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THE NEW EMPLOYMENT TAX

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Abstract

The government announced the employment tax increase in September adds needless complexity to the tax system, encourages self-employment rather than employment, and hits hardest the labour-intensive sectors that suffered most from Covid. It will encourage a shift away from labour-intensive sectors and reduce the UK's international competitiveness. The levy will add to the squeeze on real household incomes implied by surging inflation and, therefore, subtract from consumer and business spending. Higher health and social spending will add slightly more to GDP than the levy subtracts in the short run, but this will fade over time and GDP could end up slightly lower after three years. One possible intention is to increase this payroll tax further in the future, probably by linking it to NHS and social care outlays.

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Background

In September, the government announced a new Health and Social Care Levy, which initially will be a surcharge to existing National Insurance Contributions NICs, but with an extension to dividends. The levy aims to fund the NHS and social care. Effectively, there are now three separate taxes on incomes, which is two too many. Income tax, NICS and the new levy all apply to earned income, and having three taxes apply to the same base blocks tax transparency and introduces needless complexity and costs, especially for employers. The levy will be 1.25% on employees and 1.25% on employers. In total, the levy will raise £13.8bn a year, though there will be a refund of £1.8 bn to public sector employers to compensate them for their higher charges. The net increase in revenues, £12.0bn, is equivalent to about 0.6% of Gross Domestic Product (GDP).

Analysis

The government introduced a new levy because, for historical reasons, public resistance to paying higher national insurance contributions is lower than to paying higher income taxes. Initially, National Insurance tied benefits to contributions. Over time, the link loosened, but governments exploited the public's lingering illusion that National Insurance is not a tax to cut income tax and raise National Insurance contributions. Since money is fungible, it makes questionable economic sense to hypothecate revenues to individual government programs. The decisions on raising tax revenue should reflect considerations of efficiency and fairness, and tying spending to a particular tax may lead to under- or over-provision of services. However, the public often seems more willing to pay hypothecated taxes (see Doestinchem, 2010). Arguments in favour of hypothecation include trying to curb demands for higher spending by linking that more directly to higher taxes. Some argue that getting people used to a link between the provision of public services and payments is a step towards more private provision (Teja and Bracewll-Milnes, 1991; Wilkinson, 1994).

The levy will apply to dividends as well as employment incomes, but not to pensions. It increases the tax burden on workers relative to the retired, with the latter group also set to benefit most from increased health and social care spending. The continued increase in the burden of taxation on employment militates against long-run growth, for example, by disincentivizing skill acquisition. Since taxes on self-employment incomes will rise by 1.25%, instead of 2.5% in total on employment incomes, the incentive to be self-employed increases, increasing tax administration costs, and encouraging reduced firm size and economic efficiency. Economic theory says that it does not matter to which side of the labour market a tax applies. The ultimate incidence of the tax depends not on who first pays the tax but on the demand and supply conditions in the labour market. Thus, splitting a tax rise between employers and employees, as with the levy, is economically unnecessary and serves to obscure the size of the tax increase.

One of the chief criticisms of the levy is that the same tax revenue could have been raised more efficiently and equitably, for example, by raising the income tax on higher earners who have suffered less from Covid. For example, employees' National Insurance contributions drop from a 12%

marginal rate to only 2% above an upper earnings limit, making NICs less progressive than income tax.

According to the government, about 1.6 million businesses will need to prepare to pay the new levy. However, about 640,000 small enterprises will avoid the levy because they are eligible for the Employment Allowance, so just under 1 million will be making extra payments. Firms expected to suffer the most significant hits would be larger employers (i.e., those not eligible for Employment Allowance) in industries where labour costs are a high fraction of total costs.

The new levy's burden will fall on a combination of employees, firms, suppliers, and consumers. The standard economic wisdom is that since the demand for labour is far more elastic than the supply, employees bear all of the burden of payroll taxes, whoever pays the initial tax (See, for example, Brittain, 1971). However, this may not apply fully, especially in the short run (see Alvaredo et al., 2017; Beach and Balfour, 1983). To the extent that firms cannot pass on the incidence to employees, who ultimately bears the tax will vary according to the conditions individual firms face. For example, firms competing with other domestic firms in tight product markets may find that they can pass the increased cost on to consumers since their competitors will face the same cost increase. Exporters and those competing with imports will have a more complicated task because many of their competitors will be foreign businesses that do not bear the new levy. In the face of strong competition, the firm will not pass the extra cost on to consumers. Thus, the levy will reduce UK international competitiveness by reducing the attractiveness of the UK as a location.

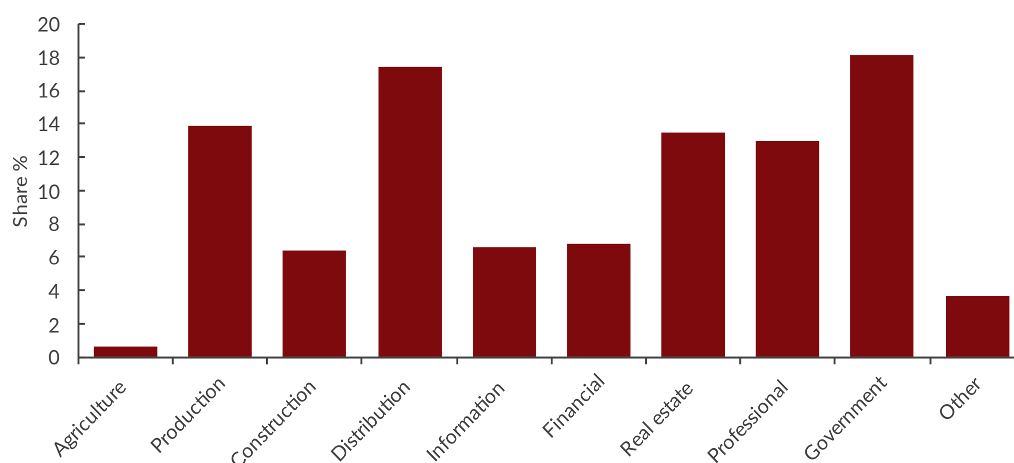
Sectors with a high share of labour costs in value-added and total sales will suffer more than firms with low labour shares. Table 1 shows that the sector with the highest share of labor costs is distribution, transport, hotels, and restaurants. One of the largest in the economy (see Chart 1), this sector includes many businesses that were among the worst affected by Covid. The sector also registered a high share of employees on furlough, pointing to still weak demand and, therefore, minimal ability to pass higher costs into prices. Those firms that Covid hit hardest will also suffer most from the National Insurance hike, though the Employment Allowance will protect smaller firms.

Table 1: Labour Shares by Sector (%)

Compensation of employees as a share of :	Value Added	Gross Output
Agriculture	37.7	14.0
Production	53.6	19.1
Construction	44.0	17.2
Distribution, transport, hotels and restaurants	68.0	35.9
Information and Communication	60.5	34.3
Financial and insurance	55.0	25.1
Real estate[1]	6.3	5.1
Professional and support	62.4	35.8
Government health and education	76.4	47.5
Other services	54.6	36.0

Source: ONS

Chart 1: UK Sector Shares



Source: ONS, NIESR

[1] Mostly imputed rent of owner-occupiers.

By itself, the increase in the household tax burden will reduce real personal disposable incomes. A reduction in savings will mean that consumption falls by less. Lower consumption and lower corporate profits will be a slight dampener on investment. Exports will be marginally weaker due to poorer competitiveness, but lower domestic demand means softer imports also. In total, we estimate that the tax increase would reduce since consumption by about ¼% after a year but by about ¾% point in the long-run. However, there is more to the story – the levy is to finance increased public spending. Public spending has a lower import content than consumption, so that reducing household incomes to increase government spending increases the share of total spending going on UK-produced goods and services. Households will pay some of the extra tax from savings so that taking government and private consumption together, aggregate spending increases in the short run. Moreover, a higher share of the higher aggregate spending directs UK output, GDP ends up higher: the short-run balanced-budget multiplier is positive. If the increased spending were to occur simultaneously with increased taxes, simulations of NiGEM, the National Institute's econometric model, suggest GDP initially could be higher by about ¼% point. The size of the effect depends on the extent to which the increase in public resources leads to higher public sector pay rather than an increase in the volume of government expenditure. Higher pay in the NHS, for example, would represent an income transfer from private-sector employees and firms to public employees, with no net impact on GDP.

The longer-run effect of increasing taxes and spending would be less favourable on GDP, with NiGEM suggesting a slight decline relative to the base. The decline arises because the increase in spending is on current government consumption, whereas a portion of the resources relinquished by the private sector would have been on investment. Lowering investment will lower the future growth rate slightly. Also, there is a slight loss of competitiveness that helps to erode the initial gains. The main effect longer term is a decline in consumption and a rise in government consumption relative to the base.

Conclusion

Macroeconomically, the combination of higher spending and a higher real tax burden is slightly beneficial for short-term GDP, though there is a drag on future growth. The main effects are to redistribute resources between sectors - making more resources available for public consumption by reducing the resources available for the private sector, mainly household consumption. The attempt to obscure the fact of this being a tax increase leads to unnecessary tax system complexity. Further, it distorts the labour market and shifts the tax burden further onto workers and away from the retired. This levy is a sub-optimal way to raise the extra resources needed to fund the NHS and social care. Its main attraction is political since the public seems not to recognise it fully as a tax. They also fail to appreciate that much of the incidence of an employers' payroll tax will fall onto employees in the long run. Those misconceptions, and the fact that the Inland Revenue is going through a lengthy and presumably costly system change to introduce the levy, suggests it is unlikely to stay long at its current rate. This payroll tax will probably increase in the coming years. It could be linked, for example, to higher NHS and social care spending, which would, to an extent, distance politicians from the decision to raise the tax. It may also be a subtle way of getting people to accept the

principle of linking payments to health and social care spending, perhaps in an attempt to try to curb their seemingly inexorable rise.

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