

EMPLOYMENT BILL

Impact Assessment –
National Minimum Wage
Enforcement

DECEMBER 2007

Summary: Intervention & Options

Department /Agency: BERR	Title: Impact Assessment of Employment Bill: National Minimum Wage Enforcement	
Stage: Final	Version: Final	Date: 5 December 2007
Related Publications: National Minimum Wage and Enforcement Agency Standards Enforcement - Government response to consultation		

Available to view or download at:

<http://www.berr.gov.uk/files/file42755.pdf>

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What is the problem under consideration? Why is government intervention necessary?

Underpayment of the National Minimum Wage (NMW) is both unfair to the workers who are underpaid and to compliant business who are undercut. At present, employers who are found to be underpaying their workers can repay what they owe without either attracting a penalty or remedying the loss of purchasing power that the worker has suffered as a result of the underpayment. Government intervention is necessary to remove all the potential profits of underpayment of the NMW, creating a clearer deterrent to non-compliance.

What are the policy objectives and the intended effects?

The Bill aims to strengthen NMW enforcement in three main ways. Firstly, by changing the way arrears are calculated so that workers do not lose out in real terms as a result of underpayment ("fair arrears"). Secondly, by introducing a new civil penalty for non-compliance to create a clearer deterrent than presently exists. Thirdly, by strengthening the criminal prosecution regime to provide more effective enforcement of the most serious cases of non-compliance.

What policy options have been considered? Please justify any preferred option.

The option of continuing with the current enforcement system has been considered but this would not meet the policy aims of encouraging a change in the behaviour of potentially non compliant employers. Primary legislation is required to strengthen enforcement of the NMW by changing the basis for calculating arrears, imposing a civil penalty and strengthening the criminal sanctions. The proposed legislation would not increase the regulatory requirements for compliant businesses and would improve fairness for them and workers.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The ongoing service level agreement between BERR and HMRC as NMW enforcers will ensure the level of enforcement and the associated costs and benefits will be monitored.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Pat McFadden, Minister of State (Employment Relations and Postal Services)

.....Date: 6 December 2007

Summary: Analysis & Evidence

Policy Option:	Description:
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' Employers: £0.15m to £0.3m for repayment of wages arrears to workers and £0.523m for penalty fees; Exchequer: up to £0.16m defending appeals and increased admin. None of these costs would arise under 100% compliance with existing NMW regulations.			
	One-off (Transition) Yrs				
	£ 0				
	Average Annual Cost (excluding one-off)				
	£ 0	Total Cost (PV)	£ 0		
Other key non-monetised costs by 'main affected groups'					

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Workers would benefit by £0.15m to £0.3m from repayment of wage arrears; Exchequer would receive £0.523m from penalty fees. None of these benefits would arise under 100% compliance with existing NMW regulation.			
	One-off Yrs				
	£ 0				
	Average Annual Benefit (excluding one-off)				
	£ 0	Total Benefit (PV)	£ 0		
Other key non-monetised benefits by 'main affected groups' Stronger enforcement of NMW should result in fewer cases of non-compliance.					

Key Assumptions/Sensitivities/Risks The costs and benefits associated with this policy change are largely transfers that would not arise in a situation of 100% compliance.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £ 0	NET BENEFIT (NPV Best estimate) £ 0
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What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	asap			
Which organisation(s) will enforce the policy?	HMRC, Defra			
What is the total annual cost of enforcement for these organisations?	£ N/A			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	£ N/A			
What is the value of changes in greenhouse gas emissions?	£ N/A			
Will the proposal have a significant impact on competition?	Yes/No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)	
Increase of	£ 0	Decrease of	£ 0
		Net Impact	£ 0

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

A: Strategic overview

The legislative proposals on National Minimum Wage enforcement stem from the Secretary of State's acceptance of the recommendation in the Low Pay Commission's 2007 report that "as a deterrent to non-compliance, the Government introduce a penalty to apply to any employer found to have underpaid the minimum wage". The Government held stakeholder meetings and undertook a public consultation on its proposed approach in May 2007, both for a new penalty regime and also on proposals to ensure a fair outcome for those who have been underpaid by their employer.

B: The issue

Underpayment of the NMW is both unfair to the workers who are underpaid and to compliant business who are undercut. At present, employers who are found to be underpaying their workers can repay what they owe without either attracting a penalty or remedying the loss of purchasing power that the worker has suffered as a result of the underpayment. Government intervention is necessary to remove all the potential profits of underpayment of the NMW, creating a clearer deterrent to non-compliance.

Rationale for Government intervention

1. Underpayments of the NMW can be viewed as involuntary interest-free loans to employers by the lowest-paid and most vulnerable workers. The employer obtains a benefit from non-compliance with the NMW (for example, they may have accrued interest on the unpaid wages, or repay wages at a rate which, due to inflation, now holds lesser value) and thus an unfair competitive advantage against those competitors who are complying with the NMW.

(i) Fair arrears

2. Workers paid below the NMW may suffer financial hardship even if arrears are eventually paid as the current method of calculating arrears does not take account of the fact that the arrears may have lost purchasing power since they were incurred. The aim of fair arrears is to restore to the worker what they had lost in real terms.

3. All workers have a right to fairness, whether working their complaint out themselves with their employer, using a third party such as HM Revenue and Customs (HMRC), or going to an employment tribunal. We therefore consider that the same method of calculating fair arrears should apply wherever an underpayment has occurred, irrespective of the means used to secure reimbursement.

4. To ensure the efficient resolution of the payment of fair arrears, the government has sought a transparent, uniform approach wherever underpayment has occurred. This will enable workers and employers to understand clearly what arrears are due. This is particularly important in enabling any employer who proactively identifies and restores an underpayment to calculate and restore the correct amount, and in enabling the worker to establish that they have received their entitlement.

(ii) Penalty

5. The aim of fair arrears is to restore to the worker what they had lost in real terms, not to punish employers. Fair arrears do not, therefore, fulfil the objective for a simple, effective deterrent to non-compliance. As a result, the Government has also considered options for a penalty, with the objective of discouraging arrears from arising in the first place.

6. The current NMW penalty formula is not straightforward to calculate. It is:

twice the hourly amount of the NMW (as in force at the date of the penalty notice) in respect of each worker to whom the failure to comply relates for each day during which the failure to comply has continued in respect of the worker.

7. As a result, because employers may not know up front what the penalty they face is, the deterrent effect of the penalty could be weakened. In addition, the penalty only applies at the end of the enforcement process, when an employer fails to comply with an enforcement notice, and is therefore essentially a deterrent to non-compliance with the enforcement notice rather than non-compliance with the National Minimum Wage Act (NMWA).

Consultation

Within Government

8. BERR has consulted with several other departments including HM Revenue and Customs and the Department of Environment, Food and Rural Affairs (Defra) as enforcers of the National Minimum Wage and the Agricultural Minimum Wage. BERR has also consulted with HM Treasury, the Ministry of Justice, the Scottish Executive and the Employment Tribunals Service.

Public consultation

9. The Government undertook a public consultation on its proposed approach in May 2007.

10. There were a total of 33 written responses to the consultation, although none referred specifically to the cost and benefit estimates made in the partial impact assessment. Full details of the responses may be found in the Government Response to consultation.

C: Objectives

11. A key Government priority is to minimise the number of workers who are underpaid the National Minimum Wage (NMW) by making sure the right incentives are in place to ensure that employers comply with the law, preventing arrears from arising in the first place.

12. This is why the Government agreed to actively consider the 2007 Low Pay Commission recommendation that “as a deterrent to non-compliance, the Government introduce a penalty to apply to any employer found to have underpaid the minimum wage.” Our aim is for **a simple, effective enforcement mechanism** that employers can easily understand.

13. The Government also aims for a fair outcome for those who have been underpaid when they are reimbursed, recognising that workers may have lost out in real terms as a result of underpayment.

Background

14. The National Minimum Wage Act 1998 creates a statutory right for a qualifying worker to be paid a minimum level of remuneration. The NMW is considered one of the most important labour market reforms introduced by the Government since 1997. It has reduced the extent of low pay in the UK and has helped close the gender pay gap at the bottom of the earnings

distribution¹. Her Majesty's Revenue & Customs (HMRC) enforce NMW legislation on the Government's behalf in the UK. In agriculture, the NMW (known as the "Agricultural Minimum Wage") is enforced by the Department of Environment and Rural Affairs in England and Wales, and by the devolved administrations in Scotland and Northern Ireland.

(i) Fair arrears

15. If a worker who qualifies for the NMW is remunerated by his employer at a rate which is less than the NMW, the worker is entitled to arrears. These are defined under section 17(2) of the National Minimum Wage Act as the difference between the remuneration received by the worker and the NMW rate they should have been paid at.

16. This calculation does not take into account that arrears may have lost purchasing power since they were incurred.

(ii) Penalty for underpayment

17. Currently employers who are brought to HMRC's attention as underpaying the NMW are able to repay arrears without attracting a penalty, either by repaying arrears during the course of an investigation or repaying arrears in full on receipt of an enforcement notice. A penalty is only applied if the employer does not comply with an enforcement notice. The current penalty regime therefore does not discourage employers from allowing arrears to arise in the first place.

18. If the enforcement notice is not fully complied with, employers are issued with a penalty notice which penalises the employer with a fine. The current minimum penalty is £231.48, for an employer who has underpaid one worker.

D: Options identification

19. As well as the option of **do nothing**, the following options on arrears and penalty regimes were considered in the May 2007 consultation:

i) Fair arrears

20. To reflect the concerns outlined in the section *Rationale for Government intervention*, the Government considered the following options for a straightforward, generic mechanism to calculate fair arrears for all workers:

i) Charging interest on arrears;

Interest is applied in some areas of employment law, such as when awarded by an employment tribunal in discrimination cases², or on the late payment of tribunal awards³. This is calculated to a set Government interest rate. This could accurately reflect what the worker might have lost in terms of interest earned whilst arrears were withheld.

ii) Charging all arrears at the current rate;

When workers are repaid, they receive arrears calculated against the rate their underpayment was incurred under. Underpayments stretching over a longer period may have been incurred under more than one NMW rate.

The NMW rate has increased annually since its introduction. Whilst there is no guarantee of this, it does mean that generally, previous NMW rates are lower than the current rate.

¹ "Shaping a Fairer Future" Women and Work Commission

² The Industrial Tribunals (Interest on Awards in Discrimination Cases) Regulations 1996

³ Employment Tribunals (Interest) Order 1990

Using the current rate for all arrears would mean that all arrears restored to workers would accurately reflect what the appropriate minimum wage is considered to be in today's economic circumstances.

This would not affect arrears which had been incurred under the current rate. Such workers would be receiving their arrears at the rate which was still considered the appropriate NMW.

iii) Arrears plus adjustment

Arrears could be calculated in the present way, and then adjusted to create an uplift payable to the worker from the employer. Adjusting the earnings owed would mitigate against the loss of purchasing power.

The level of adjustment would be determined by how much the worker had been underpaid, for instance as a fixed percentage of arrears, or as an amount depending on the "band" of arrears the underpayment fell into (for instance, arrears of £0 - £100 could see a different sum going back to the worker than arrears of £100+).

This would enable employers to quickly work out the adjustment and apply the uplift that was due to their workers, and workers could quickly ascertain whether they had been repaid their earnings correctly.

ii) Penalties

21. To create a simpler penalty regime, the Government also considered replacing the existing enforcement and penalty notice regime with a streamlined mechanism for requiring payment of fair arrears and applying a penalty. As well as taking no action, the Government consulted on the following options for the type of penalty to be introduced:

a) Fixed penalty;

A fixed penalty which would be applied to a company who met the penalty criteria.

b) Fixed penalty per worker;

A fixed penalty per worker underpaid.

c) Penalty which is a multiple of arrears;

A fixed multiplier in legislation, which could be applied to the total level of arrears outstanding to create the penalty amount.

d) Banded fixed penalty.

A fixed penalty which is determined by what "band" the total level of arrears falls into.

22. It is important to retain an incentive for employers to admit and repay arrears, even when caught. The Government therefore consulted on a penalty which escalated if arrears remained unpaid or the penalty was ignored, encouraging employers to pay arrears early, rather than delay. This would mirror the current penalty notice which is applied when an employer ignores or doesn't pay in full an enforcement notice. For each option, we asked what the initial level of the penalty should be, and what the penalty should escalate to.

Government conclusions following consultation

i) Fair arrears

23. Following the consultation, the Government has concluded that repaying arrears at the current NMW rate (**Option ii** above) would best achieve the policy aims for fair arrears. This would mean that the additional element of remuneration beyond the actual amount of underpayment would be treated as earnings and taxed through the PAYE system, whereas

(under current tax rules) the tax on interest on arrears would have to be accounted for through self assessment. The Government does not consider that workers who have been underpaid the NMW should be required to go through self assessment. Repaying arrears at the current rate would mean that arrears would accurately reflect what the appropriate national minimum was currently considered to be and would provide an incentive for employers to resolve underpayments before any rate change. More details about the reasons for this preferred option are provided in the Government response document.

ii) Penalties

24. Following the consultation, the Government has concluded that the penalty for underpayment of the NMW should be based on a multiple of total arrears (**Option c** above). This is discussed fully in the Government response, but a summary is given below:

25. This approach would act as an effective deterrent to non-compliance as the penalty would reflect the extent of underpayment. Although there is a general relationship between the number of workers and the amount of arrears, situations occur where there is either a large number of workers with a low level of arrears owed to each or, conversely, a small number of workers with a large amount of arrears owing to each. The Government therefore considers that applying a penalty per worker would not be as proportionate and as effective a deterrent.

26. A number of respondents argued that a penalty should not be applied in certain cases, such as unintentional errors. However, we have concluded that a penalty should be due in all cases where underpayment of the NMW is still outstanding at the date the enforcement body starts its investigation. This is because the new penalty regime would be more difficult to apply if enforcement officers had to consider the employer's intention when considering a case of underpayment of the NMW. Also, we want to encourage employers to take care to be compliant with the requirements of the NMWA.

27. Consideration of the civil penalty has been particularly influenced by two separate factors: ensuring that the civil regime complies with Article 6 of the European Convention on Human Rights (ECHR) and balancing the relationship between the civil penalty regime and the criminal prosecution regime for NMW offences. We have concluded that:

- The multiplier for the penalty should be 0.5 (i.e. a penalty that is half the amount of arrears);
- The penalty should be reduced by one half if the employer reimburses their worker(s) quickly;
- The penalty should not be increased if the employer fails to reimburse their worker(s) by the date specified by the enforcement body;
- There should be a minimum penalty threshold of £100, applying where the amount of underpayment is less than £200; and
- There should be an upper civil penalty ceiling of £5,000.

28. The Government has concluded that the reduction of the penalty if an employer reimburses their workers quickly would provide an incentive for employers to admit and repay arrears.

29. In addition to the civil penalty, the Government is also introducing additional civil enforcement powers to increase the efficiency of NMW enforcement, whereby compliance officers have the power to take information away from employer's premises for a reasonable time to enable them to take copies.

30. Furthermore, at present, offences under the NMW Act (such as refusal to pay the NMW or obstructing a compliance officer) are triable only in a Magistrates' Court where the maximum fine available is £5,000. We consider that this is insufficient to provide an appropriate deterrent in the most serious cases. We have therefore concluded that the offences should be triable either way, that is, as either summary offences in a magistrates' court or as indictable offences

in a Crown Court. In the latter case, the court would have the power to impose an effectively unlimited penalty as well as, for example, disqualification of a director.

E: Analysis of options

Costs and benefits

31. Penalties will only be incurred if an employer is found to owe arrears and therefore is found to infringe the requirements placed upon them under the National Minimum Wage Act. The costs for employers arising from the new system of fairer penalties and arrears are therefore **avoidable under full compliance with the existing legislation**. The proposals do not impose any additional requirements for compliant employers and aim to benefit such employers by removing the existing financial benefits gained by non-compliant employers.

32. In broad terms those employers who fail to comply would be faced with two types of cost. First of all, with fair arrears, this represents a financial transfer from the employer to the worker who has been underpaid which takes account of the fact that the arrears may have lost purchasing power since the underpayment occurred. However, this is not a cost as such, as had the worker been paid the correct wage in the first place, then the worker would not have an entitlement to fair arrears.

33. Secondly, penalties would impose an extra cost on employers who fail to comply, but as stated above this is avoidable under full compliance with the existing legislation.

34. There will be some increase in costs to the Exchequer resulting from the changes in enforcement. However, these costs will arise only in the investigation of cases of suspected non-compliance, and would probably be outweighed by the revenue generated by the collection of penalties. Any additional costs would be outweighed by the policy benefit of moving towards full compliance and ensuring equity and fairness for workers by making sure they are paid the wage that is owed to them.

35. The following analysis represents an *illustrative example* of what the impact would have been on cases closed, assuming the same numbers of cases as in the financial year 2006/07 had the proposed new enforcement regime been in place instead of the existing one.

36. The cost-benefit analysis focuses here only on the Government's preferred options. Discussion of the now discarded options is available in the partial impact assessment.

Assumptions

37. Table 1 below provides a historical overview of the number of investigations conducted by HMRC since the introduction of the NMW in 1999. Over the whole period there have been just over 45,000 HMRC investigations and a third of these cases have been found to be non-compliant. Since 2001/02 almost 78,000 workers have been affected by underpayment totalling over £28 million⁴.

38. It should be noted that these data relate only to cases that HMRC investigate and do not necessarily represent the full extent of NMW non-compliance.

39. In addition to this Defra investigates around 120 cases of non-compliance with the Agricultural Minimum Wage annually. Since this number of cases is low relative to HMRC's caseload for investigation of NMW non-compliance, this Impact Assessment focuses predominantly on the costs and benefits of the changes to the NMW enforcement regime.

⁴ Expressed in 2006 prices

Table 1. HMRC investigations into non-compliance with the NMW.

Year	Investigations*	% found to be non-compliant	Total arrears (current £)	Number of workers
1999	6041	28%	£1,242,341	n.a.
2000	7256	29%	£3,034,373	n.a.
2001	5368	36%	£5,135,799	10,378
2002	6238	32%	£3,585,941	7,373
2003	5541	39%	£2,558,096	9,428
2004	5155	34%	£3,760,361	11,261
2005	4904	32%	£3,291,516	25,314
2006	4500	34%	£3,039,680	14,187

Source: HMRC.

40. In 2006/07, 4,500 employers were subject to a completed investigation by HMRC's NMW compliance teams, 1,523 of which (34%) were found not to be paying the minimum wage, covering 14,187 workers. At this stage, 1,452 (95%) of these employers settled informally by repaying arrears to the underpaid workers, and the remaining 71 received an enforcement notice requiring them to repay all arrears to all workers in full in a given period of time. HMRC issued penalty notices to 2 employers.

41. Had a penalty notice been issued to any employer found to have underpaid the minimum wage i.e. as in our proposed legislation, then all 1,523 non-compliant employers would have been issued with a penalty.

42. If we assume the following (**Scenario A**):

- The number of complaints remain unchanged – the new system of fairer arrears gives workers more incentive to complain, but this increase might be mostly offset by a fall in the number of workers being underpaid, as the new system of an immediate penalty to all employers found to owe arrears and the requirement to repay fair arrears will mean that employers have more incentive to comply with the existing legislation;
- The number of risk assessed cases remain unchanged;
- The proportion of all cases investigated found to be owing arrears remain unchanged;
- The average number of workers per non-compliant case is 6.2;⁵
- The 1,452 employers who settled informally in 2006/07 have a relatively higher propensity to settle and would therefore all choose to settle after they had been given a penalty. The rationale behind this is that they could have waited for an enforcement notice which would have required them to pay the same arrears anyway, but they still chose to settle before this;
- The 18 employers that appealed against the enforcement notice would also appeal against the penalty under the new system given that the notice will require them to pay a fine on top of arrears; and

⁵ This figure would apply overall to all 1,523 cases.

In 2006/07, 14,187 workers were identified as having been owed arrears (and 1523 employers were found to owe arrears). This figure includes 4,700 workers identified in 1 case. If we deduct this extreme cases from the calculation, then:

$$(14,187 - 4700) / (1,523 - 1) = 6.2.$$

- The appeal rate of the remaining 53 employers (who did not appeal the enforcement notice) is now 10 per cent under the new regime given that the notice requires them to pay a penalty in addition to arrears.
- This implies that 1,500 cases would have been settled at this stage, with 23 going to employment tribunal.⁶

43. Of the 18 cases closed in 2005/06 that went to tribunal, two appeals were successful, giving an appeal success rate of 11% (the same rate of success as for appeals in 2005/06). Assuming the same rate holds, of the 23 employers that would have appealed under the new system, around 2 would have been successful. The amount of arrears set out in the current enforcement notice (that is, the difference between what a worker was paid and what he should have been paid under the NMW rate in force at the time) is the basis for the calculation of both the penalty and the fair arrears in the proposed regime. It is likely, therefore, that an appeal which was successful in the current regime would also be successful under the new regime (and vice versa).

44. Alternatively, if we assumed that of the 1,452 employers who settled informally, a small proportion, say 1%, might be incentivised to appeal if they were to receive a penalty (**Scenario B**), then we would have expected around 38 appeals to employment tribunals in 2006/07. Again, assuming an appeal success rate of 11%, then 4 of these appeals would have been successful. Table 2 below summarises the impact of each scenario on the numbers of employers having to pay arrears and penalties, and the numbers of expected appeals to tribunal.

Table 2. Enforcement outcomes under the new scenarios compared with actual for 2005/06 including the number of workers each total covers.

	Had to pay arrears owed*	Had to pay penalty**	No. appeals to tribunal
Do nothing	1,523 (14,187 workers)	2 (12 workers)	18 (111 workers)
Scenario A	1,521 (14,181 workers)	1,521 (14,181workers)	23 (142 workers)
Scenario B	1,519 (14,163 workers)	1,519 (14,163 workers)	38 (235 workers)

Source: BERR estimates based on enforcement data from HMRC.

Note: * Assumes all employers that appealed and were unsuccessful had to pay back full arrears owed. **Assumes that all employers that appealed a penalty and were unsuccessful had to pay the original penalty owed.

Sectors and groups affected

45. All sectors are affected by the NMW, although agriculture has its own NMW machinery (the Agricultural Minimum Wage). In practice, the NMW is most keenly felt in food processing, textiles and clothing, retail, hospitality, security, cleaning, social care, leisure, travel and sport, and hairdressing.

46. Looking more specifically at sectors where non-compliance is most common, the NMW Annual report 2005/06 notes that the hospitality and hairdressing sectors have shown a significant increase in the number of complaints of underpayment over the last two years (the increase in hospitality figures is mainly as a result of HMRC's targeted enforcement regime).

47. HMRC are responsible for the enforcement of the NMW, with Defra responsible for the enforcement of the Agricultural Minimum Wage.

Analysis of benefits

48. As stated previously, costs and benefits incurred through rectifying illegal activity are avoidable, however, for illustrative purposes, they will be outlined in the following sections.

⁶ Appeal: $[(71 - 18) \times 0.1] + 18 = 23$.

Settle: $1452 + (71-23) = 1500$.

Workers

49. The reimbursement of workers may at first sight be seen as a benefit, as it might be seen as a transfer from the employer back to the worker. However, the underpayment only happened in the first place due to non-compliance. Had the employer been compliant, the worker would have received the full NMW rate he or she was entitled to at the right time and the issue of reimbursement would not arise. Therefore this should not be viewed as an economic benefit as such.

50. The marginal effect is that workers will benefit by having the underpayment calculated on the basis of the current NMW rate. Where underpayments happened in the past under a lower NMW rate, workers would benefit to the extent of the difference between the current NMW rate and the NMW rate at the time. For example, an underpayment that occurred in November 2005 when the NMW rate was £5.05, would receive fair arrears at the rate of £5.52 in November 2007, a difference of around 9%.

51. Under the current system, without detailed information on the period over which the underpayment has occurred or the degree to which employers who settle informally already reimburse workers over and above the NMW rate at the time, it is necessary to make an assumption as to the marginal impact of fair arrears.

52. Therefore we assume that fair arrears will amount to between 5 to 10 per cent of the total arrears amount of £3m. The marginal benefit from fair arrears would therefore amount to between £150,000 and £300,000.

53. In general, workers identified as being owed arrears will however benefit from the options of fair arrears, as the amount of arrears paid back to the worker would take into account the fact that they may have lost purchasing power since the time they were incurred.

54. In addition, the proposed penalty serves the purpose of incentivising employers to comply with the existing National Minimum Wage legislation. This means that there will be fewer workers being underpaid overall.

55. Table 2 shows that in the new penalty scenarios, some workers might lose out because their employers might be incentivised to appeal the process and their appeals might be successful – but then this implies that the employer has not been found to be in breach of the National Minimum Wage Act and therefore these workers would be legitimately being paid their given wages.

Exchequer

56. The effect of the new penalty in terms of money received by the Exchequer will vary depending on the extent of non-compliance, as the penalty is based on a multiple of the arrears. A higher penalty would be imposed on an employer who has underpaid a small number of workers but totalled a large amount of arrears, compared to another who underpaid more workers, but total arrears owed were less.

57. Overall, however, there ought to be a positive effect to the Exchequer under the proposed new penalty regime. Under the current regime, employers who are brought to HMRC's attention as underpaying the NMW are able to repay arrears without attracting a penalty. However, under the proposed new penalty system, all employers found to owe arrears will pay a penalty (i.e. in 2006/07, had the new system been in place, 1,523 employers would have had to pay the penalty instead of the 2 who failed to comply with the enforcement notice).

58. Using data from 2006/07 it is possible to estimate the overall amount that might be paid in penalties based on the fixed multiplier option.

59. In total, just over £3m was owed in arrears, though in 97% of all cases the amount of arrears owed was less than £10,000, and in just over two-thirds of cases (68%) the amount was below £1,000. Average arrears per worker amounted to £214 and average arrears per case was £2,000 (Table 3a below).

Table 3a. Total NMW arrears owed 2006-07

Arrears	Cases	Total arrears (£)	Workers affected	Arrears per worker	Arrears per case
£1 - £99	414	£16,000	820	£20	£39
£100 - £499	410	£101,600	1,860	£55	£248
£500 - £999	215	£152,900	880	£174	£711
£1,000 - £4,999	377	£837,200	2,680	£313	£2,221
£5,000 - £9,999	58	£418,100	940	£443	£7,209
£10,000 - £19,999	29	£378,500	5,870	£64	£13,052
£20,000 - £49,999	11	£313,200	580	£544	£28,473
£50,000 - £99,999	1	£52,100	100	£506	£52,100
£100,000+	4	£796,100	460	£1,687	£192,275
Total	1519	£3,038,700	14,190	£214	£2,000

Source: HMRC

60. Therefore with a minimum penalty imposed of £100 and a cap of £5,000, this would amount to a total of just over £1m to be paid by non-compliant employers to HMRC in penalties. However, because of the provision of a reduction in the penalty for early reimbursement by the employer, the aggregate sum from penalties could amount to around £538,000. This is based on the assumption that the 95 per cent of non-compliant employers who settle informally now would reimburse their workers quickly in order to benefit from a reduced penalty (Table 3b below).

61. However, taking account of the current aggregate sum from penalties, the *net effect* of this policy change would be marginally lower at around **£523,000⁷**.

Table 3b. Estimated NMW penalties on basis of 2006-07 caseload

Arrears	Cases	Arrears penalty per case		Repayment cases		Total penalty volume (£)
		<i>unadjusted</i>	<i>adjusted</i>	<i>Quick*</i>	<i>Normal</i>	
£1 - £99	414	£19	£100	393	21	£21,750
£100 - £499	410	£124	£100	389	21	£21,750
£500 - £999	215	£356	£356	204	11	£40,181
£1,000 - £4,999	377	£1,110	£1,110	358	19	£219,848
£5,000 - £9,999	58	£3,604	£3,604	55	3	£109,931
£10,000 - £19,999	29	£6,526	£5,000	27	2	£77,500
£20,000 - £49,999	11	£14,236	£5,000	10	1	£30,000
£50,000 - £99,999	1	£26,050	£5,000	0	1	£5,000
£100,000+	4	£96,138	£5,000	3	1	£12,500
Total	1519	£1,000		1,439	80	£538,260

Source: HMRC; BERR calculations; it is assumed that in 75% of cases employers choose to repay arrears early and hence benefit from reduced rate penalty.

⁷ Currently only a small number of penalty notices are issued each year: since 2002 there have been 10 or fewer notices per year. In the year 2007-08 to date 10 notices have been issued amounting to a total penalty of around £10,500. We estimate that for the year as a whole, the total penalty amount will be around £15,000

Analysis of costs

(i) Arrears

62. Similarly it is important to be clear about how the costs are treated. As stated above, the reimbursement of arrears by the employer to the worker is not an economic transfer in the true sense. Had the employer been compliant originally, then he/she would have paid the correct NMW rate at the time. Hence the scale of arrears, amounting to over £3m in 2006/07, is not an additional cost as such to employers as a result of the policy to introduce tighter enforcement.

63. As discussed in the benefits to workers section above (paragraphs 50-52), there would be a marginal economic cost to employers of fair arrears of between £150,000 and £300,000.

(ii) Penalties

64. As discussed in the *Risks* section below, applying an immediate penalty may have resource consequences. In some cases informal settlement during the course of an investigation allows arrears to be restored to workers quickly. It also enables employers to rectify what may have been an accidental error without being penalised. In addition, employers may also be less willing to work with enforcers if they are facing a potential penalty. This again could have an effect on the throughput of cases.

HMRC

65. Extra time will be needed to calculate arrears under the proposed new method for calculating fair arrears. We have assumed that it would take around an additional 5 minutes to calculate fair arrears per worker as the methodology is based on the current method of calculating arrears. Then assuming that around 10,000 workers are identified as being owed arrears per year⁸, then the additional cost of calculating arrears per year would be around **£10,000**⁹. These additional costs could be incurred by both HMRC and non compliant employers.

66. It is also possible that, faced with fairer arrears, underpaid workers could be incentivised to complain thus increasing the number of calls to the helpline and also increase the number of investigations that will need to be carried out by HMRC's compliance teams, which would imply additional costs to HMRC. However, this effect could be offset if the implemented policy is effective in its aim of reducing non-compliance in the first place. In which case, there will be fewer workers in a position to complain, thus reducing the number of calls to the helpline. As a result, the costs incurred as a result of this effect could be minimal.

Tribunals service

67. The proposals for fair arrears and a new penalty may lead to increased costs due to an increase in the number of **appeals to tribunal**. This could occur for two reasons:

- all non compliant employers will now be issued with a penalty, and therefore the size of the pool of potential appeals is larger; and

⁸ Figures for 2003/04 were 9,428, 2004/05 were 11,261 and 2005/06 were 25,314 from the *National Minimum Wage – Annual report 2005/06*. However, the 2005/06 figures may be higher than the average as 3 cases involved a high number of workers (totalling 15,000), so deducting these bring the 2005/06 figure to around 10,000 workers. Similarly, in 2006/07 1 case accounted for 4,500 workers so deducting these bring to 2006/07 figure to a similar level.

⁹ Calculated as:

Time spent x median hourly wage (from 2006 Annual Survey of Hours and Earnings) x 1.3 (30% non wage labour costs) x 10,000 (total number of workers).

Figures rounded to the nearest £10,000.

- not only do employers have to pay higher arrears, but they also have to pay a fine on top of them, therefore there will be greater financial incentive to appeal as the cost of appealing to a tribunal for employers might be less than the expected savings if their appeal is successful (given a fixed success rate of 11% - see *assumptions*.)

68. Given the assumptions outlined under scenarios A and B under the section *Assumptions*, we could expect between around 5 to 20 additional appeals to tribunal over a year.

69. These appeals are usually listed for a one hour hearing with a Chairman sitting alone. The daily fee for a Chairman is £421 and they do at least 6 one hour cases a day. If we then add administrative costs, receipt and service of the claim, copying, etc which are fairly minimal plus an additional hours work on the day of the hearings greeting the parties, etc, we can assume that the cost per appeal to the Tribunals Service is around £100.¹⁰ The new system of an immediate penalty once non-compliance is identified could impose an additional cost to the Tribunals Service of between **£500 and £2,000**.

70. In addition, the cost to HMRC of defending each appeal is around £3,500 for a case of average size and complexity. This covers barrister costs and solicitors' office costs based on a two day hearing.¹¹ Therefore, as well as the additional costs above, appeals generated under the new system could impose an additional cost to HMRC of between **£17,500 and £70,000**.

Prosecution

71. As a result of Government's decision to make offences under the NMW Act triable as either summary offences in a Magistrate's Court or as indictable offences in a Crown Court, non-compliant firms facing prosecution may face higher costs, owing to the greater costs involved in Crown Court cases. However, these costs are avoidable if firms comply with the requirements of the NMW Act and are therefore not regulatory costs.

72. The Government may face higher costs as a result of some NMW prosecutions taking place in Crown Courts. It is estimated that the cost to Her Majesty's Court Service (HMCS) in a Magistrate's Court may be around £1,477 per day¹². In a Crown Court this figure rises to £5,284¹³. If the total Crown Court time involved in dealing with NMW cases brought by the Revenue and Customs Prosecution Office amounts to four weeks, the additional cost to Government would be around £76,140. However, it might be expected that there would be a net gain to the exchequer arising from higher penalties imposed by the Crown Court in sentencing. The estimated revenue from higher penalties has not been quantified.

F: Risks

73. The new penalty will be applied considerably more often than the current penalty notice as it would apply to the 95% of non-compliant employers who currently settle arrears informally during the course of an investigation. Issuing and collecting more penalties will have resource implications for HMRC.

74. Informally settling arrears during the course of an investigation can be a quick route to restoring arrears to workers without further action or investigation being taken. To gather the level of evidence necessary to penalise, greater input and investigation may be needed by HMRC and in some cases it could take longer to reimburse arrears to workers.

75. Some employers may be less willing to work with HMRC and repay arrears if they are facing an automatic penalty for underpayment. This is why we have proposed a reduction to the penalty to encourage for early restoration of arrears and co-operation with HMRC. Ultimately, these considerations could affect the throughput of cases. These risks should be weighed

¹⁰ Source: Employment Tribunals Service.

¹¹ Source: HMRC

¹² Ministry of Justice estimates

¹³ Ministry of Justice estimate

against the deterrent effect that a new penalty could have, and the question of whether it is right that employers should be able to be caught underpaying and not be penalised, whatever their motivation.

G: Enforcement

76. The National Minimum Wage is enforced in two ways. HMRC takes proactive steps to secure enforcement and acts on complaints. Individuals also have a right of redress to an employment tribunal or civil court.

77. The Government also issues an annual report on enforcement action. The latest National Minimum Wage – Annual Report 2005/06 can be found online, at: www.berr.gov.uk/files/file35198.pdf.

H: Recommendation and summary table of costs and benefits

78. Table 4 below presents a summary of the quantifiable costs and benefits associated with the proposed policy change. It should be noted that none of the extra costs and benefits identified below would arise in a situation of 100% compliance with payment of NMW. Therefore these figures are largely transfers from one party to another and should not be considered as additional economic costs and benefits arising from the policy changes themselves.

79. The intention of the policy is to encourage greater compliance with the NMW, so if successful we would expect to see a decrease in number of cases per year and associated costs.

Table 4. Summary of quantifiable costs and benefits.

	Costs	Benefits
Employers	£0.15 - £0.30m (fair arrears) £0.523m (penalty fees)	None
Total	£0.673m - £0.823m	
Workers	None	£0.15m - £0.30m (fair arrears)
Total		£0.15m - £0.30m
The Exchequer	£0.0005m - £0.002m (extra TS appeals) £0.0175m - £0.07m (HMRC defence of appeals) £0.01m (arrears calculation) £0.076m (Crown Court prosecutions)	£0.523m (penalty fee income)*
Total	£0.104m - £0.156m	£0.523m*

Source: BERR estimates based on enforcement data from HMRC. * NB: There will also be revenue income from prosecution cases but this is not quantifiable.

I: Implementation

The Government plans to implement this new legislation as soon as possible.

J: Monitoring and evaluation

The effectiveness of the new regime will be monitored in settling ongoing service level agreements between BERR and HMRC as enforcers.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	Yes
Small Firms Impact Test	No	Yes
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	Yes
Disability Equality	No	Yes
Gender Equality	No	Yes
Human Rights	No	No
Rural Proofing	No	No

Annexes

Please see the summary impact assessment for the details of the specific tests carried out with respect to this policy area.

