Resolution Foundation

Fifteen years later

A discussion paper on the future of the UK National Minimum Wage and Low Pay Commission

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Executive Summary

In 15 years the UK National Minimum Wage (NMW) has evolved from a bold and experimental labour market intervention into a permanent and generally uncontroversial tool of economic policy. The Low Pay Commission (LPC), enshrined in law in 1998 to recommend the rate of the NMW, has won widespread support, with its decisions endorsed by a solid academic consensus that the NMW has boosted pay without causing unemployment.[1] In the words of the Financial Times: "in this heavily studied field of economics, the jury is back in".[2] Now political support has followed. While pockets of resistance persist, all mainstream UK parties support the NMW and leading thinkers on left and right have even begun to call for it to be strengthened.[3] Public support remains exceptionally strong.[4]

Yet sitting awkwardly alongside the success of the NMW is the scale of low pay in contemporary Britain. Although extreme, exploitatively low pay has been nearly abolished, one in five workers still earn below £7.49 an hour (two thirds of median pay), just £13,600 a year for working full-time and too little to afford a basic standard of living. This proportion has risen steadily over time and is markedly higher in the UK than in comparable maturing economies. Now an unprecedentedly long period of zero growth has hit real wages hard, indeed far harder than economists anticipated. Evidence indicates that wage growth may have become more sensitive to unemployment before the crash, suggesting that, even in a recovery, wage growth—particularly for the low paid—will be hard won.[5]

Today's fiscal position makes the challenge of low pay more urgent, and is also spreading concern across the political spectrum. The costs to the UK state of pay below the Living Wage (defined as the wage that is needed for a minimum standard of living—£7.45 an hour in 2013) now amount to more than £2 billion a year for in-work benefits and foregone tax revenues.[6] Although better pay would far from negate the need for in-work support, a reasonable debate has begun about how to rebalance the responsibilities of employers and the state. At a minimum, it is clear that broad-based income growth in an era of extreme fiscal constraint will require a more assertive effort to tackle low pay at its source, rather than compensating for a lack of wage growth through rising welfare spending.

This paper launches a major new project at the Resolution Foundation that will consider what role the UK's National Minimum Wage and Low Pay Commission could play in its next fifteen years in reducing the incidence of low pay. The core of the project will be a high-level, expert panel to review the future of the NMW and LPC, chaired by Professor Sir George Bain, the founding chair of the LPC, working with some of the UK's leading labour market economists and policy experts. The project will ask whether there are practical ways in which the NMW and LPC could be strengthened to tackle low pay more generally while, crucially, not jeopardizing the success that has been achieved to date.

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[1] The National Minimum Wage p.182, *National Minimum Wage: Low Pay Commission Report 2012*, Low Pay Commission (2012). See also Butcher, *Still evidence-based? The role of policy evaluation in recession and beyond: the case of the National Minimum Wage*, National Institute Economic Review, No.219 (Jan 2012)

[2] '*Higher US minimum wage makes sense*', Financial Times editorial, Feb 19 2013

[3] Prime Minister David Cameron: "I think the minimum wage has been a success", Interview with The Observer, 18 December 2005 (http://bit.ly/17sqptm); Chancellor George Osborne: "Modern Conservatives acknowledge the fairness of a minimum wage", Speech to Demos, 21 August 2008 (http://bit.ly/1aoMYmt); Matthew Hancock MP: "The Conservative Party should not only support the minimum wage, but strengthen it", *A Conservative Agenda for Tackling Low Pay*, speech to the Resolution Foundation, 27 March 2013 (http://bit.ly/126ik8i).

[4] In 2010, 48 per cent of people polled thought the minimum wage was too low while just 4 per cent thought it was too high. YouGov, polling 1,903 adults, 6th - 7th October 2010.

[5] Gregg, P. and Machin, S., *What a drag: The chilling impact of unemployment on real wages*, Resolution Foundation (September 2012)

[6] Pennycook, M. and Lawton, K. *Beyond the Bottom Line: The challenges and opportunities of a living wage,* Resolution Foundation and IPPR (2013)

The evidence set out in this scene setting paper suggests that, while low pay is not a new problem, it has become a more worrying and apparently more structural challenge in recent years. It is now clearer than ever that low pay will not solve itself through a light touch approach of pursuing growth and investing in skills. The lower half of the UK labour market simply is not creating higher quality jobs in the way that economists once anticipated. Demand for low paid service work is rising on the back of higher consumption. Together with new technologies and an ageing population this is expanding employment in sectors like hospitality, warehousing and social care. While these trends are apparent in most advanced economies, the UK labour market is creating notably lower quality, lower paying versions of these roles than other countries. Institutions like the NMW and LPC will be indispensable in shifting this unsavoury equilibrium.

Yet if the NMW and LPC are to make a significant dent in low pay, new thinking will be needed. On the basis of reasonable, conservative projections, the UK is currently heading for a minimum wage in the region of £7.20 an hour in 2017/18—the equivalent of £6.12 in 2012-13 prices, and lower than its level in 2004/05. Moreover, the UK minimum wage has had a relatively narrow effect, doing little to help workers who are paid slightly above the minimum. Even in the years that saw the most ambitious increases in the value of the NMW—when the extent of extreme low pay (below half of median pay) fell from 6.9 to 1.8 per cent—the UK incidence of low pay more generally (below two thirds of median) fell by only 0.9 percentage points. At that rate it would take over 70 years for the UK to reach even the average rate of low pay in OECD countries. There is a large aspiration gap between where we are headed and where we would like to be.

Fortunately, though, we now also understand far more than we did in the late 1990s about the impacts of minimum wages and about low wage labour markets. We can now say with confidence that a sensible NMW can boost pay without harming unemployment and without large offsetting declines in working hours or non-wage benefits. This result teaches us important lessons. Labour markets are not as competitive as we thought, meaning that upward pressure on pay from non-market institutions can be key to ensuring that workers receive a fair share of the value they are creating. We have also learned that employers respond to such pressure in a wide range of ways—firms are smarter and more strategic than the minimum wage's opponents gave them credit for. They don't just fire people or cut hours, they squeeze pay differentials or profits, change pricing structures or find new ways to raise productivity.

Yet just as importantly, 15 years on, we are also now equipped to open up a broader debate about the particular approach the UK has taken to the minimum wage. Minimum wages are not a binary choice; there is significant international variety in their design. The UK has so far stressed a simple approach with a narrow footprint, in which the NMW is relatively isolated from broader labour market institutions. These choices have had important upsides: they have kept the policy simple, made the LPC's job easier, and have aided enforcement and communication. All of these upsides proved vital to embedding a consensus in the policy's formative years.

But these upsides have inevitable trade-offs. They mean, for example, that the UK NMW has a narrower impact than minimum wages in some other countries. In some sectors the NMW now risks becoming the going rate for entry level staff; having been intended as a legal boundary to prohibit exploitation, it has become a guide to how much certain occupations should be paid. Meanwhile, a single adult minimum wage will always be an ill-fitting garment. Although the NMW pinches hard in some parts of the economy, it puts very little upward pressure on many employers who could afford to pay more. Finally, growth in the value of the NMW has now stalled and there is little clarity about whether or when it will be restored. In all cases, the different approaches that have been taken in other countries would have led to different results. The question is: are the choices the UK made 15 years ago still right for the next 15 years?

The Resolution Foundation's new project on the future of the NMW and LPC will be considering this question in the coming months. This discussion paper sets the scene for the work.

- **Chapter 1** recaps the lessons from previous Resolution Foundation research and shares new analysis of the impact of the NMW on pay. It describes contemporary low pay and points to two developments that suggest low pay is not a problem that will solve itself simply through a light touch approach of pursuing growth and smart skills policy—the UK is creating large numbers of low skilled jobs and was struggling to generate real wage growth even in the boom years before the crash.

- **Chapter 2** reflects on what has been learned from 15 years of research into the effects of minimum wages. It looks briefly at the impacts of the UK NMW and then turns to the interesting question of why the NMW has not caused unemployment, setting out what this tells us about how low wage labour markets work.

- **Chapter 3** tees up the forthcoming project by broadening out the discussion. It explores some of the unavoidable trade-offs that are inherent in minimum wage design and compares the choices the UK has made to those of other countries. It also sets out new analysis on how the NMW is reshaping the bottom end of the UK labour market, as well as new analysis of the prospects for the NMW and low pay in the coming years.

The paper concludes by drawing together these findings and setting out some key questions that will be investigated in detail over the course of the project.

Chapter 1: Contemporary low pay—a problem that won't solve itself

The UK low pay landscape has changed markedly in the last 15 years. This chapter gives a brief description of low pay in the era of the minimum wage. Today's low pay is a different problem to the exploitatively low pay—as low as £1 an hour in extreme cases—that confronted policymakers 15 years ago. It is also, in important ways, a more worrying problem. It now seems clear that low pay is a generalised and systematic feature of the contemporary UK jobs market, and one that will not be solved with a light touch policy approach of pursuing growth and investing in education and skills. More direct efforts to shape labour market outcomes will be needed.

The challenge of contemporary low pay

In previous work the Resolution Foundation has documented in detail the rise of low pay in the UK.[7] Our work has outlined a number of important changes in the nature of low pay over recent decades:

- **Extreme low pay has declined but low pay more generally remains pervasive.** More than a fifth of the UK workforce (21.4 per cent) earns below £7.49 an hour (below two thirds of median pay).[8] This is the second highest rate of low pay in the OECD and twice the rate in some other countries.[9] Using the Living Wage as a measure gives similar results: a fifth (19.7 per cent) of the workforce earn too little to afford a basic standard of living. (See Box 1.) Meanwhile, the extent of extreme low pay (below half the median wage) has fallen by 80 per cent from 6.9 per cent in 1997 to 1.5 per cent in 2011.[10] (Figure 1.)

- **The gap between the lowest paid and those in the middle has narrowed**. The ratio between very low pay (at the 5th percentile) and the median fell sharply from the late 1990s after years of rising inequality. The ratio between the low paid (10th percentile) and the median has also stabilised. Both changes have been more pronounced in local areas with the greatest coverage of the NMW.[11] More generally, the distribution of hourly pay has been transformed. Figure 2 presents new analysis showing starkly how the distribution of pay has been affected by the NMW. It shows the distribution of hourly pay in 1997 and 2012, revealing the extent to which pay at the bottom end of the UK labour market has become compressed. Around 6.5 per cent of the workforce is now paid below, at, or within 25 pence of the NMW and around 10 per cent within 50 pence.

- **Low pay has become a more costly problem**. In common with other advanced economies, the UK has introduced a large and permanent system of in-work cash transfers, largely in the form of Tax Credits, to top up the unsustainably low wages of low income working households.[12] In combination with the trends outlined above, this has raised the fiscal cost of low pay.[13] If the Living Wage were to be paid universally in the private sector today, the government would save around £3.6 billion from increased income tax revenues, National Insurance Contributions (NICs) and reduced welfare spending. Accounting for the £1.3 billion cost of paying all public sector

[7] See the list of publications on p.16 at the end of this chapter.
[8] Pennycook, M. and Lawton, K. (2013)
[9] p.21, ibid.
[10] Although there is continued avoidance of the NMW, particularly in sectors like social care, where as many as 220,000 domiciliary care workers, overwhelmingly women, are paid below the minimum wage. See also Bessa, Forde, Moore and Stuart (2013)
[11] Low Pay Commission: "Those areas with the lowest wages prior to the introduction of the minimum wage experienced the greatest falls in inequality over the period from 1998 to 2010.", quoted in Dickens, Riley and Wilkinson (2012)
[12] See Kenworthy, L. *When does economic growth benefit people on low to middle incomes – and why?* Resolution Foundation (2011)
[13] For a full account of these costs and details on methodology see p.40-43, Pennycook, M. and Lawton, K. (2013)

workers a Living Wage, government would be left with net savings of around £2.2 billion a year. More generally, in-work welfare has made the NMW an integral part of the social security system because it limits the extent to which employers can use Tax Credits as a wage subsidy that allows them to pay even less.

- **Women, part-time workers and the young face the highest risk of low pay**: 27 per cent of women are low paid, compared to 16 per cent of men; 43 per cent per cent of part-time workers are low paid (on an hourly basis), compared to 13 per cent of full-time workers; 79 per cent of 16-20 year olds low paid, compared to 28 per cent of 21-30 year olds and 14 per cent of those aged 31 to 40. While the young face a higher risk of low pay, low paid workers in their 30s are far more likely to head a household or have dependent children.

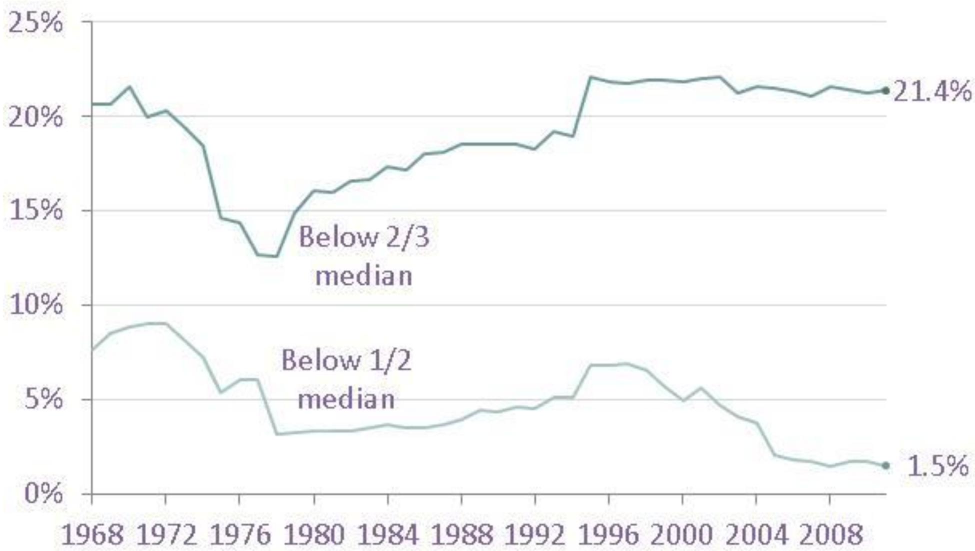
- **Low pay is, to a large degree, a sector-specific problem**: nearly half (46 per cent) of all low paid workers are employed in two sectors: *Wholesale and Retail* and *Hotels and Restaurants*. Figure 3 shows where the UK's low paid workers are located by industrial sector. We also know that most low pay is in the private sector and the private-public gap has widened over time, from 10 percentage points in 1997 (25 per cent vs. 15 per cent) to 19 percentage points in 2011 (27.5 vs. 8.5).[14] The risk of low pay also varies substantially by occupation, reaching a peak among sales and customer service staff, 59 per cent of whom earn below the Living Wage.

This profile of low pay confirms that today's low pay is a different problem to the exploitative, extreme low pay that confronted policymakers in the late 1990s. Today, low pay persists in the part of the workforce earning above the NMW but still below what is needed to attain a basic standard of living. This is a problem on a vastly bigger scale to the challenge that the NMW was designed to address: 4 per cent of workers earn at or around the NMW, while a fifth of the workforce earns below the Living Wage (see Box 1). It is also a highly sectoral problem, residing mainly in a few large, private, service sectors. And it is an expensive problem: as things stand, a failure to tackle low pay will cost UK taxpayers more than £20 billion over the next decade.

[14] p.37, Pennycook, M. and Whittaker, M., *Low Pay Britain 2012*, Resolution Foundation (2012)

Figure 1: Long-terms trends in low pay and extreme low pay

Proportion of all employees below low pay threshold, 1968-2011



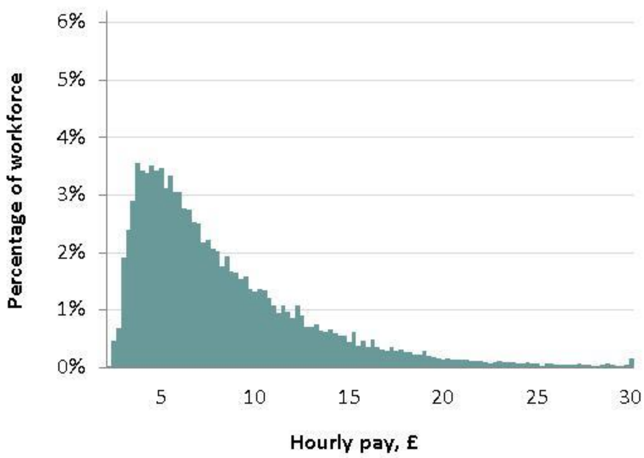
Notes: Figures are drawn from three separate data sources. For full details of methodology see Low Pay Britain 2012

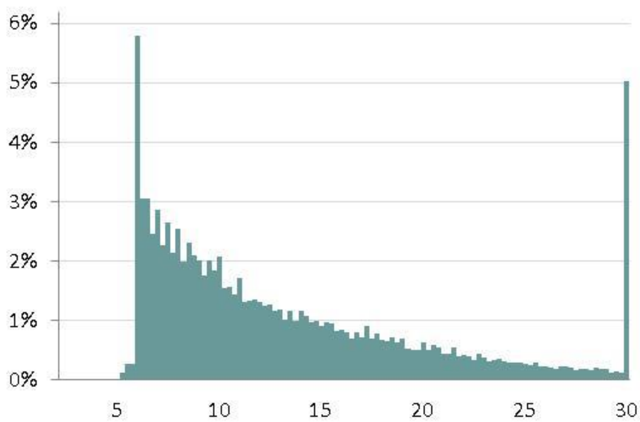
Source: Resolution Foundation analysis, DWP, Family Expenditure Survey (1968-1981); ONS, New Earnings Survey Panel Data (1975-2010); ONS, Annual Survey of Hours and Earnings (1997-2011)

Figure 2: The impact of the National Minimum Wage on the distribution of pay

Gross hourly pay excluding overtime in the UK before (1997) and after (2012) the introduction of the National Minimum Wage

1997 **2012**



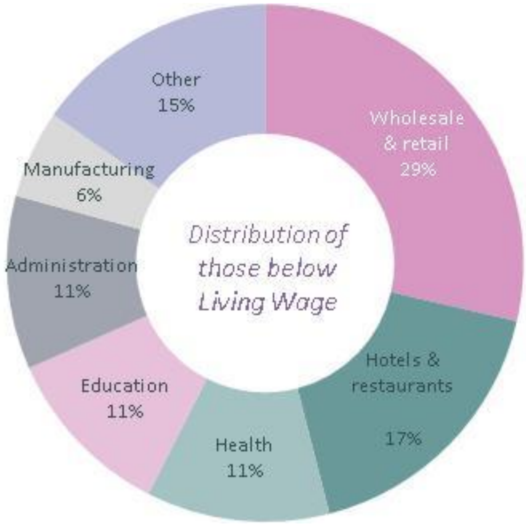


Notes: Gross hourly pay excluding over-time

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

Figure 3: Low pay by sector in the UK

Percentage of low paid people (paid below the Living Wage) in each sector, 2011



Notes: Data covers 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 2000. Figures for 2011 are based on Living Wage rates of £8.30 in London and £7.20 in the rest of the country.

Source: Resolution Foundation analysis of ONS, ASHE. See Pennycook and Whittaker, Low Pay Britain 2012

Box 1: The relevance of the Living Wage—and its role compared to the NMW

Low pay can be defined in a number of ways. The main measure we use in this report is the standard international definition of low pay as ‘earning below two thirds of the median hourly wage’. As a relative definition, this has the drawback of not being tied to an absolute measure of living standards. If wages rise in real terms across the population, giving both low- and middle-earners a better standard of living, the incidence of low pay will remain the same. Likewise, if middle-earners see their pay fall and low earners do not, the incidence of low pay will counter-intuitively fall.

The Living Wage is a useful corrective to this problem. It is calculated using focus groups to define the basket of goods that is required for a minimum standard of living (for example, basic foods and transport needs).The Living Wage thereby gives an absolute measure of the wage that is needed in modern Britain.[15] In practice, the Living Wage is close to the relative low pay threshold: in 2011, two thirds of the median wage was £7.49 and the Living Wage was £7.20, although this has changed over time (and both measures are higher in London). Wherever possible we refer to both measures to give a fuller understanding of the dynamics of low pay.

What role does the Living Wage play as opposed to the minimum wage?

There is a role for both the Living Wage and the National Minimum Wage in tackling low pay and the Resolution Foundation has undertaken a separate program of work with IPPR to examine the economic implications of the Living Wage.[16] However, it is also important to remember that the two concepts differ

[15] Although the London Living Wage incorporates a relative measure of earnings into its formula.
[16] Pennycook, M. and Lawton, K. (2013)

fundamentally and should not be confused. The National Minimum Wage is set on the basis of a judgment about employment effects and is agreed through a social partnership model, the LPC-led process of consultation and negotiation. The Living Wage is set with a formula that reflects standards of living and prices, not taking account of employment effects.

The different conceptual bases for the Living Wage and NMW mean that they require different policy approaches. A living wage could never safely be mandated through legislation—and indeed this is not a demand of the Living Wage Campaign. While the National Minimum Wage is designed to consider employment effects, allowing a mandatory, statutory approach, the Living Wage is designed to be advanced through an incremental and voluntary approach. The latter also brings the wider benefit of mobilising low-paid workers.

Their different approaches mean that the Living Wage and NMW are complementary. Any politician claiming to be concerned about low pay needs an account of the role that both can play. For the Living Wage, the challenge is how the state can galvanise a non-state campaign, for example through transparency requirements, public sector pay and commissioning or financing mechanisms that recycle any savings into efforts to encourage take-up. For the NMW, the challenge is how to raise the legal wage floor that the UK economy can bear without harming unemployment. This includes both the question of how to increase upward pressure on pay where employers can already afford to pay more and the question of how to reduce the vulnerability of key sectors of the UK economy to a higher NMW in future.

A problem that won't fix itself

While the shape of low pay has changed over time, low pay itself is not a new problem. Policymakers have long tried to boost the prospects of low paid workers through the standard levers of economic policy and through investment in education and skills. In the past 15 years, however, it has become increasingly clear that this light touch approach is insufficient; low pay has become a generalised and structural feature of the UK labour market. It remained stubbornly high even in the boom years from the late 1990s into the 2000s, staying far above the level of other mature economies, and it now looks likely to remain high or even to rise in the coming decade. In the past 15 years, two developments in particular suggest that, without more robust action, the UK's unusually high share of low pay is here to stay.

Changes in the structure of employment

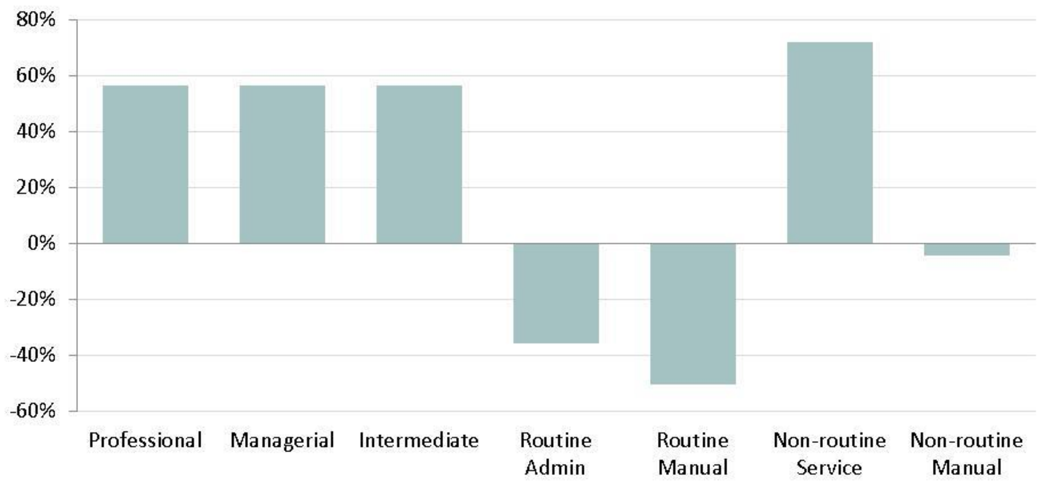
First, the UK economy is creating large numbers of low-skilled, low paying jobs that offer little by way of return to skills. This is partly a function of structural changes in the jobs market. In terms of occupations, the UK labour market is polarising. New technologies are increasingly able to automate routine middle-skilled roles (e.g. bank clerks) and it is becoming easier to off-shore middle-skilled roles. As a result, the UK labour market is shifting towards non-routine roles at the top and bottom that are harder to automate or off-shore (e.g. consultants and care assistants).[17] Meanwhile, in terms of sectors, services continue to expand their share of employment. Rising consumption has boosted demand for consumer services from retail to hospitality[18] while an ageing population and rising female employment boost employment in

[17] For further Resolution Foundation research into the 'hollowing out' of maturing jobs markets, see Holmes, C. and Mayhew, K., *The changing shape of the UK job market and its implications for the bottom half of earners*, Resolution Foundation (2012) and *Who Gains from Growth? Living Standards to 2020*, Institute for Employment Research (IER) and Institute for Fiscal Studies (IFS) for the Resolution Foundation (2012).

[18] Expanding employment in the service sector is also being driving by the rising cost of employment-intensive services; as countries get richer, employment-intensive services (e.g. social care) get relatively more expensive as productivity rises elsewhere, expanding their share of GDP.

caring sectors.[19] When these occupational and sectoral trends are put together, they lead to the growth of non-routine service jobs that can be seen in Figure 4.

Figure 4: The polarisation of the UK labour market and the rise of non-routine service work
Change in share of employment, 1981-2008



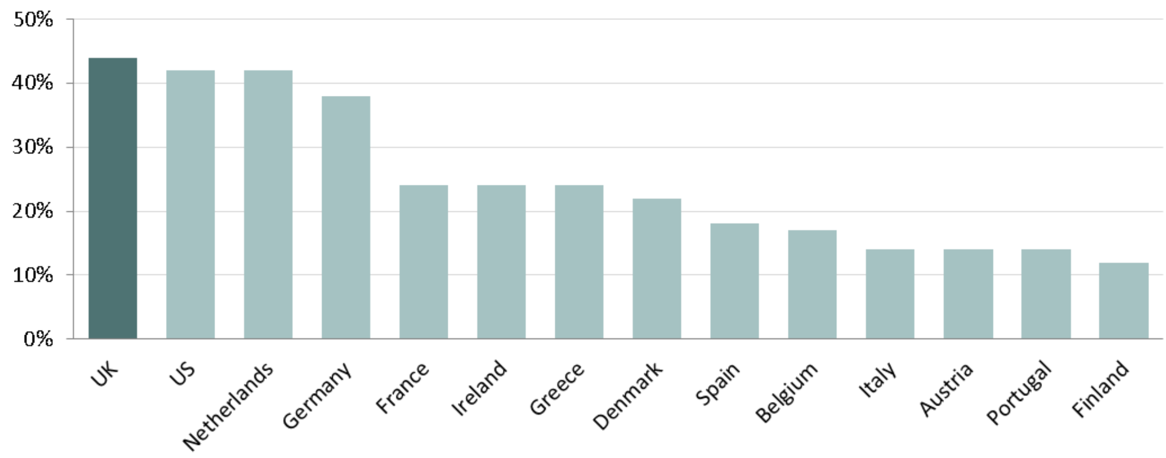
Source: LFS analysis by Mayhew and Holmes, The Changing Shape of the UK Jobs Market, Resolution Foundation, 2012

These structural changes alone do not explain low pay in modern Britain. Similar trends are taking place across the world's maturing labour markets and, with the exception of the US and Germany, many countries have avoided the UK's scale of low pay. It is when these changes interact with the UK's current labour market model that they result in low skilled, low paid jobs. Figure 5 shows the incidence of low pay in consumer service roles in a range of mature economies. It shows that being employed in consumer services, a typical non-routine service role, carries a much higher risk of low pay in the UK than in other advanced economies. UK workers suffer a higher risk of low pay even when doing similar jobs. No country has held back the tide of technology or the shift to services. But some countries have built institutions, including more assertive minimum wage strategies, that encourage employers to create good quality versions of these jobs.

[19] For estimates of the contribution of demographic change to changing consumption patterns in advanced economies, see p.73-75, *Demand Patterns and Employment Growth Consumption and Services in France, Germany, the Netherlands, the United Kingdom and the United States: Concluding Summary*, Russell Sage Foundation

Figure 5: The risk of low pay in consumer services in the UK and other leading economies

Percentage incidence of low pay in consumer service roles



Source: Adapted from Salverda and Mayhew

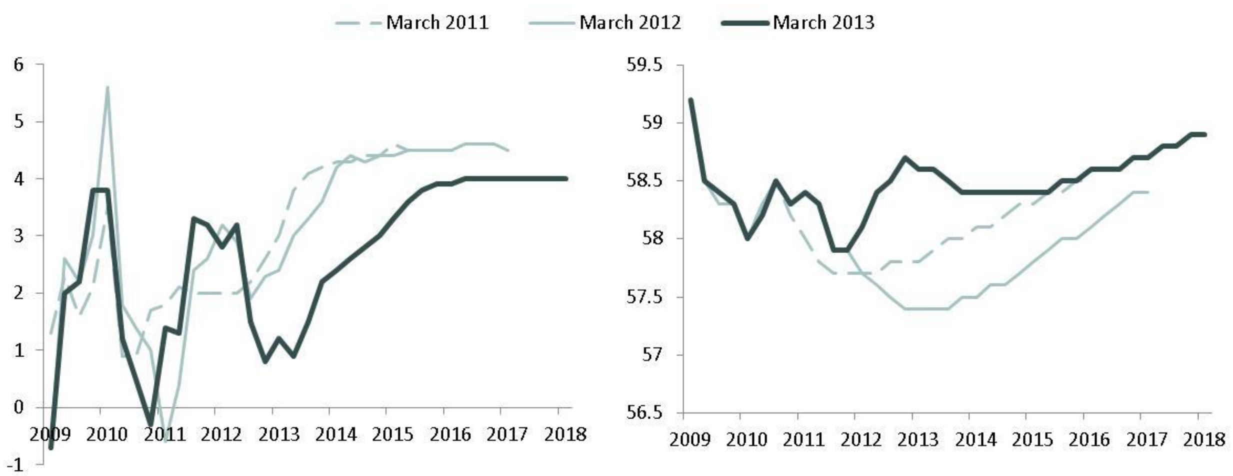
The relationship between unemployment and wage growth

Second, the UK is struggling more than it once did to generate wage growth, particularly in lower paid portions of the jobs market. In the past ten years, unemployment has begun to exert a stronger downward pull on wages than it used to. This change has been starkest during the recent downturn. Figure 6 shows Office for Budget Responsibility (OBR) forecasts for wages and employment in March 2011 (the thin dotted line), March 2012 (the thin solid line) and March 2013 (the thick solid line). It shows how much expectations for wage growth have been downgraded even while employment expectations have improved. The current downturn has hit wages unexpectedly hard and employment unexpectedly lightly when compared to past recessions.

Figure 6: Revised OBR forecasts – wages down, employment up

Office for Budget Responsibility forecasts for average earnings growth and employment rate (aged 16+)

Average earnings **Employment rate**

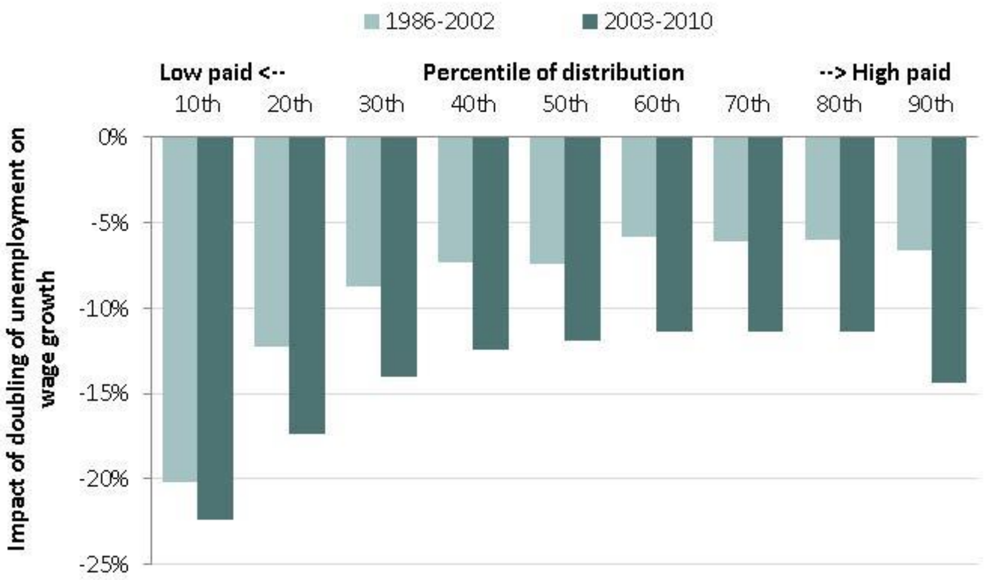


Source: Office for Budget Responsibility supplementary economy tables, March 2011, March 2012 and March 2013 outlook

Resolution Foundation research suggests that this recent trend reflects a longer-running increase in the sensitivity of wage growth to unemployment. It has long been known that unemployment pulls down wage growth while a tight jobs market boosts real wage growth, particularly for the low paid.[20] Now it seems that the downward pull on wages from unemployment has strengthened since the early 2000s, weakening the prospects for future wage growth, particularly for the low paid.[21] Figure 7 shows the impact on wage growth of a doubling in unemployment in the earlier period (1986-2002) and in the more recent period (2003-2010). The chilling effect of unemployment on real wage growth is higher now than it was and is highest of all for the low paid.[22] It has become more important to find new ways to put upward pressure on pay.

Figure 7: The impact of unemployment on real wages across distribution

Percentage decrease in real wage growth associated with a doubling of unemployment



Source: Gregg and Machin, (2012, Resolution Foundation)

Taken together, developments in the last 15 years make it seem less likely that low pay will solve itself if we simply get other aspects of economic policy right. Low pay has become a more clearly systematic feature of the UK labour market, remaining stubbornly high in good times as well as bad.

Summary

This chapter recapped existing Resolution Foundation research into low pay and looked at structural changes in the UK economy which suggest that, without an attempt to shape labour markets more directly, low pay is here to stay. The new frontline in the battle against low pay is the one fifth of the UK workforce who earn above the NMW but still too little to afford a basic standard of living. This is a problem on a different scale but also, in important ways, a more worrying problem than the extreme low pay that confronted policymakers in the late 1990s. It is now clear that low pay will not dissipate even if

[20] Layard, R., Nickell, S. and Jackman, R., (1991), Unemployment, Oxford University Press, Oxford

[21] Specifically, if unemployment had doubled at any point in the years between 1986 and 2002, this would have been expected to pull down median real wages by around 7 per cent. In the years between 2003 and 2010 by contrast, a doubling of unemployment would have been expected to pull down median real wages by around 12 per cent. In practice, this change has caused an additional £800 loss per year as a result of the stronger downward pull being put on median wages by unemployment. Gregg, P. and Machin, S. (2012)

[22] Although interestingly, the *increase* in the sensitivity of wages to unemployment was smallest for the lowest paid, suggesting that the minimum wage may have kept upward pressure on wages.

other aspects of economic policy and skills policy are successful. Even in times of growth, the UK labour market was creating large numbers of low quality, low paying jobs and was struggling more than it once did to generate real wage growth, particularly at the bottom. The downturn has only turbo-charged these trends. A more fundamental effort to directly influence pay settlements, in the manner of institutions like the NMW and LPC, now seems indispensable.

Box 1: Previous research on low pay and the changing shape of the UK labour market

The Resolution Foundation has published a number of major studies into the changing character of Britain's low wage labour market:

Low Pay Britain 2012, by Matthew Pennycook and Matthew Whittaker, is the latest edition of the Foundation's annual audit of low pay in contemporary Britain. It gives an up to date profile of low pay in the UK, detailing how the low paid workforce breaks down by gender, age, ethnicity, sector and occupation. It also describes how low pay has changed over time. Low Pay Britain 2013 will be published in the autumn of 2013.

What a drag: The chilling effect of unemployment on real wage growth, written for the Foundation by Professors Paul Gregg and Steve Machin, examines the changing effect of unemployment on real wage growth. It reveals an increase in the sensitivity of real wages to unemployment since the early 2000s and provides new estimates of the effect of unemployment on real wage growth across the earnings distribution.

The changing shape of the UK jobs market, written for the Foundation by Professor Ken Mayhew and Craig Holmes, examines in detail the polarisation of the UK labour market. It documents the changing structure of employment in the UK and looks at the extent to which the growth in top jobs represents job-title inflation. It also looks at the changing skill-profile of UK employment as well as estimating the extent to which polarisation, alongside a number of other factors, is contributing to the growth of wage inequality.

Beyond the Bottom Line: The challenges and opportunities of a Living Wage**,** by Matthew Pennycook and Kayte Lawton (joint with IPPR), carries out the first full economic analysis of the Living Wage, quantifying the impacts of a Living Wage on household incomes, public spending and employment. It also describes the respective roles of the Living Wage and National Minimum Wage and the different concepts that underlie the two approaches.

Who Gains from Growth? Living Standards to 2020, produced for the Foundation by the Institute for Employment Research (IER) and the Institute for Fiscal Studies (IFS), forecasts changes in the structure of UK employment to 2020. It projects that occupational polarisation is set to continue and that household income inequality is set to rise. It tests a number of scenarios for reshaping these outcomes, looking at the difference that could be made by raising female employment, investing in skills or combating low pay.

Gaining from Growth was the final report of the Commission on Living Standards. It represents the shared views of a wide-range of leading employers, academics and union representatives on the causes and consequences of the squeeze on living standards in the UK. Drawing on an 18 month programme of research and consultation, it sets out a high-level policy agenda for ensuring that economic growth benefits the broad majority of households.

Chapter 2: What have we learned from the minimum wage?

The first chapter gave a brief description of contemporary low pay and some of the structural forces that underpin it. This chapter turns to the specific role of the UK minimum wage, surveying what has been learned from 15 years of research. It starts by recapping the evidence on the impacts of the NMW on wages and employment and then explores what this tells us about the way low wage labour markets work. The vast improvement in our understanding of minimum wages in the last 15 years means we can make progress in key debates and in the development of policy. Policymakers now know they can proceed more confidently and innovatively on some fronts while also knowing that they need to remain cautious on others.

The impact of the minimum wage on wages and employment

The UK minimum wage has inspired a vast academic literature internationally and in the UK since it was legislated for in 1998, leaving no stone unturned. The Low Pay Commission alone has published over 100 analytical reports from some of the world's leading labour market economists examining the effects of the NMW on a wide range of economic variables. These findings have been summarised in detail elsewhere, most recently by Butcher (2012) and by the Low Pay Commission itself in its latest annual report.[23] The research has covered a wide terrain but has focused on the impact of the NMW on wages and on a range of different measures of employment.

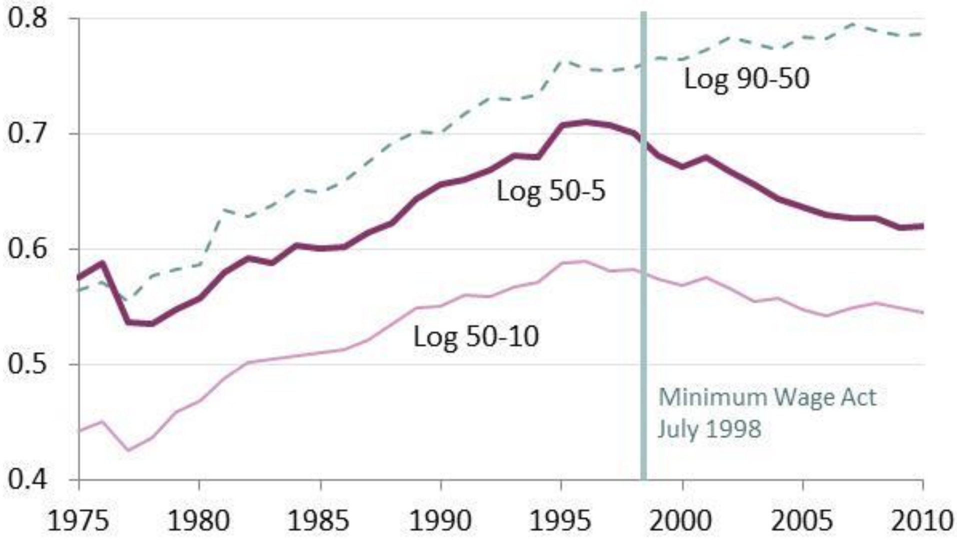
In terms of earnings, it is incontrovertible that the NMW boosted pay at the bottom of the labour market. Figure 8 provides one piece of evidence to this effect. It shows trends over time in key ratios of wage inequality: between top- and middle-earners (the thin dotted line), middle- and low-earners (the thin solid line) and middle- and very-low-earners (the thick solid line). The lowest earners catch up notably with middle-earners after the onset of the NMW, following years of rising inequality. Latest estimates suggest that among low paying groups, such as young workers, as much half of the decline in wage inequality in the bottom half of the wage distribution between 1998 and 2010 can be ascribed to the NMW.[24] These are significant changes that buck long term trends.

[23] Low Pay Commission (2013) and Butcher, T. (2012)

[24] "Our estimates suggest that for young workers something over half of the change in the log 50/5 from the period 1998-2010 can be ascribed to the NMW and 40% of the change in the log 50/10", from Butcher, T. Dickens, R. and Manning, A. *Minimum Wages and Wage Inequality: Some Theory and an Application to the UK,* Centre for Economic Performance, LSE (2012)

Figure 8: The impact of the minimum wage on inequality in the bottom half

Ratios between key points of the earnings distribution – top to middle (90:50), middle to bottom (50:10), middle to very bottom (50:5)



Source: Butcher, Dickens and Manning (2011)

There remains a more open debate about how far the effects of the NMW reach up the earnings distribution. Most studies suggest that the NMW has had relatively small so-called 'ripple effects', meaning that its impacts on pay petered out relatively quickly; rather than raising the pay of workers across the earnings distribution, it raised pay mainly at the very bottom. Other studies suggest that the NMW may have had a small but measurable positive effect on wages as high as the 25th percentile of earnings (around 40 per cent above the minimum wage itself), slightly above the current Living Wage.[25] In all, the impact of the minimum wage on earnings has been more focused on the very lowest paid workers that was anticipated at the policy's introduction.

The second key question for NMW analysis has been whether positive effects on earnings would be offset by reductions in either employment or working hours. At the birth of the UK minimum wage, different labour market models predicted different answers to this question, making this a topic for empirical analysis. In the UK, this question has now been answered and there is a broad academic consensus that the NMW has not had negative effects on overall employment[26], on employment in low paying sectors, on the employment prospects of different individuals and social groups[27] or on employment levels in different regions.[28] Latest evidence also suggests that these findings hold true for the post-2008 recession period.[29] In its latest summary of the evidence to date, the Low Pay Commission puts it as follows:

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[25] Butcher, Dickens and Manning (2012) find that the minimum wage directly affected earnings up to the 6th percentile, raising wages around 7 per cent. They find growth of around 4 per cent at the 10th percentile and just over 1 per cent at the 20th percentile. There is also some evidence that these effects vary in different parts of the UK economy. For example, ripple effects from the NMW appear to have been larger in the *Security* industry, where growth in the NMW has been accompanied by the introduction of occupational licences that required investment in training, while other sectors like *Retail* have seen more limited ripple effects.

[26] p.182, Low Pay Commission (2013)

[27] Lanot and Sousounis (2013)

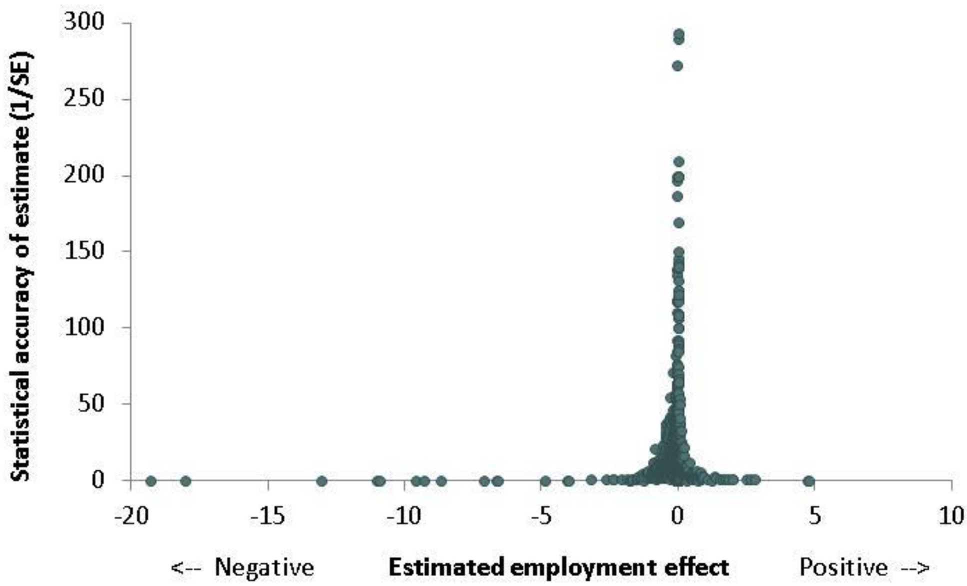
[28] Dickens, Riley and Wilkinson (2012), for example, find that the minimum wage may have had positive effects on employment from 2003 to 2007. Dolton, Rosazza Bondibene and Stops (2012) find no impact, including in the recession, and again find a positive impact on employment in some areas.

[29] Bryan, Salvatori and Taylor (2012)

"…the research [has], in general, found few adverse effects on aggregate employment; the relative employment shares of the low-paying sectors; individual employment or unemployment probabilities; or regional employment or unemployment differences."[30]

If the balance of evidence on unemployment is clear, how can some commentators still maintain that minimum wages cause unemployment? Figure 9 brings together around 1,500 results from 64 different academic studies on the impact of the US minimum wage on employment.[31] It charts employment effects from negative (on the left) to positive (on the right) along the horizontal axis and shows a measure of the statistical accuracy of the results from top (most accurate) to bottom (least accurate). The chart shows that, although the overall balance of evidence is clear, it is still possible to point to specific studies that find large negative (and indeed positive) employment effects from minimum wages.

Figure 9: The effect of the US minimum wage on employment
1,500 collected findings from 64 academic studies



Source: Doucouliagos and Stanley (2009)

What else have we learned about minimum wages?

In addition to the large literature on the impacts of the UK NMW on earnings and employment, a vast array of studies have examined the impacts of the NMW on other economic variables. These studies help us to answer the important question: why *didn't* the minimum wage cause a general rise in unemployment?[32] In doing so, they help us to better understand the way in which low wage labour markets work. Four particular lessons from the research are relevant to any debate about the future of the UK minimum wage:

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[30] p.182, Low Pay Commission (2013)
[31] Doucouliagos and Stanley (2009)
[32] For further discussion of this question see Schmitt, J. *Why Does the Minimum Wage Have No Discernible Effect on Employment?* Center for Economic and Policy Research (2013) and Metcalf, D. *Why has the British national minimum wage had little or no impact on employment?* Centre for Economic Performance, LSE (2007)

Lesson 1: Labour markets are not perfectly competitive. A regulated wage floor is therefore an important way of ensuring that workers receive a fair share of the value they're creating

In academic debate, the most fundamental issue of contention when the UK NMW was introduced was over the extent of competition in jobs markets. If labour markets are perfectly competitive then workers are paid in line with their productivity. This means that minimum wages automatically cause unemployment by forcing employers to pay more than a worker is worth. On the other hand, if wage-setting processes are not competitive, for example if there are costs to replacing workers or to switching jobs, then some workers may be paid less than their productivity.[33] In this world, a NMW can be an important way of ensuring that an employee receives a fair share of the value they are creating for their employer. The fact that the UK has introduced a NMW with substantial positive effects on pay and no marked impact on employment suggests that the latter view is more right than wrong. Minimum wages can improve overall labour market outcomes.

Lesson 2: Caution is essential when setting a national wage-floor; minimum wages are ill-fitting garments, pinching hard in some parts of the economy even while they leave space in others

Although no significant overall employment effect has been found as a result of the minimum wage, some studies have found small or weakly determined effects on other variables in some parts of the labour market. This suggests that parts of the economy are far more vulnerable to minimum wages than others. In practice, these effects have mainly played out in terms of reduced hours worked or a squeeze on non-wage benefits.

- While no overall effect on employment has been found in localities, there is some weak evidence that *growth* in employment has been slower in some very **low paid regions**, potentially reflecting the higher value of the NMW relative to median pay (the 'bite') in these areas.[34] Other papers have found more mixed effects[35] or even positive effects[36];

- While evidence on **young workers** remains mixed, one study has found reduced hours for young people in the years after the 2008 recession as a result of the NMW.[37] Although the authors have not been able to replicate these specific findings[38], young workers have been shown to be more sensitive to the effects of a minimum wage in a range of studies[39];

- Recent research has found evidence of reduced job retention among **female part-time workers**.[40] While this does not directly imply lower employment and may simply represent increased churn into and out of work, the result may reflect the fact that the NMW has a stronger impact on this low paid group;

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[33] For the leading work on labour market monopsony, see the work of Professor Alan Manning. For example, Manning, A. *Imperfect Competition in the Labour Market*, CEP Discussion Papers DP0981, LSE (2010)

[34] Galindo-Rueda, F. and Pereira, S. *The Impact of the National Minimum Wage on British Firms*, Centre for Economic Performance, LSE, Yale University and University College London (2004)

[35] Dolton, P. Rosazza-Bondibene, C. and Wadsworth, J., *The Geography of the National Minimum Wage*, Royal Holloway College, University of London (2009)

[36] Dolton, P., Rosazza Bondibene,, C. and Stops, M., *The Spatial Analysis of the Employment Effect of the Minimum Wage in a Recession: The Case of the UK 1999-2010, University of Sussex, CEP, LSE, NIESR and IAB Nurnberg (2012)*

[37] Bryan, M., A. Salvatori and M. Taylor, 2012. The Impact of the National Minimum Wage on Earnings, Employment and Hours Through the Recession, Institute for Social and Economic Research

[38] Bryan, M., Salvatori, A. and Taylor, M., *The Impact of the National Minimum Wage on Employment Retention, Hours and Job Entry*, Institute for Social and Economic Research, University of Essex (2013)

[39] See, for example Dolton, P. and Rosazza Bondibene, C. *An Evaluation of the International Experience of Minimum Wages in an Economic Downturn,* Royal Holloway, University of London (2011)

[40] Dickens, R., Riley, R. and Wilkinson, D. *Re-examining the Impact of the National Minimum Wage on Earnings, Employment and Hours: The Importance of Recession and Firm Size*. University of Sussex and National Institute of Economic and Social Research (2012)

- Early research into the minimum wage found a small negative effect on employment in **care homes containing a high share of minimum wage workers**.[41] As an extremely low paid sector that is heavily reliant on public funding, these results are not generalizable to other parts of the economy.

This evidence suggests that the LPC is right to be cautious in recommending the rate of the NMW. It does not identify unemployment effects as such. Even so, it acts as a warning that a higher NMW could cause unemployment in specific parts of the economy. Just as importantly, it also suggests that there may well be headroom for a higher wage-floor across large parts of the labour market. A single, national minimum wage will always be held back from achieving its full potential in some parts of the economy because of valid concern for employment effects in more vulnerable parts of the jobs market.

Lesson 3: Employers adjust to minimum wages in a wide range of ways, not just through the channels of pay and employment

One of the key mistakes of early opponents of the minimum wage was to underestimate employers. Rather than simply firing people, evidence shows that employers have been smart and strategic in the way they have adapted to a higher NMW. They have responded in a wide range of ways, only some of which have negative implications for low paid workers—and some of which have wider, positive impacts on the economy:

- **Boosting productivity** – increases in the NMW have been associated with increased productivity in the UK's low paying sectors over the last ten years.[42] The impact has varied for different sectors and types of firms. In general, large firms have seen bigger positive impacts on productivity than small firms.

- **Squeezing wage distributions** – firms that have been more strongly affected by the NMW have squeezed pay gaps between NMW workers and better paid workers.[43] There is also some evidence that large firms have removed intermediate occupational tiers, moving to a broader, flatter occupational structure.[44]

- **Cutting non-wage benefits and working hours** – there is some evidence that, where employers have reduced staff costs, they have done so by squeezing non-wage benefits or reducing working hours rather than employment.[45] Evidence suggests that any such reductions have been more than offset by higher hourly pay, leaving workers better off overall.[46]

- **Pushing up prices** – there is some evidence that employers in certain sectors have raised prices as a result of the NMW. These results vary by sector, with the take-away food, canteen meal and hotel service sectors having seen stronger price rises in years in which the NMW rose strongly.[47] The magnitude of these effects has been relatively small.

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[41] Machin, S., Manning, A. and Rahman, L. *Where the Minimum Wage Bites Hard: Introduction of Minimum Wages to a Low Wage Sector*. Journal of the European Economic Association. 1(1), pp. 154-180 (2003)
[42] Croucher, R. and Rizov, M. *The Impact of the UK National Minimum Wage on Productivity by Low-paying Sectors and Firm-size Groups*, Middlesex University (2011) and Riley, R. and Rosazza Bondibene, C. *The Impact of the National Minimum Wage on Firm Behaviour During Recession,* National Institute of Economic and Social Research (2013)
[43] Butcher, T., Dickens, R. and Manning, A., *The Impact of the National Minimum Wage on the Wage Distribution*. Low Pay Commission, University of Sussex and London School of Economics (2012) and Denvir, A. and Loukas, G. *The Impact of the National Minimum Wage: Pay Differentials and Workplace Change*, Institute for Employment Studies (2006)
[44] See Chapter 3. See also Allison et al., Monitoring the impact of the National Minimum Wage, Incomes Data Services (2007)
[45] Dickens, Riley and Wilkinson (2012) found some evidence to suggest that the minimum wage reduced hours for female full-time workers during the recession.
[46] Allison et al. (2007) and Dickens, R. and Riley, R. (2012)
[47] Wadsworth, J. *Did the UK Minimum Wage Affect Prices?* Royal Holloway College, University of London (2008)

- **Squeezing profits** – large early increases in the NMW were associated with a relative reduction in profits in private sector firms that were more strongly affected. [48] Analysis finds no overall increase in the rate of business failure as a result of these reductions[49] but some weak evidence of reduced rate of new business starts.[50]

These findings show that the trade-offs inherent in a NMW are not simply between higher pay and lower employment. They play out in many directions. Nor do employers respond to a minimum wage on a worker-by-worker basis but at an organisational level. They take corporate decisions, adjusting their overall approach to compensation, their pricing policy and their organisational strategy to make sure they remain successful in a world in which they have to pay their lowest paid staff more.

Lesson 4: The impact of the NMW on an employer's overall costs is surprisingly small—but it also varies substantially by sector

Very low paid workers make up a relatively small proportion of employers' overall wage bills. The result is that even a very large increase in the minimum wage has a relatively small impact on the overall cost base. Figure 10 shows Resolution Foundation analysis of how much the wage bills of large firms in different sectors would increase if the NMW were to be raised very substantially to the Living Wage of £7.45 an hour. Firms in sectors like finance or construction see their wage bills rise by only around 1 per cent while firms in low wage sectors see their wage bills rise by 5 or 6 times as much. These findings suggest that many workers could be lifted out of low pay today without employment effects if only the right mechanism could be found. There is likely to be headroom for a higher rate in key sectors of the economy.

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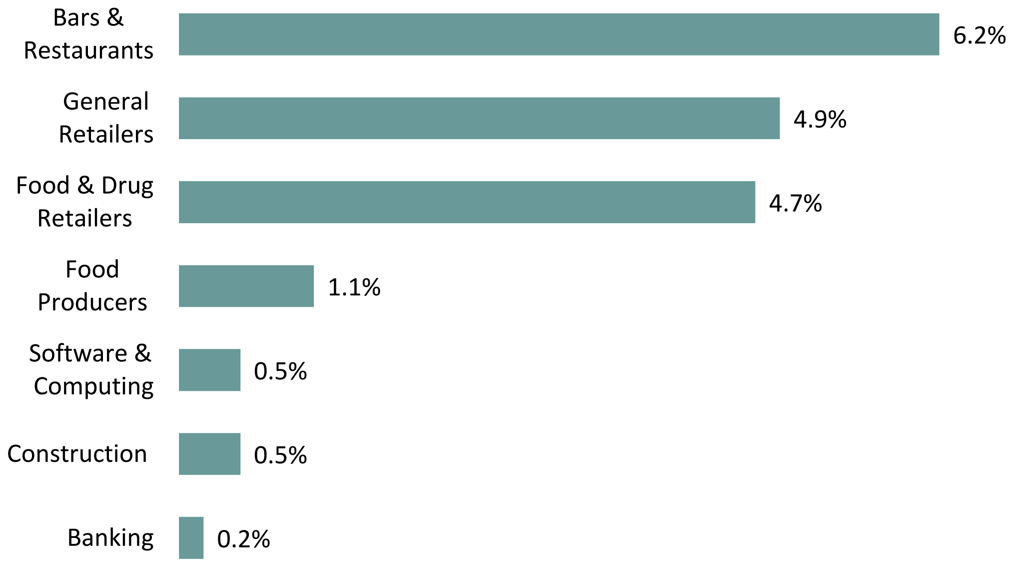
[48] Draca, M., Van Reenen, J. and Machin, S., The impact of the National Minimum Wage on profits and prices, LSE and UCL (2005)
[49] Riley, R. and Rosazza Bondibene. C. (2013)
[50] Ibid.

Figure 10: The impact on the wage bill of large firms from a higher minimum wage

Estimated percentage increase in wage bill after increase of National Minimum Wage to Living Wage



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)

Summary

In the last 15 years a rich body of evidence has transformed our understanding of minimum wages and low wage labour markets. Policymakers can now have confidence in the basic proposition that a regulated wage floor, set at a sensible level, can push up earnings without harming employment and without large offsetting declines in working hours or non-wage benefits. Minimum wages work partly because labour markets are not perfectly competitive, meaning that a wage-floor can be an important way of ensuring that employees are paid a fair share of the value they are creating. And they work because, while there are clearly limits to employers' adaptability, firms are adept at changing their business strategies, often in positive ways, to ensure that they remain profitable while paying their lowest paid staff more. Even so, caution is vital when setting a single, national wage-floor—minimum wages pinch hard in some vulnerable parts of the jobs market even while they leave significant headroom elsewhere.

Chapter 3: Where next? Choices and trade-offs in minimum wage design

While the last 15 years have seen heated arguments over the UK minimum wage, the focus of public debate has so far been relatively narrow. In the late 1990s there were of course disputes over whether or not the UK should adopt a minimum wage and today disagreements remain over the level of the NMW and some aspects of its design, most notably whether or not there should be separate youth rates. Yet countries face a much broader set of choices than this when designing minimum wages. This chapter sets the scene for the Resolution Foundation's forthcoming project on the future of the NMW and LPC by opening up a broader debate about these choices and trade-offs. It starts by setting out explicitly some of the particular choices that the UK has made and contrasting them with decisions made in other countries, exploring the trade-offs that these choices represent. It concludes with key questions for further investigation.

Where is the UK headed on its current path?

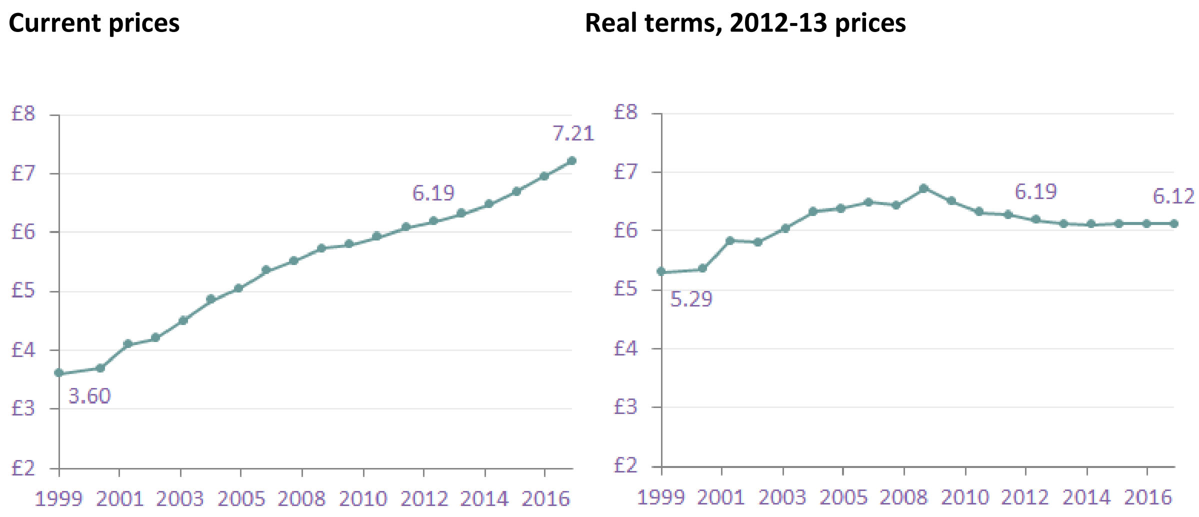
Before turning to the main discussion it is useful to get a clearer sense of where the UK is headed on its current path. What are the prospects for the NMW and for the incidence of low pay in the UK if we carry on as we are? There are a number of ways to answer this question and we look at two in turn: where the rate of NMW is currently heading under some reasonable assumptions about wage growth and, second, the prospects for a reduction in the incidence of low pay.

First, how might the value of the NMW evolve in the coming years? In recent years the LPC has been heavily influenced by projections of earnings in recommending the rate of the NMW. Broadly speaking the NMW has tracked average earnings since late 2008 (indeed, the LPC has proven more adept at forecasting average earnings than almost all mainstream economic forecasters). At times, the LPC has also appealed to a more conservative guide of the value of the NMW relative to median earnings (the so-called 'bite). The current value of the NMW is 54 per cent of median hourly earnings. A conservative forecast for the NMW would be to maintain this bite relative to the median wage.

Figure 11 forecasts the value of the NMW under a scenario in which it maintains its value relative to median hourly pay. It is based on OBR forecasts for average earnings. Hourly median wages are then forecast by adjusting hourly median wage growth in line with its historic relationship to average weekly earnings. Under these assumptions, the NMW would rise to around £7.20 an hour in cash terms from October 2017, equivalent to £6.12 an hour in 2012-13 prices. While this would maintain the NMW's value relative to median pay it would also mean that the real value of the NMW in late 2017 would be no higher than its value in 2004, 13 years earlier. This highlights the tough conditions facing the next decade of minimum wage policy—given the economic context, it is unlikely that we can tackle low pay by aggressively raising the headline rate.

Figure 11: Prospects for the minimum wage as things stand

OBR projections for average earnings adjusted for median earnings and NMW assuming a constant value relative to median pay



Notes: Assumes the NMW maintains a constant value relative to the hourly median wage. Hourly median forecasts are based on OBR forecasts for average weekly earnings adjusted for the historic relationship between the growth in median hourly pay and average weekly earnings. Real terms adjustments are made on the basis of RPI and expressed in 2012-13 prices.
Source: OBR Supplementary Economic Forecasts (March 2013), Annual Survey of Hours and Earnings (ASHE) gross hourly median wages excluding overtime, Low Pay Commission data for historic value of the NMW.

Second, putting these difficult prospects aside, what progress would the UK make in tackling low pay in a best case scenario? The period from the late 1990s to the late 2000s gives an optimistic benchmark for what an assertive minimum wage strategy can do in a growing economy. As we have seen, extreme low pay fell rapidly in these years and some progress was made in reducing the incidence of low pay more generally. The largest falls took place from 1998 to 2007, during which time the share of workers earning below half of median pay fell by 4.9 percentage points from 6.6 per cent to 1.8 per cent.[51] However, reflecting the limited ripple effects from the NMW, the reduction in low pay (the proportion of people paid below two thirds of median pay) was only 0.9 percentage points over these nine years, from 22 per cent to 21.1 per cent. The gains barely reached people earning around the Living Wage. At this pace it would take the UK roughly 70 years just to reach the OECD average rate of low pay.

These scenarios suggest an aspiration gap between the prospects for the NMW in the coming years and what would be required to tackle low pay. It will be difficult for the UK minimum wage to make a major contribution to tackling low pay unless policymakers can find new ways to amplify its effects.

[51] Errors due to rounding.

Box 3: The Low Pay Commission – a successful institution built from scratch

The Low Pay Commission (LPC) was established in mid-1997 as an independent body to recommend to government the rate of the National Minimum Wage. The LPC includes an even balance of three representatives from Trades Unions, three employers, two independent academics and an independent chair. At the outset of the LPC's life, the Economist judged that "coming up with a minimum wage that will not seriously harm the economy, and destroy jobs, will require the wisdom of Solomon—or extraordinary luck."[52] The LPC has since proven itself up to the task.

While a precise definition of the NMW was enshrined in legislation, the LPC itself was given relatively limited guidance on its terms of reference. The Commission judged its key task in its 2003 report as follows: "Our aim is to have a minimum wage that helps as many low-paid people as possible without any significant adverse impact on the economy"[53], later specifying these adverse impacts as being on "inflation or employment".[54] This has remained the key focus of the LPC's work: "unemployment has never ceased to be the prime focus of concern"[55]. As one founding member of the LPC puts it, "both the Treasury and LPC were initially acutely anxious about the potentially adverse effects of the minimum wage on inflation and on employment".[56]

The LPC's main recommendation for the headline NMW rate has always been accepted by government. However, its recommendation that the adult minimum wage should apply from the age of 21 was rejected by the government for the first seven years of its life, with the government favouring the age of 22, in part because of a desire to avoid impacting on a flagship employment program, the New Deal for Young People.

For most of the LPC's life a recommendation on the rate of the NMW was announced two years in advance. The LPC also initially used its annual report to provide government and employers with a degree of forward guidance on its plans for future years. In 2003, for example, the LPC announced its intention to increase the rate for several years above the rate of average earnings growth.[57] This period was ended with a pronouncement in the 2006 LPC report.[58] Since 2007, the LPC has judged that the economic outlook is too uncertain to recommend a NMW rate more than one year ahead, and new rates have been recommended each year.

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52 *The minimum wage: Devilish details*, The Economist (5th June 1997)
53 p.xv, *The National Minimum Wage: Fourth Report of the Low Pay Commission*, Low Pay Commission (2003)
54 Paragraph 7.28, *The National Minimum Wage: Low Pay Commission Report 2005*, Low Pay Commission (2005)
55 p.432, Brown, W., *The Process of Fixing the British National Minimum Wage, 1997–2007*, British Journal of Industrial Relations, *47:2 (2009), pp. 429–443.*
56 p.431, ibid.
57 "We therefore believe that the effective level of the minimum wage should now be increased, with a series of increases above average earnings over a number of years, gradually increasing the number of people benefiting", from p.viii, *The National Minimum Wage: Fourth Report of the Low Pay Commission*, Low Pay Commission (2003)
58 "We do, however, consider that the phase in which the Commission is committed to increases in the minimum wage above average earnings is complete and, looking forward, the Commission will start with no presumption that further increases above average earnings are required.", p.vi, *The National Minimum Wage: Low Pay Commission Report 2006*, Low Pay Commission (2006)

What marks out the UK's approach?

Given the narrowness of current debate, this aspiration gap highlights the need for new thinking. This section broadens out the debate by considering the different trade-offs that are involved in minimum wage design. In establishing the UK minimum wage and the Low Pay Commission, the UK made a number of implicit and explicit choices about the policy's design. Four characteristics of the UK's approach stand out when compared to other countries. Some are features of the wider UK labour market while others were live debates around the time of LPC's formation.

Decision 1: Keep it simple—by setting a single, national adult rate with little variation

In the formative, early years of its work, the LPC placed a high value on simplicity. In the LPC's first report, published in 1998, the Commission set out the case for a single, national adult minimum wage that would only vary on the basis of age. In fact, the 1998 National Minimum Wage Act explicitly ruled out other options for varying the NMW, saying: "No amendment shall be made […] which treats persons differently in relation to—(a) different areas; (b) different sectors of employment; (c) undertakings of different sizes; (d) different ages over 26; or (e) different occupations."[59] However, the Act did leave the LPC free to vary the NMW on the basis of age for people under the age of 26 and for people in the first six months of employment.

Initially the UK minimum wage had two rates: an Adult Rate for workers aged 22 and over[60] and a Development Rate for workers aged under 22. A separate, lower rate for 16-17 year olds was added in 2004. In 2010 the age cut-off for the Adult Rate was lowered from 22 to 21 and a new, lower, Apprentice Rate was also added. The UK's decision to introduce lower minimum wages for young people followed the precedent of many other countries. This sacrificed simplicity in exchange for protecting a group that is highly vulnerable to unemployment effects.

The UK made a different choice when weighing up other forms of variation. In several countries with federal systems of government, for example, including the US and Australia, minimum wages vary regionally, with individual states having the power to set a legal minimum wage above the level of the federal minimum. In Germany, different minimum wages have been introduced at a sector level in a growing number of industries. In Australia, a detailed system of minimum wages is set for different industries and occupations. In Hungary, a higher rate has been set for skilled occupations in an attempt both to boost wage progression for employees moving between certain roles and to underpin the value of jobs defined as requiring a minimum skill standard. (See Box 4 for fuller descriptions.) All of these countries came to different judgments when weighing up the value of simplicity against the hope of achieving a more widespread impact on pay.[61]

Box 4: How do other countries do it?

Australia – varying the wage-floor by sector to put more upward pressure on pay

The Australian system of occupational and sectoral minimum wages has evolved from a history of strong union engagement. The system, overseen by the Fair Work Commission, applies different minimum rates to different industrial sectors, with the lowest rate defining the National Minimum Wage. As a result, when the country's minimum wage panel recommends a raise in the NMW, the higher wage-floors in

[59] 1998 National Minimum Wage Act
[60] Against the wishes of the LPC which recommended an age cut-off of 21
[61] See p.28 onwards for a fuller discussion of these trade-offs in the UK context.

other sectors also rise, feeding the direct impacts through to 16 per cent of the workforce—three or four times the direct impact of the UK NMW.[62] The Resolution Foundation will be publishing a case study of the Australian system later this year.[63]

New Zealand and France – locking in the value of the minimum wage over time

New Zealand and France have high minimum wages by international standards. This is in part because of the way they have chosen to raise the rate over time. In France, the minimum wage (le S*alaire Minimum de Croissance* (SMIC)) is up-rated annually on January 1 to reflect a price index based on the spending patterns of households in the lowest fifth of the income distribution, with an additional increase to reflect the rise in purchasing power of an average worker, although political interventions have often gone beyond this.[64] In New Zealand, the government is explicit that its goal is to increase the minimum wage over time in order "to protect the real income of low-paid workers while minimising job losses". The minimum wage in New Zealand is required to rise at least in line with the CPI measure of inflation. Other countries have taken a more *ad hoc* approach, for example the Hungarian government struck a three year deal with business for a series of up-ratings from 2006 to 2008 (see below).

Germany and Sweden – sectoral minima delivered through strong collective bargaining

While Germany continues to debate the introduction of a legislated national minimum wage, binding minimum wages already apply in a number of industrial sectors linked to collective agreements. Recently, the argument for a national wage-floor has become more prominent for two reasons. First, the scale of low pay has risen to levels approaching those in the UK and US, with low pay particularly focused in personal services occupations. And second, levels of wage protection afforded through collective bargaining have weakened as coverage has declined. Sweden likewise applies a set of collectively agreed minimum wages across a range of sectors. Unlike Germany, however, there has been no development to make these minima legally binding, largely because the coverage of collective agreements remains high. Thus while both systems are built through collective bargaining agreements there are important differences in the presence/absence of statutory provisions.[65]

Hungary – striking a deal for a higher minimum wage for skilled workers, boosting ripple effects

From 2006 to 2008, the Hungarian government struck a three year deal with employers and unions for the gradual introduction of a higher minimum wage for skilled workers coupled with a programme of regular up-ratings. The policy ensures a 20 per cent differential between the two rates. The new skilled minimum wage has boosted the pay of employees in certain occupations, for example raising the wage premium of security workers. It has also generated controversy. Retail cashiers were initially classified as skilled workers and so were protected by the new, higher rate but lobbying by retail employers has since persuaded the government to reclassify cashier as an unskilled role, leading to a fall in their relative level of pay. Overall, evidence suggests that Hungary's skilled NMW has created "an *institutionalised ripple effect,* broadening the impact of the basic minimum wage.[66]

[62] Australian Bureau of Statistics, Employee earnings and hours, 2012. With thanks to Matt Cowgill of the ACTU for data.
[63] Borland, J. and Plunkett, J., *Lessons for the UK from Australia's approach to the minimum wage*, Resolution Foundation (forthcoming)
[64] An uprating can also be triggered if the price index rises faster than 2 per cent a year.
[65] See Chapter 3, Grimshaw and Bosch (2013)
[66] p.222, Banyuls, J. et al. *Wage Compression among Sales Assistants? Pay bargaining and ripple effects in the retail sector*, in Grimshaw, D. (ed.), *Minimum wages, pay equity and comparative industrial relations*, Routledge (2013)

Decision 2: Keep it separate—operating the NMW in relative isolation from other institutions

The second notable characteristic of the UK NMW is that it is relatively isolated from wider labour market institutions when compared to minimum wages in other countries, particularly in continental Europe.[67] Rather than reflecting a choice about minimum wage design, this mainly reflects the very low coverage of collective bargaining in the UK, particularly in low paying sectors like hospitality and retail, which have the highest incidence of minimum wage work. In these two sectors collective bargaining coverage in the UK private sector is now extremely low at 5 per cent and 16 per cent respectively.[68] The result is that, in the UK industries in which the minimum wage does the most work, it is also doing this work alone, largely in the absence of complementary institutions. As we see below, the lack of complementary institutions seems to shape the way in which the UK NMW affects pay.

In many other countries, long-term decisions about labour market policy have struck a different balance, rippling the effects of minimum wage increases through into wage settlements in the broader low wage economy. This is most notably the case in France where (despite low union membership) the decision to extend collective bargaining agreements to non-union members means that wage settlements linked to the minimum wage cover a large numbers of workers. More relevant to the UK, Australia achieves something similar in an economy with declines in collective bargaining coverage comparable to the UK.[69] This has been done by formalising a set of quasi-legal institutions that support the minimum wage and that, among other things, apply higher rates to key industrial sectors, sharing the direct gains from a NMW rise with as much as 16 per cent of the workforce.[70]

Decision 3: Play it by ear—re-assess the value of the minimum wage each year, without relying on formulas and without the guidance of a long-term goal

A key judgment in the early days of the UK minimum wage was to avoid the use of formulas or indexes in favour of an annual recommendation to government by the independent Low Pay Commission. The LPC is required by law to consider the impact of its recommendations on "the economy of the United Kingdom as a whole and on competitiveness" and to take into account other factors specified by the Secretary of State. The LPC itself chose quickly to focus on the question of employment effects (see Box 3, page 26). The result is that the UK NMW is set largely on the basis of backward-looking assessments of its past effects, rather than being guided by a long-term goal or a mechanism that protects or restores its value over time.

These decisions about the remit of the LPC again reflect a balancing act. The LPC itself has also taken slightly different approaches over time. In its early years, the LPC made recommendations two years ahead, for example giving employers advance notice in its 2000 report that the minimum wage would rise by more than 10 per cent over 2001 and 2002. In 2003, the LPC again set out forward guidance on its approach, saying that it intended 'a series of increases for a number of years above average earnings'.[71] In these years, the LPC's judgment was that long-term certainty would help employers adapt to a higher NMW. From 2006, the LPC declared this period of sustained, above-earnings rises over and since 2007 the LPC has made only one year recommendations in light of an uncertain economic outlook.

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[67] See Grimshaw, Bosch and Rubery *Minimum wages and collective bargaining: what types of pay bargaining can foster positive pay equity outcomes? British Journal of Industrial Relations* (forthcoming)
[68] ONS, Trade Union Membership 2011, Table 3.8. Hospitality defined as 'Accommodation and food services', retail defined as 'Wholesale, retail and motor trade'
[69] Australian coverage of collective bargaining has fallen from 85 per cent in 1980 to 40 per cent in 2008, compared to a fall from 70 to 34 per cent in the UK p.101, OECD, Divided We Stand (2011)
[70] For a fuller case study of this system see Borland, J. and Plunkett, J. (forthcoming)
[71] p.xvi, Low Pay Commission, 2003

There are alternatives to the UK's approach that make a different trade-off between independence and flexibility and the goal of protecting the value of the NMW over time. The UK leans towards the former while some other countries lean towards the latter, indexing their NMW to a measure of earnings or prices to ensure that it maintains its value. The French model is to up-rate the minimum wage in line with a price index that reflects the spending patterns of households in the lowest fifth of the income distribution.[72] In New Zealand, the government seeks to protect the real income of low-paid workers while also minimising job losses and requires that the minimum wage increases at least in line with inflation. (See Box 4.)

Decision 4: Stay focused, giving the LPC a relatively narrow remit to recommend the rate of the NMW and to analyse its historic economic effects

Finally, in establishing the LPC, the UK government and the LPC itself decided on a focused remit, sacrificing possible upsides from a broader remit (for example, looking more widely at the issue of low pay) with the importance of getting the NMW-setting process right. The LPC itself has some flexibility over its remit and indeed is asked by government to examine particular issues from year to year. But in practice the LPC has operated more as a 'Minimum Wage Commission', tasked in legislation with recommending the rate of the NMW, taking a view on technical questions about whether or not the NMW is being paid, and deciding whether different rates should be set for certain groups of workers.[73] This focuses the LPC's work on assessing the historic impacts of the NMW rather than examining the issue of low pay more generally, including its causes, implications and proactive policy responses.

Weighing up different approaches—and new areas to explore

This chapter has made clear that countries face a wide range of options when designing a minimum wage and its supporting institutions. None of the choices the UK has made are obviously right or wrong—each reflects a difficult balancing act. Policymakers must weigh up their goals in a specific time and place. What are the wider prospects for wage growth at the bottom end of the jobs market and how much work does the NMW therefore need to do? How strong or fragile is support for the minimum wage and so how much does simplicity and easy communication matter? What kind of a problem does the policy need to help solve and so how broad an impact on wages is needed?

Today's political and economic context is clearly different to the one that faced policymakers 15 years ago. This raises the question of whether the decisions that were taken 15 years ago remain right for today. This will be the focus of the Resolution Foundation's forthcoming project on the future of the NMW and LPC. It is a debate that needs to be approached with caution. As this paper has shown, the NMW and LPC have been an unquestionable—and rare—policy success. This outcome owes a lot to the care with which those involved in the policy have balanced the difficult trade-offs discussed above. Yet bringing together the description of low pay set out in Chapter 1 with the lessons learned from the research in Chapter 2, a number of issues seem ripe for reflection:

First, how have the UK's decisions about the NMW affected its so-called 'ripple effects'—and is this balance still the right one? Because only a small share of workers are paid at precisely the NMW this matters greatly to the effectiveness of the policy as a tool for tackling low pay. The new analysis in Figure 12 shows why this is particularly important in the UK, confirming that the minimum wage is reshaping the UK's low paid labour market. As the NMW has risen, higher tiers of pay have faded out over time, with the ripple effects from the minimum wage having been smaller than anticipated. The distribution of pay used

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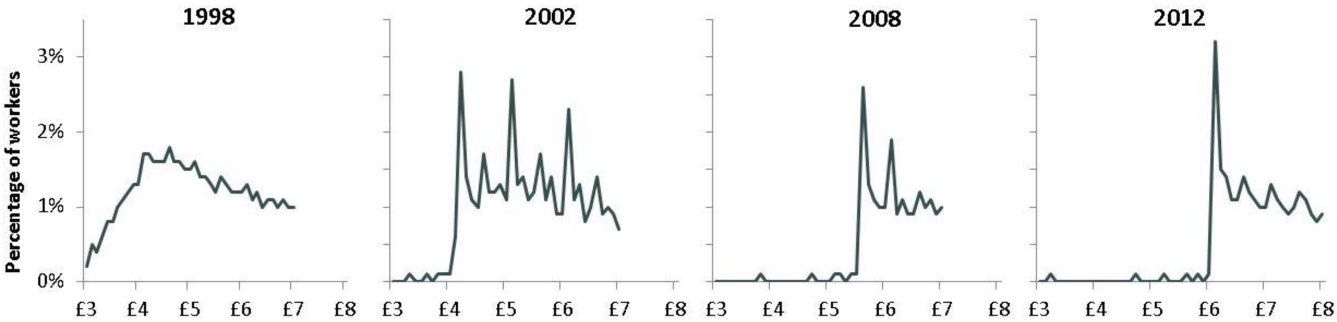
[72] An uprating can also be triggered if the price index rises faster than 2 per cent a year.

[73] The LPC's freedom to recommend variation in the NMW was limited to workers under the age of 26 or those in the first six months of employment. See p.26 above.

to spike in several places, with workers clustered at key increments (for example, at £4.00 an hour, £5.00 an hour and £6.00 an hour). Now low paid workers cluster mainly at the minimum wage.[74]

Figure 12: Pay distributions at the bottom of the labour market

Distribution of hourly pay at the bottom end of the UK labour market, percentage of workforce by 10p hourly pay band



Notes: Hourly pay excluding overtime in 10p bands
Source: Resolution Foundation analysis, Annual Survey of Hours and Earnings, with thanks to Damien Grimshaw for data

As we have seen, policy decisions affect these kinds of outcomes. Ripple effects vary internationally; they are higher in France, for example, than in the US or the UK.[75] There is also evidence that they vary in different sectors of the UK economy with the minimum wage becoming the 'going rate' for entry-level staff in sectors like cleaning, social care, fast food and retail, while other sectors (such as security, where other institutions have complemented the NMW) have seen the effects of the NMW spread out more broadly.[76] It is worth reflecting on whether more could be done to amplify the impacts of the NMW up the earnings distribution without causing unemployment.

Second, how does the trade-off between simplicity and variation play out today? Certainly the simplicity of the UK minimum wage, which has to be set at a rate that the most vulnerable parts of the economy can bear, means there is headroom for increases in other parts of the UK economy. Figure 13 reveals the value of the NMW relative to median pay (the 'bite') by sector, showing that it varies from 92 per cent in *Accommodation and Food Services* to 40 per cent in *Financial Services*. There is similar variation for different types of workers.

As we have seen, other countries do much more than the UK to exploit this by varying their minimum wage accordingly. They lose a degree of simplicity in exchange for a stronger impact on pay. In the extreme case, Australia's approach to varying the wage-floor by sector and occupation means that the minimum wage directly affects the pay of around 16 per cent of the workforce, compared to at most 4 to 6 per cent in the UK. Yet simplicity is important and so these decisions come at a cost. Has the UK got this balance right for the next 15 years?

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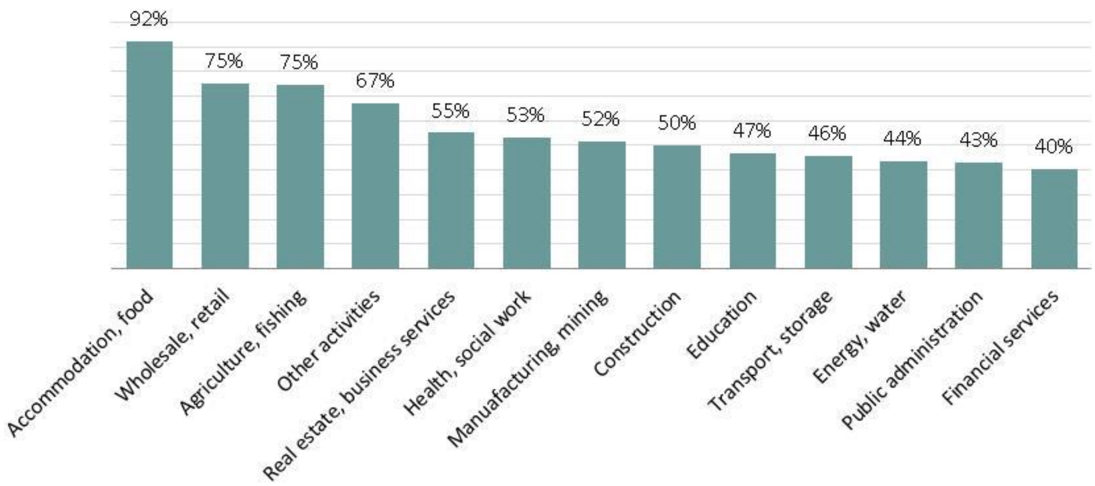
[74] For a further discussion of ripple effects in the UK compared to other economies see p.103, Grimshaw, D. (2013)

[75] Evidence also suggests that countries that have bound the minimum wage more tightly into wider labour market institutions see larger ripple effects. Grimshaw, D. (2013) See also Wicks-Lim, J., *Mandated wage floors and the wage structure: Analyzing the ripple effects of minimum and prevailing wage laws*, University of Massachusetts (2005)

[76] Dickens, R. and Manning, A., Has The National Minimum Wage Reduced UK Wage Inequality?, Centre for Economic Performance, LSE (2002); p.97, National Minimum Wage: Low Pay Commission Report 2007, Low Pay Commission (2007); p.29, National Minimum Wage: Low Pay Commission Report 2008, Low Pay Commission (2008); and p.210, Grimshaw, D. (2013). Occupational licences were introduced into the security sector in 2006 and are believed to have boosted pay across the bottom of the distribution.

Figure 13: Value of the National Minimum Wage relative to median pay by industrial sector

NMW as percentage of median by industrial sector, 2012



Notes: UK 2012 NMW (£6.19 an hour) as a percentage of median hourly pay excluding overtime for all workers in top-level Standard Industrial Code UK industrial sectors

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

Finally, what does the UK's approach mean for the value of the minimum wage itself? Figure 14 suggests that the NMW has risen strongly over time, outpacing inflation, average earnings and even GDP growth since its introduction.[77] Yet Figure 14 also obscures two more difficult facts. The NMW has grown strongly partly because it started from an extremely low base. In fact the UK's first NMW was set lower than the LPC intended because of a data error.[78] Had it been set as intended and then risen to its level today, it would have grown by less than average earnings over time.[79] Moreover, relative to prices, the NMW has now fallen in value for four years running, and it is unclear whether or when this value will be restored. As we enter a new period, it is worth exploring whether the UK's approach to the NMW will strike the right balance between caution and confidence in the rate of the NMW over the medium- to long-term. Could the UK government be clearer about where it would like the NMW to go in the next five or ten years, seeking the LPC's advice on how to get there?

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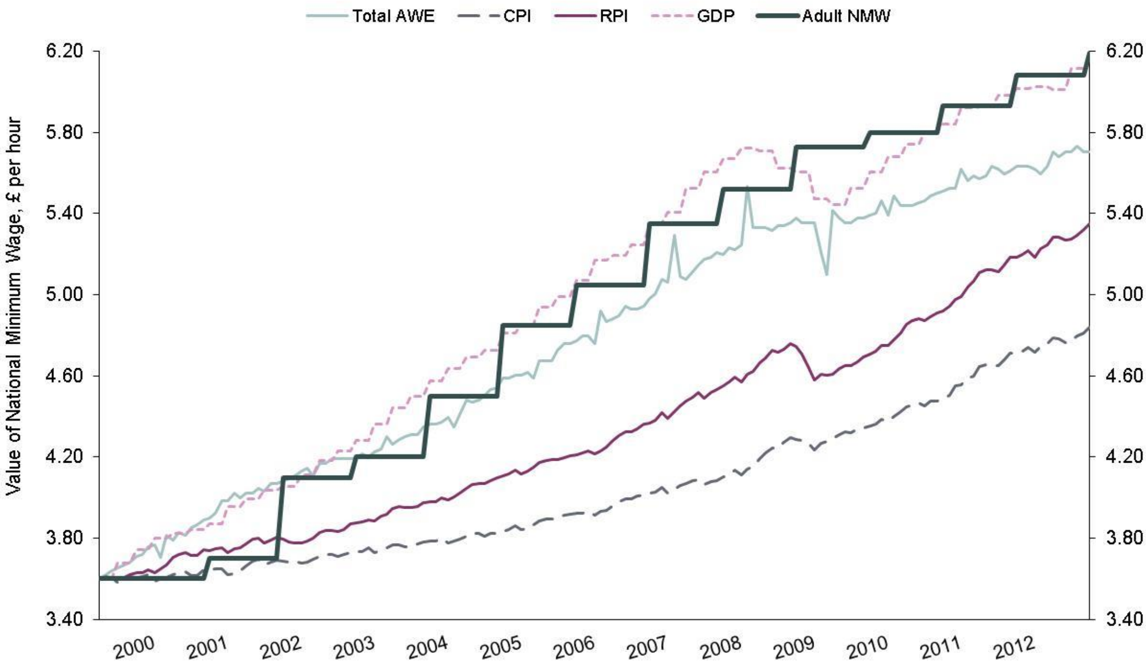
[77] This growth bucks international trends which show that countries with higher union membership tend to see faster growth in the minimum wage over time. The UK has seen surprisingly strong growth given low rates of union membership.

[78] The LPC had intended for the NMW to cover around 8 per cent of the workforce but the rate set only turned out to cover between 4 and 5 per cent. Data provided by the Office for National Statistics (ONS) later turned out to be wrong.

[79] Had the LPC set a rate to cover 8 per cent of the workforce in 1998, the NMW would have started life at around £3.96. Raising this to its subsequent rate of £6.19 in October 2012 would have meant growth of 56.1 per cent, below GDP growth and earnings growth but above inflation.

Figure 14: Value of the UK National Minimum Wage over time

£ per hour and equivalent growth in Average Weekly Earnings, CPI, RPI and GDP



Source: Low Pay Commission, with thanks to James Brennan for sharing data

Summary

While debates about the UK minimum wage in the past 15 years have often been heated, they have also been relatively narrow. Yet countries face a broad set of choices when designing minimum wages. The judgments they come to, trading off competing objectives, shape the way the minimum wage impacts on pay. In general terms, the UK has put its faith in simplicity and consensus-building over a more assertive and developed approach that would have a broader effect. These are tough balances to strike and they can only be assessed against a particular economic and political context. The trick in the coming years will be to learn from other countries, and from the UK's experience to date, developing an approach that is appropriate to the next 15 years.

Conclusion: Building on success while not breaking it

The UK introduced its first statutory national minimum wage with the 1998 National Minimum Wage Act, 15 years ago.[80] As the Low Pay Commission began its work, The *Economist* judged that it would need the "wisdom of Solomon" if it was to set a minimum wage that would boost pay without harming unemployment. Now there is a clear academic consensus that the UK NMW has done just that, raising the wellbeing of the lowest paid workers overall. The same newspaper now says that minimum wages may do more good than harm while the Financial Times judges that, in this much disputed policy debate, "the jury is back in". Politics has moved a long way too; at the time of the minimum wage's introduction, parliament divided straight on party lines. Today all three major parties support the minimum wage and leading thinkers on left and right have begun to call for it to be strengthened.

Yet while the success of the UK NMW shows up clearly in the marked decline in extreme low pay, low pay more generally remains a pressing problem in contemporary Britain. It is also increasingly clear that low pay is a systematic feature of the 21st century UK labour market that will not solve itself through a light touch approach of pursuing growth and investing in skills. The UK is creating large numbers of non-routine service jobs, absorbing a growing share of the workforce into sectors like hospitality, warehousing and social care. While these changes are common to most advanced economies, the UK is creating lower paying, lower skilled versions of these jobs than other countries. Meanwhile, the UK is struggling more than it once did to generate strong wage growth, particularly at the bottom. Simply equipping individual workers to navigate these conditions will not be enough. Institutions are needed that change the labour market itself.

Fortunately, in the last 15 years, a huge amount has been learned about how minimum wages operate and about how low wage labour markets work. Labour markets are not as competitive as was previously thought so a regulated wage-floor can be an important way to make sure workers get paid a fair share of the value they are creating. Employers also adapt to upward pressure on pay in a wide variety of ways, many of which have either benign or positive impacts on the wider economy: they change pay distributions, shift pricing or organisational strategies, and make new efforts to boost productivity. Of course, there are limits to the labour market's adaptability, but employers have so far proven adept at changing the way they operate to make sure they remain viable or profitable while paying their lowest paid workers more.

Despite these successes, a broader debate about the role of minimum wages is also sorely needed. On its current path, the UK is unlikely to make much progress towards tackling low pay. As things stand, over £20 billion will be lost in the next decade to pay that is below the Living Wage through forgone tax revenues and in-work welfare. Under reasonable assumptions, the NMW is on course to be no higher in late 2017 than it was in 2004. Yet even in the most ambitious period of a rising NMW, in the growing economy from 1998 to 2007, when extreme low pay was reduced by nearly four fifths, low pay more generally fell by only 0.9 percentage points. At that rate it would take over 70 years for the UK to achieve even the OECD average rate of low pay.

Broadening out the debate about the NMW and LPC means realising that minimum wages are not a binary choice; different countries approach them differently with a range of implications for pay—particularly in terms of the ripple effects that benefit workers earning above the mandatory minimum. There is a good case for reflecting on the particular choices the UK has made. Do we still have the right balance between

[80] The act received royal assent on 31st July 1998 .

simplicity and the need to put more upward pressure on pay in parts of the economy that could afford to pay more? Could more be done to share the benefits of a NMW rise with a broader group of workers, without sacrificing too much in terms of flexibility? Have we still got the right balance between, on the one hand, wanting a cautious and evidence-based approach from year to year and, on the other, having a clear, driven aspiration to make a higher NMW possible over time?

All of these questions are made more not less urgent by the UK's fiscal position. As the UK enters a long period of extreme fiscal constraint, income growth will necessarily rely more on rising wages, including for low paid workers, than on further growth in state support. Far from being an issue that can wait until a recovery, the need for new ideas to tackle low pay has become even more pressing.

This paper launches a new project at the Resolution Foundation to examine the contribution the NMW and LPC could make to this challenge. The project will be led by a high level expert panel chaired by Professor Sir George Bain, the founding chair of the LPC, working with some of the UK's leading labour market economists and policy experts to test out and recommend practical proposals. A great deal has been learned about low pay in the first 15 years of the UK NMW and LPC and a huge amount has been achieved. The task now is to develop the best approach for the next 15 years.

The Resolution Foundation

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

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

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