



National Minimum Wage RIA Increasing adult and youth rates in October 2005 and 2006

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This regulatory impact assessment (RIA) considers the impact of proposals to increase the adult and development rates of the National Minimum Wage (NMW) in 2005 and 2006. The proposals reflect the recommendations of the Low Pay Commission's (LPC) sixth report¹ into the NMW.

The specific changes that the Government proposes to implement are that:

- The adult rate of the NMW increases from £4.85 an hour to £5.05 in October 2005, and the development rate for 18 to 21 year olds increases from £4.10 an hour to £4.25 in October 2005.
- The adult rate of the NMW increases from £5.05 an hour to £5.35 in October 2006, and the development rate for 18 to 21 year olds increases from £4.25 an hour to £4.45 in October 2006.

¹ Sixth report of the Low Pay Commission: Low Pay Commission Report 2005

Purpose and intended effect of measure

Objective

1. The purpose of the NMW is to create a minimum pay level and thus to protect workers from unacceptably low rates of pay. The NMW forms part of the government's policies to make work pay, alongside Tax Credits and the New Deals.

Background

2. Decisions on the NMW rates are made on the basis of recommendations by the independent LPC. The LPC reports contain a large body of evidence and analysis on the impact to date of the NMW. The evidence and data collected and produced by the LPC have been used to inform this RIA.

3. The NMW was introduced in April 1999. The adult and development rates have increased in a number of steps, most recently in October 2004.

4. Previous LPC reports have announced staged increases in the minimum wage such as the fourth report in March 2003² which recommended an initial increase in October 2003 and a further increase in October 2004.

5. In accepting the recommendations of the LPC's sixth report³, the Government has agreed that the Commission should report back a year later on whether the economic conditions are consistent with the second-stage of the minimum wage increase provisionally proposed for October 2006.

² Fourth report of the Low Pay Commission: "Building on Success"; March 2003
<http://www2.lowpay.gov.uk/lowpay/report/pdf/lowpay-nmw.pdf>

³ Sixth report of the Low Pay Commission: "Low Pay Commission Report 2005"
<http://www2.lowpay.gov.uk/lowpay>

Options

6. The LPC has recommended that the adult and development rates of the NMW should be increased to £5.05 and £4.25 in October 2005 and to £5.35 and £4.45 in October 2006. The LPC concluded that these recommendations would increase the earnings of the lowest paid without damaging their employment prospects. The Government accepts these recommendations. The alternatives would have been to choose higher or lower rates.

7. The government accepts the LPC's analysis, that these proposals represent an acceptable balance between maintaining and enhancing the value of the NMW and preserving employment prospects for many of the most vulnerable workers.

Costs and benefits

8. The impact of the proposed increases in the NMW rates will be to increase the pay of some workers above the level that it would otherwise have been. This will be a cost to employers and a benefit to workers. The NMW is now a recognised part of employment practices and implementation costs of administering the proposed increase will be minimal.

Business sectors affected

9. All sectors are affected by the NMW although agriculture has its own minimum wage machinery. In practice, the impact of the NMW is most keenly felt in a number of sectors: retail; hospitality; cleaning and security; social care; manufacture of textiles, clothing and footwear; and hairdressing. In their report, the LPC paid particular attention to these sectors.

Number of potential beneficiaries

10. The latest official data on the prevalence of low paid jobs in the UK relates to spring 2004. At that time, it is estimated that around 1.8 million jobs held by those aged over 21 were paid below the proposed October 2005 adult rate of £5.05 and that 0.2 million jobs held by those aged 18 to 21 were paid below the proposed development rate of £4.25.

11. The numbers of jobs that actually stand to benefit from the proposed increases in October 2005 and October 2006 will depend upon what has happened, and is likely to happen, to the wages of workers in the period between spring 2004 and October 2005 and then between October 2005 and October 2006.

12. The adult and development rates of the NMW were increased to £4.85 and £4.10, respectively, in October 2004, and it is assumed that these changes fed through into earnings for all workers earning below those levels (i.e. that there was full compliance with the October 2004 rates). When working out the stand-to-benefit numbers for October 2006, we make a similar assumption that there is full compliance with the October 2005 NMW rates.

(i) Increase in adult and development rates in October 2005

13. In this RIA, our main assumption is that the hourly pay of all those earning less than the October 2005 rates increases in line with average earnings growth (measured by the Average Earnings Index) between spring 2004 and October 2005. This is based on an average increase using actual data for the period April 2004 to October 2004, and a forecast rate of increase thereafter derived from the HM Treasury comparison of independent economic forecasts.

14. On this assumption, the proposed October 2005 increase would have no effect on the pay of both jobs held by adults and jobs held by 18 to 21 year olds⁴. Whilst this is the calculation that goes into the RIA, it should be noted that the DTI also estimates that the proposed October 2005 increase will cover around 1.3 million workers.

15. An alternative assumption which is less likely is that the hourly pay of all those earning less than the October 2005 rates will have increased in line with Retail Price Index (RPI) inflation between April 2004 and October 2005. This is based on an average increase using actual data for the period April 2004 to October 2004, and a forecast rate of increase thereafter derived from the HM Treasury comparison of independent economic forecasts. On this assumption, the number of jobs that would potentially benefit from the proposed October 2005 increase is 1.5 million, made up of 0.2 million jobs held by 18 to 21 year olds and 1.3 million jobs held by those aged over 21⁵.

(ii) Increase in adult and development rates in October 2006

16. In this RIA, our main assumption is that the hourly pay of all those earning less than the October 2006 rates increases in line with average earnings growth (measured by the Average Earnings Index) between spring 2004 and October 2006. This is based on an average increase using actual data for the period April 2004 to October 2004, and a forecast rate of increase thereafter derived from the HM Treasury comparison of independent economic forecasts.

⁴ This estimate is calculated by deflating the October 2005 proposed rates by actual and forecast average earnings growth, i.e. by 5.3 per cent over 18 months, producing equivalent spring 2004 rates of £4.80 and £4.04 for adult and development rates respectively. The numbers affected are then calculated from cumulative distributions of jobs by hourly pay based on the ONS low pay central estimates developed by the LPC.

⁵ Calculated as above but using the actual and forecast increase in RPI rather than average earnings; so the October 2005 proposed rates are deflated by 3.7 per cent, producing equivalent spring 2004 rates of £4.87 and £4.10 for adult and development rates respectively.

17. On this assumption, the number of jobs that would potentially benefit from the proposed October 2006 increase is 1.4 million, made up of 0.1 million jobs held by 18 to 21 year olds and 1.3 million jobs held by those aged over 21⁶.

18. An alternative assumption which is less likely is that the hourly pay of all those earning less than the October 2006 rates will have increased in line with RPI inflation between April 2004 and October 2006. This is based on an average increase using actual data for the period April 2004 to October 2004, and a forecast rate of increase thereafter derived from the HM Treasury comparison of independent economic forecasts. On this assumption, the number of jobs that would potentially benefit from the proposed October 2006 increase is 2.0 million, made up of 0.2 million jobs held by 18 to 21 year olds and 1.8 million jobs held by those aged over 21⁷.

Impact on labour costs of uprating

19. The impact of the upratings on wage and labour costs also depends upon the assumptions made about the likely path of wage increases between October 2004 and October 2006.

20. The methodology for estimating the increase in wage costs for the uprating is as follows:

- For the 2005 and the 2006 increases, we calculate the additional average hourly uplift in pay that is required to bring all those jobs paying less than the October 2005/October 2006 proposed rates

⁶ This estimate is calculated by deflating the October 2006 proposed rates by actual and forecast average earnings growth, i.e. by 10.0 per cent over 18 months, producing equivalent spring 2004 rates of £4.86 and £4.05 for adult and development rates respectively. The numbers affected are then calculated from cumulative distributions of jobs by hourly pay based on the ONS low pay central estimates developed by the LPC.

⁷ Calculated as above but using the actual and forecast increase in RPI rather than average earnings; so the October 2006 proposed rates are deflated by 6.3 per cent, producing equivalent spring 2004 rates of £5.03 and £4.19 for adult and development rates respectively.

onto the minimum wage. The size of this average increase will depend on the assumption made about what happens to earnings in these low paid jobs between October 2004 and October 2006 (i.e. the two scenarios discussed above). It is assumed that there is full compliance with the October 2004 rate when calculating the average wage increase for the October 2005 uprating⁸ and full compliance with the October 2005 rate when calculating the average wage increase for October 2006 uprating.

- Multiply this average increase per hour by the average number of hours worked by those workers affected. The latest data⁹ shows average hours worked per week including overtime hours was 33.5 hours for low-paid adults (22 and over) and 35.9 hours for low-paid 18 to 21 year olds¹⁰;
- Multiply by 52 weeks per year.
- Multiply by the number of potential beneficiaries (see above).

21. To go from the total wage bill to total labour costs, we multiply by 20 per cent to take account of the cost of employers National Insurance and any other non-wage benefits (such as pension contributions) that are linked to wages. We use a figure of 20 per cent, which is less than the 30 per cent figure used in other RIAs, because low-paying jobs are likely to be associated with smaller non-wage benefits.

⁸ For the October 2005 up rating, although full compliance with the October 2004 rates indicate presumed minimum rates of pay of 4.85/ 4.10, we need to maintain a constant price base. So, we deflate these presumed minima to 4.81/4.07 to take account of 6 months of earnings growth between April and October 2004 under the AEI scenario. Similarly, for the October 2006 up rating , in presuming full compliance with the October 2005 rates of 5.05/4.25, we deflate these minima to 4.80/4.04. Under the alternative RPI scenario shown in the annex, the presumed minima are deflated using the RPI.

⁹ Source: April 2004 Annual Survey of Hours and Earnings.

¹⁰ Used hourly pay excluding overtime in April 2004 for all aged over 22 earnings below 4.85 and all 18 to 21 year olds earnings below 4.10.

22. It should be noted that the RIA only considers the direct impact of the uprating. We have implicitly assumed that the uprating has no significant impact on wage-setting behaviour above the minimum wage rates. This means we have not accounted for additional costs to employers or benefits to workers as a result of the uprating.

23. The size of the average hourly increase in pay that employers are required to pay to comply with the minimum wage policy depends on the assumption made about what happens to low-paid earnings between April 2004 and October 2005/October 2006. The two scenarios discussed above were that in the absence of any uprating, earnings would have risen in line with RPI or average earnings.

24. Tables 1 and 2, below, show the effect on the aggregate wage bill and labour costs of the October 2005 and 2006 upratings under the assumption that in the absence of any uprating low-paid earnings would have risen in line with average earnings.

Table 1: Impact of the October 2005 uprating on aggregate wage and labour costs (assumes low-paid earnings rise in line with average earnings)

Increase in wage bill for proposed 2005 rates	£0 million
Percentage increase in economy's total wage bill due to uprating	0%
Increase in labour costs for proposed 2005 rates	£0 million

Source: DTI

25. Table 1 shows that employers face no additional cost (over and above what they would in any case have to pay their workers) because the NMW is not rising faster than average earnings in October 2005. Table 2 shows a significant wage bill effect in October 2006, but this is still modest in comparison to the economy's total wage bill.

Table 2: Impact of the October 2006 uprating on aggregate wage and labour costs (assumes low-paid earnings rise in line with average earnings)

Increase in wage bill for proposed 2006 rates	£320 million
Percentage increase in economy's total wage bill due to uprating	0.05%
Increase in labour costs for proposed 2006 rates	£383 million

Source: DTI

26. Under the alternative, less likely assumption that low-paid earnings rise in line with the RPI, the impact on wage and labour costs would be slightly greater. This effect is shown in the Annex.

Costs for a typical business

27. The proposed changes to the October 2005 rates represent an increase of 4.1 per cent on the current rate for adults and 3.7 per cent for 18 to 21 year olds. The proposed changes to the October 2006 rates represent an annual increase of 5.9 per cent for adults and a 4.7 per cent for 18 to 21 year olds. Those employers with staff currently paid at or close to the minimum wage will therefore see the earnings of these workers increase above the expected growth rate of average earnings. However, most workplaces do not employ people at or near current NMW rates and therefore will be unaffected. And most workplaces that do employ people at or near current NMW rates are unlikely to employ significant proportions at these rates. Thus most businesses are unlikely to see any large changes to their cost base.

Benefits

Increase in adult and development minimum wage rates in October 2005/ October 2006

28. We calculated earlier that the 2005 uprating will lead to no additional increase in employers' wage bill for the year commencing October 2005,

(over and above the increase in employers' wage bill that would have occurred anyway), and an estimated £320 million increase in employers' wage bill for the year commencing October 2006. On this basis, the estimated aggregate benefit to workers on low pay is expected to be neutral in the year commencing October 2005. The aggregate additional benefit for workers is expected to rise to around £320 million in the year commencing October 2006. This benefit is equivalent to an average pay rise per worker benefiting of around £225¹¹ per year before tax in the year commencing October 2006.

29. Under the alternative assumption that low-paid workers' earnings rise in line with the RPI, the estimated wage bill effect and aggregate benefit to workers is expected to be around £204 million and around £447 million for the years commencing October 2005 and October 2006, equivalent to an average pay rise per worker benefiting of around £140 and £225 per year before tax for the years commencing October 2005 and 2006 respectively.

Equity and fairness

30. The LPC report shows that increases in the NMW continue to benefit certain groups disproportionately: women; people from ethnic minorities; the disabled and part-time workers.

Small firms' impact test

31. The LPC recommendations were based upon extensive analysis and gathering of evidence, including evidence received from, and discussion with, small businesses and their representatives.

¹¹ Based on average hours worked per week of 33.5 for adults and 35.9 for 18-21 year olds

Competition assessment

32. The NMW provides a floor for wages and therefore ensures that firms cannot compete against each other by driving down wages to unacceptable levels. Most of the sectors where the impact of the NMW is felt most keenly are characterised by large numbers of relatively small firms. To the extent that the NMW increases labour costs, these are borne by all employers in a sector. It is therefore unlikely that the NMW creates significant barriers to entry.

Enforcement and sanctions

33. The NMW is enforced in two ways. The Inland Revenue takes proactive steps to secure enforcement and acts on complaints. Individuals also have a right of redress to an employment tribunal.

Consultation

34. The Low Pay Commission has undertaken in their latest report a thorough examination of the issues relating to the uprating of the existing minimum wage rates.

Monitoring and review

35. The Government issues an annual report on enforcement action.

36. More broadly, the LPC is charged with reporting on the impact of the NMW. In due course, the Government will formally ask the Commission to report again in 2005 on the operation of the minimum wage and the Government will provide the Commission with its own evidence ahead of the next report.

Declaration

37. I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed



Date

February 25th 2005

Lord Sainsbury of Turville, Parliamentary Under-Secretary of State – Minister for Science and Innovation

Contact Details

Any comments on this regulatory impact assessment should be addressed to:

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Annex

38. Tables 1 and 2 in the main section of the RIA set out the effect of the uprating on the aggregate wage bill and labour costs under our main assumption that in the absence of any uprating, low-paid earnings rise in line with average earnings.

39. Tables A1 and A2, below, show the effect on wage and labour costs under the alternative assumption that in the absence of any uprating, low-paid earnings rise in line with the RPI. Other than the replacement of the AEI assumption by the RPI assumption, the methodology is the same as that described in the main section of the RIA.

Table A1: Impact of the 2005 uprating on aggregate wage and labour costs (assumes low-paid earnings rise in line with the RPI)

Increase in wage bill for proposed 2004 rates	£204 million
Percentage increase in economy's total wage bill due to uprating	0.04%
Increase in labour costs for proposed 2004 rates	£245 million

Source: DTI

Table A2: Impact of the 2006 uprating on aggregate wage and labour costs (assumes low-paid earnings rise in line with the RPI)

Increase in wage bill for proposed 2004 rates	£447 million
Percentage increase in economy's total wage bill due to uprating	0.08%
Increase in labour costs for proposed 2004 rates	£537 million

Source: DTI

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