

Alternative Approaches to a Living Wage for London: a Methodological Review¹

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Overview

Our brief in this report is to review alternative approaches to the specification of a London Living Wage, in relation to the current (GLA defined) London Living Wage, models of practice elsewhere, broader principles, particular features of the London context and the practicalities of data availability, reliability and the likely stability of alternative methods.

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¹ This report was originally prepared in December 2011 for a client's internal use, on a commissioned basis. This version of the report has been edited simply to remove references to the client..

Summary Findings

- Concern over living standards of the poor in the UK (and other advanced economies) has produced three distinct concepts:
 - A poverty line (PL), based on resources required to sustain a decent/basic standard of living (SoL), in particular household circumstances, used as a benchmark for entitlement to state support. What counts as a decent SoL is accepted as varying over time, and often approximated by a relation (commonly 60%) of equivalised² average incomes to the societal median level, usually calculated for welfare purposes (though 120% of social security is also used sometimes).
 - A living wage (LW), grounded in the belief that fully employed people and their families, should not fall below the poverty line, and seeking to translate that norm into an appropriate minimum wage figure for workers with a family- though actual personal circumstances will clearly vary, and many of those on low wages may not have families; and
 - A minimum wage (MW), set in relation to potential labour market consequences, with no direct regard for personal circumstances (except perhaps age), living standards or family responsibilities. The MW rates, as recommended by the UK's Low Pay Commission, reflects the levels that will help as many low-paid workers as possible without any significant adverse impact on employment or the economy..
- Internationally, similar issues are raised and the concept of a living wage as a basis for employment decisions is found in the USA, Australia and other major developed countries.
- Both the PL and the MW have direct policy significance, whereas the LW is largely normative, being applied publicly as a test of social responsibility for private firms, and as a standard for public agencies and local authorities to apply to their own workers, those employed by those to whom they sub-contract, have supply contracts with and/or in receipt of subsidies from them.
- Applications of the PL tend to be spatially differentiated at least to the extent of recognising unavoidable differences in housing costs – which are the costs that vary most between areas. The MW is not spatially differentiated in this way, though there would be a case for distinguishing on an economic basis between what would be affordable in a successful / pressurised agglomeration versus a lower cost peripheral region. The LW is much more spatially focused, because it emerges out of bottom-up campaigns aimed at local employers; because a national/state MW is less adequate in keeping working families out of poverty in some areas with higher costs; and because a higher base wage is seen as more achievable (in economic-political terms) in some places than in others.
- Approaches to defining a local LW have in common the idea that (in local circumstances) it, together with non-means-tested services/benefits, should be adequate to keep mainstream families out of poverty or above a line defined by government as acceptable.

² Equivalisation is a standard methodology that adjusts household income to account for different demands on resources, by considering the household size and composition.

- These approaches to estimating a LW differ most commonly in two respects:
 - what they take as a reference family, in terms of size of households and proportion of adults working (though incorporation of child-care as an allowable cost greatly reduces the importance of the latter, in relation to employment of mothers of young children); and
 - the extent to which they are based on local costings and circumstances or take a national PL as the reference point (in whole or part);
- Reviews suggest that nowhere has taken the MW (even with cost-adjustment for area differences) as a base-line for definition of their LW – because they are quite different concepts, with the LW being expected to be significantly higher.
- If a national PL (or MW) were to be taken as a point of departure for a London LW, with cost adjustments, the latter would primarily involve the (considerably higher) level of London housing costs – though the magnitude of these depends crucially on assumptions about tenure (and on housing benefits).
- A separate issue is the different makeup of the population and households and indeed of access to subsidised housing – but the assumption used is on a standard family across the country.
- It is not possible simply to make such an adjustment from an available Cost of Living index, since:
 - ONS appears to have abandoned efforts to construct such a regional index (though proposals for regionalised public sector pay might revive this);
 - The existing area cost adjustment formula is not fit for this purpose; and
 - What would be required is a customised measure for working households on the margins of poverty, who face different patterns of cost, especially in relation to housing.
- The GLA Living Wage Unit's current basis for defining a London LW is a compromise between two methods – one based on (indirect) costing of the basket of goods, the other on a translation of the idea of a median-related PL to wage levels – with an additional contingency allowance.
 - The combination of methods drawn from different approaches is a sensible insurance against data inadequacies and the heterogeneity of the target group;
 - The contingency allowance added on to the threshold poverty wage, as security against descents back into poverty is an intuitively reasonable concept, but not currently supported by substantial argument or evidence as to the appropriate scale. It should be explored in future rounds of LW setting.
- Beyond recognition as morally fair and economically realistic, requirements for a local LW to be used both as a contractual condition for public agencies and as a normative standard for socially responsible businesses are that it be:
 - Reasonably transparent in its bases;
 - Updatable in a smooth/predictable manner avoiding sudden shocks for its users or unplanned disruption of relativities; and
 - Certain in its implications and free of conflicts or confusion with any other LW standards operating in the community

Establishment and Fixing of Local Living Wages in London and elsewhere

Grassroots movements to establish local LWs have spread during the past 20 years in contexts where provision or support for public services has been out-sourced from public agencies to suppliers whose competitive edge depended on lowering wage costs, and where wage inequality had grown sharply. They have been strongest within US cities, where LWs of some kind have been widely adopted. By contrast in continental Europe, where neither trend has been as strong over this period, developments of this kind are much less evident.

This range of initiatives has had a number of things in common, notably an emphasis upon securing family living standards with a wage above the applicable MW – adequate to make the family independent of means-tested benefits, and a typical focus on two parent/two child households.

An ILO review of practice in advanced economies¹ identified 13 different methodologies (6 classed as original, of which 4 were more widely copied, and 7 classed as derivative). These vary in several detailed respects, notably in the assumptions they made about relevant household sizes and numbers of earners – two key factors (along with number of hours to be worked) in making a translation between household economic needs and the wage level required to secure it. There are also examples of inappropriately arbitrary assumptions, as in taking either required food or housing expenditures as a fixed proportion of the total, without regard to how (very large) actual variations in the price of housing would alter these. From our perspective, the most significant general difference lies between:

- a) those which were based on assessment of the costs of acquiring a given basket of goods in the context of a particular area (in two cases with an additional allowance for contingencies²); and
- b) those which are based on application of a national PL with adjustments e.g. for housing cost differences.

Significantly, none of them appear to have made reference to a national / state MW, adjusted in some way for local price differences.

In **London**, the LW adopted by London's first elected Mayor (Ken Livingstone) in 2005 was the outcome of a 5 year campaign initiated by a broad alliance of East London communities associations (TELCO³), later joined by the UNISON trade union, and inspired by US examples, notably the Baltimore LW⁴. The campaign initially focused on the position of contract cleaners working for major banks at Canary Wharf and in East London hospitals, taking as its standard a calculated living wage rate for London computed by the Family Budget Unit at York University.

The campaign gained some direct successes and generated a *Socially Responsible Contracting* document in 2003 (which estimated the additional costs on contracts of meeting the LW standard to be 30%), prior to persuading the successful Mayoral candidate in the 2004 election to establish a Living Wage Unit within the GLA to take over production of an annually updated London Living Wage standard. Following the 2008 election, the next Mayor agreed to continue this practice, and has lent his active support to the LW campaign, most clearly in a 2010 London Assembly session when he announced the new figure, and

the latest set of big employers signing up to the standard⁵, saying that, though there could be problems:

'at the margin, for some employers, particularly people with businesses on very tight margins.... I became convinced by it talking to people [in charge of] very large organisations who'd had people on quite low wages - very low wages - and who'd found that it generated loyalty, and that it thereby enabled them to cut down on their employment costs in hiring and firing. And I think that that is a powerful case that we can make to London and to London business' (Question Time 9th June 2010).

The original FBU report⁶ produced estimates of the weekly incomes required for five types of household, each with 2 children and living in local authority housing, but variously with one or two parents and different combinations of part and full-time work (a lone parent with 2 children, and a two parent household with one full-time and one part-time worker) to maintain a low cost but acceptable standard of living in East London. At 2001 prices the *net* income required ranged between £267 and £337 per week, while the gross hourly pay rate required to achieve this ranged between £3.70 in one case – equal to the national minimum wage at the time - and £7.88 in another.

These estimates were an adaptation of a set initially produced for York, carefully adjusted in relation to East End prices and preferences, on the basis of focus groups. Though various cost differences between the two locations are noted, no overall comparison is presented. In fact, the bottom-up approach seems more geared to producing absolute local estimates of the required budget for target groups, than making inter-area comparisons. And, it could not be applied to estimating a national average benchmark, without substantial compromise on the methodology.

When the GLA Economics' LWU assumed responsibility for determination of the London LW standard in 2005 they applied a more sophisticated combination of methods to defining it, which have continued to be used in annual updates⁷. This maintained the FBU definition of an LW as aiming:

To provide a **minimum acceptable** quality of life ... as a wage that achieves an **adequate** level of warmth and shelter, a healthy palatable diet, **social integration** and **avoidance of chronic stress** for earners and their dependents⁸.

But, critically, it distinguished between a poverty threshold wage (effectively the wage corresponding to PL) and the living wage (LW), setting the latter about 15% higher in order to cover 'contingencies', over and above the basic budget, on which the family might sooner or later need to expend resources.

The poverty threshold itself has been set by reference to two kinds of evidence:

1. *Basic Living Costs*: the estimated local cost of a standard 'basket of goods', as in many US initiatives (a simplified version of the FBU approach), focused particularly upon four categories where London costs were known to differ significantly: housing, council tax, transport and childcare. Households with children are assumed to live in social housing, and those without in private renting; and

2. *Relative Income*: adapting the national (60% of median disposable income *after housing costs*) operationalisation of the PL to the London level.

In both cases, estimates of the required wage (the poverty threshold wage) are derived separately for household types, and then averaged (weighted by numbers involved), rather than privileging a particular household model, as in some of the US methodologies. The two estimates of the poverty threshold wage are then simply averaged.

Finally the 15% margin is added on to convert this to an LW estimate. This margin (or contingency allowance) is repeatedly referred to in Mayoral introductions in the terms:

'A 'living wage' must include a reliable margin over and above this, which has been taken at 15 per cent, such that the person receiving it will not fall into poverty if they face the kind of day-to-day challenges that those of us who are better off can take in our stride'.

It is an intuitively plausible idea, but not given further explanation (or evidence base) in the published reports. As noted, it seems to have one precedent in the Canadian Centre for Policy Alternatives methodology where a (rather smaller) contingency allowance is explained as providing for cover for two weeks per year of required absence from work by a parent. But this is not referred to in the GLA work, and the 15 per cent margin seems quite arbitrary after detailed calculation of other items.

It should be noted that the London LW is computed on the basis that workers will be taking up *all* available benefits and tax credits – unlike some US standards which aim to make workers independent of means-tested benefits⁹. The difference between London LW assessed with and without benefits is £1.80 on the 2011 estimates, i.e. the *average* recipient of the LW would still receive that amount in benefits (adding 25% to the cash value of poverty threshold wage or 21.5% to the LW). One effect is that when benefits are restricted (as in 2011) the value of the London LW is raised to compensate for this. This is one reason, in addition to differential rates of inflation for items on which poorer workers in London spend more, why changes in the London LW standard since 2005 do not simply follow an average of UK cost of living and median earnings trends.

Issues with and Alternatives to the GLA's London Living Wage

Adoption (and continuation) of a London Living Wage by London's first two directly elected Mayors has been a very significant and constructive step, in a city where:

- income inequalities have grown very substantially;
- money wages in the bottom tranche of jobs have been depressed;
- living costs have risen faster than elsewhere because of increased pressure of housing demand (from those with growing incomes, and to a lesser degree from migrants); and
- the National Minimum Wage has little relevance.

The initiative is still quite young, and much of its potential is likely to be symbolic / normative (both for the private sector, and for local authorities). Its value in this regard

depends *both* on its being seen to be reasonable *and* as a *uniquely* authoritative definition of the LW standard for London employers.

Any suggestions for revision or alternatives ought to have regard to both of these considerations.

By the standards of methodologies adopted elsewhere, GLA Economics' Living Wage Unit's work has been relatively sophisticated. Its two basic elements, relating respectively to costs of specific basic needs and to the relative income standard conventionally used to set poverty lines at national level, relate to the main alternative approaches pursued in the North American literature. This could seem schizophrenic, and is not clearly explained, but seems essentially to represent a form of triangulation which seeks to minimise the distortions liable to be produced by any single method, in a context where basic data is limited (in relation to living costs) and the affected population is very heterogeneous. That heterogeneity remains a problem in detailed application of the methodology, but it is problematic for the inescapable reason that different household structures and housing situations can radically alter the impact of a worker's wage on the welfare / poverty of their household. That tension cannot be resolved directly, but where low wages are a major cause of poverty (and the tax/benefit system cannot fully compensate for these) it cannot be avoided either.

The other aspect of the sophistication of the London Living Wage is the 15% margin for contingencies simply added on to the poverty threshold wage, with only the sketchiest of suggestions as to its precise rationale, and no discussion of why its scale should be what it is. That is unsatisfactory and does not add to the credibility of the LW standard, which may become more important in difficult and austere economic times. The argument is intuitively right and there must be social scientific work and evidence which could buttress an allowance of this magnitude – but it really does need to be worked through and presented in reports in future years.

One possible alternative to the present basis of calculation of the London Living Wage could be a cost of living adjusted version of the prevailing National Minimum Wage (the London Minimum Wage Guidance or LMWG). Two positive arguments in favour if this are:

- its simplicity and transparency – at least in relation to the NMW, though establishing a relevant cost of living index (in the absence of any official sub-national ones) brings us back to many of the problems faced in pricing a set of basic needs; and
- its likely relative stability / smoothness of trend (now the NMW itself has found its natural level), as compared with the LLW (see Figure 2 below) – though as we have noted earlier this instability, and faster recent rates of increase, is less reflective of any technical problem, than of the influence of more restrictive welfare policies on the gap between continuing needs of those on low wages and the support available from their benefit/tax credit entitlements.

This last point really says that the LLW standard is behaving as one would expect any LW standard to do. It links to a more fundamental observation, namely that the LW and MW are conceptually distinct – and that almost of necessity the LW can be expected to be significantly higher, as well as distinct in its trends.

In our view there is a clear role for something like the LMWG – but as a statutory provision within the Low Pay Commission's formal Minimum Wage setting - where account would have to be taken of labour market realities (including work incentives) as well as simply living costs – rather than as guidance.

Background Material

Setting the UK National Minimum Wage

National minimum wages have a long history in other Anglo-Saxon countries, including in the US (though its value in real terms has been on a downward trend over the past 40 years¹⁰). Among the EU/EFTA countries, a substantial majority have statutory minimum wages – mostly (apart from the UK and Ireland) long-established – while the remainder, including Austria, Denmark, Finland, Germany, Italy, Norway and Sweden, and Switzerland, generally have strong systems of sectorally-based collective bargaining with a high degree of coverage¹¹. The actual minima vary enormously in size between countries, however, being much lower in Mediterranean countries, and even more so in Eastern Europe. Among north west European countries, the UK figure appears (in Euros per hour) to be close to the lower end, just above Austria, significantly below Benelux, Germany or France, and half that in Denmark¹². It should be noted, however, that in practice coverage of minimum wages may be incomplete, with many migrants in particular being reported to have substantially lower pay (e.g. in the US or Spain¹³).

The UK minimum wage dates only from 1998, brought in by the Blair government in the wake of the abolition of (the more limited system of) Wages Councils by its predecessor. Its aims and scope were much broader than the Councils, however:

'It was a presumed permanent tool of economic policy intended to mitigate a number of deepening problems developing from Britain's increasing inequality of income. These included growing numbers of families and children in poverty, the escalating cost of combating that through social security support and the consequential discouragements to move from welfare to work. The minimum wage had to be palatable both to the employers who would have to pay it directly and to the wider society that might pay for it indirectly. To achieve this, it was important that it was fixed by a process that was both sensitive to economic circumstances and distanced from party politics (Brown, 2009)¹⁴.

As this description implies, the UK's MW was not simply conceived of in LW terms (though that was an aspect of it), and the independent Low Pay Commission (LPC) established to set and monitor its level did not proceed by assessing the economic needs of workers and their families. Nor did it start with terms of reference which provided clear pointers to the basis on which the MW should be determined. The retrospective account of an insider rather points to a process in which the LPC felt its way toward decisions which secured internal unanimity (across social partners and independents), continued government acceptance of the Commission's role, and the avoidance of damaging economic consequences. In its first phase, this involved a rather cautious approach until evidence was secured of the absence of significant negative effects, then (in 2003) it formulated a positive statement of aims as:

'to have a minimum wage that helps as many low-paid people as possible without any significant adverse impact on the economy'.

Accordingly for the next 3 years the MW was increased significantly faster than overall earnings. In 2006, however, they defined this phase as being complete (i.e. the MW as

having arrived at a more or less appropriate level), with future increases more likely to be at or around those in average earnings¹⁵.

It should be noted that, as a new and potentially vulnerable initiative, the LPC sought very active enforcement of the MW¹⁶. Though there clearly are infractions in segments of the market (including in London's Chinese labour market), and the LPC has drawn attention repeatedly to weak enforcement and penalties, it still seems very likely that the UK MW is more effectively enforced than its (much longer established) US counterpart¹⁷.

The London Weighting and Other Central Government Policies Relevant to Area Differences in Costs

Though the MW is not currently differentiated by region there are other areas of central government policy which are relevant to area differences in the Living Wage. These relate, on the one hand, to public sector pay and, on the other to the funding of local authorities in areas with higher/lower costs of living and higher/lower market wages.

Traditionally public sector pay in the UK - like rates of social benefits - has been set nationally, without regard to cost of living variations or labour market competition. The last government sought to move away from this toward regional differentiation responding to such factors, with limited effect. The coalition government is minded to go much further, as indicated by the Chancellor in his Autumn Statement, promising a shift toward market-based regional pay differentiation.

Historically, however, the one important departure from the principle of uniform pay norm has been *London Weighting* (LonW), which has generally been used in its current form since 1974, is an addition to the pay of public sector workers (including teachers, police officers, civil servants, firefighters and college staff) in London to take account of the higher costs of living in the capital. Civil service LonW-type payments have been made since the 1920s. Average payments are currently about £4000 per annum.

The Pay Board, which recommended a level of LonW which “aimed to compensate employees for the additional costs of living and working in London, and to equalise real earnings for comparable work elsewhere in the UK. The allowance consisted of four main elements – housing, travel to work, ‘wear and tear’, and other consumer expenditure, and was applied uniformly across the public sector”¹⁸. These are of interest here, since London Living Wage issues are analogous to those underpinning the LonW.

LonW is a source of payments to staff members that, in turn, have implications in terms of differential costs for local authorities (and public sector institutions such as NHS Trusts, universities etc.) for which central government has to make provision. The relatively high labour costs faced by a number of councils as a result of local labour market conditions have for many years been recognised by the *Area Cost Adjustment* (ACA). Successive governments have accepted that the costs of employment are higher in some parts of England than others. Much research has been commissioned by the government and by councils themselves in an attempt to produce a defensible measure of the different costs of

operating public services. Similar 'London weighting' type measures also exist in the NHS, the police and other parts of the public sector.

The official use of ACA-type funding supplements means that government departments (and the Treasury) accept that costs of living vary substantially from place to place. The Chancellor has recently announced an inquiry into the possibility of introducing differential regional pay rates within the public sector in England. The acceptance that there are significantly different living costs can also be seen as part of the justification for having a 'living wage' in London.

In the Department for Communities and Local Government's publication *Methodology for the Area Cost Adjustment 2011/12 and 2012/13*, it is stated that the underlying rationale for the labour cost adjustment (LCA) within the ACA "is that local authorities have to compete for staff with other potential employers...in order to secure and retain various categories of staff of a given quality, they will need to pay the local 'going rate'¹⁹ The LCA draws its data on wage rates from the Annual Survey of Hours and Earnings (ASHE).

The starting point for calculating LCA factors is wage evidence for each area, using hourly wages excluding overtime. However, average wages vary between areas for a number of reasons. For example, there are differences in the structure of employment – some areas having a high proportion of people working in relatively highly-paid sectors. Such differences are taken into account so as to identify accurately the underlying going rate for each area.

The local government ACA uses regression analysis to establish underlying wage differentials. A regression is run on hourly earnings (excluding overtime payment) against a number of variables. The control variables include age, gender, occupation and industry. The coefficients on the area variables suggest the relative wage in each area, having allowed for differences that are due to the control variables. There is 'smoothing' to reduce volatility.

Labour cost adjustments vary from 1.555 in the City of London, 1.305 in Inner London, 1.1705 in West Outer London and 1.1081 in the rest of Outer London. There are similar adjustments for areas around London, and smaller ones for a number of places outside the Greater South East. These labour cost adjustments are applied to a proportion of spending within each service block within the Revenue Support Grant to deliver an uplift that recognises the relatively higher labour costs in some areas.

Of course, pressures for higher public sector labour costs are not the same as the pressures on lower-paid workers in the private sector, though there might be implications for staff on contract to a council or other public sector institution in the context of a 'living wage'. It is clear there are significantly different pressures on public sector pay inside London and, also, in London as compared to the rest of the country. A living wage might be expected to reflect similar levels of differentiation. The London Living Wage has been in the range of 30 to 35 per cent higher than the National Minimum Wage in recent years²⁰ - roughly in line with overall earnings differentials.

Evidence on the incidence of low pay in London

There are two relevant official sources of evidence on pay distributions at sub-national level:

- The Annual Survey of Hours and Earnings (ASHE - previously the New Earnings Survey, NES) an employer-based survey with a sample drawn from PAYE records, covering approximately 1% of National Insurance contributors, though about 30% are missed either because of employer non-response or employee turnover. These may produce weaker coverage at the bottom end, though a supplementary survey of employees with pay below the NI threshold suggested that their omission made only a small difference; and
- The Annual Population Survey (APS – incorporating the Labour Force Survey, LFS), with coverage of employees across all pay ranges, and weighting to adjust for non-response, but reliant on individual reporting of pay/hours, which may be less accurate than that of firms. This source has the advantage of substantial background data on individuals (and their households), beyond the simple age, sex, occupation and industry available from ASHE/NES.

The NES/ASHE is particularly useful in charting regional differences in the pay of particular occupations and how these have evolved. Figure 1 focuses on the set of (specific) occupations with the lowest average pay nationally, and 20% of total employment in a benchmark year, i.e. the bottom quintile, the group to which an LW is likely to be relevant. It charts the how its average hourly pay at regional level (adjusted for price changes) has fluctuated since the mid-1970s. Throughout this period London stood out as having significantly higher pay than other regions, in these bottom tier jobs as well as in the higher rungs. But in this case uniquely the differential (which had been around 25%) was very largely eroded during the later 1990s, before recovering partially a decade later. The national MW was a contributory factor, because most London workers in these jobs already earned more (in cash terms) than the MW level, from which workers in other regions benefitted. Another, stronger factor, however, was the short-term impact of the upsurge in migration from poor countries during this period²¹.

The 2009 APS²² indicates that about 16% of London workers then earned less than the 2009 London LW. Of these about half appear to be full-time workers. Half were single never married. Half were in households with children – most commonly a couple with 2 children, though this type only included 20% of those with children. Almost half were owner-occupiers, while about a quarter each were in social or privately rented accommodation. Half of them worked for private firms in workplaces with less than 25 employees. This is a very diverse target group to have to address – probably more so than would be the case elsewhere in the UK.

On average, the weekly earnings of those with pay below the London LW were a quarter of those above it. Hence the total wage bill of those in this situation was just 4% of total London wage costs. The aggregate economic impact even of quite large proportionate changes in earnings within this group from a successful LW policy would thus be limited

Evidence on cost-of living differences between London and the UK as a whole, as they affect the lower paid

The fact of higher living costs in London (and big US cities) than in the wider territory for which the MW is set – implying a larger shortfall from a (real terms) LW – is a very important part of the rationale for the local LW initiative. It is a good deal harder (particularly in Britain) to establish how large this gap in living costs actually is, and hence to design and update a local LW with an equivalent real value to the national MW (or some proportionate mark-up on that) – if that were the intention.

In contrast to the US, there are no systematic sub-national cost of living indexes in the UK, and occasional pilot exercises from the ONS²³ have been both incomplete and subject to conceptual difficulties /uncertainties²⁴. Building on the 2004 initiative, and in line with the then government's commitment to publish regional indices and to take more account of regional and local conditions in determining public sector pay, it was expected that there would be a regular series. But this has not materialised, and nothing seems to have been produced since 2004. This situation might conceivably change with the present government's apparently stronger intent to pursue regional pay differentiation – though with an emphasis on reflecting market forces (suggesting reference to private sector pay norms rather than living costs) this may not be the case. There are, of course, private consultancies (such as Regional Reward Services²⁵) supplying estimates of regional cost relativities, but their frame of reference tends to be that of mobile professionals/managers rather than those close to the breadline. Their estimates of the London cost differential have been typically *much* higher than official methodologies would imply²⁶, probably because they are geared to relocation situations and costs of an identical lifestyle in different places, whereas established residents make adjustments in the face of relative local costs.

For the most part, calculation of comparative regional consumer price indices simply involves use of disaggregated data from the existing sources used to compute national time series data. The one evident issue with this concerns margins of sampling error, and it is clear that, without a substantial increase in sample size, time series data for regions could not be produced with a precision comparable to those in national estimates.

Where the same representative basket of goods is not appropriate for all areas there are additional difficulties in estimating weights. This is likely to be particularly relevant in London because of the different age, household structures and income differentials observed in the capital – all of which affect the weights relevant to any particular area. The only consistent attempt to produce an index for a particular group is that for pensioners – which is subject to considerable criticism because of lack of robust information about the relevant basket-weights.

The evidence from the pilot studies is that for a very wide range of goods and services inter-regional price differences are modest in scale, and London prices are not substantially or consistently above the national average. Indeed in some contexts, notably car running costs and basic foodstuffs they may even be lower. A similar message came from the FBU work on LW estimates for the low paid groups in York and East London. From their local

investigations and focus group work they reported that only insurance, childcare, water charges and housing were significantly more expensive in the latter area (while a few items were slightly cheaper). The two major comparative analyses - by the Employment Policy Institute in the US and the Centre for Research on Social Policy in the UK - across a range of cities similarly indicated that only rent, local taxes and child care costs varied significantly by locality²⁷.

The major difficulties come with elements of living costs that are strongly related to density and agglomeration –both in relation to housing and to transport – where the amount, type and mix of what is purchased – as well as its price - varies as a consequence of these factors, which also affect the significance and subsidy element of public provision in these services.

In the case of housing, inter-area differentials arise from the difficulty of adjusting supply to changes in demand particularly in areas of increasing population and incomes. In developing the social security system it was always recognised that (i) most goods would have very similar prices across the country because of competition and replication and (ii) the differences in housing costs were so great that it was too costly to include them in the basic minimum income requirement because those in high housing cost areas would need so much higher a minimum income than the average. As a result housing was always been excluded from the social security minimum income levels and subsidy payments have been related to individual circumstances. In the housing case, there are the additional complications including:

- (i) for owner occupiers the timing of financial outlays is not simply related to consumption of housing services, and that part of their expenditure is in the nature of investment, especially in those more pressurised areas where asset values can be expected to grow faster. In these areas while direct costs may be disproportionately high the overall return on investment may be more than enough to offset these costs over a lifetime;
- (ii) while those living in social housing have faced much lower than market rents – and therefore require a lower wage to cover their overall costs - access to social housing is highly restricted, especially in London to the point where relatively few working households, especially with two workers, have been eligible;
- (iii) more generally housing cost tend to vary in relation to the time people have been in their home – with costs for new entrants much higher than average (again Londoners move more often and so tend to face higher than average costs) . This is particularly relevant if the objective is to ensure an adequate supply of labour – although this is not a direct objective of the Living Wage; and
- (iv) finally, there is the issue of whether it is appropriate to use the actual basket of goods observed as this is itself is the result of people being excluded from living in London because of these higher costs. Households unable to afford adequate housing move to cheaper areas thus modifying the socio economic mix and income distribution. In incentive terms this matters only if there is an inadequate labour supply; but in terms of equal opportunity this exclusion may be relevant.

In the London context at the lower end of the labour market, the choice of housing, especially for new entrants may be limited to private renting. Relatively few such households can afford the entry costs of owner occupation. Equally relatively few households in full time employment (especially if there are two earners) are likely to be in priority need for social housing. The majority of households looking for accommodation will therefore be accommodated in the private rented sector. Even so, there are many households even on lower incomes who have in the past gained access to social housing and owner-occupation and who will therefore almost certainly pay much lower than average housing costs. More generally the situation in London is clearly different as compared to parts of the country where there are larger social sectors and lower priced owner-occupied housing available. This applies both to the cost per unit and the weight given to housing costs in expenditure patterns

Estimates of cost differentials for London

There have been no official statistics on regional price differences in the UK to provide an authoritative answer. A first (almost complete) set for 2000 was published by the Office of National Statistics (Baran and O'Donoghue, 2002). These showed that on average, prices of goods purchased in London were 2.6% above the national average (with differences of 4-7% for food, non-alcoholic drinks and clothing). Overall goods prices were higher than in any other region, the second highest being the South East government office region.

For services – where local wages and rents figure more strongly among costs -- price differences are wider, with the London average (for items other than housing) being 7.3% over that for the UK and 12-13% above that in the low labour cost regions of the North East and Wales. In the neighbouring South East and Eastern regions service prices were found to be 4-5% below those inside London.

The main single factor in London's higher living costs is housing. Conceptually what is required for this purpose is not a measure of what new purchasers and renters pay but rather what the average household (not the new entrant) needs to ensure minimum standards. Also for owner-occupiers what is required is not the average mortgage payments among occupiers, but an imputed cost reflecting the value of the rent which occupiers should pay themselves in their role as owners. Two reasonable starting points are the percentage differences in free-market rents and mix-adjusted house prices between London and the UK. The latest DCLG figures suggest that the differential in private rents between London and England as a whole is about 57% - although this figure is based on 2007 evidence. The differential in house prices at the end of 2010 was 61% for mean house prices and 51% for the median – which is more relevant to lower income households. These figures are fairly consistent with earlier years so provide a reasonable starting point..

Of importance in estimating the differential costs is the assumption to be made about access to income related subsidy. In the USA where income related benefits are available only at the bottom of the income distribution the Living Wage is usually calculated to enable the household to live adequately without recourse to benefits. In the UK where income related benefits go further up the income scale a definition which assumes all households will claim what they eligible for is more relevant. Over 30%, and perhaps even 40% of

households in the private rented sector are eligible for the Local Housing Allowance (LHA) which will dampen – although by no means remove - the inter-regional differentials. Into the future as LHA is restricted to the lowest 30% of the local market these differentials are likely to increase.. How much housing assistance a household on the Living Wage would receive would depend on location within London and on household circumstances as well as income so it is not possible to give a clear estimate of outcomes.

More generally, the impact of higher housing costs varies substantially between groups in the population, according to the share of their overall expenditure which is devoted to housing. In particular, this reflects income levels, household size, the housing tenures to which people aspire and/or have access, and in the case of owner-occupiers how recently they entered the sector. Those most sensitive to London's higher housing costs are those on lower incomes, with fewer working-age adults in the household, and more recent entrants to owner-occupation. Outright owner-occupiers (without mortgages to pay off) are the least sensitive, while tenants in social housing are currently protected by a smaller London differential in this sector – averaging 35% in the local authority sector and somewhat lower at 30% in the Housing Association sector.

In terms of overall standards of living there are three aspects of these figures which need to be taken into account (i) no allowance is made for capital gains which are clearly far higher especially in absolute terms in London than elsewhere; (ii) on the other hand, differences in the quality are not taken into account – so Londoners on average actually buy smaller dwellings and a higher proportion of flats than elsewhere in the country; and (iii) these costs are anyway averages – they take no account of the differential problems faced by new entrants or how individual households fare.

In terms of suitability for estimating the living wage the first two issues may not be so relevant as compared to the principles around estimating the standard of living. The third is relevant and ideally one should be using estimates that relate to households who are otherwise at the living wage level.

In current housing conditions, unlike earlier estimates, it may well be reasonable to argue that private rents provide the best estimate of housing costs for relevant lower income households –especially those just entering the housing market. The GLA estimates have traditionally used council house rents for a three bedroom family home. This could be argued to be inappropriate in the current environment because of the lack of available council housing as compared to other tenures; the mix of households in London which disproportionately includes smaller households; and government policy which is looking to achieve higher densities of occupation and to use private renting for most requirements.

Even so, using private rents within the calculations for the Living Wage, even allowing for eligibility for the LHA will both increase differentials with the rest of the country and significantly over-estimate the costs for those in social housing and owner-occupation who may have lived in London for many years. In this context, it is relevant to note that under the Affordable Rents regime social rents will slowly move much closer to rents in the private sector. This will further significantly increasing the differential housing costs for Londoners.

Overall, it is housing costs which point towards the need for a different living wage for London. Estimating such differences is however fraught with difficulty not only because of the quality of the data but because of the enormously varied individual opportunities. The GLA methodology does not fully reflect the housing circumstances of Londoners even at the present time and is likely to need significant adjustment over the next few years. But the principles of accepting the role of income related housing benefits in determining the Living Wage and of identifying housing costs as the most important element in differential costs of living appear robust.

Available evidence on potential knock-on effects of application of a London/local employer Living Wage significantly above the present National Minimum Wage.

Some indirect effects of MW regulations, beyond a simple raising of lower wages up to MW level, are more or less inevitable, and maybe intended. In particular, wage levels for jobs previously paid just above the threshold are also liable to rise to some extent, particularly where the same employers are involved, and there is a need to preserve some pay differentials. Studies of the UK MW are ambiguous about whether there has been any real spillover of this kind. But even the one suggesting some such effect during the period of significant up-rating in NMW (2003-6), suggests that two thirds of the impact on pay was contained within those on the NMW²⁸.

In the US a majority of economists believe MW to have negative effects on employment and efficiency, though labour economists are divided on this²⁹. In the case of the UK MW, however, the consensus of empirical studies is that there has been no effect on employment levels, while among the candidate explanations is the possibility that changes in practices induced by the MW have boosted *both* productivity and competitiveness³⁰.

In the case of LWs which are applicable only to firms involved in supplying public agencies associated with the initiative (or perhaps in receipt of support from them), and to those firms who choose publically to align themselves with the LW initiative (as a matter of principle, for reasons of staff morale, and/or public relations), the spillover effect to higher wage bands might be weaker. There could (and should) be spillovers to pay levels for similar groups of low paid workers in other firms, without such direct links to public agencies. Where their pay is unaffected, there could of course be gains in employment offsetting any losses that there might be among firms adopting the LW (if they did not actually receive boosts to their competitiveness).

Definitions and Approaches: Living Wage, Minimum Wage and Poverty Lines

This section presents a review of the relation between three concepts – the Minimum Wage (MW), Living Wage (LW) and Poverty Line (PL) – and how these have been applied in practice, since versions of both the MW and PL are currently in operation in the UK, applied on a nationwide basis.

All three of these ideas, and the labels themselves, have roots in the late 19th century, as reactions to situations, not least in London, where poverty was rife, as a consequence of low wages among a substantial segment of the workforce, as well as substantial under-employment, associated with chronic problems of ill-health/unfitness, and of a casual/semi-casual labour market, together with great cyclical volatility in the structure of demand, and competition from migrants desperate for work. At this time the 'LW' term became an element in Catholic social teaching, though with very doubtful salience in Britain.

In some places, notably Australia and New Zealand, responses to similar situations included legal specification of an MW – though sometimes referred to in LW terms. In the US, a national MW was introduced later, in the 1930s, in the context of the last great Depression³¹. In the UK, however, this was not the case (at least across mainstream labour markets). Rather the portfolio of policy responses focused on efforts to reduce under-employment (e.g. through creation of labour exchanges), improve health/housing conditions, and provide forms of social protection for those who fell into poverty. In effect, the issue of low wages was left to be dealt with through collective bargaining in the labour market (involving much extended membership of trades unions, with substantial legal protection for their activities), bolstered over time by a social wage that provided some kind of effective floor to market wages (for those entitled to it), and by promotion of fuller employment (particularly in the second half of the last century by macroeconomic policies). Only exceptionally in 'sweated trades' where collective bargaining was perceived as inadequate, or pay was especially low was this regulated by Wages Councils - until these were abolished in the early 1990s.

Within this British package, the PL concept played a very important role, underpinning the social wage by defining a minimum decent standard of living to which all in the society should be entitled, whether able to work or not. Its basis was identification of a set of individual basic *needs*, for people in different demographic positions (children, the elderly etc.) and translation of these into material requirements, and the financial costs required to assure these. A fundamental issue of debate, however, was as to whether these needs (and the ways in which they could be met) were *absolute* in character, applying in the same way across times and places, or were essentially *relative*, reflecting socially defined aspiration levels which differed between societies and would shift over time, as general levels of productivity and affluence grew. Political debate over this continues, but the mainstream position (influenced in the UK particularly by Peter Townsend's work) has come to be one defining needs, and the state of poverty arising when these are unsatisfied, as absolute in character (not simply expressions of envy) - *but* as nevertheless shifting in relation to the norms of the society, determining what in practice it takes to be an effective member of the society, able to bring up children adequately, and develop/sustain the attributes required

for employment. Operationally, on the basis of policy responses to a series of studies, this came to be translated, both in the UK and by international agencies into a PL expressed as a proportion of a median household income (adjusted / equivalenced for household size and demographic mix) – generally at 60% of that level.

Commonly, as in the UK, the PL is set nationally, implying both that needs/standards are to be defined across the *national* society as a whole, and that the costs of meeting these are effectively constant across the whole country. An implicit exception to this is where needs are to be met directly by provision of public services, rather than through financial provision, since the real cost of these services may vary substantially (e.g. where labour and premises costs are higher, or low density makes delivery expensive and provision less efficient). A more explicit (though uneven) exception is in relation to housing costs, where allowance may be made for area differences, either by defining household incomes after deduction of housing costs, or relating housing benefits/support to prevailing market rents.

The terms of debate about practical ways of securing the minimum basic standard of living (at/above the PL) shifted in the 1990s – at least in the UK and US – as a consequence of shifts, within the previous decade, in the scale/intensity of economic competition and how this was reflected in the labour market and the role of the state. In particular, these came to involve labour market deregulation (with a weakening of union power), a strong trend to wider inequalities in earnings/wages, and a shift away from direct provision of public services by state agencies and toward a mix of direct market provision and competitive tendering for sub-contracted work. Shifts in political priorities led also (in the US) to attrition of the real value of the MW, and (in both the US and UK) to greater concern over 'dependency' on state benefits and a perceived lack of work incentive, with reforms weakening the extent to which the PL could be counted on as setting an effective floor to market wages. In this context, increased immigration played a role, exerting a downward pressure on earnings in activities which had been immune to direct competition from low wage economies because their products were essentially untradeable.

Political responses to this new situation included a heightened attention to issues of wage levels at the bottom end of the labour market and poverty among the employed (the 'working poor'). In the UK such concerns, and those with work incentives, led to the introduction by the Blair government in 1999 of a first national MW. In the US - which already had both a national MW and higher MWs in many states - the main response was at grass-roots level in cities with campaigns for a locally-defined LW, notably in Baltimore, where the city legislated for this in 1994. Many other places have followed suit, and the issue is currently under (very) active debate in New York City. In the UK, their example has so far only effectively been followed in London, where the Mayor adopted a London LW in 2005.

In these cases, the idea of an LW has come to have a much more particular application, additional to the normative role which it has played over the previous century, and also distinct from the (national or state-wide) MWs. This specifically focuses on the minimum wage to be paid by city agencies themselves, and (more importantly) by those with whom they contract for provision of goods/services - together sometimes with those private businesses in receipt of subsidies (or other privileges) from city authorities. Outside these

bounds, however, the LW is seen as playing a normative role, defining a socially acceptable basic wage level, which LW cities also actively seek to get major employers to publically sign up to (as in the London case³²).

These local LWs are naturally set above the wider national/state MW, else they would be irrelevant. In the places where they have been introduced, there are two basic rationales for setting an LW significantly above the MW. One of these has to do with local living costs which are often well above the average for the territory across which the MW is applied, notably in major cities/agglomerations with high land/housing costs (and consequentially high costs for untraded services). The other, however, has to do with a rather different/broader target group. As one commentary suggests³³:

'the minimum wage is "negative": it offers legal protection against extreme exploitation by employers. The living wage is more positive: it is an acceptable wage for providing a household's basic needs'.

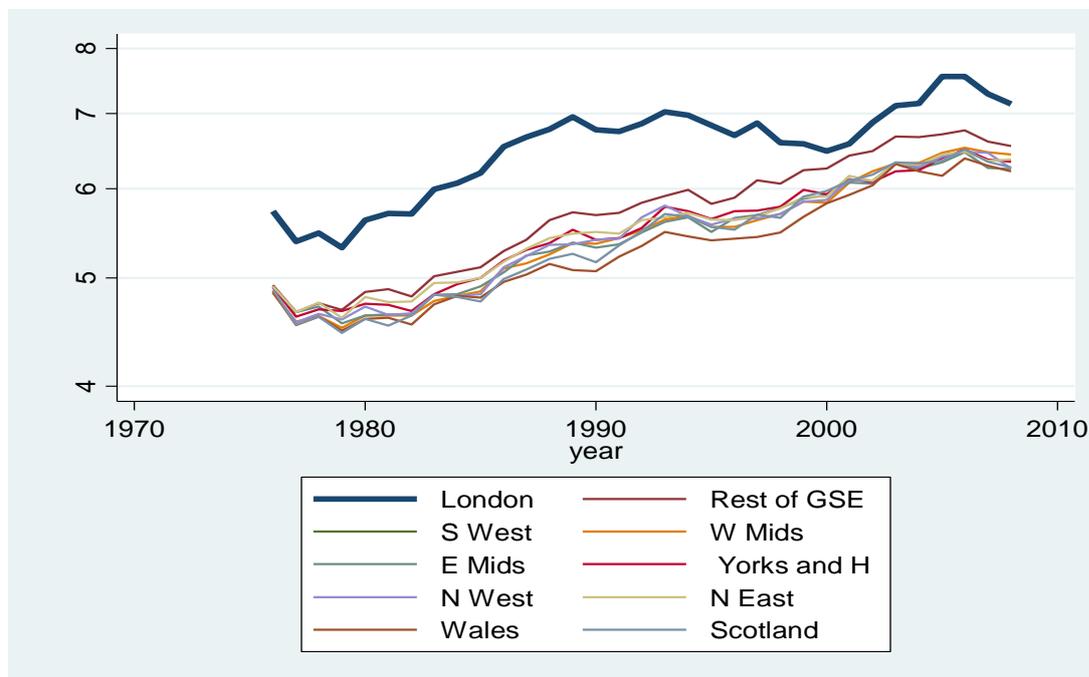
Household in this context typically implies a family, whereas the minimum wage is not set with regard to dependants. As an ILO review observes:

'There is a clear *overall consensus* that a living wage should be *sufficient to support a worker and his or her family*..... *A living wage is clearly a family concept*³⁴.

In contrast to discussion about MW, the review found that in principle the LW was seen as independent of labour market considerations, though in practice local economic conditions clearly affected the rates actually set in municipal living wage laws³⁵. It has to be grounded in judgements (backed up by some evidence) about needs and how these translate into financial requirements in particular local contexts.

Figures

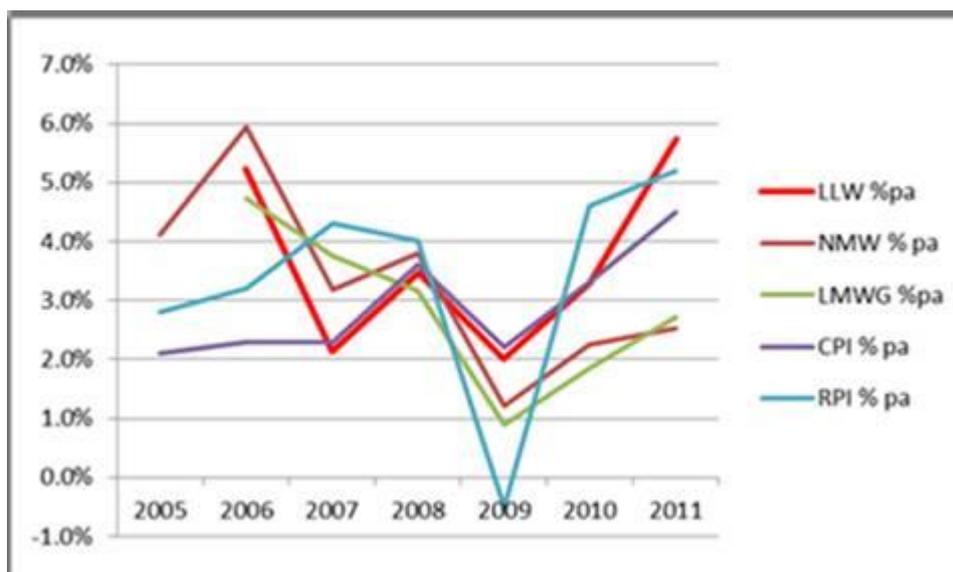
Figure 1: Bottom Quintile Real Hourly Earnings (£s 2008 UK prices)



Source:

I.R. Gordon and I. Kaplanis (2010) 'Accounting for Big City Growth in Low Paid Occupations: Immigration and/or Service Class Consumption', Spatial Economics Research Centre, LSE; based on NES micro-data.

Figure 2: Trends in Minimum and Living Wage series, the LMWG proposal and Price Indices



Source: produced for the commissioned project internally.

Notes

- ¹ R. Anker (2011) *Estimating a living wage: a methodological review*, ILO Conditions of Work and Employment Series, 29. The actual examples found were from the US, UK, Canada and international organisations.
- ² One of these cases was the Canadian Centre for Policy Alternatives, the other was the GLA's MWU (discussed below).
- ³ This became the founding chapter of the wider London Citizens organisation.
- ⁴ This chronology all derives from: J. Wills (2011) 'A chronology of the London living wage campaign', London Living Wage Research, Geography Department, Queen Mary University of London: (<http://www.geog.qmul.ac.uk/livingwage/chronology.html>).
- ⁵ Clifford Chance, Deloitte, Nomura, Prudential and Standard Chartered.
- ⁶ H. Parker (ed.) (2001) *Low Cost but Acceptable: a minimum income standard for households with children in London's East End*, Family Budget Unit, University of York. http://www.york.ac.uk/res/fbu/documents/lcba_apr2001b.pdf
- ⁷ Most recently: GLA Economics Living Wage Unit (2011) *A Fairer London: The 2011 Living Wage in London*, London: GLA.
- ⁸ GLA Economics Living Wage Unit (2009) *A Fairer London: The 2009 Living Wage in London*, Greater London Authority.
- ⁹ The reason is probably that redistributive policies in the US are more strictly confined to those below a PL than in the UK.
- ¹⁰ See Thomson and Chapman EPI impacts report, <http://www.epi.org/publication/bp170/>
- ¹¹ L.Funk and H. Lesch (2005) *Minimum wages in Europe*, European Industrial Relations Observatory Online : <http://eurofound.europa.eu/eiro/2005/07/study/tn0507101s.htm>
- ¹² Source as for ref 2.
- ¹³ M, Carley (2005) 'Industrial relations, in the EU, Japan and the USA 2003-4', European Industrial Relations Observatory Online: <http://eurofound.europa.eu/eiro/2005/02/feature/tn0502102f.htm>
- ¹⁴ W. Brown (2009) 'The Process of Fixing the British National Minimum Wage, 1997–2007', *British Journal of Industrial Relations*, 47, 429-473.
- ¹⁵ Source as for previous note.
- ¹⁶ Source as for previous note.
- ¹⁷ See Metcalf, D. (2008) 'Why has the British National Minimum Wage had little or no impact on employment', *Journal of Industrial Relations*, 50, 489–512. This cites US evidence (from Borjas) that two fifths of workers who qualify for the minimum wage were paid less than that around year 2000.
- ¹⁸ *Report of the London Weighting Advisory Panel*, June 2002, London Assembly, Greater London Authority, Para 1.4
- ¹⁹ Department for Communities and Local Government's publication *Methodology for the Area Cost Adjustment 2011/12 and 2012/13*, DCLG, 2011, page 2
- ²⁰ *A Fairer London: The 2011 Living Wage in London*, GLA Economics, May 2011, Table 4.3
- ²¹ I.R. Gordon and I. Kaplanis (2010) 'Accounting for Big City Growth in Low Paid Occupations: Immigration and/or Service Class Consumption', Spatial Economics Research Centre, LSE;
- ²² Used for convenience in the limited time, though 2010 data are available.
- ²³ D. Baran and J. O'Donoghue (2002) 'Price levels in 2000 for London and the regions compared with the national average', *Economic Trends*, 578, January; and A. Gall & D. Fenwick (2004) 'Relative regional consumer price levels in 2003', *Economic Trends* 603, February.
- ²⁴ Discussed in several issues of the City of London's *London's Place in the UK Economy* for which we have been responsible (notably the 2003 and 2004 reports)
- ²⁵ http://www.cronersolutions.co.uk/Regional_Salary_Surveys.html
- ²⁶ Around 30% as compared with 10-15%.

²⁷ Findings summarised in Table 13 of the ILO review cited above.

²⁸ The paper reporting the modest spillover is Dickens, R. and Manning, A. (2006) 'The National Minimum Wage and Wage Inequality: An Update', Paper to WPEG, 12 October. A more recent paper claiming no such effect (at the bottom decile) is Mark B Stewart (2011) 'Wage Inequality, Minimum Wage Effects and Spillovers', *Warwick Economic Research Papers*, 965.

²⁹ Wikipedia (n.d.) 'Minimum Wage': http://en.wikipedia.org/wiki/Minimum_wage

³⁰ Metcalf, D. (2008) 'Why has the British National Minimum Wage had little or no impact on employment', *Journal of Industrial Relations*, 50, 489–512

³¹ Though some 14 US states had attempted to legislate earlier in the century.

³² The most recent report on progress is in GLA Economics Living Wage Unit (2011) *A Fairer London: the 2011 Living Wage in London*, London: GLA.

³³ B. Haussamen (2007) 'The Minimum Wage: information, opinion, research', <http://www.raiseinwage.org/index.html>

³⁴ R. Anker (2011) *Estimating a living wage: A methodological review*, Conditions of Work and Employment Series No. 29, Geneva, International Labor Office, p. 24.

³⁵ Source as for previous note.