Economic impacts of expanding the National Insurance Contributions holiday scheme – Federation of Small Businesses policy paper

Overview

This research paper sets out estimates for the economic and employment impact of extending the existing regional National Insurance Contribution (NIC) holiday to all small firms, rather than just newly founded ones. In line with the Federation of Small Businesses' (FSB) previous proposals, the calculations are aimed at firms with up to four employees with separate estimates for the current target areas that exclude London, the south east of England and East Anglia as well as ones for the entire UK.

The current scheme has been less successful than expected by the Government as fewer than 15,000 companies made use of it in the first 18 months. This compares with initial projections of 200,000. Against this background, the FSB is mindful of the risks of overstating the potential benefits of a policy change. The multiplier analysis used is based on evidence from 2009 – a time of falling output - so the economic impact estimates should fit the current context. However, given the weak state of the UK's domestic demand, firms may be more cautious than usual to add employees to their workforce while dark clouds hang over the eurozone and full recovery from the financial crisis still appears to be far away. Therefore, the research uses conservative, evidence-based assumptions and figures have been scaled down (via an employment displacement effect) to reflect exceptional current economic circumstances.

The key findings include:

- **EMPLOYMENT**: Over a two-year period, it is estimated that an extension of the NIC holiday to all micro firms will boost employment via lower labour costs to firms by **27,000** for the current limited area of eligibility and by **45,000** if London, the east and south east of England are included
- **ECONOMIC ACTIVITY**: As additional direct employment raises incomes which trickle down through the economy and create a multiplier effect, an annual increase in economic activity of **£700 million** in the scheme's current limited area and of **£1,270 million** for the whole UK is predicted once the full employment impact has been realised

- **TAX INCOME**: The rise in employment is projected to raise additional income and payroll taxes of **£511 million** for the restricted area or **£949 million** for the whole of the UK over a three-year period. This contrasts with a loss of employer NICs of about £691 million in the limited area or £1,669 million for the entire UK over the suggested three fiscal year period

The paper begins by presenting employment impact estimates. Multiplier analysis is used to gauge the wider economic impact this employment creation may have, including indirect job creation and the effect on national income.

The effective tax cut from lower payroll taxes is estimated to increase labour income in the economy. This papers focus is the increase in employment due to a lowering of effective labour costs for small firms and the associated economic benefits. It also presents a brief estimate of the income effect from lowering taxes.

Factoring in an income effect and its associated annual tax benefits, the fiscal loss is expected to be offset in the limited area as the combined profit and employment effects create economic activity. A projected additional 4,000 and 11,000 jobs could be created across the limited and UK-wide schemes respectively (table 8).

Table 1: Fiscal impact timeline, £ million, 2012 prices

Fiscal impact, 2012 £ million	2013/2014	2014/2015	2015/2016	2013/2014 to 2015/2016
Increased tax revenue, labour cost effect				
Limited area	146	183	183	511
Whole of the UK	271	339	339	949
Increased tax revenue, income effect				
Limited area	54	54	54	163
Whole of the UK	101	101	101	302
Lost Employer NIC				
Limited area	(230)	(230)	(230)	(691)
Whole of the UK	(556)	(556)	(556)	(1,669)
Net increase/decrease in taxes, £				
Limited area	(30)	7	7	(17)
Whole of the UK	(184)	(117)	(117)	(418)

If the Government's logic of targeting small business employment through a NICs cut is correct, the policy experiment shows that:

- The initiative was positive where taken up
- The scheme needs to be more widely targeted to have a greater impact

The FSB recommends the scheme be targeted at growing firms for greater levels of job creation to occur. The public finance figures in the FSB's proposed scheme are based on the current NICs holiday scheme a new firm receives for additional employment.

Policy Context

The Government has introduced a number of explicit and non-explicit schemes to boost job creation. These schemes take different formats and target specific demographics. Each has loans, mentoring or training as part of the offering. The major schemes include:

- Work Programme
- The Youth Contract
- The Regional Growth Fund
- Universal credit and other welfare reforms
- New Enterprise Allowance and Start-Up Loans

The FSB believes that an initiative targeting micro-businesses looking to grow and take on additional level of employment is missing. If the Government's assumption that many new jobs will come from small firms, this area needs to be addressed. Separate research by the FSB has found that 88 per cent of unemployed people actively looking for work find employment in the private sector do so by starting up or joining a small business[1].

Direct employment impact from existing firms

A recent FSB member survey[2] revealed that payroll taxes are a major barrier to hiring, with one in four respondents saying these were a major factor in keeping them from taking on new staff. An even higher share, 53 per cent, of the 2,700 responses said that a tax break incentive on NICs would be the policy measure that would most encourage them to take on new staff. The high number of responses

[1] FSB Back to Work, the Role of Small Businesses in Employment and Enterprise, Sept 2012
[22] FSB member survey panel June 2012; 2774 respondents http://www.fsb.org.uk/fsb-survey-panel

indicates that a more broad-based NIC holiday, which would be available for all small businesses, could have a strong employment and overall economic impact.

While the survey results provide a useful baseline, the phrasing of the question is open and doesn't specifically mention a temporary tax cut. To gain more robust estimates of the policy proposals' potential, the impact of the existing NIC holiday has been analysed. In the first 19 months of the current scheme (June 2010 to end of March 2012) 13,769 firms report to have applied for the scheme, with firms starting business four months prior to the schemes inception eligible to apply. That constitutes about 5.4 per cent of the number of new companies created in the limited area in question, based on data from Office for National Statistics Business Demography publication.

To estimate the employment impact of an NIC holiday extension, the number of firms that would look to hire as well as the number of staff hired by each will need to be known. The 5.4 per cent figure provides an evidence-based estimate of the number of existing small businesses that may take advantage of the scheme to hire additional staff. To be cautious when estimating the impact of the proposed policy change, the research only applies the empirical take-up estimate to the number of small firms with employees rather than those without, as the latter are around five times more numerous. In addition, it is assumed that only half of jobs created are genuinely new positions, with the other half representing a displacement of activity from existing firms. The 50 per cent share of actual job creation is judgment-based, as comparable historical data on displacement effects is currently unavailable to the best knowledge.

The research assumes one full-time equivalent (FTE) is hired per participating company. Within this, the UK-wide proportion of 27.6 per cent of part-time jobs - taken to be 0.5 FTE – is applied, which is expected to be reflected proportionally in new hiring. From this, a further assumption is used: 50 per cent of businesses hire one full time worker, while the remaining 22.3 per cent hire two workers. Although more hiring is possible, it is unlikely as the average number of employees for eligible firms in the proposed scheme is just 1.4. The resulting number of FTE is rounded from 1.09 to 1 jobs in order to make subsequent computations more transparent.

The employment impact would be larger if the policy were extended to all parts of the country, as four in 10 businesses are located in these regions. Table 2 summarises the results, estimating the creation of 12,105 new jobs for the current limited area and 20,171 for the whole of the UK. The time horizon for the direct employment creation effect is one calendar year and the extent of the estimates appear realistic in light of annual small business employment creation and considering that a price elasticity of demand for labour approach would yield similar results.

Table 2: Direct employment impact

	Policy take-up rate	Number of small firms with employees	Proportion of job displacement	Direct job creation
Limited area	5.4%	450,145	50%	12,105
Whole of UK	5.4%	750,110	50%	20,171

Employment multiplier

When jobs are created, it leads to additional business and job creation along the value chain. The additional employment impact from each new position varies by industry, but given the sector breakdown of small firms on a regional basis we can derive an overall estimate. Table 3 shows the results including the weighted multiplier derived from Cebr's proprietary model. It indicates that each new job arising from the scheme an additional 2.24 jobs are created in the whole of the UK. The estimate of 2.26 in the limited area shows that induced employment creation is similar across all areas.

Taking the multiplier effect into account, **27,405 jobs** could be created if the policy is extended to all micro-firms in the restricted area and a **substantially higher 45,195** if the whole of the UK is eligible for an extended NIC holiday.

Table 3: Total employment impact via employment multiplier, labour cost effect

	Direct job creation	Employment multiplier	Total employment creation
Limited area	12,105	2.26	27,405
Whole of UK	20,171	2.24	45,195

It is estimated that the impact of job creation will mainly come into force in the first year of the policy's inception. In the first year (2013-2014), four fifths of the employment impact is expected to be realised: about 22,000 jobs in the limited area, or about 36,000 for the whole of the UK. For the following year, the impact would be about 5,000 jobs and 9,000 respectively, with no major additional impact expected for the third year of the policy. The higher employment level and its associated economic benefits are projected to be maintained over the proposed three-year horizon. Again, it should be noted that the evaluation only focuses on the impact on existing firms. New firms created will face lower labour costs, resulting in higher employment compared with the absence of an NIC holiday. Given a relatively small impact and to limit the complexity of the analysis presented, the research only focuses on existing firms. Table 4 summarises the projected time profile of employment creation between 2013-2014 and 2015-2016.

Table 4: Time profile of job creation

	2013/2014	2014/2015	2015/2016	2013/2014 - 2015/2016
Limited area	21,924	5,481	-	27,405
Whole of the UK	36,156	9,039	-	45,195

Overall economic impact

On the basis of the total employment effect the impact on the wider economy can be evaluated. An increase in job numbers results in higher incomes that can be used in the income perspective on gross domestic product (GDP) to estimate the overall effect on national output. To calculate the growth impact the estimate for the direct employment impact is used in conjunction with data on average gross wages from the Office for National Statistics' latest Annual Survey of Hours and Earnings. The private sector median, adjusted for lower wages outside the east and south east of England, provides the best estimate for this figure and yields the total direct income impact.

In addition to the direct impact, a multiplier applies to incomes as they are spent or saved, creating value throughout the economy. Household consumption adds revenue for businesses while savings become available for investment. Incomes are boosted as these funds flow through the economy, with the additional impact at about 150 per cent of the initial increase. Table 5 summarises the results and shows that a substantial increase in national output can be expected from rising employment via the income identity of GDP.

Table 5: Economic impact of job creation via incomes

	Direct jobs created	Gross average earnings, £	Total income gain, £	Income multiplier	Increase in GDP, £
Limited area	12,105	22,997	278,372,777	2.51	**697,333,299**
Whole of UK	20,171	25,000	504,282,207	2.52	**1,272,300,494**

As the employment impact is expected to occur in the first two years of the policy, the economic benefits are also likely to accrue over this period and to remain while the increase in employment is maintained. The estimated time for this to take effect and accrue is again four fifths in the first fiscal year and one fifth in the second fiscal year after the introduction of the policy. If the policy has the impact estimated here, it would boost national output by about 0.1 per cent per year.

Table 6: Economic impact of job creation over three years, £million (2012 prices)

GDP increase from increased earnings, 2012 £ million	2013/2014	2014/2015	2015/2016	2013/2014 - 2015/2016
Limited area	558	697	697	1,953
Whole of the UK	1,018	1,272	1,272	3,562

Impact on the public finances

In light of the public finance course of the Government, the Exchequer implications of economic initiatives are a major consideration. By creating new jobs directly and via a multiplier effect, income tax and national insurance contributions from employees and from non-eligible employers (via the multiplier effect) are raised on the additional employment that the reduction in payroll taxes brings.

Taking median salaries for the respective regions and the previous employment creation estimates, such direct tax gains are annually expected to add up to **£132 million for the limited area and to £247 million for the entire UK** once the full employment impact is realised. In addition, the rise in national income should also yield a ‘return’ for the Treasury from higher value-added tax (VAT) receipts. Currently about 7.2 pence is collected for each pound of national output, suggesting that £697 million in additional national income would result in £50 million of VAT receipts for the restricted area and £92 million for the whole of the UK’s £1.3 billion income gain.

Tax losses result from firms eligible for the NIC holiday that would have hired staff regardless of the policy. The figures assume a share of small business hiring, proportional to the employment share of firms with zero to four employees, which lies at seven per cent. Based on changes in employment and the number of redundancies (with a 67% uprating of the redundancy figures to take into account churn in the labour force not captured by involuntary redundancies) it is estimated that about 230,000 full-time equivalent jobs were created by small firms in the UK over the last 12 months for which data is available. Given the weak economic outlook, it can be assumed that the current economic climate will persist over the forecast horizon and therefore use this number as an estimate of new job creation from small firms. Together with average gross earnings, the total amount of employer NIC lost to the public purse can be estimated. See the final column of Table 7 for details of expected annual tax losses.

In line with employment creation and the rise in economic activity, the tax gains are predicted to be phased in over two years following the introduction of the policy. Lost NIC employer contributions would occur in each year of the policy. Table 1 summarises the tax costs and benefits along the timeline.

Table 7: Tax implications once policy takes full effect and labour cost impact, £ (2012 prices)

	Direct tax gains	Indirect tax gains	Total tax gain	Lost Employer NIC contribution, per year	Net tax impact per year
Limited area	132,282,422	50,385,790	182,668,212	230,253,727	47,585,515
Whole of UK	247,123,605	91,930,023	339,053,628	556,268,133	217,214,505

Estimating the income effect of lowering employer NIC contributions

A tax cut in employer payroll taxes should raise profits for the firms that take advantage of the scheme. Assuming that the cut in effective labour costs does not affect the labour market significantly, other costs will remain the same, and the tax reductions will directly increase profitability. Small business owners, boosting the economy and creating employment in the process, will spend much of the additional income. The resulting increase in economic activity will also yield considerable tax revenues, reducing the net cost to the Exchequer.

Table 8 sums up a simple estimate of the economic, employment and tax impact of the income effect arising from the small firm NIC holiday. Starting with the lost revenue from Table 8, it estimates an equivalent increase in after-tax profits given under 'Increase in profits', which is equal to the tax cut minus an assumed corporation tax rate of 20 per cent (the rate for small firms with little revenue, to be conservative on tax take). Of these profits, all but the national saving ratio – averaging about 6.3 per cent since 2011 – is assumed to be spent as final consumption expenditure, therefore raising GDP. An assumed general expenditure multiplier of 1.3 is applied to the amount spent, leaving an estimate of the 'Total spending increase'. Taking the same proportion of output as GDP as in Table 7 as a VAT revenue estimate indirect taxation is added to the overall fiscal impact.

The rise in output has been converted into an employment impact via average productivity per worker. As in the previous section, the rise in labour income from higher employment would yield higher income tax and NIC contributions, estimated in the 'Rise in labour taxation' line. Adding corporation and labour income taxes, gives an estimate of direct taxation. The employment increases are non-trivial as they amount to nearly a quarter of the impact from lower labour costs.

Table 8: Estimated annual economic impact of the NIC holiday via an income effect

Income effect from lower taxes	Limited area	Whole of UK
Tax cut £	230,253,727	556,268,133
Increase in profits £	184,202,981	445,014,506
Income tax from higher profits £	46,050,745	111,253,627
Direct rise in spending £	172,598,194	416,978,592
Total spending increase £	224,377,652	542,072,170
Rise in VAT £	16,212,398	39,167,404
Increase in employment	4,611	11,141
Rise in labour income £	106,046,708	256,197,393
Rise in direct taxation £	31,437,603	85,948,869
Total annual rise in taxation £	93,700,747	236,369,899

Delivery of the new scheme

It is important to recognise that economic assumptions and detailed measurements, such as those in this paper, do not take into account the processes (internally at HMRC and any required legislative changes), which may need changing or introducing. Legislative space is available due to House of Lords reform bill being scrapped, and allows for more economic reform and growth measures.

As the scheme comes to an end in September 2013, the Government has the opportunity to build this scheme as a replacement, which would run until the end of the current Parliament.

The most effective method of defining the policy is to specify that an employee qualifies only when that employee takes the headcount of the business to a peak not previously attained since the start of the reformed scheme. Clear and simple rules will ensure that the jobs created are genuinely new, using definitions that already exist in the tax code:

- The relief would be limited to trading businesses
- The relief will not apply to any employee who is participating in or connected to the owner of the business (within the meaning of Part XI of the Income and Corporation Taxes Act 1988). It would also only apply where the business is for commercial purposes. Together these measures would prevent people taking advantage of the scheme to employ relatives or domestic staff for example
- The relief would exclude associated businesses in order to prevent people setting up new businesses simply to provide goods and services to existing businesses

The relief could be operated through the PAYE system or through a rebate system in order to minimise any administrative burdens. Thought must also be given to how this reformed scheme will operate with Real-Time Information (RTI).

Every business that employs staff has a unique PAYE reference number. To employ someone a business must to set up an account with HMRC and pay any National Insurance and income tax owed by the business or its employees quarterly. At the end of every tax year, the employer makes an annual return filling in a P35 and P14 forms. These summarise all the payroll figures for the year and show the number of employees employed during the previous year. Once again, under RTI, some of these procedures will change.

When an employer takes on a new employee, they must send HMRC either a P45 part 2 (if the employee has previously been employed) or a P46 (for an employee who is a new entrant to the job market, or who has lost their P45).) This creates a new record for that employee, determining their tax status. When an employee leaves the employer it creates a P45 for that employee and sends part 1 to HMRC. These processes will give HMRC an up–to-date picture of the number of people employed by an employer at any one time. This will allow HMRC to have an up-to-date record of all businesses and enable the relief to be applied straight away.

These options are under the current payroll system and elements of this may change under RTI. The FSB believes that under RTI, the monitoring systems of past year employee numbers could be improved and give more confidence to HMRC.

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Notes

This paper has been commissioned by the FSB. Analysis has come from the Centre for Business Research (Cebr). Numbers in charts have been rounded for ease of reading.