

**The National Minimum Wage “Making a
Difference: The Next Steps”, third report
(volume two) of the Low Pay Commission
(Extracts)**

The National Minimum Wage

Making a Difference: The Next Steps Third Report (Volume Two) of the Low Pay Commission

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Chairman's Foreword

- 1 In the first volume of our third report we concluded that the National Minimum Wage has been a success. It has benefited many workers without any discernible adverse impact on employment. And around 70 per cent of beneficiaries have been women, hence the minimum wage has contributed to a significant narrowing of the gender pay gap. We also recommended that the main rate should increase to £4.10 per hour from October 2001 and to £4.20 per hour from October 2002, which the Government has accepted. This second volume contains important analyses and recommendations about how the minimum wage is working in practice, its effect on incomes, and its impact on young people, other groups and on low-paying sectors. We also look at compliance and enforcement and suggest how the minimum wage should be reviewed in future.
- 2 Once again, the treatment of young people posed a considerable challenge. In this volume we outline a longer-term strategy that will continue to protect their employment. We remain convinced that, in line with the practices of the vast majority of employers, 21 year olds should be included in the adult rate. We have made this recommendation in our previous two reports, and we hope that the Government will now agree that it would be prudent to accept it.
- 3 In our first report, three years ago, we noted that workers and employers wanted protection from both unfair pay and competition based upon unfair pay. The National Minimum Wage has addressed this matter: the worst excesses of low pay have largely been removed and firms can compete on the quality of their goods and services rather than low pay alone. Many workers have benefited without any adverse impact on employment or competitiveness. The challenge is to maintain the value of this achievement. We believe that there needs to be a defined process of regular reviews that will reassure low-paid workers that the protection provided by the

minimum wage will continue and that will allow businesses to plan ahead. We have learned a great deal from the combination of an empirical approach and the experience of the businesses and workers affected by the minimum wage. Anyone can set a minimum wage rate. The trick is to set one that will benefit low-paid workers without damaging the economy and, consequently, their employment prospects. The Low Pay Commission, whose members have a wide range of experience, has played a key part in recommending an affordable minimum wage.

- 4 Together the two volumes of our report comprise a coherent package of recommendations that will ensure the minimum wage continues to be workable and worthwhile. I should like to thank my fellow Commissioners for the contribution they have made to this process, both in terms of the quality of their input and their personal commitment to making it work. As one of the Commissioners has noted, this has been a shared and mutual education. We have laid a firm foundation on which a future approach can safely be built.



June 2001

The Commissioners



from left to right standing:

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Margaret Prosser
Paul Gates
George Bain
David Metcalf
William Brown

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Executive Summary

Chapter 1: Introduction

- 1 In response to representations that business needed as much notice as possible of forthcoming changes to the National Minimum Wage, we announced in January 2001 that we would submit our third report early to the Government in two volumes. This second volume addresses a number of important aspects of the minimum wage, including its treatment of young people and training, its impact on incomes, implementation issues, the accommodation offset, compliance and enforcement, and the future review process. Our conclusions and recommendations on these matters continue to be based on wide-ranging consultation and analysis.

Chapter 2: Young People and Training

- 2 Young people have benefited from the National Minimum Wage without any discernible negative impact on their employment. There is also no evidence of any adverse impact on the New Deal, on apprentices or on training provided by employers. An age-related Development Rate for young adults lacks equity and our longer-term aim remains to link the Development Rate to accredited training rather than age. To achieve this without risking an adverse impact on youth employment, however, changes must be phased incrementally: we will need to be confident that there will be no adverse employment impact from lowering the age at which the main rate applies. We believe this is already the case for 21 year olds and we recommend once again that they should receive the adult rate; this recommendation is supported by pay data on the lowest-paid young people and on those in new jobs, and by evidence of employer practice. For 18–20 year olds we recommend that the age coverage of the Development Rate should be kept under review.
- 3 We note that take-up of the Development Rate for older workers has been low; we would like to review the merit of

continuing this concessionary rate again in the light of future developments. And we will need to make a full assessment of the impact of the National Minimum Wage on those younger workers excluded from it and keep their treatment under review. The relativity between the Development Rate and the main rate has protected employment and training opportunities without any adverse impact on incentives to work. We therefore recommend an increase in the Development Rate in line with the main rate to £3.50 per hour in October 2001 and £3.60 per hour in October 2002.

Chapter 3: Impact on Incomes

- 4 While the minimum wage affects households across the income distribution, it has had most impact on the poorest working households. The effect of the tax and benefits system is to reduce the impact on incomes for some, but not all, households affected by the minimum wage. The minimum wage has led to a small reduction in poverty rates. It must be seen as part of a package of in-work support: in combination with the minimum wage, recent tax and benefits changes have reduced the number of people living in poverty by nearly a quarter. By underpinning the system of tax credits and benefits the minimum wage supports the strategy of in-work benefits to help the low paid in work. And by providing a guaranteed level of income in work, the minimum wage increases the incentive to move into work.

Chapter 4: Compliance and Enforcement

- 5 The vast majority of employers are complying with the National Minimum Wage. We are not complacent, however, because some workers continue to be underpaid. Although overall awareness of the existence of the minimum wage is very high, we recommend further publicity for the headline rate, the enforcement service and the Helpline number to improve awareness among the public. The enforcement system is generally seen as effective, but we hope that Government will strengthen it further by using its initiatives to promote compliance with tax and other legislation also to tackle non-compliance with the minimum wage. We welcome the pilot

projects being developed by the Government in partnership with external agencies to promote the reporting of non-compliance.

- 6 We also welcome proactive enforcement by the Inland Revenue and Government publicity for enforcement actions and we hope that they will do more of both of these. Some workers continue to experience detriment and dismissal related to the minimum wage, and we recommend that the Inland Revenue and the Advisory, Conciliation and Arbitration Service (ACAS) continue to monitor service to customers at the boundary between the two organisations and examine the scope for action to strengthen it.

Chapter 5: Implementation Issues

- 7 The definition of the National Minimum Wage adopted in the Regulations has worked well and the great majority of employers has found the operation of the National Minimum Wage Regulations unproblematic. But we received some representations about specific issues including the Supported Employment Programme, voluntary workers, the accommodation offset, tips, the funding of the social care system, and fair estimate agreements for output workers. The Government made additional funding available for supported employment in 1999/2000. We believe the Government should do so again and should also provide reassurance to employers about how the Supported Employment Programme will work in future. We also invite the Government to examine with the voluntary sector how far their concerns can be met within the framework of the current legislation.
- 8 The accommodation offset has remained at the same rate since the introduction of the minimum wage in 1999. We recommend that it should be increased to £3.25 per day. We consider the issue of whether tips which are not paid through the employer's payroll should be included in the minimum wage but conclude that the present system is the fairest. And we received proposals on fair estimate agreements: we recommend that the Government should consult representatives of output workers and employers on possible change in this area.

- 9 The social care sector is in an almost unique position because of its reliance on public funding. We recommend that the Government should ensure that the new concordat on commissioning of care to be endorsed by central and local government, health bodies, and nursing and care home providers makes clear that commissioning policies should reflect the costs of provision.

Chapter 6: Future Reviews

- 10 A process for reviewing the National Minimum Wage at regular intervals will ensure that it continues to provide effective protection for low-paid workers and predictability for businesses. As the National Minimum Wage is relatively new and we are still learning about its impact, each review should take account of all relevant factors and allow scope for judgment. Formulaic uprating would not satisfy this requirement. We therefore recommend that the Low Pay Commission should continue to review the minimum wage through a comprehensive process of data gathering, consultation and analysis. Reviews also need to be frequent enough that the minimum wage does not lose its effectiveness as a wage floor. Hence we recommend biennial reviews, with the Commission reporting in February to allow sufficient notice of implementation the following October.

Chapter 7: Conclusion

- 11 The National Minimum Wage has an important place in the labour market and makes a difference to the living standards of many workers. Its impact must be kept under review. The Low Pay Commission's work would be assisted by standing terms of reference that enable us to plan a strategic, longer-term programme of research. We believe that our recommendations will help ensure the continuing effectiveness of the minimum wage, both in the immediate future and the longer term.

Recommendations

Choosing a New Rate

- The main National Minimum Wage for adults aged 21 and over should be increased to £4.10 per hour in October 2001 and to £4.20 per hour in October 2002.

Young People and the Development Rate

- Twenty one year olds should be included in the main National Minimum Wage.
- The age coverage of the Development Rate should be kept under review.
- The level of the Development Rate should be £3.50 per hour in October 2001, and £3.60 per hour in October 2002.

Compliance and Enforcement

- There should be further publicity for the headline rate of the National Minimum Wage as well as for the existence of the enforcement service and the National Minimum Wage Helpline number.
- The Inland Revenue and the Advisory, Conciliation and Arbitration Service should continue to monitor service to customers at the boundary between the two organisations and examine the scope for action to strengthen it.

Implementation Issues

- The accommodation offset should be increased to a maximum weekly amount of £22.75 or £3.25 per day.
- The Government should consult representatives of output workers and their employers to see whether there is a case for a change in the Regulations on fair estimate agreements.

- The Government should ensure the Strategic Commissioning Group's concordat makes clear that policies on commissioning care, particularly places in care homes, should reflect the costs of provision.

Future Reviews

- Future uprating should be based on recommendations by the Low Pay Commission resulting from consultation and analysis of a comprehensive range of factors.
- There should be biennial reviews reporting in February for implementation in the following October.

3 Impact on Incomes

While the minimum wage affects households across the income distribution, it has had most impact on the poorest working households. The effect of the tax and benefits system is to reduce the impact on incomes for some, but not all, households affected by the minimum wage. The minimum wage has led to a small reduction in poverty rates. It must be seen as part of a package of in-work support: in combination with the minimum wage, recent tax and benefits changes have reduced the number of people living in poverty by nearly a quarter. By underpinning the system of tax credits and benefits the minimum wage supports the strategy of in-work benefits to help the low paid in work. And by providing a guaranteed level of income in work, the minimum wage increases the incentive to move into work.

3.1 In Volume 1 we assessed the impact of the minimum wage on the earnings of workers in different groups and sectors of the economy. We showed that the earnings of the low paid have been rising faster than the earnings of those higher up the distribution, pointing to the impact of the minimum wage in narrowing the earnings distribution, and in narrowing the gender pay gap.

3.2 In this chapter we examine whether increased earnings for the low paid translate into increased income for low-income families. We look at the position in the income distribution of those affected by the minimum wage, and discuss the impact of the tax and benefits system and employment effects. We present new research on the impact of the minimum wage on poverty rates. Later in the chapter we consider the impact of the minimum wage in providing an incentive to work, and discuss the importance of the minimum wage as part of a package of in-work support to promote the decision to work.

Low Income and Poverty

3.3 In this section we look at the interaction of the minimum wage with the income distribution and numbers in poverty. Some

critics have argued that minimum wages are ineffective in tackling poverty since the poor are mainly pensioners or those without work (see, for example, Gosling, 1996). Others have pointed to disemployment effects of minimum wages leading to increased numbers on low income. As well as presenting new research on these issues, we examine the role of the tax and benefits system in determining the gains from a minimum wage.

Income Distribution

- 3.4 In order to assess whether the minimum wage affects the poorest households, we asked Richard Dickens from the London School of Economics to examine the position of individuals affected by the minimum wage in the income distribution and the distribution of gains. An individual affected by the minimum wage is defined as any person living in a household that contains a minimum wage worker. The analysis considers the effect of going from no minimum wage to a £4.10 per hour minimum wage, with £3.50 per hour for those aged 18–20. The results are presented in Tables 3.1 and 3.2 for the whole population and for working-age households with someone in work.

Table 3.1

Household income decile by individuals	Individuals in all households		Individuals in working-age and employed households	
	% affected by NMW	Distribution of affected individuals	% affected by NMW	Distribution of affected individuals
1st decile	12.7	12.6	39.7	30.2
2nd decile	16.1	14.3	22.8	16.4
3rd decile	14.5	11.7	22.3	15.1
4th decile	16.0	14.1	18.9	12.7
5th decile	15.2	13.9	9.4	5.6
6th decile	11.8	10.8	11.3	6.7
7th decile	9.3	8.3	7.6	4.4
8th decile	6.3	5.7	8.7	4.7
9th decile	7.0	5.8	5.9	3.0
10th decile	3.6	2.8	2.8	1.4
All deciles	11.4	100.0	16.3	100.0

Source: Based on the Family Expenditure Survey data 1998/99. Provided by Richard Dickens, London School of Economics

Notes:

- Population includes children and pensioners.
- Each individual is assigned their household's net equivalised income. Deciles are then computed across all individuals across all households.
- Household income equivalised using McClements Scales.
- An individual/household is affected by the NMW if a household member is paid below £4.10 per hour (aged 21+) or £3.50 per hour (aged 18–20).
- Earnings are adjusted to October 2001 using the Average Earnings Index, with an assumption of earnings growth of 4.25% between October 2000 and October 2001.
- The Wage Gap is computed by summing all the gains from the NMW in the household: i.e. (NMW – current wage) multiplied by hours for each affected household member. This gain is then equivalised.
- Material from the Family Expenditure Survey is Crown copyright; it has been made available by the Office for National Statistics (ONS) through the UK Data Archive (UKDA) and has been used by permission. Neither the ONS nor the UKDA bears any responsibility for the analysis or interpretation of the data reported here.

- 3.5 Looking at the whole population, it is clear from the first two columns of Table 3.1 that the minimum wage affects the bottom of the income distribution: 12.7 per cent of the bottom decile are affected, and 12.6 per cent of those affected are in the bottom decile. However, individuals in the bottom decile of the income distribution are not the group most affected, because the bottom decile contains many pensioners and individuals in workless households. Although two-thirds of those affected are in the bottom half of the income distribution, most of those affected by the minimum wage are in deciles two to five. The next two columns of Table 3.1 present the same information for individuals in working-age and employed households. The figures show that within this group the minimum wage is much better targeted. The highest incidence of those affected is in the bottom decile and 80 per cent of those affected are in the bottom half of the income distribution.
- 3.6 Table 3.1 shows that there are some people gaining from the minimum wage at the top of the income distribution. In work which we commissioned, Sutherland (2001) found that the most important reason households further up the income distribution benefit from the minimum wage is that they are in receipt of significant other sources of income or contain more than one worker.
- 3.7 This analysis tells us only about where individuals affected by the minimum wage are in the household income distribution. Table 3.2 shows the amount gained from the minimum wage and the importance of this gain for household income. The amount of the gain is the difference between a £4.10/£3.50 per hour minimum wage, and pre-minimum wage hourly wages. The percentage increase in household income resulting from the introduction of the minimum wage will depend on the number of affected workers, hours worked and the level of household income. The table ignores any loss in income due to tax or benefit withdrawal so the income gain is a gross gain.

Table 3.2

Household income decile by individuals	Individuals in all households		Individuals in working-age and employed households	
	Wage gap as % of total household income	Distribution of aggregate gains	Wage gap as % of total household income	Distribution of aggregate gains
1st decile	2.3	13.0	5.2	28.9
2nd decile	1.5	13.9	1.8	16.7
3rd decile	1.4	16.5	1.3	14.9
4th decile	0.9	12.9	0.8	9.0
5th decile	0.9	12.8	0.4	5.5
6th decile	0.5	7.1	0.6	8.8
7th decile	0.4	8.5	0.3	4.7
8th decile	0.3	5.9	0.2	5.3
9th decile	0.2	6.5	0.2	4.1
10th decile	0.1	2.8	0.1	2.1
All deciles	0.9	100.0	1.3	100.0

Source: Based on the Family Expenditure Survey data 1998/99. Provided by Richard Dickens, London School of Economics

Notes:

- Population includes children and pensioners.
- Each individual is assigned their household's net equivalised income. Deciles are then computed across all individuals in households containing at least one person of working age in employment.
- Household Income equivalised using McClements Scales.
- An individual/household is affected by the NMW if a household member is paid below £4.10 per hour (aged 21+) or £3.50 per hour (aged 18–20).
- Earnings are adjusted to October 2001 using the Average Earnings Index, with an assumption of earnings growth of 4.25% between October 2000 and October 2001.
- The Wage Gap is computed by summing all the gains from the NMW in the household: i.e. (NMW – current wage) multiplied by hours for each affected household member. This gain is then equivalised.
- Material from the Family Expenditure Survey is Crown copyright; it has been made available by the Office for National Statistics (ONS) through the UK Data Archive (UKDA) and has been used by permission. Neither the ONS nor the UKDA bears any responsibility for the analysis or interpretation of the data reported here.

- 3.8 Across all households, the effect of the minimum wage is to increase incomes by 0.9 per cent. The biggest gain occurs at the bottom of the income distribution: a 2.3 per cent increase for those in the bottom decile. So, although there are fewer individuals affected by the minimum wage in the bottom decile, the proportionate gain in income is the most important for this group. Leaving out pensioner and workless households means that the proportionate gain becomes even stronger – nearly 30 per cent of all gains going to the bottom decile. Gains from the minimum wage will therefore be disproportionately felt at the bottom of the income distribution, and we conclude that the minimum wage has the potential to reduce income inequality, in particular among working households. This effect could be reduced through the workings of the tax and benefits system or by negative employment effects, both of which are addressed later in this chapter.
- 3.9 We also looked at the effect of the minimum wage on household income by type of area. We commissioned Phimister *et al.* (2001) to examine the impact of the introduction of the minimum wage on poverty in rural, semi-rural and non-rural areas. The results of their analysis are presented in Table 3.3, which gives the proportion of households in each income quintile by type of area and the proportion of sub-minimum wage workers. Their figures use pre-minimum wage data, and numbers of sub-minimum wage workers are not therefore an estimate of non-compliance.
- 3.10 The first column of the table shows that the accessible rural area has the highest incomes, with the smallest proportion in the bottom income quintile, and the remote rural areas are the poorest. Comparing the proportion of sub-minimum wage workers against the proportion of individuals in each quintile gives the extent of over- and under-representation of people affected by the minimum wage. In the accessible rural areas, the proportion of households affected by the minimum wage is greater than the actual proportion of households in the second, third and fourth quintiles. The degree of over-representation of the minimum wage is greatest in the third quintile, which contains 30.6 per cent of people affected by the minimum wage, and only 20.7 per cent of the population. In the remote rural areas – the poorest areas – households in the second quintile are most likely to be affected by the minimum wage, with 23.8 per cent of the population, but 34.2 per cent affected by the minimum wage.

7 Conclusion

The National Minimum Wage has an important place in the labour market and makes a difference to the living standards of many workers. Its impact must be kept under review.

The Low Pay Commission's work would be assisted by standing terms of reference that enable us to plan a strategic, longer-term programme of research. We believe that our recommendations will help ensure the continuing effectiveness of the minimum wage, both in the immediate future and the longer term.

- 7.1 In the first volume of this report we concluded that the implementation of the National Minimum Wage has been a success: it has benefited many workers without damaging the economy. In particular, it has been generally manageable across low-paying sectors and has helped low-paid workers. In this volume, as well as looking at the impact of the National Minimum Wage, we demonstrate that the other aspects of the minimum wage have also worked well and consider the next steps in its development.
- 7.2 The National Minimum Wage has provided a significant increase in the incomes of young people, without any negative impact on their employment. Indeed, employment of young people has continued to grow since the introduction of the minimum wage.
- 7.3 We are concerned about the inequity of a lower rate for young people. Our longer-term aspiration remains that any lower rate should be linked to training rather than age. But we are also concerned about the possible negative effects on young people's employment prospects if we recommend the immediate abolition of the young persons' Development Rate. We have therefore concluded that it would be prudent to take a progressive approach to lowering the age at which the main rate applies. We propose to look at this issue over time. Most importantly, we shall examine the condition of the labour market to determine when we can safely recommend that the age at which the main rate applies could be lowered without having a detrimental impact on young people's employment.

With this in mind, we do not consider it appropriate at this stage to recommend that young people receive the main rate. But the vast majority of employers treat 21 year olds in line with other adult workers. And the lowest decile pay of 21 year olds, and their pay in new jobs is closer to that of older than younger workers. Excluding them from the main rate appears illogical to employers and employees alike, since labour market practice predominantly recognises 21 year olds as adults. We believe that 21 year olds should receive the main rate and we are confident that this change would not have any adverse impact on their employment. We will keep the age coverage of the Development Rate under review in our future work.

- 7.4 Although firms' take-up of the Development Rate for older workers has been low so far, this could improve as employer awareness of the facility, which is also currently low, increases and as employers adapt to increases in the main rate of the National Minimum Wage over time. We will need to keep the usefulness and relevance of the Development Rate for older workers under review.
- 7.5 The level of the Development Rate has protected employment and training without any discernible negative impact on incentives to work. We have therefore concluded that the Development Rate, both for young people and for older workers, should broadly maintain its relative value and rise in line with the main rate. We estimate that at least 115,000 young people aged 18–20 will benefit from our recommendation and the impact on the cohort wage bill for this age group should be no more than 0.81 per cent.
- 7.6 We believe that the current exemption of 16 and 17 year olds from the National Minimum Wage is justified on the grounds that they should not be seen as full participants in the labour market. We are concerned, however, about possible substitution effects and the very low rates of pay which some 16 and 17 year olds receive. But we believe that a longer period is needed before we can assess whether or not there have been significant unintended effects from the exemption of 16 and 17 year olds, and whether or not there is a case for extending some kind of minimum wage protection to this age group. We believe that the Commission should look at this issue in the future.

- 7.7 We are pleased that evidence and research indicate that the vast majority of employers comply with the National Minimum Wage. The enforcement system is generally working well, but we were told that some workers continue to be underpaid. We welcome the proactive enforcement work by the Inland Revenue. We consider that the effectiveness of enforcement could be increased still further by giving more publicity to the enforcement service and to successful enforcement action, using other government compliance initiatives to promote compliance with the minimum wage, and co-ordinating more closely the work of the Inland Revenue and ACAS.
- 7.8 We considered the impact of the minimum wage on income distribution, poverty and work incentives. The minimum wage has contributed to a narrowing of the earnings distribution, and has increased the incomes of the lowest paid. We have always recognised that the minimum wage should be considered in the light of other measures to make work pay, such as the tax and benefits system. We are pleased that the minimum wage has had a positive effect on take-home incomes and has contributed to an improvement in the financial incentive to work for the unemployed. In general, the minimum wage provides an effective underpinning of the tax and benefits system and helps to prevent the system being misused to subsidise exploitative wages.
- 7.9 We looked carefully at evidence on the definitions of workers, working time and pay. We gave close attention to the impact of the National Minimum Wage Regulations on disabled workers and the voluntary sector. We concluded that although there are still some issues of concern to employers and employees, overall the definition of the minimum wage adopted in the Regulations has continued to work well. And we have recommended an increase in the maximum accommodation offset in line with increases in the main rate since the introduction of the minimum wage.
- 7.10 We believe that the National Minimum Wage must be reviewed regularly if its benefits are to be maintained. The National Minimum Wage is at an early stage in its development and more needs to be learned about its impact. We need to be able to consider a comprehensive range of factors in future reviews and to have long enough between them to conduct the