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BRIEFING

Analysing the National Living Wage

Impact and implications for Britain's low pay challenge

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The most eye-catching announcement in the Summer Budget was the National Living Wage (NLW). National Minimum Wage workers aged 25 and over will, from April 2016, receive a premium on top of the current legal wage floor, raising their hourly earnings from £6.70 to £7.20. Thereafter, the NLW is expected to rise steadily, surpassing £9 by April 2020. This article considers this announcement and some of the important implications for the labour market and public policy. It does not focus on the changes to tax credits and benefits which we've looked at elsewhere.[1]

The history of the National Minimum Wage

The National Minimum Wage (NMW) came into effect in 1999. Its introduction was hugely controversial, with claims of up to 1 million jobs being at risk. In order to ease fears around possible negative employment effects, a number of rates for younger workers stood alongside the main adult rate. Today, the NMW applies to all those aged 21 and over, with other, lower levels for those aged 18-20, 16-17 and apprentices.

These rates are recommended by the Low Pay Commission (LPC), a nine-member panel composed of employer and worker representatives, as well as three independent members, usually with an academic background in labour market economics. Its remit is to set the NMW at a level that will not harm employment. As such, the LPC's approach is evidence-based, assessing the impact that the previous year's NMW rise has had on the labour market as well as tracking broader economic indicators to judge how big an increase would be affordable for employers. Each year, its members reach a consensus on what the rate should be and make their recommendation to the Secretary of State for Business, Innovation and Skills. It is the Secretary of State's decision whether or not to accept the LPC's recommendation; however in practice the government has never overruled the LPC on the main NMW, although it has done so on the non-adult rates, for example on this year's apprentice rate.

The LPC's 2014 report described four 'phases' in the NMW's evolution: cautious introduction, rapid increases, real-terms falls in the downturn; and the recent return to above-inflation rises. The NMW currently stands at £6.50 and will rise to £6.70 in October this year.

The "National Living Wage" – its scale and timeline

The National Living Wage (NLW) announced in the Summer Budget represents a radical shift in the UK's approach to low pay. The NLW will be introduced in April 2016, with a starting rate of £7.20. This will be the new legal wage floor for all workers aged 25 and over with the current NMW becoming in effect the 21-24 year old rate. The rise from £6.70 to the NLW of £7.20 is a 7.5 per cent nominal increase, the largest since 2004. If we look at the year-on-year change, i.e. comparing the minimum legal rate applying in April 2015 to that in April 2016, it equates to a 10.8 per cent increase. This equals the highest ever rise which occurred in 2001.

It is worth noting, however, that the large increases in the NMW in the early 2000s were applied to a much lower base, with the NMW then equal to just 45 per cent of the typical (median) hourly wage. This ratio between the minimum wage and that at the median, known as the 'bite', is higher today standing at 54 per cent. As such, the NLW will have a large impact, with an estimated **2.7 million people** expected to directly gain as a result. More than **3 million** others further up the earnings ladder will also potentially benefit from a 'spillover' effect, if firms choose to retain some pay differentials between employees (though these spillover calculations are always more speculative).

This is a major and very welcome gain for millions of the lowest-paid workers in the UK. Today, one in five employees fall below the low pay threshold, equivalent to two-thirds of the hourly median wage across all workers, many of whom will benefit greatly as a result (not taking account of other tax credit and benefit changes). In terms of future policy on low pay, there are, however, a number of important implications and outstanding questions.

[1] http://www.resolutionfoundation.org/media/press-releases/welcome-boost-on-low-pay-but-severe-welfare-cuts-will-mean-big-losses-for-many-low-income-working-families/

Terminological muddle

The title of the new policy – the National Living Wage – adds significant confusion to what was already a muddled debate[2] on the purpose and definitions of the various rates. The NLW is a large increase in the legal wage floor, a role that is currently played by the NMW.

The Living Wage as we know it is overseen by the Living Wage Foundation and has a very different logic underlying it. The Living Wage is calculated based on the public's perception of what is needed for a minimum acceptable standard of living for different family types. It is a *voluntary* wage rate that employers are encouraged to pay to help workers and families achieve that standard, and currently stands at £7.85 outside London and £9.15 in London. It is worth emphasising that £7.85 represents an average of what is necessary across different family types. As an example, a single parent supporting two children will require a much higher wage in order to reach that minimum acceptable standard compared with a childless couple.

Crucially, the Living Wage is also calculated to take account of existing in-work support. Without this, the level of the Living Wage would need to rise. For instance, the London Living Wage is currently £9.15. If in-work support were abolished, it would rise to £11.65.[3] None of this is reflected in the new NLW. Indeed it is a misnomer to label it a 'Living Wage'. The government's proposed NLW is in fact a minimum wage "premium" for those aged 25 and over (as it is accurately described in the Budget document).

Another potential source of confusion is the different months in which the NMW for 21-24s (October) and NLW (April) are increased.

Implications of the 2020 ambition for the NLW

Rather than reflecting the rising cost of living, the NLW will instead aim to reach 60 per cent of a typical (over-25) worker's hourly wage by 2020. (£7.20 is expected to be equivalent to 55 per cent on the same measure in April 2016.) The OBR estimates that to achieve this, the NLW will have to rise to around £9.35 in 2020: as Figure 1 shows, this is about £1 higher than the expected level of the NMW in that year (in 2020 prices). It should be noted however that in calculating this figure, the OBR uses average weekly earnings to estimate the expected pace of *median* earnings growth. This is quite likely to be wide of the mark. Historically, median earnings have generally grown more slowly than average earnings so the central estimate of £9.35 may be a bit high.

With regard to the 60 per cent ambition, the Chancellor has referenced the Resolution Foundation's review of the minimum wage, led by Sir George Bain.[4] The Bain review suggested this might be an appropriate upper limit for future ambitions for the NMW by examining international evidence on how high minimum wages have gone relative to median earnings without endangering employment. In its analysis of the impact of the NLW, the OBR estimates that, on this measure, compared with the UK's current mid-table position among the OECD countries, by 2020 the UK will be in the top tier, although still trailing a handful of countries, including France, New Zealand, Israel and Slovenia.

Analysing similar evidence, the Bain review came to the conclusion that 60 per cent of median, follow further research and consultation, might represent an upper limit for the NMW. As such, progress towards that point should be made carefully, and the ambition should only be set following close consultation with the LPC. The government's ambition pushes further than the Bain review however, as it aims for 60 per cent of the *wage of over-25s* rather than all workers (thereby excluding young, low-paid workers). How fixed a target the government's 60 per cent will be remains unclear; flexibility and discretion for the LPC is vital. Nonetheless, we welcome

[2] http://www.resolutionfoundation.org/media/blog/will-wages-fill-the-tax-credit-gap-dont-budget-for-it/

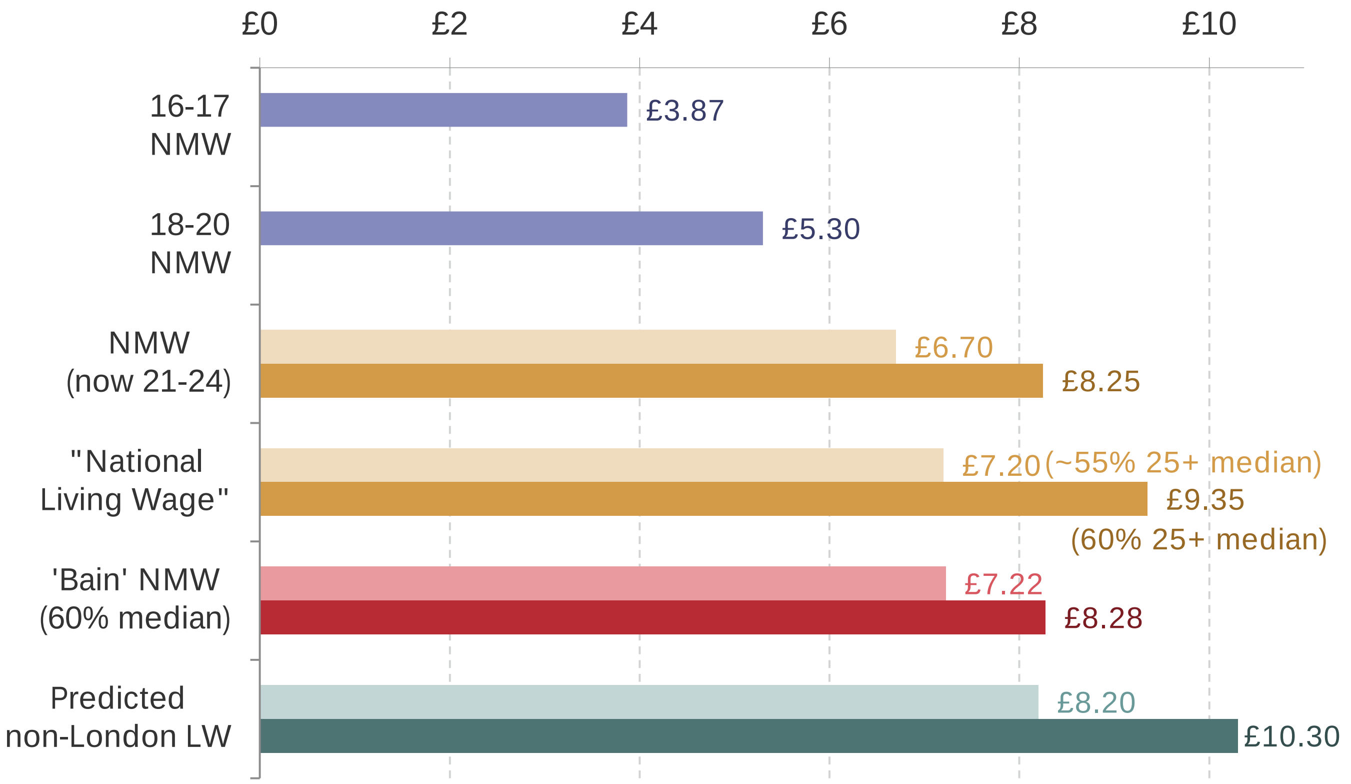
[3] https://www.london.gov.uk/sites/default/files/living-wage-2014.pdf

[4] http://www.resolutionfoundation.org/publications/minimum-review-minimum-wage-final-report/

the sense of greater ambition and the faster pace at which the wages of the UK's lowest earners are now likely to rise.

Figure 1:
How the various wage rates could grow to 2020

Rate in April 2016 and April 2020



Source: OBR; Uprating the out of London Living Wage 2014, Loughborough University; RF calculations

Notes: The predicted non-London LW rate in 2016 and 2020 is calculated by increasing the current rate (£7.85) by average earnings growth plus 2 per cent each year, and assuming no real drop in the reference rate as per the approach spelled out in the source. The National Living Wage and NMW projections rely on median earnings growth being the same as average earnings growth while for the Bain NMW scenario, the historical ratio between median and average wage growth is used, resulting in slower growth.

Tax credits and the wage floor: complements, not substitutes

In assessing the overall impact of the NLW, the earnings boost needs to be weighed against the major cuts to working-age support that were also announced at the Budget. For many low to middle income families the extra earnings they receive will be greatly outweighed by the hit to their in-work support. Put simply, the £4 billion wage boost implied by the NLW will not compensate for the £12 billion cut to benefits.

Moreover, the patterns of losses (and gains) play out very differently by household type. Those not on tax credits should gain, for example a single person working full time on the current NMW can expect to be better off to the tune of more than £2,000 come 2020. In contrast, a couple with three children, both earning the NMW, with one working full-time and the other part-time, could be £250 worse off as a result of cuts and freezes in in-work support. And for those who are already earning more than the NLW but with low weekly wages, the squeeze is even tighter. A single parent of one child, working part-time on £9.35, is set to see their annual income fall by £1,000.

If the aim of these reforms is to reward working but low-earning families, we can't overlook the far-reaching impact of the cuts and freezes to tax credits and benefits.

The NLW isn't as effectively targeted at low-income households as in-work support. Many of today's NMW-earners are in households in the top half of the income distribution. To protect the living standards of those at the bottom, a rising wage floor must be a complement to, not a substitute for, in-work support.

The future of the Low Pay Commission

The size of the government's ambition on low pay raises important questions about the future role of the LPC. As part of the Bain review process, we consulted with a range of stakeholders, weighing the views of business, unions, academics, LPC staff and former Low Pay Commissioners. One of the most difficult challenges facing that review was striking the right balance between preserving what was best about the current settlement – the LPC's autonomy and evidence-based process – while recognising the potential it had to put its expertise to work in tackling the UK's low pay problem. Given some of the shifts in the government's approach towards the minimum wage (and the LPC) set out in the Budget it should now consult on the future role and powers of the LPC including the sort of wider remit recommended in the Bain review.

This should be done on the basis that it is absolutely crucial – as the Bain review concluded – that the LPC's freedom is maintained. This would be entirely compatible with a non-binding medium term ambition (expressed as a percentage of the median wage), consulted on with the LPC, that would act as a "lodestar" (as Bain described it). But if the government is committed to increasing the NLW to 60 per cent of median earnings for over-25s by 2020, regardless of the economic circumstances, then the LPC may be reduced to little more than advising on the pace of the increases. It is unclear what would happen if, some years down the line, in forecasting the economic weather the LPC recommended an increase that would slow or derail progress towards the government's 60 per cent target. Would the government overrule them, or heed their advice?

One issue, therefore, is for the government to be clearer about the grounds on which it would in the future choose to deviate from the LPC's recommended path, and what evidence would support that decision. The strong presumption must be that it follows the LPC's judgement.

The Bain review argued that any ambition on a target should be agreed with the LPC and should not restrict the year-on-year flexibility of the LPC to recommend the rate they felt was appropriate for the NMW.[5] Nor should they be compelled to hit the medium term ambition if economic circumstances did not permit it. The OBR has tried to estimate how many jobs might be lost as a result of the NLW. These sorts of modelling exercises are always subject to huge uncertainties but the OBR's central estimate of a 60,000 rise in unemployment only strengthens the argument for an independent LPC to guide the NLW on a sensible but ambitious path.

In addition, the ambition as set out in the Bain review was supposed to assist the LPC in playing a pro-active role in identifying the road-blocks to reaching a higher NMW and in challenging government and others to try and address any such barriers that were impeding progress. Protecting the status of the LPC, and giving it scope to flag problems within sectors, appears to have been less of a consideration with the NLW (with the OBR choosing to note that it is as yet unclear how the LPC will act on their new remit).

The announcement of the NLW and the change it represents in the government's approach to low pay should act as a prompt to clarify the LPC's role and its powers. Retaining its independence and its role as the primary advisor on what is affordable, taking into broader economic circumstances, is vital to ensure the success of the NLW (and the NMW). More widely, the government

[5] One of the lesser noted changes in the Budget was the requirement that the LPC return to a practice from its early years and called for in the Bain review – publishing this year's recommendation but also an indicative figure for the following year, to give employers and workers a better sense of how the wage floor would rise.

– recognising as the Bain review did that a higher wage floor can only ever be one part of the effort to tackle pervasive low pay – should use this period of change to consider how the LPC can play an enhanced role in advising on how to tackle this crucial issue.

Sectoral concerns

The LPC's deep knowledge of the UK's low-pay sectors will be all the more vital as the NLW is introduced. Analysis for the Bain review found that for many sectors, the wage bill increase required to meet a Living Wage would be relatively minor. This finding chimes with the OBR estimate that the NLW will increase total employee compensation across the economy by just 0.1 per cent. It will always be the case, however, that some sectors will find it more challenging to absorb these increases. Retail and hospitality may well feel pressure but above all it is social care that offers the greatest cause for concern, due to the cocktail of already pervasive low wages, sharp falls in funding, rising demand for services and limited prospects for major productivity gains (in the short term at least). The Resolution Foundation estimates that 160,000 frontline social care jobs are already paid below the NMW, with nearly 1 million below the Living Wage. And the LPC has for years singled out the care sector as a drag on the current NMW, with every increase in the NMW bringing an increased risk of non-compliance.

Given that the majority of care services are publicly funded, what happens in terms of low pay in the care sector is to a very significant degree up to government. Analysis by the Resolution Foundation published earlier this year found that paying the Living Wage to the entire frontline care workforce would have required an extra £1.4 billion in public funding in 2013 (though there would be significant offsetting savings to the Exchequer from lower in-work support).[6] Unless the sector receives appropriate additional funding to meet the higher wage-bill, the NLW is likely to imply a deterioration in service quality or availability.

Compliance

Although of particular concern in social care, the question of compliance with the NLW merits attention. One of the positives of the NMW since its introduction has been its simplicity. Everyone 21 and over is entitled to the same minimum hourly rate. The introduction of an extra band (21-24), and the lack of clarity around the name – will it be clear that the National Living Wage is compulsory? – could increase the likelihood of non-compliance. More fundamentally, it will be crucial that enforcement rises to meet the challenge the higher rate may present (there are already widespread concerns about the effectiveness of existing enforcement under the NMW). Worries around compliance shouldn't be an insurmountable obstacle for the NLW but it must be taken seriously and be properly resourced to ensure all of those who should gain do so.

Younger workers

What happens next for younger workers is also uncertain. Having borne the brunt of the downturn, with typical wage falls of 13 per cent for those aged 22-29 compared with falls of 5 per cent for those in their 50s, those under 25 will not benefit from the NLW. The downside is a new pay differential for those aged 21-24. The upside is that some employers may prefer younger, cheaper workers over their older counterparts. There is a risk that if the NLW was applied to younger, less experienced workers – traditionally seen as being among the most vulnerable to negative impacts of minimum wages – there may well have been bigger employment effects. It is also worth noting, however, that many employers already pay those aged 20 and under, and thus ineligible for the NMW, the full rate and so some under-25s can expect to find themselves on the NLW.

[6] http://www.resolutionfoundation.org/publications/as-if-we-cared-the-costs-and-benefits-of-a-living-wage-for-social-care-workers/

Progression and wage compression

One of the concerns raised by the Bain review (as well as other RF research)[7] has been the share of people who get stuck on low pay and the NMW. Initially intended as an absolute minimum that only a minority of employees should receive, the NLW risks becoming much more of a 'going rate'. The OBR expects 7 per cent of the total workforce to be on the NLW by 2020. Although they do also anticipate that the effects of the NLW to ripple further up the earnings ladder – affecting an estimated 6 million people in total – the size of the increase raises important questions about pay progression. We already know that one in four (23 per cent) of NMW earners have failed to progress onto higher wages within five years, while 13 per cent are still stuck on it after a decade.[8]

The higher wages the NLW will bring are very welcome but the added compression at the bottom of the earnings distribution makes working with employers to create more progression routes, and improved skills, in large low pay sectors even more of a priority than it was before. Public policy in the UK has long been weak on this issue. The NLW makes it more vital than ever that this changes.

Tax-free minimum wage?

Another announcement in the Budget that has received scant attention was the postponement of the 'Tax-Free Minimum Wage'. The Tax-Free Minimum Wage was supposed to mean that a person working 30 hours on the NMW will not pay any income tax. We learned in the Budget however that this would now not come into force until the end of the parliament, after the personal tax allowance reaches £12,500 (in contrast to the Conservative manifesto which said it would apply from the first Budget of this parliament). As we discussed last week,[9] had that commitment been implemented as planned, it could have required faster increases in the personal tax allowance, with a potentially large bill for government of around £3 billion cumulatively across the parliament. In any case, the policy's significance is greatly diminished as a result of the NLW introduction, since the NMW, and therefore the Tax-Free Minimum Wage, will only be relevant for those aged 21-24. For those 25 and over it no longer applies.

Conclusion

The National Living Wage is a bold attempt to get to grips with the UK's endemic low pay problem. The resulting pay increases for those aged 25 and over on low earnings will be highly significant. But to ensure the policy will work for employers, employees and the wider economy, a higher wage floor will need to go hand in hand with strong demand in the labour market and action to raise productivity. Moreover, pay gains don't in any sense justify significant cuts to in-work support and work incentives. The impacts of the cuts to in-work support will continue to squeeze the incomes of many low-income families in coming years. A large amount of work remains to be done to flesh out the NLW and the future role of the LPC. This should be done carefully and in full consultation with the LPC.

[7] http://www.resolutionfoundation.org/publications/escape-plan-understanding-who-progresses-from-low-pay-and-who-gets-stuck/

[8] http://www.resolutionfoundation.org/publications/turning-point-the-minimum-wage-in-2014-and-beyond/

[9] http://www.resolutionfoundation.org/media/blog/the-tax-free-minimum-wage-a-gimmick-or-a-real-giveaway-2/

Resolution Foundation

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- *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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