Taxing Jobs

Practical policies for a pay recovery

Matthew Tinsley
Edited by Ruth Porter

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Policy Exchange

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Executive Summary

Throughout the course of the recession, there have been a number of unexpected developments that have implications for future economic and labour market policy. Traditional economic theory suggests that wages do not fall in a recession as workers are resistant to accepting reduced pay – in technical terms wages are "sticky". In this recession, however, that has not been the case. Real wages have fallen by 8% over the past 5 years. Equally, and perhaps as a result, unemployment did not rise as much as might have been anticipated with the precipitous drop in output. Most forecasts predicted unemployment would rise above three million and yet this failed to happen. In fact, even though the recovery is relatively nascent, Britain now has record numbers of people in employment and economic inactivity has fallen.

This range of changes to the labour market has created widespread debate about what will happen as the recovery gathers pace. There has been a regular flow of reports and claims, from politicians, academics and think tanks that a significant proportion of the working population are unlikely to gain from an economic recovery in terms of increased pay. At the core of this argument is that there has been a "decoupling" between productivity and wages.

This report analyses this argument by comparing the growth of GDP, the total compensation of workers (including pay, bonuses, National Insurance and pension costs) and total pay. Before the recession, these three factors grew closely in line with one another at a per-worker level. This meant that any growth in productivity led to employers having to spend more to employ people and workers receiving higher wages.

From 2008, GDP per worker fell sharply. Total pay and compensation did not contract immediately, however, which meant that a gap between output and remuneration developed. As the labour market adjusted, this gap disappeared. The labour market was slow in adjusting to the recession, suggesting some initial 'hoarding' of workers by employers whilst wages were adjusting to lower productivity. However, by 2011, pay was back in line with its previous levels relative to GDP per worker. Our analysis therefore demonstrates that the link between productivity and wages has been robust.

As well as being apparent at the national level, it is possible to observe the relationship between output growth and remuneration growth within different regions and sectors of the economy. In both the build-up to the recession and the change since the beginning of 2008, increases or falls in output per capita have been mirrored by changes to total compensation across all regions of the UK. Similarly, compensation per worker in different industries has reflected changes in gross value added per worker. The only clear exception to this is in the agriculture, forestry and fisheries sector where output per worker has fallen consistently, but compensation has been more robust.

It is this strong relationship in both economic growth and contraction which demonstrates that, in a recession where workers have been retained in greater numbers than previous years but the economy has still shrunk, lower output per worker has led inevitably to lower pay per worker. In this respect, in the trade-off between lower employment and lower wages, the slack in the economy has been reflected in lower earnings.

The breadth of the recession across the economy and across different job types means that pay has contracted across the whole of the income distribution. Average hourly wages had fallen a total of 8% by 2013.

Supporting pay

Any meaningful recovery in pay over the coming years therefore relies primarily on economic growth, which we expect to drive a recovery in productivity. What is critical however is what steps, if any, the government can take to support wage growth and increase earnings.

Minimum Wage

One of the most significant changes to the UK labour market over recent years has been the introduction of the National Minimum Wage (NMW). This created a wage floor for all workers, in an effort to reduce extreme low pay and exploitation of workers. Initially, an adult minimum wage of £3.60 was set from April 2009, with lower rates for younger workers. In 2010, an additional apprentice minimum wage rate was introduced.

Since its introduction, the minimum wage has slowly increased in value. As a proportion of the median hourly wage, it increased from slightly over 47% at the time of its introduction to more than 54% when the recession began and closer to 55% today. Incomes at the first decile of the income distribution therefore rose more quickly in the build-up to the recession than the rest of the income distribution.

However, the minimum wage has risen more slowly than inflation over the course of the recession. By the time of its October 2013 increase, it was still 34p below its 2007 value. Despite this real terms fall, wages at the median have fallen more quickly. The first decile of the income distribution has therefore again seen pay be more robust, with the minimum wage seeming to offer some protection.

A significant amount of analysis into the impact of the minimum wage on the labour market has been conducted. The majority of research has failed to find a significant impact of the introduction of the minimum wage on employment. One approach found no impact on the retention of workers, highlighting that this was likely to be because of the relative low level of the minimum wage in the UK, compared to France, where the minimum wage, worth 70% of median adult full time pay, was found to have a negative impact on employment.

However, there is also evidence that the minimum wage reduced the number of hours that individuals worked. This was a particular issue among younger workers, highlighting an area where care must be taken in setting the level of the minimum wage.

The 3% increase announced for 2014 will mean that the minimum wage is likely to have increased above the rate of inflation for the first time since 2007. Despite this, it will still be significantly below its 2007 value. **This report**

therefore recommends that the National Minimum Wage increases above the rate of inflation in 2015 and 2016 to regain its 2007 value.

This is likely to mean that the minimum wage again increases above the rate of growth of median wages. This higher "bite" means that more people will be influenced by changes to the minimum wage, jeopardising the effectiveness with which the minimum wage has increased without harming employment. **This report therefore recommends that, once median wage growth returns, the minimum wage returns to its bite level of around 55% of median hourly wages, with permanent increases in the coverage of the minimum wage resisted due to the risk they present to employment.**

These changes work within the existing structure of the minimum wage, without requiring any fundamental changes. The role played by the minimum wage in supporting incomes both before and since 2008, as well as the strong support for the minimum wage and compliance with it, have been largely successful and this report therefore does not recommend any further structural changes.

Employee taxes and Tax Credits

Over a number of years, successive governments have sought to support earnings though combinations of direct tax cuts and benefit spending.

Under New Labour, a significant amount was spent as Tax Credits were reformed and expanded. Working Tax Credit (WTC) tops up incomes, on the condition that individuals are in work. Meanwhile, Child Tax Credit (CTC) supports families based on their composition, in particular, the number of children they have. These benefits are withdrawn together as incomes rise. Since their introduction in 2003, it is CTC that has grown more quickly, with WTC only keeping pace with inflation. As a result, the proportion of total Tax Credit eligibility that carried work requirements shrank.

Since the 2010 election, there has been greater prioritisation of changes to Income Tax, with a series of large increases in the personal allowance. Between 2010/11 and 2014/15, the personal allowance will have increased three times as quickly as in the two previous decades. Increasing the personal allowance this quickly above the rate of inflation was a tax cut worth an estimated £6.5 billion. Because it has been done in line with changes to some higher thresholds, the changes have tended to focus on workers with more moderate incomes. However, earners with incomes below the personal allowance will not have benefitted.

Between them, employee taxes and Tax Credits offer the government a significant amount of flexibility when targeting support at specific parts of the income distribution.

However, as this report has identified, wages are currently compressed because of weak economic growth and the significant amount of slack that remains in the economy. Changes to employee taxes and the benefit system are direct in their ability to support earnings. However, in achieving this, they do little more than subsidise low pay.

Instead, wage growth in the coming years will be supported by stimulating economic growth and other ways of generating broad increases in the demand for labour. Research has highlighted that Income Tax and social security changes are less effective at stimulating growth than some other those of tax reductions.

Changes to the taxes that employees pay on their employment and the benefits used to support incomes therefore do not address the fundamental cause of the recent downturn in pay. **While a balanced tax and benefit system has a clear role in supporting incomes, this report recommends deprioritising both increasing Tax Credits and cutting employee taxes.**

Employer payroll taxes

As has been highlighted with employee tax cuts, many changes that the government can make will only influence the demand for workers indirectly. Another option available to government is to cut the cost of hiring people and therefore directly address the slack in the labour market that is currently being seen.

Employer National Insurance (NI) is paid by employers at a rate of 13.8% of employee earnings above a certain level (the secondary threshold). This creates a wedge between what employers pay and what workers receive, as well as increasing the marginal cost of increasing pay.

Over recent years, while Tax Credits have increased in value and Income Tax has been cut, employer NI has steadily increased. This was in particular the case in 2011/12 when an increase in the NI rate by the previous government was only partially offset by an increase to the secondary threshold. The net change increased the wedge between employer compensation and the pay received by employees at the same time as increasing the average cost of hiring.

As a form of economic stimulus, analysis has shown employer payroll taxes to be more effective than other similar cuts. For example, forecasts from the Congressional Budget Office in the United States estimated employer payroll tax would have a 1/3 greater stimulus effect than an equivalent change to employee payroll tax or higher social security payments.

At a time when the labour market is weak, a combination of a lower cost of employment and broader economic stimulus make a cut to employer NI one of the most effective tools at stimulating growth and incentivising greater hiring. This will be the most effective way of reducing the slack in the labour market to the extent that it can stimulate a recovery in pay. On top of this, reducing the wedge between what employers pay and employees receive should make it easier for companies to increase pay after a period of time where that wedge has only increased.

The government has already recognised the importance of reducing employer National Insurance costs in supporting the labour market, with the exception of under-21s from employer NI and an allowance for all businesses before they start paying NI that will disproportionately help small businesses.

However, the slack in the labour market is broad, with significant room for productivity and wage growth across the whole of the income distribution. A broader change to employer NI is therefore required to stimulate the recovery.

This report therefore recommends that the employer National Insurance threshold (the secondary threshold) increases from £157 to £192 per week in 2015/16, the equivalent of £10,000 per year. This would reduce employers' yearly NI liability by £250 per employee earning more than the secondary threshold and reduce government tax revenues by an estimated £5.4 billion per year.

Conclusion

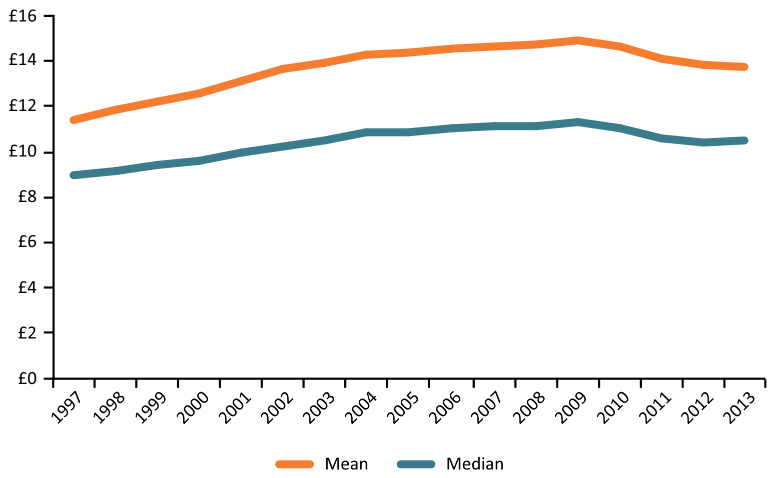
This report shows clearly that the link between productivity and pay is strong and has remained so over the course of the recession and recovery. It is this relationship that is essential as policymakers seek growth in pay over the coming years.

That is why this report recommends that government policy should focus on reducing the cost of employment. To facilitate a stronger recovery in the labour market, the government should now focus on cutting payroll taxes, in the form of a higher employer National Insurance threshold.

1
Pay Across the Population

Average wages have fallen in real terms across the UK in recent years and are now significantly below their pre-recession levels. Through its impact on pay, the recession and slow recovery have had a clear impact on the working population.

Figure 1.1: Mean and median hourly pay of employees excluding overtime in the UK in 2010 prices



Source: ASHE

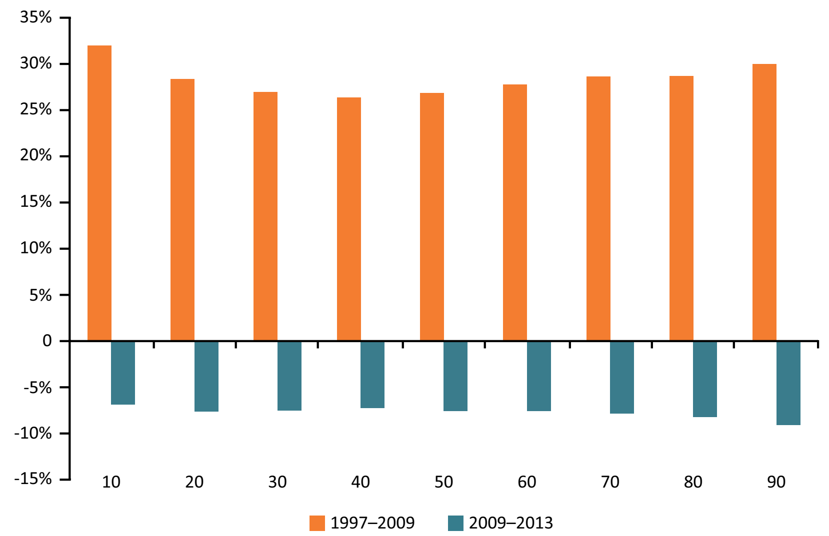
The wage growth before 2008 and contraction since then were seen across the entire income distribution. However, as Figure 1.2 shows, there are areas where these trends have been more pronounced. In the years before the recession, pay growth was slowest at the 40th percentile. Above this point, pay growth increased by a greater proportion further up the income distribution. However, the fastest rate of pay growth was seen among some of the lowest earners (10th percentile), where real hourly pay grew by 32% between 1997 and 2009.

Over the course of the recession, the best picture has again been seen at the bottom of the income distribution, where hourly wages fell by slightly less than 7% between 2009 and 2013. Among higher incomes wages fell slightly more, up to over 9% for the 90th percentile.

This demonstrates that, in total since 1997, the slowest increases in pay were seen at the *lower-middle part* of the income distribution.

This report finds little in this data that highlights a specific problem with pay for the lowest earners. Indeed, it appears that reforms like the minimum wage have quite effectively increased wages at the bottom of the income distribution since the late 1990s and perhaps offered some protection over the course of the recession.

Figure 1.2: Change in hourly pay of UK employees excluding overtime in the UK pre-recession and since 2009 with fixed prices



Source: ASHE

One consequence of this is a slight narrowing of the range over which wages are spread. The ratio of real hourly wages between the 90th and 10th percentiles fell slightly over this period of time, driven by a contraction in income inequality in the bottom half of the income distribution, and a smaller increase in inequality above the median.

GDP, pay and compensation

The contraction in pay over the course of the recession and recovery raises important questions about its sources and what might happen as the economy recovers more fully. On top of this, it is important to understand how much working people might have to gain from any economic growth.

Recently, a significant amount of political discussion has focussed on the argument that there has been a "decoupling" between productivity and wages, with the consequence that workers have little stake in an economic recovery. In late 2013, Labour leader Ed Miliband made exactly this argument as part of a wider criticism of the government:

> *"We've got a growth crisis in Britain, but we've also got a living standards crisis because the proceeds of economic growth are not being fairly distributed any more (sic)"*[1]

The relationship between productivity and remuneration is therefore very important, especially as the UK economy emerges from a serious recession.

To consider this, this report analyses the recent relationship between economic output and remuneration in the UK by comparing GDP per worker, average total compensation per worker and average pay per worker.[2] This replicates analysis

1 Ed Miliband: "The proceeds of economic growth are not being fairly distributed any more"', *New Statesman*, 05/11/13. www.newstatesman.com/business/2012/11/ed-milibandthe-proceeds-economic-growth-are-not-being-fairly-distributed-any-more

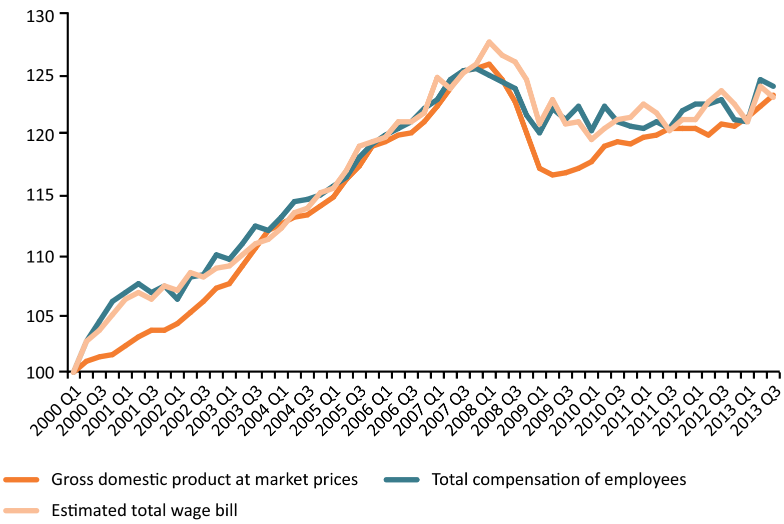
2 This replicates the strong relationship between compensation and GDP that was found by Pessoa and van Reenen (2013), however we consider a shorter time period, whilst including an estimate of total pay.

of the long run relationship between productivity and wages by Pessoa and Van Reenen (2013) which finds no evidence of net decoupling.[3] However, they do demonstrate the significant impact of higher income in equality on median incomes and non-wage costs on the gap between compensation and earnings. Our analysis extends this by considering the UK's recent recession and recovery.

The report finds that, taking the whole period from the start of 1997 to the end of 2007, compensation paid by employers rose faster than GDP per capita (31% compared to 26%, in 2010 prices). This was primarily a result of more rapid growth in average labour costs in the late 1990s and, therefore, an increase in the share of GDP going to employee compensation.

Focussing on the years shortly before the recession, Figure 1.3 shows that average wages and the total compensation per worker (including salaries, bonuses and pension contributions) still grew at the same rate as GDP per worker. In the four years to the end of 2007, all three of these measures increased by around 8% in real terms, with wages growing slightly faster.

Figure 1.3: Growth in UK GDP, pay and compensation per worker deflated using GDP deflator (2000=100)



Sources: ONS Quarterly National Accounts and ONS Labour Market Statistics

The consequence of this is that, in the years before the recession, the share of national income accounted for by employee compensation was stable at 53%.

This changed at the beginning of the 2008 recession, with GDP per worker decreasing sharply. By the first quarter of 2009, it had fallen back to levels seen at the beginning of 2005. As Figure 1.3 shows, this initial fall in output was significantly greater than the reductions in compensation and wages. Throughout 2009, a divergence between output and wages can therefore be seen. This might reflect the rigidity in wages, meaning that it took time for wages to adjust for the lower output per worker. In this respect, there is an indication of some labour hoarding, with firms keen to retain talent, even if it imposes additional costs for a period of time.

Since 2009, GDP per worker has improved slightly, whilst average worker compensation and wages have not risen as much. The consequence is that, since

3 Pessoa, J. and Van Reenen, J. (2013), "Decoupling of Wage Growth and Productivity Growth? Myth and Reality"

2011, the labour share of GDP had nearly returned to its 2007 level. This crucially means that, with the exception of a period of adjustment, the link between output per worker, compensation and wages has remained strong over the course of the recession.

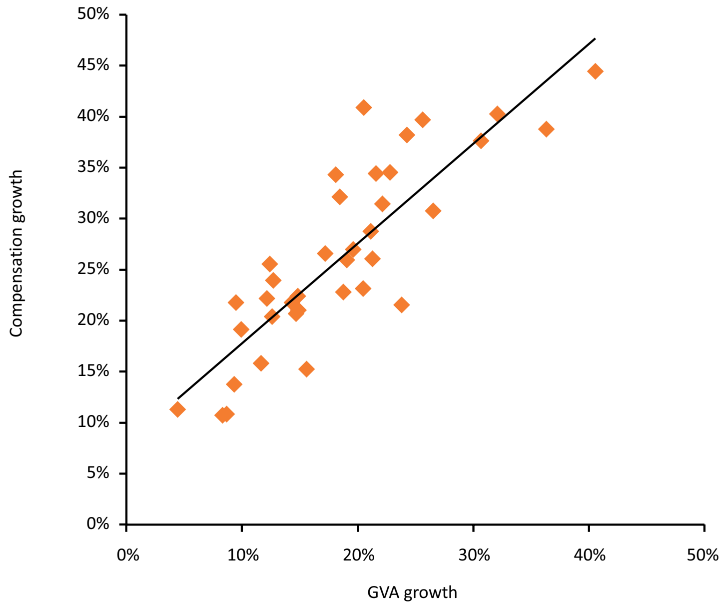
However, it is possible to observe a small change over the course of the recession when comparing wage rates to their higher peak in 2008, suggesting that there might have been a slight divergence between wages received by employees and total compensation paid by employers. Research from the Office for National Statistics shows that non-wage costs of employment have risen significantly faster than pay levels.

> *Non-wage costs have risen in real terms throughout much of the period since around 2001, although they stabilised between 2006 and 2009. The upward trend may reflect growing employer payments necessary to tackle pension fund deficits. Non-wage costs jumped sharply between 2009 and 2010, in part due to a rise in employers' national insurance contributions, and this may have contributed to the weakness in real wages during this period.*[4]

Regional and sectoral trends

At the aggregate level, the link between economic output per worker, compensation of workers and average wages has been strong, both in the decade to 2007 and over the course of the recession. This is backed up by evidence from the World Economic Forum's 2013/14 Global Competitiveness report. This shows that that the extent to which "pay is related to worker productivity" is high in the UK, ranking 11th out of 148 countries and coming second behind Switzerland out of OECD countries.[5]

Figure 1.4: Growth in Gross Value Added and Employee Compensation per capita between 1997 and 2011 in 37 NUTS2 regions



Source: ONS Regional Gross Value Added dataset[6]

4 Taylor, C. Jowlett, A. and Hardie, M. (2014) *'An Examination of Falling Real Wages'*, Office for National Statistics, pp. 10.

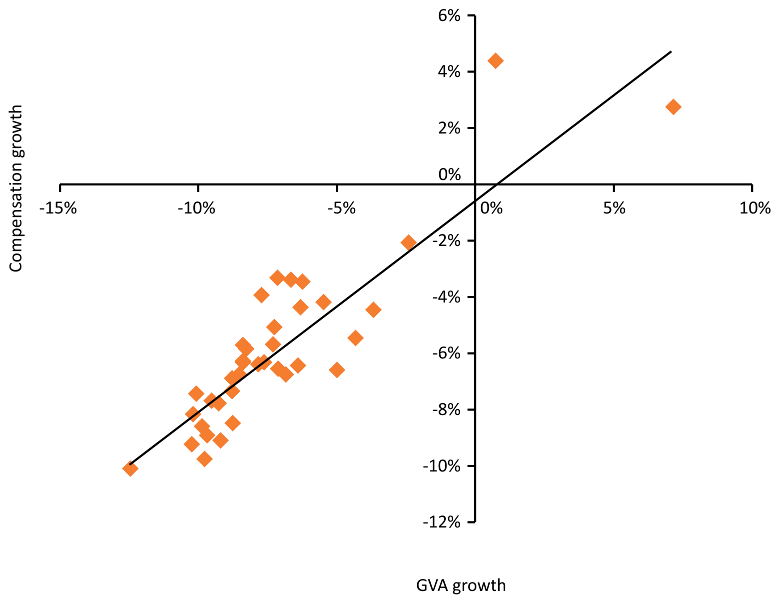
5 World Economic Forum (2013) *'Global Competitiveness Report 2013–2014'*, Part 2.2, Table 7.06.

However, it does not necessarily follow that wages and output are as strongly linked across the whole labour market. Our research considered this by comparing the growth rates in Gross Value Added (GVA) and employee compensation per capita across 37 different parts of the UK. This demonstrates that compensation growth has closely mirrored the increases in economic output between 1997 and 2011 (Figure 1.4).

Over this 14 year period, it is apparent that changes in economic output have been reflected in compensation across the country. Indeed, compensation tended to grow by more than GVA, with only two areas seeing it grow more slowly.

Focussing on recent years, Figure 1.5 shows the strong relationship between output and employee compensation as the economy has contracted. Again, this provides evidence of a small amount of labour hoarding, with wages not falling as quickly as productivity does.

Figure 1.5: Growth in Gross Value Added and Employee Compensation per capita between 2007 and 2011 in 37 NUTS2 regions



Source: ONS Regional Gross Value Added dataset and ONS Labour Market Statistics

This clearly demonstrates that the link between economic output and employee compensation has been strong, regardless of where someone works in the country. At the same time, there are some areas where compensation appears to be growing more quickly or more slowly than we would expect. It is possible therefore that certain geographic areas with weaker economies might have experienced some decoupling.

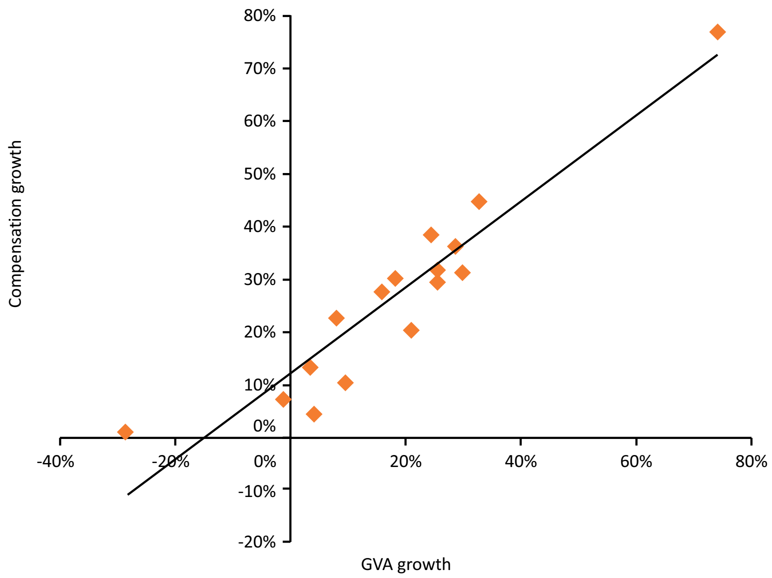
However, this report finds that the difference between compensation and GVA growth is not strongly correlated with a region's per-capita output or compensation in 1997.[7,8] This report therefore concludes that any unusually high or low compensation growth is in no way related to an area's initial economic position.

6 We have not updated this to account for the December 2013 release of the Regional Gross Value Added (Income Approach) statistics as, at the time of writing, they did not include per-head GVA estimates in Scottish regions between 2002 and 2010.

7 Source: ONS Regional Gross Value Added dataset and ONS Labour Market Statistics.

8 The correlation between the differences between GVA and compensation growth and 1997 GVA is 0.009, for 1997 compensation the correlation is 0.125. These are not statistically significant.

Figure 1.6: Growth in Gross Value Added and Employee Compensation per worker between 1997 and 2010 in 16 industries



Source: ONS Regional Gross Value Added dataset and ONS Labour Market Statistics[9]

The relationship between output and compensation growth is also seen across different industries in the UK, as shown in Figure 1.6. Again, it is easy to observe that compensation increased at a faster rate than GVA in all industries, with the exception of administrative and support services where the growth rate is marginally lower. A notable outlier that in this data is agriculture, forestry and fishery, where output has contracted by nearly 30%, whilst compensation has increased marginally. This is the largest gap between compensation and output growth of any sector and suggests a structural change within that specific sector.

This report finds that this relationship has been strong over the course of the recession but, again, with the exception of agriculture, forestry and fishery.[10]

Decomposing labour market slack

As this analysis has highlighted, total pay rates have fallen in line with the decreases in output in different industries and across different parts of the country. This report therefore rejects the argument that there has been any net decoupling between productivity and wages in the UK since the late 1990s or, crucially, over the course of the recent economic downturn and recovery. This means that total pay in the economy should rise along with the increased demand for workers that comes with economic growth.

This growth could manifest itself in a few different ways. The more traditional labour market response to greater demand for labour would probably be higher employment rates and lower unemployment (with economic inactivity possibly falling alongside it). However, employment has already been relatively strong in this recession, with total employment higher than it was at its peak in the spring of 2008.[11]

As well as more people in work, there should be an increase among those who were already employed working more hours, reducing the underemployment that

9 The December 2013 release of this data did not include Headline measures of GVA and compensation broken down by industry. This data therefore uses the 2012 release, restricting the analysis to data up to 2010.

10 Source: ONS Regional Gross Value Added dataset and ONS Labour Market Statistics.

11 ONS Labour Market Statistics.

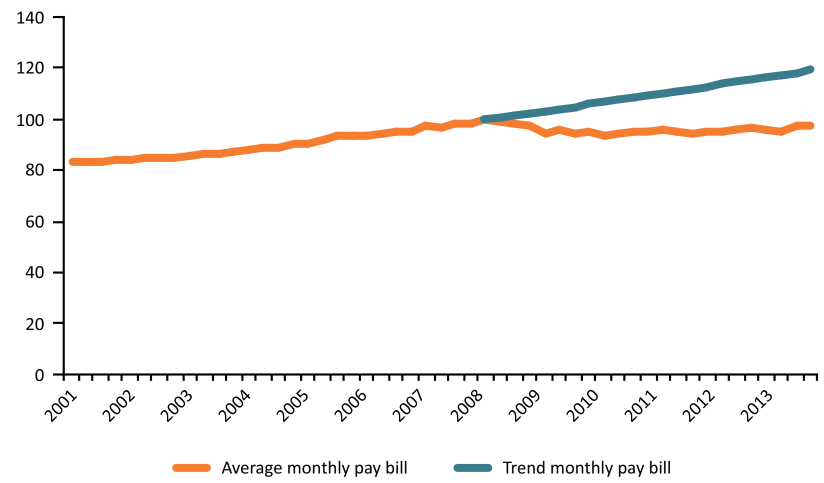
comes when people work fewer hours than they would like to. In many respects, this expansion of hours worked would be similar to reductions in unemployment in that it involves utilising more of the available labour supply.

Finally, during the recession, employers might retain staff but, as a result of lower hourly productivity, pay lower hourly wages whilst output per hour is lower. This would give employers the opportunity to retain workers for a period of time whilst demand falls and then increase productivity and wages when demand returns.

This report also examined the composition of the slack in the UK economy using these three dimensions, comparing the current total pay bill to the level it would have reached had pre-2008 growth rates continued.

Our estimates show that, if the employment rate, wages and hours worked per worker per week had increased in line with their growth in the five years until the first quarter of 2008, total pay would have increased by another 19.2% by the second quarter of 2013. Because total pay fell in total, this leaves a 22.7% gap between current total pay and the level that that would be expected given pre-2008 growth.

Figure 1.7: Total labour market slack and continuation of 2003–2008 trend growth rate (Q2 2008 = 100)



Source: ONS Labour Market Statistics

There has been little change in the average number of hours worked in the UK economy. Whilst the average number of hours worked by employed people decreased in late 2008, by 2013 it had recovered to 32 hours per week in by 2013, around the level seen consistently between 2003 and 2008.

The total employment level has risen slightly, with more people in work in the third quarter of 2013 than ever before. However, employment is still around 4% below where it would have been in 2013 had it continued on the trend seen before 2008.

The employment level has taken some of the labour market slack and therefore plays some role in the labour market being so far behind trend. However, nearly 78% of the gap between current total pay and the level it would be at if pre-2008 trends continued can be explained by lower hourly pay. Real average hourly pay is nearly 15% below its trend level.

The fall in total remuneration which has been seen in the UK economy over recent years is therefore primarily accounted for by lower hourly pay, rather than fewer people working or a shorter average working week.

One reason for this might be the high flexibility in wage setting seen in the UK. Analysis by the World Economic Forum has shown that the UK ranks highly in terms of flexibility of wage determination, coming 12th out of 148 countries and only behind Japan in the OECD.[12] At the same time, the UK comes 27th in terms of the flexibility of hiring and firing workers, 6th of OECD countries. Therefore, whilst the UK has a very flexible labour market overall, its flexibility is disproportionately seen in wage flexibility.[13]

Together, this means that, even if it is too optimistic to expect hourly productivity and pay to increase in line with where pre-recession productivity growth would suggest it could be, there is significant room for pay growth if economic growth is strong.

Conclusion

This section has identified the strong relationship between economic output and employee remuneration, which remained through the pre-recession economic growth and the subsequent crash, and has remained strong across most of the UK's regions and industries.

The consequence of this is that we should expect the total remuneration in the economy to grow alongside any economic growth that is seen over the coming years. Given the significant amount of slack in the economy that is observable in lower hourly wages and productivity, it seems likely that much of this increased labour demand will result in higher pay, with a smaller increase in employment coming alongside this.

The nature of labour market slack in recent years explains much of the behaviour of employers over the recent recession. The opportunity to maintain employment as a result of wages falling with productivity will have significantly limited the need to make redundancies. The consequence of this trade-off is that the total employment level can be at the same level as before the crash, despite GDP being lower. It can be hoped that this retention of employees will reduce any of the unemployment scarring of higher unemployment.

The most important consequence of this is that the low paid have a strong stake in any economic growth that is seen over the coming years. However, before the recession, pay grew more at the tenth percentile than higher up in the income distribution, with one effect of this being that the bottom half of the income distribution was more compressed in 2013 than it was in 1997.

Rather than being an issue facing the low paid alone, the reduction in wages seen across the entire income distribution during the recession means that nearly all workers and working families should expect to have something to gain from economic recovery.

Efforts to support pay for individuals with the lowest hourly wages are important, and this will be considered in detail later in this report. However, there should be a broader concern around the slower pay growth seen by large parts of the income distribution especially around the 30th, 40th and 50th percentiles. Our consideration of available policies will therefore look more broadly than the individuals with the lowest hourly pay, taking into account the steps which can speed up the labour market recovery which is needed for pay to increase.

12 World Economic Forum (2013) *'Global Competitiveness Report 2013–2014'*, Part 2.2, Table 7.02.

13 World Economic Forum (2013) *'Global Competitiveness Report 2013–2014'*, Part 2.2, Table 7.03.

2
Previous Policy Approaches

So far this report has shown how pay has fallen across the whole of the income distribution since the start of the 2008 recession. Rather than seeing unemployment rise and significantly fewer hours being worked in the economy, there has instead been significant retention of workers, with the slack in the labour market predominantly being seen in lower hourly wages and productivity.

This has a clear cost for most individuals who are in work and the living standards of households in most regions of the UK. However, as remuneration across the entire economy has maintained its strong link with GDP, had wages not fallen in this way, there would have been a significant reduction in employment.

The consequence of this is that policies that look to support pay must be considered with the recognition that total remuneration is only likely to rise significantly in line with increases in output. Before growth has returned in this way, any efforts to mandate higher pay must consider the potential for a cost in the form of lower employment. The unemployment that this could cause would likely be concentrated on a smaller portion of the labour market, potentially intensifying the impact of lower incomes and its long-run costs.

A broader challenge that this report identifies is supporting pay growth beyond just the very bottom of the income distribution, with the slowest rate of hourly pay growth before the recession seen towards the lower middle part of the hourly pay distribution and the first decile seeing the fastest rate of growth.

This section considers how existing and potential future policies can look to support wages during this period of economic recovery and growth, focusing on four different areas:

- Increases to the National Minimum Wage and changes to the way that minimum wages are implemented across the UK.
- Cuts to employer National Insurance Contributions, changing both the threshold above which it is charged and the National Insurance rate, as well as other ways it has been changed in recent years.
- Cuts to employee income-based taxes, in the form of Income Tax and National Insurance.
- Direct transfers to families through Tax Credits.

Minimum wages

One of the most significant public policy interventions made in the UK labour market over recent decades has been the introduction of a minimum wage in the late 1990s and its subsequent increases. As this section will show, minimum wages give the government the very direct ability to influence pay levels at the bottom of the labour market but have limitations in their reach and ability to encourage genuine structural changes. We must also be concerned about negative impacts on employment should minimum wages try to have an influence on too much of the labour market.

The UK National Minimum Wage (NMW) was first introduced under the National Minimum Wage Act 1998, with the Minimum Wage set at £3.60 from the beginning of April 2009. Most recently it was increased to £6.31 in October 2013, with a further increase to £6.50 scheduled for October 2014.[14,15]

"Ahead of the 2014 Low Pay Commission recommendations, members of the coalition government have suggested they might seek a more significant increase than has been seen in recent years"

The Low Pay Commission (LPC) makes recommendations to the Secretary of State, including what level to set the minimum wage at and whether certain groups of individuals should be excluded from minimum wage regulations. In recommending the rates, the commission considers a range of labour market factors, including the potential effects on employment, the number of people covered and the position of the minimum wage relative to mean and median wages.

The Secretary of State retains flexibility over whether to implement the commission's recommendations in full or in part. This allows them to set rates that are different to those recommended by the commission, as well as make regulations which differ to or are unrelated to the commission's recommendations. The decision made is then laid before Parliament, with a statement explaining the reasons for it.[16]

They also have the ability to change the eligibility for the minimum wage. For example, in 2010, the adult rate was changed to cover individuals aged 21 and over, having previously covered those aged 22 and over. At the same time, an apprentice rate was introduced. However, the current legislation does not allow for flexibility across different areas of the UK, sectors or occupations.

The adult NMW has consistently increased in line with the Low Pay Commission's recommendation. However, ahead of the 2014 Low Pay Commission recommendations, members of the coalition government have suggested they might seek a more significant increase than has been seen in recent years. The Chancellor of the Exchequer George Osborne stated "I think Britain can afford a higher minimum wage. I think we have worked hard to get to this point and we can start to enjoy the fruits of all that hard work"; continuing to highlight that, had the minimum wage increased in line with inflation, it would be worth £7 in 2015/16.[17,18]

Uptake, enforcement and impact

Following its introduction, adherence to the adult minimum wage was quite quick. In 1999, more than 5% of workers (1.17 million) would have been below the level of the NMW at the time of its introduction 1999. This fell to just over 2% after it was introduced in 1999 and, subsequently, around 1% of eligible workers have been paid below the adult minimum wage. This has remained the case over the course of the recession, with the proportion of those who were eligible for but paid below the adult minimum wage has consistently been below 1%.

14 National Minimum Wage, Low Pay Commission Report 2013.

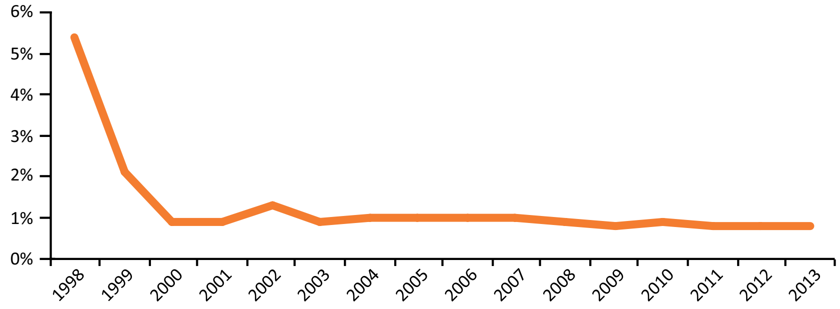
15 www.gov.uk/government/news/low-pay-commission-recommends-new-minimum-wage-rates.

16 *National Minimum Wage Act 1998 Section 5(4).*

17 *Osborne wants above-inflation minimum wage rise*, BBC, 16/01/2014 www.bbc.co.uk/news/uk-politics-25766558.

18 Our calculations later in this report estimate that it would be worth marginally less than this, around £6.95.

Figure 2.1: Proportion of those eligible earning below adult minimum wage



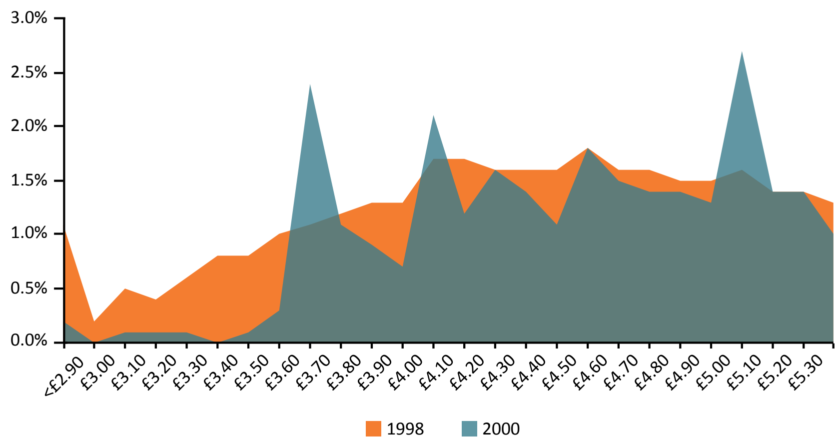
Source: Office for National Statistics
Note: 1998 statistic considers those below the April 1999 introductory National Minimum Wage

The adjustment was more dramatic for the industries where low pay was a greater feature before the recession. Most pronounced was the Hotel and Restaurants sector; in 1998, 22.8% of working people were paid below the minimum wage that would have applied at the time of its introduction in 1999. This had fallen to only 3.5% two years later.

However, this does not reveal the extent to which individuals are being employed informally, with their employers not paying tax properly. This could hide a number of people who are paid below the minimum wage.

The impact of NMW on low earners can be seen in the change to the earning distribution in the years after the introduction of the minimum wage. Figure 2.2 shows that in 1998, before the minimum wage was introduced, there were a significant number of individuals earning less than £3.70 per hour. By April 2000, by which time NMW had been established at £3.70 for one year, there was a clear clustering of workers earning the minimum wage and at certain levels above it, with a large reduction in the number of individuals at all levels below the minimum wage.

Figure 2.2: Proportion of adult workers earning certain hourly wages in 1998 and 2000



Source: Office for National Statistics

Alongside its impact on more extreme low pay (below £2.90 in 1999), and support for individuals marginally below it, a range of studies have examined the effects of the minimum wage. These have considered the impact of its increases and its presence during the economic downturn on various aspects of the UK labour market.

Stewart (2002) analysed the impact of the minimum wage on the retention of workers at the time of its introduction in April 1999.[19] Using three datasets, the analysis finds no impact of its introduction on the probability of remaining in employment for male, female, youth or adult workers. The report also highlighted that this result is similar to evidence from USA where no significant impact was found for an adult minimum wage that was 38% of full-time median earnings, but differed from French evidence which found a negative impact of the minimum wage on employment when it was set at 70% of median adult full time pay, significantly higher than the UK's 46%.

Analysing the effect of NMW on the hours worked by low earners, Stewart and Swaffield (2006) found that the introduction of the National Minimum Wage reduced work by 1 to 2 hours per week, primarily driven through lagged effects, indicating that employers are not able to adjust to these changes quickly so their labour market impact is not observed immediately.[20]

A report to the LPC in 2012 focused on various impacts of the minimum wage over the recession, comparing a range of potential impacts to their pre-recession levels.[21] The report finds no evidence that impacts of minimum wage upratings during the recession differ to those before the recession in terms of the likelihood of somebody remaining in their work. They also found no impact of NMW on employment in any year. Considering the number of hours worked by those affected by a minimum wage increase, the analysis indicated that upratings reduced the number of hours worked, with statistically significant falls of 3 to 4 hours during both the pre-recessionary and recessionary periods. Together, this analysis shows that the recession has not had a particular impact on the effects of minimum wage upratings, but that there should be concerns around the effect on the number of hours worked, especially by younger people.

Setting the rate

The value of the minimum wage increased significantly in the years after its introduction, rising by 34% in real terms by October 2007. However, by the time of its October 2013 increase it had fallen in value by 5.1%.[22] The contraction in the value of the minimum wage has reflected the recognition by the LPC that the labour market has weakened considerably and that, because unemployment has remained lower than the experience of previous recessions would imply, much of this slack has been reflected in lower wages.

Bite and coverage

One of the factors considered by the Low Pay Commission in setting the minimum wage is the "bite", which examines how far into the income distribution the minimum wage goes. Over the course of the recession, there has been very little deviation between the growths of the minimum wage and average wages:

> *In practice, our recommendations have approximated very closely to what has proved to be the path of average earnings – since 2009, the two series have diverged by only one penny.*[23]

19 Stewart, M. (2002) *'The Impact of the Introduction of the UK Minimum Wage on the Employment Probabilities of Low Wage Workers',* Warwick Economic Research Papers.

20 Stewart, M. and Swaffield, J. (2006) *'The other margin: do minimum wages cause working hours adjustments for low-wage workers?',* Economica, 75.

21 Bryan, M. Salvatori, A. and Taylor, M. (2012) *'The impact of the National Minimum Wage on Earnings, Employment and Hours through the Recession',* Institute for Social and Economic Research, University of Essex.

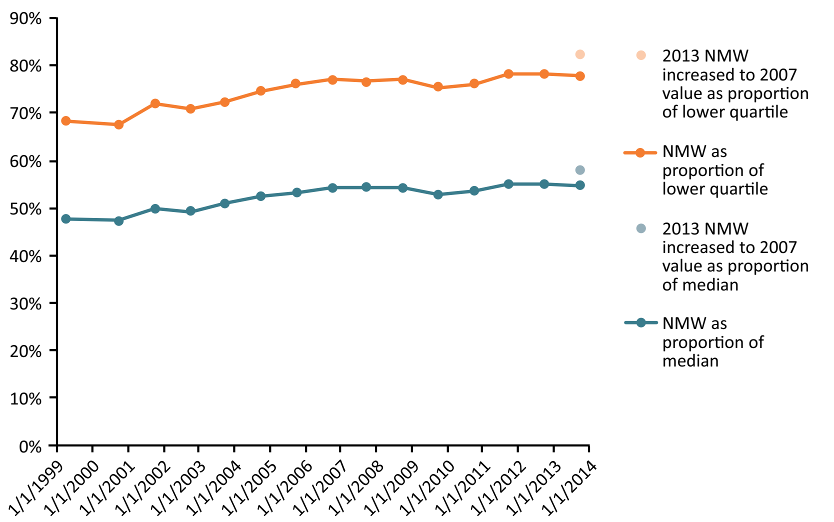
22 Office for National Statistics data, author's calculations.

23 National Minimum Wage, Low Pay Commission Report 2013, Section 5.100.

However, as Figure 2.3 shows, the minimum wage has increased as a proportion of the median hourly wage, especially in the first seven years after its introduction. At the time of its most recent increase, the minimum wage was 54.6% of the median, with only the previous two years seeing it any higher.

If the minimum wage had increased in line with Consumer Price Inflation (CPI) since it hit its highest real value in October 2007, it would be worth £6.65 in 2013/14. An increase to this level would see the minimum wage rise to 57.5% of the median and 77.9% of the lower quartile. Comparing this to the analysis of Stewart (2002), this increased minimum wage would be 51% of the median full-time wage, slightly above the 46% found not to have an effect on employment in the UK and significantly below the 70% found to have a negative impact on employment in France.

Figure 2.3: National Minimum Wage as a proportion of the median and lower quartile hourly wage, and effect of increasing 2013 NMW to its 2007 value[24]



Source: ASHE

A further consideration made when the minimum wage is set is the proportion of the employed population that are being paid it and therefore the number of people affected by an increase. 2013 ASHE data estimated that 911,000 individuals were paid at or below the 2012 minimum wage of £6.19.

At the same time, our estimates show that there were 1.97 million (7.96%) over-21s earning no more than £6.51, the level of the 2012 minimum wage plus the 32p required to increase it to its 2007 value. An increase in the minimum wage to its pre-recession level will therefore cause a meaningful increase in the proportion of the working population affected.[25]

However, it is unclear how many of these jobs are already strongly influenced by the minimum wage; for instance, they might be below the current minimum wage level if it did not exist or still be paid marginally more than it, even after an increase. It therefore does not follow that 2 million people would be paid at or below the minimum wage following this increase.

24 This does not consider the announced 2014 increase as no median income or inflation data is available for this point in time.

25 Distribution of Low Paid Jobs by 10p Bands, 1998 to 2013. Low Pay, April 2013. Office for National Statistics.

The minimum wage has therefore closed on the middle of the income distribution slightly since its introduction. Any increase above the recent trend of increasing NMW roughly in line with expected wage inflation would therefore see the minimum wage rise significantly in relation to the rest of the income distribution to a position it has not previously occupied. Indeed, the 2014 increase to £6.50 is likely to do this, assuming that pay increases at a slower rate than 3%, as official economic forecasts predict.[26]

Other approaches

As has been highlighted already in this report, the National Minimum Wage has successfully reduced the extent of extreme low pay, whilst taking the potential impact on employment very seriously and implementing a system that is simple and predictable. However, other approaches have been considered:

- Sector minimum wage: Higher wage floors in sectors that can afford them offer the potential of higher wages for certain groups of workers. However, the system itself would introduce a large amount of complexity for employers, employees and regulators. It would also require a significantly more complicated analysis of what sectors could afford without threatening employment, with a risk that some sectors might function differently and therefore have a minimum wage set to the wrong level.
- Regional minimum wage: With a key goal of the minimum wage being to support living standards, the different cost of living in different regions suggests that different minimum wage levels might be required. However, this could have a profound effect on local economies. A low minimum wage will affect living standards and spending power, affecting specific industries in local economies. Higher minimum wages might discourage employment and economic growth. Whilst these are concerns with a nationally set minimum wage, a regional measure would see areas influenced in very different ways, magnified by the differing abilities of certain industries to adapt. This regional disparity could also been seen as unfair and would not account for large differences in the cost of living between areas within a given region.

Creating different minimum wages across sectors or regions in the UK would therefore have significant potential costs and uncertainties. However, the ability to increase earnings for groups of workers, whilst recognising the more specific factors that affect employment. These potential benefits need to be considered alongside the cost of simplicity, which could be seen as one of the key benefits of the current minimum wage.

Conclusion

Whilst the minimum wage has grown in value since its introduction, it has seen little structural change. Part of the reason for this might lie in its success in improving incomes for the lowest earners, as well as the lack of evidence of a large impact on employment. However there are a number of potential areas of change for the minimum wage that must be considered:

26 Economic and fiscal outlook – December 2013. Office for Budget Responsibility.

- To what extent the minimum wage should look to recover its pre-recession value over the coming years through above-inflation increases.
- The long-run value of the minimum wage relative to the median, in particular, whether it should have a higher bite and whether short-term increase should be permanent.
- Any large structural changes to the groups across which the minimum wage is set.

Employer National Insurance

The relationship between productivity, the compensation paid by employers and the wages received by workers has remained strong through the growth before the recession and since 2008. However as analysis highlighted earlier in this report showed, non-wage costs of employing have risen more quickly than pay, creating a "wedge" between productivity and pay growth. One element of this is the size of the National Insurance (NI) Contributions, a payroll tax paid by employers on top of employee salaries.

2011/12 changes

Since the recession, there have been two significant changes to employer NI. First, an increase in the NI rate from 12.8% to 13.8% was scheduled for 2011/12, increasing government revenue by an estimated total of £4.58 billion in that year, increasing to £4.93 billion by 2013/14.[27]

“Whilst the lower cost of employing low paid workers might be seen as a positive move, there is a higher marginal cost of increasing wages, creating a disincentive to increase pay”

The incoming coalition government sought to offset this rate increase in the June 2010 Emergency Budget, increasing the threshold below which no employer NI is paid (the secondary threshold) by £21 above indexation, costing an estimated £3.11 billion in 2011–12.[28]

However, this will not fully offset the increased rate. A higher threshold will mean that employers of individuals on incomes just above the threshold would see their NI liability fall. However, after a certain point, the higher NI rate would cost employers. The costs of employing workers with low weekly wages therefore fell, but the costs of employing higher earners rose.

Whilst the lower cost of employing low paid workers might be seen as a positive move, there is a higher marginal cost of increasing wages, creating a disincentive to increase pay.

Adapting NI to other purposes

This shows that changes to the secondary threshold and the NI rate have quite different impacts. However, as well as this, it is important to recognise that, for firms paying National Insurance, the system is relatively simple. This also means that it offers relatively little flexibility to be adapted to other purposes. In addition, National Insurance is determined according to weekly pay and not at the hourly level, as much of this report has focussed on so far.

When the minimum wage was increased to £6.31 in October 2013, an individual would need to be working at least 23 hours on the minimum wage before their employer came over the £148 secondary threshold. Employers of part time minimum wage workers will have little or nothing to gain from

27 The total 1 point increase in 2011/12 was introduced in two parts, in the 2008 and 2009 Pre-Budget report. Together the cost was estimated in table 2.2 in the March 2011 Budget report.

28 HM Treasury, Budget 2011, Table 2.1.

any reductions in employer NI. Changes to National Insurance therefore could only influence a limited number of minimum wage workers and do so in an untargeted way.

In the face of a potential increase in the minimum wage, this presents an issue should a government wish to reduce the costs faced by businesses through National Insurance. First, NI offers no way to target individuals with low hourly wages; a low weekly wage might simple be a result of working few hours. As well as this, there is no way to change only the national insurance paid by employers of individuals on low weekly wages, with an increased secondary threshold reducing NI for employers of all eligible workers and lower National Insurance rates saving the most money for employers of individuals on higher wages.

Given that National Insurance constitutes the primary form of employment-related taxation faced by firms, using taxation to effectively compensate firms for a higher minimum wage would be very difficult.

Employment allowance

One significant modification that is being made to employer National Insurance Contributions is the introduction of an allowance from April 2014, meaning that every business and charity will not have to pay the first £2,000 of their National Insurance liability in any given year.[29] The scheme is implemented through usual payroll software, meaning that employers are only required to confirm their eligibility through their regular payroll processes. In this respect, its implementation might be significantly simpler for employers than some other employment subsidy schemes.

In the 2013 Budget, where this was announced, the policy was forecast to cost £1.255 billion at the time of its introduction in 2014/15.[30]

In the 2014/15 financial year, an employer with one worker earning the 2013 median pre-tax income of £21,900 would see their National Insurance liability fall from more than £1,800 to £0.[31] An employer with two employees earning this amount would not pay National Insurance until the 7th month of the financial year.

The proportional savings are therefore greatest for employers who previously had small National Insurance liabilities. As a result, this approach effectively targets NI cuts at small businesses (or more specifically those paying relatively little in National Insurance). Large employers will notice only a small impact relative to the size of their existing National Insurance liabilities.

Around 60% of workplaces in the UK have between 1 and 9 workers and a further 9% have between 10 and 49 (a further 13.5% have no employees at all and therefore do not have these liabilities).[32] A large proportion of the employers eligible for the Employment Allowance will therefore be small businesses. However, most employees work for large companies, with more than 40% in a workplace with more than 2,500 workers and a further 13% in a workplace with 500–2,499 workers.

In this respect, this policy is quite deliberately supporting small businesses, but will have little impact on employment and pay decisions for a large range of hiring decisions. A broader policy might therefore be required to reduce the tax burden applied to the employers of most workers.

Removing NI for under-21s

In the 2013 Autumn Statement, the Chancellor, George Osborne, outlined plans to abolish employer National Insurance for workers aged 21 or under, with

29 www.gov.uk/government/news/employment-allowance-boost-for-business-bill-introduced-to-parliament, http://www.hmrc.gov.uk/news/nic-emp-allowance.htm

30 HM Treasury, Budget 2013, Table 2.1.

31 ASHE and government employment allowance calculator www.employmentallowance.com/allowance-calculator

32 Size of firms in London local authorities by enterprise size 2001–2012, ONS.

the exception of those earning more than the upper earnings limit (£813 per week).[33]

This creates a strong incentive for employers to hire younger workers, as well as reducing the marginal cost of paying more. This might have an impact on overall employment, by reducing the average cost of labour. However, a portion of any increased employment seen among workers aged under the age of 21 is likely to come as a result of substitution away from older workers. Evidence on this issue is discussed later in the report.

Targeted approaches such as this are therefore likely to be the most cost effective way of supporting job creation among a certain group. However, the analysis in this report points to a broader problem of slack in the UK labour market, suggesting that a broader policy response might be required.

Impact of employer payroll tax cuts

Focusing on a payroll tax cut, analysis from the United States Congressional Budget Office (CBO) highlighted four ways that firms could react:

- Passing cost savings onto consumers, stimulating more spending and therefore demand for workers.
- Giving savings to employees through increasing pay and non-wage compensation; however, wages might be inflexible in the short-term, limiting this effect.
- Firms could retain the cost savings as profits, limiting the immediate impact on employees, but potentially improving cash flow, providing relief for those facing issues.
- More labour might be employed; however, the majority of savings would be based on the employees firms already have, limiting the incentive to hire more.[34]

The report also discussed the 1977/78 New Jobs Tax Credit, which gave firms who raised the total employment by at least 2% a credit worth half of the increase in their wage bill above 102% of the previous year's wage bill, with maximum credits introduced for individual employees and firms as a whole.

There were issues with the complexity of the policy, with many firms discouraged or unaware of their eligibility, especially smaller firms, whose participation rates were very low. Impacts were unclear; one study indicated that firms who were aware of the policy hired 3% more workers, other research claimed that the lack of a good counterfactual meant that strong estimates of the credit's impact was not possible.

In total, the CBO estimated that a temporary payroll tax cut for all employers would have a cumulative impact on GDP that was 1/3 higher than a cut in employee payroll taxes or one-off social security payments. A payroll tax cut targeting employers who hire more staff or increase the size of their wage bill by other means would lead to an even greater impact. However, the complexities of targeting the correct firms and successfully communicating the change were made clear by the New Jobs Tax Credit, meaning that this form of policy might be difficult to implement.

In certain low unemployment areas in Northern Finland, temporary employer payroll relief of 3 to 6 percentage points was introduced in the early 2000s, by removing requirements to make certain pension and health insurance contributions.

33 Autumn Statement 2013, HM Treasury, December 2013.

34 *'Policies for Increasing Economic Growth and Employment in 2010 and 2011'*, Congressional Budget Office, January 2010.

Comparing these regions to ones unaffected by the policy, analysis estimated that employment in firms rose by 6.0% percent more and total wages rose by 8.7%.[35] However, other specifications and subsequent analysis did not find statistical significance due to large standard errors indicating that, despite the experimental nature of this tax changes, the design of the experiment was not strong.[36]

In Sweden, when facing high and rising youth unemployment, reforms were adopted that together reduced the employer's payroll tax for workers aged 19 to 25 from 32.42% to 15.52% in two steps.[37] Focusing on the effect of the initial 11 point decrease in the retail industry, analysis has estimated a small impact on job entry and exit, leading to a 1.8% increase in net employment among blue collar workers in this age group, which the authors claim is small relative to the size of the tax cut. The impact for white collar workers was smaller, however, minimum wage workers see much larger impacts, with employment rising between 6 and 8%, indicating that the high and binding minimum wages in this sector were putting significant pressure on employment. Analysis of the second cut was affected by the onset of the financial crisis.

In France, where payroll taxes are again large, subsidies were introduced for low-wage workers in 1993 and strengthened in 1995 and 1996, offering significant reductions in payroll tax rates for workers earning up to 30% more than the minimum wage.[38] An analysis that looked at the response of firms estimated that average employment of low wage workers rose by 2.24% in manufacturing and 3.15% in non-manufacturing jobs, worth around 420,000 jobs between 1994 and 1997.

The analysis found that the share of unskilled workers rose in firms by a statistically significant 0.61 percentage points, with the proportion of labour relative to capital rising. The lower cost of low skilled workers therefore caused a substitution towards them and away from both higher skilled workers and capital. This meant that firms saw lower average productivity of labour and capital, with labour costs falling at the same rate as labour productivity, and that the efforts to change the distribution of employment across the skills distribution were successful.

In the EU, rather than focusing on payroll taxes, they instead experimented with a cut in VAT for labour-intensive service sectors across nine countries, arguing that lower prices would increase demand for goods and workers. However, this requires firms to pass on the reduced costs to prices, consumers to demand more and output increased by increasing the size of their workforce.[39]

The commission found no substantial impact of the tax relief on employment, with those countries where employment rose unable to attribute it to the VAT change.[40] This echoed previous evidence which showed that a VAT cut was not the best or most cost effective tool for promoting employment, with firms not passing the VAT reduction onto consumers. Another commission paper found that cuts to labour costs were more than 50% more effective at increasing employment, compared to a VAT cut, even under the unrealistic assumption that a VAT cut was fully passed onto consumers.[41]

Conclusion

Employer's National Insurance does not offer the same flexibility to target specific income groups as other tax cuts do. Furthermore, they look to increase earnings less indirectly than government transfers might do.

35 Korkeamäki, O. and Uusitalo, R. (2006) 'Employment effects of a payroll-tax cut: Evidence from a regional tax exception experiment', Working Paper Series 2006:10, Institute for Evaluation of Labour Market and Educational Policy.

36 Korkeamäki, O. (2011) 'The Finnish payroll tax cut experiment revisited, or where did the money go?', ERSA conference papers, European Regional Science Association.

37 Skedinger, P. (2013), *'Effects of Payroll Tax Cuts for Young Workers'*, Nordic Economic Policy Review.

38 Crépon, B. and Desplatz, R. (2003). *'The effects of payroll tax subsidies for low wage workers on firm level decisions'*, Working Papers 2003–06, Centre de Recherche en Economie et Statistique.

39 Ainsworth, R. (2011) *'Will cutting the payroll tax increase jobs? (Empirical evidence from the EU VAT)'*, Boston University School of Law, Working Paper No.11–01.

40 *'Experimental application of a reduced rate of VAT to certain labour-intensive services'*, report from the Commission to the Council and the European Parliament.

41 'Evaluation report on the Experimental application of a reduced rate of VAT to certain labour-intensive services', Commission to the Council and the European Parliament staff working paper.

However, the breadth of the fall in wages that has come during the recession means that supporting pay might demand broader changes.

Targeting employer NI can stimulate higher wages through a number of different channels. Primarily these changes to employer payroll taxes have the benefit of reducing the wedge between employment costs and pay, increasing the proportion of what employers spend on labour that goes to workers. At the same time, by reducing the costs faced by businesses, they also encourage greater spending on labour and encourage a greater reduction in the slack in the labour market. This offers the additional advantage of encouraging more natural wage growth as the labour market grows. A broader stimulus effect is also likely as firms and workers have higher incomes and employment rises.

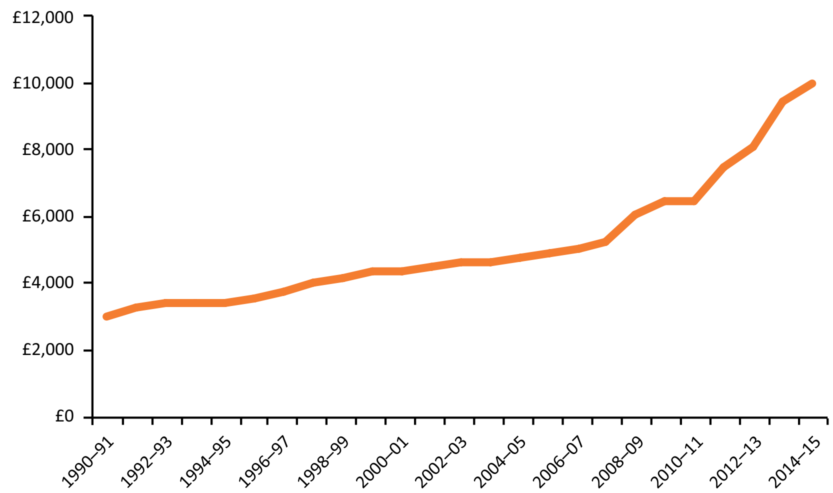
Employee tax cuts

So far this policy section has focussed on the burden of taxation put on employers and reducing the "wedge" effect of non-wage compensation costs. However an alternative and potentially more direct way to support take-home incomes through tax cuts would be to reduce the Income Tax or National Insurance paid by employees.

Both Income Tax and employee National Insurance have multiple rates and allowances. This offers a significant amount of flexibility, meaning that the government can focus tax cuts on specific parts of the income distribution.

One of the most significant changes that have been made to employee taxation in recent years is a series of increases to the Income Tax personal allowance, with much of this focused on increasing the incomes of individuals earning the basic rate of Income Tax. Between 1990/91 and 2010/11 the personal allowance increased by an average of 4% per year, however by 2014/15 it will have increased by an average of 12% per year since 2010/11.

Figure 2.4: Income Tax Personal Allowance nominal value 1991/91 to 2014/15



Source: Institute for Fiscal Studies, HMRC

42 June 2010 Budget, 2011 Budget, 2012 Budget, 2013 Budget. HM Treasury.

The costs of these four changes, along with adjustments to higher thresholds, have been significant, totalling £9.6 billion in 2014/15.[42] Not increasing thresholds for the higher rate of Income Tax at the same rate reduced the cost of the change. However, if the personal allowance had only increased in line with the 4% that was common before 2010 it would have increased by only 31% as much as it has done, the faster rise in the allowance could therefore have cost as much as £6.5 billion.

The primary threshold, above which employee NI starts to be paid, was the equivalent level of the Income Tax personal allowance (except NI is determined weekly instead of annually) between 2000/01 and 2007/8. However, since then it has increased at a slower rate, leaving it £2,034 lower by 2015. Increasing it to the same level would cost an estimated £5.5 billion and lower the amount of NI paid by up to £244 per employee per year.[43,44]

"The recent fall in earnings is a direct consequence of the economic downturn and the way that the significant lack of demand for workers is manifesting itself in lower productivity and wages, rather than unemployment"

This focus on the Income Tax personal allowance will have provided a significant tax cut to a large number of earners. However, an alternative focus on lower marginal rates of tax would have had the advantage of improving incentives to work more hours and earn more, highlighting the trade-off between thresholds and tax rates.

Impacts

Income Tax and National Insurance can therefore be changed in ways which will increase the earnings of individuals in work, and can target different income groups quite effectively. This approach benefits from ensuring that workers benefit tax cuts quite directly.

However, as this report has demonstrated, the recent fall in earnings is a direct consequence of the economic downturn and the way that the significant lack of demand for workers is manifesting itself in lower productivity and wages, rather than unemployment. The consequence of this is that, in order to generate a recovery in wages, a broader increase in the demand for workers is required.

As has been highlighted, analysis from the Congressional Budget Office in the United States estimated that employee tax cuts would have a smaller impact on employment than employer tax cuts, largely because it looks to act more directly, rather than having to impact on consumer spending increasing and leading to employment growth.

Following this analysis, the *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010* extended the reduction of employee payroll taxes from 6.2% to 4.2% by one year, worth a total of around $112bn in 2011.[45]

Surveys by the Federal Reserve Bank of New York of recipients found that 36% of extra income was spent, which was significantly more than individuals had previously said they planned on spending. Respondents also planned to spend less of the extra income received if the tax cut was temporary. This offered support for the permanent income hypothesis, which argues that individuals seek to smooth their consumption across their lifetime, with permanent changes required to stimulate greater spending.

One of the most obvious impacts of lower income-related taxes for employees is a greater incentive to work and therefore greater employment levels or individuals working more hours.

43 This costing assumes that the upper earnings limit, after which the employee NI rate falls to 2%, is held in line with the threshold where Income Tax increases to 40%.

44 A £39.12 per week increase, costing £280 million per £2, according to HMRC estimates of direct effect of illustrative tax changes http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf

45 Graziani, G. van der Klaauw, W. and Zafar, B. (2013), *'A Boost in the Paycheck: Surbey Evidence on Workers' Response to the 2011 Payroll Tax Cuts'*, Federal Reserve Bank of New York, Staff Report No. 592.

Analysis has shown that individuals sometimes increase their labour supply along with their work incentives. However, the size of the impact varies, depending on the circumstances of the individual. Analysis in the Mirrlees Review, conducted by the Institute for Fiscal Studies, showed that:

> *"hours of work do not respond particularly strongly to the financial incentives created by tax changes for men, but they are a little more responsive for married women and lone mothers"*[46]

Other analysis has identified significant impacts of tax changes on married women and lone mothers. However, it also recognised that income effects can reduce labour supply at the household level, meaning that individual participation decisions can be strongly influenced by tax cuts experienced by a spouse.[47]

Conclusion

Cutting income taxes can therefore have an important influence on labour market participation. However, participation rates are already very high, with working age economic inactivity in 2013 at its lowest level since 1990. At a time when unemployment and underemployment remain high, this high inactivity suggests that working incentives are strong and that increasing labour supply is not a pressing concern.

Increasing employment income through tax cuts can have a stimulus impact on the economy; however, analysis suggests that the impact of employer payroll tax cuts is greater. In the context of an economy with a large amount of labour market slack, employee tax cuts might only offer a limited solution.

Tax Credits

Whilst Income Tax and National Insurance rates vary significantly across the income distribution, Tax Credits offer flexibility when looking to support families according to their household type. Working Tax Credit (WTC) targets individuals if they work enough hours per week and is more generous to couples and single people with children. Child Tax Credit (CTC) offers support based on household type, with a specific per-child element. Both CTC and WTC are withdrawn gradually after a certain income level, increasing marginal tax rates and creating a disincentive to work more.

Since their introduction in April 2003, the values of both WTC and CTC have changed. The basic element of WTC grew slightly faster than inflation until 2010, when it decreased slightly as its nominal increases were limited to a level below the rate of inflation. The main per-child element of CTC rose more quickly, meaning that, between 2003/4 and 2014/15, a family with one child and no disabilities will have seen CTC rise by 23% in real terms; a family with two children will have seen their CTC eligibility rise by 31%.[48]

The consequence is that Tax Credits have risen in value for families on low incomes and that the portion which contains no work requirements has grown more quickly.

Supporting living standards with Tax Credits

While individuals on the lowest incomes and households completely out of work will not pay Income Tax or National Insurance, they can be targeted through

46 Meghir, C. and Phillips, D. (2009), *'Labour Supply and Taxes'*, in Mirrlees Review, Dimensions of Tax Design, Institute for Fiscal Studies.

47 Blundell, R. W. (1995), *"The Impact of Taxation on Labour Force Participation and Labour Supply"*, OECD Jobs Study Working Papers.

48 Source IFS and HMRC, author's calculations. All calculations deflated using CPI indices, using Office for Budget Responsibility Economic and Fiscal Outlook, December 2013.

the benefit system. Tax credits also allow flexibility, with CTC being especially effective at targeting financial support according to family composition.

Before 2010, the higher pace of increases in CTC indicate that direct transfers were seen as a more effective tool for increasing the take-home income of low earning households with children. Since then, the priority has switched to the Income Tax personal allowance. Both of these directly support incomes, but therefore come at a high fiscal cost.

Similarly to changes to Income Tax, Tax Credits do not have the potential to stimulate the economy as other tax cuts. However, the effectiveness with which they target certain individuals means that they remain an important part of the tax and benefit structure, even if they might only be a weak tool when looking to support the reduction in labour market slack.

3
Discussion and Recommendations

This report has outlined the way that the recession has affected pay and identified a variety of ways that a government might look to tackle low earnings.

The most direct intervention into the amount workers are paid is the National Minimum Wage, the structure of which has not changed significantly since its introduction. However, it can only have an influence over a narrow range of individuals and comes with the risk of threatening employment should it seek to reach a larger number of people. The breadth of the impact that the recession has had on pay will therefore not be tackled by the minimum wage alone.

Despite this, the success of the minimum wage can be seen in the strength of hourly pay for the bottom decile relative to the rest of the income distribution, both during the recession and in the decade before. Within its current structure, the NMW can therefore play a role in elevating some of the recent contraction in pay at the very bottom of the income distribution.

The most direct ways that government can alleviate the impact of low pay on households are through cuts to employee taxation and increases in Tax Credit generosity. These changes (be they a transfer or a tax cut) have been used at different times by the current coalition government and the previous government in an effort to directly improve incomes and, on other occasions, to improve work incentives.

However, the primary lesson from this report is the strong link between productivity and wages. The UK's strong employment record since the beginning of 2008 has been facilitated by the ability of employers to retain workers for lower wages and lower output levels. A recovery in pay therefore relies on reducing the slack in the labour market through economic growth so far that this higher output leads to a recovery of the lost output per worker and therefore higher wages.

Except through their more limited ability to stimulate economic activity, changes to employee taxes and Tax Credits do not achieve this. Instead, cuts to employee taxation and greater Tax Credits represent extensions of the way in which the state takes on the burden of low pay, rather than looking to increase labour market demand.

Recommendation 1: Employee tax cuts and Tax Credits

From 2015/16 tax, the government should deprioritise decreasing Income Tax and employee National Insurance and also increasing the value of Tax Credits.

These approaches have an important role in supporting living standards among the lowest earners and, along with the whole range of taxes and benefits, should be used to create a balanced and consistent tax and benefit system. However, at a time when increasing wages relies on utilising the excess supply in the labour market, they do not provide suitable economic stimulus or reduce the cost of employment faced by firms.

Employer's National Insurance

Policies to support a recovery in the labour market and reverse the real terms fall in wages must therefore focus on economic growth and incentivising greater hiring.

This would enable employers to utilise the economic potential of their existing workforce more fully, both when it is the easiest way to generate higher output and when lower unemployment limits new hiring opportunities. There is already some evidence that shortages of skills are increasing the wages of new employees.[49] This higher productivity and wages is an achievable goal given productivity achieved these levels before the recession; however, it will require significant reduction of the slack in the economy.

This report has shown evidence that targeted tax cuts towards the employment of specific groups of workers can encourage substitution towards them and away from other workers or capital. In addition, modelling of the impact of various changes, research has shown reductions in employers' payroll taxes to be more effective at creating jobs than employee tax cuts or one-off social security payments. This is likely because they affect employers and the cost of hiring more directly, whereas other cuts look to act through factors such as consumer demand or business investment. Wages have also been affected by the "wedge" effect, increasing non-wage costs of employment and reducing the proportion of employer labour costs received by employees. Some of this wedge might be inevitable, for instance, as costs increase to meet the large burden of pension commitments. However, some of the more recent problems have come from a higher taxation of employers. Reducing non-wage costs of employment is therefore important to ensure that workers receive a greater proportion of what their employer pays.

In many ways, the employer portion of National Insurance is very simple. Whereas taxes like Income Tax or the employee element of NI have various thresholds with either higher or lower rates further up the income distribution, the marginal tax rate of employer NI is fixed above the secondary threshold. The consequence of this is that the government is left with the option of changing this threshold or the rate that incomes above this weekly threshold are taxed at.

As was highlighted earlier in this report, increasing the secondary threshold will reduce the employer National Insurance contribution for every employee earning more than the previous threshold. Above the new threshold, it would offer the same saving all the way up the income distribution.[50]

A change in the employer NI rate would reduce the marginal tax rate paid by all employers of workers over the secondary threshold. This would make it less

49 The January REC/KPMG Report on Jobs found permanent salary growth at a six-year high, alongside decreases in staff availability.

50 For example, in 2014/15, a £10 increase in the threshold would save employers of an individual earning above the new threshold of £163 £1.38 per week.

expensive for employers to increase pay. However, it would also benefit employers of the most well paid the most as they would have the largest payment being reduced.

Changes to NI rates therefore favour higher earners more, whereas increased thresholds cut taxes for employing workers more evenly, but have the greatest proportional reductions just above the previous secondary threshold.

Recommendation 2: Increasing the employer's National Insurance threshold

This report recommends that the weekly employer's National Insurance threshold (the secondary threshold) is increased to £192 per week for the 2015/16 financial year. This would mean that employers do not begin to pay NI until an employee earns £192 the equivalent of £10,000 per year.[51,52]

This increase, from a counterfactual level of £158, would decrease government revenues by an estimated £5.425bn extra in 2015/16.

This would reduce the NI liability firms face for most workers by £251 per year, and would mean that employers of 900,000 employees were no longer paying National Insurance.[53]

Minimum wage

Since the implementation of the National Minimum Wage in the UK in 1999, extreme low pay fell rapidly and compliance was high. As well as this, public support for increasing the minimum wage further is strong.[54] Furthermore, it has offered a significant amount of protection to the bottom of the labour market, with the bottom decile seeing the smallest contraction in wages over the course of the recession

In these respects, the National Minimum Wage has been a clear success in its current form. It has the further advantage of simplicity, covering different sectors and regions with the same rules and same minimum wage rates. Given that the slowest growth in wages before the recession came at the fourth decile, the structural issues leading to lower wage growth for many individuals seems to be somewhat detached from the issue of the minimum wage.

However, it is important to recognise that the value of NMW has fallen in real terms since 2007. NMW peaked in value in 2007 and its increases have since fallen below inflation. If it had continued increasing in line with CPI, it would have been £6.65 in October 2013, 34p higher than it was actually set.

A 3% increase announced for 2014 means that the minimum wage is set to rise faster than the rate of inflation for the first time since the financial crisis began, an increase to £6.50 in October 2014.

However, NMW still has a significant amount of its value to recover. It would require increases 2.4 percentage points above the rate of inflation in 2015 and 2016 for the minimum wage to regain its value.

This sort of change is likely to see the minimum wage increase more quickly than incomes across the rest of the labour market. This will mean that the minimum wage will have an influence over pay in a much greater share of the labour market. There must be some concerns that continued increases such as this would push employers too far and threaten both the employment of low-wage

51 Assuming that 2015/16 counterfactually sees the same £5 or 3.4% increase in the secondary threshold that was seen for 2014/15.

52 Cost estimated using HMRC estimates of direct effect of illustrative tax changes www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf

53 Estimated from AHSE weekly pay data.

54 http://yougov.co.uk/news/2014/01/12/cross-party-support-raising-minimum-wage/

workers and the profitability of firms with low paid workforces, potentially threatening employment further. As above-inflation wage growth returns, there is an opportunity to allow the minimum wage to increase above the rate of inflation, whilst decreasing as a share of GDP, meaning that it can return to its pre-recession bite point.

Recommendation 3: Increasing the National Minimum Wage

This report therefore does not recommend any change to the structure of the National Minimum Wage, believing instead that it has been a relative success in its current form and its simplicity should remain an essential feature.

However, the minimum wage is still below its 2007 value and this report recommends that it recovers gradually to this previous level in real terms with two further above-inflation increases in 2015 and 2016.

Following this, the government should allow the minimum wage to return to its pre-recession bite level, at around 55% of the median hourly wage, so as not to provide a permanent increase relative to the rest of the income distribution. However, this should not be a hard rule, with the LPC using its discretion about the correct level, account for changes to the economy and the labour market.

Conclusion

Since 2008, the recession and slow recovery that followed has been primarily felt in wages. This is a direct consequence of the decline in output per worker that was seen as the economy shrank but employment remained surprisingly strong. However, it is the same robust link between economic output per worker and employee compensation that means that broad economic growth is the most important factor as policymakers seek a recovery in wages.

Given the extent to which output per worker still lags below the levels seen before the recession, there is considerable room left for productivity to grow. However, the large amount of slack in the labour market means that a significant amount of growth is required even to return to previous productivity levels. Much of this report has therefore focused on supporting the recovery in the labour market.

The government has the ability to very directly cut taxes of employees or target Tax Credits. However, these measures do not offer the potential to support the economic recovery and stimulate the productivity growth needed to generate genuine wage growth.

Instead, the focus should be on reducing the size of employer National Insurance. This will ensure that a greater proportion of what employers spend on their workers goes to employee wages. In addition, the ability of an NI cut to incentivise higher levels of employment means that it is the best approach to supporting the labour market recovery that the UK economy currently needs.

However, this report also recognises that, over the longer term, there is a significant issue with productivity creating a slower wage growth in the lower middle part of the income distribution. Understanding the longer-term drivers of productivity is therefore essential in order to support the living standards of large parts of the labour market who risk being left behind by economic growth.

The way that the financial crisis and subsequent recession impacted the UK labour market differed from past recessions and the experiences of many other countries. Instead of high unemployment as an economic crash caused jobs to be shed, the majority of the impact has been seen in wages, which have continued to fall into 2014. This has sparked significant debate about how the recession has affected different groups of people and who stands to benefit most from economic recovery.

This report shows clearly that, despite these fears, the link between the productivity of workers and their wages is robust. In the years before the recession, wages and total employee compensation grew in line with output per worker. As GDP has fallen since the start of 2008, an increasing working population has meant that output per worker has fallen significantly, with the decline in wages mirroring this. This relationship has been robust across different regions and sectors of the UK, with output and wages contracting together.

This means that living standards have suffered as a direct result of the recession, with this impact potentially broader across the population because unemployment did not rise to the levels that some expected. However it also means that a recovery in wages can be expected to materialise as productivity returns. A sustained period of economic growth will be the most important influence on wages.

However, as a result of the current high unemployment and large increase in the number of people who want to work, the labour market still has a long way to recover. The focus of policy should be speeding up this recovery, encouraging higher productivity and therefore wages.

This report discusses a range of options to achieve this. It demonstrates that, whilst cutting employee taxes and higher tax credits have been a spending focus for recent governments as they looked to boost living standards, these employee-side measures do little more than subsidise low pay. Instead the government needs to support a labour market recovery. The most direct way that the government can do this is by reducing the costs businesses face when employing people. This can be achieved through a cut to employers National Insurance in the form of a significantly higher threshold before it starts being paid. This will also make sure that a higher proportion of what businesses pay their employers is seen in wages.

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