Briefing

Resolution Foundation

Minimum Wage Act II:

Options for strengthening the UK minimum wage

A Resolution Foundation policy discussion paper

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Executive Summary

Fifteen years ago the UK introduced its first minimum wage into a hostile environment. The House of Commons was divided over the policy and there remained a degree of trepidation even among the policy's supporters about its effects. Today, things are different. There is a confident academic consensus that the minimum wage boosted earnings without causing unemployment, and broad political support has followed. If the minimum wage debate has been maturing for some time, it truly came of age in January 2014, when a Conservative chancellor said he not only supported the policy but thought the rate should rise significantly.

The Chancellor's intervention did not come out of the blue. It follows a broader push for a stronger minimum wage from leading thinkers on both right and left. This debate, a response to the growing challenge of low pay, has secured the position of the minimum wage. But it has also thrown the policy into flux. The minimalist settlement that served Britain so well for fifteen years, in which the trusted Low Pay Commission (LPC) dispassionately recommends the rate each year with little guidance or thought to the long-term, has run its course. This minimalist approach, which was well-designed to respond to early opposition and uncertainty, seems less adequate now that a consensus is secured and so much has been learned about the impact of the policy. Yet so far politicians have been improvising and a formal new policy has not yet been put in place.

So what could it mean to more formally strengthen Britain's minimum wage and the architecture of the Low Pay Commission? How could the policy be given renewed relevance for the next fifteen years? This paper sets out a range of practical options. The ideas it presents try to manage the tension inherent in any reform of Britain's minimum wage. On the one hand, policymakers need to protect what works well in today's approach. The minimum wage, after all, is one of the most effective policy reforms of the last thirty years. And at the heart of this success is the trusted and evidence-led approach of the LPC.

On the other hand, much has changed since the current settlement was forged in 1998. After fifteen years of research we have a much clearer insight into how minimum wages work. And today's challenge of low pay is itself a different beast to the one we confronted fifteen years ago. At least one in five employees, and possibly many more, earn below £7.71 an hour, two-thirds of the median wage and the standard definition of low pay. But recent data suggests only 9 per cent of these low paid workers are on extreme low pay (below half the median) of the kind that a legal wage-floor can easily address. Back in 1997, a third (32 per cent) of all low paid workers—7 per cent of the *total* workforce—were on extreme low pay. Today's frontline in the battle against low pay is people who earn above the minimum wage but still too little to get by; this challenge may be beyond the reach of today's approach.

Other lessons have also been learned in the last 15 years. In some sectors, the minimum wage has become the going rate. With little pressure to go beyond their legal obligation, some employers have taken the NMW as a guide—something the LPC was clear it never intended. While evidence suggests that many employers could afford to pay more, the NMW is inevitably held back by the most vulnerable parts of the UK economy. And contrary to received wisdom, we have also found that, for most of those who suffer it, low pay is not a temporary state that affects only the start of a career; three-quarters of low paid workers in 2002 had failed to fully escape from low pay ten years later.[1]

When weighed against today's challenge, three particular weaknesses of the 1998 settlement stand out. First, the policy's scope is narrow. The Low Pay Commission, despite its name, is in effect a Minimum Wage Commission. This is not the LPC's fault; despite its demonstrable expertise, the body has never been *asked* to monitor overall low pay, assess its causes, consequences or costs, or advise on policy to tackle it. This is in part because the government more broadly has no explicit ambition to tackle low pay and no strategy to do so. Second, the process for setting the NMW is short-term, but tackling low pay is clearly a long-term project. The annual uprating of the NMW is unveiled each year just six months before it comes into force. This creates uncertainty for business but also leaves the policy rudderless. It is hard to see how firms can be expected to help deliver a future with less low pay, and how government can be expected to support that goal, if neither knows where we are going.

Third, the LPC has only the blunt instrument of a single mandatory minimum wage at its disposal. This has proven to be a highly effective tool against extreme low pay but it has been relatively ineffectual against low pay more generally. The LPC has no powers to push or even encourage employers to go further than the NMW when they can afford to. Indeed, discussions about whether some parts of the UK economy could afford to pay more are out of keeping with the LPC's founding legislation. With little pressure on many employers to pay their lowest paid workers more, this amounts to a strategy of 'the minimum wage plus a penny'.

Of course any change to a body as successful as the LPC brings risks. But in light of these lessons learned, and today's different labour market environment, now is the right time to strike a new and judicious settlement for the policy's next fifteen years. To that end, this paper explores three ways in which the minimum wage settlement could be strengthened. At this stage, we do not opt for any one of these paths; each has strengths and weaknesses and this paper simply sets out options. These options are under consideration in the Resolution Foundation's ongoing review of the future of the minimum wage, under the chairmanship of Professor Sir George Bain, the founding chair of the Low Pay Commission. Final recommendations will be published next month.

First, we explore how the remit of the LPC could be broadened to make the body a genuine *Low Pay* Commission. This might involve some simple additions to the LPC's work, asking the body to become experts on the scale, causes, costs and consequences of low pay, publishing regular reports, commissioning research and advising the government on policy. This also raises the difficult and much broader question of what measure of low pay should guide government policy in general—for example, pay below two-thirds of the median wage or pay below the Living Wage? And it also raises the question of what form the government's ambitions on low pay should take e.g. is there a need for a target and should it be set by politicians? We talk through the pros and cons of the different options.

Second, we explore how the tool of the NMW itself could be made more ambitious, in particular by giving more clarity over where it is heading in the medium-term. This would reduce uncertainty but could also make the policy less passive, not only giving businesses the

[1] Hurrell, A. Starting out or getting stuck? *An analysis of who gets trapped in low paid work—and who escapes*, Resolution Foundation (2013)

notice they need to adapt, but also encouraging government to help them, for example through employer taxes or skills policy. We explore three options: emulating the Bank of England's forward guidance approach; setting a political intention for the future value of the NMW; or changing the current settlement entirely by raising the NMW by fiat over a number of years while the LPC monitors effects.

Third, we explore whether the LPC could be given new powers and responsibilities to complement the powerful but necessarily blunt tool of a single mandatory wage-floor. One lesson from the last fifteen years is that a legal wage-floor is an effective but limited instrument. We now know that the NMW's effects did not ripple upwards and that, in some sectors, where employers feel little other pressure to pay more, it has become the going rate. We consider whether there are ways for the LPC to encourage employers in some parts of the economy to pay more when they could afford to. One approach would be for the LPC to publish 'reference rates' for the wage-floor that firms in key sectors could afford to pay. The same could be done in London. Ideas like these are out of keeping with the minimalism of the LPC's founding legislation. This tells us more about deals that were struck 15 years ago than about the challenge of low pay we face today.

Taken together, these types of reforms would mean a broader, more confident and assertive approach to the minimum wage. However, they each have advantages and disadvantages that need to be weighed up. The Resolution Foundation's review is considering these ideas among others and will publish its final report with full recommendations next month.

Outline of the paper

- **Chapter 1** starts by taking stock of the role and functions of the LPC today, talking through how the body's founding legislation, governance arrangements and remit guide the tone and rhythm of its work.

- **Chapter 2** reflects on the strengths and shortfalls of today's NMW settlement. It reaffirms how successful the LPC has been at establishing the principle of a minimum wage. But it also shows how the current settlement falls short of what is needed in the next 15 years.

- **Chapter 3** learns lessons from the strategies that are used in other areas of economic policy. From fiscal policy to monetary policy to policy on skills and migration, a range of different approaches are taken, many broader and more assertive than our current strategy on low pay.

- **Chapter 4** applies these lessons to the architecture of the LPC. It looks at how the LPC could be strengthened in three respects: by broadening its work into a genuine Low Pay Commission, by giving more clarity on where the NMW is heading in the medium-term, and by giving the LPC additional tools to help encourage employers to pay more.

Chapter 1 – Today's settlement

Before evaluating the strengths and weaknesses of Britain's minimum wage, it is useful to take stock of how the approach works today. Here we talk through the roles and functions of the LPC, taking the body's legislative underpinnings, governance arrangements and work plan in turn. In the next chapter we weigh up the strengths and weaknesses of this policy architecture.

The Low Pay Commission

The Low Pay Commission was established in 1998 to support the introduction of the UK's first National Minimum Wage. In technical terms, the LPC is a non-Departmental Public Body (NDPB) and as such it operates within both statutory and delegated authorities. The LPC derives its legal status from the 1998 National Minimum Wage Act and it derives its delegated authority to recommend the rate of the NMW from its sponsoring Department - the Department for Business, Innovation and Skills (BIS) - with the Secretary of State for BIS deciding whether or not to accept the rate that the LPC recommends. These delegated authorities are set out in its Terms of Reference. To understand how the LPC goes about its work, we need to understand these underpinning governance arrangements.

1. Legislative underpinnings

The National Minimum Wage Act defines the work of the LPC in a number of important respects. It established the LPC to advise the Secretary of State on several aspects of NMW policy:

- The hourly rate of the NMW
- How the hourly rate should be defined (i.e. what is and is not included)
- Whether a different rate should be applied for younger people and what that rate should be, and (within tight limits) other classes of people to whom a different NMW should be applied.

The Act only required the Secretary of State to seek the LPC's advice on the first level of the NMW, but also included powers to "at any time refer to the Low Pay Commission such matters relating to this Act as the Secretary of State thinks fit". In practice this has meant that each year since April 1999 when the first NMW came into force, the Government has sought the LPC's advice on the level of the NMW as well as its advice on matters relating to enforcement and the fit between the NMW and other policies or practices. Aside from two exceptions, when the government rejected the LPC's recommendation to start the adult rate at age 21 and instead started it at age 22 and when it rejected its recommendation to freeze the apprentice rate in 2013 and instead increased the rate by 1 per cent, the government has always accepted the LPC's advice.

The 1998 National Minimum Wage Act also establishes the composition of the LPC. It requires that the LPC consist of a chairperson and eight members, with an appropriate balance between:

"(a) members with knowledge or experience of, or interest in, trade unions or matters relating to workers generally;

(b) members with knowledge or experience of, or interest in, employers' associations or matters relating to employers generally; and

(c) members with other relevant knowledge or experience."

In practice this has meant an LPC composed of three trade union representatives, three employer representatives, and three independent members, including the chairperson. These independent members have usually been academics. In addition to this, the LPC has eight permanent civil servant staff.

The 1998 Act is narrow in scope, focusing the LPC on the level and application of the NMW. In practical terms, it means that the legislative reach of the LPC does not extend beyond the NMW to the problem of low pay more generally. The Secretary of State has no specific legislative authority to refer matters to the LPC that do not relate to the level of the NMW and its application (i.e. those matters covered by the National Minimum Wage Act).

In some cases, this limited scope prompts the LPC to diverge from standard approaches to low pay. For example, the term 'low pay' is used in the LPC's work to mean pay around or below the level of the Minimum Wage. This definition has also been picked up by other official UK bodies, such as the ONS in its annual 'low pay' report.[2]

This is markedly narrower than standard definitions of 'low pay' used by other agencies both in the UK and internationally. For example, the focus of the ONS's report 'Low Pay' is the 279,000 jobs that are paid below the NMW. Similarly, the LPC estimates that in the region of 5 per cent of the UK workforce earn around the NMW. By contrast, the OECD definition of low pay—hourly pay below two-thirds of the median wage—covers at least 21 per cent of the UK workforce.

The 1998 NMW Act also in effect prohibits greater variation in the NMW beyond the categories of young people or people in the first six months of a new job. The Act states that:

"No amendment [to the NMW] shall be made […] which treats persons differently in relation to—(a) different areas; (b) different sectors of employment; (c) undertakings of different sizes; (d) different ages over 26; or (e) different occupations."

Since the LPC's work is focused tightly on the NMW, this in effect means it is beyond the scope of the LPC to consider whether different parts of the economy could bear a higher wage-floor. The two exceptions to this—workers under the age of 26 or those in the first six months of employment—are written into the legislation on the grounds that these groups might justify a lower rather than a higher rate.

[2] *Low Pay*, April 2013, Office for National Statistics

2. Governance arrangements

In addition to this founding legislation, the LPC's work is shaped by its governance arrangements. These include its Terms of Reference and the annual remit the body receives from the government. The LPC's Terms of Reference are included in Annex 1. These describe how it will exercise its statutory powers through research, evidence-gathering, and the functioning of the Commission. They also define the LPC's purpose as:

> *"to recommend levels for the minimum wage rates that help as many low-paid workers as possible without any significant adverse impact on employment or the economy."*

This formulation—to find the highest NMW that does not cause sufficient adverse impacts—is a delegated rather than statutory authority. It is set by Government rather than by Parliament so changing it would not require primary legislation. However, it has remained essentially unchanged since the LPC's first Terms of Reference were set in 1997.

The LPC's activities are further defined in its remit from Government. This remit is usually set annually, and generally asks the LPC to:

- "Monitor, evaluate and review" the levels of the NMW rates and to recommend levels for the following year;
- Review or consider the implications for the NMW of any relevant policies, practices or reforms. In recent years this has included regulations on salaried hours workers, the treatment of accommodation costs, and proposals to abolish the Agricultural Wages Board; and
- Take account of wider factors as appropriate—including for example the state of the economy, tax and benefit reforms and other changes.

The LPC's annual remit has lately focused on the position of young people, with the last two remits requesting the LPC to "review the contribution the NMW could make to the employment prospects of young people". Through this wording, the LPC has in effect been asked to advise on whether the NMW could be set so as to *improve* employment rather than advising on the highest rate that could be achieved without *damaging* employment. In the past, the LPC has also been asked to look at wider issues such as the persistence of minimum wage work and the adequacy of the NMW when considered alongside state support. But having been posed in the LPC's annual remit, rather than as reforms to the NMW Act or the LPC's permanent Terms of Reference, these issues have been explored as one-offs rather than becoming core parts of the LPC's work.

3. Month-to-month work plan

The LPC's founding legislation and governance arrangements in effect prescribe an annual cycle of activities: the LPC receives its yearly remit, undertakes a research programme into the effects of the NMW, takes evidence in writing and orally, carries out analysis and produces a report with recommendations. This annual cycle has not changed since its inception. It plays a strong role in shaping the content of the LPC's work through the discussions, research, and evidence-gathering that it carries out.

Figure 1: the annual cycle of the Low Pay Commission

The LPC's annual Remit is usually issued in June, before the summer Parliamentary Recess, with a requirement to report by the end of February. This gives nine months to complete the cycle, with the commissioning of research and consultation over the summer, evidence sessions held in the autumn, and evidence assessed and findings agreed in the autumn/winter. The LPC's commissioners are highly engaged in this process, making visits to employers and discussing at length the latest academic evidence. Because of the tasks it is set, the LPC has come to focus its work on assessments of the historic effects of the NMW and on how the immediate economic outlook might affect the prospects for a higher rate the subsequent year. Typically the new rate of the NMW is unveiled in March or April and comes into force on October 1st.

The research commissioned by the LPC focuses on the direct effects of the NMW on a range of variables and is mostly technical in nature. Recent examples include:

- An assessment of the impact of the NMW on low paying companies[3]
- An assessment of the impact of introducing the apprentice rates[4]
- An assessment of the NMW on the domiciliary care sector[5]

In its first fifteen years of operation, the LPC has commissioned over one hundred independent reports, the vast majority of which have been focused on an assessment of the impacts of the

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[3] Riley, R. and Rosazza Bondibene, C. (2013) "The impact of the national minimum wage on firm behaviour during recession" National Institute of Economic and Social Research
[4] Higton, J. et al (2012) "An Assessment of the Introduction of the Apprentice Rate", ipsos MORI and Cambridge Policy Consultants
[5] Bessa, I. et al, (2013) "The National Minimum Wage, earnings and hours in the domiciliary care sector", University of Leeds

NMW. This constitutes one of the best bodies of evidence on the impact of minimum wages anywhere in the OECD. It has centred mainly on the variables of earnings, employment and unemployment and working hours, with additional work carried out on the effects on profits, prices, productivity and business closures.

While the focus of the LPC's research has not changed significantly since it was established, the academic context is now very different. The LPC's early work broke new ground, revealing for the first time the effects of a wage-floor in the UK. This was not least because the overnight introduction of the NMW, and its large early up-ratings, provided a useful natural experiment for economists to investigate. Today's research more often refines established findings.

Chapter 2 – Strengths and shortfalls

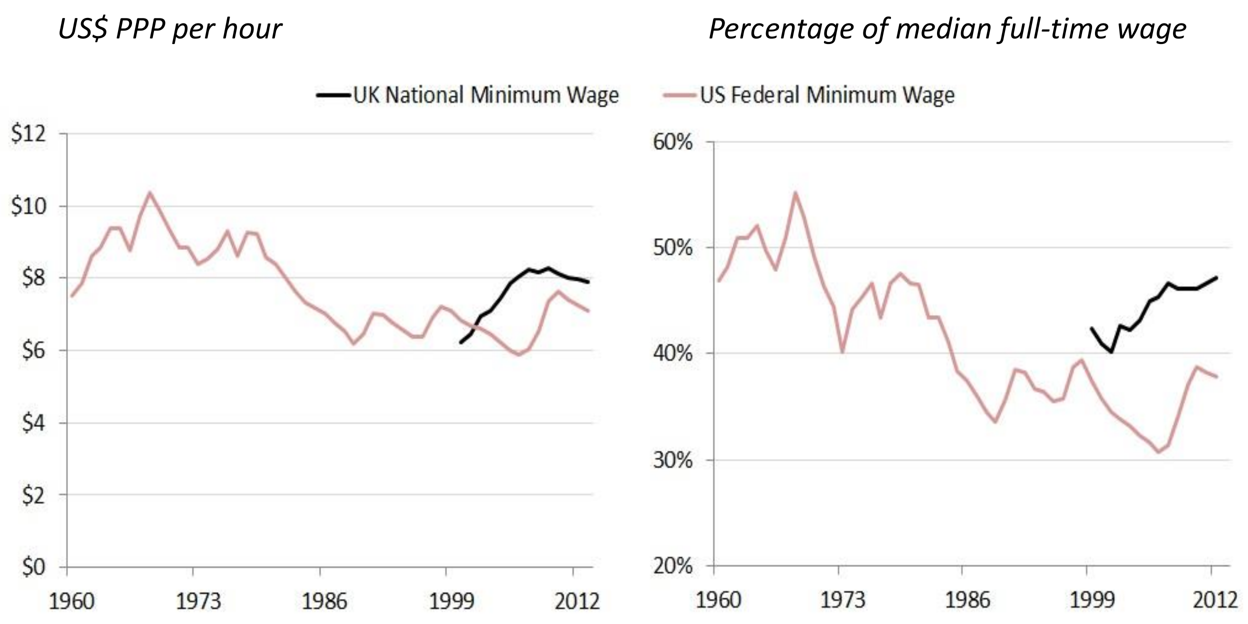
The short biography of the LPC provided in Chapter 1 shows how the settlement designed in 1998 continues to shape the tone and rhythm of the body's work. This chapter reflects on some of the key strengths of that approach, as well as the shortfalls that stand out when it is weighed up against today's challenge of low pay.

Strengths of the current settlement

The approach that was outlined in Chapter 1 is clearly minimalist in the way it conceives of the NMW and low pay, and in the way it thinks about setting the NMW and researching its impacts. As one might expect, this minimalism has proven to be a sensible way to establish the NMW as a new policy given the controversy and opposition it faced upon its introduction. It undoubtedly enabled the LPC to deliver on the tasks for which it was designed. The system has had some particular strengths in the NMW's first 15 years:

- **It depoliticised the process of setting the NMW,** helping to replace the division of the late 1990s with the consensus the policy enjoys today. This success is most obvious when Britain's experience with the NMW is compared with that of the US Federal Minimum Wage (FMW). The FMW, which can only be raised by an Act of Congress, remains highly divisive politically. Most recently, the US President has had to resort to raising the FMW for federal contractors only—something within his executive authority—for want of the ability to raise the rate for minimum wage workers not employed on public contracts. In the UK, the LPC has helped to ensure a much cooler debate.
- **It secured the buy-in of the businesses and unions through taking a social partnership approach**. The LPC has reached a unanimous view from its employer- and union-members in every report it has produced, including throughout the difficult economic environment since 2008. Despite the contentious nature of the minimum wage and the wide range of opinions that feed into the LPC's deliberations, there has been little sustained criticism of the LPC's judgements after they are made.
- **Its process for annually uprating the NMW gave the LPC flexibility to adapt to changing economic times.** Again, this stands in marked contrast to the US's experience. Figure 2 shows how the US system has raised the FMW rarely and abruptly, increasing uncertainty for both workers and employers. The UK NMW has risen much more smoothly.

Figure 2: Comparing the UK and US national and federal minimum wages



Source: Resolution Foundation analysis, OECD Stat.

The UK's approach also contrasts with countries that index their minimum wage to prices. In France, for example, where the minimum wage is linked to a measure of the cost of living, increases have been steadier but also less responsive to labour market conditions. The UK's LPC set a low NMW at first, then ambitiously increased the rate faster than inflation for a number of years in the early and mid-2000s. This was followed by below inflation increases from 2008 to 2013. Had the NMW instead been tied to inflation, the result would have been an NMW which rose more slowly in good times and more quickly in difficult times. The LPC's method has allowed for a much more responsive approach.

- **The LPC has built from scratch a UK evidence base around the minimum wage**, with a robust and objective commissioning process to minimise disagreement about the facts. This research has transformed our understanding of the impacts of wage-floors and the operation of low wage labour markets. Research commissioned by the LPC has shown, for example, that employers have adapted to the NMW through channels other than employment, adjusting profits, wage distributions, pricing and productivity rather than reducing employment.[6] It has also helped us to understand which parts of the labour market are more vulnerable to a higher NMW, for example young workers, care homes and women in part-time employment. There is even evidence that the UK minimum wage literature is more objective than the US literature, with statistical analysis revealing publication bias in the US literature— that is, studies are more likely to be published if they find a negative impact from the minimum wage.[7] This is not found in the UK

6 Plunkett, J and Hurrell, A. *Fifteen Years Later: A discussion paper on the future of the UK National Minimum Wage and Low Pay Commission*, Resolution Foundation (2013)

7 Doucouliagos H. and Stanley T.D. (2009) "Publication Selection Bias in Minimum-Wage Research? A Meta-Regression Analysis"

literature, perhaps partly because of the central role the LPC has played in commissioning neutral research.[8]

Shortfalls of the current approach

Alongside the strengths of Britain's current minimum wage settlement, there are a number of ways in which the architecture of the LPC falls short in its response to the challenge of low pay. Rather than being a failure of the LPC itself, this reflects the fact that the LPC has done what was asked of it 15 years ago. While it is important to note that the NMW and the LPC as a body can only ever be one part of efforts to reduce low pay, it is clear that the world has changed a lot since the policy's introduction, not least because of the NMW's success. Looked at afresh today, a number of shortfalls stand out:

The first and most obvious shortfall is the narrowness of the LPC's work. The LPC would more aptly be called a Minimum Wage Commission, focused on the specific technical question of the appropriate level of the legal wage-floor. The LPC concentrates overwhelmingly on assessing the impact of the NMW, which at £6.31 covers at most 5 per cent of the workforce. This is a *far* smaller share than the 21 per cent of the UK workforce that is low paid under the official definition, the threshold for which is around £7.71 hour, a number that might itself be a large under-estimate.[9]

In the late 1990s, the LPC's focus on extreme low pay made sense. In 1997, 7.0 per cent of the entire UK workforce suffered extreme low pay, being paid below half the median wage. This population, prime targets for the NMW, made up 32 per cent of the workers who were low paid (being paid below two-thirds of the median wage). Extreme low pay was therefore a good place to start the battle against low pay more generally. In latest figures, by contrast, only around 1.9 percent of the UK workforce faces extreme low pay, the vast majority of whom are teenagers or apprentices, the remainder representing illegal avoidance of the NMW. This is 9.2 per cent of today's low paid workforce. The vast majority of low paid workers are now in the region above the NMW but below the low pay threshold of around £7.71 an hour.

The LPC's narrow focus is just one symptom of the fact that the UK government does not have an explicit ambition or objective of economic policy to tackle low pay. No part of government is tasked with monitoring low pay, investigating its causes and consequences or advising ministers on steps that could be taken to tackle low pay. Moreover, the government has no overall view on what it is trying to achieve with regard to low pay and no strategy guiding its approach. As the problem of low pay has grown, other agencies, most notably the Social Mobility and Child Poverty Commission, have improvised in this space, exploring low pay in an *ad hoc* fashion. No institution has however been formally tasked with undertaking such a role.

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[8] Linde Leonard, M. Stanley T.D. and Doucouliagos, H. (2013) "Does the UK Minimum Wage Reduce Employment? A Meta-Regression Analysis"

[9] Analysis in the IFS's *Green Budget* places the proportion of low paid people at 29 per cent. The different estimates are a result of the use of two datasets, the Annual Survey of Hours and Earnings used in this paper and the Labour Force Survey to which the IFS's figure refers.

The second apparent shortfall of Britain's current approach to low pay is the short-termism of the minimum wage itself. Neither the government nor the LPC has any view on where they hope or expect the NMW to be in the medium-term. This sits uncomfortably when we know that tackling low pay will be a long-term task. It also has practical costs. It means, for example, that each year the NMW is unveiled just six months before it comes into force, creating uncertainty for employers, when in other areas of economic policy it is now standard practice for the government to give foresight about its intentions.

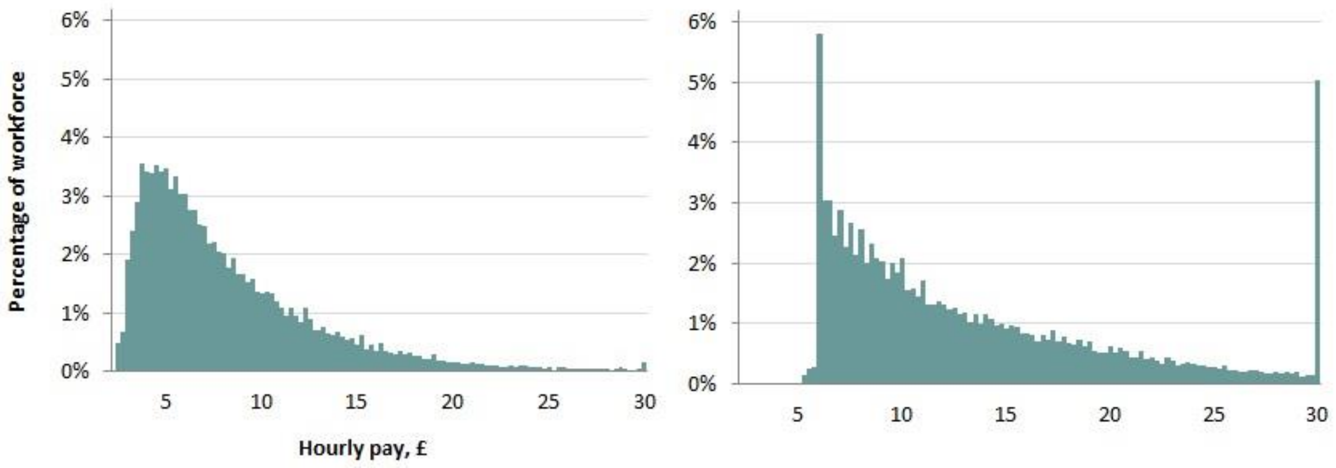
The lack of direction for the NMW also makes the policy inherently passive. The LPC is tasked with describing the UK labour market as it sees it today, with all its current constraints. This has consequences for how employers respond: how can they be clear on their role in reducing low pay if they have no sense of where the minimum wage is going? And it has implications for the LPC's relationship to government. For example, the LPC does not advise the government on steps it could take to make a higher NMW possible in future, only on the NMW that can safely be introduced today.

Of course the short-termism of the NMW reflects the difficulty of setting a wage-floor in advance. But as we will see in Chapter 3, there may be ways to balance this need for flexibility while also giving more clarity about future intentions. And again, it is interesting that Whitehall has already improvised an ad hoc response to this problem. The Chancellor's recent intervention, supporting the idea that the NMW could rise significantly to restore the value it has lost in recent years, fed into the LPC's annual process of recommending the level of the NMW while not binding the LPC's hand. Yet it fed in unexpectedly just a month before the LPC was due to make its annual decision. With the NMW having fallen in real terms for five years running, the government feels understandable pressure to make clear that this value will be restored as an economic recovery takes hold. But there is not yet a formal policy process for giving this guidance or direction.

Third, the LPC only oversees the single tool of the mandatory national minimum wage. In the past fifteen years the effectiveness of this tool has become clear but so have its limitations. When the NMW was introduced a key concern was that its effects would ripple upwards, pushing up wages across the economy and causing inflation. The opposite problem has transpired. The NMW has had such a limited ripple effect that workers now cluster at the NMW, making the minimum wage the going rate in some sectors. As Figure 3 makes clear, the lack of pressure points above the NMW has left the UK labour market increasingly bottom heavy, with a large number of workers paid at or around the legal wage-floor.

Figure 3: Before and after the National Minimum Wage

Distribution of gross hourly pay excluding overtime in the UK in 1997 and 2012



Notes: Gross hourly pay excluding over-time
Source: Resolution Foundation analysis, Annual Survey of Hours and Earnings

The LPC has neither the power nor responsibility to do anything to encourage employers to go beyond their legal obligation to pay the NMW. In effect, the LPC and the government takes a 'minimum wage plus a penny' approach, focusing only on the level of the NMW and its enforcement. Because further variations in the structure of the NMW are prohibited in the NMW Act, any conversations about whether some parts of the economy could afford to pay more are entirely out of keeping with the way the LPC's work has been framed.

Summary

The strengths and shortfalls of today's NMW settlement represent a system that was well-designed for the world of 1998 and carefully negotiated to reflect political pressures at the time. In its narrowness, short-termism and singular reliance on the NMW, the LPC provides only a minimalist contribution to the fight against extreme low pay. In the next chapter, we explore case studies of how other bodies with different functions related to economic policy take a broader, more assertive approach and ask what, if any, lessons could be learned.

Chapter 3 – Learning from different approaches

The government has established a number of independent bodies to advise it on key aspects of economic policy. In this chapter we look at four of these examples to draw lessons for what a bolder LPC could look like. We consider:

- **The Office for Budget Responsibility**'s work on fiscal policy
- **The Monetary Policy Committee**'s work on monetary policy
- **UK Commission for Employment and Skills**' work on skills policy
- **The Migration Advisory Committee**'s work on migration policy

These bodies obviously have very different responsibilities and powers from the LPC, and from each other, each striking a different balance on key policy trade-offs. What, if any, lessons do they hold for what a stronger LPC could look like?

1. The Office for Budget Responsibility

The Office for Budget Responsibility (OBR) was established under the 2011 Budget Responsibility and National Audit Act "to examine and report on the sustainability of the public finances ... including through forecasting, long-term projections and balance sheet analysis". Its two key functions are to publish economic and fiscal forecasts at key fiscal events (Budgets and Autumn Statements); and at the same time to assess the government's progress against its 'fiscal mandate' of achieving a balanced current budget (cyclically-adjusted) within five years.

While the OBR's forecasters have struggled in a highly unpredictable economic climate, there is a political consensus that the body has earned its place, improving the quality and independence of the advice government receives on fiscal policy. Just four years in to the OBR's life it already feels highly unlikely that its role would be removed.

Because of the way the OBR has helped the government deliver on a clear and contentious objective of economy policy, it carries some interesting lessons for what a more assertive LPC could look like.

First, while the OBR's judgments are independent, its work is based on a clear political objective that is defined by a target (the fiscal mandate). This target requires that the government always has in place a plan to eliminate the structural deficit. This is an interesting example of how a target can give a clear trajectory but not tie hands. It focuses minds and gives direction while retaining flexibility. Indeed the government's main fiscal target has come into criticism for being too flexible. The rolling timetable only requires that there be a plan to eliminate the structural deficit, not that the deficit in fact be eliminated. These debates echo the tensions inherent in giving a sense of direction on low pay or the minimum wage. It is also interesting that the government's clear objective on fiscal policy makes the relationship with the OBR far more pro-active. Its judgments drive policy changes in a much a broader way than the LPC.

Second, the OBR combines its main publications at key fiscal events with a longer-term programme of in-house research. Its biannual statements run alongside a Fiscal Sustainability Report, which diagnoses the long-term prospects for the public finances. Examining the path of spending and revenues over the next 50 years, this is by nature an ambitious and uncertain piece of research. Despite this, few experts have questioned its worth. The OBR also publishes a range of work that stands aside from its annual process: Briefing Papers for technical audiences; Working Papers diving into specific issues; Discussion Papers to invite views; and Occasional Papers to provide ad hoc advice to parts of government at request.[10] This is a different approach to the LPC, less focused on one task, more dependent on internal work, and broader in scope.

Third, the OBR's track record suggests that a new body can establish legitimacy in a contentious area of economic policy even if it is composed of experts. The five members of the OBR's Oversight Board are economists, not representatives of interest groups, making the OBR a council of experts rather than a social partnership body. While the OBR has taken criticism, its impartiality has not been widely questioned. There may be good reason to think that setting a minimum wage is a different task, requiring social partnership, but the OBR reminds us that well-chosen experts can gain legitimacy while working on a difficult and highly contentious area of economic policy.

Overall, the OBR is an interesting example of how the government can balance a clear medium-term political objective but be guided in achieving that objective by an independent body. The government's rolling primary deficit-reduction target has given a sense of direction and momentum to fiscal policy without tying the government's hands as economic conditions change. And the OBR's broad and credible research agenda, backed by expert advisors, has brought accountability and evidence to the process.

2. The Monetary Policy Committee

The Bank of England's MPC offers different insights for the LPC. While not formally an NDPB, the MPC has similar characteristics and performs comparable functions. It was established in legislation in the Bank of England Act 1998, which also gave the Bank of England responsibility for monetary policy with the objective "(a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment."[11]

One lesson from the MPC is the way its bounded inflation target balances a clear political goal with flexibility, in similar fashion to the OBR. The Bank has a clear mandate on price stability but the government reserves the power to define the inflation target.[12] This target sets a clear intention despite being backed only by the weak accountability mechanism that the Bank of

[10] Two Occasional Papers have been published to date, on oil revenues and Scottish taxation.
[11] The Bank of England Act 1998, s.11
[12] Initially this was defined an inflation rate of 2.5% on the Retail Prices Index (excluding mortgage interest) and later a rate of 2.0% on the Consumer Prices Index.

England Governor is required to write a letter when the target is missed by more than one percentage point.[13]

Second, the MPC's recent experiment with forward guidance, for all the criticism it has attracted, was a serious attempt to increase clarity about the direction of travel in an uncertain area of economic policy. Since 2013, the MPC has had a formal mandate to trade off growth and potentially higher inflation, and the government explicitly noted (in the MPC's 2013 remit) that:

> *"The Committee may also judge it to be appropriate to deploy explicit forward guidance including intermediate thresholds in order to influence expectations and thereby meet its objectives more effectively."*

The main lesson from this experiment is how difficult it is to balance clarity and flexibility. The Bank's initial response to this remit[14] was to say it would not consider raising interest rates until unemployment fell below 7 per cent (while medium-term inflation prospects or financial stability were not at risk). The Bank has now broadened this criterion to include a full basket of indicators of spare capacity. Some say the policy has done little to increase certainty about the path of policy[15] though the Bank itself claims that the policy has helped to increase confidence over the future path of interest rates.[16] The approach raises the question of whether the LPC could be clearer about the conditions in which it would raise the NMW ambitiously in the recovery, or whether this would struggle to increase certainty.

Third, the MPC's position in the wider of Bank of England shows how a tightly defined technical committee can sit within an organisation with much broader responsibilities. The MPC long ago established itself as being legitimate in its own right, and it is hard to imagine now an approach which located monetary policy either back in the hands of politicians or outside the Bank of England. And the MPC's work is not confused by the fact that it sits within the broader BoE. This is a useful lesson, raising the possibility that the NMW-setting process, and its social partnership model, could be quarantined within a broader LPC with new resources, powers and responsibilities.

Fourth, the MPC again shows the degree to which an expert body can operate successfully while overseeing a highly contentious issue. Despite the controversial nature of the decisions the MPC takes, its members do not pretend to represent the interest groups impacted by these judgments. While the substance of its decisions is hotly contested, the legitimacy of the MPC's decisions or its authority to make them is not in question. Again, while there are strong reasons to protect the social partnership model of the LPC, this may suggest that not all aspects of the government's work on low pay need to pass through the clearance process of the nine-member social partnership body of the current LPC (or that social partnership involvement in low pay issues should be limited to the NMW setting process).

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13 When inflation remains outside this range of 1-3%, then letters should be sent every three months.
14 http://www.bankofengland.co.uk/publications/Documents/inflationreport/2013/ir13augforwardguidance.pdf
15 http://www.ft.com/cms/s/0/31609b0a-1af1-11e3-87da-00144feab7de.html#axzz2hhbepuSA
16 http://www.bankofengland.co.uk/publications/Documents/inflationreport/2013/ir13augforwardguidance.pdf

In summary, the MPC reminds us again that there are different ways for policy to balance clarity and flexibility. The LPC settlement again looks minimalist and short-termist, even by contrast to the highly flexible model of the MPC. It is also notable that the Bank and MPC have become more assertive as conditions have changed while the LPC still works on a model designed in 1998. This is interesting given that the balance of concern between growth and inflation has shifted in a similar way to the balance of concern between unemployment and wage growth.[17]

3. The UK Commission for Employment and Skills

The UK Commission for Employment and Skills (UKCES) applies a very different model. It was established in 2008 in response to the Leitch review of UK skills policy18 and works to raise employer investment in skills. Rather than just advising government or holding ministers accountable, it works actively to change employer behaviour. It uses a variety of tools to work towards this. UKCES:

- Exerts moral and reputational pressure on employers by developing standards and frameworks (e.g. for apprenticeships);
- Forecasts the supply and demand of skills in the UK economy;[19]
- Directly invests public money in (usually co-funded) programmes to encourage employer-investment in skills;[20]
- Commissions employer surveys and shares the data with researchers;[21] and
- Uses its own Commissioners as advocates.

The main lesson from the work of UKCES is that a variety of tactics can be used to change employer behaviour. This is a far wider set of activities than those undertaken by the LPC, not least because UKCES has over 10 times more staff than the LPC (see Table 1). UKCES also feeds into policy in a wider range of areas, from the design of youth employment programmes to changes to skills funding. UKCES has taken on this more activist role over time.

Another interesting pointer from UKCES lies in the way it convenes employers, providing a neutral space outside government in which employers can meet to address collective action problems. UKCES is overseen by a team of thirty commissioners, the majority (eighteen) of whom represent employers, with four places held by trade union representatives. Commissioners meet every three months and contribute between meetings through events and other activities. It is notable that there is no equivalent body to convene employers on the issue of low pay, especially in light of its common causes within particular sectors. It is fair to say, however, that the UKCES operates in an area that is less controversial for social partners to support.

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17 Gregg P. and Machin S. (2012) "What a drag: the chilling effect of unemployment on real wages," Resolution Foundation
18 Leitch, S. (2006) "Prosperity for All in the Global Economy: World Class Skills"
19 Wilson, R.A. and Homenidou K. (2012) "Working Futures 2010-2020: Main Report"
20 Employer Ownership of Skills pilots, as well as through a Growth and Innovation Fund and Employer Investment Fund
21 Employer Skills Survey, Employer Perspectives Survey

4. The Migration Advisory Committee

Finally, it is worth touching on the work of the Migration Advisory Committee (MAC). The MAC is useful as an example because it works in a similar area of labour market economics to the LPC.[22] The MAC was established in 2007 alongside a new points-based system to shift the balance of migration towards groups with the most to contribute to the UK economy. The MAC's focus has changed over time from advising on skills shortages among specific occupations to studying policy impacts, including limits on migration.

The MAC's work is useful when weighing up whether the LPC could feasibly take on more difficult judgments, particularly over the sensitivity of different parts of the UK labour market to a higher NMW. It carries out extremely detailed modelling to identify gaps in the UK labour force that could be filled by migration. It does this by maintaining the Shortage Occupation List or the Codes of Practice, a thorough list of occupations in which the UK has skills shortages, calculated both through academic work and in consultation with a wide range of stakeholders. Despite its complexity the MAC's work has not received significant push back. The MAC's five members, including the chair, are independent academics while representatives from the Home Office and UKCES also attend and the work is supported by a secretariat of 10 civil servants. This suggests that it might be possible for a broader LPC to take more work without necessarily becoming a far more complex body.

Table 1: Comparing the capacity of bodies on economic policy

Budget and staff of advisory economic non-departmental public bodies

	Funding	Permanent staff	Commissioners or Board members
Low Pay Commission	£827,000	8	9
Office for Budget Responsibility	£1.75m	11	5
Monetary Policy Committee	N/A	N/A	9
UKCES	£19.2m*	97	30
Migration Advisory Committee	£796,000	12	5

*Notes: * Excluding programmes*

Summary

Looking at how these other institutions do their work reminds us that there is more than one way to design a body like the LPC. It also helps to dampen fears that any reform of the LPC will inevitably break the current settlement. There are ways to design policy to give more clarity over the direction of travel, even in uncertain economic environments, while retaining flexibility.

22 Metcalf, D. (2013) "Immigration and the British Labour Market: The role of the Migration Advisory Committee"

Independent advice can be maintained even when the government is very clear about what it is trying to achieve. It is also clear that legitimacy can be won through expertise and there are benefits to both social partnership and expert led processes. And other tools can be utilised to influence employer behaviour far beyond those used by today's LPC.

In the final chapter we look at how some of these lessons could be applied to our approach to low pay, forging a broader and more assertive settlement. Rather than recommending particular reforms, we set out the menu of options that is being considered by the Resolution Foundation's ongoing review of the future of the NMW and LPC.

Chapter 4 – Elements of a bolder settlement

This paper has evaluated the UK's current minimum wage settlement. For a sense of how other institutions work we have also looked at case studies across a range of economic policy areas. In this chapter we draw on these studies to sketch out some practical options for how today's minimum wage settlement could be strengthened. The areas we discuss link to the shortcomings that were outlined in Chapter 2. Each has its pros and cons and we set out a range of options rather than recommending any particular reform.

First, we explore how the LPC could be broadened into a more genuine Low Pay Commission. The practical elements of a broader LPC could be uncontroversial: writing annual reports on the incidence of low pay, conducting research into its causes, consequences and costs, and advising government on policy that affects low pay. But asking the LPC to help the government achieve a broader objective on low pay also raises a question: what measure of low pay should drive government policy and what form should this objective take? The different options, for example tackling pay below the Living Wage, have quite different implications for policy. We talk through the pros and cons of different approaches.

Second, we look at how the government, or the LPC itself, could give more clarity over where the minimum wage is heading in the medium-term. This is inevitably a balancing act. Giving too much clarity would mean asking the LPC to do the impossible and would also tie the body's hands even as labour market conditions change. Yet, as we have seen, and as the Chancellor implicitly acknowledged in his recent statement, today's settlement is rudderless, giving no sense of where the NMW is headed. As a result it is also passive, describing the UK labour market as it is today rather than trying to change it. Improving on these shortfalls without undermining the flexibility or independence of the LPC is a difficult challenge but is far from impossible. We apply some lessons from the MPC and OBR to set out a spectrum of potential reforms that range from the modest to the more assertive.

Third, we look at whether the LPC could be given additional powers and responsibilities to complement the impact of the NMW. Because of the inevitable bluntness of a single mandatory minimum wage, additional tools are likely to be needed to tackle the broader problem of low pay. Some will of course fall to other parts of government. But the LPC may be well-placed to lead on others. For example, we know that the minimum wage is to some extent an ill-fitting garment: it pinches hard in some parts of the economy even while many other employers could afford to pay more. This simplicity is a real strength and there are big downsides to fragmenting the mandatory NMW. We look instead at whether the LPC could complement the NMW by publishing an assessment of a non-binding 'affordable wage' that employers in certain parts of the economy could pay, whether in specific sectors or in a distinct economy like London.

1. Options for making the LPC a genuine Low Pay Commission

We start by considering how the LPC could be given a broader remit to tackle low pay. This would extend its work significantly beyond the NMW, which covers at most around 5 per cent of the workforce, to consider the 21 per cent or more who are low paid. Drawing on the work of other bodies, some of these additional roles could include:

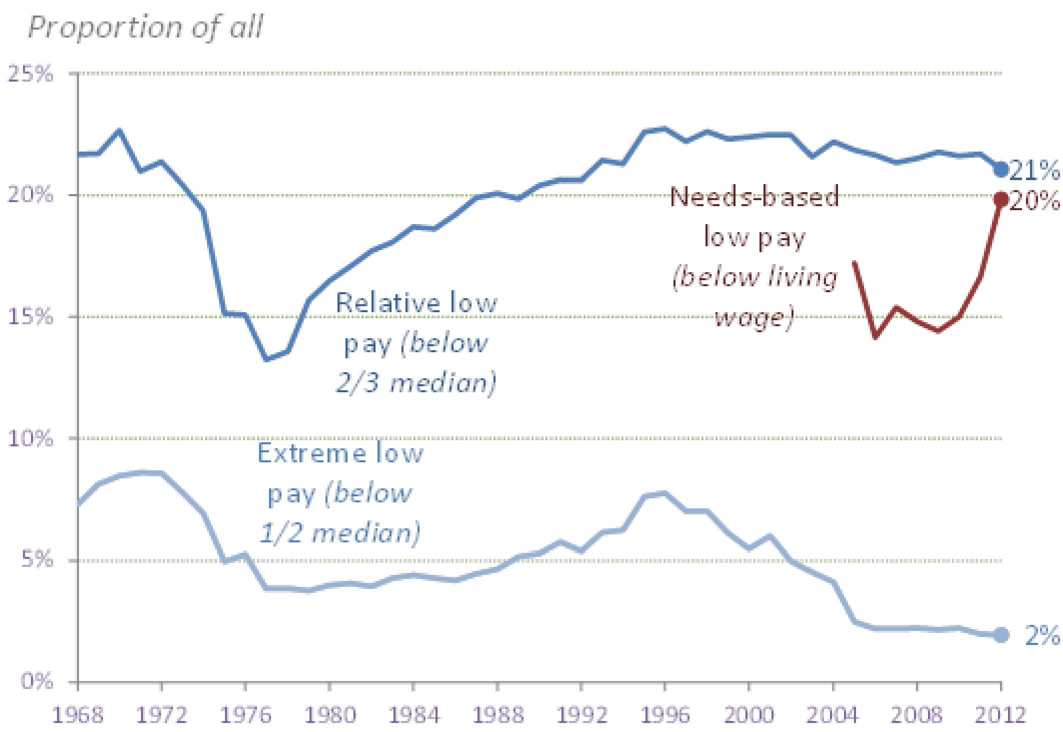
- Publishing an official annual assessment of the incidence of low pay across the UK economy, mapping low pay by sector, gender, age and region;
- Conducting or commissioning deeper research into key features of low pay, such as its persistence over time, its extent in certain occupations or industrial sectors, or its relationship to gender;
- Conducting, commissioning or drawing together evidence on what works in tackling low pay, and working with government and social partners to share and build on this evidence-base;
- Advising the government on the design of policy that effects low pay, for example welfare reform, skills and progression; and
- Convening employers in key sectors to discuss what it would take to reduce the incidence and persistence of low pay.

While these activities would extend the remit of the LPC significantly, and no doubt raise questions of resourcing, they do not fundamentally alter the nature of the LPC's work and would go with the grain of approaches taken in other areas of economic policy. They could also help to shift the conversation around the NMW and low pay to a more proactive footing.

A more difficult question raised by this broader remit is: how do we define low pay and what should the government be trying to achieve? This comes down to the question of what specific measure of low pay should drive government policy and what form this objective should take.

There are two prominent options when it comes to measuring low pay: aim to reduce the share of people paid below the Living Wage or reduce the share of people paid below two-thirds of the median wage. Figure 3 shows trends in low pay on the two measures. In practice, the results are similar: the Living Wage from November 2013 is £7.65 an hour outside London while two-thirds of the median wage (from April 2013 data) is £7.71. The share of workers earning below each is therefore also similar. But it is important to understand that, despite this apparent similarity, the two measures are nonetheless fundamentally different and will almost certainly diverge sharply in coming years.

Figure 4: Incidence of low pay in the UK



Source: Resolution Foundation analysis, Annual Survey of Hours and Earnings

The Living Wage (LW) is now almost certain to diverge sharply from the official measure of low pay because of the way it is calculated (see Box 1 for full details). In simple terms, the LW is the wage needed to buy a basic basket of goods after state support. Its annual increase is then capped at the growth rate of average earnings plus 2 per cent to stop the LW from rising too fast. Today's real LW is in fact £9.08 an hour; it is only set at £7.65 because the cap has been in effect over recent years.[23] The LW will catch up with this real rate over time, held back only by the cap, meaning it is almost certain to rise faster than earnings for the foreseeable future. This means that the share of workers paid below the LW will rise steeply. Over the longer term, it also means that the share of workers paid below the LW can be volatile, being driven by the price of certain goods and by decisions over state support, neither of which is related to earnings.

These are inevitable weaknesses of any attempt to set an absolute standard for pay as the LW does. The flipside is that the LW avoids many pitfalls of the standard relative measure of low pay (two-thirds of median earnings). These pitfalls are familiar from debates about poverty. First, relative measures are arbitrary; they tell us little about the actual living standards of workers. Second, relative measures can perform counterintuitively—for example, one way to reduce the UK's official share of low paid people is to reduce pay at the median. Third, relative measures of pay are narrow in scope, ignoring factors such as the price of goods that have a strong bearing on living standards. For all its weaknesses, the Living Wage has been designed to respond to these important problems.

23 Hirsch, D. *Working paper: uprating the UK Living Wage in 2013*, Centre for Research in Social Policy (2013)

Box 1: Why can't the government raise the minimum wage to the Living Wage?

The Living Wage campaign itself recognises that the Living Wage should not be mandated through government policy. Instead, it is clear that the LW is to be pursued through a civil society campaign in which employers sign up to the LW voluntarily. To understand why this voluntarist approach is necessary, we need to understand how the LW is set. The national rate is calculated as follows*:

- Focus groups agree on the basket of goods that is needed to live a basic standard of living in Britain today for nine different types of households
- The cost of these baskets is used to calculate the lowest wage a person would need to earn, working full-time and after taxes and benefits are taken into account, to pay for these goods. These nine results are then averaged to produce a single figure.
- This figure is in effect the real LW and is known as the 'reference rate'. In 2013-14 it is £9.08. However, to prevent the LW from rising too quickly, annual increases are capped at the growth of average earnings plus two percentage points. In recent years this cap has limited the 'applied' LW to £7.65 an hour. This is the rate of the LW used by campaigners today.

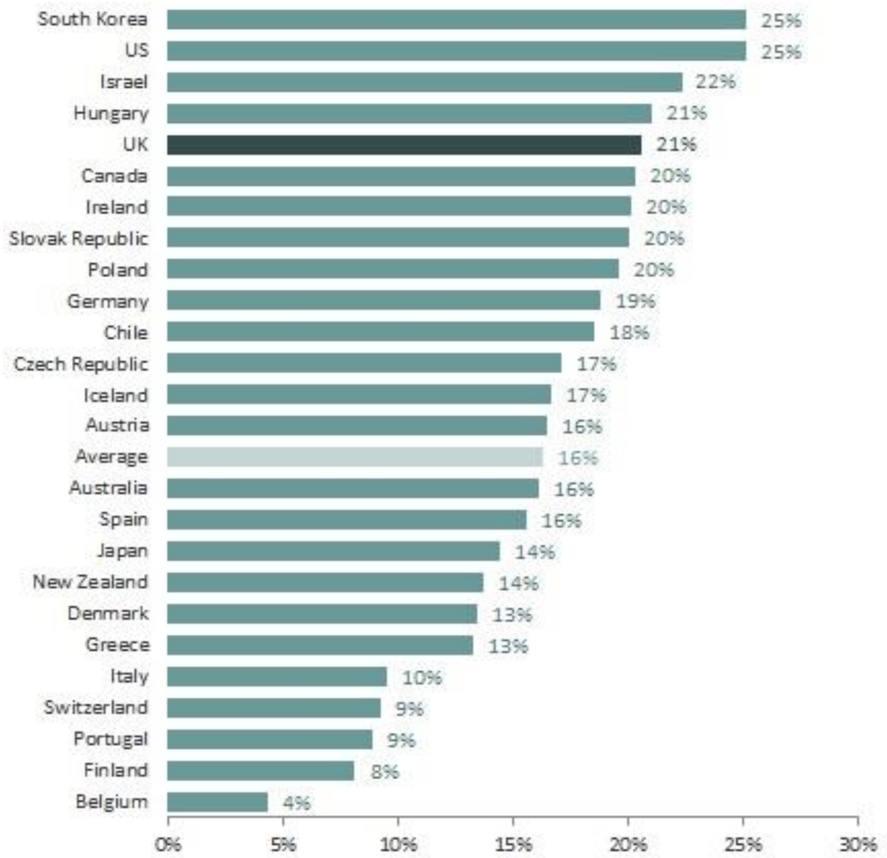
The formula that is used to calculate the LW has a number of implications. First, because the applied rate has fallen some way behind the real rate, the Living Wage is now all but certain to rise 2 per cent faster than average earnings for the foreseeable future as it catches up. Second, the value of the LW is affected by changes to welfare policy; the LW rises when state support is cut and falls when state support is made more generous. Third, because it reflects the cost of a minimum standard of living, the LW is sensitive to the prices of particular goods. This is inevitable in any attempt to calculate an absolute measure of living standards like the LW. It does mean, though, that the LW moves largely independently of wider earnings in the economy.

Together these facts mean that the LW, which already covers at least one in five workers, is likely to cover a rapidly increasingly share of the UK workforce in coming years. They also mean that this coverage is volatile. From 2009 to 2012, for example, the share of UK employees earning below the LW jumped from 14 to 20 per cent while the share below the official relative definition of low pay stayed relatively flat at just over 20 per cent.

* The London Living Wage is set differently, also taking into account the poverty line and adding a buffer of 15 per cent to reflect the need to save for large irregular costs.

The official relative measure of low pay also has a number of strengths. It compares the fortunes of the lowest earners with those in the middle, giving a sense of whether earnings growth is shared across the pay distribution. It is also a relatively simple measure to calculate and explain as opposed to the LW which as we have seen is in some ways 'fixed' to allow for a more achievable level. One final upside of relative measures of low pay is that they allow for international comparisons. Figure 5 shows the share of low pay in OECD economies (focused on full-time workers for comparability). [24] No country has eliminated low pay but its incidence varies widely, from 4 to 25 per cent across developed economies. The average share of low pay among OECD countries is 16 per cent, well below the UK's share of 21 per cent.

Figure 5: International shares of low pay



Source: Resolution Foundation analysis, OECD stat.

Finally, it is important to note that neither the Living Wage nor the standard measure of low pay takes into account the **persistence of low pay**. Recent work by the Resolution Foundation found that around three quarters of low paid workers fail to fully escape from low pay over ten years or more, though this has improved over time[25]. Recent work by *Inclusion* found that around one in six workers are in low pay for at least one year.[26] While measures of persistent low pay are inevitably less timely, and so a difficult guide to public policy, reducing the persistence of low pay is nonetheless an appropriate policy goal.

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[24]OECD Employment Outlook 2012

[25] Hurrell, A. (2013) "Starting out or getting stuck? An analysis of who gets trapped on low pay – and who escapes" Resolution Foundation

[26]Wilson, T. et al (2013) "Work in Progress", Centre for Economic and Social Inclusion

2. Options for giving more medium-term clarity over the minimum wage

If the government were to adopt a broader goal on low pay it would allow for a more strategic approach. But a goal alone would do little without tools to help achieve it. Indeed an ambition not backed by serious effort could be counter-productive. In the next two sections we consider how the NMW and LPC could do more to help tackle low pay, asking first how the minimum wage itself could do more and second, whether the NMW could be complemented with other tools.

When it comes to the NMW itself, we have seen that its relatively short-term and passive approach was entirely sensible upon its introduction, given the trenchant opposition it faced. We have learned a number of lessons since then that suggest a stronger approach might now be possible. Unveiling the NMW just six months before it comes into force creates uncertainty for business and makes it hard to expect business to plan for a future with less low pay—or indeed for government to help them. A clearer direction could also make the policy more pro-active, with the LPC not just recommending the rate but also pointing to blockages that prevent the minimum wage from being higher (which could range, for example, from the taxes that face small firms, who struggle most with a higher NMW, to the adequacy of social care funding).

Indicating the future path of the NMW is not an entirely new idea, indeed there is some precedent from the LPC. From 2001 to 2006 the LPC made two-year recommendations for the NMW, only switching to one year recommendations as the economic outlook worsened. The LPC was also asked in 2011 whether more clarity could be introduced. It concluded against the idea, arguing that: *"the disadvantage of constraining the Commission to positions which by definition cannot be based on timely evidence outweighs any benefit in increased clarity, particularly in the present uncertain business environment."*[27]

The LPC is right to say that any longer-term approach to the NMW involves an inevitable trade-off, sacrificing a degree of independence and flexibility in exchange for more clarity over the future direction. So how could policy best balance these competing demands?

One option would be to emulate the Bank of England's forward guidance approach. This could mean asking the LPC to present, alongside its annual recommendation, its central scenario for the medium-term path of the minimum wage. A conservative path would simply follow a forecast for median earnings. The LPC could then be requested to set out the conditions under which a more ambitious path would be followed, from sustained growth in GDP to low or falling unemployment. A more ambitious path could be to raise the NMW relative to median earnings.[28] The LPC could also note policy changes that would allow it safely to recommend a higher rate in future.

Forward guidance could give employers more clarity that, under certain conditions, they will be expected to share the benefits of a buoyant economy with their lowest paid workers. It would

[27] http://www.lowpay.gov.uk/lowpay/report/pdf/8990-BIS-Low%20Pay_Tagged.pdf

[28] The precise phrasing of this is important. If a forward guidance approach is to strengthen and not weaken the NMW, the LPC would need to be asked to set conditions in which it would be *more* ambitious than their default level of ambition. For example, if the LPC was asked to set out the conditions in which it would raise NMW, or raise the NMW relative to inflation, this would mean adding a limitation to a process that happens anyway and would, in effect, weaken the current approach.

also retain flexibility. However, critics have been quick to highlight the downsides of the policy as undertaken by the Bank of England. The Bank's need to continually clarify, and then fundamentally revise, its policy of forward guidance, suggests that this approach might in fact have little effect.

A stronger option would be for the government to set a clear goal for the future value of the NMW, with the LPC continuing to advise on the rate each year as well as advising on policy changes that could quicken progress. This would in effect formalise the Chancellor's current approach, while allowing the LPC to respond in a more considered way on the back of research and consultations. One way to structure this would be for the government to set out its hopes for the future value of the NMW on a rolling five year basis, while the LPC continues to pass judgment on the increase that is possible from year to year. In this scenario the LPC might be encouraged both to recommend the rate and to comment on any blockages to achieving the government's ambition. To increase certainty for business, the LPC could also be asked to recommend not just the rate of the NMW that should come into force in six months' time, but also its preliminary thoughts on the rate that should come into force in 18 months' time.

In important respects this change would make the LPC a more pro-active body. Rather than just asking whether the NMW has had employment effects, the LPC would ask how the UK could safely achieve a higher minimum wage over the next five or ten years. The government would set its medium-term goal for the NMW as a contribution to its wider ambition to reduce the incidence of low pay. This would undoubtedly represent a shift away from the history of the LPC, in which its recommendations were made completely separately to government. The danger is of course that political pressure could push the LPC to recommend rates it otherwise would not choose, whether higher or lower, politicising what has until now been seen as an objective process.

A third option would be simply to raise the minimum wage over five years, asking the LPC to monitor the effects. This would change fundamentally the LPC's role, turning it into a monitoring body. The LPC would monitor closely and perhaps more frequently any negative effects and would advise on steps to ease the transition, for example by raising the gap between the youth and adult rate, steadily reducing employer taxes for small firms or adequately funding social care.

The benefits of this approach would be to give some confidence to those in low pay that they will see future earnings increases - which may in turn support consumption in the short-term - and it would give greater certainty to employers over the likely scale of potential wage pressures arising from the NMW. But it would come at a very high price. The drawback is clearly that the approach would undermine the independence of the LPC; it would effectively end the LPC in its current form.

Choosing a number?

A major challenge in all of these options is that the government would need to decide on an appropriate medium-term ambition for the value of the NMW. How could this judgment be made? Three options would be to:

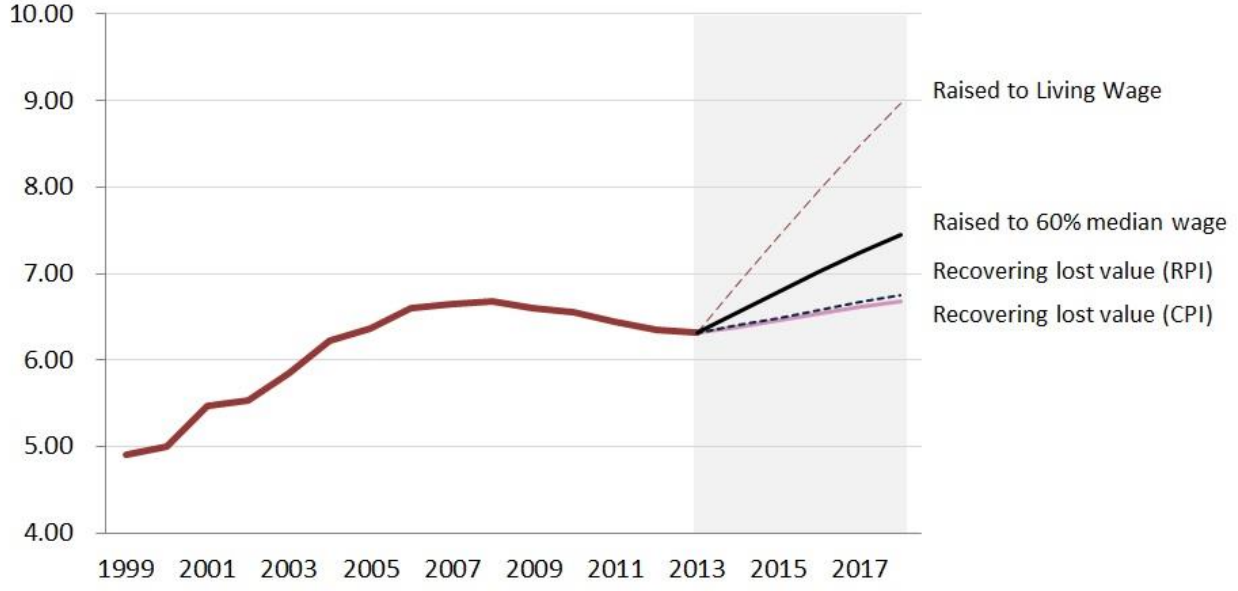
- Raise the NMW to the Living Wage over a number of years;
- Restore the value the NMW has lost in the last five years, based on either the CPI or RPI measure of inflation; or to
- Raise the NMW to a set proportion of median earnings, perhaps based on an international benchmark.

Figure 6 gives an indication of how the value of the NMW would evolve under each of these options, raising its value over the years from 2013 to 2018. These scenarios should be treated as highly indicative. They are based on the latest (December 2013) Office for Budget Responsibility projections for earnings and inflation which themselves are uncertain, with adaptations made for the likely path of median hourly earnings.[29]

[29] OBR Economic Forecasts December 2013

Figure 6: The future value of the NMW under different ambitions

£ per hour, constant prices CPI-adjusted



Source: Resolution Foundation analysis, OBR and ONS

The first implication of this analysis is that it is unlikely that the NMW could be raised to the Living Wage in the medium-term (see also Box 1). A more viable option appears to be restoring the value of the minimum wage to its level in 2008 in real terms, regaining the ground that has been lost through five successive real terms falls. This is essentially the idea that has been mooted by the Chancellor. The result depends slightly on which measure of inflation is used.[30] Under the CPI measure of inflation, which does not include housing costs, the NMW would need to be in the region of £7.40 an hour by 2018-19 in order to restore its lost value. Under the flawed but fuller RPI measure, under which measure the NMW peaked in 2009, the NMW would need to be in the region of £7.50 an hour by 2018-19.

Restoring lost ground is clearly an important benchmark. It is easily understood and is likely to have significant public salience. What this measure does not achieve, however, is any sustained sense of direction for the NMW once lost ground has been made up. It does not offer a vision for the future of the NMW beyond getting back to its pre-crisis level. It also fails to take into the performance of median wages or other worthwhile indicators in the wider economy.

Finally, therefore, we show the path of the NMW if it were to rise to 60 per cent of the hourly median wage. This is based on a forecast of the median wage adapted from OBR forecasts for average earnings and should again be treated as indicative. A NMW of 60 per cent of the median would be at the upper end of international experience. One merit of this approach though is that it ties the NMW to wider earnings in the economy, a more economically relevant metric than

30 The new RPI-J measure is not yet forecast by the OBR so we are limited to the CPI and RPI measures here.

either the LW or past values of the NMW. Again, it is worth noting that a relative measure is necessarily arbitrary. There are lessons to be learned here from the child poverty target, particularly in terms of how relative targets perform when median income or earnings are stagnant. It is also worth noting, though, that 60 per cent of the median wage appears to be an ambitious but plausible level for the NMW. The Chancellor's recent suggestion of a £7.00 NMW in 2015, for example, would equate to around 57 per cent of the median wage.

Whatever ambition was set for the NMW, the LPC could advise government on policy steps to help achieve it. Evidence from the first fifteen years of the NMW gives a good sense of which parts of the economy struggle most when the NMW is raised. These might therefore be priorities for support to adapt:

- **Social care:** early studies into the effects of the NMW found some evidence of reduced employment from the NMW in small, low paid care homes.[31] There is a clear link here to flexible and responsive social care funding that is adequate to cover the NMW.

- **Young workers:** while there is no consistent finding of statistically significant employment effects, studies have tended to find larger effects on younger workers. A higher adult rate could in theory be combined with an increased gap between the adult and youth rates.

- **Small employers:** firms with fewer than 10 employees face a larger wage-bill effect from a higher NMW than larger firms, and may be worth targeting through reduced employer taxes.[32]

- **Female part-time workers:** there is some evidence of reduced hours of work among female part-time workers, where the level of the NMW is high relative to earnings. This might justify, for example, targeted skills interventions.

3. Options for strengthening the LPC with additional tools

In the third and final section of this chapter we consider whether extra powers or responsibilities could be given to the LPC to complement the impacts of the NMW. Whatever the Government's level of ambition, the minimum wage will only ever be one of several tools needed in the battle against low pay. Some of these tools, from education and skills to industrial strategy, will fall to other areas of Government. But the LPC may be well-placed to lead on others.

One reason for thinking that additional tools will be needed is that any single, mandatory NMW will always be limited by a basic constraint: it has to be set with an eye on the most vulnerable part of the labour market. While we have argued above that a higher NMW might be possible if this goal was actively supported by wider government policy, the NMW will always be a blunt tool. Indeed, there may be good reasons to avoid a world in which the NMW covers a very large

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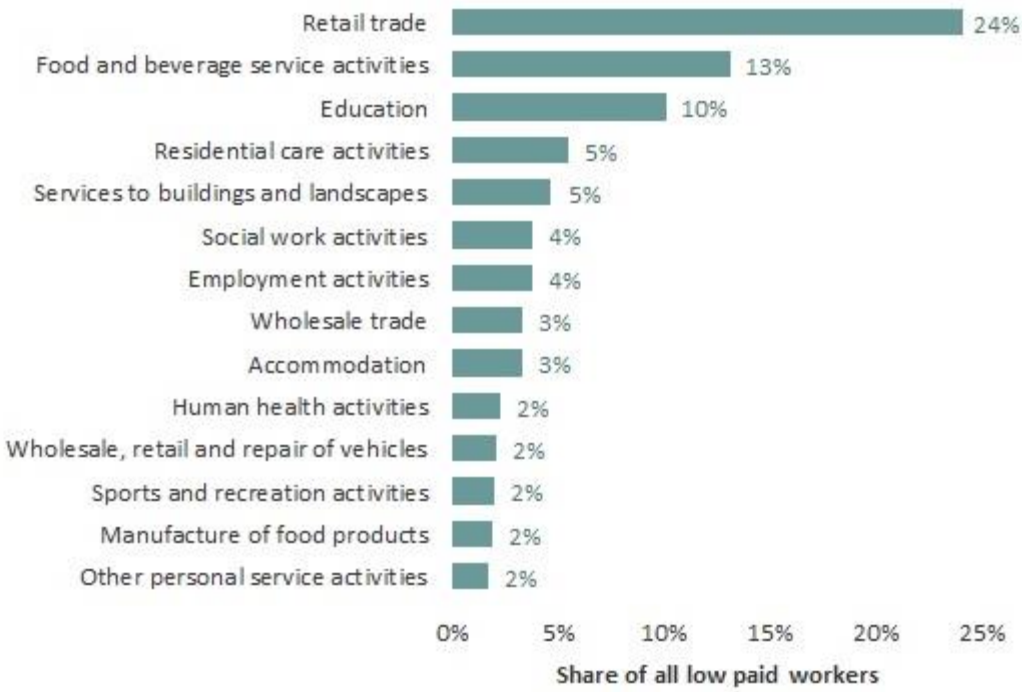
31 Machin, S., Manning, A. and Rahman, L. *Where the minimum wage bites hard: the introduction of the UK National Minimum Wage to a low wage sector*, London School of Economics (2002)
32 *Resolution Foundation*, forthcoming

share of workforce; an alternative aim would be to find new ways to push employers to go further than the NMW, where they could afford to do so, inserting new pressures points into the system. As the Living Wage campaign has shown, some of these roles fall to civil society, pressing employers to pay more than their legal obligation. But there may also be ways in which the LPC could inform these debates, drawing on its expertise and authority.

Figure 7 highlights the uneven spread of low pay by sector. More than four-fifths of all the UK's low paid workers are found in just 14 sectors. This presents both opportunities and challenges. Small improvements within these sectors would have big impacts. It also means that, in most sectors, low pay makes up a small share of the workforce and a higher wage-floor would have a small impact on wage-bills. Collectively these sectors contain a large number of low paid workers, and could very likely afford to pay them more.

Figure 7: Distribution of low paid workers by sector



Source: Resolution Foundation analysis, Annual survey of hours and earnings

Sectors are of course not the only way in which low pay varies. Regional disparities, particularly between London and the rest of the country, are striking. While the high cost of living in London suggest that a higher minimum wage would be merited, doing so without reference to the labour market may be unwise. Recent research does suggest, however, that had it been asked to recommend a minimum wage for London, the LPC would likely have set a higher rate for the capital.[33]

Publishing 'reference rates' might be one way in which the LPC could put its authority and legitimacy to good use while not departing from the analytical, labour market focus of its current

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33 Ussher, K. *London rising: The case for a London minimum wage*, Centre for London (2013)

work. These suggested rates for what would be 'affordable,' taking into account wage bills, profits, firm size and any other relevant factors, would introduce new pressure points without setting additional mandatory minimum wages. They would also allow campaigns such as the Living Wage to use the LPC's reference rates as part of a push for better wages where affordable. This could be one route to generating some upward pressure in sectors that can afford it without going down the burdensome and bureaucratic path of having varying mandatory minimum wages in different sections of the economy.

Any decision to give the LPC additional tools would not need to be implemented overnight. It may be that the LPC could in time, and subject to initial forays into extra roles, carry out a range of other tasks to help support a government objective on low pay. There is also a legitimate question as to whether such work would fall to the nine-member panel of the LPC itself, or to the secretariat of a broader body in which this Minimum Wage Panel would sit. There are arguments on both sides. On the one hand, securing buy-in from social partners for action on low pay would give authority to the recommendations. On the other hand, this would substantially broaden the LPC's discussions and could risk overloading the body and could put at risk its fundamental role of setting the NMW in a consensual, evidence-based way. At a minimum the new body would need to be better resourced.

Summary and next steps

This chapter has put into practice the lessons learned from other bodies involved in economic policy. Rather than settling on any particular reform, it has set out a range of options for a broader, more assertive and more confident approach to the minimum wage and low pay.

Of course there are risks and rewards involved in any reform of the minimum wage. But it does seem that there are practical ways to strengthen the LPC while preserving many of the strengths of the current settlement. This discussion paper has talked through some of the options. The final report of the Resolution Foundation's review of the future of the National Minimum Wage and Low Pay Commission will be published in March 2014.

Annex 1 – Low Pay Commission Terms of Reference

The Purpose of the Low Pay Commission

The Low Pay Commission (LPC) is an advisory Non-Departmental Public Body, established under the National Minimum Act 1998. Its purpose is to provide independent advice to the Government on matters relating to the National Minimum Wage (NMW), referred to it by the Secretary of State for Business, Innovation and Skills (BIS).

The Aim of the Low Pay Commission

The aim of the LPC is to recommend levels for the minimum wage rates that help as many low-paid workers as possible without any significant adverse impact on employment or the economy. The advice the LPC offers the Government, in pursuit of this aim, will be based on the best available evidence.

The Commissioners

The LPC will consist of a Chair and eight other Commissioners, who will be appointed by the Secretary of State for BIS. Commissioners will be appointed in accordance with the Code of Practice for Ministerial Appointments to Public Bodies issued by The Commissioner for Public Appointments.

The LPC will have a balance of Commissioners who have a knowledge, experience or interest in: trade unions or matters relating to workers; employers' associations or matters relating to employers generally; and independents, with other relevant knowledge or experience, for example academic experts in labour markets.

The Operation of the Low Pay Commission

The LPC will publish a Business Plan each year. The Business Plan will include details of its remit, key milestones, research programme, and resources allocated to fulfil its function. The Business Plan will be published on the LPC website.

The LPC will be advised of issues it is required to consider by way of a remit from the Government (usually annually). The LPC will discharge the remit by way of a report, which will be submitted to the Government within the prescribed timetable.

In considering the issues in the remit, the LPC will undertake a detailed analysis of the evidence before making any recommendations, and it will take an open and consultative approach to its work. The information that informs the LPC's considerations will be gathered through wide-ranging research and consultations, including visits, discussions with businesses, workers, representative bodies, Government and academics. In reporting to the Government, the LPC will detail the procedures it adopted in respect of any consultation, taking evidence and receiving representations, along with the reasons for its recommendations.

The quorum for formal meetings of the LPC will be five Commissioners, including at least one independent, one employer and one employee Commissioner. If the Chair is absent for any formal meeting, one of the independents will chair proceedings. For visits and other meetings, the quorum will be as decided by the Chair.

Further details concerning the operation of the LPC can be found in the Code of Conduct. These Terms of Reference will be reviewed periodically.

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

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