similar rates of increase in the bite for each region and nation. However, upon reaching the target only London, the South East and England as a whole would have bites less than two-thirds of median earnings. Wales, already close to the two-thirds target in 2018, would increase close to a 75 per cent bite under such a target. On a firm-size basis, micro firms and very large firms (excluding public sector workers) have the highest bites as they tend to employ higher proportions of low-paid workers. We estimate that both would have bites greater than the two-thirds target – micro firms are already in excess of 70 per cent of median earnings.

2.18 The numbers of workers paid at the NLW and below the two-thirds threshold are shown in Figure 2.5. By far the largest increase in the numbers directly affected by a higher pay floor is for workers in retail occupations; just over 300,000 are currently covered by the NLW, compared with nearly a million workers paid below two-thirds. There are more than twice as many low-paid hospitality workers as those covered by the NLW (600,000 compared with 230,000) with coverage of cleaning and maintenance workers doubling to almost half a million. In percentage terms the largest difference would be in office work and for childcare workers, where a two-thirds NLW would cover almost four times as many workers.

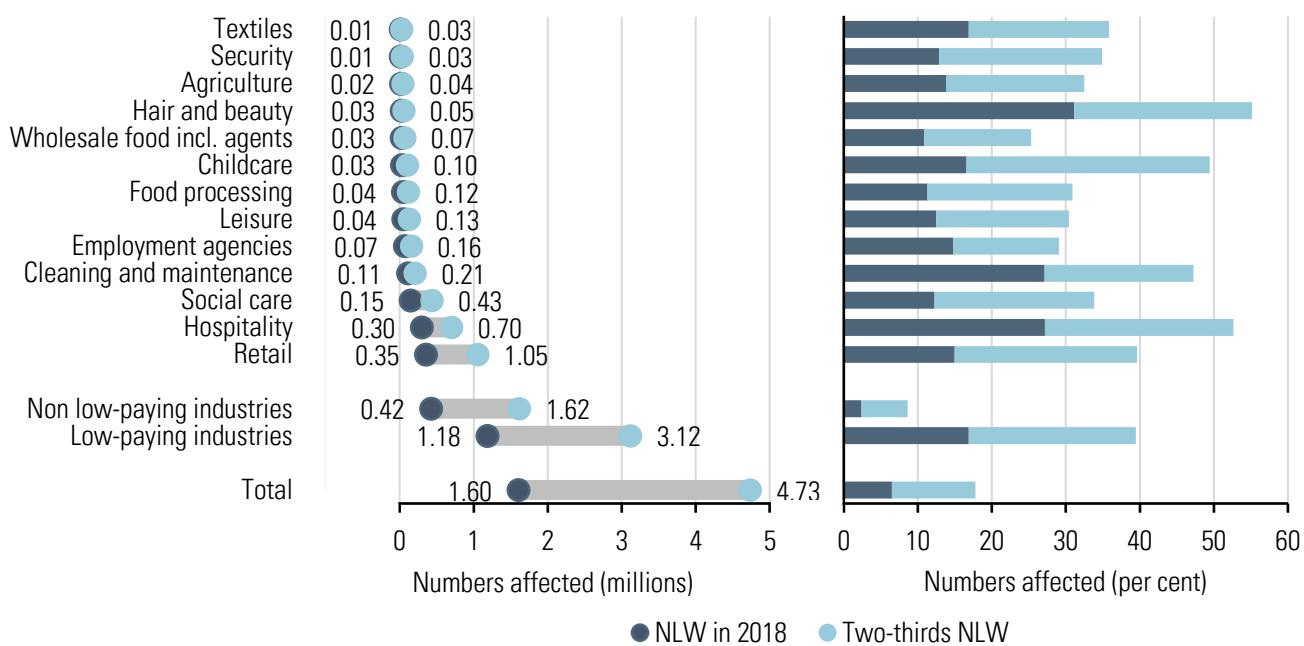
Figure 2.5: Numbers affected by a two-thirds NLW target for workers aged 21 and over, by occupation, UK



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

2.19 Figure 2.6 shows the difference across industries between minimum wage workers and low-paid workers as a share of the total (those aged 21 and over). Childcare would be particularly affected, though this is partly due to the fact that it has a young workforce with many workers aged 21-24. Otherwise the relative size of the increases would fall broadly in line with the current distribution of coverage. However, non low-paying industries would see the numbers affected increase by close to three-times current coverage; for low-paying industries the increase would be only slightly more than one-and-a-half times current coverage.

Figure 2.6: Numbers affected by a two-thirds NLW target for workers aged 21 and over, by industry, UK



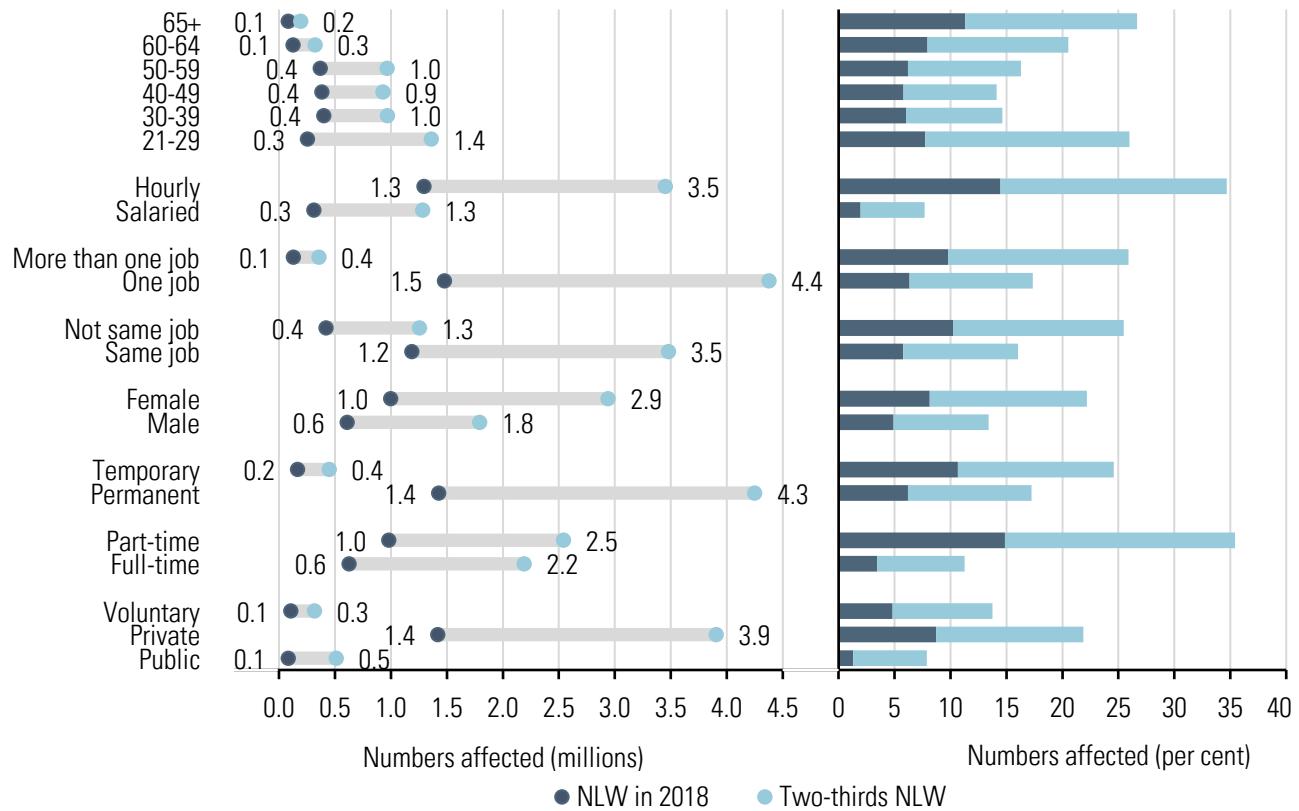
Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

2.20 Figure 2.7 shows estimates of the numbers likely to be affected across a range of worker characteristics following the move to a two-thirds bite for those aged 21 and older. The largest differences in levels are likely to be for workers that are in the private sector; are on permanent contracts; are female; have been in the same job for 12 months; have one job; or are paid hourly. Some comparators see large proportionate increases in numbers affected, including those who have recently moved job, which treble in size, and salaried workers, who quadruple to over one and a quarter million. Increases are split evenly between full-time and part-time workers.

2.21 Figure 2.7 also shows how the change to a two-thirds NLW for employees aged 21 and over would affect the numbers of workers by age. It would result in a substantial increase in NLW coverage among workers aged 21-29 – partly due to the higher level of the wage floor, but mainly as a result of the reduction of the age threshold to include workers aged 21-24, who are currently covered by the 21-24 Year Old Rate, and therefore not included in the NLW comparison base case.

National Minimum Wage

Figure 2.7: Numbers affected by a two-thirds NLW target for workers aged 21 and over, by characteristics, UK

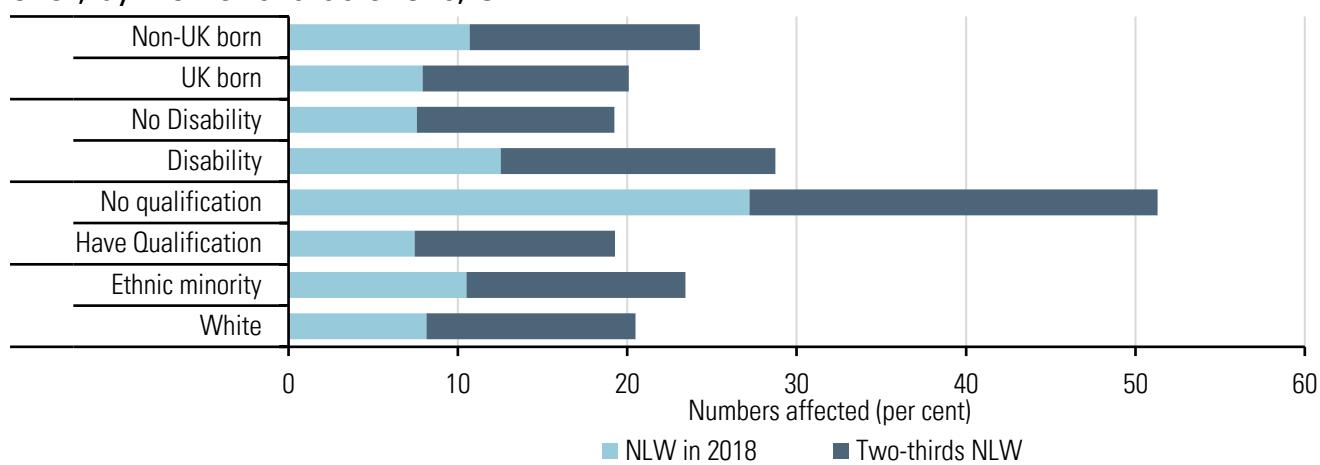


Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2018.

2.22 In addition to information from ASHE, we can supplement our analysis using data from the Labour Force Survey (LFS) which contains a greater range of characteristic information. Whilst wage data from the LFS are not as reliable as ASHE, we can still use the information to look at changes in the proportions identified as being affected by the new target.

2.23 Figure 2.8 shows that non-UK workers, those with disabilities, those without qualifications and ethnic minorities are more likely to be affected by a two-thirds target than their direct comparators. As with the current NLW the gap is widest for those workers with no qualifications, who are more likely to be employed in lower-paid unskilled jobs.

Figure 2.8: Proportions affected by a two-thirds NLW target for workers aged 21 and over, by worker characteristic, UK



Source: LPC estimates using LFS microdata, income weights, quarterly imputed wages, not seasonally adjusted, UK, Q2 2018-Q1 2019.

What are the implications for tax and benefits?

2.24 The NLW cannot be considered in isolation; it interacts with other policies including the tax and welfare system. The total cost to employers will generally exceed the minimum wage rates because of the additional pressures of National Insurance and pension contributions, as well as the costs of covering annual leave, statutory sick pay and parental leave. At the same time, the actual pay that employees take home is reduced by tax and pension contributions. This creates a wedge between what employers pay and what employees receive.

2.25 Some respondents to our consultation noted the importance of considering interactions with tax and benefits in setting any new NLW target. The Low Incomes Tax Reform Group (LITRG) told us that 'the interactions that exist between the minimum wage and tax and benefit systems mean that NLW does not necessarily translate into cash in the pockets of low-paid workers. For example, higher pay means things like paying tax....and paying more in pension contributionsIt may also impact on the amount of in-work benefits you receive...we would like to see the LPC's.....remit extended to focus more on how to improve the outcomes of low-paid workers in the round'.

2.26 National Insurance (NI) is levied on a weekly or monthly basis, with a current threshold of £166 per week. Employees on the current NLW rate of £8.21 need to work more than 20.2 hours per week before they are eligible to pay. The proportion of NLW employees paying National Insurance has risen from 52 per cent in April 2015, prior to the introduction of the NLW, to 62 per cent in April 2018. If we were to raise the NLW to two-thirds of median pay we would expect around 67 per cent of NLW employees to pay National Insurance, assuming no change in the distribution of hours worked.

National Minimum Wage

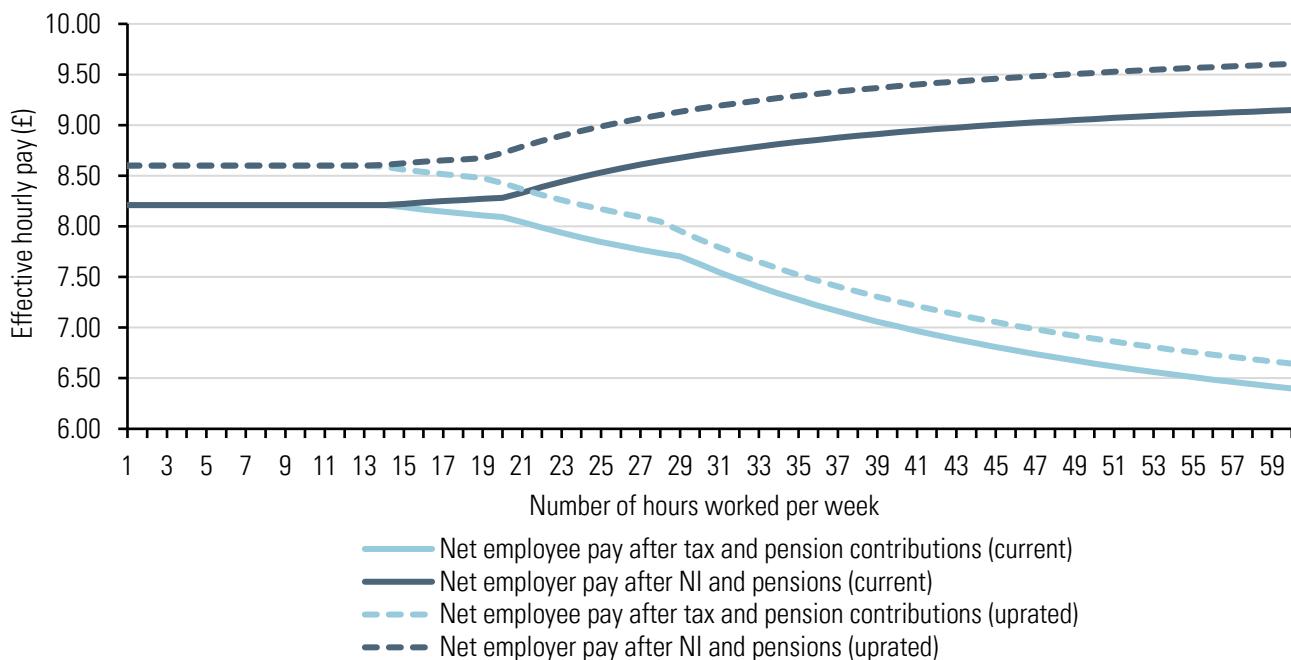
2.27 NLW employees are less likely to pay Income Tax, which is levied on an annual basis on earnings above £12,500, equivalent to working 29.1 hours per week on the NLW. The proportion of NLW employees paying Income Tax has risen from 38 per cent prior at the introduction of the NLW to 43 per cent in April 2018. If the NLW rate was set at two-thirds of median pay, we would expect the proportion paying Income Tax to increase to 46 per cent.

2.28 The introduction of automatic enrolment pension schemes has also increased the effective difference between the costs employers face and what employees take home. In most automatic enrolment schemes, employees pay a minimum of 5 per cent on annual earnings over £6,136, while employers pay a minimum of 3 per cent on pay over this threshold.

2.29 As a worked example, an NLW employee working 40 hours per week on the current rate (£8.21) would earn £328.40 gross per week. However, they would pay £19.49 in National Insurance contributions, £17.87 in Income Tax and could pay £10.55 in pension contributions. This would leave them with an effective hourly rate of £7.01. Meanwhile, their employer would pay the equivalent of £8.93 per hour including National Insurance and pension contributions, leading to an effective hourly ‘wedge’ of £1.92 per hour. As a result of the threshold for employer National Insurance contributions, this wedge increases as workers work more hours and it is cheaper for employers to employ two people working 20 hours per week than one person working 40 hours per week.

2.30 If the NLW rate were to be increased to two-thirds of median earnings, more employees would be in scope for National Insurance and Income Tax contributions, further increasing the wedge between what employers pay and what employees receive. Figure 2.9 shows the effective hourly rates for both employers and employees at the current NLW rate and a hypothetical NLW rate based on two-thirds of median earnings for employees over 21 (£8.60, based on ASHE 2018). The difference between employer costs and employee earnings increases with the number of hours worked, and this difference is greater on the higher rate. An employee working 40 hours per week would nominally receive an additional 39 pence per hour on the two-thirds rate, but they would only take home an additional 25 pence per hour while the employer would pay an additional 46 pence per hour. As the wedge increases, some employers may choose to limit the hours that NLW employees work in order to reduce their effective hourly costs. We do not have any strong evidence that this has happened as a result of previous increases but we will continue to monitor the impact of the NLW on hours and underemployment.

Figure 2.9: Effective hourly rates for employers and employees based on the 2019/20 NLW rate (£8.21) and a hypothetical rate based on two-thirds of median earnings (£8.60)



Source: LPC estimates, assuming current thresholds for Income Tax and National Insurance contributions, and employee pension contributions of 5 per cent on annual earnings over £6,136 and employer pension contributions of 3 per cent

2.31 The NLW also interacts with the benefits system. Workers on low pay may be eligible to have their income supplemented by Universal Credit (UC) or legacy benefits such as Working Tax Credits. The level of support that individuals are eligible to receive is dependent on many factors, including household circumstances and age. As an example, a single adult over 25 who does not need support with housing costs and does not have children could be eligible for a monthly UC payment of up to £317.82 in addition to the pay they receive from employment. This payment is tapered and reduces as they receive more money from employment. For every £1 they earn above £503 per month, an individual in these circumstances would lose 63 pence of their entitlement.

How are Universal Credit payments calculated?

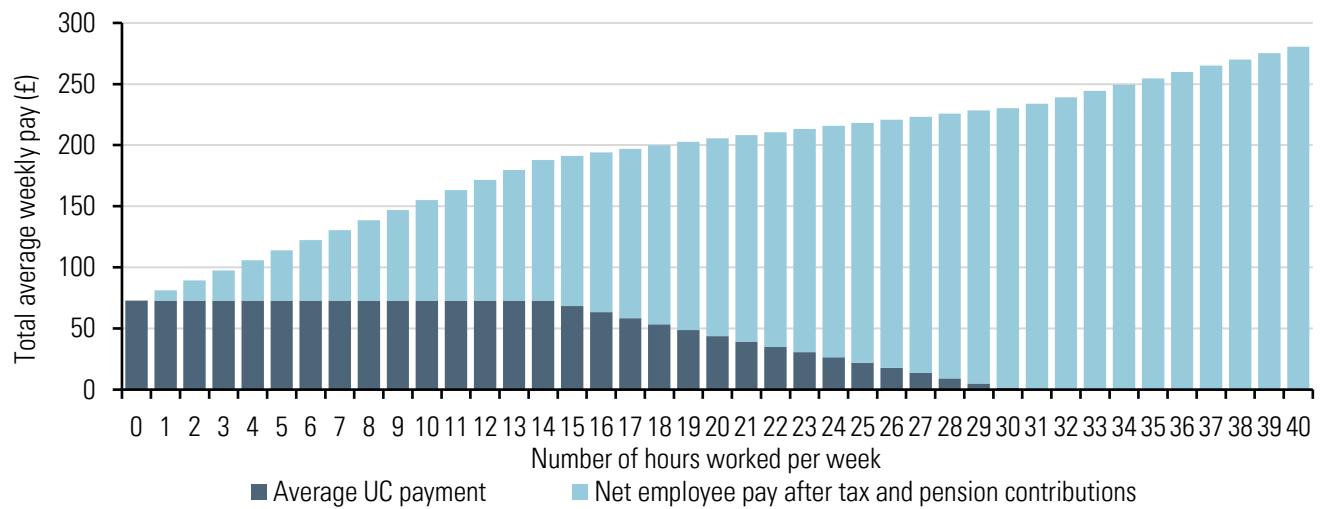
Universal Credit is paid on a monthly basis. Payments consist of a standard allowance and any extra allowances for children, housing or to support with a health condition or disability. The standard allowance is based on age and household circumstances, ranging from £251.77 per month for a single person under 25 to £498.89 for a couple where either partner is over 25.

Those who are employed are entitled to a monthly work allowance, beyond which the Universal Credit payment decreases by 63 pence for every additional £1 earned. This monthly work allowance is £503 for those on the standard UC allowance or £287 for those who also receive support with housing costs.

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2.32 Figure 2.10 shows how an individual's total weekly pay increases with the number of hours worked. Employees who are in the range of the taper see the smallest increases in pay if they increase the number of hours that they work. For example, if an NLW employee who receives the standard UC allowance increases the number of hours they work from 15 to 20 hours per week, they would effectively only receive an average of £2.89 per additional hour worked. As a result, this group are likely to have reduced incentives to increase their working hours.

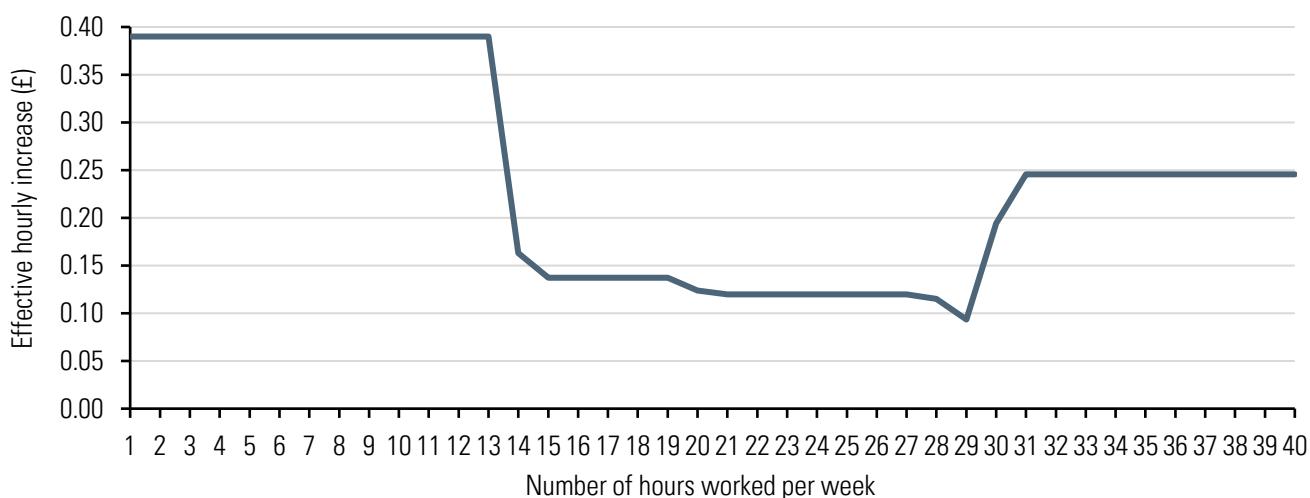
Figure 2.10: Total average weekly pay for an NLW employee who receives the standard Universal Credit allowance



Source: LPC estimates, based on a single adult over 25 who receives the standard UC allowance with no children or housing support. We have accounted for Income Tax and National Insurance contributions and assumed pension contributions of 5 per cent on annual earnings above £6,136. Note that UC is calculated and paid on a monthly basis and we have derived an average weekly payment.

2.33 Increasing the NLW will affect people differently if they are in receipt of in-work benefits. Again, we look at the example of a single adult who is paid at the NLW and supported by UC with no housing or childcare support. Figure 2.11 shows the effective increase in hourly pay that this individual would receive if the NLW rate was raised from £8.21 to a hypothetical rate of £8.60, based on two-thirds of median pay. Employees in this situation who work between 15 and 29 hours may see an effective increase of less than 15 pence per hour, because of the combined impact of tax deductions and reductions in the level of UC support that they are entitled to. NLW employees who receive in-work benefits are likely to be rewarded less by any substantial increases to the rate.

Figure 2.11: Estimated increase in hourly pay for an NLW employee who receives the standard UC allowance, assuming an NLW of two-thirds of median pay



Source: LPC estimates, based on a single adult over 25 who receives the standard UC allowance with no children or housing support. We have accounted for Income Tax and National Insurance contributions and assumed pension contributions of 5 per cent on annual earnings above £6,136. Note that UC is calculated and paid on a monthly basis and we have derived an average weekly payment.

Conclusions:

Reaching an NLW target of two-thirds of the median wage will require sustained large annual increases in the wage floor. The size of these increases will depend on the end-date which is set for a target, but even over a ten-year period the size of the increases required may still be over four per cent a year.

An NLW target based on two-thirds of median wages would significantly increase the number of workers whose pay is directly influenced by the minimum wage. The newly affected would include many workers, industries and occupations which have not previously had a high prevalence of minimum wage workers. This has implications for the Government's work on communications and guidance around the minimum wage, as well as for compliance and enforcement.

All things being equal, a two-thirds NLW rate would increase the proportion of NLW workers who pay Income Tax and National Insurance contributions. This would increase the 'tax wedge' between what employers pay and how much employees take home and could make it more attractive for some employers to limit the hours they offer in order to reduce their effective hourly costs, increasing the risk of underemployment. We do not have any evidence that employers have responded in this way to NLW increases to date, but it will be an area we watch closely as the rate continues to rise.

As already happens, NLW workers who receive Universal Credit will not receive the full benefit of any ambitious increases to the minimum wage. A higher NLW has the potential to accentuate this effect. In setting a higher NLW target, the Government should take account of interactions with the welfare system and consider carefully the combined effects of the two policies.

Chapter 3

Conditions for a higher NLW

3.1 The current remit for the NLW is to reach 60 per cent of median hourly earnings (for those aged 25 and over) by 2020. In order to allow for a more ambitious target, it is important that it is supported by a strong economy. It would be higher risk to attempt to pursue a more ambitious target if the economic conditions did not support it. For this reason, our remits from the Government have always asked us to take economic and labour market conditions into account when making our recommendations. Under the NLW framework – which we discuss in more detail in Chapter 5 – our recommendations are ‘subject to sustained economic growth’, which we have heretofore interpreted as rolling four-quarter growth in GDP of 1 per cent per year.

3.2 In the period leading up to the financial crisis the economy grew strongly while employment was relatively high and stable, which allowed the National Minimum Wage (NMW) to grow strongly in both real (i.e. compared with prices) and relative (i.e. compared with average earnings) terms. During the resultant recession and its immediate aftermath, the increases in the NMW were more modest than had been experienced previously. Although the relative value of the NMW was maintained and indeed increased a little, this was mainly due to the weakness in the growth of average earnings. The real value of the NMW fell in this period, although that fall was not as fast as the fall in real average earnings. As the economy picked up after 2012, we recommended increases that allowed the real and relative value of the NMW to increase again.

3.3 We monitor a range of factors to assess whether the economy can bear higher a minimum wage. These include strong employment, economic growth, increasing pay, increasing productivity and a range of considerations that affect the affordability of the NLW to individual firms and the quality of jobs for workers. All of these are related to one another to varying degrees but uncover different dynamics at play. Not every factor must be met for faster minimum wage increases to be appropriate. The weight we choose to place on each will depend on the economic situation at the time, but generally employment will be our key indicator.

Strong Employment

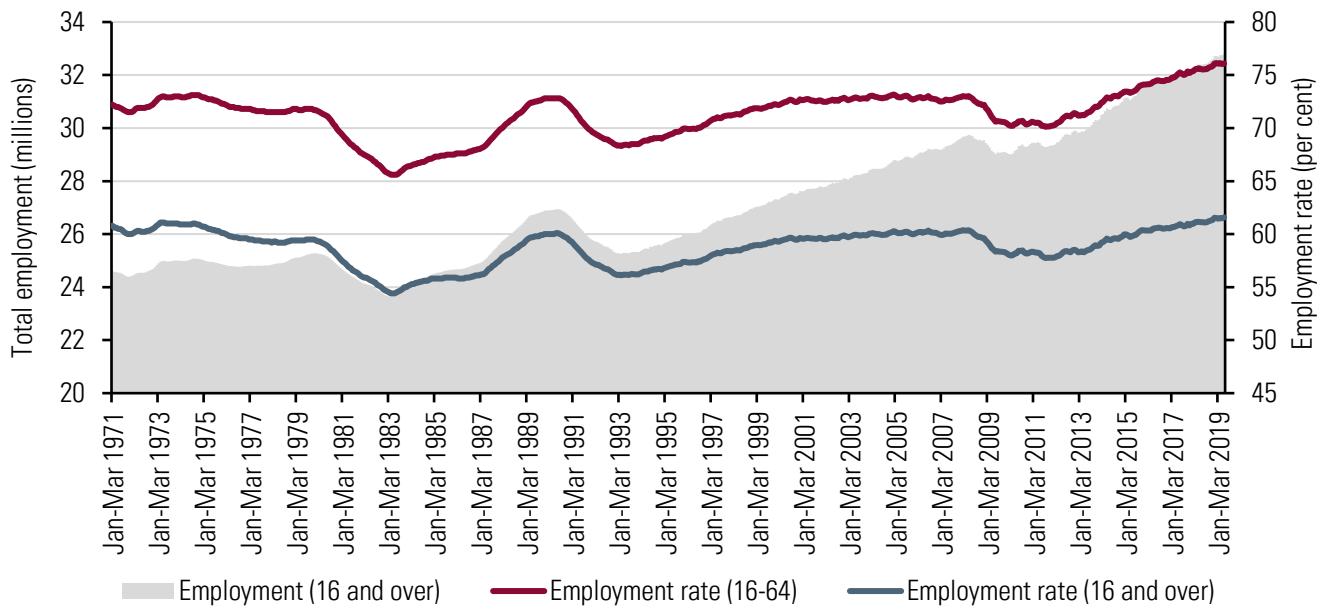
3.4 A high level of, or growth in employment, suggests that demand for labour is strong. Therefore, pushing up the cost of this labour through increases in the minimum wage should have less of an effect than when the demand for labour is weak.

3.5 Strong employment could mean different things depending on the situation. We generally think of it as meaning either high levels or continual increases in employment. We look both at the economy more widely and at the sectors most vulnerable to changes in the minimum wage. This includes occupations and industries where there is a wide prevalence of minimum wage use, groups of individuals that are more likely to be paid the minimum wage, and geographic areas where low pay or minimum wage use are more common. We also look at wider measures of slack in the labour market including vacancies, underemployment, hours and non-standard employment.

3.6 We measure aggregate employment in a number of ways, including the total number of workers in a job, the total number of jobs and the total number of hours worked. On all three measures, the UK labour market has been historically strong in recent years.

3.7 Since the end of the recession, employment has grown rapidly in the UK. This has been driven by increased participation of women, particularly those with children and those affected by the equalisation of the State Pension Age to 65 to match that for men, an increase in the participation of older workers, and increases in net migration. As Figure 3.1 shows, the employment rate has been at or above 76 per cent for the last six months and employment has been above the pre-2008 peak reached in January 2005 since December 2014. This has presented a benign backdrop for the fast increases in the minimum wage since the introduction of the NLW in April 2016.

Figure 3.1: Employment levels and rates, 1971-2019



Source: LPC estimates using Office for National Statistics (2019e): total employment for those aged 16 and over (MGRZ), employment rate for those aged 16 and over (MGSR) and employment rate for those aged 16-64 (LF24), quarterly, UK, 1971-2019.

3.8 However, on other measures the labour market seems less secure. Since 2008, there has been an increase in the use of zero-hours contracts, minimum-hours contracts, of self-employed workers with no employees and underemployed workers. While employment on some of these measures has fallen recently, these workers may act as a further source of labour supply, indicating that the record levels of employment may not represent the whole picture. We looked in detail at some of the issues associated with zero-hours and minimum-hours contracts in our response to the Taylor Review (Low Pay Commission, 2018).

3.9 Another factor in determining if the labour market can absorb faster increases in the minimum wage is whether there is progression out of minimum wage jobs to higher-paying jobs. Faster progression, whether within an employer, or between employers indicates that demand for these types of workers is high and that workers on the minimum wage can command higher pay in other roles. The number of workers moving between employers fell in the post-crisis period. While the number of job moves from high and medium-skilled occupations has recovered to the pre-crisis level, for the lowest-skilled occupations moves are still below their level pre-crisis.

3.10 We are especially interested in the experiences of the sectors and groups most exposed to the minimum wage. Figure 4.4 and Figure 4.5 (pages 49 and 50) show how employment has grown faster for the groups of workers most affected by the minimum wage, despite the fact that employment in the lowest-paying occupations has fallen, which could suggest that workers are choosing to move into higher-paying occupations. This shows that because no one indicator of the strength of the labour

market is perfect, it is important to take a balanced look across multiple indicators to get an idea of the resilience of the labour market.

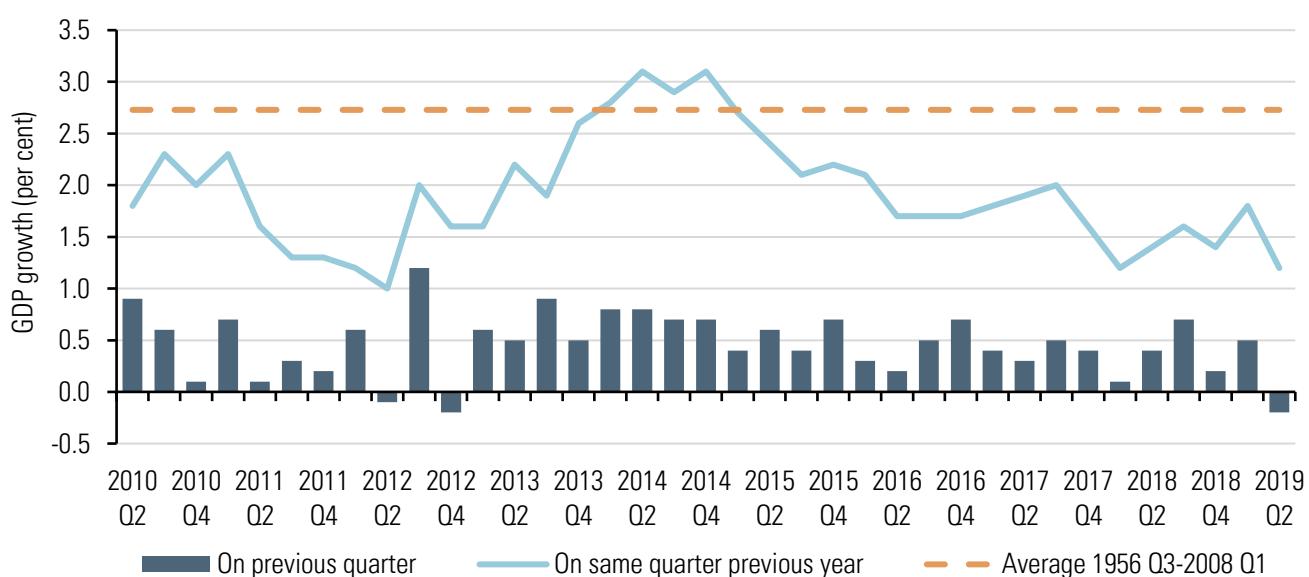
Economic growth

3.11 Our remits from the Government under the NLW framework state that recommendations on rates should be ‘subject to sustained economic growth’. We have thus far interpreted this as rolling four-quarter average real gross domestic product (GDP) growth of 1 per cent per year, based on a definition of ‘normal times’ used in the Charter for Budget Responsibility (HM Treasury, 2015). This condition has been met every year since our current remit was introduced.

3.12 Strong GDP growth shows that demand in the economy is increasing. Higher demand in the economy means that employers may be more able to increase prices, output or invest in other cost savings in response to higher minimum wages.

3.13 GDP grew in every quarter between the fourth quarter of 2012 and the first quarter in 2019. These 25 consecutive quarters of growth, as shown in Figure 3.2, represent the second-longest period of consecutive quarterly growth since the Second World War. However, despite the length of this expansion, the rate of growth was fairly anaemic, with annual growth rising above the average for the fifty years prior to the 2008 crisis only for a brief period in the second half of 2014 and the first half of 2015. This is somewhat at odds with the period of strong employment growth as explored in the previous section.

Figure 3.2: Quarterly and annual GDP growth, UK, 2010-2019



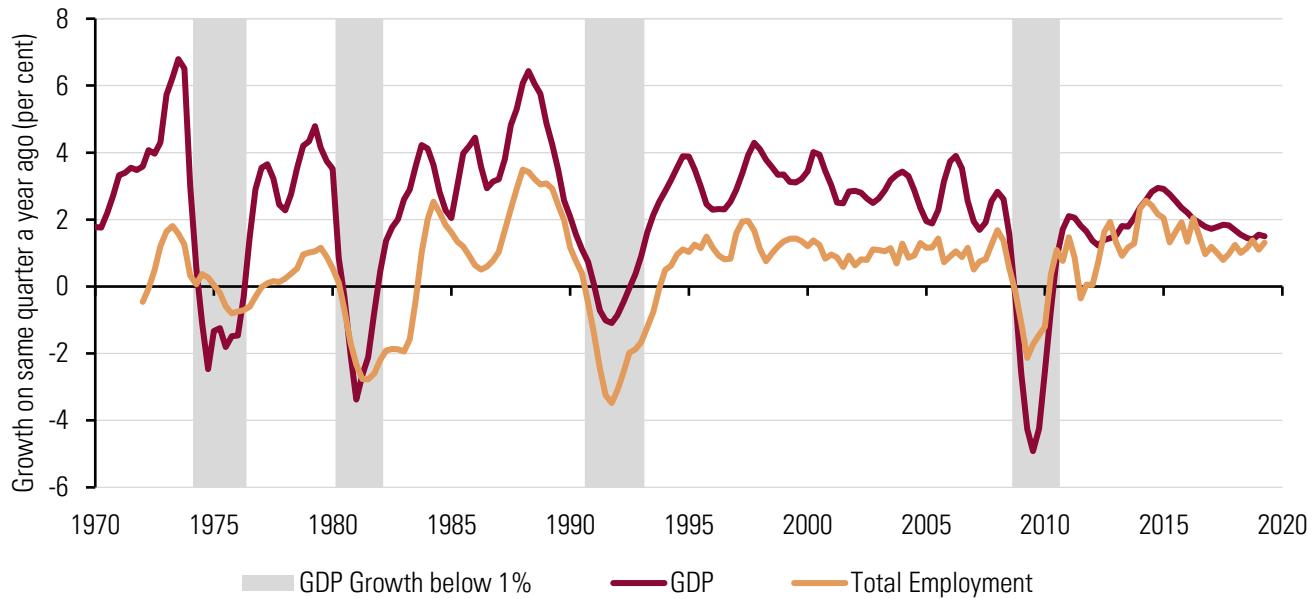
Source: LPC estimates using Office for National Statistics (2019g): GDP quarter on quarter growth (IHYQ), GDP Q-on-Q4 growth rate (IHQR) and GDP chained volume measures (ABMI), quarterly, UK, 1955-2019.

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3.14 Figure 3.3 shows that since 1970 four-quarter GDP growth has only fallen below 1 per cent on four occasions. On each of those occasions the UK has subsequently gone into recession: the 1970s oil shock recession; the 1980s recession; the 1990s recession; and the financial crisis recession of 2008-09. Thus, if the economy in future follows the same patterns as in the past, when growth goes below 1 per cent, it is likely to be a harbinger of recession. Therefore, within our current remit, we would only deviate from a path based on the current sustained growth definition when the UK is in recession.

3.15 Figure 3.3 also indicates how the link between employment and GDP is not always strong. While employment has only fallen during, or immediately after a recession, the growth in employment is not closely linked to growth in GDP. Between the two recessions in the 1970s, GDP growth rebounded quickly but employment growth remained subdued. In the 1980s employment growth tracked GDP growth quite closely, but in the 1990s employment falls preceded GDP falls. Despite the slower GDP growth since 2010, when compared with the period between 1994 and 2008, employment has risen faster in the last 9 years than it did during 1994-2008.

Figure 3.3: Annual GDP growth and total employment growth, UK, 1970-2019



Source: LPC estimates using Office for National Statistics (2019g): real GDP (ABMI), rolling four-quarter average annual growth, quarterly, UK, 1969-2019 and Office for National Statistics (2019e): total employment for those aged 16 and over (MGRZ).

3.16 One issue with using GDP as a signal is that GDP measures are not necessarily timely and can be subject to substantial revisions. For example, in the second quarter of 2008 – the first quarter to see a fall in GDP when compared with the previous – annual growth in GDP was still 2.6 per cent and it was not until the fourth quarter of 2008 that this measure fell below 1 per cent. Due to limits in the estimation of GDP in real time, growth in the second quarter of 2008 was not recorded as negative until it was revised in June 2009. The 2008-09 recession was first called as such in January 2009, when ONS reported that growth was negative in the third and fourth quarters of 2008, despite subsequent revisions stating that it had started in the second quarter. This limits the ability of specific GDP thresholds to act as a determinant of our decision making.

3.17 One factor that has driven the growth in GDP recently has been population growth. When we look at GDP per capita (GDP divided by the number of people in the country) we can see that it has typically grown more slowly than GDP due to population growth. However, the gap between the two has been particularly high over the last 8 years showing that GDP growth has been particularly reliant on population growth over the period. Growth in the size of the economy that was driven by population increases would be less of a signal that the economy could afford faster increases in the minimum wage than economic growth created through improvements in the amount produced per person.

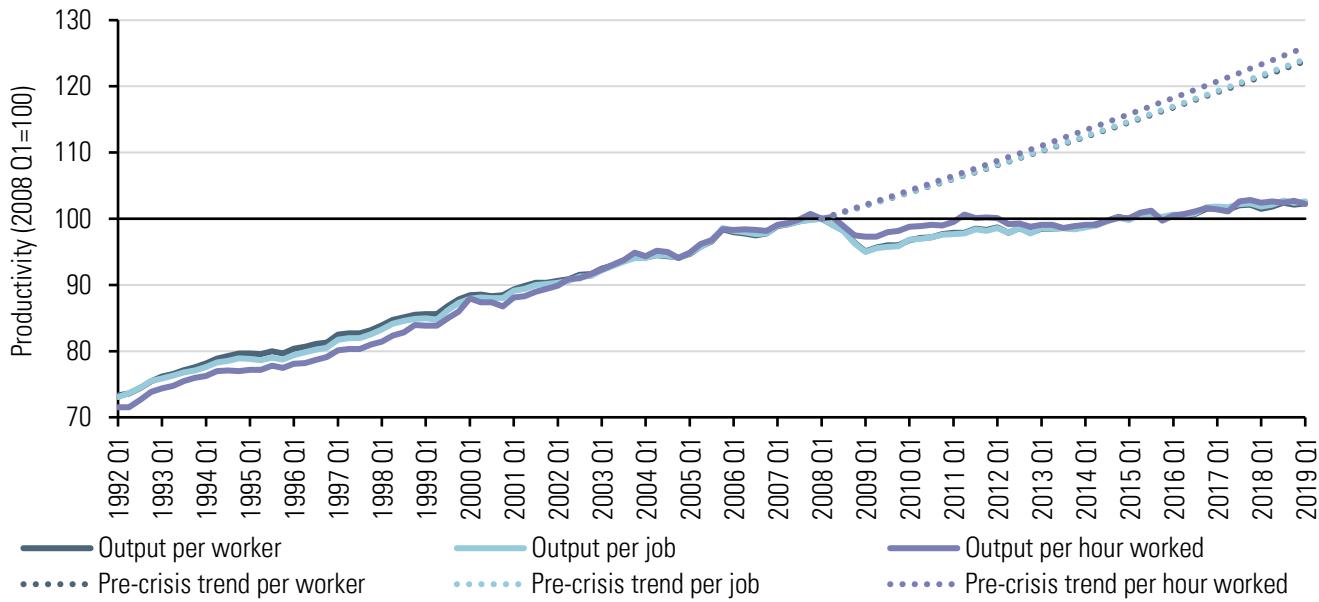
3.18 We also examine other factors related to a strong economy that matter for firms that employ a high proportion of minimum wage workers. These include measures of consumer spending and consumer confidence, as many low-paying firms are in the hospitality, retail and leisure industries which are particularly dependent on consumer spending.

3.19 Overall, this shows that while GDP growth is an important criterion for sustainable increases in the minimum wage, it is not the only factor to consider. Moreover, while it is produced in a reasonably timely manner, it is subject to revisions that create issues with using it as the sole measure of economic circumstances. We explore this issue more in paragraphs 5.14 to 5.17.

Productivity Growth

3.20 The gap between the strong performance of the labour market in terms of employment and the relatively poor level of economic growth can be explained by productivity. The recent period has not seen economy-wide increases in productivity in the UK. As demonstrated in Figure 3.4, productivity increased steadily up to the start of the financial crisis in 2008, but since then has remained mostly flat. If productivity had continued to grow along its pre-crisis trend, it would be a quarter higher than it currently is.

Figure 3.4: Output per hour, job and worker, UK, 1992-2018



Source: LPC estimates using Office for National Statistics (2019d): output per worker (A4YM), output per job (LNNN), output per hour (LZVB), quarterly, seasonally adjusted, UK, Q2 1991-19.

3.21 The level of labour productivity in an economy is a key determinant of long-run wages. If workers are more productive then firms can afford to pay them more, and – in a competitive labour market – other firms will offer higher pay to induce movement as these workers are more valuable, leading to higher wages. A higher minimum wage relative to the median wage could be affordable through two main measures. Firstly, if firms have historically underpaid workers versus their level of productivity – through exploiting monopsonistic labour market power – then a higher minimum could bring wages closer to the level of productivity. Secondly, if productivity for the lowest paid grows more quickly than for the median worker, then a higher minimum wage – relative to the median worker – becomes more affordable.

3.22 The causality of effects between productivity and wages is not clear-cut and could potentially flow both ways. Standard economic theory suggests that increases in productivity are matched by increases in wages, as firms have to pay workers more or they will move to a firm that will reward their higher productivity. On the other hand, there are theories that argue that higher wages can lead to more output, and therefore faster productivity growth. Wage-led growth, and its effects on productivity is a theory that has been explored in the economic literature (for example, Lavoie and Stockhammer [2013] and Stockhammer and Onaran [2012]). This theory argues that higher wages induce firms to invest in improving productivity, so that higher wage growth leads to higher productivity growth. Efficiency wage theory states that higher pay can induce more effort from workers, resulting in higher levels of output.

3.23 Indeed, employers often tell us that they intend to raise productivity in response to minimum wage increases; in the long term, they view this as the most sustainable way to manage the increased cost. However, we have found few specific examples in our consultations of employers succeeding in raising productivity through technological, organisational or skill-related means. Employers have instead focused on easier ways to increase productivity; we have repeatedly heard evidence, including from Chartered Institute of Personnel and Development (CIPD) employer surveys, that firms are relying on getting their staff to work harder to increase output. In our latest consultation, smaller firms were sceptical about their ability to invest in automation to improve productivity and there were signs that they are increasingly cutting investment. This is reflected in survey data from the Federation of Small Businesses (FSB) and British Chambers of Commerce (BCC). But it is worth remembering that investment decisions are not driven solely by the minimum wage. In contrast, we have heard from large employers in some sectors, notably retail, that productivity is a major concern and investment in automation and reorganisation is ongoing.

3.24 The extent of up-skilling and re-skilling of workers in the economy is an important determinant of the level of productivity. Increased investment in skills could boost the potential level of productivity in the labour market and create a situation where further increases in the level of the NLW can be more affordable to businesses.

3.25 There have been a number of studies examining the effect of the NMW on productivity. However, the evidence so far is mixed. Two papers, Forth and O'Mahony (2003) and (Forth, Harris, Rincon-Aznar and Robinson (2009), found that the NMW had a positive but not significant impact on productivity at industry level, while others (Galindo-Rueda and Pereira [2004], Crawford, Jin and Simpson [2013] and Riley and Rosazza Bondibene [2013]) found some positive impact on labour productivity at firm and industry level. Rizov and Croucher (2011) found a positive impact on labour productivity and total factor productivity. However, Forth, Harris, Rincon-Aznar and Robinson (2009) found no significant effect on productivity at firm level.

3.26 We do not have data to examine the relative productivity differences between minimum wage workers and the median worker. However, we can look at productivity growth in industries that have a high prevalence of minimum wage workers.

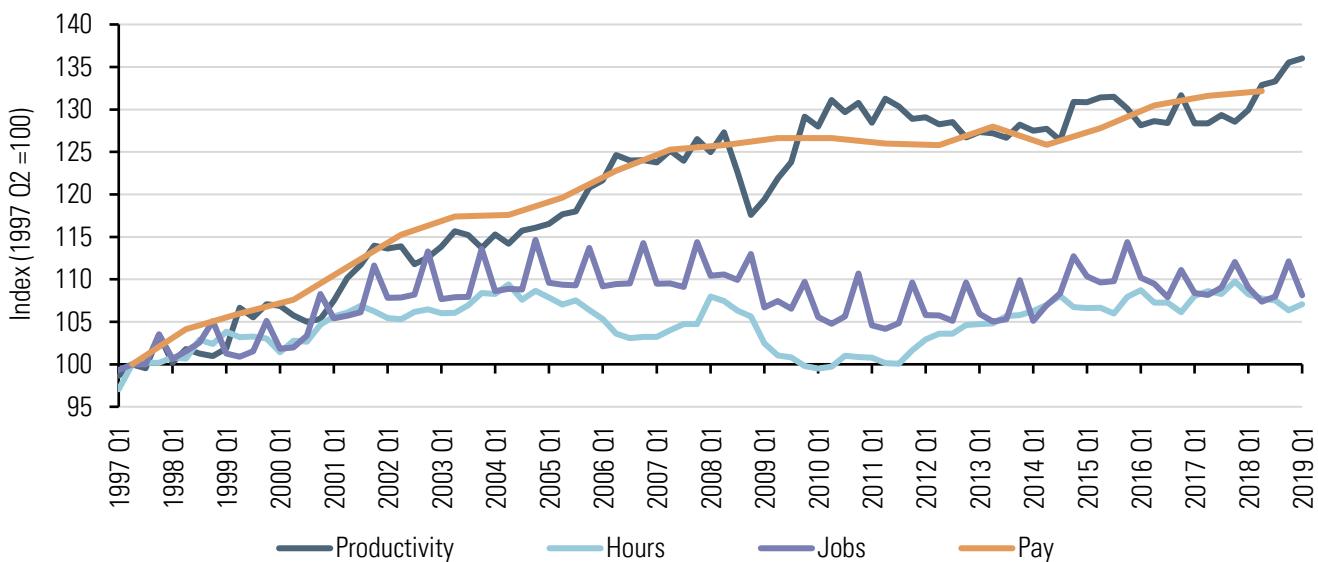
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3.27 We have examined how average pay per hour, employment and output per hour have changed since 1997 in nine low-paying industries: agriculture, forestry and fishing; cleaning; domiciliary care/childcare; food processing; hospitality; leisure/travel/sport; residential care; retail; and textiles and clothing. It is important to note that output per hour worked is not purely a measure of labour productivity (the additional output from each extra hour of labour) – it includes contributions from capital and total factor productivity.

3.28 Our analysis shows that outcomes can be categorised into three broad groups. The first group is those industries – domiciliary care/childcare and retail – where productivity and wages grew at a similar pace, suggesting that wages are about as affordable as they were in 1997. The second group contains two industries – hospitality and textiles and clothing – where productivity growth has outpaced wage growth, suggesting higher wages may be more affordable now than before the NMW was introduced. The final group contains the industries where wage growth outpaced productivity growth, suggesting wages may have become less affordable. This third group contains the remaining low-paying industries: agriculture, forestry and fishing; cleaning; food processing; leisure/travel/sport and residential care. Overall output per hour grew by slightly less than 30 per cent over the period, which was faster than in all the low-paying industries, with the exceptions of retail, hospitality and textile manufacturing.

3.29 Figure 3.5 shows how pay growth in the retail industry has tracked productivity quite closely since 1997, with the exception of the period between 2008 and 2009, when there was a dramatic fall in productivity during the 2008-09 recession and its immediate aftermath, but average pay held up.

Figure 3.5: Real pay, productivity, hours and jobs in retail, UK, 1997-2019



Source: LPC analysis using ONS figures. Productivity and hours from Office for National Statistics (2019c), jobs from Office for National Statistics (2019a) and pay from Office for National Statistics (2018a), deflators from Office for National Statistics (2019b).

Note: productivity and hours figures are seasonally adjusted, job figures are not. Pay data is on an annual basis.

3.30 There is no clear evidence on whether the productivity conditions are in place to enable further increases in the NLW. The research that examines whether increases in the pay floor lead employers to improve productivity has a mix of outcomes, and while productivity in the two largest low-paying industries (retail and hospitality) has grown faster than pay, other sectors look to be in a more challenging situation – particularly cleaning, domiciliary care/childcare and residential care.

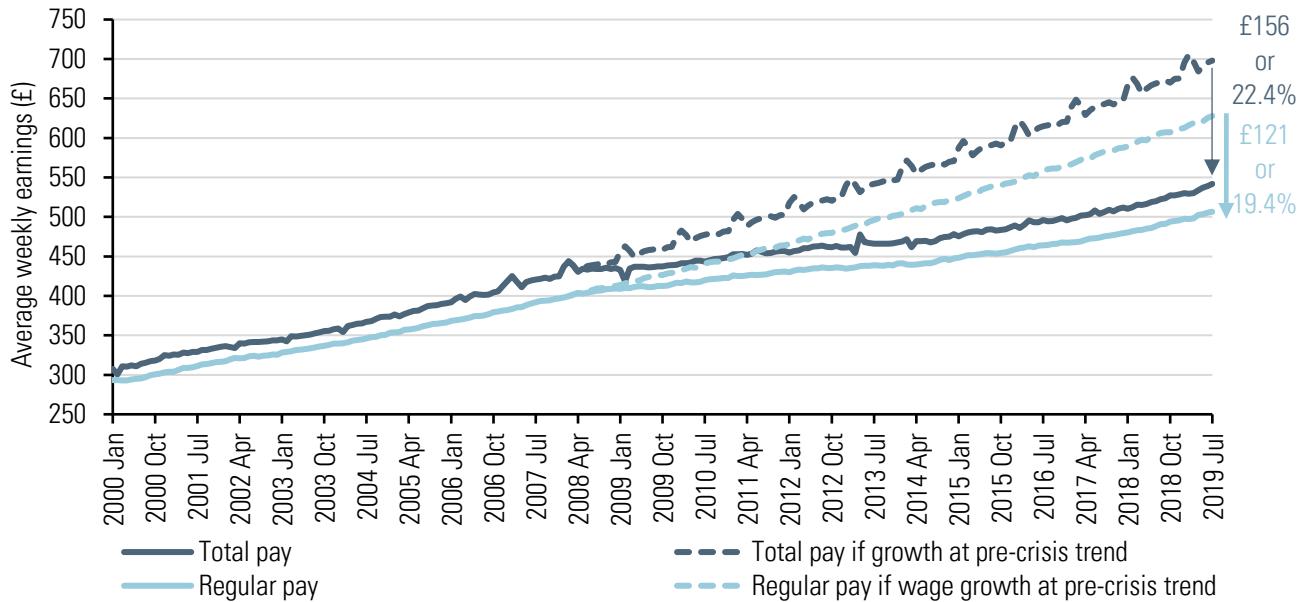
Wage Growth

3.31 Wage growth is also an important factor. While in the long-run productivity is the key determinant of wages, in the short run wages are also determined by the balance of supply and demand for labour. Historically the LPC has used wage growth as a key factor in determining if there was enough demand for labour to cope with larger increases in the minimum wage. However, the relationship is somewhat complicated by the use of a 'bite' target. If wages grow faster, then the median wage that we set the minimum wage relative to will also grow faster, which means that the minimum wage increase will need to be larger to stay on track to hit the bite target.

3.32 Nonetheless, employers may find it easier to afford increases in the minimum wage when other wages are also increasing. The 6.7 per cent increase in the minimum wage needed to move from a 60 per cent bite to a 61 per cent bite in the context of a 5 percent increase in median pay may be more manageable than the equivalent 1.7 percent growth in the median in a world of zero median pay growth.

3.33 Pay growth is measured in nominal terms, the difference in pay in pound terms, and real terms when the growth is adjusted for changes in prices. During the recession in 2008 and 2009, while in nominal terms wages for the most part remained flat, real wages fell sharply as inflation surged and prices increased much faster than pay. The lower level of real pay and cuts to hours enabled employers to avoid reducing their employment headcount, explaining the smaller than expected fall in employment over the crisis, as seen in Figure 3.3. In the post-crisis period pay growth has been very low. Real total pay is still below its level in 2008, while – as shown in Figure 3.6 – nominal average wages are around 20 per cent lower than they would have been had they grown in line with their pre-crisis trend.

Figure 3.6: Total and regular average wages, 2000-2019



Source: LPC estimates using Office for National Statistics (2019e); real average total weekly pay and real average regular weekly pay, quarterly, GB, 2000-2019 and Office for National Statistics (2019f) CPIH inflation (L522).

3.34 We also examine wage growth across the pay distribution. We look at how the distribution of wages has developed in the economy and how pay levels are changing in different sectors of the economy. Figure 4.1 shows how pay has grown over the first three years of the NLW across the pay distribution.

3.35 While pay growth has been slightly better in the last three years than it was in the period between 2010 and 2016, the NLW has not overlapped with a period of particularly strong wage growth. In fact, the low level of wage growth relative to forecasts in 2015 and the self-correcting nature of the NLW bite target, has seen the target level of the NLW in 2020 fall from £9.35 when the policy was announced to our March 2019 forecast of £8.67.

Affordability and job quality

3.36 As well as assessing the aggregate macroeconomic data, it is also essential to understand how our decisions affect the ability of firms to afford the minimum wage and their implications for workers' total reward packages and job quality. The importance of good employee relations – balancing employer concerns with employees' needs – has always been a fundamental principle that has enabled the social partners to make unanimous recommendations. Indeed, alongside our economic and statistical analysis, we have always emphasized the importance for our decision-making of qualitative evidence from stakeholders. This information – gained from our visits around the UK, our formal written and oral consultation exercises and our regular contact with stakeholders – complements our in-house analysis and the findings of commissioned and independent research.

3.37 Using official data we can investigate impacts from minimum wage increases on wages, employment, and hours at a disaggregated level with regards to employer and job characteristics as well as by worker characteristics. These data are relatively timely and reasonably robust. In contrast, the official data on, for example, profits, productivity, prices, investment and training are much less useful for assessing the impact of the NLW. They are generally available only at a highly aggregated level – meaning we cannot isolate data for particular low-paying parts of the economy – and are less timely. We therefore need to supplement the aggregate data by using the stakeholder evidence that we gather through our consultations. This evidence provides insights into how the impact of the NLW on costs and profit margins varies by firm size, sector and geography, as well as more detail on employers' strategies for coping with the increase in costs.

3.38 The employers we speak to often tell us that their main concern is the affordability of increases in the minimum wage, and that this hinges not just on the rate itself, but a range of interconnected factors: the magnitude and variability of other costs; the ability to pass costs on to customers; and the capacity to improve total productivity (by producing more output with the current inputs or the same output with fewer inputs at lower costs). They note that some of the recent discrepancy between changes in productivity and pay can be explained by the increase in total employment costs, as National Insurance and pension contributions have increased along with costs unrelated to wages, such as annual leave entitlement, sick pay, and parental leave arrangements. The ability of employers to pass the higher costs on to their customers is another factor that affects the affordability of increases, and this depends on the amount of market power firms have.

3.39 The costs that employers face are varied and depend on the type of business and the sectors of the economy they act in. We can typically categorise these costs into three groups. The first covers business costs set by market rates. Examples of these include food costs to pubs, restaurants and food retailers, the costs of stock to other retailers and the costs of energy and fuel to most firms. The second set of costs covers wage-invariant costs set by the Government, including business rates and other taxes. The final set of costs are those Government-set costs that vary with wages, such as pension auto-enrolment, the Apprenticeship Levy and National Insurance contributions.

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3.40 Beyond just their hourly wage, workers care about their entire reward package. This includes both the total reward (total basic wages plus premia for overtime and unsocial hours, and other payments), non-wage rewards and their overall job quality. The last item can be affected by a number of things, including control and variability of hours, level of job security, and the amount of control and responsibility workers feel over their work. In some cases we have heard that employers have responded to a higher minimum wage by cutting the non-basic wage elements of the job, reducing the overall reward package or making work more precarious. In other cases employers are simply requiring their workers to work harder. This changes the risk/reward profile of increases to the minimum wage and therefore can influence our decision making. While there is some evidence on pay premia from the official data, there is precious little on other important aspects of the job and there is little information available on these important aspects of the job in official data. It therefore becomes vital to gather this information directly from workers and firms.

Conclusions:

There are a range of factors that indicate whether the economy can bear a higher minimum wage. These include strong employment, economic growth, increasing pay, productivity growth, the affordability of increases to firms and the quality of jobs for workers. Each factor covers a variety of underlying indicators and measures. The importance we accord to each varies depending on the economic circumstances and we do not identify a single key metric or threshold in our decision-making.

During the period of the NLW we have seen differing performance on each of these measures. Employment has been strong, with employment reaching records highs and unemployment falling, whereas economic growth and pay increases have been weak by historical standards and the UK's productivity performance has been particularly poor over the last decade.

However, these measures do not tell the whole story and gathering information directly from stakeholders is key for us to understand the situation on the ground and what this means for the NLW.

Chapter 4

The impact of the National Living Wage so far

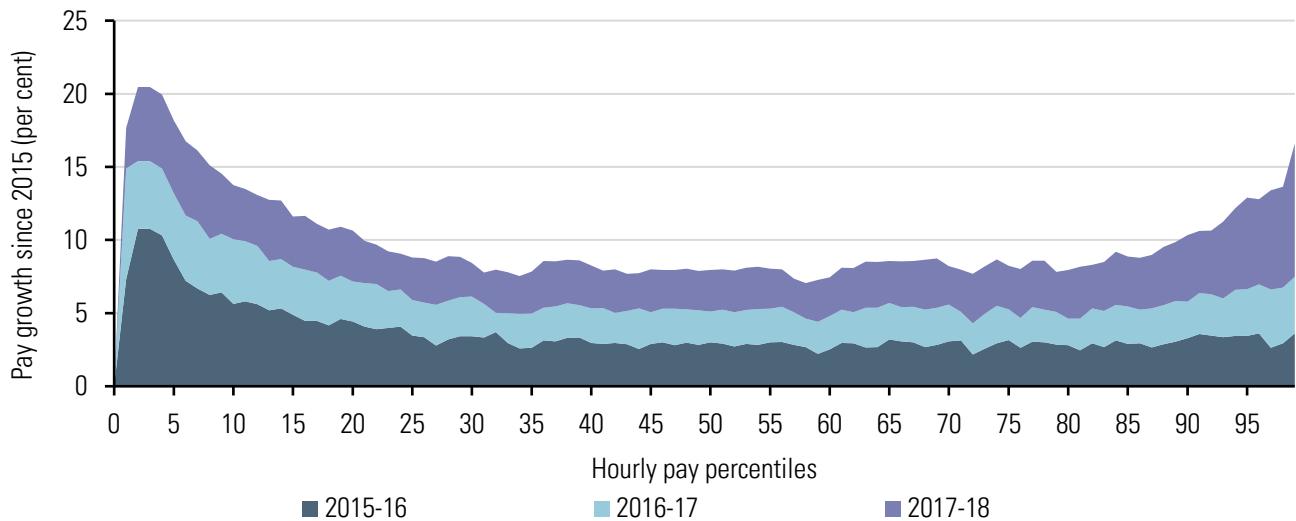
4.1 This year we celebrated the 20th anniversary of the introduction of the National Minimum Wage (NMW) in April 1999. We have access to a wealth of evidence of the impact that the NMW has had over this period and we have more limited evidence on the impact of the National Living Wage (NLW). The NMW and NLW have raised pay for millions of employees without strong evidence of higher levels of overall unemployment. We assessed the twenty-year impact of the NMW in Low Pay Commission (2019a). In this chapter, we summarise our analysis of the impact of the NLW to date, to enable us to anticipate the possible consequences of an even higher NLW and to help inform a decision on the likely trade-offs involved in moving to an even higher target. However, it is important to note that over its life the NLW will consist of five upratings, but we only have econometric evidence on the first three of these. It is therefore too soon to draw firm conclusions on the impact of the NLW. We also look at the emerging international evidence on the impacts of ambitious minimum wage increases.

The impact of the National Living Wage on pay

4.2 The introduction of the NLW and the subsequent upratings in 2017 and 2018 led to the lowest end of the hourly wage distribution receiving faster growth than the rest. Figure 4.1 shows nominal pay growth between 2015 and 2018 across the pay distribution, highlighting how the fastest growth in this period has been at the extreme ends of the pay distribution. Growth between the 30th and 80th percentiles has been fairly flat across the three years.

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Figure 4.1: Growth in the hourly wage distribution for workers aged 25 and over, UK, 2015-18

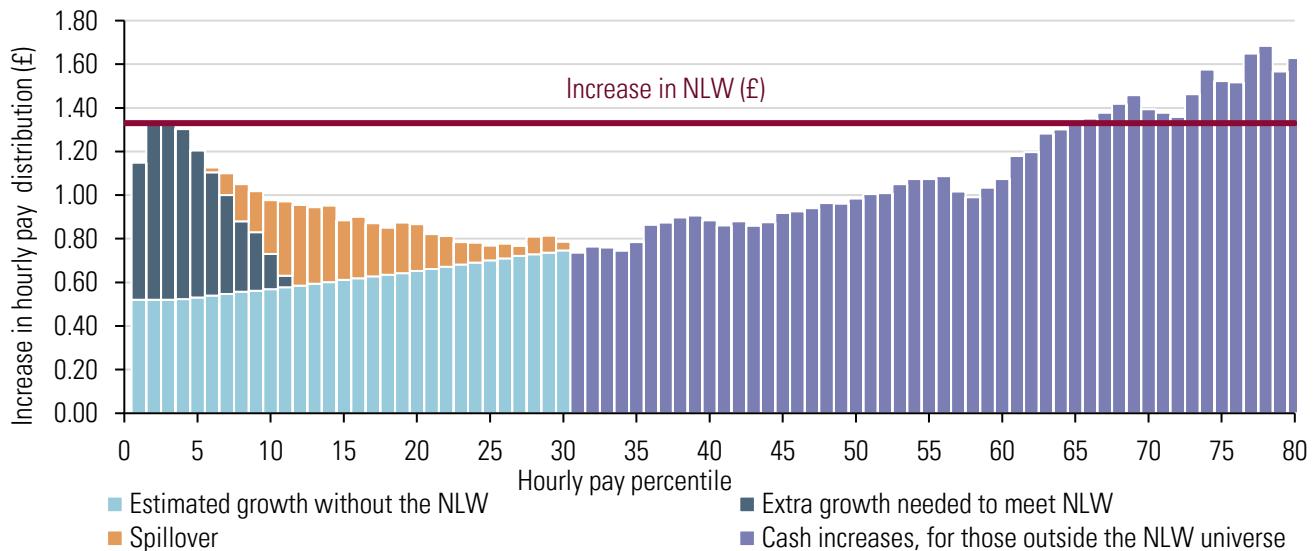


Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2015-18.

4.3 The NLW has not just raised pay for those who are paid the minimum. It has also led to pay for those just above the NLW growing faster than it otherwise would have, as firms try to maintain pay differentials to the NLW. Assuming that in the absence of large increases in the minimum wage, pay for the lowest-paid would have grown at a similar pace to the middle of the pay distribution⁵, we can estimate the size of these ‘spillovers’. Figure 4.2 shows how workers up to the 30th percentile have benefited from the increase to the NLW. Therefore, any move to a two-thirds target is likely to lead to increases in pay beyond those directly affected by the higher floor. This will increase the costs to firms.

⁵ This is likely to be a conservative assumption. In Low Pay Commission (2019a), we found the lowest-paid workers tended to receive lower percentage pay increases than the rest of the workforce before the NMW was introduced, but that the introduction of the NMW reversed this trend.

Figure 4.2: Cash growth in the hourly wage distribution including spillovers for workers aged 25 and over, UK, 2015-2018



Source: LPC calculations using ASHE 2010 methodology, standard weights, UK, 2015-18.

4.4 As the data show, there are significant wage spillovers from the NLW, but for the most part these do not match the increases in the wage floor. Employers and workers tell us that the resulting reduced differentials between job grades can affect employee relations, morale and staff retention. We have heard suggestions from many stakeholders, including the Confederation of British Industry (CBI), that large employers are now looking to restructure their workforces and pay scales to be able to manage issues with differentials.

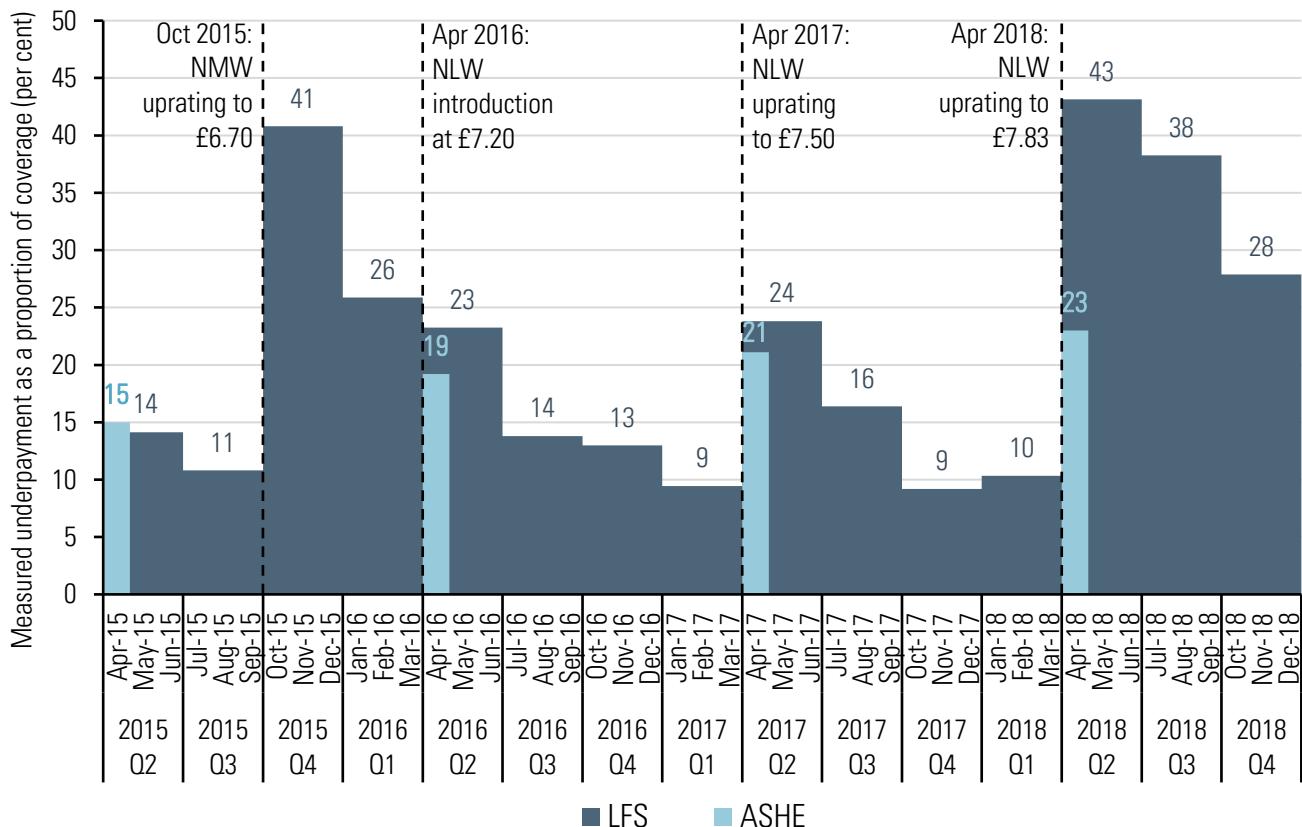
4.5 Some employers say that they have made changes to pay and reward to manage the risk of increased costs, and some workers perceive that there is a trade-off between increases in pay and a deterioration in working conditions and non-wage benefits. It is not clear that this has accelerated because of the NLW, and other stakeholders have talked about competition on basic pay driving changes. Indeed, as a counterpoint to the effect of the NLW on pay, representatives of sectors including hospitality, social care and agriculture have said that labour shortages are also putting upwards pressure on pay for some employers.

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4.6 Research conducted for the LPC support the findings of significant pay impacts from the NLW and wage spillovers. Avram and Harkness (2019) use geographic variation in levels of minimum wage coverage at a travel-to-work-area level to estimate the level and extent of spillovers up to 2018, while controlling for compositional differences between areas. The authors find significant spillovers up to the 30th percentile, with a 1 percentage point increase in coverage associated with a 2.0-to-2.5 per cent increase in wages at the 5th percentile, 1.5-to-2.0 per cent increase at the 10th percentile and 1.0-to-1.5 per cent at the 30th percentile. The authors also find that weekly earnings growth has grown less progressively than hourly pay, but that weekly wages at the 5th and 10th percentile grew faster in areas with a higher proportion of minimum wage workers than in areas with fewer minimum wage workers.

4.7 Not all workers receive the pay that they are entitled to, because some employers do not comply with minimum wage rules. We have concerns over the quality of the available data on underpayment; survey timing issues make it difficult to compare the period immediately prior to the NLW's introduction with the move to £7.20, and the absence of any data on the grey economy makes it impossible to accurately measure the true incidence of non-compliance (Low Pay Commission, 2019b). In addition, some of the measured underpayment will relate to legitimate deductions from workers' salaries. Nevertheless, we think non-compliance has become more prevalent since the NLW's introduction. Figure 4.3 shows changes in the profile of measured underpayment since 2015. When the NLW was introduced in 2016, we estimate around 19 per cent of those covered by the policy (or 305,000 individuals) were underpaid. This proportion steadily increased to 23 per cent of coverage (or 369,000 individuals) by 2018. Labour Force Survey (LFS) data show a similar pattern, although we consider this a less reliable source than the Annual Survey of Hours and Earnings (ASHE). Despite the flaws in our measures, the trend in the data suggests that underpaying staff may be an increasingly common way some employers have responded to a rising NLW.

Figure 4.3: Estimates of underpayment as a proportion of coverage for workers aged 25 and over, UK, 2015-2018



Source: LPC calculations using ASHE and LFS:

Notes:

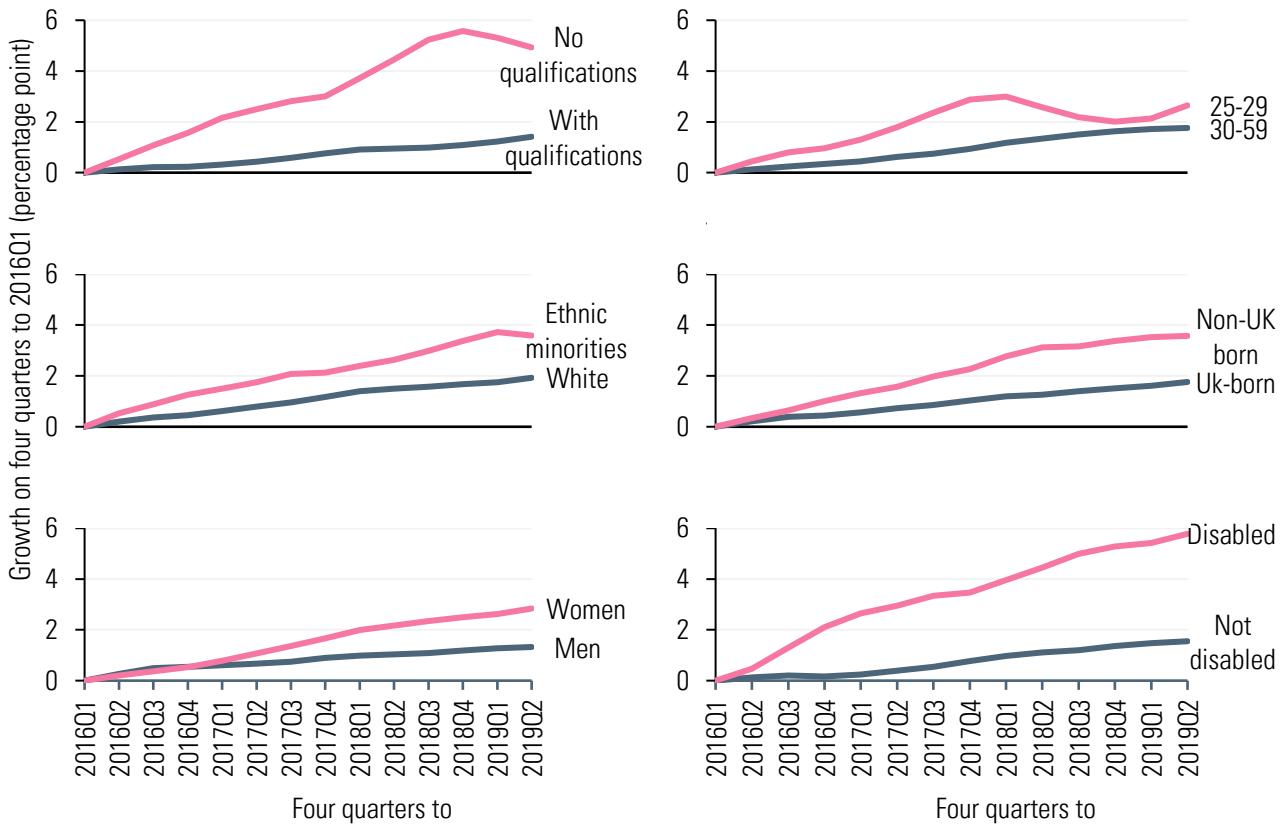
- a) ASHE 2010 methodology, low pay weights, UK, 2015-18.
- b) LFS, income weights, quarterly, not seasonally adjusted, UK, 2015 Q2 – 2018 Q4.

The impact of the National Living Wage on employment

4.8 Increases in the minimum wage have clearly led to higher wages and improved earnings for a broader population than just those receiving the minimum. In this section, we look at how demand for labour, as measured by employment and hours, has changed since the introduction of the NLW. The period since the introduction of the NLW has overall been a benign one, with the employment rate hitting record highs and unemployment falling to historically low levels. Employment growth for the groups most affected by minimum wages has outperformed comparators, as shown in Figure 4.4.

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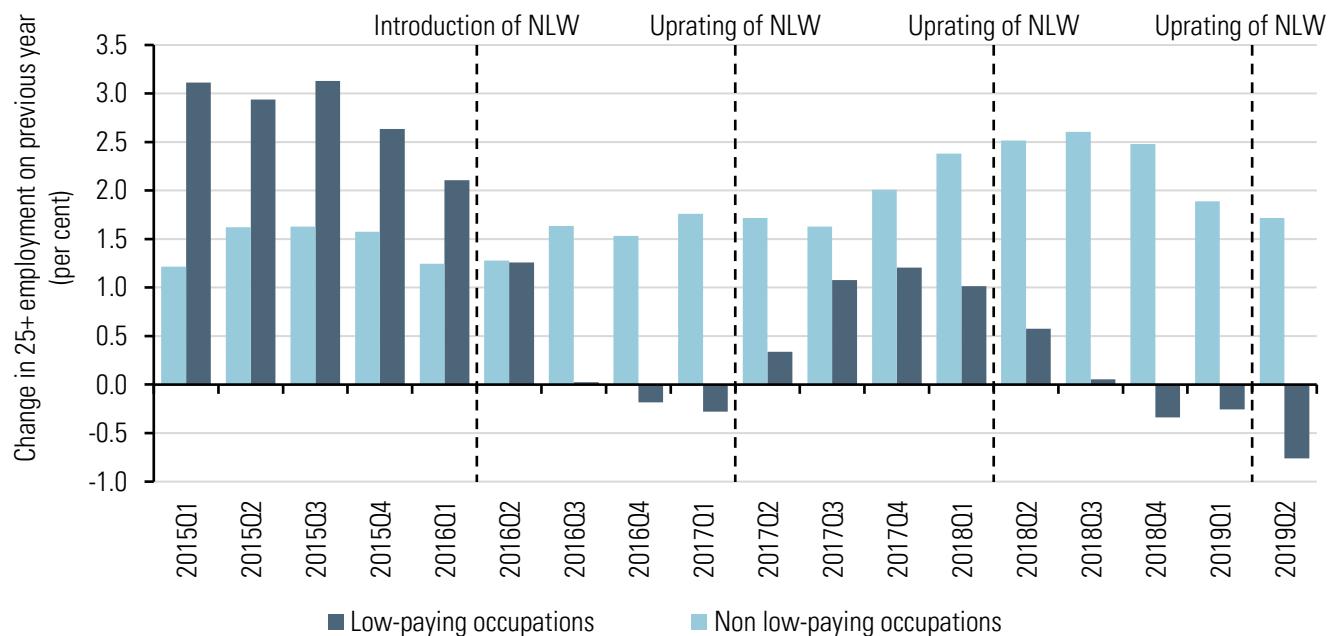
Figure 4.4: Change in employment rates for those aged 25 and over, by personal characteristics, UK, 2016-2019



Source: LPC estimates using LFS Microdata, population weights, quarterly, four quarter moving average, UK, Q2 2015-Q2 2019.

4.9 The situation is less clear-cut when we look at employment changes by occupations. Figure 4.5 shows that prior to the introduction of the NLW, employment in the lowest-paying occupations was growing more quickly than in higher-paying ones. However, since 2016 employment growth in low-paying occupations has slowed markedly while growth in higher-paying occupations has increased. This may just represent the tightening labour market, where a pick-up in hiring in non low-paying occupations is attracting employees away from low-paying sectors. On the other hand, this could be an effect of the NLW. A preliminary study examining the effects from the introduction of a minimum wage in Germany Dustmann, Lindner, Schönberg, vom Berge and Umkehrer (2019) found that the minimum wage led more workers to switch from a lower-paying firm to a higher-paying one. A similar mechanism may be at work in the UK, behind the changes from lower-paying occupations into higher-paying ones.

Figure 4.5: Change in employees aged 25 and over, by occupation, UK, 2015-2019



Source: LPC estimates using LFS Microdata, population weights, quarterly, four quarter moving average, UK, Q2 2013-Q2 2019.

4.10 The great majority of employer representatives we have spoken to since 2016 have not claimed that the NLW has directly led to a reduction in employment. Survey results from these groups have not shown redundancies to be a common or increasing response to NLW increases. Only 10 per cent of respondents to a 2018 CBI survey who had been affected by the NLW said they had reduced employment. While employer representatives in some sectors – convenience retail, textiles, wholesale and hairdressing – have told us that some businesses have reduced employment, all accept that the NLW is one factor among several in these business decisions. Equally, the reported employment responses are more likely to be through slower hiring or adjustments to hours than redundancies, where employers are asked separately; around 5 per cent of affected respondents in Federation of Small Businesses (FSB) member surveys each year since 2016 made redundancies, while approximately 20 per cent made changes to hours. This anecdotal evidence does not tell us whether there is a net reduction in employment or whether people are able to find jobs and hours lost elsewhere.

Evidence from econometric research

4.11 We have commissioned four research projects since 2017 looking at the employment effects of the NLW, with different projects covering different periods. While, none of the projects have found strong evidence that the NLW led to falling overall employment, three of the projects have indicated some small effects for some groups of workers. However, these have not been consistently replicated across all data sources and methodologies in projects and no study has found employment effects for all

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low-paid workers. However, it does appear that some groups, particularly women working part-time, may be at a greater risk of experiencing a reduction in employment from a higher minimum wage.

4.12 One project Aitken, Dolton and Riley (2018) looked at the introduction of the NLW and the first uprating in 2017. The analysis compared workers who earnt the NLW with those whose earnings were slightly higher. They found no robust effect from the NLW on overall minimum wage employment retention, but did find some evidence of a negative impact on employment retention of 2.5 percentage points for women working part-time (at 5 percent significance level). The authors state that this implies an elasticity⁶ from increases in the minimum wage to employment retention of between -0.35 and -0.2. The authors also found a small fall in retention of part-time women in the retail industry (of 9.3 percentage points following the 7.5 per cent increase of the NLW in 2016). They also found weak evidence of a fall in hours worked by full-time male workers in the hospitality industry of around 1 hour 45 minutes following the 2016 introduction of the NLW. This was, however, reversed in the subsequent year. The authors concluded that the NLW had had little adverse impact on employment retention overall.

4.13 Another project Dickens and Lind (2018) used the variation in minimum wage ‘bite’ across travel-to-work areas in the UK to model the impact of the NLW introduction and the 2017 uprating to £7.50. This approach captures all entry and exit from employment and the labour market, and not just employment retention (exits from employment as measured in Aitken, Dolton and Riley [2018] and McGuinness, McVicar and Park [2017]). The research found a strong wage effect in both years and a modest, but statistically significant, negative effect on employment for part-time women workers in 2017, but not in 2016. The authors interpret this by saying that a 10 per cent increase in the bite is associated with a 2.9 per cent lower employment rate. The results suggested that those who would have been in employment without the higher minimum wage are economically inactive instead. The authors’ estimate of employment loss from the increase of the NLW to the 2020 level, assuming 2017 employment effect, was within the band of employment loss expected by the Office for Budget Responsibility (OBR) at the time of the NLW’s introduction.

4.14 A further project McGuinness, McVicar and Park (2017) examined the effect of the introduction of the NMW and the NLW on employment retention and hours worked using the differences in minimum wages across the border between Northern Ireland and the Republic of Ireland. No employment effects were found for the period covering the introduction of the NLW in 2016 – although

⁶ The elasticity is the percentage change in employment that follows from a 1% change in the NMW/NLW.

the sterling depreciation at this time following the EU referendum could have obscured any impact from the NLW. No impact on hours was found in either 1999 or 2016.

4.15 An ongoing project Capuano, Cockett, Gray and Papoutsaki (2019) is examining the impact of the minimum wage on employment and hours using ASHE and the LFS (due to report in autumn 2019). The authors examine the effects from the introduction of the NLW and the two upratings in 2017 and 2018. Similar to Aitken, Dolton and Riley (2018), the authors compare the employment outcomes of workers whose pay was below the incoming minimum wage with those whose wages were just above it. The authors find a negative effect from the minimum wage on employment retention for part-time women and for part-time men in 2016, and state that their findings suggest a 1 per cent increase in the minimum wage is associated with a reduction in employment retention of 0.47 to 0.56 per cent for part-time women and a reduction in retention for part-time men of around 0.72 to 0.75 per cent. The authors also find weak evidence that men working full-time experienced a fall in hours worked following the introduction of the NLW (of around 2.5 to 3.5 hours a week) in the LFS but not in ASHE.

How have employers responded?

4.16 Evidence suggests that instead of reducing employment, most employers have instead responded to increasing wage bills through five main measures: accepting lower profits, increasing prices, making cuts to non-wage labour costs, restructuring their workforce and pay structures and increasing output through improved productivity and work intensification. Employers' choice of strategy is driven by the nature of their firm, their industry, the level of competition they face and wider developments in the economy. Although it is likely that businesses' responses will change over time as further increases are implemented, the evidence we have heard so far suggests that cutting jobs is not a preferred response and not one to which businesses have had to resort.

4.17 Nevertheless, the range of responses listed above shows that increases in the NLW have not been without consequence. In employer surveys, reductions in profits or price increases have consistently been among the most common responses by employers affected by the NLW, though we cannot tell the magnitude of these changes from survey data. In CBI, Chartered Institute of Personnel and Development (CIPD) and FSB surveys, between 50 and 70 per cent of employers reported having absorbed some or all of the cost of the NLW through lower profits. Employer stakeholders repeatedly tell us that this is not sustainable in the long term; if profits are repeatedly cut then eventually the business becomes non-viable. Furthermore, some businesses rely on their own profits to fund their investment.

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4.18 Between 20 and 50 per cent of employers in these surveys reported raising prices in response to NLW increases, with respondents to the FSB's survey at the top of these ranges. This suggests a higher proportion of smaller firms have taken this kind of response. This perhaps reflects the limitations SMEs can face in their adaptation strategies; they may lack the economies of scale to make meaningful changes to workforce or pay structures and they may not have the funds to invest in productivity improvements, instead opting to cut investment to save on cost. In stakeholder evidence and surveys, smaller employers are more likely to say they have cancelled or scaled down investment in response to the NLW. For example, almost 30 per cent of responders to the FSB's NLW survey said they'd done this, compared with 6 per cent of large firms in CIPD's survey.

4.19 Overall, although many employers expected to raise productivity to help manage the cost of the NLW, it appears that many have been unsuccessful or their measures in this area have been limited to encouraging greater worker effort. The relationship between the NLW and productivity is discussed in more detail in Chapter 3. As described above, the effect of NLW increases on pay and differentials has been a common issue for employers, and their responses have the potential to adversely affect job quality, employee relations or progression opportunities.

International comparisons

4.20 Recent years have produced a wealth of new international evidence on minimum wages. Since 1998, most Organisation for Economic Cooperation and Development (OECD) countries have raised their minimum wage at a faster rate than average earnings growth. Several places have also introduced new statutory minimum wages in this period, including Germany and several US cities and states. All of these examples provide useful research opportunities and offer lessons which could be applied to the UK. In this section we identify countries and other locations that may provide useful evidence for the future path of the NLW.

4.21 We have identified some international examples that will be particularly useful to study: New Zealand, Germany, South Korea and a number of US cities and states. Below we touch on the existing research from these but note that the review of international evidence that the Government has commissioned Professor Arindrajit Dube to conduct will be invaluable in identifying the most up-to-date and relevant research. Clearly, countries with a high minimum wage bite will provide useful precedents. However, we are also interested in the effects of significant increases in minimum wages, especially where they exceed average earnings growth. Additionally, bite is not the only indicator of the extent of a minimum wage's effects. We therefore also look at places with high coverage.

4.22 According to the OECD's bite data, no comparable country has a minimum wage approaching two-thirds of median earnings. The comparable countries with the highest bite – all in excess of 60 per cent – are France, Portugal and New Zealand. New Zealand is also in the middle of a series of rapid increases (from \$NZ16.50 to \$NZ20 in three years), while South Korea has raised its minimum wage by 29 per cent over two years and several US states and cities are on ambitious paths to \$15 minimum wages. Despite US state minimum wages generally having bites substantially below two-thirds, some have coverage of up to 20 per cent, for example Massachusetts (Thompson, 2018). Similarly, Germany's minimum wage affected up to 15 per cent of workers when it was introduced in 2015 (Dustmann, Lindner, Schönberg, vom Berge and Umkehrer, 2019), at a bite of 48 per cent according to the OECD.

4.23 New Zealand's minimum wage applies from the age of 16 – instead of having youth rates like the UK it has a restricted version called the 'starting out' rate.⁷ This partly explains its high bite in the OECD's calculations, the limitations of which we have noted (the inclusion of younger workers lowers the average wage against which a bite is calculated). When calculated against all workers, including part timers, New Zealand's minimum wage in 2018 of \$NZ16.50 was higher still: around 66 per cent of the median. The New Zealand MBIE (Ministry of Business, Innovation and Employment, 2018) assessed options for increasing the minimum wage in line with the new Government's commitment to raise it to \$NZ20 by 2021. Under the preferred, straight-line path option of raising the minimum wage to \$NZ17.70 in 2019, which would give a bite in excess of 70 per cent, MBIE estimated a reduction in employment of 8,000 jobs, equal to about 0.3 per cent of total employment. There are signs that this has led to a reduction in low pay, with a 1.5 percentage point fall in the OECD's measure from 2017 to 2018 (Organisation for Economic Co-Operation and Development, 2019a).

4.24 Several US cities and states are raising their minimum wages far in excess of the US federal minimum of \$7.25. The most common target is \$15, though this has so far only been attained in New York City (and then only for large employers), Seattle (\$16 for large employers) and a few small cities in California. The highest state-wide minimum wages are \$12, but some will continue to increase to \$15 over the next few years. In most cases the large increases have taken place in large cities with very high median earnings. Nevertheless, such examples are already producing a wealth of research. Most studies so far have found either no or small employment effects, though some have found larger effects for certain groups. Professor Arindrajit Dube will summarise the existing research and its applicability to the UK in his report commissioned by the Government.

⁷ The 'starting out' rate can be paid to workers in New Zealand who are 16-17 years old and have been with their current employer for less than 6 months, 18-19 year olds who have previously been in receipt of benefits and have been with their current employer for less than 6 months and 16-19 year olds on some training contracts.

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4.25 Germany introduced a statutory minimum wage in 2015 at 8.50 EUR per hour. While the bite of the minimum wage was just 48 per cent, coverage was high. Six months prior to its introduction up to 15 per cent of workers in Germany earned below the incoming rate, rising to almost a quarter in the former East Germany (Dustmann, Lindner, Schönberg, vom Berge and Umkehrer, 2019). Equally, the minimum wage as a percentage of median earnings in the East is much higher than nationwide, at above 55 per cent in almost all areas and higher than 65 per cent in some (Caliendo, Schröder and Wittbrodt, 2018). Early evidence does not suggest widespread job losses, though there have been effects on ‘mini-jobs’ (where people earn less than 450 EUR per month) and contracted hours.

4.26 France has the highest minimum wage bite in the OECD’s rankings, but its utility as a precedent for raising the bite of the UK’s minimum wage is perhaps limited. The bite of France’s minimum wage has been effectively unchanged over the last 20 years. The increase announced by the French Government in 2019, will be paid for by the state through a rise in the ‘prime d’activité’ (employment bonus) to workers, not in wages paid by employers. This too limits how informative research on its effects will be for our deliberations.

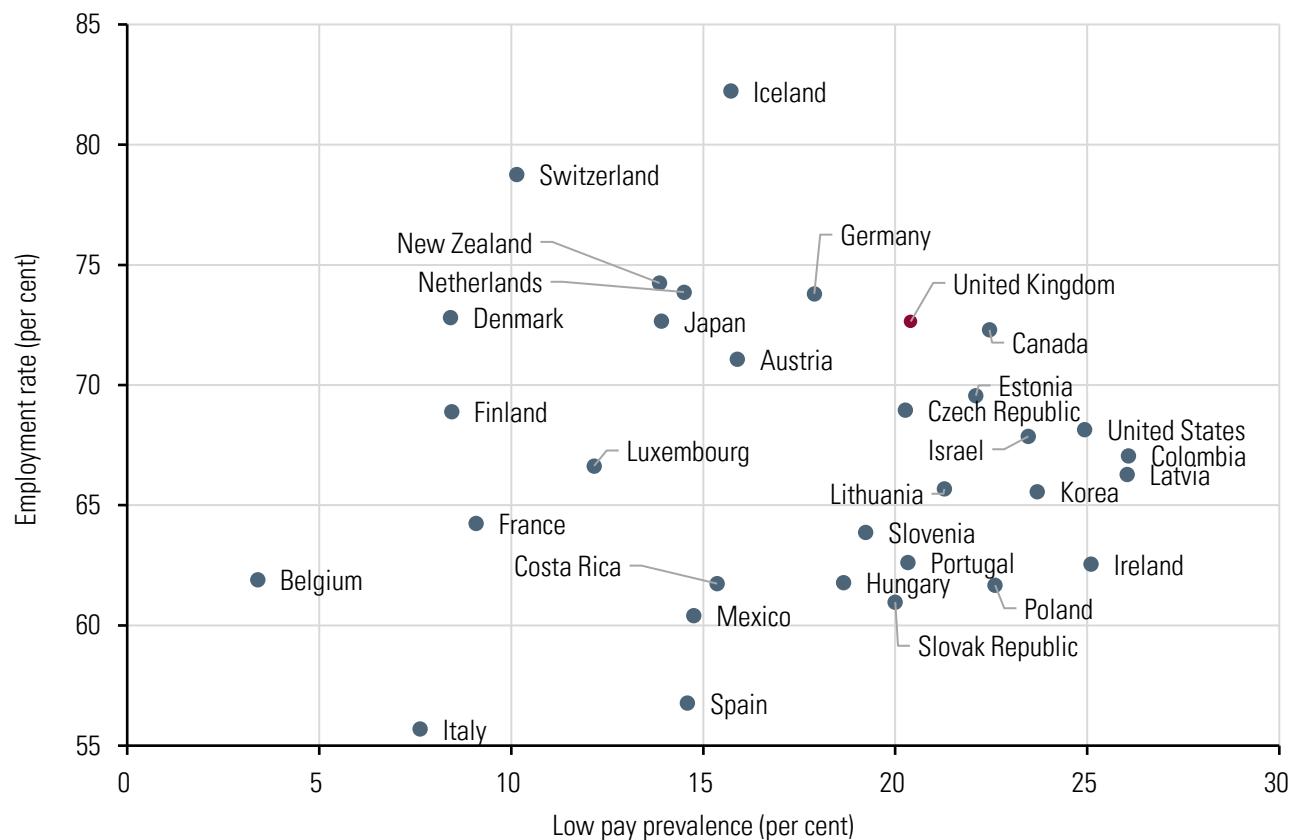
4.27 The proposed minimum wage increase in France is one of several being discussed or set to be implemented this year. It is likely that more countries and more US states will raise minimum wages significantly, both nominally and relative to median earnings. The Spanish Government raised the minimum wage by 22 per cent in late 2018, albeit from a low base. There are also ongoing debates in other countries. For example, the Labour Party in Ireland is calling for a two-thirds bite target. The US ‘fight for \$15’ movement continues, with Illinois among states considering a higher minimum wage. South Korea, which has already raised its minimum wage by 29 per cent over the last two years, has an ambitious target that has been criticised by some business groups, with the result that the government has slowed its planned increases.

4.28 Eurofound (2019) predicts that 2019 will be an ‘interesting year for those following minimum wage developments and how they are set closely. Stronger political influence, including from citizen movements, higher nominal increases in the context of a good economic climate and labour shortage, the return to setting rates according to a – new – national practice in Greece, and many debates around how minimum wages can be set in a more predictable and transparent way in Europe – are the just the tip of the iceberg.’ Such developments will be valuable sources of insight for the UK’s minimum wage in the future, though their utility will depend on understanding the unique context of each case. The next section goes into more detail on that context, and relates minimum wages and other policies to low pay.

Other factors affecting low pay internationally

4.29 Given the stated ambition of ending low pay, we have also examined successful comparators for evidence on the broader factors that affect it. While the UK sits in the middle of the OECD's low pay rankings, seven countries combine a lower level of low pay with an employment rate equal to or higher than the UK's. Shown in Figure 4.6, in 2014 (the most recent year for which data are available) were Denmark, Germany, Iceland, Japan, the Netherlands, New Zealand and Switzerland. As set out in Chapter 2, the effect of minimum wage policies on absolute levels of low pay according to the OECD's measures is limited, and indeed three of the seven comparators identified here – Denmark, Iceland and Switzerland – do not have statutory minimum wages.

Figure 4.6: Low pay prevalence and employment rate, OECD, 2014



Source: Organisation for Economic Co-Operation and Development (2019d), Organisation for Economic Co-Operation and Development (2019a)

4.30 Looking beyond minimum wages, there is no single common theme linking the specified countries that have addressed low pay while retaining high employment levels. Demographics, labour market differences and institutions can all make a difference. On demographics, Japan and Germany have notably older populations than the rest of the countries listed and the OECD average. Older workers would generally be assumed to be higher earners, and there will be a smaller proportion of younger and, on average, lower-earning workers. This may help explain their low levels of low pay.

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4.31 There are no clear trends or differences between the countries in terms of employment by sector or proportion of those employed working part-time. However, the UK lags further behind comparator countries on employment rates of those with a university degree than for those with fewer qualifications. This may indicate a lower-skilled, lower-paid workforce. It is also striking that in 2014 the UK had greater inequality of earnings on all the OECD's measures than most of the countries we compare it with here, Germany being the exception.

4.32 One notable way in which the UK differs from the comparators is that most have higher collective bargaining coverage. In Iceland and Denmark, and to a lesser extent Switzerland, the lack of a statutory minimum wage is balanced by collective bargaining, which covers over 80 per cent of workers in the former two and around half in the latter. Eurofound (2019) reports that the lowest collectively agreed rate in Denmark – for industrial cleaners – is equal to around £11.18 adjusted for purchasing power, higher than any EU or OECD country's statutory minimum wage. Research in this area has found that these rates are generally followed by employers not covered by the agreements. Among countries with minimum wages, the Netherlands and Germany also have far higher collective bargaining coverage than the UK, which may help reduce wage inequality. This would be consistent with research that shows a wage premium for union membership, and more compressed pay distributions in countries with strong collective bargaining (OECD, 2018). In line with this, New Zealand's government-appointed Fair Pay Agreement Working Group recently recommended the introduction of sector-wide collective bargaining specifically to address low pay.

4.33 Returning to minimum wages, we also note that their impact on workers and employers depends on differences between tax and benefit systems. Looking only at gross minimum wages and their bite does not account for added costs to employers in the form of social security contributions, nor does it necessarily reflect the true benefit to workers of the minimum wage. Among our comparator countries, only New Zealand has lower employer social security contributions at the minimum wage level. The other comparator countries have at least double the rate of employer contributions. This suggests that the true cost to employers of minimum wage increases will be compounded in some countries more than others.

4.34 In terms of tax and benefit interactions, effective tax rates in the UK for a household composed of a single minimum wage earner without children are among the lowest in the OECD (Carcillo, Goujard, Hijzen and Thewissen, 2019). This means that the true income of a minimum wage worker is relatively closer to other countries we would consider to have a high minimum wage like France and Australia. Indeed, the UK scores better than Germany, despite having a lower gross minimum wage in purchasing power parity terms.

4.35 This evidence on the factors affecting low pay and the relationship between minimum wages and earnings is a reminder not to forget the importance of the broader labour market and institutional context. Looking at the bigger picture as well as the minimum wage is important in a UK context, but also affects how we view emerging evidence from our international counterparts.

Conclusions:

The NLW has led to faster increases in pay for the lowest-paid employees. Workers across the bottom 30 per cent of the pay distribution have benefited directly or indirectly from the NLW through spillovers. There has been a rise in non-compliance alongside increases in the NLW, but its overall impact on pay remains strongly positive.

Despite this we have not found evidence of the NLW leading to a decrease in total employment. Some of the research we have commissioned has found that the NLW has led to lower employment for part-time women, but not for other groups of workers. When we look at the aggregate data we see that employment has grown fastest for the groups of workers more exposed to the minimum wage.

Employment in low-paying occupations is at the same level it was before the introduction of the NLW, while higher-paying occupations have seen faster growth, suggesting that workers may be switching out of the lowest-paid occupations.

Minimum wages are a prominent issue in several OECD and EU countries. This means there are examples to draw on, both of high minimum wages and significant increases. So far, academic research on the effects of minimum wages in other countries has in general not found negative employment effects. The review of international evidence by Professor Arindrajit Dube commissioned by the Government will provide valuable context and evidence for its and our deliberations.

In the countries that have lower levels of low pay and higher employment rates than the UK, there are a number of contributing factors. Minimum wages play a part in some, but other examples do not have statutory minimum wages. Demographics, labour market differences and institutions like collective bargaining can all play a part in reducing low pay.

Chapter 5

The policy framework for the National Living Wage

The design of the National Living Wage up to 2020

5.1 In this chapter, we consider the policy design underpinning the National Living Wage (NLW). Leaving aside questions of the level of the NLW and the pace of annual increases, there is widespread agreement among stakeholders that any target should not be absolute and should respond to economic circumstances. We have reflected on the design of the framework surrounding the NLW and how this influences the LPC's recommendations. The key principle guiding this work is that the LPC should be empowered in making its recommendations to respond to economic conditions and the accumulating evidence on the NLW's effects.

5.2 The existing framework, supporting the 60 per cent NLW target, was developed between the target's announcement in March 2015 and the introduction of the first NLW rate in 2016. The NLW essentially has two components: a target based on a percentage of average earnings; and a set of circumstances whereby the NLW moves off this path.

5.3 A target set as a proportion of the median already has, in theory, a degree of responsiveness to economic conditions built in. Average earnings growth generally adjusts in line with the economy: when the economy is booming so does pay, whereas in a recession growth in earnings tends to fall, and earnings growth even turns negative in some circumstances. However, changes in the level of median pay are determined partly by the composition of jobs in an economy. If the economy loses a disproportionate amount of low-paid jobs, then the median wage may rise through a compositional effect. Therefore, a target set as a proportion of the median could have a contrary relationship with other changes affecting the low-paid. Moreover, the annual adjustments to the NLW in a path-based model would actually be based on forecasts of earnings, so the more relevant question is whether forecasts of earnings respond in the same way. We consider this below using the case of the 2008 financial crisis as an example.

5.4 The NLW target has built into it additional formal mechanisms for responding to wider conditions. The starting point for the framework was the LPC's 2016 remit from the Government, which stated that when looking at the NLW, 'the LPC is asked to consider the pace of the increase, taking into account the state of the economy, employment and unemployment levels, and relevant policy changes.' In remits since 2016, the condition has usually been simplified to 'sustained economic growth'. In our 2019 remit, we were asked 'to recommend *whether economic conditions allow* for the rate ... to meet 60 per cent of median earnings.'

5.5 The Government did not define at the time – or since – what factors it considered key in determining the state of the economy, or what was meant by 'sustained economic growth'. The LPC therefore set out its own interpretation of this, as meaning GDP growth above 1 per cent. This was originally drawn from HM Treasury's Charter for Budget Responsibility, which defined a 'significant negative shock' as 'real GDP growth of less than one per cent on a rolling 4 quarter-on-4 quarter basis' (HM Treasury, 2015). HM Treasury has since abandoned this condition in the Office for Budget Responsibility's (OBR) charter, but we have continued to use it as a threshold.

5.6 The other key factor which we assess in determining the sustainability of the NLW is employment impacts. In modelling the impact of the NLW in 2015, the OBR forecast an associated employment impact of 20,000-110,000 jobs (albeit in the context of a forecast overall increase in total jobs of over 1 million). We inferred from this that the Government was willing to accept job losses within – but not beyond – this range. As it did prior to the NLW's introduction, econometric analysis of employment effects makes up a significant part of our research programme and the evidence which Commissioners consider in making their annual recommendations. This kind of evidence is key for determining whether the threshold for job loss has been breached.

5.7 In practice, we have continued to take into account a similar range of indicators when making recommendations on the NLW as under the previous, non-target-driven National Minimum Wage (NMW) framework. But the current framework has not been tested, because over the period of the NLW, the key indicators – GDP and employment levels – have been positive. Equally, apart from at the outset, forecasts of earnings growth have been broadly in line with the outturn, which means the upratings have been predictable and stable.

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5.8 The framework was formulated in reaction to the Government's announcement of the 60 per cent target, rather than designed in conjunction with it. And, as we set out in the following sections, there are inherent difficulties with the evidence base – and with the design of the target itself – which have the potential to hinder our ability to respond to changes in economic conditions. For all these reasons, before finalising a target and an end-date for the period beyond 2020, it is important to revisit the basic design of the policy and restate the principles which would justify a departure from the NLW target.

The evidence base for recommendations on the National Living Wage

5.9 Since its foundation, the LPC has been an evidence-based body which makes its recommendations on the basis of social partnership (see box on page 62). In making their recommendations, Commissioners weigh up a wide range of qualitative and quantitative evidence, collected and evaluated over the course of the year. This includes first-hand testimony from the employers and workers we meet with in the course of our regional visits programme; the consultation submissions and testimony we receive from stakeholder groups; research findings, both from projects we have commissioned and others; and a wide variety of economic data. Our annual report sets out the evidence we have considered and how this has informed our recommendations.

5.10 While the economic data form a crucial part of our decision-making processes, they inevitably come with lags which present challenges for the responsiveness of the NLW. GDP is a crude measure which may not account for local or sectoral issues and can be inaccurate, particularly during shocks such as recessions. These potentially inaccurate data are then revised, sometimes many times over a period of years. Inaccuracies in GDP data prevented the 2008/09 recession from being identified until well after it had already set in. While GDP is undoubtedly a key metric for understanding the state of the economy, these factors suggest it is problematic to have an NLW framework so reliant upon it via the 'sustained economic growth' threshold.

5.11 Employment data alone do not allow us to know to what extent changes in the job market are attributable to the NLW as opposed to other factors – especially in a period of generally stable or rising employment. Instead, this requires detailed analysis of sub-groups and areas and econometric studies using several quarters of data, ideally at least one year after the fact. This evidence can also be inconclusive and involves a significant lag.

The Social Partnership model of the LPC

The 1998 Minimum Wage Act put the LPC on a statutory footing as an independent social partnership body. This means that the legislation requires a ‘balance’ between representatives from employer, worker and academic backgrounds. There are nine Commissioners, drawn from each of these groups, ensuring that both worker and employer views contribute to the final recommendations. Commissioners bring significant expertise and a shared sense of purpose: to help low paid workers by raising minimum wages without damaging employment or causing other negative effects.

The Commissioners are supported by a small secretariat of economists, statisticians and policy professionals, whose role is to provide Commissioners with the evidence they need to make their recommendations. This evidence base has three main pillars: commissioned research, in-house economic analysis and stakeholder evidence.

The last of these – talking to stakeholders with an interest in the minimum wage – has always been a fundamental part of the LPC’s evidence base. As a social partnership organisation, it is vital that the LPC understands and reflects the views of all sides of the debate.

Commissioners undertake formal oral evidence sessions with stakeholders and a programme of regional visits, which involve meeting with employers – often small businesses – and groups of workers to understand how the NMW is affecting their lives. This is partly because it is important to make sure that both workers’ and employers’ views are taken into account, but undertaking these activities together also ensures that Commissioners undergo a “shared and mutual education” as to the issues (Low Pay Commission, 2001).

There are further benefits to the social partnership model. Evidence alone cannot answer the question as to what the level of the NMW should be; making this decision also requires an element of judgement. Commissioners’ different backgrounds and areas of expertise allow the LPC to find a balance between economics, a pragmatic view of the labour market and employee relations.

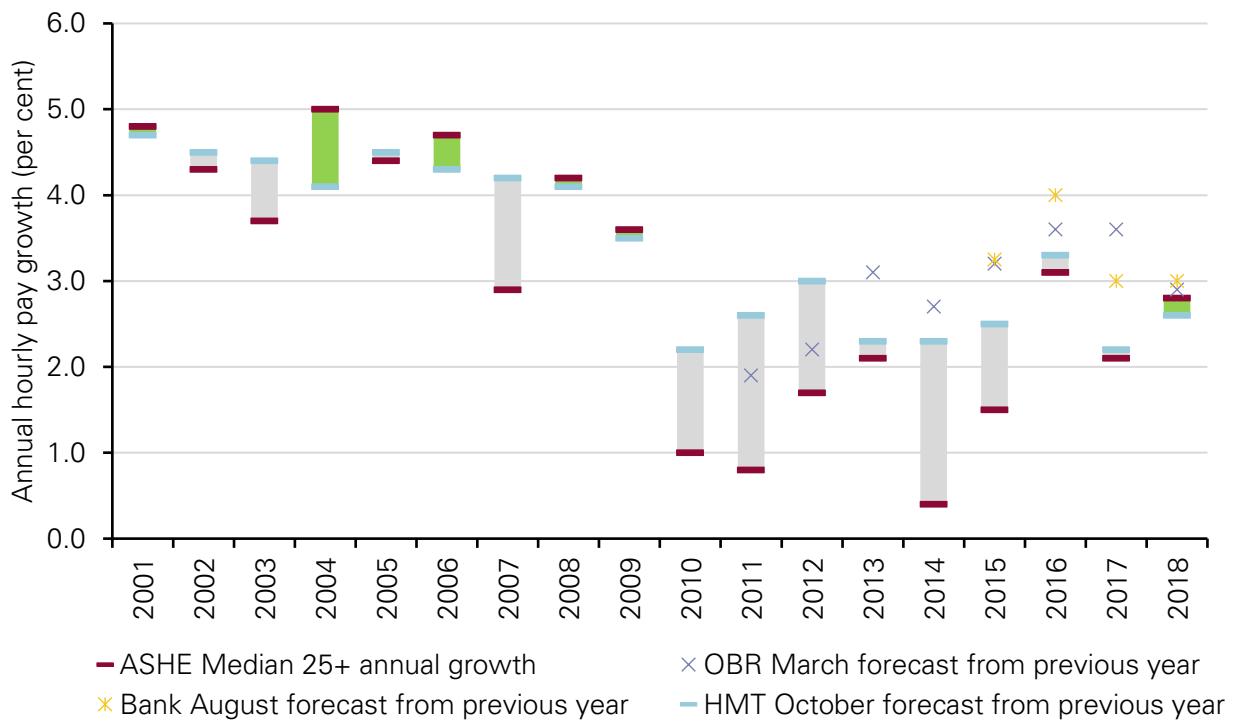
As the LPC’s first report stated: “Ultimately, the introduction of a National Minimum Wage in the UK is not a scientific exercise; rather, it is a journey into uncharted waters... We made every effort to identify and listen to the sectors of business and to the people for whom the National Minimum Wage might have the greatest impact...” (Low Pay Commission, 1998).

The recommendations of the LPC have always been unanimously agreed by Commissioners. The fact that these judgements are made by social partners, working together and reaching decisions via consensus, ensures that the concerns of both workers and employers are taken into account and that all recommendations are backed by both groups alike.

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5.12 In addition, an NLW target is based on forecasts for earnings growth, which themselves may be slow in reflecting changes in economic indicators. Over the lifetime of the NLW, forecasts⁸ of earnings have been fairly accurate, but in the immediate aftermath of the recession this was not the case (see Figure 5.1). As set out in the box on page 64, in 2009 the LPC recognised and commented on the inaccuracy of forecasts; it recommended an increase in the NMW below the forecast increase in average earnings. Given the NLW target is based around forecasts, the LPC is more constrained than previously in its ability to apply its own interpretations to forecasts.

Figure 5.1: Earnings forecasts and outturn, UK, 2001-2018



Source: LPC estimates using: ASHE, April 2011-18, standard weights, UK; HMT panel of independent forecasts, October 2011-18; OBR average earnings forecasts 2011-18; and Bank of England average weekly earnings projections, 2015-18.

Note: The data for 2018 is for January-August 2018, compared with January-August 2017.

5.13 It is vital to our work that we have access to timely data to inform our recommendations. The NLW's introduction was accompanied by a shift in the LPC's annual cycle, moving the date of upratings from October to April and affecting the quality of data to which we have access. Data from the Annual Survey of Hours and Earnings (ASHE), our main source of evidence on pay, now reflects only a few weeks' impact of the new NLW rate. Therefore, it is possible that an earnings effect may not be picked up in the data until the ASHE collection a year later. And ASHE is an annual snapshot only – it does not pick up in-year changes (unlike other data sources such as Average Weekly Earnings, the Labour Force

⁸ The LPC uses the HM Treasury independent panel of forecasts when making recommendations on the NLW path as these are the most up to date at the time when we are due to provide our advice.

Survey or GDP data, which are reported throughout the year). A potentially more responsive data source would be HM Revenue and Customs' Real Time Information (RTI), which gathers pay-related information for tax purposes. We discuss this in more detail later in the chapter.

How the LPC responded to the 2008/2009 recession

5.14 The LPC's decision-making in the previous recession, following the 2008 financial crisis, offers an example of how issues with the evidence base can affect Commissioners' decisions and how those decisions can take into account shortcomings in the evidence. The previous recession pre-dated the target-driven NLW framework; it is useful to consider how that framework could affect the LPC's recommendations, were it to find itself in similar circumstances in the future.

The 2008 and 2009 reports

In its March 2008 Report, on the brink of recession, the LPC looked back with a generally positive view at the labour market of the previous year: the report noted record levels of employment, rising hours and vacancies, falling unemployment and jobs in low-paying sectors increasing faster than overall. But it also noted signs of weakening: consumer and Government spending were both slowing, as was business investment; and GDP forecasts had been revised downwards (although were still for positive growth of around 2 per cent). Stakeholders disagreed over the economic outlook.

In these difficult circumstances, where the essential data was inconclusive, the LPC's social partnership model was an important factor in agreeing an approach. The LPC recommended an increase below the forecast rise in average earnings, 'balancing the generally positive messages in the data with the need for caution implied by the uncertain economic outlook'. This meant a 3.8 per cent increase, against a forecast of 4 per cent earnings growth. This increase was projected at the time to hold the NMW's bite more or less flat at 52.3 per cent. In fact, actual average earnings growth for 2008 turned out to be 3.5 per cent, underperforming both the forecast and the NMW increase. However, median hourly pay, according to ASHE, did grow by 4.0 per cent between April 2008 and April 2009.

The next year's report was published in May 2009; the LPC had asked the Government for a delay in its reporting deadline, to access two months' additional data and conduct further analysis of the impacts of the potential recession. Forecasts for GDP growth in 2009 had fallen from 2.1 per cent to -3.1 per cent. Employment had fallen, consumer confidence had weakened dramatically and the retail and hospitality sectors were performing worse than the economy as a whole.

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The LPC recommended an increase of 1.2 per cent for the NMW. This was below the forecast average earnings growth (2.7 per cent); but the report noted that these forecasts had been consistently too high (the actual outturn for average earnings growth was 1.3 per cent) and it assumed they would be so again. The LPC nevertheless expected the 1.2 per cent to equate to a real-terms increase. Increases to the two youth rates were both in line with this. It declined to project a recommendation for the 2010 NMW rate, but did recommend lowering the age of eligibility for the NMW from 22 to 21.

The 2009 Report recognised deficiencies in forecasts and set out the Commission's own expectations and assumptions about the economic direction of travel. It expected that employment levels in the low-paying sectors would fall more sharply than those for the economy as a whole; and assumed that average earnings growth would continue to underperform forecasts. The NMW's bite increased as a consequence of extending the rate to 21 year olds, but on a like-for-like calculation, the 2009 increase essentially meant the bite remained flat (at 51 per cent).

5.15 If there had been an NLW target path in 2008, the LPC may have struggled to justify departing from it: the labour market seemed strong, especially in low-paying sectors, and GDP forecasts, although revised down, were still comfortably above the current 1 per cent threshold. But Commissioners nevertheless recommended an increase which essentially held the NMW's bite flat – exercising caution in the face of uncertainty. The most important signs of uncertainty which the report identified were global: economic slowdown in the US, volatility and weak growth throughout Europe and Asia. But there were also worrying signs domestically: consumer spending had slowed, house prices stagnated, business investment declined and sterling weakened.

5.16 Overall, the case for 'sustained economic growth' in 2008 was arguable; if understood in terms of a 1 per cent GDP threshold, or reviewing the most recent evidence from the jobs market, the economy was still in growth and the outlook – as captured by forecasts – was generally positive. But looking at wider indicators there was a reasonable case that the immediate prospects were not for sustained growth. The situation in 2009 was clearer, with sufficient evidence to recognise that 'sustained economic growth' was not happening: GDP growth was negative, employment was falling across the economy and low-paying sectors were being affected particularly badly. Forecasts were consistently wrong, but Commissioners recognised this and adjusted their expectations accordingly. Our research evidence shows that these upratings did not damage employment (Bryan, Salvatori and Taylor, 2012), despite the backdrop of the UK's deepest post-war recession and findings that employment is more sensitive to minimum wages in recessions (Dolton, Rosazza Bondibene, Schivardi and Spinnewijn, 2012). This is a clear example of the success of the social partnership model. Commissioners were able to come to agreement on the appropriate rate despite difficult economic circumstances and an uncertain evidence base.

5.17 If the NLW framework had been in place in 2008 – and the LPC been committed to increases towards a fixed target as long as GDP remained above a certain threshold – the LPC may have struggled to justify departing from the pathway. The more narrowly defined the conditions for leaving the NLW pathway, the less flexibility the LPC has to act and the more likely it is to have to rely on lagged or inaccurate indicators or faulty forecasts.

5.18 The use of average earnings forecasts to set the NLW rate exacerbates this problem. In 2008 and 2009, the forecasts were an important indicator for Commissioners to take into account. But once consistent positive bias in wage forecasts became apparent, the LPC could correct for this. Under the NLW, earnings forecasts are not just one indicator among several but the main reference point for determining the value of the rate. Identifying and correcting for bias in the forecasts now entails a fundamental adjustment to the rate; this arguably means a higher burden of evidence would be needed to justify such correction.

The design of the National Living Wage beyond 2020

5.19 There are clearly advantages to the NLW framework. Giving employers foresight over the rate over a period of years has enabled long-term planning and made it easier for businesses to adjust to ambitious increases. But for the next stage of the NLW, we think there is a case for reconsidering the design of the framework, to ensure there is the right balance of flexibility for the LPC to respond to economic conditions; and clarity for stakeholders over the circumstances in which the LPC will consider a departure from the pathway or the target. A more ambitious NLW target needs to have the confidence of both employers, that they will not be pushed to achieve a target which is economically harmful, and workers, that the LPC will push towards a target in good faith.

5.20 We assume that, in setting an NLW target for the period after 2020, the Government will prescribe a target level and a view on timescales, and leave the pathway towards that end-date to the judgement of the LPC. The LPC should have flexibility each year to take account of economic conditions in making its recommendations, which may require it to vary this pathway.

5.21 We believe there is a case for broadening the condition of ‘sustained economic growth’. The economic conditions needed to support continued minimum wage increases go beyond just GDP. While the 1 per cent GDP threshold has served its purpose in the generally favourable economic conditions since 2016, we cannot rely on similar circumstances lasting through the course of the NLW’s next phase. The LPC should have the freedom and the flexibility to take a wide-ranging view of economic conditions and whether these support continued progress along the set pathway to the NLW target.

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5.22 In practice, we would not expect these to differ substantially from the indicators we look at now; the overall output of the economy, levels of employment (particularly in low-paying sectors) and growth in earnings and productivity will all be important. As since 2016, any indication that the impact of NLW increases on employment is greater than that foreseen in the OBR's modelling will be an important measure which would justify departing from the pathway. We do not think it will be appropriate for us to tie our judgements in advance to specific thresholds for any of these – or any other – indicators. We set out more extensively in Chapter 3 the conditions we consider essential for continued NLW increases.

5.23 The Government, which has final ownership of any NLW target and end-date, may wish to specify its tolerance for the NLW's impact on employment or other measures. To date, it has not explicitly set out these tolerances for the current NLW (the current threshold for employment loss was inferred by the LPC from OBR modelling, rather than stated by Government). If the Government states specific maximum tolerances and thresholds for the NLW's impact, these will clearly be a critical piece of context when we make our recommendations. But in the absence of such thresholds, we would exercise our independence in recommending whether economic conditions justify continuing on the pathway towards an NLW target, or departing from it.

5.24 A recommendation to depart from the pathway may mean one of the following options:

- Adjusting the pathway to the target without altering the target end-date. This would either slow the pace of the NLW's increases for a given period, on the assumption that the pace would then accelerate in future years to offset that slowdown (effectively back-loading large increases to the end of the target period). Or, to respond to favourable economic conditions, it would accelerate the pace of increases, front-loading increases which would then be slowed later. In either case, this would mean a temporary adjustment in the trajectory of the NLW but no change to its end point. However, the scope to front-load or back-load the increases diminishes with each step along the path. Were we to recommend backloaded increases part-way through or towards the end of the path, this may result in the need for substantial back-loaded increases.
- Moving the target end-date. In this circumstance, the LPC would recommend shifting the end point at which the NLW reached its bite target. This would have the effect of definitively changing the expected pace of NLW increases – either slowing them to respond to difficult economic circumstances or accelerating them if conditions are more positive than expected.

5.25 There is a risk that increasing the NLW eventually causes the rate to cross a ‘tipping point’ beyond which further increases would cause economic harm, regardless of the pace of change. Assessing whether this point has been reached would require strong and robust evidence, such as repeated econometric studies under various specifications (with the inevitable time delays associated with such studies). If there appeared to be evidence of significant economic impacts, we would carefully consider our approach. We would in the first instance seek clarification from the Government on several points: whether it maintained its ambition for the NLW; its appetite for economic risk; and the supporting policies required to support a minimum wage at that level and mitigate any negative impacts.

5.26 The level of nominal wage growth is particularly important for our decision-making. Were we to find that a particular uprating had led to significant job losses it is likely that our subsequent recommendations would allow the bite to fall. This would be achieved by making recommendations that increase the NLW by a smaller percentage increase than for average earnings. The higher nominal earnings growth is, the more scope there is to do this. For example, if nominal pay growth is 5 per cent a year and the NLW rate is frozen then the bite would fall by a greater amount than if growth was 2 per cent. By contrast, were nominal earnings growth to fall close to zero (as it did in 2011 and 2014) then the scope for allowing the bite to fall is significantly curtailed.

5.27 It is important to note the principle that the variability of the NLW target should be symmetrical; it should not only be a question of being able to adjust the trajectory of increases downwards. If the economy or labour market outperform expectations, it should be possible for us to recommend a greater level of ambition on the basis of the evidence.

Stakeholder views

5.28 In the course of our consultation, we heard a range of views from stakeholders on the framework to support an NLW target and the conditions which should trigger any departure from the target. There was, however, near unanimity from both employer and worker representatives on the importance of the LPC’s role as an independent, evidence-driven body making recommendations to the Government.

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5.29 A large number of responses to our consultation centred on the desirability or otherwise of a further NLW target. Many employer representatives argued against a framework built around a politically-set target, advocating instead an approach driven by the LPC's assessment of the evidence. The Federation of Small Businesses (FSB) stated that 'it is crucial for the LPC to maintain a firm level of independence - the NLW shouldn't be dictated by arbitrary political targets'. The British Chambers of Commerce (BCC) stated that 'The LPC should regain its independence to be able to set NLW rates according to economic conditions'. The Federation of Wholesale Distributors (FWD) stated that 'the Government should allow the Low Pay Commission independently to set wage rates based on objective economic analysis and in consultation with employers, trade associations, trades unions and other stakeholders'. Make UK told us that 'in a slight shift to previous submissions, because of the economic uncertainty, we are detecting less of an appetite amongst manufacturers for a continuation of a formula-based approach for setting the NLW post-April 2020 in contrast to support in relation to reaching a target of 60 per cent of median earnings by April 2020. Manufacturers want the economic context to be taken into account'.

5.30 UK Hospitality told us that they were 'opposed to a tightly prescribed route-map to see the NLW hit a defined percentage of median earnings by a certain date. We recognise that there is a widespread desire for the NLW's bite to increase and would be content with a general remit for the LPC to recommend above average increases as is justified by the prevailing economic and business climate. This means that the LPC would revert to its pre-2016 role of providing evidence-based, independent analysis upon which future increases are based'.

5.31 As an alternative to a target, the Confederation of British Industry (CBI) set out a proposal for the LPC 'to set a medium-term indicative path so that employers can plan for the future, but to do so free from a politically set, rather than evidence-led timetable. As the evidence base for future increases shrinks, the need for flexibility to respond to emerging evidence grows'.

5.32 In contrast, trade unions generally argued for a prolongation of the current framework. UNISON stated that 'the experience of the Low Pay Commission's role in overseeing the process of navigating the highest minimum wage rate from 53.3 per cent to 60 per cent of average earnings in the space of four years has provided an excellent model for governing the next stage in the development of the minimum wage ... the linking of the wage to average earnings provided a built in response to changed circumstances and the commission had the ability to adjust the planned path if "severe economic shocks" occurred'. The Trades Union Congress (TUC) argued that without a target, any aspiration to end low pay would be vague and hard to communicate.

5.33 Several stakeholders were in favour of the LPC using a wide range of indicators to judge whether economic circumstances met the conditions for sustained NLW increases. The TUC noted that the LPC might depart from the path to a target if there was a recession, if the economy differed markedly from forecasts, or if there was clear evidence of an impact on employment rates, whether overall or in specific sectors or regions. The CBI argued that ‘A broader range of factors like impacts on jobs, hours, career progression and pay differentials, and higher prices need to be considered’.

Improving the evidence base

5.34 The Government’s ambition for the next phase of the NLW should be paralleled by greater ambition for the evidence base which underpins our recommendations and their decisions. The Government should seek to maximise the usefulness of existing data sources, and to develop new ones where possible. Our programme of commissioned research is regularly delayed by the clearance timetables – which can be up to six months – involved in researchers getting authorisation to access ASHE and other key data sources. Bringing this period down would significantly improve our responsiveness to economic evidence.

5.35 In addition, the Real Time Information (RTI) data on the tax system used by HM Revenue and Customs has potential as an alternative source of employment and earnings data to complement the Labour Force Survey (LFS) and ASHE. RTI data currently provide estimates of employment and earnings for around 45 million employees and pensioners via the PAYE system. They are at the moment available as an experimental statistical bulletin, although there are plans to move to monthly releases later this year and to make available a more granular breakdown of the data. Both of these would help improve the evidence base for our recommendations. More consequential, however, would be the inclusion of the number of hours worked in RTI data. This would place extra burden on businesses in making their returns; but would also create a rich and up-to-date dataset on hourly pay which would enhance the LPC’s ability to understand and respond to economic conditions.

Supporting policies

5.36 As set out in Chapter 1**Error! Reference source not found.**, the NLW cannot solve the problem of low pay by itself. If a new NLW target is to be a success, it will need to be supported by Government action in a range of other areas. We have already noted in Chapter 3 the necessary conditions for further NLW increases to be achievable. The Government must consider what it can do to support sustainable increases in productivity in low-paying sectors, including via the Industrial Strategy. We cannot depend on a rising minimum wage by itself to drive the productivity improvements needed. There is also an important role for Government in ensuring employers have adequate access to skilled workers, both via the apprenticeship system and other policies. Equally, given the challenges and potential transitions faced by various low-paying industries, it is important that individuals have the opportunity to re-skill when needed throughout their careers.

5.37 A higher minimum wage will be only one of the factors which shape people's working lives over the years to come; although we try to forecast the NLW's effects, it is difficult to foresee every aspect of how employers and workers will respond to changing labour market conditions. This is why there is a need for strong labour market institutions beyond the minimum wage to ensure the fair treatment of workers. At Government's request, we examined last year the problem of 'one-sided flexibility' leading to a deterioration in individuals' working conditions (Low Pay Commission, 2018). We made recommendations around new employment rights which the Government is now taking forward. As the NLW rises and the nature of work continues to change, the Government should continue to take a broad view of the institutions and interventions needed to protect the fairness and quality of people's jobs.

5.38 We noted in Chapter 2 the effects of interactions between the minimum wage and the tax and benefits systems. Fundamentally, these two areas should be designed as complementary; one cannot serve as a substitute for the other. If policies in this area do not work in conjunction with the minimum wage, it can limit how far workers feel the benefit of NLW increases, and how far minimum wage policy succeeds in lifting workers out of low pay and poverty. It would seem sensible, at a minimum, for the Government to consider the links between tax and earnings thresholds and increases in the minimum wage. But more broadly, if the Government's ambition is to end low pay, then more needs to be done to understand the consequences of these interactions for individuals and for households, to minimise the risk of distorted incentives and unintended consequences.

5.39 Each year in our consultations, employers tell us about the range of rising costs which they face; this year was no different, and there is no reason to believe that these concerns will diminish as we move beyond 2020. Some of these costs are general across all sectors (National Insurance contributions, pension auto-enrolment, the Apprenticeship Levy), while others are industry-specific (for example, the cost of alcohol duty for the beer and pub industry). The impact of such cost increases may be felt particularly sharply when a sector is simultaneously undergoing significant structural changes, as is the case with the retail sector currently. We will continue to pay attention to the challenges faced by employers across the economy, but our focus is necessarily on a single policy lever, the minimum wage. It has to be for the Government to keep track of and, where necessary, take measures to alleviate, the overall burden of costs and regulation for businesses.

5.40 Similarly, each year we hear evidence from the social care and childcare sectors about the pressure of accommodating minimum wage increases in a context where overall funding is frozen, or where increases are limited. In social care in particular, we have heard overwhelming numbers of examples of both the pressure faced by commissioning bodies and the gradual erosion for care workers of their pay and working conditions. In childcare, the combination of a widespread freeze in funding levels and the introduction of the entitlement to 30 hours of free childcare has led to very substantial difficulties and a spike in rates of minimum wage underpayment. While poor employer practice and non-compliance cannot be excused by funding restrictions, the current approach to funding both these sectors is clearly creating pressures which are not sustainable. In setting an ambitious NLW target for beyond 2020, the Government must take responsibility for the delivery of that target in the sectors where it is the main source of funding.

5.41 An ambitious target will be fundamentally undermined – and competition harmed – if employers do not comply with their minimum wage obligations. In our report on non-compliance and enforcement earlier this year, we noted that the statistical estimates of the number of underpaid workers have increased year-on-year since the NLW's introduction. The accurate measurement of non-compliance is challenging, but the trend is apparent. The NLW was accompanied by a major increase in the funding of HMRC's enforcement activity, in recognition of the greater number of workers expected to be affected by a higher rate. In setting a further NLW target, we expect the Government to carefully consider its implications for the enforcement challenge, including both the strategic approach to targeting non-compliance and the level of funding required for effective enforcement. A higher target will also bring new employers and new sectors into the minimum wage, which might not previously have considered themselves as low-paying; there will be a need for active promotion and information campaigns, to make sure that no one can use ignorance as an excuse for underpayment.

Stakeholder views

5.42 Several stakeholders noted the need for the Government to think holistically about the supporting policies needed to support the NLW. The TUC stated that 'Industrial strategy should be broadened to include the low paid industries, drawing on the TUC's proposals for the establishment of Modern Wages Councils'. At oral evidence, they again noted the need for the full range of policy – including fiscal and transport policy – to solve the problems which the NMW alone could not.

5.43 The FSB told us 'Government must recognise that the minimum wage has its limitations as an intervention in addressing income inequality. Significant changes to minimum wage levels alone will not achieve the goal of reducing poverty in the UK. Government should also review other major policy areas, such as Universal Credit, affordable housing, education, childcare and accessible transport - all have a vital role to play.'

5.44 In some cases, this went hand in hand with arguments to broaden the LPC's remit. Unite thought the remit 'should be extended to include a long term advisory role – investigating the causes and consequences of low pay and making recommendations to the government'. The GMB argued that the LPC should 'make recommendations that have the effect of pulling up wages and conditions for a broader population of the workforce'. Usdaw stated that in making recommendations, the LPC should look at workers' wider pay packet – such as overtime premiums – rather than only hourly pay, and take into account where elements of discretionary pay have been withdrawn.

Conclusions:

Regardless of how high or how fast an NLW target is set, it is essential that all parties are confident in the LPC's independence and its ability to recommend stepping off the pathway towards any target. During the financial crisis of 2008 and 2009, the LPC's social partnership model enabled it to cut through unreliable economic data and to make recommendations to slow the growth of the NMW. Evidence shows that despite the recession, the NMW did not contribute to job losses in this period.

However, these recommendations would have been more difficult to make under the current NLW framework, with its dependence on forecasts of earnings and GDP data. Plotting the path required to hit a target requires forecasts of average earnings, but these proved inaccurate as they were slow to respond to economic conditions in 2008, resulting in overestimating earnings growth for several years. And GDP data are lagged and subject to significant revision. It is now known that the 2008 recession began in the second quarter of 2008, but at the time positive GDP growth was reported.

The dependence on these data can be mitigated by broadening the range of factors which we take into account in making recommendations on the NLW. Rather than increases being subject to the condition of 'sustained economic growth' only (interpreted as one per cent GDP growth), we should have the flexibility to take into account a wide range of considerations in determining whether it is appropriate to continue towards the NLW target. This will be essential in maintaining stakeholders' confidence in an ambitious new target.

This flexibility should also mean we can recommend departing from the NLW target, either by adjusting the pathway without altering the target's end-date, or moving the end-date. In these cases, the variability of the target should be symmetrical; it should be possible for us to recommend faster increases if evidence suggests these are achievable.

As set out throughout in this report, the minimum wage alone cannot solve the problem of low pay. The Government's ambition in this area should be matched by its ambition in building the evidence base and as far as possible aligning the various policies which interact with the NLW for both workers and employers.

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