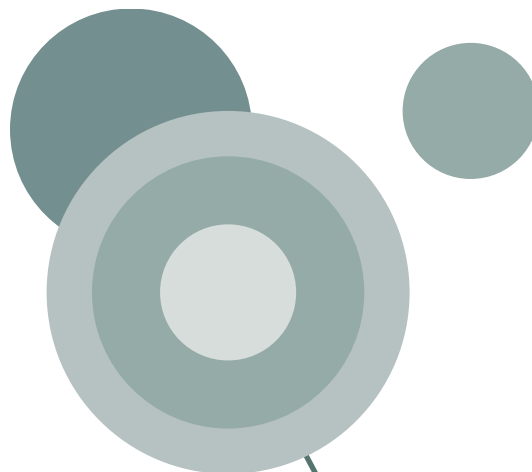


# BEYOND THE BOTTOM LINE

*The challenges and opportunities  
of a living wage*



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## CONTENTS

Executive summary .....	4
Introduction .....	8
SECTION 1: EXPLANATIONS AND DEFINITIONS .....	10
Chapter 1: What are living wages? .....	10
Chapter 2: How are living wages calculated? .....	14
SECTION 2: AN ECONOMIC ANALYSIS OF THE LIVING WAGE.....	19
Chapter 3: The UK low pay landscape.....	19
Chapter 4: The impact on employment and employer costs.....	27
Chapter 5: Who benefits from the living wage? .....	35
SECTION 3: IMPLICATIONS FOR POLICY.....	44
Chapter 6: Lessons and policy proposals .....	44
Conclusion .....	60
Reference .....	61
Appendix 1: Additional low pay data .....	66
Appendix 2: Calculating the impact of the living wage on firm-level wage bills.....	69
Appendix 3: Comparing data sources .....	75
Appendix 4: Costs for a range of local authorities .....	77

## Executive summary

Eleven years after it was revived by a broad-based community campaign in East London, the living wage is now an established fixture of our national policy debate. Representatives from across the political spectrum compete to associate themselves with the idea and few discussions about living standards are complete without the living wage being floated as a potential solution. And with good reason: at a time when powerful forces are bearing down on wages at the bottom end of the labour market, living wages are a rare example of countervailing pressure; a rallying cry against low pay that has harnessed the power of social norms to reframe perspectives and deliver tangible gains for thousands of low-paid workers.

Yet in some senses, living wages have generated more heat than light. Despite the campaign's resonance, and although the methodology behind the calculation is published each year, in practice there is limited knowledge of how living wages are calculated; little detailed understanding of the role that living wages might play in addressing endemic levels of low-paid work; only the most cursory analysis of the possible effect of living wages on incomes, employment, or employer costs; and almost no debate about how public policy might be used to extend coverage of living wage agreements. As the living wage campaign gathers momentum and the concept begins to attract serious scrutiny, the time is ripe for a far more rigorous and informed discussion.

This report begins that discussion and brings new evidence to bear on the likely economic and social impact of more extensive living wage coverage. It starts by clarifying what living wages (as of November 2012, set at £8.55 in London and £7.45 outside the capital compared with the current National Minimum Wage of £6.19) are and correcting some common misconceptions. A large part of the allure of the living wage – for activists, the public and politicians of all stripes – has been the power of its apparent simplicity: an hourly wage rate that guarantees a basic but acceptable standard of living. In fact, living wages cannot promise this. Family circumstances vary and no realistic hourly pay rate can ever lift every family to an adequate living standard. Importantly, both UK living wages are premised on the full take-up of tax credits and other in-work benefits; without state support, they would be *far* higher. So living wages do not precisely do what they say on the tin. Yet by explicitly focusing on living standards, they look beyond the minimum wage, which focuses on what the labour market can bear without a significant effect on employment. At their best, living wage campaigns are also about more than just pay. The living wage movement that originated in the United States (US) sought to involve low-paid workers in their own struggles for better pay, through new forms of community organising that can help to empower workers who otherwise lack representation in the workplace.

The attraction of the living wage is explained by a simple fact: far too many people in the UK earn far too little to get by. While low pay is a feature of all advanced economies, the UK has a particularly high share of low-paid workers, with one in five employees in low-paid work. After falling in the early 1970s, the rate of low pay has risen gradually for the past 30 years. It is most prevalent among women, part-time and younger workers. In some sectors it is endemic; in hospitality, 69 per cent of workers are low paid, in retail 41 per cent. Recent years have also seen gradually rising rates of in-work poverty, in part the result of a public policy focus on “work first” that converted a significant minority of poor workless households into poor working households reliant on one or more low-paid jobs. While the minimum wage continues to play a vital role in safeguarding around one million of these workers from extreme low pay, on its own it is not a solution to the wider problem of endemic low-paid work.

How much scope is there to extend living wage agreements and what are the likely effects on employment? Far more extensive living wage coverage could be achieved without risking jobs, with many large firms facing an impact on their wage bill as a result of introducing the living wage of less than one per cent. Evidence also makes clear that firms adapt to higher wage costs in a number of ways that are less damaging than disruptive changes to employment or hours. This is not to suggest that the living wage can be adopted by all. Modelling an extreme scenario in which the living wage is guaranteed to all private sector employees in the UK we find that while four million workers would see their pay rise, overall labour demand would fall by 160,000. The effects would be larger among younger workers and in certain sectors, particularly retail and hospitality. This is an extreme 'worst case scenario' (a similar model would have predicted job losses from the National Minimum Wage (NMW), which we now know did not happen) but it confirms that we should not legislate for a statutory living wage, an option which, in any case, few living wage activists advocate.

If more extensive living wage coverage is possible, who would benefit? Again modelling an extreme scenario in which the living wage is guaranteed to all UK employees we find that the workforce would see their gross earnings rise by £6.5 billion. These gains would not all flow down to the poorest working households. In fact, households around the middle of the income distribution would gain disproportionately from the living wage as lots of low earners live with others who are not necessarily low paid. But the biggest beneficiary of the living wage would be HM Treasury, which would see income tax receipts and national insurance contributions rise, while spending on tax credits and in-work benefits would fall. We estimate that the Treasury would achieve gross savings of around £3.6 billion if the living wage was universally applied. Spending on in-work benefits, particularly in the form of tax credits, grew significantly between 2003 and 2008 and it is unlikely that similar growth can be repeated in these fiscally straitened times. As such, the projected fiscal gains associated with living wages, alongside the material benefits that would flow to low earners, are an important part of what makes the living wage attractive.

Given all of the above, what is the role of public policy in supporting progress on the living wage? The living wage exemplifies the power of bottom-up processes of organising and campaigning in securing wage gains. This must remain at the heart of the living wage idea. However, there is a clear role for public policy in supporting civil society campaigns that provide economic and social value.

### **Encouraging living wage leadership within the public sector**

The living wage campaign will have failed to fulfil its potential if it does not make meaningful inroads into the private sector. Yet the public sector, as a direct employer of millions of workers, has a key role to in paying the living wage and as a beacon for change among private companies. While we recognise that affordability is a pressing concern and living wages will need to be considered alongside other spending priorities and budgetary challenges we recommend that:

- Whitehall departments pay all their directly-employed staff at least the living wage by April 2015
- London local authorities commit to paying all of their directly-employed staff the living wage by April 2015.
- Local authorities outside London, who face substantially larger costs, conduct feasibility studies into the costs and benefits of the living wage by April 2015 and publish the results.

### **Using the procurement power of national and local government to extend living wage coverage**

Public procurement can be an effective means of changing behaviour among private sector employers. Using the procurement power of national and local government to extend living wage coverage involves challenges. There is the need to take reasonable steps to comply with EU law and achieve value for money

but the most significant barrier is cost. However, steps can be taken to assess the costs and benefits of extending living wage agreements to sub-contracted workers and thereby shed light on whether progress is possible. We recommend that:

- All London-based central government departments review the costs of re-tendering contracted services on a living wage basis, publish the results and publish a timetable for implementation where affordable.
- All central government departments and agencies outside London embark on the same process within the next five years.
- Individual local authorities and other public sector employers, including NHS employers, continue to review the affordability of implementing the living wage in contracts when they are due to be re-let and publish the results.

### **Supporting the take-up of living wages among large private sector employers**

The UK needs to be very careful not to follow the US experience, where living wages are almost exclusively linked to public sector jobs and public sector procurement. The overwhelming majority of low-paid workers in the UK work in the private sector and large, profitable private employers should continue to be the focus of living wage initiatives. Public policy can aid the efforts of campaigners, by increasing transparency around low-paid work. We recommend that:

- Without exception, public sector employers are transparent about low pay, publishing the proportion and number of their staff paid below the living wage.
- The government amends the UK corporate governance code to require listed companies to publish the proportion and number of their staff paid below the living wage, and legislate for this if necessary.

### **Incentivising living wage coverage among small and medium-sized enterprises (SMEs)**

Many small and medium-sized firms are likely to struggle with the costs of implementing the living wage if a significant proportion of their staff are low paid. However, this should not mean that low-paid workers that happen to work in smaller firms should be permanently exempted from efforts to secure a living wage. If SMEs are to implement the living wage they may require additional support from government and organisations like the local chamber of commerce to do so. Given the potential tax and benefit savings to HM Treasury from increasing living wage coverage there are sound reasons to provide such support. We recommend that:

- The government explore using the architecture of City Deals to create 'living wage city deals', drawing forward future tax and benefit savings from paying local government workers the living wage and devolving this money to support private sector businesses in transitioning to the living wage.

### **Strengthening the living wage campaign**

The success of the living wage depends ultimately on the performance of the campaign itself. A key measure of the campaign's success in the coming years will be whether a major, low paying private sector employer signs up. Achieving this breakthrough will be a sizable challenge and involves some tough questions: as things stand, would such an employer feel able to tie their pay-setting decisions for their lowest-paid workers to the level of the living wage over time and, if not, what can be done to provide employers with

greater certainty and confidence in UK living wages? While the direction of the living wage campaign is ultimately a decision for campaigners themselves we recommend that:

- The campaign explores the case for bringing the calculation method underlying the London living wage into line with that underpinning the UK living wage or, alternatively, explores the benefits of calculating an additional London supplement to the national living wage rate for employees in the capital.
- The campaign continues to strengthen its institutions and governance through broader employer involvement and expert technical advice.
- The government funds an independent research unit, be based in a university or in Whitehall, to support further rigorous analysis of the costs and benefits of living wages.

## Introduction

In 2001 a dormant idea with deep historical roots<sup>1</sup> was revived in London's East End: the living wage. In that year a broad-based alliance of community organisations launched a campaign to ensure their low-paid members secured hourly wages sufficient to provide them and their families with a basic but acceptable standard of living. In doing so, they updated an idea that first emerged in the heartlands of Britain's second industrial revolution and that had been providing inspiration for campaigners in the US since the early 1990s.

In the years since, the idea of a living wage has gained increasing traction across the political spectrum. In 2010, Prime Minister David Cameron responded to mounting awareness by pronouncing the living wage an idea "whose time has come," and both of London's elected Mayors, Ken Livingstone and Boris Johnson, have been vocal advocates in the nation's capital. As leader of the Labour Party, Ed Miliband has started to flesh out a vision for making Britain a "fairer and more prosperous place" in which living wages are a prominent theme.

Living wage initiatives have delivered tangible gains. Local and regional initiatives continue to proliferate, building on a string of successes that have secured improvements in pay for nearly 45,000 low-paid workers.<sup>2</sup> In addition to the nine local authorities that have been formally accredited as living wage employers,<sup>3</sup> a growing number of private sector employers have introduced living wage agreements including KPMG, Deloitte, Linklaters and Lloyd's of London.<sup>4</sup> More widely, living wage initiatives have reshaped social norms around wages and in-work poverty and have refocused attention on the role that decent pay above the national minimum can play in raising living standards, alongside remedial redistribution through tax credits and in-work benefits.

Yet the excitement generated by a decade of success has belied the fact that relatively few workers have secured a higher wage as a result of a living wage campaign. In London, an estimated 570,000 workers were earning less than the London living wage in 2011, yet only 10,341 workers won a living wage in the six years between 2005 and 2011.<sup>5</sup> Despite recent progress, the number of accredited living wage employers – primarily high-profile financial and legal firms and public sector bodies – remains small. Aside from a handful of notable exceptions such as the cosmetics retailer, Lush, and eight London hotels under the management of Intercontinental Hotel Group (IHG), relatively few companies in sectors with a large proportion of low-paid workers have become living wage employers.

The limited and partial progress to date is to be expected. The revival of the living wage in the UK has been rooted in grassroots organising that by its nature delivers incremental and fragmented gains. For many, this method will not bring change at the pace desired and some have reacted by calling for the statutory imposition of living wages from above. Yet doing so would inevitably involve acute trade-offs. While pure voluntarism is likely to mean slow progress, excessive statism risks altering the essence of a campaign that

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<sup>1</sup> The first full-length treatise advocating a living wage was issued in 1894 by Mark Oldroyd, Liberal MP for Dewsbury, Yorkshire

<sup>2</sup> According to estimates produced by Professor Jane Wills of Queen Mary, University of London 14,367 workers in London have gained a wage increase as a result of a living wage initiative and 30,000 workers outside London, see <http://www.geog.qmul.ac.uk/livingwage/numbersandmoney.html>

<sup>3</sup> See chapter 2 for more details on the Living Wage Foundation's accreditation process

<sup>4</sup> For a full list of accredited living wage employers as of 5 November 2012 see <http://www.livingwage.org.uk/sites/default/files/Accredited%20Employers%209th%20Nov.pdf#overlay-context=employers>

<sup>5</sup> Professor Jane Wills, <http://www.geog.qmul.ac.uk/livingwage/numbersandmoney.html>. This figure relates only to workers in accredited living wage employers and may underestimate the numbers covered by living wage arrangements where employers have decided to pay a living wage but have not been accredited.

has been rooted in worker empowerment and civic mobilisation. This report is therefore premised on the need to navigate the tension between grassroots voluntarism and state legislation. It contributes to the debate in three main ways:

- By clarifying what living wages are, correcting some misconceptions and setting out in detail how the London and UK living wage rates are calculated.
- By presenting the first full economic analysis of the living wage in the UK, including:
  - modelling its potential impact on labour demand and considering the potential costs of living wages for employers;
  - analysing which workers and families benefit most from the living wage;
  - quantifying the fiscal savings to government of wider living wage coverage.
- By setting out the key lessons that emerge from this analysis and making recommendations for how campaigners, employers and the state can work together to ensure many more workers benefit from the living wage.

Living wage initiatives are not a panacea for Britain's endemic levels of low pay or the problem of faltering living standards. However, at a time when powerful forces are bearing down on wages at the bottom end of the labour market, they are a potentially important means of boosting wages for low earners who, more than ever, require pay to do more of the heavy lifting required to maintain living standards.

### **The structure of this report**

The report is in three sections. The first section **explains the concept** of a living wage:

- In chapter 1 we set out the conceptual underpinnings of living wages, and correct misconceptions about how they relate to other areas of policy.
- In chapter 2 we set out in detail how the London and UK living wage rates are calculated.

The second section of the report conducts the first **full economic analysis** of living wages in the UK:

- In chapter 3 we describe the incidence, composition and evolution of low-paid work in the UK.
- In chapter 4 we quantify the likely impact that broader coverage of the living wage would have on employment and on the costs faced by employers.
- In chapter 5 we analyse who benefits from the living wage, including the first detailed analysis of the fiscal savings that accrue to government.

The third section of the report draws out key lessons and sets out our **policy recommendations**:

- It starts by outlining six lessons for the living wage that should inform the work of both campaigners and policymakers.
- It then applies these lessons to practical policy areas, focusing on ways in which government could support a wider range of living wage initiatives.

## **SECTION 1: EXPLANATIONS AND DEFINITIONS**

### **Chapter 1: What are living wages?**

Living wages have risen to prominence rapidly in recent years and there remain a number of misconceptions about their role and the way they are defined. This chapter starts by bringing some clarity to this debate, defining what living wages are and what objectives they are designed to meet, as well as situating living wages alongside other tools to combat low pay and low incomes. First, we look at the relationship between living wages and minimum wages. We then turn to explore the relationship between living wages and in-work benefits. Finally, we set out the different approaches that have been taken to living wage campaigns in the US and UK, before going on in chapter 2 to detail the formulas that are used to calculate the London and UK living wage rates.

#### **1.1 Living wages are very different from minimum wages**

Living wages are clearly distinct from statutory minimum wages. While the process for determining minimum wages may involve a consideration of cost of living pressures faced by low-paid workers, this is secondary to a focus on prevailing labour market conditions. Minimum wages represent the highest wage floor that is thought to be consistent with avoiding significant job losses in the lowest paying firms or sectors, even if many firms in those sectors could afford to pay higher wages. These considerations have been intrinsic to the approach taken by the Low Pay Commission (LPC) in setting UK National Minimum Wage rates since 1999 (Howarth and Kenway 2004).

Living wages are fundamentally different. They focus on the wage rate that is necessary to provide workers and their families with a basic but acceptable standard of living. This minimum standard of living is socially defined (and therefore varies by place and time) and is often explicitly linked to other social goals such as the fulfilment of caring responsibilities. Living wage advocates typically emphasise the roles of workers beyond the workplace, for example, as parents and members of a community, and call for a wage rate that will ensure that workers do not have to work for excessive hours in order to achieve an adequate income. The potential impact on employment or the effect on employers is given little if any consideration.

These conceptual differences help to explain the different ways in which living wages and minimum wages are advanced. In the UK, living wages are voluntary and usually adopted by employers after a local campaign or process of negotiation. This allows employers who feel unable to bear the cost of introducing a living wage without shedding labour to decline to commit to paying one. Living wages therefore tend to be partial and fragmented in nature. Minimum wages by contrast are imposed universally (although most have exemptions) through legislation at the national or sub-national level.

#### **1.2 Living wages complement in-work benefits but cannot replace them**

Living wages are explicit in seeking to provide a decent standard of living through earnings rather than by means of cash transfers from the state. Living wage movements are thus inherently positive about paid work, stressing the importance of wages that are earned rather than benefits that are dispensed by the state. As a result they explicitly reject the inevitability of supplementing very low wages with state support, while also rejecting the alternative of worklessness.

A core tenet of living wage initiatives is that there is social value to incomes being sustained predominantly by wages rather than means-tested benefits and other state support. Many living wage supporters associate state benefits with 'dependence' whereas earnings are seen to signify 'independence' (Pollin 2008). This position is supported to some extent by empirical evidence showing that most people prefer earnings over benefits as their main source of income, and that low earners would prefer to increase their incomes by raising their earnings rather than through more generous cash transfers (Miller and Gardiner 2004). For example, Dean and Mitchell (2011) found that although workers in receipt of working tax credits (WTC) valued the additional income, the payments did nothing to reduce the sense of exploitation among low earners who felt overworked or undervalued. Some also object to tax credits on the grounds that they represent a state subsidy to low-paying employers, arguing that employers rather than the state should be primarily responsible for the living standards of their employees (Ryan 2004). Others, by contrast, see a more legitimate role for sustained state support for low-income working households (Macpherson 2004, Kenworthy 2011, Krugman 1998, Graf and Lange 1997).

In practice, the living wage calculations adopted in the UK recognise the role of state support by taking account of benefit income – without this, the two rates would need to be significantly higher (the calculation process is discussed in more detail later in the next chapter). If means-tested benefits were excluded from the calculation method for the London Living Wage, for example, the rate announced in November 2012 would rise from £8.55 an hour to £10.70 an hour. As a result, some analysts have concluded that living wages as practiced in the UK offer a similar approach to the 'making work pay' strategy adopted by the previous Labour government, with its combination of a statutory minimum wage and generous in-work transfers (Grover 2008). In this sense, living wages simply tip the balance of responsibility for basic living standards further away from state support and towards wages without offering a fundamentally different strategy for addressing low pay and in-work poverty (Bennett and Lister 2006). This is not least because the hourly wage required for a household to achieve a minimum acceptable standard of living depends heavily on the number of adults in work and the number of adults and children in a given household. Living wages are therefore not an *alternative* to tax credits and other in-work support.

### **1.3 Living wage campaigns differ widely but at their best they are about more than pay**

Beyond their ability to lift wages and living standards, living wage initiatives have the potential to empower low-paid workers, many of whom lack voice and power in the workplace and in wider society. Many living wage initiatives, both in the US and UK, have sought to mobilise low earners directly rather than campaigning on their behalf, by organising workers and communities through a process described as 'community organising' or 'community unionism' (Fine 2005). Activists learn organising and negotiating skills and forge relationships with others in similar positions and with powerful allies, which enables them both to consolidate the gains of a successful living wage campaign and go on to fight for further gains. Because they focus on a narrowly defined and achievable goal, Pollin (2008) argues that living wage campaigns seek to enable low earners both to protest against their labour market position and achieve a concrete solution for themselves.

Living wage initiatives grounded in forms of community organising seek to increase the bargaining power of workers who lack access to more traditional forms of representation such as through trade union structures. In both the US and UK, organising for a living wage in this manner is usually based on a mix of geographic areas and workplaces rather than purely on workplaces or occupations as in traditional union organising. This is a response to changes in employment practices, such as increased outsourcing of services, that make

traditional forms of organising difficult, as well as the fact that unions have always struggled to penetrate certain parts of the low-paid labour market (Fine 2005, Wills 2008). This is not to say that living wage campaigns and trade unions are antithetical. Living wage campaigns in the US and the UK have typically been based on alliances that include trade unions alongside religious and community organisations in a particular locality (Nissen 2000).

### **Box 1: Living wage campaigns in the UK and the US**

In the US, the first living wage ordinance was enacted in 1994 after a campaign by the Solidarity Sponsoring Committee, an alliance of the community organisation BUILD (Baltimore United in Leadership Development) and the public sector union AFSCME (the American Federation of State, County and Municipal Employees). The campaign relied on local residents talking to neighbours and friends to build up a body of supporters capable of filling town hall meetings and participating in living wage 'actions' (Reynolds 2004). Convincing local politicians that passing a living ordinance would secure large numbers of votes, and that the SSC could get voters to turn out, was crucial. These efforts were concentrated in low-income, predominantly Black, neighbourhoods, where unions had rarely had a presence and most of the city's low-paid workers were concentrated.

In the UK, calls for a living wage re-emerged in the early 2000s in East London. The campaign was led by a coalition of unions and faith and community organisations under the umbrella of the East London Community Organisation (TELCO). The campaign initially focused on low-paid workers like porters and cleaners contracted to work in NHS hospitals, with significant support from the major public sector union Unison (Wills and Linneker 2012). TELCO also targeted high-profile employers in the City of London and Canary Wharf, where there was little union presence, although the campaign was strongly supported by the then T&G union (now part of Unite). TELCO led public demonstrations involving low-paid cleaners and other sub-contracted staff, designed to embarrass high-profile employers into meeting with campaigners (Wills 2008). Barclays was the first bank to become a London living wage employer, quickly followed by most of the major legal and financial companies in Canary Wharf and the City. TELCO, and its parent organisation London Citizens, has also been successful in gaining the support of successive mayors of London, a vital platform for the campaign.

In Baltimore, the Solidarity Sponsorship Committee was also instrumental in enforcing the living wage ordinance, using their power to force the city to act when it became clear that a local transport contractor was systematically violating the ordinance (Reynolds 2004). The Committee also went on to enforce agreed increases in the living wage and to secure other gains for low-paid workers, including the right to retain their job if their employer lost a city contract and stronger rights to organise in public sector workplaces (Fine 2005). In Canary Wharf, the T&G union used the successful living wage campaign as the basis for new approaches to organising contract cleaners, while London Citizens uses the networks it develops through living wage campaigns to mobilise support for campaigns that go beyond the workplace (Wills 2008).

However, despite the rhetoric of many living wage campaigners, the practice of living wage campaigns in both the UK and the US has been highly variable. Nissen (2000) argues that low-paid workers have not played a major role in most of the US living wage campaigns that emerged after the Baltimore campaign. In some cities, living wage ordinances have been passed by politicians without a local campaign; elsewhere,

coalitions of local unions and charities have successfully lobbied for living wage ordinances without engaging significantly with low earners or mobilising mass support (Nissen 2004). Living wage campaigns in the US have also struggled to make inroads into the private sector, to organise low-paid workers into unions or to negotiate directly with employers (Fine 2005). Many have therefore fallen back onto making the case for living wages in so far as they are linked to public funds, whether through sub-contracting, tax breaks or development subsidies (Nissen 2000). Many US living wage campaigns have had little impact in firms and sectors that have no direct commercial relationship with public sector organisations.

The London living wage campaign stands apart from US campaigns given its private sector successes in the City and Canary Wharf. Rather than campaigning for a public policy outcome, London Citizens played on the reputational risk for prestigious companies paying very low wages to sub-contracted support staff while offering generous remuneration packages to their own employees. This continues to be a key factor, for example, in Intercontinental Hotels Group's (IHG) decision to pay the living wage to staff in their London hotels, which was clearly linked to their status as the preferred hotel chain for the first living wage Olympic Games. Other UK living wage initiatives have taken a different route, often based on local authorities agreeing to pay the living wage after private negotiations or because the living wage has been adopted by the local political leadership. The living wage campaign in Scotland achieved success in the NHS and local government through national lobbying from public sector unions rather than taking a community organising approach. This was explicitly done because campaigners knew they lacked the ability to mobilise mass support.

## Chapter 2: How are living wages calculated?

We have seen that the concept of a living wage is disarmingly simple: it is a wage that ensures a socially acceptable minimum standard of living. Yet turning this simple concept into a single hourly rate is complex. This chapter details this process for the UK and London living wage rates. Ultimately, the process of setting a living wage is subjective, involving value judgements about what constitutes a socially acceptable standard of living as well as compromises to ensure that, in practice, living wages are accepted as proportionate.

In the UK there are two widely recognised living wage rates: a London living wage (from 5 November 2012 set at **£8.55** per hour) and a UK living wage rate for every other region outside the capital (from 5 November 2012 set at **£7.45** per hour). Table 1 provides details of each rate since the year of their creation and places these alongside the main NMW rate for that year. In addition, the Living Wage Foundation runs a scheme to accredit employers as a ‘Living Wage Employer’ (see box 2).

**Table 1: National Minimum Wage and living wage rates since 2005**

	National Minimum Wage	London Living Wage	UK Living Wage
2005	£5.05	£6.70	
2006	£5.35	£7.05	
2007	£5.52	£7.20	
2008	£5.73	£7.45	
2009	£5.80	£7.60	
2010	£5.93	£7.85	
2011	£6.08	£8.30	£7.20
2012	£6.19	£8.55	£7.45

### Box 2: How do you become a ‘Living Wage Employer’?

The Living Wage Foundation offers accreditation for employers who commit to paying all staff the appropriate living wages rates, as set by the Greater London Authority (GLA) and researchers at Loughborough University (see below for details). To receive accreditation, employers must agree to pay all their directly-employed staff at least the living wage (applies to staff aged 18 and above). Pay rates must be increased within six months of a new rate being announced. Employers must also ensure that outsourced staff are treated on the same basis as directly-employed staff, to the extent permitted by law. This applies to outsourced staff who work for two or more hours a week in any given day in a week, for eight or more consecutive weeks in a year, on the organisation’s premises or property and land owned or occupied by the organisation. Each organisation agrees a timetable for implementing the living wage in particular contracts, where permitted by law.

The Living Wage Foundation was established by Citizens UK and is funded by a group of charitable trusts, commercial partners and charities. It is overseen by an advisory council, whose members include business leaders, academics and policy advisers, who provide strategic guidance on the

direction and strategy of the movement. A separate policy group provides expert policy advice and oversight of the methodology used to calculate the rates.

The London living wage has been calculated by the GLA living wage unit since 2005. The UK living wage is a far more recent creation, having only been calculated by academics at the Centre for Research in Social Policy (CRSP), Loughborough University, since 2011. These are the two rates that the Living Wage Foundation uses for its accreditation purposes. Prior to the calculation of the UK living wage rate, a variety of non-London living wage rates existed in different localities. The Living Wage Foundation adopted a single non-London rate in part to avoid the problems that emerged in the US, where multiple rates and methodologies proliferated, causing uncertainty among employers and weakening the clarity of the living wage movement's message (Hirsch and Moore 2011). Researchers at CRSP also argued that the average cost of living does not vary significantly outside London so a single rate would be appropriate.

At the core of both living wage rates is an estimate of the costs of a socially acceptable minimum standard of living for a range of household types, although these costs are calculated in different ways for each rate. The London living wage rate is based on a 'basic living costs' approach which seeks to estimate a 'low cost but acceptable' (LCA) budget for 14 different household types in the capital. This LCA budget is made up of housing, council tax, transport, childcare and all other costs in 'a regular shopping basket'.<sup>6</sup> An average wage is then calculated that would meet the costs of this budget for different family types, with the average weighted to reflect the composition of families in London. For 2012 the GLA living wage unit estimated the wage needed to meet their LCA budget to be £7.10 per hour. The GLA then calculates the wage that would be required<sup>7</sup> to lift a worker and their family above the capital's *relative* poverty threshold of 60 per cent of median household income. This produced a wage rate of £7.80 in 2012 (GLA Economics 2012). An average is then taken of the 'basic living costs' wage and the 'income distribution' wage to calculate a 'poverty threshold wage' (£7.45 in 2012). A 15 per cent margin is then added to account for any unforeseen events that would otherwise take a family below the minimum standard of living. This took the 2012 rate to £8.55 per hour.

The UK living wage is calculated using a similar approach to the LCA budget calculation, but draws instead on the Minimum Income Standards (MIS) project based at the University of Loughborough and supported by the Joseph Rowntree Foundation. The MIS uses focus groups to agree a minimum acceptable family budget for nine different household types. It therefore reflects prevailing social norms rather than expert opinion (Hirsch 2011).

Crucially, both rates are premised on the *full take-up* of tax credits and other in-work benefits. Both are therefore extremely sensitive to changes in benefit and tax credit policy. If benefits or tax credits are cut, the living wage goes up. In 2011 the London living wage rose by 5.7 per cent compared to an increase of 2.5 per cent in the minimum wage, in part because the value of some tax credits and in-

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<sup>6</sup> The LCA budget includes housing, council tax, transport and childcare (costs are based on specific data for London) and all other costs in 'a regular shopping basket' (estimated using a comparison of regional price differences produced by the Office for National Statistics)

<sup>7</sup> Appropriately weighted for a series of household types

work benefits went down (GLA Economics 2011). Without the addition of benefits, both living wage rates would need to be *far* higher to deliver a minimum standard of living.

The two living wage rates differ in terms of how the rate is permitted to change from year to year. The annual increase in the UK living wage rate is limited to a maximum of two percentage points above the higher of either of the following: the rise in average income or median earnings (Hirsch and Moore 2011). For 2012 – the first year that the UK living wage rate has been uprated – both mechanisms for limiting the annual increase were applied<sup>8</sup> to produce a rate of £7.45 per hour. The limit that applies to annual increases in the UK living wage are designed to increase certainty for employers, with the trade-off that in some years the living wage will not keep pace with rising living costs. The difference between the true rate and the capped rate is stark: if the UK living wage rate had not been capped in 2012, it would have been £8.80 per hour, higher than the 2012 London living wage rate. There is no limit to the annual change in the London living wage rate.

A number of challenges arise from the way that both rates are calculated. First, differences in the calculation methods for the London and UK rates add complexity and reduce the reliability of the calculation formula for employers. Second, living wages inevitably interact with prices and aggregate wage trends in ways that are very different to the NMW that is formulated with employment impacts in mind. Perhaps most importantly, it means that living wage rates are intrinsically sensitive to fluctuations in prices.<sup>9</sup>

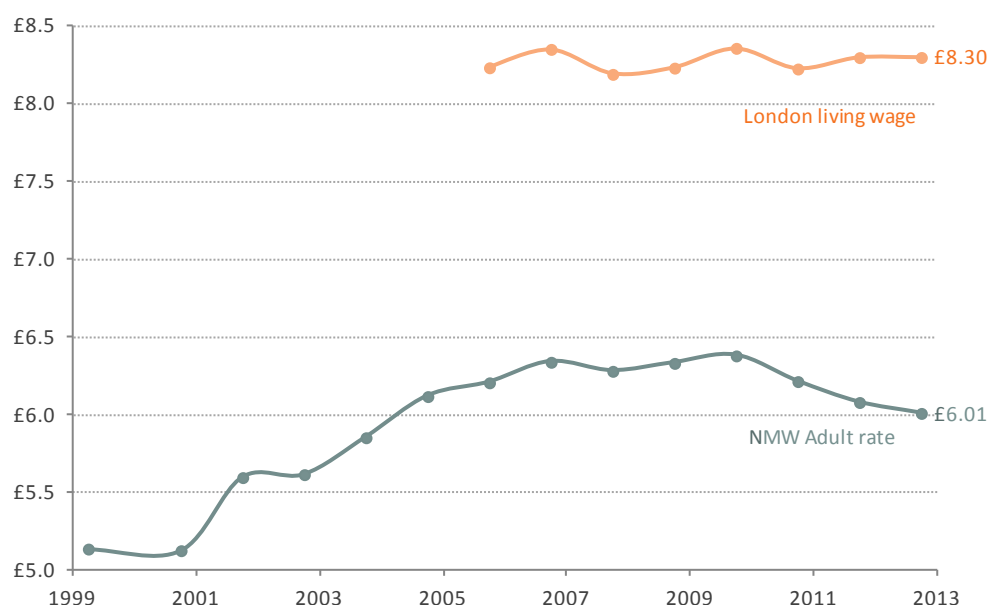
Figure 1 shows what this means for the London living wage rate over time when compared to the NMW. It shows in particular that the London living wage has increased relative to the NMW since the 2007 downturn. While the value of the NMW has fallen in real terms in each of the last three years the London living wage has maintained its value. Even with a limit on annual increases, the UK living wage increased in real terms by 5p in 2012.

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<sup>8</sup> The most appropriate limit takes precedence in this case average the divergence of the living wage calculation and average earnings increases (1.7 per cent) thereby limiting the rise in the 2011 rate of £7.20 rate to £7.20 + 3.7 per cent (rounded to nearest five). For a detailed explanation of the mechanism for limiting single-year increases see (Hirsch and Moore 2011).

<sup>9</sup> Just as they are to reductions in entitlement to means-tested benefits

**Figure 1: Real terms London living wage and NMW rates, 2005 – 2012**

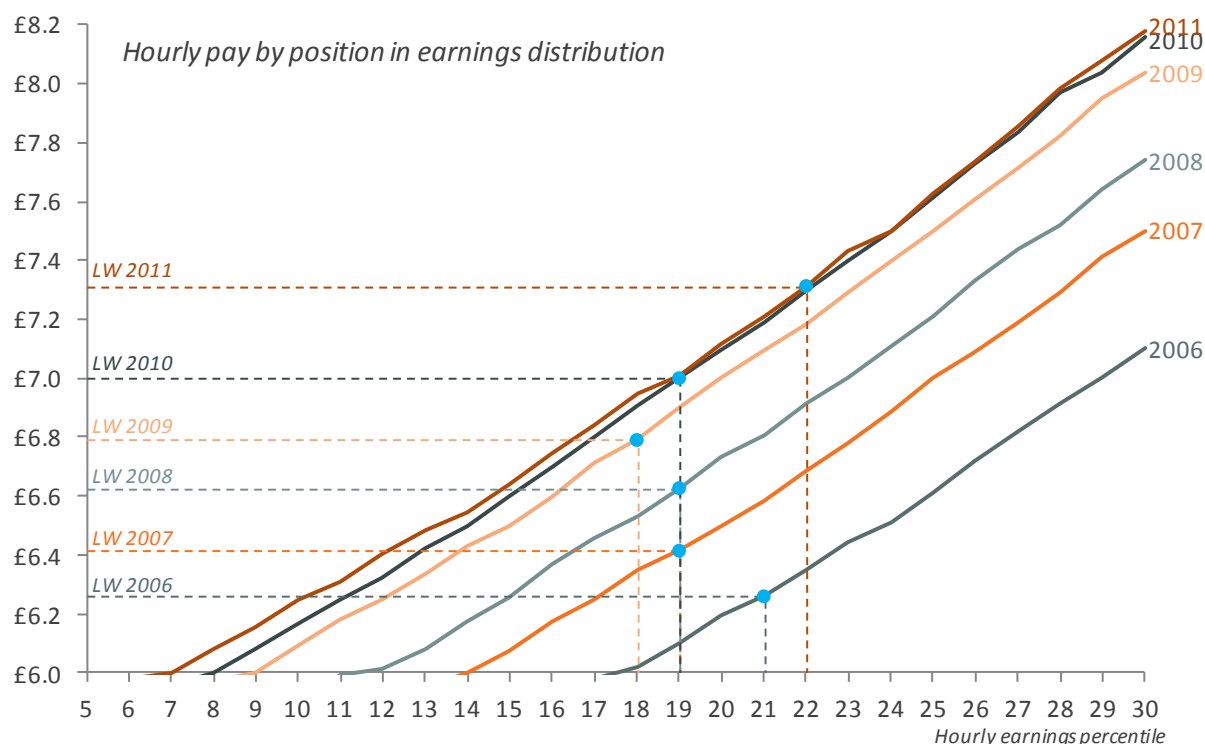


Note: 2011-12 prices, deflated by RPI

Source: Resolution Foundation estimates using data from the Low Pay Commission and GLA Economics Living Wage Unit

Figure 2 brings this point home by showing how fluctuations in the living wage determine the scope of potential living wage coverage over time. The lines show the distribution of UK hourly pay in the years from 2006 to 2011, plotting the hourly wage at different percentiles near the bottom of the distribution. The value of the living wage in each year is plotted in dotted lines, showing the proportion of workers that were below this rate. As can be seen, from around 2007, the living wage rose roughly in line with earnings, with the result that this proportion did not increase. However, in 2011, which saw above-inflation rises in living wage rates and little or no rise in aggregate wages, considerably more workers were brought within the potential remit of living wage initiatives. This explains why, as will be seen in the following chapter, the number of people earning less than the living wage increased from 3.5 million in 2010 to 4.7 million in 2011. This kind of volatility is inherent to the concept of the living wage.

**Figure 2: The interaction of annual living wage rate increases with aggregate wages**



Note: Living wage rate derived from a weighted average of the London and UK living wage rates. Hourly earnings in nominal terms

Source: Resolution Foundation estimates using ASHE

Reflecting this volatility, some employers (for example, Newcastle City Council) have agreed to pay staff at least the living wage but have decided not to pursue accreditation in order to retain flexibility over future pay rates. Employers operating within national pay structures agreed through collective bargaining processes may face a particular challenge in this respect. For example, when the London living wage rose to £8.30 an hour in 2011, it significantly outstripped the lowest hourly pay rate agreed in the construction industry (then £7.87) for the first time (Local Government and Regeneration Committee 2012). This is a particular challenge for public sector employers, where national collective bargaining remains the dominant form of pay-setting.

## **SECTION 2: AN ECONOMIC ANALYSIS OF THE LIVING WAGE**

### **Chapter 3: The UK low pay landscape**

Chapters 1 and 2 have cleared up some misconceptions about living wages and detailed how the London and UK living wage rates are calculated. This section of the report now sets out a full economic analysis of living wages in the UK. This chapter begins by profiling the incidence and spread of low-paid work in the UK, comparing the UK to other countries and describing which groups are most at risk of low pay. It makes clear that the strong appeal of the living wage has a simple explanation: there are far too many people in the UK today whose pay does not provide for a basic but acceptable standard of living.

#### **3.1 Low pay in the UK**

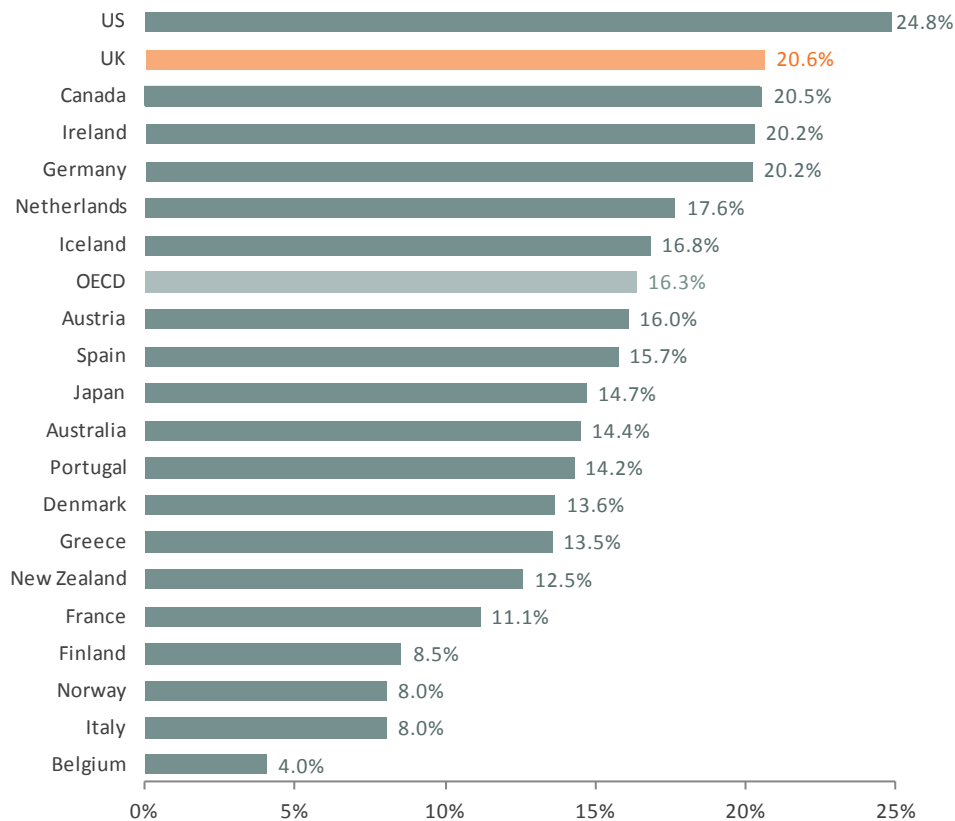
When comparing different countries and analysing trends in the UK over time, it is necessary to use a standard benchmark for low pay. In this chapter, we use a definition of pay below two thirds of the median wage, which is the standard measure used by the Organisation for Economic Cooperation and Development (OECD). Because this measure of low pay is a purely relative concept, while living wages rely on a more complex concept of the standard of living, living wages rates can vary considerably from year to year compared to movements in low pay thresholds.<sup>10</sup>

Low pay is a feature of labour markets in all advanced economies, but the UK stands out as having a particularly high proportion of low-paid workers. As figure 4 shows, in 2011 just over one in five British employees (21 per cent, or just over five million individuals) were in low-paid work with just under one in five (20 per cent or just under five million individuals) paid less than the geographically appropriate living wage. The UK has an incidence of low pay a full four percentage points higher than the OECD average, with UK employees five times more likely to be low-paid than their counterparts in better performing countries such as Denmark, where just over 13 per cent of workers earn below the low pay threshold.

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<sup>10</sup> The standard definition of low pay is hourly wages below two-thirds gross median hourly pay for all employees. We calculate the 2011 low-pay threshold as £7.49, equivalent to gross earnings of £13,600 a year for a 35-hour working week

**Figure 3: Share of full-time employees in low-paid work across advanced economies, selected OECD countries 2009**



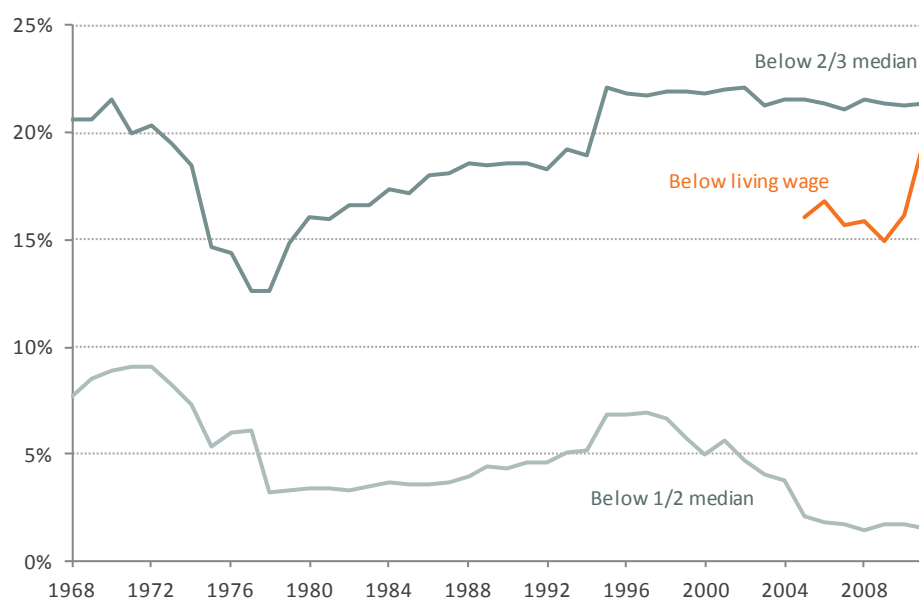
Note: Low pay is defined by the OECD as earning less than two-thirds of the national gross median hourly full-time wage.

Source: OECD stat.extract; data for France and Netherlands refer to 2005, taken from Mason and Salverda (2010).

While the UK's large share of low-paid work is not exceptional (the US and, more recently, Germany have broadly comparable shares), low-paid work in the UK is associated with a number of negative attributes not shared by other advanced economies. These include higher pay penalties for part-time work (Manning and Petrongolo 2004); a greater risk that women will find themselves in low-paid employment; and a higher risk of low-paid work in certain low-skilled occupations such as personal services (Mayhew and Salverda 2009).

The UK has not always had such a high incidence of low-paid work. Figure 4 shows trends in low pay in the UK since 1968. The share of low-paid work declined rapidly in the early 1970s, probably as a result of the Equal Pay Act of 1970 and the incomes policy of the 1974–77 Labour government, both of which had positive effects on the earnings of the lowest-paid workers (predominantly women) relative to the median (Coats 2012, Taylor 2004). This decline was then reversed from the late 1970s onwards, as levels of low pay gradually increased (including a brief period of sharp growth in 1994 and 1995, most likely the result of the abolishment of the remaining wages councils in 1993). These trends run hand-in-hand with trends in poverty. In-work poverty in particular has risen since the mid-1990s, in part as the result of “work first” active labour market policies that have turned many poor workless households into poor working households reliant on one or more low-paid jobs.

**Figure 4: Proportion of all employees below standard low pay threshold, GB, 1968 – 2011**



Notes: Figures are drawn from three separate data sources. Where these sources overlap, differences exist in the proportions of employees reported to be below the various low pay thresholds. Figures prior to 1997 have been adjusted to account for the magnitude of difference recorded in these overlapping periods, in order to create a consistent time series. The original, unadjusted, data is presented in appendix 1. The living wage has been calculated in London from 2005, but an outside London rate has only been in place from 2011. To allow for the estimates shown above, we project the outside-London living wage backwards, on the assumption that it has been subject to the same year-on-year growth rates as the London figure.

Sources: Authors' analysis of Family Expenditure Survey (1968-1981); New Earnings Survey Panel Data (1975-2010); and Annual Survey of Hours and Earnings (1997-2011)

Figure 4 also shows the proportion of the workforce paid below the living wage. While low pay has remained steady since the late 1990s, the proportion of people paid below the living wage has varied significantly. While 4.7 million workers were paid below the living wage in 2011, 3.5 million workers were paid below the living wage in 2010.

Until the introduction of the NMW in 1999, the British labour market was lacking in low pay protection to a degree not seen since the Second World War. Despite falling in real terms (adjusting for inflation) for three consecutive years,<sup>11</sup> the minimum wage continues to safeguard around one million workers (4.4 per cent of all employees)<sup>12</sup> from extreme low pay, ensuring that these workers are less badly paid than their counterparts in other countries such as Germany and the US.<sup>13</sup> Figure 4 makes clear the impact of the NMW on extreme low pay in terms of sharply reducing the number of employees in the UK paid below half of the median wage.

<sup>11</sup> On 1 October 2012, the NMW rose in cash terms by 11 pence from £6.08 to £6.19 per hour. However, the NMW is now at its lowest real terms level since 2003

<sup>12</sup> The Low Pay Commission (LPC) defines a minimum wage job to be one that, in April 2011, paid at or below the relevant NMW rate. They also include those paid up to five pence above the minimum wage.

<sup>13</sup> The United States has a federal minimum wage but it has fallen progressively over the last three decades. Starting in the late 1980s, as the real value of the US minimum wage fell far below its historical levels, many states began to set state-specific wage floors above the federal rate. In 2011, 17 states had state-level minimum wages above the federal minimum. The highest of these, however, were still about 20 per cent below the low pay threshold

However, the NMW was never intended to reduce the overall incidence of low-paid work in the UK. Instead, the NMW was introduced to tackle the most serious cases of exploitation in the labour market and to improve work incentives for low earners without significantly raising unemployment (Gregg 2000). This is why it has consistently been set at levels far below the low-pay threshold.<sup>14</sup> As a result, while the NMW has dramatically improved outcomes for some of Britain's lowest paid workers it does not offer an escape route from low pay or, depending on household circumstances, in-work poverty.

### **3.2 What are the characteristics of low-paid workers?**

In 2011, 4.7 million UK employees were paid less than the living wage. They were predominantly female, part-time, in permanent employment and working in the private sector (Pennycook and Whitaker 2012). Estimates<sup>15</sup> indicate that:

- around three million women are paid below the living wage (62 per cent of all employees paid below the living wage);
- women are at greater risk of low-paid work with 25 per cent of all female employees paid below the living wage compared to just 15 per cent of all male employees;
- a total of 2.7 million part-time workers are paid below the living wage (41 per cent of all part-time employees) compared just under two million full-time workers (11 per cent of all full-time employees);
- workers on temporary or casual contracts are more at risk of being paid less than the living wage (34 per cent of all temp/casual workers are paid less than the living wage compared to 19 per cent of those with permanent contracts);
- the vast majority of employees paid below the living wage have a permanent contract (86 per cent);
- almost four million workers paid less than the living wage work in the private sector, (86 per cent of all low-paid workers).

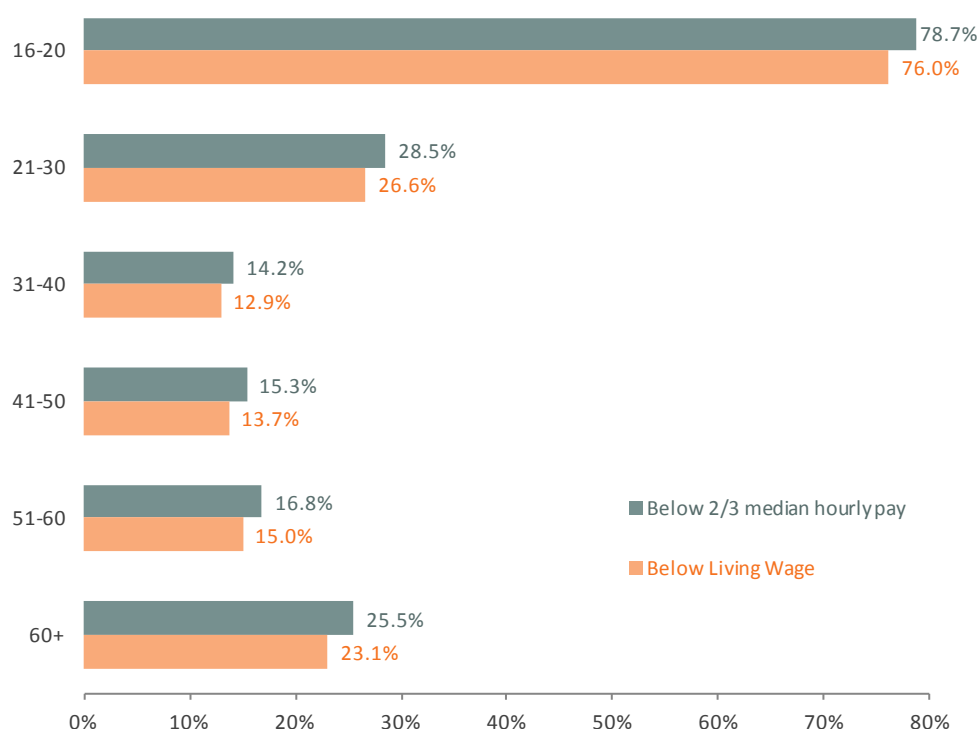
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<sup>14</sup> Defined as hourly wages below two-thirds gross median hourly pay for all employees

<sup>15</sup> Resolution Foundation analysis of hourly pay data across full-time and part-time employees from the Annual Survey of Hours and Earnings (ASHE)

As Figure 5 makes clear, younger workers face a severe risk of low pay with 76 per cent of under-20s paid below the living wage. The extreme prevalence of low pay among this group is partly explained by the traditional trajectory of earnings over the life course but this established pattern has almost certainly been exacerbated by the explosion in student employment over the last two decades.<sup>16</sup> However, for a significant minority of employees, low pay persists over the life course. For example, 13 per cent of those aged between 31 and 40 (a time when many could expect to reach their peak earnings) are paid below the living wage. This persistence of low pay among a significant minority of workers in all age groups highlights that the opportunities for progression from low-paid work in the UK are often quite poor (Sissons and Wright 2012).

**Figure 5: Prevalence of low pay by age, GB, 2011**



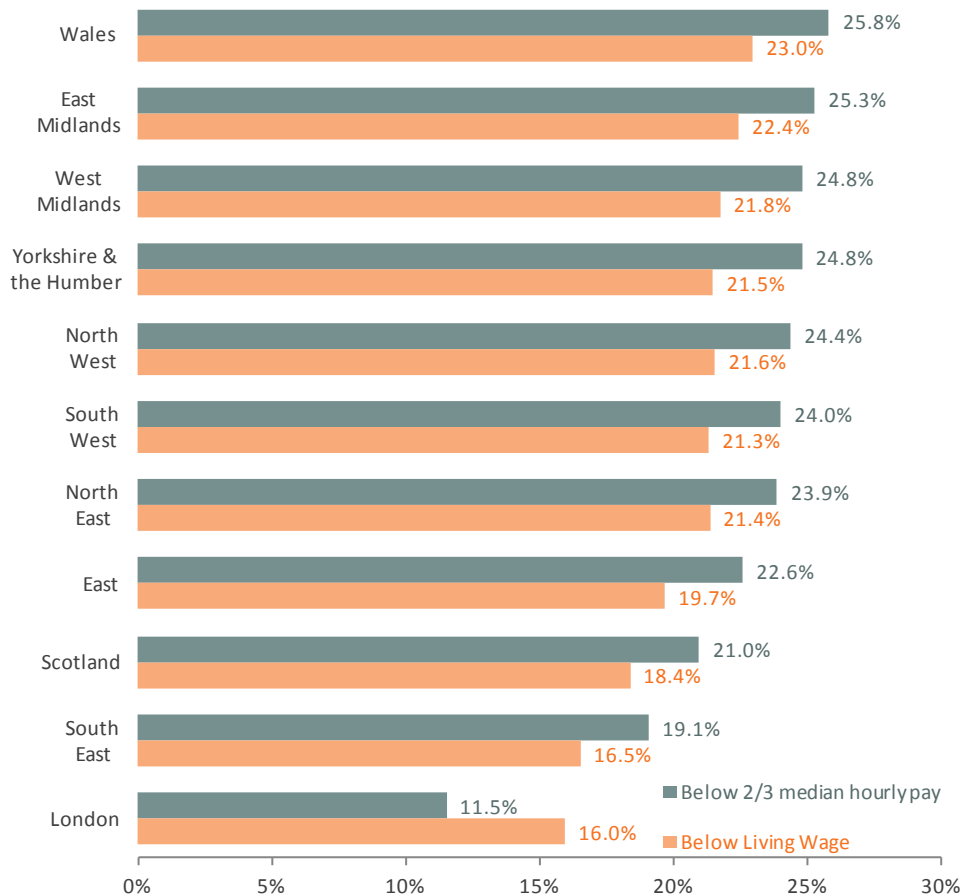
Notes: See notes to appendix 1

Source: Authors' analysis of ONS, *Annual Survey of Hours and Earnings*

Figure 6 highlights that workers paid less than the living wage can be found in every region of the UK. Approximately one-quarter of employees in most regions are paid less than the living wage, with the distribution of below living wage employment not varying extensively on the basis of geography. Wales has the highest share of workers paid less than the living wage (23 per cent of employees) and the South East region has the lowest share (17 per cent of all employees). Interestingly, London stands out as having more employees earning below the living wage (16 per cent) than below the more traditional low pay threshold (12 per cent) reflecting the fact that the London living wage is derived using a calculation method based, in part, on an estimate of basic needs that are higher in the capital than other regions.

<sup>16</sup> The period 1996 to 2006 witnessed a 54 per cent increase in the numbers of student workers. Students are overwhelmingly employed in low-wage sectors, with more than 40 per cent of full-time student employees in the wholesale, retail and motor trade sector, and just over 20 per cent in the hotels and restaurants sector

**Figure 6: Prevalence of low pay by region, GB, 2011**



Notes: See notes to appendix 1

Source: Authors' analysis of ONS, *Annual Survey of Hours and Earnings*

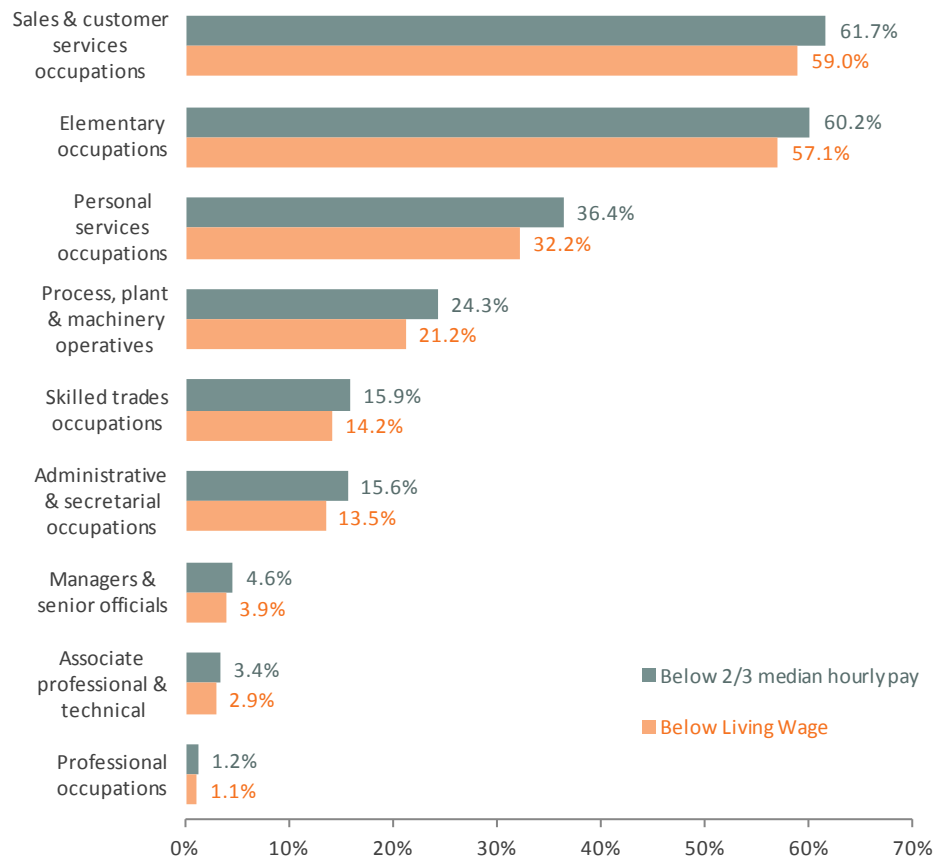
The prevalence of work paid at below living wage hourly rates is heavily concentrated by occupation, as shown in figure 7. Thus, while low-paid work can be found in every occupation, it is more prevalent in certain occupational groups including sales and customer services<sup>17</sup> where just over a million workers were paid less than the living wage in 2011 (59 per cent of all employees in that occupational group). Close to 1.7 million people in elementary occupations<sup>18</sup> were paid less than the living wage (57 per cent of all employees in that occupational group), while 0.7 million workers in personal services<sup>19</sup> received less than the living wage (32 per cent of all employees in that occupational group).

<sup>17</sup> Includes roles such as retail assistants, cashiers, telephone salespersons, and customer service

<sup>18</sup> Includes roles such as cleaners, security guards, catering assistants, leisure workers and restaurant/bar staff

<sup>19</sup> Includes roles such as social care and childcare

**Figure 7: Prevalence of low pay by occupation, GB, 2011**

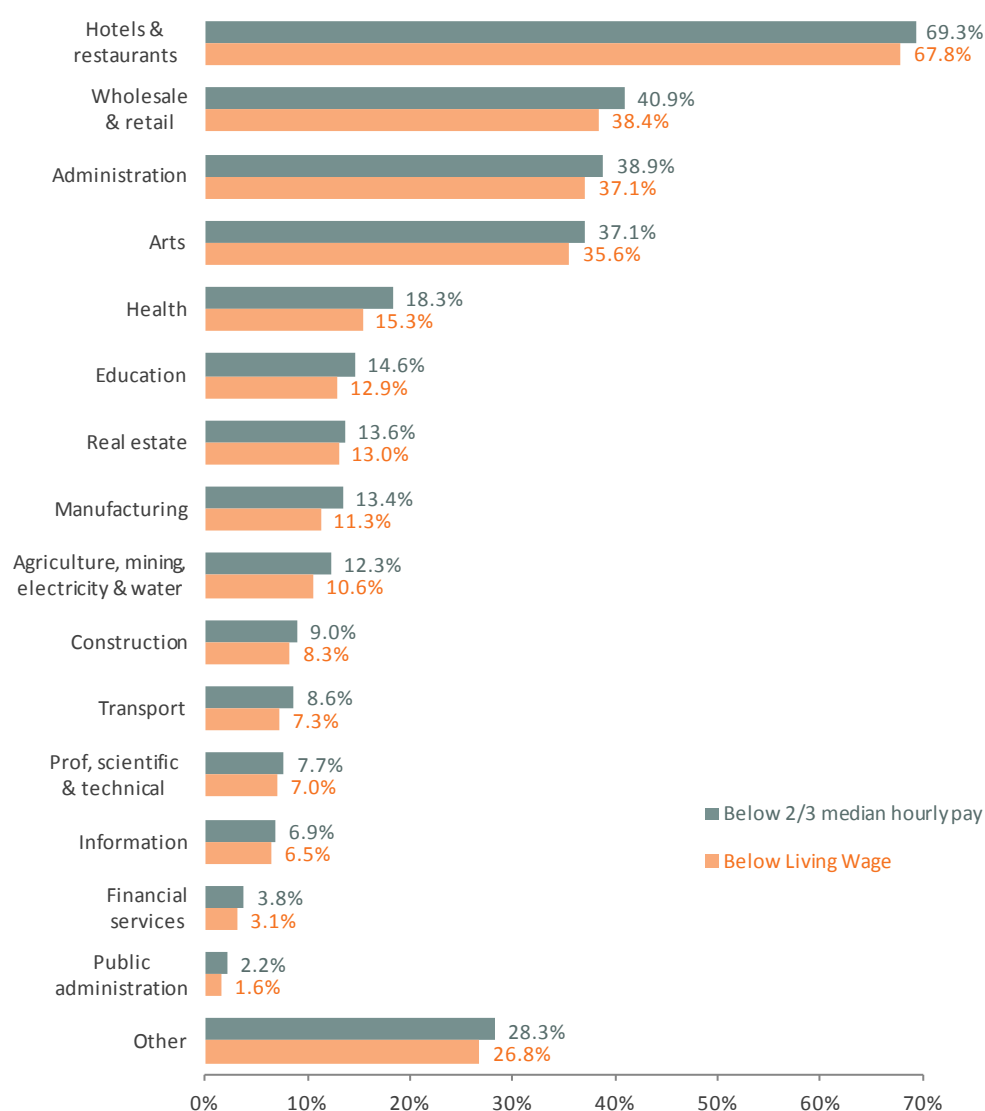


Notes: See notes to appendix 1. Occupations based on SOC 2000 categories.

Source: Authors' analysis of ONS, *Annual Survey of Hours and Earnings*

Figure 8 makes clear that the prevalence of work paid at below living wage hourly rates is also heavily concentrated by industrial sector. Thus, while low-paid work is also found in every industrial sector, it is concentrated in certain sectors such as wholesale and retail where 38 per cent of all workers are paid less than the living wage (just over 1.3 million workers). In the hotels and restaurants sector two in every three employees were paid less than the living wage in 2011 (68 per cent of all workers, just under one million workers).

**Figure 8: Prevalence of low pay by industry, GB, 2011**



Notes: See notes to appendix 1. Industries based on SIC 2007 categories.

Source: Authors' analysis of ONS, *Annual Survey of Hours and Earnings*

## Chapter 4: The impact on employment and employer costs

We now turn to the question of the relationship between the living wage, employment and employer costs. We first consider the impact on employer demand for labour, using new economic modelling. We also examine the possible impact of living wages on employment, drawing on a range of empirical studies from the UK and US. We then consider the potential impact of the living wage on the wage bills of firms. We finish by discussing briefly the evidence on how employers have responded to higher wages in practice, drawing on evidence from the introduction of the NMW.

### 4.1 The impact of living wages on employment

While there is not yet sufficient data to examine directly the impact of UK living wages on employment, two approaches can provide a general sense of the scale of their effect. First, we present the results of modelling of an extreme scenario in which all private sector employees<sup>20</sup> in the UK receive at least the living wage, in effect, raising the NMW to the living wage. Although this is an extreme scenario that few living wage campaigners advocate, it gives a sense of an upper bound of the impact on labour demand of broader living wage coverage. Second, we draw insights from the US experience, where mandatory living wage floors have been instituted in some cities and states. This gives us a basis on which to draw some illustrative conclusions.

There is a rich debate about the impact of higher wages on employment. This has long moved on from a simple classical approach in which any higher wage floor is assumed to cause unemployment, in part as the result of empirical evidence to the contrary based on studies of minimum wages. Even so, at some point, a higher wage floor would cause unemployment, whether by encouraging employers to substitute labour for other inputs, such as investment in productivity-enhancing capital, or by increasing prices, dampening demand for certain products, thereby reducing employment in certain sectors.

Using the Labour Force Survey (LFS) our calculations suggest that 4 million employees in the private sector would see their earnings rise if all employers paid at least the living wage. This has to be set against the estimated reduction in labour demand that might result (see box 3 for details). A relatively standard model of labour demand suggests that moving the hourly pay of every low-paid worker in the UK up to the living wage would reduce overall labour demand by around 160,000. Given the scale of the increase in wages at the bottom end of the labour market, this aggregate effect is perhaps surprisingly small – it is equivalent to less than four per cent of the more than four million employees in the private sector that would benefit from a pay rise.<sup>21</sup> Nonetheless, it represents an important note of caution to advocates of the widespread adoption of the living wage, particularly in the current climate.

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<sup>20</sup> Public sector employees are excluded because the dataset we use for this analysis does not include some key information about public sector organisations.

<sup>21</sup> Although it is important to bear in mind that this labour demand effect does not take into account changes in labour efficiency or changes in output as a result of a wholesale move to a living wage.

As well as reducing aggregate labour demand, the extreme scenario of an economy-wide living wage for the private sector would entail negative impacts on labour demand for certain sectors and groups of workers. The research suggests that the largest negative impact occurs in wholesale and retail, and in hotels and catering, where total labour demand across these two sectors falls by 2.6 per cent (Riley forthcoming). In the model, demand for young employees (aged 21 or under) with intermediate or no qualifications would fall across all industry sectors by a total of 300,000, with the largest reductions again seen in wholesale, retail, hotels, restaurants and social and personal services.

### **Box 3: How did we arrive at the results?**

We report the results of modelling commissioned from the National Institute for Economic and Social Research (NIESR) that estimates the impact of the extreme (and highly improbable) case of introducing an instant economy-wide living wage pay floor<sup>22</sup> on labour demand for low-skill, low-paid workers (Riley forthcoming). NIESR's modelling examines 11 different sectors of the economy and five classifications of employee (defined by age and highest educational qualification). The modelling uses detailed data on wage costs for selected industries, skill and age groups and time-series data to estimate the extent to which higher wages among particular groups reduced the extent to which employers were willing to hire members of those groups. This latter estimate, the "elasticity of demand for labour," is crucial to the modelling as it assumes, in common with other standard labour market models, that all things being equal, each one per cent rise in labour costs among a particular group causes employers to want to hire a given percentage fewer workers among that particular group.

The modelling in no way provides an estimate of the *actual* aggregate impact of more extensive living wage coverage as the voluntary nature of living wages in the UK means that coverage will remain partial and unevenly distributed. The analysis also only provides estimates of the impact of a wholesale move to the living wage pay floor on labour demand. This provides a valuable insight into the employment trade-offs associated with a move to a living wage economy but it is not a prediction of the direct employment effects of such a move.<sup>23</sup> The modelling does not account for possible endogenous changes such as any increases in labour efficiency or a change in the scale of production that might occur as a result of a move to a living wage pay floor and is therefore not, and was not intended to be, indicative of a general equilibrium change in employment.

This fall in demand for younger workers is larger than the total fall because the model assumes that employers would substitute older, higher-skilled workers for younger, low-skilled ones, since applying the living wage to all workers would raise the cost of younger workers relative to older workers. The analysis suggests that demand for employees aged over 30 and with intermediate skills would rise in most industries as a result of a move to a wholesale living wage economy (with mixed

<sup>22</sup> NIESR's analysis is based on 2011 living wage rates of £8.30 in London and £7.20 for the rest of the UK

<sup>23</sup> The labour demand effects calculated in the paper are conditional on both the scale of output, labour force participation and labour efficiency. This means that the labour demand effects discussed here do not necessarily provide estimates of the employment effects of the living wage.

results for those aged 30 and above with no qualifications). While a reduction in labour demand would not necessarily feed through into impacts on employment on a similar scale, a drop in demand for low-skilled younger workers on this scale would be a cause of significant concern, particularly given the current state of the youth labour market.

There are a number of reasons to think that these estimates represent a worst case scenario. This same model would have estimated that the introduction of the NMW would have led to a reduction in conditional labour demand of approximately 22,000 employees (or two per cent of low-paid employees) in the private sector (Riley forthcoming). In fact, most research suggests that the NMW has boosted wages with no job losses (Dickens, Riley and Wilkinson 2009, Manning 2012, Stewart 2001). While there is some evidence to suggest that the introduction of the NMW had an adverse effect on hours (Stewart and Swaffield 2002 and 2004), weekly earnings rose as the increase in hourly earnings provided by the new minimum offset any reductions in hours worked.

It is therefore clear that standard labour market models tend to overstate labour demand effects. In particular, such models cannot account for employers changing the way they operate in response to a living wage. They are also likely to underplay the imperfections that are now known to be prevalent in low-wage labour markets (Card and Krueger 1995, Bhaskar, Manning and Tu 2002, Manning 2003). In some cases, this evidence suggests that wage floors can actually increase employment in the aggregate, not least by increasing the incentive to work.<sup>24</sup> There is also a substantial body of literature on efficiency wages (Akerlof and Yellen 1998, Greenwald and Stiglitz 1988, Stiglitz 1987) that details how higher wages may lead to workers feeling greater satisfaction with their job (or increase the fear of losing a job that is thereafter perceived to be more valuable) and proactively increasing their effort and productivity.<sup>25</sup> At the same time, these labour demand estimates do not take into account possible changes in the scale of production or spillover effects to the wages of workers paid more than the living wage that might further dampen labour demand.

Given these uncertainties, standard labour demand modelling can only get us so far. What does the empirical evidence tell us about how employers have actually adapted to living wage initiatives? In the UK, there is evidence that some contractors in London have responded to the additional costs of a living wage by reducing employment or hours. However, a far larger number have adapted by finding other ways to manage costs so that the net impact on costs has been lower than that implied by the direct effect on wage bills (Wills and Linneker 2012). Evidence from the US is more extensive, with many large empirical studies of the 140 or more city-based living wage ordinances that have passed in the US since the first initiative in Baltimore in 1994 (Chapman and Thompson 2006). Most US studies find little or no adverse impact on either employment or working hours, with one outlying study having been criticised on methodological grounds (Chapman and Thompson 2006, Freeman 2005, Adams and Neumark 2000, Neumark 2002).

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<sup>24</sup> By breaking the link between the wage and the marginal cost of labour curve

<sup>25</sup> It should be noted that there is not widespread agreement on the impact of efficiency wages on employment levels. Some argue that efficiency wages result in a fall in employment, whilst others hold that it has a marginal, if not positive effect. It should also be noted that if living wage rates are widely adopted then the market clearing rate would come to approximate the living wage rate and consequently the efficiency wage would lie above living wage level.

Of course, we cannot discount the possibility that more extensive living wage coverage might have other negative impacts. There is some evidence that low-paid workers who gain a living wage lose out on other non-wage benefits, including overtime rates, sick pay, and pensions (Carroll and Grimshaw 2002). As with the NMW, some employers have also squeezed pay differentials within firms, reducing the gap between their lowest paid workers and those just above them. In all cases, these effects are likely to be mitigated when living wage campaigns take a broader form, helping to organise workers to increase their bargaining power over pay and conditions more generally.

## 4.2 The impact of living wages on costs for firms

The above discussion provides a broad sense of the impact of living wages on employment, both under the extreme scenario of a national pay floor set at the level of the living wage and from the more direct, if limited, experience of employers who have adopted a living wage in practice. For a better understanding of the decisions that employers are faced with when considering whether or not to adopt the living wage, we have also estimated the impact of living wages on the average wage bill of employers across a range of sectors. Table 2 shows the results.

**Table 2: Aggregate increase in wage and salary costs across sectors as a result of a living wage (excluding the public sector)**

	15-29		30+			Total
	University degree	Intermediate/None	University degree	Intermediate	None	
Other production	-	2.9%	0.3%	0.9%	-	1.0%
Manufacturing: food & bev, tobacco, textiles, recycling	5.1%	7.0%	0.9%	2.6%	3.5%	3.2%
Manufacturing: wood, paper, chemicals, minerals & metals	0.9%	3.3%	0.1%	0.6%	2.6%	0.9%
Manufacturing: machinery & construction	0.6%	3.3%	0.0%	0.4%	2.6%	0.6%
Wholesale & retail, hotels & transport & storage	6.0%	12.0%	1.3%	3.7%	7.4%	5.6%
Post & telecommunications	2.0%	4.2%	0.3%	1.0%	-	1.3%
Financial intermediation	-	3.1%	0.1%	0.8%	-	0.8%
Real estate, renting & business	1.1%	1.4%	0.0%	0.2%	-	0.3%
Other community, social & other industries	0.8%	4.0%	0.2%	1.2%	5.2%	0.9%
	2.6%	9.2%	0.3%	1.8%	7.4%	2.8%
	0.5%	4.2%	0.1%	1.0%	4.0%	0.8%

Notes: Living Wage set at £7.85 for workers resident in London and £7.20 for workers in the rest of GB; calculations based on HOURPAY; weighted with PIWT09; Industry codes SIC92; wage and salary costs exclude employers' pension contributions and National Insurance Contributions; increase in wage and salary costs is equivalent to the increase in average hourly wages and salaries paid by the employer because the distribution and quantity of hours worked is unchanged in this calculation; - indicates small cell size, result not reported; young workers with no qualifications not reported separately because of small cell sizes.

Source: Labour Force Survey 2010

To supplement these findings we have also conducted more detailed modelling based on a sample of UK-incorporated firms listed on the London stock exchange (LSE)<sup>26</sup> (see box 4 and appendix 2 for a detailed methodology). This shows the impact on wage bills in the UK's largest companies if those firms paid all their directly-employed staff at least the living wage.<sup>27</sup> This more detailed analysis also allows us to calculate the costs of 'spillover' effects on wages, as firms would be likely to raise wages of workers already earning above the living wage in order to maintain pay differentials. While there is little consensus within the academic literature as to the size of these effects, we would expect to see some spillover from living wage agreements (Butcher, Dickens and Manning 2009; Dolton, Rosazza Bondibene and Wadsworth 2009; Stewart 2009).

#### **Box 4: Calculating the impact of the living wage on firm-level wage bills**

These estimates were produced using a custom-built model which calculates the *average* wage bill increase that UK-incorporated firms listed on the main market of the LSE, across a range of sub-sectors, could expect as a result of implementing a living wage (Pennycook 2012). As detailed wage distribution data for individual firms is not publicly available, large-scale survey data is used to derive estimated pay distributions for different types of firms across a range of broad industrial sectors.<sup>28</sup> These derived pay distributions are then applied to a sample of real firms. We then model the impact of raising the hourly wages of every directly-employed worker earning an hourly pay rate below the living wage to the full geographically-appropriate living wage rate (based on 2011 rates: £8.30 in London, £7.20 elsewhere).

To represent a modest spillover effect, we model a 10 per cent increase in the wage rate for workers who earn between £8.30 and £10.52 in London and between £7.20 and £8.32 elsewhere (the difference between the NMW and the geographically-appropriate 2011 living wage rate above the new living wage pay floor). This is coupled with modest increases further up the pay distribution to model for the tapering effects of wage spillovers.

The scenario is applied to 79 individual medium (with a maximum of 250 employees) and large-sized (more than 250 employees) firms sampled from a total of 1,058 firms listed on the main market of the LSE as of January 2012. Firms for which no accurate data on the total number of UK-based

<sup>26</sup> In only taking account of directly employed staff the analysis presented here overlooks the issue of subcontracted staff. Subcontracted employment is now commonplace across a range of service, distribution and manufacturing sectors and for this reason most living wage campaigns have sought to bring subcontracted staff within the remit of any wage agreement. In omitting subcontracted staff this analysis simply measures the cost to the employers wage bill, not the increase on total costs that would accrue to the employer if they sought to use their position at the head of the supply chain to ensure subcontracted workers are brought within the remit of a living wage agreement

<sup>27</sup> As this analysis focuses on the wage bill cost (percentage increase to the total wage bill) of introducing a living wage hourly pay floor across a given firm's directly employed workforce the impact described is distinct from the total cost of living wage implementation on a given firm's labour costs. Analysing the impact of living wage implementation on a firms total labour costs would entail consideration of other items such as National Insurance Contributions which are excluded from this analysis.

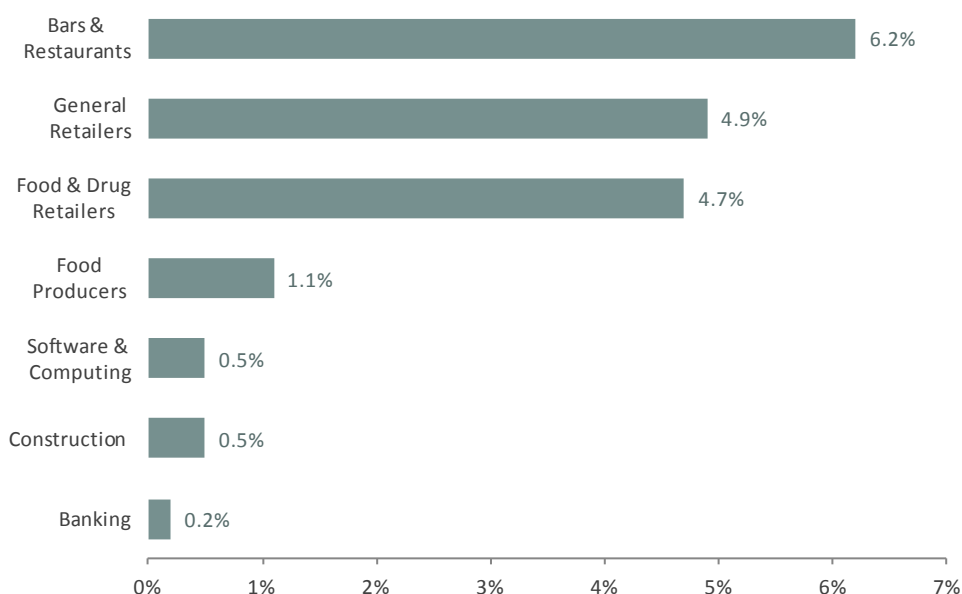
<sup>28</sup> See Appendix 2 for more detailed information about the data from which assumed wage distributions were derived. The numbers of low-paid workers by broad industrial sectors in absolute terms is as follows: Distribution, Hotels & Restaurants (2.6 million), Manufacturing (0.6 million), Transport & Communications (0.3 million), Construction (0.2 million), and Banking, Finance, Insurance and Real Estate (0.6 million)

employees is available are excluded from the analysis as are firms listed as UK-incorporated but which do not base more than 50 per cent of their workforce in the UK.

For each of the 79 firms sampled, consolidated financial data is sourced from publicly-available company annual reports. Data sourced included total employee numbers, turnover, operating profit/ (loss), net profit/ (loss), and wage costs. The 79 UK-incorporated firms sampled for this report are taken from the following seven industrial sub-sectors listed on the main market of the LSE: Banking (3), Construction (15), Software & Computing (13), Food Production (4), Food & Drug Retailers (7), General Retailers (27) and Bars & Restaurants (10).

Figure 9 shows the average effect on wage bills in listed companies in seven industrial sub-sectors associated with paying all staff at least a living wage. While there will of course be differences between firms within sectors, we estimate that the average wage bill increase is significant in the major low-wage sectors of general retailers, food and drug retailers and bars and restaurants (an increase of between 4.7 and 6.2 per cent) while relatively small in other sectors (an increase of around one per cent or less). These results are premised on a modest spillover effect.<sup>29</sup> They are broadly consistent with the LPC estimates of the annual aggregate increase in the wage bill as a result of the introduction of the much lower NMW in 1999, at around 0.25 per cent and around 0.35 per cent with spillover effects (LPC 2001).

**Figure 9: Average firm-level wage bill increase by industrial sub-sector**



Note: Average firm-level wage bill increases were calculated using consolidated financial data for 79 large and medium-sized UK incorporated firms sampled from LSE listings in seven industrial sub-sectors. 10 firms were sampled from the Bars & Restaurants sub-sector, 27 from General Retailers, 7 from Food & Drug Retailers, 4 from Food Producers, 13 from Software & Computing, 15 from Construction and 3 from Banking  
Source: Pennycook (2012)

<sup>29</sup> See appendix 2 for a detailed methodology and an analysis of alternative wage spillover scenarios on the costs of living wage implementation on firm-level wage bills

### 4.3 How do employers adapt to higher wage costs?

Perhaps the most surprising finding of the analysis presented in this chapter is the relatively modest effects of the living wage on aggregate labour demand and employer costs. This is promising in part because we know that standard labour market models overestimated the impact of the minimum wage, and in part because evidence suggests that firms are capable of absorbing modest increases in costs in a number of ways. To conclude this chapter we run through briefly the evidence on how firms adapt to higher costs in practice, whether by raising labour productivity, passing on costs in the form of higher prices (or reduced quality) or by reducing profits or running down reserves.<sup>30</sup> In many cases, such strategies prove to be lower cost than the option of shedding employees or working hours.

#### *Productivity and cost management*

Firms can adapt to higher wage costs by raising productivity. Evidence suggests that many firms saw increased productivity as a result of the introduction of the NMW (Metcalf 2007, LPC 2001). The CBI itself has noted that ‘the NMW may have led some companies to replace inefficient systems of work organisation and to introduce practices such as multi-skilling or team working practices’ (LPC 2001). These impacts may come directly through greater satisfaction and effort among employees<sup>31</sup> or from knock-on effects of reduced turnover, allowing firms to retain more experienced staff. Alternatively, they may flow from more explicit attempts by employers to reorganise activities, change management practices or invest in training.

There is now growing evidence that efforts to raise productivity by investing in the workforce can make sense even for employers in sectors traditionally dominated by low pay, low-skilled business strategies. Zeynep Ton finds, for instance, that low cost retailers in the US have been able to boost customer experience and decrease costs by investing in staff (Ton 2012). In response to the UK’s minimum wage, the strongest productivity gains appear to have been made by large firms (Croucher and Rizov 2011), with few small and medium-sized enterprises introducing new products or processes to cope with the minimum wage. There will of course be some small companies that have lots of scope to increase their productivity and some large companies that may find it more difficult. However, there is evidence to suggest that some smaller firms in the UK face barriers to increasing productivity including a lack of skilled labour, lack of managerial skills and increased competition. Any firm that was not able to easily increase labour productivity would have to find alternative ways of absorbing the costs of a higher wage floor.

There is also limited evidence from UK living wage initiatives that a higher wage floor has boosted productivity. Employer surveys suggest that the London living wage has led to productivity improvements (GLA Economics 2009), with five out of six employers reporting that the living wage had enhanced the quality of their staff, two thirds reporting an increase in output per worker per

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<sup>30</sup> At present unusually high across private non-financial companies. The balance sheet, total currency and deposits of private non-financial companies stood at £723.9 billion at Q3 2011, a rise from £616.6 billion from Q3 2007 (ONS 2011)

<sup>31</sup> For the well-established economics literature on efficiency wages see (Akerlof and Yellen 1998; Greenwald and Stiglitz 1988).

hour and half reporting intensified work effort (although the evidence in this regard was more mixed). Other studies suggest small positive impacts (Wills and Linneker 2012), with many London contractors responding to living wage costs on fixed-cost contracts by reducing costs elsewhere. Whether this would remain the case if large numbers of employers introduced the living wage is debatable but it is clear that living wages are associated with productivity gains.

US evidence also supports the view that living wages can help boost productivity (Chapman and Thompson 2006). Moreover, the productivity gains in these US cases do not appear to come from firms substituting higher-skilled employees for lower-skilled ones, but from current employees responding to higher wages by raising their work effort (Brenner 2005). In the case of San Francisco airport, staff turnover fell by up to 80 per cent across several low-paid occupations following the introduction of a living wage (Hall, Jacobs and Reich 2003).

### ***Prices and profits***

Where productivity gains are insufficient to cover wage bill increases, some UK firms have responded to increases in the minimum wage by increasing prices. Their freedom to do so is clearly dependent on the degree of market competition they face and the price-sensitivity of their customers. These factors vary considerably between sectors containing large proportions of low-paid workers, and between firms in the same sectors. While some services such as pubs, dry cleaners, and cafes have little scope to pass on costs in the form of higher prices because price demand is less elastic, there is more scope for services such as hotels, restaurants and take-away food outlets to pass on the costs of higher wages to consumers (Wadsworth 2007). Almost 70 per cent of firms affected by the introduction of the NMW claimed to have raised prices, though only 30 per cent did so significantly (LPC 2001). Increases were least likely for textile firms, operating in a highly competitive market, and social care, where public funding is a significant constraint. Firms in the hotels, bars and restaurants sector, which also faced high wage bill increases as the result of the minimum wage, were more able to pass on price rises. Evidence on the living wage is far more limited but suggests that a majority of UK firms that transitioned to a living wage felt no need to alter prices in response (GLA Economics 2009).<sup>32</sup> In the US, price increases are harder to identify because the living wage has focused on the public sector. However, we might reasonably expect firms in sectors that find it difficult to raise labour productivity (hairdressing being the textbook example) would look to prices to absorb the costs of a higher wage floor. Firms in this situation would need to increase the quality of their service in order to retain customers.

The most commonly reported adjustment to the minimum wage was for firms to reduce profits: nearly 90 per cent of firms surveyed reported a reduction in profits (LPC 2001). This effect was more prevalent in sectors with less competition (Draca, Machin and Van Reenen 2011). Evidence from the US also suggests some reductions in profits among firms introducing a living wage. Brenner (2005), for example, found that 40 per cent of service contractors in Boston responded to the living wage ordinance in that city by reducing profits. These reductions in profits clearly have knock-on effects across the economy, though estimating the scale of these effects is difficult.

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<sup>32</sup> The suggestion from this analysis is that a number of firms surveyed did raise prices but it is not clear by how much.

## Chapter 5: Who benefits from a living wage?

Having described the landscape of low pay in the UK and the likely effect on labour demand and employer costs, this chapter outlines who would benefit from a living wage. It quantifies not only the cash gains to individuals and households, broken down by different demographic groups, but also sets out the first ever detailed study of the gains accruing to government through increased tax revenues and reduced benefit spending. In doing so, it provides an account of the true costs and benefits to government of more extensive living wage coverage. We start, though, by considering the benefits to individuals and households.

### 5.1 Which individuals benefit from a living wage?

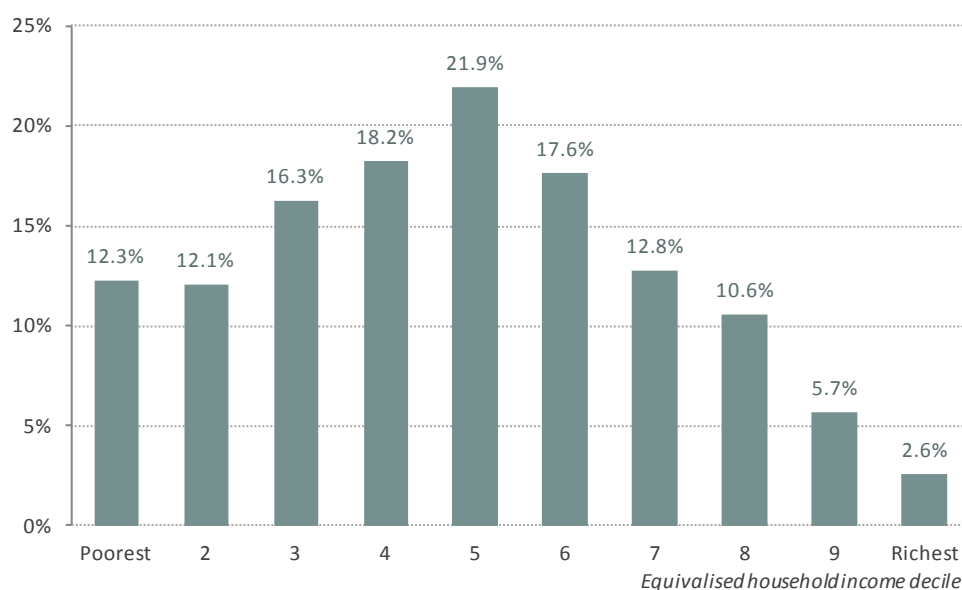
The first step to understanding which individuals would benefit from a living wage is to see where low-paid workers fall in the household income distribution. This is important because poverty and low income are usually measured at the household level rather than the individual level. The location of low-paid workers in the household income distribution therefore determines, in part, the ability of the living wage to reduce poverty and raise standards of living.

Approximately 13 per cent of all British households contain at least one adult earning less than the living wage.<sup>33</sup> As figure 10 makes clear, this proportion is highest among households towards the middle of the income distribution (the fourth, fifth and sixth deciles), where almost one fifth of households have someone earning less than the living wage. The share is lower among the poorest fifth of households, since they are less likely than better-off households to contain anyone in work. The poorest households in Britain are typically those in which no-one works rather than those containing low-paid workers. Although low-paid workers are concentrated towards the poorer half of households, they are found across the household income scale, with around four per cent of the richest fifth of households containing someone earning less than the living wage. These will be individuals who are low paid but who live with a high earning partner or have other significant sources of income.

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<sup>33</sup> See appendix 3 for a fuller discussion of data sources.

**Figure 10: Proportion of households containing at least one adult earning less than the living wage, 2008-09 (in 2012 prices)**



Source: Authors' calculations using FRS and LFS

The relationship between low pay and household poverty or low-income is not therefore straightforward. The risk of household poverty is about ten times higher among low earners than among workers paid above the standard low pay threshold. However, only one tenth (approximately 9.6 per cent) of low earners live in poor households, compared to 1.2 per cent of higher earners (Maitre et al 2012). The relationship between earnings and income is complex for a number of reasons:<sup>34</sup>

- **Family size:** different types of families need different amounts of money to enjoy a similar standard of living – a low earning single person may be able to achieve a decent standard of living while a parent with three children on the same wage would struggle.
- **Working hours:** take home pay depends on working hours as well as hourly pay so a low hourly wage may be sufficient for someone working long hours but inadequate for a part-time worker.
- **Other sources of earnings:** people earning less than the living wage often live with parents or a partner with higher earnings – among full-time low earners in Britain aged 30 to 44, one quarter experience household poverty if they are the only earner compared to just one per cent in multiple-earner households (Maitre, Nolan and Whelan 2012). Approximately one half of this group of low earners are second earners, of whom around 85 per cent are women.
- **Other sources of income:** benefits and tax credits make up a large chunk of household income for many low earners and can be sufficient to provide a decent standard of living.

These complicating factors mean that an increase in the coverage of the living wage will not necessarily raise the incomes of many of the poorest families or be confined to benefitting low to

<sup>34</sup> This assumes that household resources are split evenly among members of the household, which may not be the case in practice

middle income households. The location of low-paid workers within the household income distribution suggests that the biggest beneficiaries from broader living wage coverage would be households in the middle of the income scale. A smaller proportion of the poorest households would benefit, and there would also be gains for relatively well-off households. As such, efforts to increase the spread of the living wage is surprisingly majoritarian if assessed at the household rather than individual level but would also need to be accompanied by other measures if the incomes of the poorest families were to be raised relative to the median as well.

#### **Box 5: How did we make these calculations?**

The analysis in this chapter uses the IPPR tax-benefit model<sup>35</sup> to simulate the effect of a more widely applied living wage on a representative sample of households, which can then be scaled up to the population as a whole and aggregated to estimate the impact on the public finances. The analysis compares net household incomes under current wage patterns with those achieved if a living wage was applied to particular groups of employees. The modelling uses the living wage rates announced in November 2012 (£8.55 in London and £7.45 in the rest of the UK but is based on data from 2008-09), but with wages and other prices uprated to 2012. The deterioration in the labour market since 2008-09 means that our results may overestimate the impacts of a living wage in the current labour market, since there are now fewer people in work.

The model uses data from the Family Resources Survey (FRS), which contains data on household income but lacks a direct measure of hourly pay. This can be derived by dividing a variable for weekly earnings by a variable for weekly hours but other studies have found this produces unreliable estimates of hourly pay (Brewer, May and Phillips 2009). We therefore impute a measure of hourly pay in FRS based on the relationship between direct and derived measures of hourly pay contained in the Labour Force Survey (LFS).<sup>36</sup> There are several different ways in which this can be done and appendix 3 details how these various methods of obtaining hourly wage data differ, as well as setting out alternative results under these different methods. The results outlined in this chapter are based on our best estimate of the most appropriate method to use but should be treated as a guide only.

For a number of reasons, the results should be treated as illustrative of the likely effect of broader living wage coverage. While they assume full, national coverage of the living wage, they do not consider other adverse effects, such as those discussed in chapter 4. Lower employment, lower profits, or higher prices would affect receipts from employment taxes, corporation taxes, consumer spending and revenues from consumption taxes like VAT. Lower employment and higher prices could also offset all or some of the improvement in family spending power generated by higher wages. There may also be positive knock on effects, not least for productivity and consumption, which are also not taken into account.

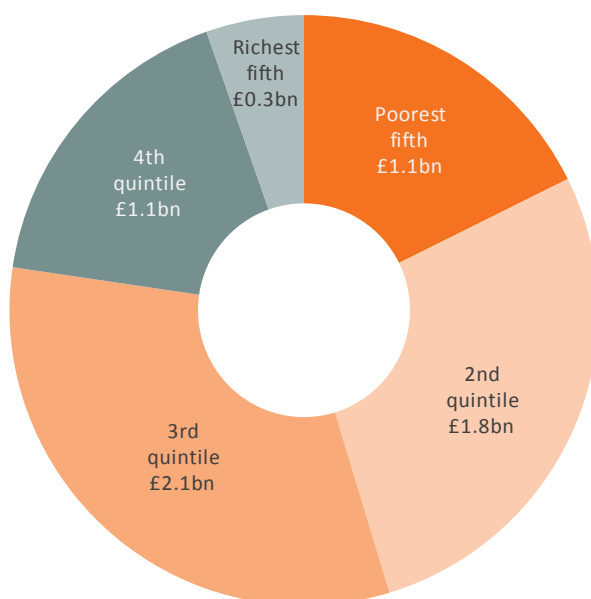
<sup>35</sup> More information is available here <http://www.ippr.org/research-project/44/7106/modelling-reforms-to-the-tax-and-benefit-system>

<sup>36</sup> Appendix 3 contains a more detailed explanation of the data and methods used in this chapter. We do not use the LFS for the main part of the modelling because it does not contain enough information about household income.

## 5.2 The impact of the living wage on family incomes

Given the complex relationship between pay and household income, and the interactions between earnings and the tax and benefit system, the precise impact of a more widespread living wage on family incomes will vary for each household. We estimate that if everyone currently paid less than the living wage saw their hourly pay increased to the appropriate living wage rate, total gross earnings for employees would rise by £6.5 billion.<sup>37</sup> In this scenario, we calculate that average gross annual pay for people previously earning less than the living wage (but at or above the NMW) would rise by approximately £1,280 to £11,540 a year.<sup>38</sup> Just over five million employees (20.6 per cent of the total) would see their wages rise. As Figure 11 shows, of the additional £6.5 billion in gross earnings, the largest absolute gains would flow to households around the middle of the income distribution. The poorest fifth of households would see their gross earnings rise by £1.1 billion in total, while households in the second and third income quintiles would gain £1.8 billion and £2.1 billion respectively. The richest fifth of households would gain around £350 million in extra gross wages.

**Figure 11: Increase in total gross wages by household income decile if all employees were paid at least the living wage, 2008-09 (in 2012 prices)**



Note: Does not sum to total due to rounding

Source: Authors' calculations using FRS and LFS

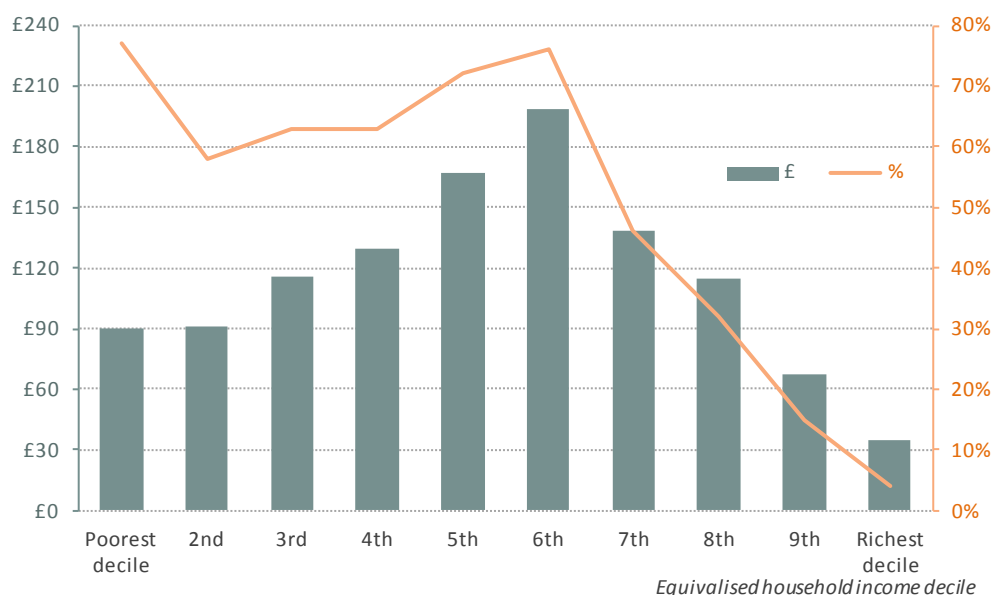
Importantly, these results refer to gross earnings: that is, pay before the effect of the tax and benefit system. Figure 12 shows how the net *income* gains would be spread across households if everyone paid less than the living wage was paid the living wage. The results are small because they show the average effect across *all* households, including the majority of households that see no benefit because all adults already earn above the living wage. The cash gains increase from the second to the sixth income decile before falling sharply for more affluent households. In relative terms, the

<sup>37</sup> This excludes workers who are currently paid less than the minimum wage.

<sup>38</sup> Equivalent to £24.60 and £221.90 a week.

average gain across all households would be fairly small, at less than one per cent across all income deciles, although they are higher for the bottom half of households than for the top half.<sup>39</sup>

**Figure 12: Average change in annual net household income if all employees were paid at least the living wage, all households, 2008-09 (in 2012 prices)**



Note: Household incomes are before housing costs

Source: Authors' calculations using FRS and LFS

If we restrict our analysis to those households that would directly benefit from the living wage, on average these households would be better off by around £850 a year. The cash gains are similar across the household income scale but in proportional terms, the impact would be strongly progressive. By far the largest proportional gains would be felt by the poorest 10 per cent of households, who would see their disposable income rise by around 7 per cent on average. However, as Figure 12 shows, a smaller number of households in the poorest decile would see their incomes rise compared to households further up the income scale, because a smaller share contain working adults.

The gains associated with the living wage also differ by family type and size, with the largest gains typically going to single people and couples without children. Table 3 shows that among households who would gain if all employees were paid at the least living wage, single people would see their net income rise by an average of £727 a year, while couples without children would be better off by £922 on average. The smallest gains would be for lone parents, although they would still be better off by almost £400 a year on average.

<sup>39</sup> Brewer et al (2012) found that the proportional gains associated with increasing the minimum wage by 10 per cent would be largest for households in the 3<sup>rd</sup> and 4<sup>th</sup> income deciles.

**Table 3: Gains for families if all employees were paid at least the living wage**

	Average annual net income	Average increase in net income	Average % change in net income
Single no children	£13,079	£727	5.6%
Couple no children	£27,106	£922	3.4%
Lone parent	£22,612	£398	1.8%
Couple with children	£31,549	£614	1.9%

Note: Figures are only for households who would see an increase in wages, not the average across all households  
Source: Authors' calculations using FRS and LFS

These gains differ in part because households with children are more likely to be in receipt of means-tested benefits or tax credits. When combined with income tax and national insurance contributions, this can generate high marginal deduction rates (MDRs), which determine the proportion of additional gross earnings that a family keeps in the form of net income. Under the current benefit system, families can face marginal deduction rates of up to 96 per cent, meaning that for every additional £1 earned, they keep just 4p.<sup>40</sup> The introduction of Universal Credit from October 2013 will limit MDRs to 76 per cent for all families, enabling most families to keep more of any additional earnings than in the current system (Brewer, Browne and Jin 2011).<sup>41</sup> However, some families will face a slightly higher MDR under Universal Credit than under existing arrangements.

These findings are closely related to the ongoing debate about how best to support low-income households, between the Coalition's current policy to raise the personal income tax allowance to £10,000, and those who argue that tax credits are a more targeted form of support. Our findings confirm that increasing wages at the bottom of the labour market is a relatively inefficient way of tackling low-income across all households given the distribution of low-paid workers. However, the gains from raising the personal income tax allowance are also skewed towards the upper half of households because the majority of workers, not just the low-paid, see their take home pay rise (Lawton 2011).<sup>42</sup> Raising the personal allowance also does nothing to help very low earners, who already earn too little to pay income tax, while having a large cost to government in lost revenues. Solutions based on the tax and benefit system also fail to engage with the broader aims of living wage movements and do not challenge the underlying causes of low pay.

### 5.3 The impact of the living wage on the public finances

As well as benefiting individuals, greater coverage of the living wage would have substantial fiscal benefits to government. These upsides have increased in recent years as spending on in-work benefits, particularly in the form of tax credits, has grown. Spending on the current generation of tax credits, introduced in 2003 and incorporating working tax credit and child tax credit, peaked in 2009-10 at £28.6 billion. As Figure 13 shows, sectors that contain a large share of low-paid workers, such

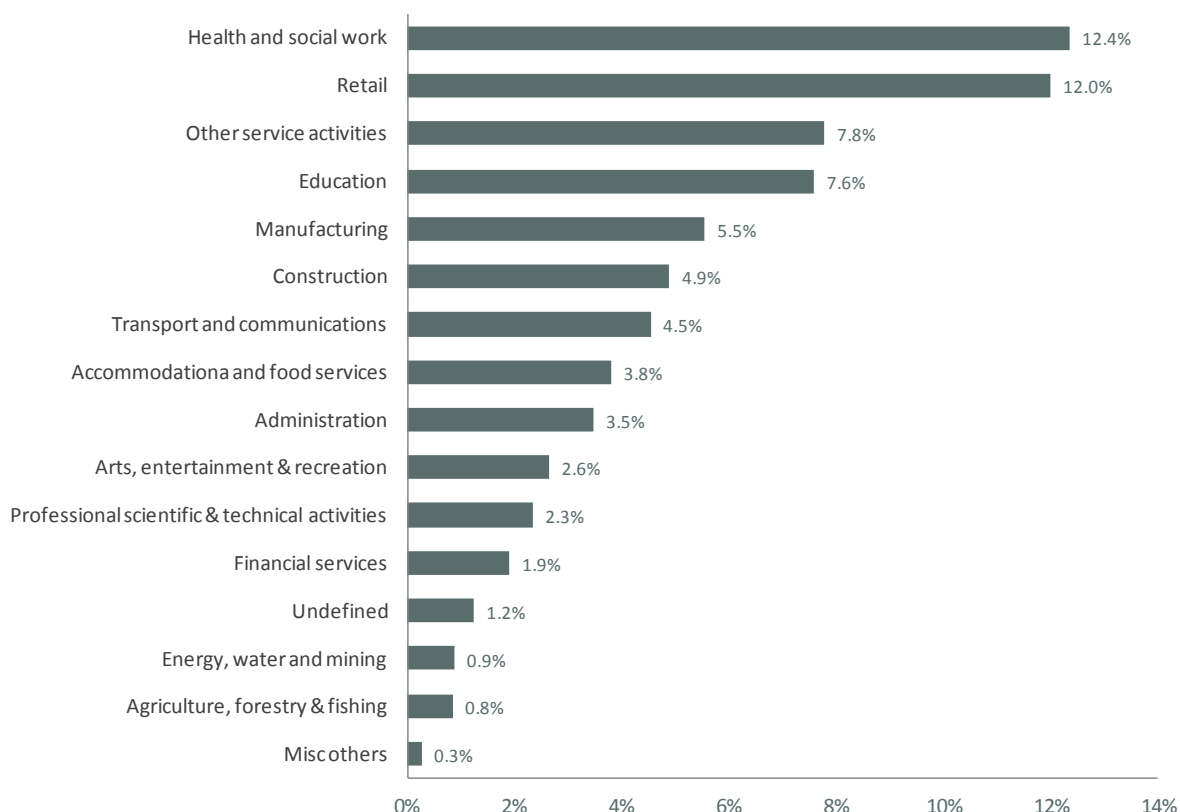
<sup>40</sup> This applies to families in receipt of tax credits, housing benefit and council tax benefit, with at least one earner paying income tax and national insurance contributions.

<sup>41</sup> Although this doesn't factor in the effect of council tax benefit localisation, which is likely to increase MDRs for some families above 76 per cent. Families will face a higher MDR under UC than in the current system if they are currently only claiming tax credits and not housing benefit and council tax benefit (currently creating an MDR of 73 per cent).

<sup>42</sup> The very highest earners do not gain because the value of the personal allowance is reduced by £1 for every £2 of income above £100,000 until it is worth zero.

as health and social work and retail, attracted the lion's share of this spending. While under current plans, total tax credit expenditure is set to decline and tax credits will be subsumed into the new Universal Credit from late 2013<sup>43</sup>, high marginal tax rates will continue to face large swaths of households. This means that raising wages among workers in low-income families will generate significant savings for government, in addition to the increased tax revenues.

**Figure 13: Distribution of tax credit spending by industry, 2009-10**



Notes: Columns sum to 72.1% because 27.9% of tax credit spending goes to single non-earners who cannot be assigned to an industry. Tax credits received by non-earners in couple households are assigned to the industry in which the adult who is earning works.

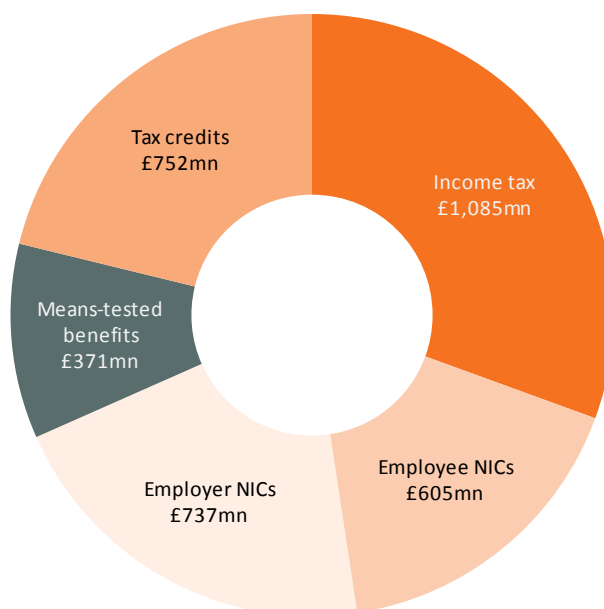
Source: Resolution Foundation calculations using Family Resources Survey data, 2009-10.

In total, we estimate that HM Treasury would make gross savings of £3.6 billion if the living wage was universally applied. The bulk of the upside would come from higher income tax payments and national insurance contributions. Figure 14 makes clear that of those gross savings of £3.6 billion, income tax receipts account for around £1.1 billion, national insurance contributions for around £1.3 billion and savings on means-tested benefits and tax credits for a further £1.1 billion. As outlined in

<sup>43</sup> Changes introduced in April 2011 included a reduction in support for childcare costs through the Working Tax Credit (WTC), an ongoing three-year freeze in the basic and 30 hour elements of WTC and faster withdrawal of tax credits as income rises – although these losses were offset for some households by a £180 above-inflation increase in the child element of the Child Tax Credit (CTC). Bigger cuts were implemented in April 2012 including the removal of the £545 family element of CTC from middle income families (saving £475 million in 2012-13); the reversal of the coalition's previous plan to increase the child element of CTC by £110 (saving £1.0 billion in 2012-13); an increase in the number of hours that couples with children are required to work in order to receive WTC from 16 to 24 hours (saving £515 million in 2012-13); the reversal of the previous government's plans to introduce a supplement in CTC for children aged one and two (saving £180m in 2012-13); and a freeze in the value of the £1,950 couple and lone parent elements of WTC (saving £265m in 2012-13)

box 5, this estimate should be seen as an upper bound, not accounting for possible effects on employment, profits or prices.

**Figure 14: Estimated gross savings to Treasury if all employees were paid at least the living wage**



Source: Authors' calculations using FRS and LFS

While the Treasury would secure gross savings of £3.6 billion if all employees were paid at least the living wage, other parts of the public sector would face higher wage bills. Importantly, the costs and benefits of a living wage will affect different parts of government in different ways, with a large portion of the additional wages paid by local government and the NHS while the Treasury receives all of the direct cash savings. We estimate that the higher wage costs for public sector employees as a result of introducing a universal living wage would be around £1.3 billion. This figure represents the cost of moving employees working in public administration and defence, education, and health and social work to a living wage.<sup>44</sup> These public sector wage bill costs reduce the net savings to the state of a universal living wage to approximately £2.2 billion.

As well as modelling the implications of a universal living wage, we also consider how the public finances might be affected by alternative scenarios for the living wage. We look in particular at a London living wage, given the strong case for prioritising living wages in London, not least given the particularly low value of the minimum wage compared to median earnings in the capital. If all employees living in London were paid at least the London living wage, the Treasury could save around £691 million a year.

We also model how much would be saved from the major sectors that could most easily afford to pay a living wage. In chapter 4, we found that applying the living wage to all employees in non-low paying industries like finance, construction and computing would cost large firms less than one per

<sup>44</sup> These sectors are not a direct match for employees employed in the public sector. They will exclude some employees directly employed in the public sector (e.g. refuge workers) while including employees who are not directly employed in the public sector (e.g. care assistants), although many of the later will be working on public contracts.

cent of their total wage bill. If the living wage was paid to all employees in these major non-low-wage sectors, then we estimate that around one million employees in the UK would see their wages rise and the Treasury would gain around £1 billion as shown in Table 4. These benefits are large given the relatively small impact on employer costs of making this move. A similar impact would be seen if all retail workers were moved up to the living wage, but this is a much less realistic proposition.

**Table 4: The impact of alternative scenarios for the living wage<sup>45</sup>**

	Gain to Treasury			No. of employees affected	% of UK households affected
	Additional revenue	Benefit and tax credit savings	Total		
All London employees receive at least the London living wage	£469m	£222m	£691m	436,000	1.4%
All employees in non-low wage industries receive at least the living wage	£680m	£287m	£967m	929,000	3.3%
All employees in retail receive at least the living wage	£640m	£315m	£955m	1,097,000	3.9%

Note: Some of the gains to the total Treasury in this scenario would be offset by increased wage bills in the public sector, primarily in public contracts since most directly employed public sector workers are paid above the London living wage. Figures relate to workers who live in London so will include workers who commute out of the capital and exclude those who commute in. Non-low wage industries are those where NIESR estimate that the impact of the living wage on total wage bills would be less than one per cent. They are agriculture, mining and quarrying; manufacture of wood, paper, chemicals, minerals, metals, machinery and equipment; construction; post and telecoms; finance; real estate and business activities. This estimate does not include staff working on contracts.

Source: Authors' calculations using FRS and LFS

<sup>45</sup> The estimate for the number of workers affected in London is lower than the figure we quote earlier in the report of 570,000 London workers being paid less than the living wage. This is because of the measure of hourly wage we chose to use in this analysis, which is explained further in appendix 4.

## SECTION 3: IMPLICATIONS FOR POLICY

### Chapter 6: Lessons and policy proposals

In this final section of the report we turn to the implications of our findings for policy. We start by drawing out some overarching lessons that should inform policy development. These flow from our analysis and help to situate what has to date been a relatively rootless policy debate. We then apply these lessons to more practical policy proposals, pointing to five promising areas for further development work.

#### 6.1 Six lessons for advancing the living wage

The analysis presented in this report carries six key lessons for policymakers and others with an interest in advancing living wages, clarifying the role that living wages can play and the goals for public policy:

- 1. There are clear reasons not to legislate for a statutory living wage: the living wage should not be seen as a replacement for the minimum wage.** The minimum wage is based on an empirical judgment about employment effects and is agreed through a social partnership model, allowing a mandatory, statutory approach. The living wage reflects standards of living and prices and does not take account of employment effects. Advancing the living wage therefore requires an incremental approach, which can also bring wider benefits by mobilising low-paid workers who lack traditional forms of representation. The question for policymakers is the extent to which the state can support a campaign rooted in civil society. The question for minimum wage policy (supported by skills and other policy levers) is how to raise the legal wage floor without significantly lowering employment. Although this question is beyond the scope of this report, policymakers need to consider a more ambitious, long-term strategy for how the minimum wage can be used to push employers to raise their game (Manning 2012).
- 2. The employment effects of raising the minimum wage to the level of the living wage are not certain and could be large, but *far* more extensive coverage could be achieved without significant employment effects.** Many large firms in sectors employing large numbers of low-paid workers could afford to pay a living wage today. This is in part because the impact on wage bills is surprisingly small. It is also because firms can – and do – adapt in ways beyond reducing employment or hours: they raise productivity through reorganisation or training, they absorb costs through higher prices, they shift pay distributions or they accept reduced profits. In most cases, adaptation is likely to be far harder for smaller firms with significant numbers of low-paid employees. This does not necessarily mean they should be exempted from all efforts to advance the living wage. But we need to accept that not all smaller employers can pay a living wage, and even those who might be able to in future will need support to adapt their business practices.

3. **The main beneficiary of the living wage is the Treasury.** It collects more than half of the financial gains from the living wage in higher income tax payments, higher national insurance contributions and reduced spending on in-work benefits. This has a number of important implications. First, the true cost of paying public sector workers the living wage is smaller than it seems – but importantly the costs and benefits are not borne by the same part of government. Second, living wages do less to lift household incomes than many people think. Other support will always be needed as part of a wider strategy to boost incomes in low to middle income households, particularly in households with children.
4. **Living wages will fail if they become a purely public sector phenomenon.** Four in five workers who earn less than the living wage work in the private sector. If the public sector is to play a role in extending coverage of the living wage, it must be in large part through mechanisms that encourage uptake in the private sector. Although the public sector has a key role to play, the UK needs to be very careful about following the route of the US, where living wages have become almost exclusively linked to public sector jobs and public sector procurement. We should also remember that a large share of low-paid employees work in sectors like retail and hospitality, where even public procurement has limited reach. There must be a concerted focus on increasing take-up in these sectors.
5. **Living wages complement, rather than replace, in-work benefits.** This is explicitly recognised in the way they are calculated. Indeed, every time means-tested benefits are cut, the living wage goes up. This is unavoidable because in-work state support plays roles that living wages can never play. For example, the pay of an individual is never going to reflect their family size nor compensate when working hours are cut. This does not mean we should give up on notion of a living wage, but we do need to strike a careful balance between recognising that employers should pay a decent wage where affordable but that state support is still necessary. It must also be recognised that households who gain from the living wage are not always the same households who lose out when tax credits are cut.
6. **At their best, living wage campaigns are about more than wages.** The greatest successes in securing the living wage have been made through bottom-up processes of organising and campaigning. These processes have sought to involve low-paid workers directly in the struggle to improve their own wages, as well as building broader alliances with a diverse mix of unions, faith organisations and community groups. This must remain at the heart of the living wage idea and the process of securing a living wage should be seen as a first step towards shifting power and resources to those who typically lack both. However, the living wage movement itself has some hard questions to answer as its campaign becomes more mainstream. How can very large employers have more confidence in the process and formula that sets the living wage rate each year? Do we know enough about the impacts and trade-offs of introducing a living wage into different firms, sectors and sub-sectors, and in particular places? The role of public policy is not to meddle in these processes but to lend the movement support where it can and identify new ways of working with civil society and employers to advance the living wage in partnership.

These lessons point to some practical opportunities for policy development in five areas. First, we consider the role of the public sector as a direct employer. Second, we look at the role of public procurement. Third, we consider ways to affect the behaviour of large private sector employers. Fourth, we consider how small and medium-sized firms could be supported to move to a living wage. Finally, we outline some suggested next steps for the living wage campaign.

## 6.2 Direct public sector employment

The public sector performs a key social function by being an exemplary employer. It has a long history of leading the way in progressive employment practices, whether on gender equality, parental leave or flexible working. The same should apply to the living wage. **Where it is affordable, the public sector should pay directly-employed staff the living wage and should extol the virtues of doing so.**

Affordability is a very significant caveat. Our analysis has shown that the costs of paying public sector workers the living wage are not as high as they might seem because many of the benefits that flow back to government through tax receipts or reduced welfare spending. But even so, in the current fiscal climate, additional spending on public sector wages would need to be paid for through spending switches or new sources of revenue. If these costs were borne by reducing support for low-income households or by raising their taxes, the overall result could well be regressive.

Paying the living wage in the public sector therefore comes down to costs. These will vary significantly across different public sector employers. A number of major public sector employers have already found it possible to pay directly-employed staff at least the living wage. This includes the NHS in England, Wales and Scotland<sup>46</sup>, and the Scottish Government. The costs for Whitehall departments of paying all their directly-employed staff a living wage are likely to be negligible and would have a powerful galvanising effect on other public sector bodies. **We therefore recommend that all Whitehall departments publicly commit to paying all their directly-employed London-based staff the London Living Wage by April 2015.**

Local government will find this harder. Councils are typically major employers in their local areas and a sizeable portion of the local government workforce are low-paid, particularly school support staff like catering assistants, meal supervisors and cleaners. In 2011 there were approximately 80,000 full-time and 228,000 part-time directly employed workers in local government in England and Wales who were paid less than the appropriate living wage rate, the vast majority of whom are women (Kenway, Parekh and Aldridge 2011). In practice, the costs councils would face from a living wage vary considerably, both by region and the proportion of low-paid staff that are directly employed.

We recommend a different approach in London and outside of London. In inner London boroughs, our analysis suggests that the costs of paying the living wage are negligible because the lowest point on the pay scale, after the inner London weighting, is close to the London living wage.<sup>47</sup> Although the

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<sup>46</sup> The lowest pay grade in the Agenda for Change pay system used in the NHS is above the non-London living wage rate. NHS Scotland has explicitly committed to being a living wage employer.

<sup>47</sup> The lowest pay point in the NJC local government pay scale for 2012-13 is £12,145, equivalent to £6.67 for a 35 hour week, well below the non-London living wage rate from November 2012. With inner-London weighting, the lowest pay

outer-London weighting is lower, in practice, costs for outer London boroughs who have adopted the London living wage have also been small (see appendix 4). Typically, less than one per cent of the workforce is affected by upgrading council staff to the London living wage in both inner- and outer-London boroughs. **We call on all London local authorities to pay their directly-employed staff a living wage by April 2015.**

Outside London, the costs are substantially higher. In Scottish local authorities, where progress on the living wage has been greatest, somewhere between three and 10 per cent of the workforce saw their hourly wages rise, at a cost of between £122,000 and £322,000 in the first year. In major metropolitan authorities including Newcastle and Cardiff, the estimated costs are around £1 million, with around 2,000 staff affected, equivalent to approximately 15 per cent of the workforce. (See appendix 4 for a cost breakdown for other local authorities.) It is also important to recognise other legitimate obstacles councils face in implementing a living wage:

- Local government pay is set nationally, with a pay scale structure based on a common assessment of roles, partly in order to meet equal pay requirements, which the living wage could not contravene. Most councils have chosen to implement the living wage as a supplement rather than changing the underlying pay scale, in order to avoid any potential challenges under equal pay legislation.<sup>48</sup>
- Outside London, introducing a living wage for directly-employed staff could significantly reduce pay differentials. Eroding the gaps in final pay between supervisory staff and more junior roles can be problematic, not least for morale and productivity, while retaining differentials adds costs.
- If local government pay continues to be frozen for a number of years or rises slowly, more and more employees will become eligible for a living wage supplement, pushing up costs for individual councils who choose to pay the living wage.

Ultimately, local authorities are best placed to decide how to spend their resources. Decisions about the living wage should properly feed into local budget negotiations alongside other funding priorities. At a minimum, progress on this debate requires better data. Public norms surrounding low pay cannot help to drive decisions if the public does not understand the scale of low pay or the costs of implementing a living wage, and the trade-offs this implies. **We therefore call on all local authorities to conduct feasibility studies by April 2015 into the costs and benefits of introducing the living wage for all directly-employed staff, measuring and publishing the costs of doing so.**

### 6.3 Public sector procurement

The procurement power of the public sector is one of government's main levers for changing behaviour among private sector employers, but this power remains underused. Using this power to extend living wage agreements could have a big impact but it would also carry significant costs. Yet it is clear that more needs to be done to boost wages for sub-contracted workers. The expansion of labour sub-contracting is crucial to understanding how many employers are able to hire workers to

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point rises to £15,444, equivalent to £8.49 for a 35 hour week, very close to the London Living Wage rate announced in November 2012.

<sup>48</sup> Advice to councils is that this is a legally-tested way to lift pay, with market supplements providing a legal precedent.

do similar work on differentiated pay rates, hours and conditions (Allen and Henry 1997, Benyon, Grimshaw, Rubery and Ward 2002, Smith and Morton 2006). The UK's public services industry is now the most developed in the world and estimates suggest that private and voluntary providers of public services now employ around 1.2 million people (Department of Business, Enterprise and Regulatory Reform 2008). Given the concentration of outsourced workers in typically low-paid roles in social care, leisure services, cleaning and security, the share of outsourced workers paid less than the living wage is likely to be substantially higher than the UK average of 20 per cent and sub-contracted low-paid work should continue to be a central focus of living wage campaigns.

The accreditation process for becoming a living wage employer already requires organisations to set out a timetable for implementing a living wage in all contracts, including living wage requirements in new contracts when they are due to be relet.<sup>49</sup> This process can take a number of years. The six accredited living wage London boroughs<sup>50</sup> are committed to reviewing all contracts by March 2014, with a view to providing all sub-contracted workers a living wage.

How could these requirements be extended more widely? One concern is over the legality of using public sector procurement to extend the living wage. Many UK public contracting authorities have taken the view that blanket living wage requirements in all contracts are unlawful under both EU and domestic law because they prevent a proper consideration of value for money.

Procurement law allows local authorities to take workforce matters into account *where consistent with EU law and value for money*.<sup>51</sup> Under EU law<sup>52</sup>, contracting authorities can include social and environmental considerations in a contract as long as they are non-discriminatory, relate to the subject matter of the contract and are proportionate. The European Commission has stated that living wage requirements are probably consistent with EU law, so long as they are applied only to workers directly under the public contract and are not directly or indirectly discriminatory (Local Government and Regeneration Committee 2011). In general, legal advice suggests that public authorities are safe to proceed on a case-by-case basis so long as they take reasonable steps to comply with EU and domestic law. This is supported by the fact that many public sector bodies have now implemented living wages in contracts without legal challenges.

The more significant barrier is cost. A key driver of low pay in services that rely on public funding but in which many low-paid staff are employed by private contractors are limits to public spending. Government, which spends £238 billion each year on public procurement, therefore faces acute trade-offs between paying higher wages and purchasing services at a lower cost (Maer 2012). As things stand, little is known about the scale of low pay in public sector contracts across the UK or the proportion that fall below the living wage, and therefore about the costs of moving to the living wage in different areas of public sector procurement. For central government, these costs may well be manageable, particularly for London-based contracts held by Whitehall departments and in cases where contractors themselves are able and willing to absorb some of the costs of a living wage.

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<sup>49</sup> Assuming that this can be justified on EU and domestic law

<sup>50</sup> The following six London boroughs have been accredited living wage employers: Lewisham, Islington, Camden, Lambeth, Hounslow and Southwark.

<sup>51</sup> Under the Local Government Act 1999

<sup>52</sup> Article 26 of the Public Procurement Directive

Following a sustained campaign by London Citizens in Whitehall the facilities management company, Telereal Trillium, which supplies cleaners to the Department for Work and Pensions, recently agreed to pay the costs of a living wage to its 500 Whitehall employees. There are signs that other Whitehall departments may follow suit in actively encouraging the payment of the living wage when retendering service contracts.<sup>53</sup> **All London-based central government departments should review the costs of the living wage as new contracts are due for re-tendering and publish the results alongside a decision on whether to introduce the living wage and a timetable for doing so where affordable. Within the next five years, this process should be started for all contracts held by central government departments and agencies outside London.**

For local authorities the costs of paying the living wage for outsourced staff are likely to be an order of magnitude higher than for directly-employed staff. The largest costs are likely to stem from social care contracts, given the scale of long-term care services operated by local authorities, the extent of outsourcing in this sector and the prevalence of low wages.<sup>54</sup> A handful of councils have produced tentative estimates of the cost of applying the living wage to all their contracts. Ealing Council estimates that introducing the living wage to all contracts in the adult and children's department (where the bulk of contracts are held) would cost approximately £23 million out of a total contractor budget of £100m.<sup>55</sup> **Individual councils should continue to review the affordability of implementing the living wage in contracts when they are due to be relet and should publish the results.**

Councils should not rule out all options that carry a price tag; as this paper has shown, the extra costs of a living wage can be offset, for example through better contract management. Islington Council managed to meet the costs of a living wage for contract cleaners by bringing workers back in-house (Crowe 2012). In fact, living wage deals that apply to both directly-employed and outsourced staff would diminish the case for outsourcing, where savings relative to direct public provision are often partly achieved on the basis of weaker pay and conditions. Even so, costs in some areas, particularly social care, will be high. Here, there is an urgent need for a sustainable funding settlement covering better pay, status and qualifications for care workers, as well as funding arrangements for service users. Ultimately, better pay in social care will require national leadership. It is also important to remember that around 200,000 care workers – one in five of the workforce – are currently paid below the *minimum* wage (Hussein 2012). This is not just morally unacceptable but also illegal. Paying a living wage in social care may be difficult in the current funding settlement but when it comes to procuring social care services, local authorities should do all that they can to ensure that sub-contracted staff are receiving the legal minimum wage.

## **6.4 Large private sector employers**

As evidence throughout this report has shown, it is vital that efforts on the living wage reach the four in five low-paid workers who are employed in the private sector. The UK should not follow the US down a route of focusing overwhelmingly on the public sector. We have argued that the use of

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<sup>53</sup> See <http://www.guardian.co.uk/society/2012/dec/15/living-wage-public-servants-closer>

<sup>54</sup> Median hourly gross wages for care assistants in April 2011 were £7.93 in the UK, and £8.43 in London.

<sup>55</sup> This could fall to £13m if implemented only across contracts let solely by Ealing council, as many long-term care services are jointly commissioned with other local authorities in West London. And extra £5 million may be needed to deal with pay differentials where supervisors are currently paid close to the London living wage.

the public sector to change behaviour both in its role as a direct employer and through procurement can help change behaviour in the private sector. But there are also ways for public policy to more directly affect private sector practice.

### ***Transparency***

Evidence is vital to public debate and to help guide the focus of living wage campaigners and organisers. Forcing the publication of data is one of the main ways government can empower community-based campaigns. The UK is already a world leader in the open use of public data, allowing campaigners and businesses to re-use data in any number of positive and unexpected ways. In the public sector this decision should be a simple one. The fact that the public sector is paying people too little to afford a minimum standard of living is a legitimate issue for public debate. **Without exception, public sector employers should be transparent about low pay, publishing the proportion and number of their staff paid below the living wage.**

But public policy also places publishing requirements on listed private companies through the UK corporate governance code. We call on the government to amend the code to require that companies include in their annual reports a figure for the proportion of directly-employed staff based primarily in the UK whose hourly basic rate of pay is less than the geographically-appropriate living wage. The code should also recommend that companies declare whether payment of the living wage is a requirement in all, some or none of the service contracts they hold.<sup>56</sup> The code operates on a 'comply or explain' basis but is in practice seen as mandatory.<sup>57</sup> **Even so, government should make its intention clear that if companies do not comply, it will change the law to require the reporting of sub-living wage pay by law. In time, this could be extended to larger unlisted companies.**

Of course, the power of public exposure will not force all firms to change their behaviour; employers would continue to weigh up the economic benefits against the reputational risks. But as we have seen with successful campaigns to encourage large companies to pay their fair share of tax, a dynamic in which major companies compete over their reputations in competitive consumer markets can be an incredibly powerful driver of change. These tax campaigns have been driven by civil society organisations and prominent parliamentarians. Yet they could not have happened if the data had not been available.

### ***Institutional investors***

Campaigning for living wages need not be confined to the shop floor. Over the last 20 years, a number of attempts have been made to give shareholders greater power over top pay, following repeated public outcry about excessive executive remuneration. Since the 2002 Directors' Remuneration Reporting Regulations, shareholders have had an advisory vote on company pay

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<sup>56</sup> In most cases, companies won't be able to say what proportion of contract staff are paid less than the living wage. One of the problems of outsourcing is that the 'real employer' usually has no knowledge of, or interest in, the wages of outsourced workers.

<sup>57</sup> Available here by Sonia Sodha <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

policies and, following intensive public and political debate in 2012, shareholders are being granted new powers that include a binding vote on pay. Genuine shareholder activism remains limited, but has primarily focused on challenging excessive executive remuneration. More recently, shareholder living wage campaigns have begun to bear fruit.

Shareholder calls for a living wage are premised on the argument that living wage standards are a core element of corporate social responsibility (CSR) for any reputable employer. The campaign group FairPensions – which promotes responsible investment by pension funds and fund managers and coordinates shareholder efforts to persuade large companies to adopt the living wage – is now engaged in dialogue with over half of FTSE 100 companies. It has been instrumental in persuading a number of major financial and insurance companies to adopt the living wage across their UK operations.

Yet so far, shareholder activism on the living wage has been confined largely to socially responsible investors and individual shareholders who have used the opportunity afforded to them by AGMs to place corporate boards under pressure to pay attention to the wages and well-being of low-paid employees and contractors' staff. The widely held but narrow interpretation of investors' legal duties held by many pension funds and asset managers, which emphasises maximisation of short-term financial returns, holds back such investors from engaging in dialogue with companies about the living wage. FairPensions has called for statutory clarification of these legal duties to encourage more long-termist, responsible investor behaviour (FairPensions 2012). Helpfully, the Law Commission will begin a review into this issue in 2013. In the meantime, it is essential that CSR campaigners pick up the baton by ensuring that low pay, as well as top pay, is a core concern.

### ***Incentives in the tax system***

Some have questioned whether harder-edged policies could be used to change the incentives faced by private sector employers when it comes to the living wage. Broad parts of the low-paid labour market will remain outside the reach of public sector procurement – particularly sectors like retail and hospitality – suggesting that other levers may be needed. There will also be employers for whom reputational risks associated with increased transparency and campaigning are not enough. This has led some to wonder whether the tax system could be used to incentivise employers to pay the living wage. This would be a significant departure from the approach to date, and its use of bottom-up, community organising tactics.

Tax incentives for the living wage have an intuitive appeal. As we have seen, low pay carries significant fiscal costs through public spending on in-work benefits and tax credits, not to mention other, less tangible effects. Because moving to the living wage also carries costs for employers, we might wonder whether a deal could be struck, with government recycling some of the money it would save into support for employers. Indeed, it seems perverse that we currently do the opposite; part of the reason that government benefits from higher pay is that employers are effectively penalised by the tax system for moving to a living wage, being required to pay higher national insurance contributions (NICs).

One approach would be to offer a lower rate of employer NICs or corporation tax for employers who made a commitment to pay the living wage. However, enforcing such a scheme would add complexity to the tax system, meaning significant costs for both government and employers.<sup>58</sup> Activists may also point out, with some justification, that incentivising companies with tax breaks undermines the argument that employers should pay the living wage because it is the right thing to do.

A better option may be to remove the disincentive to raise pay to the living wage by charging employers a higher lump sum rate of employer NICs for all workers earning less than a living wage – in effect a tax increase for employers paying below the living wage (relative to current rates).<sup>59</sup> This would mean that employer NICs would not rise as workers moved up to a living wage; moving a full-time minimum wage worker outside London to the living wage would currently cost an employer £316 a year in higher NICs. This would not require complicated enforcement but would raise taxes on low paying employers, including SMEs.

Even here, though, the intuitive appeal of tax incentives for the living wage hides a number of difficult design challenges:

- The deadweight costs of any tax incentive – paying companies to do what they do already – would be very considerable;
- A more focused scheme could lessen deadweight costs by giving tax breaks to firms in particular sectors or of particular sizes but complexity is expensive;
- Perverse incentives are a significant risk, particularly in encouraging employers to outsource functions to ‘hide’ sub-living wage employees;
- The burdens of monitoring could be high and central government agencies like HMRC are already ill-equipped to monitor compliance with the minimum wage;
- Any tax change that was punitive for low paying employers would disproportionately hit SMEs.
- A flat rate of employer NICs would discourage employers increasing wages above the living wage, potentially reducing wage progression beyond the living wage.

Although we would not rule out further investigation into this area, it seems likely that the tax system will be too blunt a tool to encourage the take-up of the living wage.

## **6.5 Supporting small and medium-sized enterprises**

While some companies, large and small, could introduce a living wage without significant difficulty, many smaller firms are likely to struggle. We have seen that many employers are able to respond to changing costs in a variety of ways, whether through changes in productivity, prices or profits but also that some small firms may find these transitions difficult. Are there ways that government could help SMEs make this transition?

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<sup>58</sup> From personal conversations

<sup>59</sup> As proposed here <http://www.newstatesman.com/politics/2012/11/promote-living-wage-we-need-reform-tax-system>

The tax and benefit gains that accrue to the Treasury when an employer switches to the living wage create resources that could be used to provide support to those employers who would otherwise struggle to adopt the living wage. One option would be a deal between business and the state, with the state providing support for individual firms that take steps to adopt the living wage. The challenge is to craft deals in such a way that they encourage further living wage take up, but without the burdens of complex bureaucracy. **We recommend that the government use the architecture of City Deals to create ‘living wage city deals’, drawing forward future tax and benefit savings from the payment of living wages in local government and devolving this money to support living wages in the private sector.**

As an existing mechanism for devolving funding and power to local areas in return for strengthened local governance and financial commitments, City Deals offer a means to test the viability and success of offering support to SMEs in transitioning to the living wage. City Deals operate at the city-region level in England, covering cities and conurbations with a shared labour market (usually two or more local authorities). Coverage of City Deals is not uniform and deals are tailored to the characteristics of any given area. This facilitates innovation and experimentation across city-regions, helping policymakers understand more about what could work. We recommend time-limited ‘living wage city deals’ in which central government would draw forward a part of the anticipated tax and benefit savings from every local public sector employer in an area in which the majority of local authorities have adopted a living wage. These savings would be placed in ring-fenced ‘living wage development funds’ held at a local level and used to support the transition costs of moving to a living wage for participating SMEs.<sup>60</sup>

Access to these funds would be limited to SMEs who had made a firm commitment to introduce a living wage. The funds would be used to provide advice and financial support to help businesses adapt to the costs of a living wage. This could include identifying more profitable markets, where competition is based more heavily on quality rather than purely on price, as well as investing in training and changes to work organisation that could enable employees to be more productive. The goal would be to challenge and support firms to rethink their business strategies so that investing in the workforce becomes an integral part of business models. Similar support and challenge is available to SMEs in other European countries, but UK governments have often been unwilling to intervene at the level of the firm. This may explain why the UK tends to have a greater number of firms operating in low-value, low-skill industries, with knock-on effects for wages, job quality and government expenditure (Lanning and Lawton 2012). However, we fully recognise that significant numbers of SMEs will always find it difficult to afford the living wage and we do not expect living wage city deals to reach anywhere near full saturation in terms of the share of SMEs paying the living wage. The point is to use the combination of public resources and the saliency of living wage campaigns to push as many firms as possible towards paying the living wage, with concrete incentives and support for businesses.

How would living wage city deals work in practice? A first step would be for a majority of top-tier local authorities in a city-region to pay all of their directly-employed staff the living wage and to

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<sup>60</sup> Since City Deals are only applicable in English city-regions, the Scottish and Welsh governments would need to consider their own arrangements for Scottish and Welsh local authorities.

commit to a timetable for reletting service contracts on a living wage basis. This would enable these local authorities to apply for accreditation as living wage employers through the Living Wage Foundation. Once the majority of top-tier local authorities in a given city-region were accredited, they would seek support from the local chamber of commerce or local employer association to work together on a bid for a 'living wage development fund', with employer associations publicly pledging to support efforts to help a portion of their members move towards a living wage with the promised assistance.

The amount of cash released into the fund by HM Treasury would be based on an estimation of savings to central government associated with the relevant local authorities becoming living wage employers. The city-region would have to draw up a plan detailing how the fund would be used to help local SMEs transition to a living wage. The recipients of living wage city deals could apply for a renewal of their deal if they could prove that an agreed number of local SMEs had become living wage employers over the course of the initial deal.

On the employer side, a key goal of living wage city deals would be to bind in trusted intermediaries with the capacity to provide genuine support to businesses and to strengthen local employer associations. These organisations often lead business improvement elsewhere in Europe but are relatively weak in many parts of the UK (Heseltine 2012). To date, most UK chambers of commerce have been unfavourable about living wages<sup>61</sup>, with the exception of Brighton and Hove, where the local chamber is leading the living wage campaign.<sup>62</sup> Providing such organisations with additional resources that are of value to their members may help to raise support. Preference would be given to deals driven by a partnership model, with directors of the living wage development fund drawn equally from the city-region authorities, employer representatives and civil society organisations. Affording a formal oversight role to civil society organisations would tie in living wage city deals to the broader living wage movement, and help retain the character of the original campaigns. In such a scenario, civil society organisations, including unions, faith groups and local charities, would have a role in holding city-regions to account for their use of public money and their progress in advancing the living wage. They could also ensure that living wage agreements are enforced without the need for excessive state bureaucracy, and help to secure further gains among low-wage workers.

#### **Box 6: How much support could city regions get?**

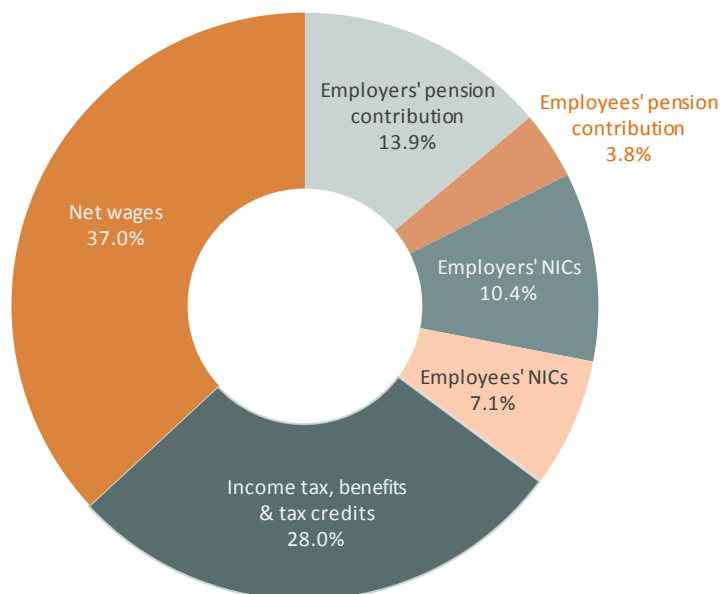
Figure 15 shows the break-down of the total cost of implementing a living wage for directly-employed staff in a council, including how much of this cost then goes to the employee and how much to central government. For every £1 spent by the local authority around 76p goes to the employee, of which 35p is taken home in higher net wages, 30p goes to the Treasury in income tax and reduced tax credit and benefit spending, 7p to the Treasury in employee NICs and 4p into employee pension contributions.

<sup>61</sup> For example, see

[http://www.kentnews.co.uk/news/east\\_kent\\_chamber\\_of\\_commerce\\_boss\\_attacks\\_living\\_wage\\_plan\\_1\\_1683148](http://www.kentnews.co.uk/news/east_kent_chamber_of_commerce_boss_attacks_living_wage_plan_1_1683148) and <http://www.bbc.co.uk/news/uk-england-derbyshire-20264650>

<sup>62</sup> <http://www.businessinbrighton.org.uk/the-brighton-and-hove-living-wage-campaign>

**Figure 15: Estimated average break-down of costs of applying the living wage to local government workers**



Notes: Based on average employer pension contribution of 18.4% and assumes employee pension contribution of 5.8%; assumes employer NICs of 13.8% and employee NICs of 11%. Income tax and benefit savings to Treasury are based on an average MDR across all workers paid less than the living wage. Assumes that all affected workers already earn above the thresholds for income tax and NICs.

To give an idea of the savings to government, we can look at Newcastle and Gateshead City Deal, which was in the first wave of city deals signed in July 2012. Newcastle City Council also introduced a living wage for all directly employed staff in November 2012, when the Council estimated the move would cost £980,000 and would affect approximately 2,218 staff, out of a total workforce of around 13,200.<sup>63</sup> This means that just around 17 per cent of the council's workforce will see their gross pay rise, at an average cost of £442 per worker. Gateshead Council has not implemented a living wage but assuming that a similar proportion of the total workforce earns less than the living wage as in Newcastle City Council, around 1,235 staff would see their gross pay rise if they were to do so. Assuming that the average cost per worker in Gateshead Council was the same as for Newcastle, the total cost to Gateshead would be in the region of £545,870.<sup>64</sup>

The total cost borne by Newcastle and Gateshead councils in raising hourly pay up to the level of the living wage would be around £1.5 million a year. Of this, according to the break-down in Figure 15, around £525,000 would go to workers in higher take-home pay; approximately £270,000 would be added to employer and employee pension contributions; and £705,000 would be returned to the Treasury through higher income tax and NI payments, and lower benefit and tax credit expenditure. If central government agreed to return half of these savings to the local area over a period of five years, Newcastle and Gateshead would receive £1.8 million for a living wage development fund. It should be noted that the precise costings and savings to government would depend on the specific household circumstances and pre-existing pay levels of the affected workers.

<sup>63</sup> <http://democracy.newcastle.gov.uk/ieListDocuments.aspx?CId=857&MIId=4118&Ver=4>

<sup>64</sup> All costs relate to the living wage rates announced in 2011 (£7.20 outside London)

Of course, not all the support provided through a living wage city deal would work. But the benefit in a localised approach is that it allows different city-regions to try out different approaches. New ways of helping businesses transition to better paying business models are unlikely to be generated from Whitehall. Fostering innovation by devolving money and powers to local areas is a much more promising approach. Using City Deals would do this while trying to deliver a ‘double dividend’ on low pay – higher public sector pay saves central government money which is then recycled into support for better pay in the private sector. The hope is to avoid islands of public living wage employers in sea of lower paying private sector employers, a problem with the approach pursued in the US.

## **6.6 Next steps for the campaign**

The success of the living wage depends ultimately on the performance of the campaign itself. The campaign’s approach to date has been highly successful. However, making the transition from small victories among banks and local authorities to securing wage gains for low-paid workers in mainstream major low paying sectors is a task of a different order of magnitude. Living wage campaigners are well aware of this and have already begun to update their approach, for example by improving the governance of the Living Wage Foundation. For the living wage campaign, meeting increased expectations while maintaining the vibrancy, community roots and media savvy of its early years will be a sizable challenge.

A key measure of the campaign’s success in the coming years will be whether a major, low paying private sector employer signs up. To achieve this breakthrough the campaign needs to ask itself a tough question: as things stand, would such an employer feel able to tie their pay-setting decisions for their lowest paid workers to the level of the living wage over time? Answering yes to this question requires, at a minimum, that employers have absolute confidence in the reliability and integrity of the living wage calculation method and the governance on which it rests. This is particularly important when it comes to the scale of the annual increase in the living wage. A large employer able to pay the living wage in any one year may be reluctant to commit to pay the living wage permanently, given that the calculation method (particularly in London) can produce relatively large annual increases and is not tempered by a consideration of labour market conditions. The fact that some employers now pay the living wage but do not publicise the fact and are reluctant to apply for living wage accreditation suggests there is currently some nervousness around these questions.

The direction of the living wage campaign is ultimately a decision for campaigners themselves. But we believe that campaigners should consider reform in the following areas:

### ***Calculating the rate***

There is a strong case for greater consistency in how the two living wage rates are calculated and how they rise each year. The calculation method for the national rate has a number of advantages over the London rate:

- It is less arbitrary, that is, it does not add a ‘buffer’ of 15 per cent.

- It has a more direct link to living standards, that is, it is not averaged with a relative low income threshold.
- It is capped to prevent large annual increases, providing employers with increased certainty around annual cost increases but leaving open the possibility that the living wage rate can regain lost ground later.

There is a case for using the calculation method behind the national living wage rate to produce a more robust London living wage rate or, alternatively, for exploring the benefits of calculating an additional London supplement to the national living wage for employees in the capital. Doing so would increase certainty for London employers who may currently fear annual increases that are not capped in any way. However, it would also be a big decision and would not be cost-free – the London rate would almost certainly rise as a result, creating uncertainty for London employers in what might be a difficult transition period. Yet in the long term such a rise would address the fact that the London living wage rate is too low. In 2012, the London living wage was worth 54 per cent of median earnings compared to between 62 and 74 per cent in the other regions and nations of the UK.<sup>65</sup> Most bottom grades of public sector pay scales are already around the London living wage or higher once the London weighting is factored in, which is not the case for the rest of the country. There would also be long-term value in bringing the two calculation methods into line in terms of the simplicity of a single, national formula.

### ***Governance***

The Living Wage Foundation has already recognised the importance of stronger governance as a pre-requisite of further living wage advances. It has established an advisory council, including business leaders, academics and policy advisers, to guide the movement. It has also set up a ‘policy group’ to provide ongoing advice on the calculation methodology. This is a sensible approach and when considering next steps it will be important to retain this distinction between overall campaign strategy and the setting of the rate itself. On the latter, it is vital to stay true to a living standards approach, which is the essence of the living wage. Muddying the link between living wages and living standards risks making the living wage a poor copy of the minimum wage, emulating a function already carried out with great success by the LPC.<sup>66</sup> There may be a case for further improvements in two areas:

- On the campaign, there is a case for building on the advisory council through broader employer involvement, to ensure the campaign’s strategy reflects a broader range of interests.
- On the rate, there is a case for a more formal and larger ‘policy group’ to advise the Foundation on technical issues on an ongoing basis.

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<sup>65</sup> This is based on the rates announced in November 2012 related to official pay data from April 2012.

<sup>66</sup> Which, as the Resolution Foundation has argued elsewhere, should be reformed

## **Resources**

The most direct support the government could give to the living wage would be to publically fund living wage campaigns and related organisations. We would not recommend this. The independence of the living wage movement and its basis in community organising is essential to its success. It gives the living wage much of its ethical force and it gives the campaign an energy often lacking in public sector bodies, as well as the freedom to innovate. The living wage should not be set in Whitehall and nor should the organisations behind the living wage campaign become an arm of the state.

Yet the government routinely gives financial support to civil society bodies of demonstrable social and economic value, without taking any editorial control or exerting day-to-day influence. The public interest case for supporting the living wage is very clear, both for the individuals it helps and for public spending at a time of extreme fiscal constraints. The Mayor of London currently funds the GLA living wage unit that calculates the London living wage and carries out research into its impacts, but such resources are not available for campaigners and employers outside London. As the campaign moves into new sectors and seeks to expand coverage of the living wage in public contracts, rigorous analysis of the costs and benefits will be vital in demonstrating the case to employers and working through tensions and trade-offs. **We recommend that government fund an independent research unit, based in a university or in Whitehall, to support this analysis.**

## **Flexibility**

Living wage campaigners have shown a great deal of flexibility when negotiating living wage deals with employers. The deal with Intercontinental Hotels, for example, will see the living wage introduced for outsourced staff over a five year period. As part of its accreditation process, the Living Wage Foundation accepts that employers will only be able to implement a living wage for outsourced staff where compatible with their legal obligations and acknowledges that this may limit progress in some organisations.

As living wage campaigns move into new firms and sectors, greater flexibility may be required in order to accommodate different business models and alternative remuneration arrangements. Many parts of the retail sector, particularly large employers, have a tradition of offering staff remuneration packages in addition to basic pay. This can include annual bonuses or profit-sharing arrangements, generous overtime payments, non-wage benefits like discount cards, and, in some cases, relatively generous employer contributions into occupational pensions.<sup>67</sup> The danger is that a living wage comes at the expense of cuts to other parts of the remuneration package, or that employers do not sign up to the living wage because they feel unable to offer one in addition to the other benefits they provide.

Greater flexibility may come from allowing certain parts of remuneration beyond basic pay to be included in the living wage calculation; or from setting a monthly or annual 'living wage' threshold, so that bonuses and profit-sharing payments can be incorporated. These issues are more likely to be picked up if living wage campaigns involve workers who are likely to be directly affected by any living

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<sup>67</sup> For example, Tesco continues to offer new starters access to a defined-benefit pension.

wage deal, since they will be able to report on the precise remuneration arrangements in each firm and take a view on where their priorities lie in the balance of remuneration.

Employers may also have concerns about paying a living wage to new starters whose value has not been proved. Campaigners may want to consider whether staff should be subject to a probationary period during which employers are not required to pay a living wage. Greater flexibility runs the risk of weakening the simplicity of a campaign based on a single hourly wage rate and there is clearly a balance to be struck between retaining the coherence of living wage campaigns and working with employers to overcome practical barriers so that many more workers can benefit from a living wage. Ultimately, these are decisions that must be taken by campaigners and organisers but the proposals put forward in this report should be considered by those involved in the governance of living wage campaigns.

## Conclusion

For over a decade the living wage has served as a rallying cry for decent pay above the national minimum. Harnessing the power of social norms, it has raised the profile of working poverty and has broadened the debate about low pay. Much of the idea's power lies in its simplicity; the view that working people should be paid enough to afford a minimum acceptable standard of living. And much of its vibrancy lies in a bottom-up, community organising approach, which has caught the imagination in a world in which worker empowerment was often assumed to be in serial decline.

The question is: how can public policy support a civil society campaign without undermining these great strengths? The answer will not be a Whitehall diktat and nor is it likely to be a single, simple policy ruse. Government will need to find ways of working in partnership with business, workers and civil society and adopt a mixture of approaches, leading by example, unleashing data into the hands of campaigners, raising the heat on social norms, and finding new ways to reward local areas for innovation. One thing is clear: progress is both possible and desirable, not least for the public purse. Ultimately, though, it will come down to leadership from employers, unions and campaigners.

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## Appendix 1: Additional low pay data

**Table A1: Profile of those falling below selected low pay thresholds: GB 2011**

	Below 2/3 median hourly pay			Below 1/2 median hourly pay			Below Living Wage			Below 90% Living Wage		
	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold
<b>Total</b>	5,070,000	21%	100%	360,000	2%	100%	4,660,000	20%	100%	2,900,000	12%	100%
<b>Sex</b>												
Women	3,140,000	27%	62%	230,000	2%	63%	2,890,000	25%	62%	1,810,000	16%	63%
Men	1,930,000	16%	38%	140,000	1%	37%	1,770,000	15%	38%	1,090,000	9%	37%
<b>Age group</b>												
16-20	800,000	79%	16%	270,000	27%	75%	770,000	76%	17%	620,000	61%	21%
21-30	1,400,000	28%	28%	30,000	1%	8%	1,310,000	27%	28%	810,000	17%	28%
31-40	780,000	14%	15%	20,000	0%	6%	710,000	13%	15%	420,000	8%	14%
41-50	980,000	15%	19%	20,000	0%	6%	870,000	14%	19%	490,000	8%	17%
51-60	750,000	17%	15%	10,000	0%	3%	670,000	15%	14%	370,000	8%	13%
60+	360,000	25%	7%	10,000	0%	2%	330,000	23%	7%	190,000	13%	6%
<b>Region</b>												
Wales	280,000	26%	6%	20,000	2%	6%	250,000	23%	5%	160,000	15%	6%
East Midlands	420,000	25%	8%	30,000	2%	9%	380,000	22%	8%	230,000	14%	8%
West Midlands	520,000	25%	10%	40,000	2%	10%	460,000	22%	10%	280,000	13%	10%
Yorkshire & the Humber	500,000	25%	10%	30,000	1%	8%	430,000	22%	9%	260,000	13%	9%
North West	630,000	24%	12%	50,000	2%	15%	560,000	22%	12%	350,000	13%	12%
South West	490,000	24%	10%	40,000	2%	10%	440,000	21%	9%	270,000	13%	9%
North East	220,000	24%	4%	20,000	2%	4%	200,000	21%	4%	130,000	14%	5%
East	500,000	23%	10%	30,000	2%	10%	430,000	20%	9%	260,000	12%	9%
Scotland	450,000	21%	9%	30,000	1%	9%	400,000	18%	9%	250,000	11%	8%
South East	630,000	19%	13%	50,000	1%	13%	550,000	17%	12%	310,000	9%	11%
London	410,000	12%	8%	20,000	1%	6%	570,000	16%	12%	410,000	11%	14%

Table A1 cont...

	Below 2/3 median hourly pay			Below 1/2 median hourly pay			Below Living Wage			Below 90% Living Wage		
	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold
<b>Occupations</b>												
Sales & customer services	1,090,000	62%	22%	80,000	4%	21%	1,040,000	59%	22%	690,000	39%	24%
Elementary occupations	1,770,000	60%	35%	180,000	6%	49%	1,680,000	57%	36%	1,190,000	40%	41%
Personal services	810,000	36%	16%	40,000	2%	11%	710,000	32%	15%	390,000	18%	14%
Process, plant & machinery operatives	340,000	24%	7%	10,000	0%	2%	300,000	21%	6%	160,000	12%	6%
Skilled trades	270,000	16%	5%	20,000	1%	6%	240,000	14%	5%	140,000	8%	5%
Administrative & secretarial	450,000	16%	9%	20,000	1%	6%	390,000	13%	8%	180,000	6%	6%
Managers & senior officials	170,000	5%	3%	10,000	0%	2%	150,000	4%	3%	70,000	2%	3%
Associate professional & technical	120,000	3%	2%	10,000	0%	2%	100,000	3%	2%	50,000	1%	2%
Professional	40,000	1%	1%	10,000	0%	1%	40,000	1%	1%	20,000	1%	1%
<b>Work status</b>												
Part-time	2,880,000	43%	57%	260,000	4%	72%	2,700,000	41%	58%	1,830,000	28%	63%
Full-time	2,190,000	13%	43%	100,000	1%	28%	1,950,000	11%	42%	1,070,000	6%	37%
Temporary/casual	590,000	36%	12%	50,000	3%	15%	570,000	34%	12%	370,000	22%	13%
Permanent	4,400,000	20%	87%	300,000	1%	83%	4,020,000	19%	86%	2,480,000	11%	86%
Not classified	70,000	27%	1%	10,000	3%	2%	70,000	26%	1%	50,000	17%	2%

Table A1 cont...

	Below 2/3 median hourly pay			Below 1/2 median hourly pay			Below Living Wage			Below 90% Living Wage		
	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold	Number	% in group below threshold	% of all below threshold
<b>Industry</b>												
Hotels & restaurants	830,000	69%	16%	140,000	11%	38%	810,000	68%	17%	640,000	53%	22%
Wholesale & retail	1,420,000	41%	28%	90,000	3%	25%	1,330,000	38%	29%	830,000	24%	29%
Administration	560,000	39%	11%	10,000	1%	3%	530,000	37%	11%	360,000	25%	12%
Arts	160,000	37%	3%	20,000	4%	5%	150,000	36%	3%	100,000	24%	4%
Health	600,000	18%	12%	20,000	1%	5%	510,000	15%	11%	290,000	9%	10%
Education	570,000	15%	11%	30,000	1%	9%	510,000	13%	11%	240,000	6%	8%
Real estate	40,000	14%	1%	0	1%	1%	40,000	13%	1%	20,000	7%	1%
Manufacturing	310,000	13%	6%	10,000	0%	3%	260,000	11%	6%	130,000	6%	4%
Agriculture, mining, electricity & water	50,000	12%	1%	0	1%	1%	50,000	11%	1%	20,000	5%	1%
Construction	70,000	9%	1%	10,000	1%	2%	70,000	8%	1%	40,000	5%	1%
Transport	90,000	9%	2%	0	0%	1%	80,000	7%	2%	30,000	3%	1%
Professional, scientific & technical industries	110,000	8%	2%	10,000	1%	2%	100,000	7%	2%	50,000	4%	2%
Information	60,000	7%	1%	10,000	1%	2%	60,000	6%	1%	40,000	4%	1%
Financial services	40,000	4%	1%	0	0%	1%	30,000	3%	1%	20,000	1%	1%
Public administration	30,000	2%	1%	:	:	0%	20,000	2%	0%	10,000	1%	0%
Other services, household & extra-territorial	130,000	28%	3%	10,000	2%	3%	120,000	27%	3%	80,000	17%	3%
<b>Public/private sector</b>												
Private sector	4,190,000	27%	83%	320,000	2%	88%	3,920,000	26%	84%	2,550,000	17%	88%
Public sector	570,000	9%	11%	20,000	0%	7%	460,000	7%	10%	200,000	3%	7%
Unclassified	310,000	18%	6%	20,000	1%	5%	270,000	16%	6%	150,000	9%	5%

Notes: Data cover all employees on adult rates of pay who have not had their pay affected by absence in the time covered. Industry categories correspond with SIC 2007 and occupation categories correspond with SOC 2003.  
2011 figures are based on a median hourly pay rate (for all employees) of £11.24 and Living Wage rates of £8.30 in London and £7.20 in the rest of the country.

Sources: Authors' analysis of ONS, *Annual Survey of Hours and Earnings*

## Appendix 2: Calculating the impact of the living wage on firm-level wage bills

The estimated average wage bill increases (percentage of the total wage bill) presented in this report were produced using a bespoke ‘what-if’ firm level model that identifies the impact of implementing a living wage across a given firm’s workforce on its wage bill. The report does not provide detailed firm-specific wage bill cost projections but instead draws on individual firm-level analysis across a range of industrial sub-sectors to provide an estimate of the average wage bill increase that a typical large (more than 250 employees) or medium (with a maximum of 250 employees) listed firm in a given sector might expect if they made the decision to implement a living wage.

The analysis was run under the following scenarios: every directly-employed worker earning an hourly pay rate below a living wage is brought up to the full geographically appropriate living wage rate wage rate (£8.30 in London, £7.20 elsewhere).

For any given sampled listed firm, the following was sourced from the consolidated financial data publicly available in company annual reports:

- Total number of employees
- Firm coverage: regional, national or international
- Location of head office
- Industrial sector turnover
- Operating profit/(loss)
- Net profit/(loss)
- Wages
- NICS
- Pension costs
- Total assets

Where available a detailed breakdown of the proportion of a given directly-employed workforce that were full-time (35 to 40 hours a week) and part-time (17.5 to 20 hours) was sourced but in cases where such information was not available it was assumed that a given firm’s workforce breakdown approximated that outlined in ONS labour market statistics as of October 2011 (73 per cent full-time and 27 per cent part-time).

Given the absence of detailed wage distribution data for individual listed firms, wage distributions derived from an analysis of a four-quarter combined Labour Force Survey (LFS) sample, covering a total of 440,000 records, were assumed to be in place across a range of broad industrial sectors. We broke down the sample of 440,000 records across 13 regions (including the UK as a whole), nine industrial sectors and three firm sizes (small, medium and large), resulting in 351 separate wage distributions (13 x 9 x 3). In some instances, the resulting sample sizes are prohibitively small: for example, we find no employees working in large agricultural firms in Northern Ireland. However, in relation to the sub-sectors covered by the 79 firms we look at in the model, sample sizes are adequate in all cases: the smallest base used (in relation to mid-sized construction firms in Yorkshire and Humberside) is 116 and in most instances the sample is significantly bigger. To take an example, for a large (more than 250 employees) firm with national coverage in the broad industrial sector of distribution, hotels and restaurants the impact of living wage implementation was calculated on the assumption that that firm’s wage distribution reasonably approximates the average wage distribution derived from 1,572 sampled firms with similar geographic, size and sectoral characteristics.

## Firm sampling method

Data was taken for 79 individual medium (with a maximum of 250 employees) and large (more than 250 employees) firms quoted on the main market of the London Stock Exchange (LSE) and incorporated in the UK. Listed firms for which no accurate data on total number of UK-based employees were excluded from the analysis as were firms listed on the LSE as UK incorporated but which did not base more than 50 per cent of their workforce in the UK. Of a total of 1,058 firms listed as of January 2012 we sampled companies from the following industrial sub-sectors:

- Banking
- Construction
- Software & Computing
- Food Production
- Food & Drug Retailers
- General Retailers
- Bars & Restaurants

These seven industrial sub-sectors were selected from the LSE listings for two principle reasons. The first reason is that these seven industrial sub-sectors were representative of the varying incidences of low-paid work across a range of broad industrial sectors. Selecting a sample of industrial sub-sectors that was representative of the range of varying incidences of low pay across broad industrial categories was important because the precise size of the wage bill cost that any given firm considering living wage implementation might expect is necessarily linked to the proportion of its workforce employed on hourly rates below the living wage.

The second reason that these seven industrial sub-sectors were selected was that they provided a reasonable match for the broad industrial categories from which the assumed firm-level wage distributions utilised in the firm-level modelling in this report were derived. In selecting industrial sub-sectors from which to sample individual firms it was therefore important that industrial sub-sector categories corresponded approximately to the broad industrial sectors used to derive assumed wage distributions in the modelling behind the analysis. Table 5 illustrates the precise relationship between broad industrial sectors and the industrial sub-sectors sampled in this report.

**Table 5: Relationship between broad industrial sectors and sampled industrial sub-sectors**

<b>Broad Industrial Sector, SIC 2007 (Source for derived wage distributions )</b>	<b>Industrial Sub-Sector, London Stock Exchange listings (Source for sample of 79 UK incorporated firms)</b>
Banking, Finance, Insurance and Real Estate (J-K)	Banking (3 firms in sample)
Construction (F)	Construction (15)
Transport & Communications (I)	Software & Computing (13)
Manufacturing (D)	Food Production (4)
Distribution, Hotels & Restaurants (G-H)	Food & Drug Retailers (7)
Distribution, Hotels & Restaurants (G-H)	General Retailers (28)
Distribution, Hotels & Restaurants (G-H)	Bars & Restaurants (10)

## **Dynamic complexity**

A simplified approach to the cost of living wage implementation at a firm-level was taken. The analysis makes no assumptions about possible supply-side effects of living wage implementation such as productivity increases associated with higher effort, cost savings on recruitment and induction training, reduced absenteeism, lower staff turnover, increased stability of workforce, improved worker morale, motivation and commitment, and reputational benefits.

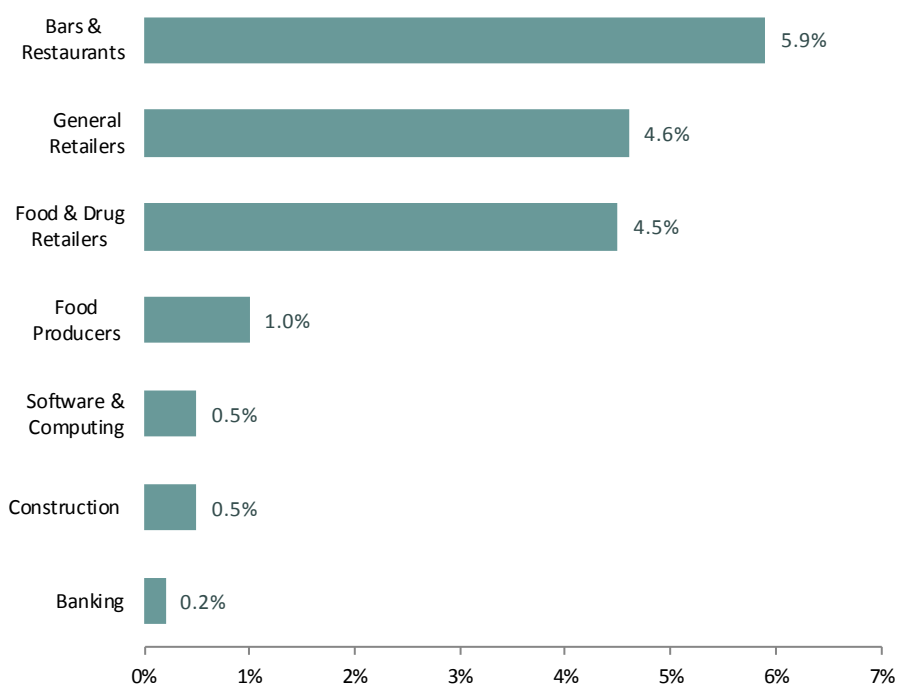
The analysis also makes no assumptions about the range of different coping strategies that different employers might implement to offset wage bill increases that might result from wholesale introduction of living wage rates across a workforce including adjusting pay structures, reducing non-wage benefits, attempting to increase productivity, raising prices (or reducing quality), accepting reduced profit margins, adjusting hours of work or reducing the number of individuals employed.

## **Accounting for wage spillover effects**

Within the academic literature – confined to examinations of possible wage spillover effects as a result of increases in the National Minimum Wage – there is little consensus as to the actual magnitude of wage spillover effects (that is, of wage increases further up the wage distribution on account of changes to the floor rate). An econometric analysis of spillovers conducted by Stewart (2009) found that, in general, spillover effects from the minimum wage were small and typically did not reach above the 5th percentile of the earnings distribution. In contrast, Butcher, Dickens, and Manning, in their analysis of differentials, found that areas most affected by the minimum wage had the largest spill-overs, with effects evident up to the 25th percentile. Dolton, Rosazza Bondibene and Wadsworth found evidence to suggest that the minimum wage may have squeezed differentials at the bottom of the earnings distribution

Altering the magnitude of the wage spillover effects necessarily produces different average firm-level wage bill increases. For example, Figure 16 shows the average firm-level wage bill increase by industrial sub-sector if modelling for zero wage spillover.

**Figure 16: Average firm-level wage bill increase by industrial sector – no wage spill-over effect**

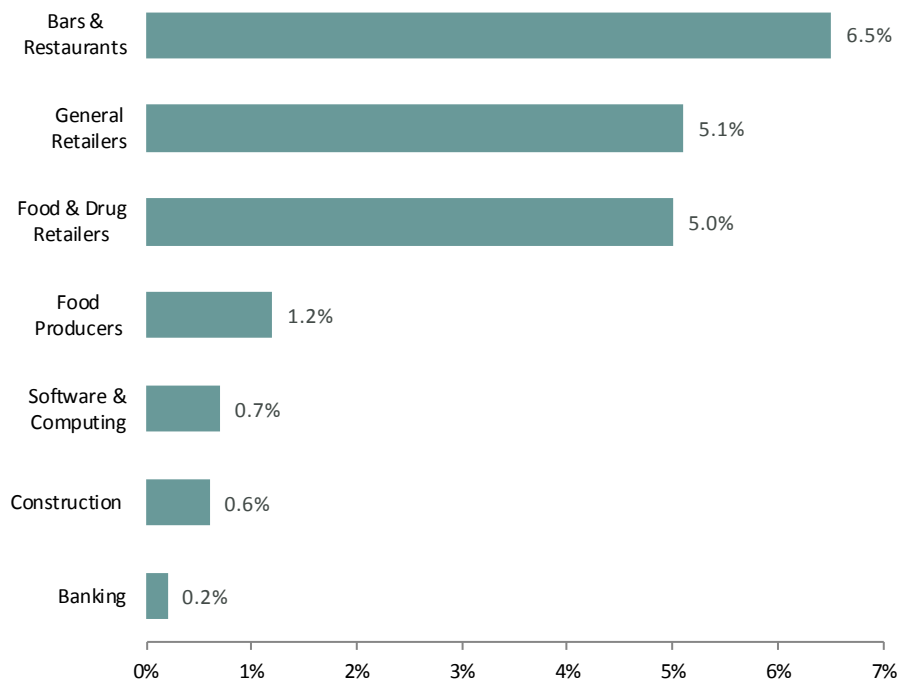


Note: Average firm-level wage bill increases were calculated using consolidated financial data for 79 large and medium-sized UK incorporated firms sampled from LSE listings in seven industrial sub-sectors. 10 firms were sampled from the Bars & Restaurants sub-sector, 27 from General Retailers, 7 from Food & Drug Retailers, 4 from Food Producers, 13 from Software & Computing, 15 from Construction and 3 from Banking

Source: Resolution Foundation analysis

In contrast, Figure 17 (below) shows the effects of a large wage spill-over effect. In this instance the move to a full living wage rate was modelled on a 20 per cent increase in the wage rate for workers who earn between £8.30 and £10.52 in London and between £7.20 and £8.32 elsewhere (the difference between the NMW rate and the geographically appropriate living wage rate above the new living wage pay floor). The spillover wage increases that are applied to wage rates immediately above each threshold, as set out above, are coupled with increases further up the pay distribution to model for the tapering effects of wage spillovers.

**Figure 17: Average firm-level wage bill increase by industrial sector – large wage spillover effect**



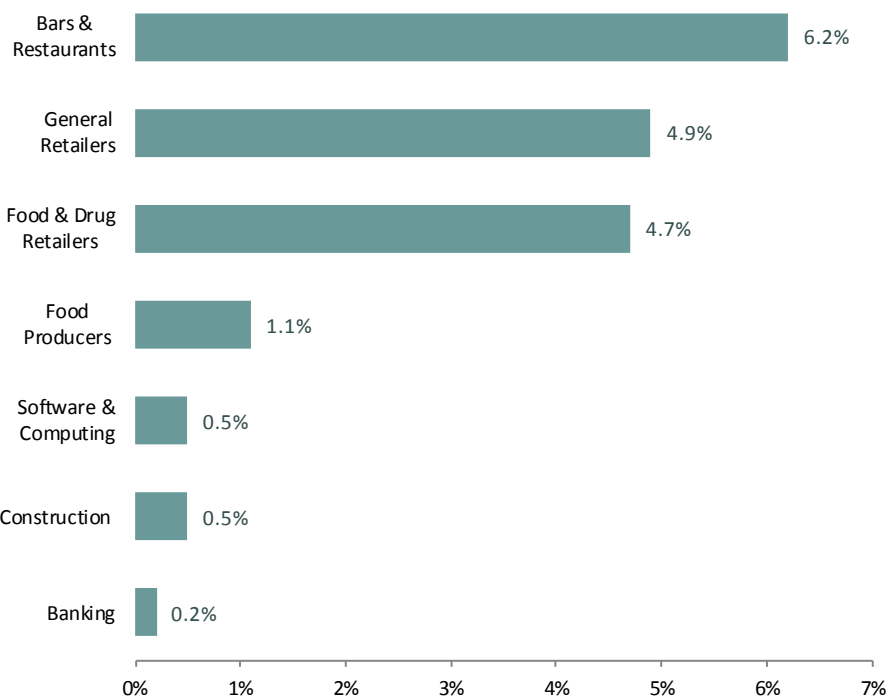
Note: Average firm-level wage bill increases were calculated using consolidated financial data for 79 large and medium-sized UK incorporated firms sampled from LSE listings in seven industrial sub-sectors. 10 firms were sampled from the Bars & Restaurants sub-sector, 27 from General Retailers, 7 from Food & Drug Retailers, 4 from Food Producers, 13 from Software & Computing, 15 from Construction and 3 from Banking

Source: Resolution Foundation analysis

The results displayed in Figure 16 and Figure 17 make clear that while modelling for different wage spillover magnitudes necessarily impacts on the magnitude of the wage bill increase the effects are not considerable. The range of the average wage bill increases (if modelling for both a large spillover effect and zero wage spillover effect) as a result of moving to a full living wage rate pay floor is just 0.2 percentage points in the Food Producers sub-sector and 0.1 percentage points in the Construction sub-sector. Even in the three retail sub-sectors analysed above the range of average wage bill increase is just 0.6 percentage points in Bars & Restaurants, 0.5 percentage points in General Retailers, and 0.5 percentage points in Food & Drug Retailers.

Given this relatively narrow range of results and the fact that wage spillover effects are a contested issue within the relevant academic literature the analysis contained in this report is premised on a modest spillover effect as a result of implementing a full living wage floor of 10 per cent increase in the wage rate for workers who earn between £8.30 and £10.52 in London and between £7.20 and £8.32 elsewhere (the difference between the NMW rate and the geographically appropriate living wage rate above the new living wage pay floor). Figure 18 (below) shows once again the results produced under this 'core' scenario.

**Figure 18: Average firm-level wage bill increase by industrial sector – moderate wage spillover effect**



Note: Average firm-level wage bill increases were calculated using consolidated financial data for 79 large and medium-sized UK incorporated firms sampled from LSE listings in seven industrial sub-sectors. 10 firms were sampled from the Bars & Restaurants sub-sector, 27 from General Retailers, 7 from Food & Drug Retailers, 4 from Food Producers, 13 from Software & Computing, 15 from Construction and 3 from Banking  
Source: Resolution Foundation analysis

### Appendix 3: Comparing data sources

Table 6 compares the proportion of employees paid less than the minimum wage and the living wage under four different measures of hourly pay: one from the Annual Survey of Hours and Earnings (ASHE) 2011, the most robust source of wage data in the UK, and three different measures created in FRS.<sup>68</sup> Imputing hourly pay for all employees ('FRS wage measure 1' in Table 6) overstates the proportion that are paid less than the living wage. We tested two other approaches to correct this. FRS wage measure 2 uses the imputed hourly wage only where the derived hourly wage is less than the living wage. FRS wage measure 3 uses the imputed hourly wage only where the derived hourly wage is less than the minimum wage.

**Table 6: Proportion of employees below low pay thresholds, 2008-09 (at 2012 prices)**

	% of employees paid less than the NMW	% of employees paid at or above the NMW but below the living wage	% of employees paid less than the living wage
FRS wage measure 1	4.5%	23.0%	27.5%
FRS wage measure 2	4.3%	15.7%	20.0%
FRS wage measure 3	3.5%	20.6%	24.1%
ASHE 2011	1.2%	18.8%	20.0%

Source: Authors calculations and ONS (2011)

With each FRS wage measure, the proportion of employees paid less than the NMW is overstated compared to ASHE.<sup>69</sup> It is not clear how to treat these people for the purposes of the modelling, as it is likely that a large proportion are actually paid above the NMW but we cannot produce an accurate estimate of their actual hourly pay. We have chosen to exclude them from our analysis. This means that FRS wage measure 3 is the most appropriate measure of hourly pay to use in our analysis, since it produces a figure for the share of employees earning at or above the minimum wage and less than the living wage (the group we are interested in) that most closely matches the proportion found in ASHE.<sup>70</sup>

The choice of wage measure, and the decision to include or exclude employees who appear to be paid less than the minimum wage from the analysis, has a large effect on the estimated increase in gross earnings associated with an increase in the coverage of the living wage. To illustrate this, we simulate the impact on total gross wages of a universally applied living wage.<sup>71</sup> Our estimates vary between £5.1 billion and £10.1 billion depending on the choice of wage measure and the treatment of people earning less than the minimum wage. Our preferred measure of hourly pay (FRS wage measure 3) produces estimates that are roughly in the middle of the range. The range of estimates means that the results presented in this chapter are uncertain and should be treated as illustrative.

<sup>68</sup> ASHE is a survey of employers rather than households. We cannot use ASHE for the basis of our modelling because it does not contain any variables about household income and expenditure.

<sup>69</sup> Some people are legitimately paid less than the adult minimum wage rate, including young people aged 16 to 20, apprentices and workers who benefit from subsidised accommodation linked to a job. However, this proportion is clearly overstated in all of the FRS wage measures we estimate.

<sup>70</sup> This implies that we accept the data on weekly wages and hours contained in FRS for everyone earning more than the NMW but believe this data to be incorrect for those whose derived hourly wage is less than the NMW.

<sup>71</sup> This means that everyone who is paid at or above the NMW but below the appropriate living wage rate has their weekly earnings multiplied by a multiplier constructed by dividing the living wage by their imputed or derived hourly wage. This procedure essentially assumes that weekly earnings in FRS are accurate but weekly hours are not, which is supported by the fact that earnings data is far more rigorously checked than hours data in the survey questionnaire.

**Table 7: Increase in total gross earnings of introducing a comprehensive living wage under different scenarios and wage measures, 2008-09 (in 2012 prices)**

	All employees are paid at least the living wage (including those currently paid below the NMW)	Employees earning at or above the NMW paid at least a living wage
FRS wage measure 1	£10.1bn	£7.8bn
FRS wage measure 2	£7.0bn	£5.1bn
FRS wage measure 3	£7.9bn	£6.5bn

## Appendix 4: Costs for a range of local authorities

Local authority	First full year costs	No. of staff affected	Total workforce size (headcount)	No. of staff affected as % of total workforce
Hounslow	£14,056	44	6,783	0.6%
Ealing	Zero	None	7,134	-
Enfield	£1,700	45	10,159	0.4%
Birmingham	£1.3m	3,074	50,310	6.1%
Cardiff	£1.0m	2,261	15,697	14.4%
Newcastle	£1.0m	2,000	13,214	16.8%
Preston	£36,600	84	1,454	5.8%
Brighton & Hove	£179,000	410	9,643	4.3%
East Renfrewshire	£141,236	234	4,400	5.3%
North Ayrshire	£174,000	294	9,700	4.4%
West Dunbartonshire	£200,000	400	5,700	7.0%
Dumfries & Galloway	£310,000	800	7,700	10.4%
Dundee	£122,371	234	7,300	3.2%
Highland	£322,000	600	10,100	5.9%
South Ayrshire	£198,000	541	5,300	10.2%

Source: Total workforce size from Scottish local government employment statistics <http://www.scotland.gov.uk/Topics/Statistics/Browse/Labour-Market/PublicSectorEmployment/LAPSE> and England and Wales from ONS Quarterly Public Sector Employment Survey [http://www.local.gov.uk/web/guest/local-government-intelligence/-/journal\\_content/56/10171/2991184/](http://www.local.gov.uk/web/guest/local-government-intelligence/-/journal_content/56/10171/2991184/). Other data is from public reports from the relevant authorities.

Notes: In most cases, figures include all school staff. This not an exhaustive list of all living wage councils, just those from whom we could source reliable data.