LOW PAY AND INCOME INEQUALITY IN SCOTLAND

1. Introduction

Low pay and in-work poverty are significant issues in Scotland. The evidence tells us that most of those in the three lowest income deciles who are in work receive low hourly pay. While low pay ahs an influence on the attractiveness of work, poverty traps can also act as a disincentive to people making the transition from benefits into work.

In examining how poverty and income inequality in Scotland may be tackled effectively, the impact of low pay is an issue that requires close consideration. While the majority of low paid workers in Scotland are employed in the private sector, there is scope for the public sector to set standards in terms of wage levels.

This paper examines the impact that raising the minimum level of public sector pay in Scotland would have on the poorest in Scotland in terms of the impact it would have on the share of national income they receive. It then examines the effect that raising wages of the low paid has on disposable household incomes, by looking at the interaction between wages and the tax and benefits system.

2. Policy context

Pay policy: The Scottish Government's policy on public sector pay applies to the Scottish Government, Executive Agencies and related Departments (the civil service below Senior level), NDPBs and Public Corporations whose pay increases require the approval of Scottish Ministers. This policy covers around 30,000 staff in total but does not apply to other parts of the public sector such as the NHS, LAs and teachers.

The majority of public sector wages are not determined through Scottish Government policy. For example, Local Government and NHS Scotland pay increases are determined through separate arrangements. Local Government pay is a matter for local authorities and their recognised unions and increases in the NHS are recommended by an independent pay review body

The UK Government sets and enforces the National Minimum Wage, which is currently set at £5.80 per hour (for over 21s), and the Scottish Government cannot change this under the current devolution settlement.

It is important, therefore, to be clear that this analysis is a hypothetical exercise looking at the *potential* impacts of raising minimum wages across the public sector.

Solidarity: The Government Economic Strategy set key Purpose targets for Scotland - of particular relevance to this paper is the 'Solidarity' target to reduce income inequalities. This target is "to increase overall income and the proportion of income earned by the three lowest income deciles as a group by 2017[1]." The target exists to ensure that opportunities - and incentives - are provided for all to contribute to Scotland's sustainable economic growth, and to reduce income inequality.

To deliver on this target, a wide range of measures are set out in the Scottish Government framework for tackling poverty and income inequality, *Achieving Our Potential.* 'Making work pay' and 'maximising income for all' are two major themes within this document, and this analysis was commissioned as part of the ongoing delivery of the framework.

3. Defining a 'Living Wage'

There are a number of living wage campaigns across the UK, who lobby for employers to pay wages at a standard that ensures workers do not live in poverty. Rather than demanding legislative change (e.g. to raise the National Minimum Wage), these campaigns have brought demands for a 'living wage' directly to employers (both in the public and private sector).

A living wage is defined as a wage that gives individuals and families enough income to meaningfully participate in society, rather than merely provide the minimum income necessary for basic necessities. In the UK, living wage campaigners take the position that a full-time worker on the National Minimum Wage cannot purchase a standard of living that meets "socially acceptable" standards[2].

To examine the impact of raising minimum wages, the level that has been chosen for this analysis has been the 'Scottish Living Wage' standard, as defined by the Scottish Living Wage campaign. This figure is £7 per hour, and has been based on the Minimum Income Standard (MIS) research, funded by the Joseph Rowntree Foundation. This is an estimate of the income required in order to have the minimum acceptable standard of living in the UK today.

The MIS project has undertaken a comprehensive programme of research aimed at defining the level of income needed to allow a "socially acceptable" standard of living in Britain for a range of household types and geographic regions[3]. This research was conducted through focus groups, and is based around listing of the goods and services that a person or family requires to maintain an acceptable

[1] Full details of the Solidarity Purpose Target are available at http://www.scotland.gov.uk/Topics/Statistics/About/NotesSP/TechnicalNotesSPPT5

[2] By "socially acceptable standard of living" in Britain is meant "A minimum standard of living … that includes, but is more than just, food, clothes and shelter. It is about having what you need in order to have the opportunities and choices necessary to participate in society." (Bradshaw *et al* (2008) p. 1.)

[3] This paper relies partly on the work of the *Minimum Income Standard for Britain*, which is a research collaboration between the Centre for Research in Social Policy (CRSP) at Loughborough University and the Family Budget Unit at York University aimed at defining the level of income needed to allow a minimum acceptable standard of living in Britain today. It is funded by the Joseph Rowntree Foundation and its website is at: http://www.minimumincomestandard.org/

standard of living, and then calculating the cost of acquiring / using these goods and services.

4. Projected impact upon income inequality

Analysis was undertaken in order to estimate the effect that introducing a living wage of £7 an hour in the public sector would have on income inequality, as it is measured through the Solidarity target**.** The focus of this analysis is exclusively on the impact that a living wage of £7 per hour could have on the distribution of household income - it does not consider the wider effects and potential benefits that introducing a living wage could have and it makes the assumption that any employment effects will be minimal.

4.1 Methodology

National surveys estimate the number of public sector workers in Scotland and the proportion who earn less than £7 an hour[4]. These data sources show that in 2009 there were 623,000 people employed in the public sector[5] in Scotland, of which approximately 33,000 (5%) were estimated to earn less than £7 an hour. By way of comparison, approximately 18% of workers in the Scottish economy as a whole were estimated to earn less than £7 an hour during 2009.

The Scottish Government microsimulation model of the UK tax and benefit system, and data from the Family Resource Survey (FRS) has been used to estimate the impact that introducing a living wage of £7 an hour in the public sector would have on the proportion of equivalised household net income accruing to households in the bottom three income deciles. The microsimulation model works by estimating the net income of a representative sample of Scottish households under different scenarios after taking account of their entitlement to benefits and their tax liabilities.

Using this approach it is possible to estimate the proportion of equivalised household net income accruing to households in the bottom three income deciles under the current tax and benefit system. The effect that introducing a living wage may have on the distribution of household net income can then be estimated after accounting for changes in households' entitlement to tax and benefits[6].

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[4] Annual Survey of Hours and Earnings and Public Sector Employment series.
[5] Total public sector including public sector financial institutions (Royal Bank of Scotland Group, Lloyds Banking Group and Northern Rock).
[6] It should be noted that the resulting distribution produced using the microsimulation model is not directly compatible with the estimates made using the Households Below Average Income (HBAI) dataset. The principle reason for this is that the microsimulation analysis assumes individuals claim all the benefits to which they are entitled whilst the HBAI results are based on the benefits which individuals report that they receive.

The following analysis assumes (i) a Living Wage hourly rate of £7.00 and (ii) a National Minimum Wage of £5.73 per hour. An increase from £5.73 to £7.00 is a 22.2% increase in gross wages[7].

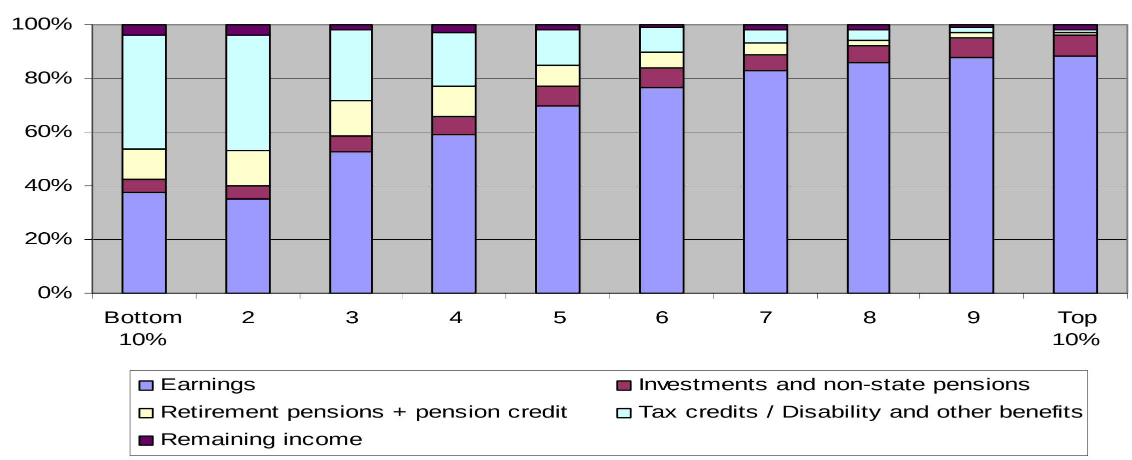
4.2 Results

The Scottish Government microsimulation analysis suggests that introducing a Living Wage across the public sector in Scotland would not be expected to increase the share of income going to the lowest 3 (L3) income deciles significantly.

Running the microsimulation model it is estimated that between 14 and 15 per cent of household income accrued to households in the bottom three income deciles in 2008 before the introduction of a living wage. Introducing a living wage of £7 an hour in the public sector is estimated to increase the income of some households in the bottom three deciles. <u>However the effect does not produce a statistically significant increase the overall proportion of equivalised household income accruing to this group.</u>

There are a number of reasons why a living wage may not affect the distribution of household income. Firstly, less than half the income received by the bottom three income deciles comes from employment, (as shown in Chart 1). As such, any changes in earned income would have a comparatively small impact on this group.

Chart 1 - Source of Household Income by Equivalised Income Decile 2006/07



Source: Department of Work and Pensions, *Family Resources Survey 2006/07*

[7] The analysis was performed prior to October 2009, and so the then current NMW rate was used as the baseline, but the difference between using a baseline of £5.73, and the current NMW of £5.80 is marginal.

Secondly, the households estimated to benefit from the introduction of a living wage in the public sector are distributed throughout the income distribution and are not confined to the bottom three deciles. This may reflect the fact that some households include a combination of adults on high and comparatively low incomes. Therefore rather than being targeted at households at the bottom of the income distribution the benefits of a living wage may be more widely dispersed throughout the income distribution.

Thirdly, for households on low incomes the introduction of the living wage may be partly offset by reductions in the income received from benefits and higher tax payments, thereby limiting the policy's effectiveness. This is illustrated in the hypothetical examples below which set out how the net income of a single adult and a lone parent would change when moving from earning the minimum wage to a living wage of £7 an hour. The results demonstrate that although earned income increases by 22% in both examples the accompanying increases in taxation and reductions in benefits mean that the resulting increase in net income is significantly lower. Therefore the increase in expenditure by the Scottish Government on a living wage would in some circumstances be offset by an increase in taxation/reduction in benefits which would occur automatically through the UK tax system.[8]

Table 1 – Weekly Income – Single Adult, no children in Local Authority Accommodation working 37 hours a week (2008/09)

	Minimum Wage (£5.73 an hour)	Living Wage (£7 an hour)	% Change
Earned Income	£212	£259	+22%
Less Income Tax and National Insurance	-£33	-£48	+44%
Plus benefits	+£14	+£0	-100%
Net Income (before housing costs)	£193	£211	+9%

[8] It should be noted that these results represent the entitlements and tax burden of hypothetical households. The calculations make a number of assumptions about council tax rates, housing costs and other variables. They do not necessarily reflect the full range of benefits and entitlements which may be available to specific individuals or the change in net income they may incur from the introduction of a living wage.

Table 2 – Weekly Income – Single Adult, 1 Child (Under 5) in Local Authority Accommodation working 37 hours a week (2008/09)			
	Minimum Wage (£5.73 an hour)	Living Wage (£7 an hour)	% Change
Earned Income	£212	£259	+22%
Less Income Tax and National Insurance	-£33	-£48	+44%
Plus benefits	+£118	+£99	-16%
Net Income (before housing costs)	296	310	+5%

The model was also used to look at the impact on couple households. In the following scenarios, it has been assumed that the two partners are in the same situation as one another.

Married Couple with 1 child aged 11-15 - Private Sector Rented Accommodation - Both earning the Minimum Wage - Working 37 Hours a Week			
	Minimum Wage (£5.73 an hour)	Living Wage (£7 an hour)	% Change
Earned Income	424	518	22%
Less Income Tax and National Insurance	67	96	44%
Plus benefits	49	29	-41%
Net Income (before housing costs)	407	452	11%

Married Couple with No Children - Private Sector Rented Accommodation – Both earning the Minimum Wage - Working 37 Hours a Week			
	Minimum Wage (£5.73 an hour)	Living Wage (£7 an hour)	% Change
Earned Income	424	518	22%
Less Income Tax and National Insurance	67	96	44%
Plus benefits	0	0	0%
Net Income (before housing costs)	357	422	18%

As with single individuals, the net effect of a wage uplift for married couples does not match the gross increase, although the net increases may be high (up to 18% in the cases modelled). Full-time workers tend to see a higher net increase than those working part-time.

5. Key observations and conclusions

The results from this analysis indicate that introducing a living wage in the public sector would not have a significant impact on the proportion of income accruing to households in the bottom three income deciles.

There are a number of reasons why this might be the case. Firstly many households in the bottom three deciles receive a comparatively small proportion of their income through paid employment and so any policy which increases earned income may have only a small impact on this group. Secondly for households on low income, any increase in earned income may be partially offset by withdrawal of benefits and higher levels of taxation, mitigating the policy's impact. Finally, some households may comprise adults on a combination of high and comparatively low incomes. In such circumstances households benefiting from a living wage would be spread across the income distribution. As a result This may again imply that the policy would not increase the share of income accruing to those at the bottom of the income distribution.

Raising wage levels from National Minimum Wage (NMW) to living wage levels would have a positive effect on the situations of many low paid individuals and families. However, the gross increase in wage income would be (usually) much larger then the increase in net income for workers on low pay. This arises from increased tax liabilities and lower benefit entitlements. For example:

- A single adult receiving a wage uplift from the NMW to £7 per hour would retain less than half the additional income, as shown in the first 3 tables above. Only in very specific and limited cases does the uplift in net income approach the wage increase.
- In general, for households with children, the increase in net income is very modest, ranging from 1% to 11%.

Many of situations above illustrate how many can find themselves in "poverty traps". These are situations where it is difficult for individuals to raise their levels of net income despite increases in their gross wages. This is of course already the situation for many people who secure increases in wages at this level, for example through securing a promotion or by working longer hours.

References

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