

# WHITE PAPER

**Wage Compression in the United Kingdom  
The National Living Wage, Inflation and  
Reshaping of Pay Structure**

**March 2026**



# EXECUTIVE SUMMARY

The United Kingdom Labour market is undergoing a structural shift in pay distribution. Over the past decade, sustained increases in the National Living Wage (NLW), combined with high inflation and tight labour markets, have significantly narrowed wage differentials across many sectors.

The NLW is now designed to remain at or above two thirds of median earnings, placing it among the highest minimum wage targets internationally.

This policy has delivered clear gains in living standards for low paid workers. However, it has also produced a measureable phenomenon known as wage compression. Wage compression occurs when the gap between entry level and experienced employees narrows, reducing the financial incentive for progression and increasing organisational pressure on pay structures.

Evidence from the low pay commission shows this effect is already material. In low paying industries, the gap between the median wage and the NLW has fallen significantly, and employers report growing dissatisfaction among workers paid just above minimum.

**This white paper provides a comprehensive examination of wage compression in the UK in early 2026, including:**

- Policy drivers and macroeconomic context
- Evidence of within firm compression
- Sector specific impacts
- Consequences for recruitment, retention, and productivity
- Strategic responses for employers

**This document is intended as a reference resource for business leaders, HR professionals, policymakers, and labour market analysts.**



# INTRODUCTION

Wage compression is not a new economic concept, however, the pace and scale of compression in the UK since 2016 is historically unusual.

The introduction of the National Living Wage in 2016 marked a major shift in minimum wage policy. The government adopted a target to raise the NLW to two thirds of median earnings, a level expected to affect a far larger share of the workforce than previous minimum wage regimes.

By 2026, the NLW is projected to reach £12.71 per hour, maintaining this two thirds median earnings benchmark.

This has fundamentally altered the lower half of the UK pay distribution.



## 2. POLICY AND ECONOMIC CONTEXT

### 2.1 The Evolution of the National Living Wage

The NLW has evolved from a safety net into a central labour market policy tool.

Key milestones:

- Initial target of 60 percent of median earnings by 2020
- Updated target of two thirds of median earnings by mid 2020s
- Extension of eligibility to workers aged 21 and over
- Continued commitment to maintaining the two thirds threshold

The Office for Budget Responsibility notes that a minimum wage at this level affects a significantly larger proportion of workers than earlier policies .

This means the NLW is no longer limited to the lowest paid roles. It now influences wage levels across entire pay bands.

### 2.2 The Current UK Wage Landscape

Key data points:

- NLW forecast for April 2026: £12.71 per hour
- Median full-time salary in 2025: approximately £39,039
- NLW target level: two thirds of median earnings

A minimum wage set this high creates strong spillover effects across the labour market.



## 3. UNDERSTANDING WAGE COMPRESSION

### 3.1 Definition

Wage compression occurs when pay differences narrow between:

- Entry level and experienced workers
- Junior and supervisory roles
- Long serving employees and new hires

This is most visible within firms, where internal pay hierarchies flatten.

### 3.2 Evidence of compression in the UK

The Low Pay Commission provides the clearest evidence:

- The premium of median wages above the NLW in low paying industries fell by 5.8 percentage points.
- The gap between the 20th and 40th wage percentiles fell from £1.11 to £0.69.
- Employers report reduced progression incentives and worker dissatisfaction.

This confirms that compression is not theoretical. It is already embedded in the labour market.



## 4. DRIVERS OF WAGE COMPRESSION

### 4.1 Rapid Minimum Wage Growth

The most significant driver is policy driven wage growth.

The NLW is designed to increase faster than average wages when required to maintain its share of median earnings.

This creates upward pressure at the bottom of the pay distribution.

### 4.2 Inflation and Cost of Living

Inflation has amplified compression pressures.

Real income research shows minimum wage increases raise household income and consumption, particularly among low income households.

However, when inflation affects all workers, employers face budget constraints that limit wider pay increases.

This creates a compression chamber effect:

- Entry level wages rise due to legislation
- Mid level wages lag due to affordability
- Pay differentials shrink

### 4.3 Spillover Effects

Minimum wage increases affect more workers than those directly earning the minimum.

OBR analysis highlights spillover effects on workers earning just above the NLW.

This produces compression across multiple pay bands.

# 5. SECTOR IMPACT ANALYSIS

Compression is uneven across the economy.

## 5.1 High Exposure Sectors

Sectors with large low wage workforces face the strongest impact:

- Retail
- Hospitality
- Social Care
- Logistics and Warehousing
- Cleaning and Facilities Management

## 5.2 Why These Sectors Are Vulnerable

Characteristics include:

- Thin operating margins
- High labour intensity
- Limited pricing power
- Large entry level workforce

These constraints make it difficult to raise pay across all grades.



## 6. ORGANISATIONAL CONSEQUENCES

### 6.1 Employee Morale

Evidence shows narrowing pay differentials lead to dissatisfaction among workers paid above the NLW.

Common reactions include:

- Perceived undervaluation of experience
- Reduced motivation
- Increased disengagement

### 6.2 Retention and Recruitment

Compression affects both retention and recruitment.

When pay progression is limited:

- Experienced workers may leave for marginal pay gains elsewhere
- Supervisory roles become harder to fill
- Career pathways lose attractiveness

Employers report difficulty recruiting for roles with additional responsibility when pay premiums are low.

### 6.3 Productivity and Progression

Reduced pay differentials weaken traditional incentives:

- Promotion becomes less financially attractive
- Skills development may decline
- Internal progression slows

This presents long term productivity risks.



# 7. BROADER ECONOMIC EFFECTS

## 7.1 Positive Outcomes

Wage compression is not entirely negative.

Benefits include:

- Reduced low pay prevalence
- Increased household income
- Improved income equality

The number of jobs below two thirds of median earnings has fallen significantly.

## 7.2 Trade Offs

However, compression creates structural challenges:

- Rising labour costs for employers
- Pressure on business margins
- Need for new reward strategies



## 8. STRATEGIC RESPONSES FOR EMPLOYERS

### 8.1 Maintaining Pay Differentials

Common strategies include:

- Maintaining minimum hourly pay gaps between bands
- Staggered pay increases
- Annual pay structure reviews

These approaches aim to preserve career progression incentives.

### 8.2 Total Reward Strategies

Forward thinking organisations are shifting beyond base pay.

Key levers include:

- Skills based pay frameworks
- Structured career pathways
- Training and upskilling programmes
- Non-financial benefits and flexibility

### 8.3 Redesigning Progression

Employers are increasingly redefining progression to include:

- Skills acquisition
- Responsibility levels
- Autonomy and flexibility
- Recognition and status

This reduces reliance on hourly pay differentials alone.



## 9.OUTLOOK

The trajectory of UK wage policy suggests compression will continue.

The government has asked the Low Pay Commission to consider whether the NLW could rise beyond two thirds of median earnings.

If this occurs, compression pressures will intensify.

Organisations must prepare for a labour market where:

- Entry level pay continues to rise
- Pay hierarchies flatten further
- Non pay incentives grow in importance

A woman in a blue uniform and safety glasses is working on a smartphone in a factory setting. She is using a small tool to work on the device. Other workers are visible in the background, also working on smartphones. The scene is overlaid with a red tint.

# 10.CONCLUSION

Wage compression is now a defining feature of the UK labour market.

The National Living Wage has successfully raised the floor of pay and reduced low wage prevalence. However, it has also reshaped internal pay structures, particularly in labour intensive sectors.

The challenge for employers is not simply managing rising wage costs. It is redesigning reward, progression and engagement strategies for a flatter pay landscape.

Organisations that adapt proactively will be better positioned to retain talent, maintain productivity, and remain competitive in the evolving labour market.



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