Bank of England

Dame Meg Hillier MP
Chair, Treasury Committee
House of Commons
London
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Andrew Bailey
Governor

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Dear Dame Meg,

I wanted to get back to you with some thoughts about the possible impact of the increase in employer National Insurance Contributions (NICs) in the Autumn Budget.

As set out in the February 2025 Monetary Policy Report, the Monetary Policy Committee (MPC) continues to judge that firms are likely to use a number of different channels in response to the change in NICs. Based on the costing provided by the Office for Budget Responsibility (OBR), Bank staff estimate that the change works to increase firms' employment costs by just short of 2%. Firms may choose to absorb this increase in costs within their profit margins, pass on the cost to consumers through higher prices, or mitigate the impact by reducing nominal wages or employment. Evidence from both the Bank's Decision Maker Panel (DMP) Survey and Agents' annual pay survey suggests that firms will respond through all of these channels. Taking this evidence into account, the increase in employer NICs contributes between 0.1 and 0.2 percentage point to the projected 1 percentage point near-term rise in consumer price inflation in the MPC's February forecast.

At the hearing on the Bank's November Monetary Policy Report (MPR), Dame Harriett Baldwin asked if the Bank's models would allow us to tease out what the impact would be if – hypothetically – the economy adjusted along only one of these channels of adjustment.

While such a thought experiment can be done in principle, I should note that Bank staff first use an empirical tax multiplier to derive the demand effect of the changes to the NICs before adjusting inflation and labour market variables for direct employment cost effects. Such an empirical approach relies on margins of adjustment that are in line with past observed behaviour in the economy rather than allowing a hypothetical use of one channel. Any experiment for the cost effects will therefore be highly hypothetical, and it will not give answers to questions of what might actually happen.

That said, for illustration, if firms were to absorb all of the increase in employment costs in lower profits margins alone, this would mechanically reduce the profit share of national income by nearly a percentage point, from about 29% to slightly above 28%. However, as described in the November 2024 MPR, the profit share of income has fallen in recent years, and such a further decline would take the profit share below its previous trough in 2001. The Bank's Agents report that firm margins are compressed, which appears to have started to cause cash-flow constraints for some smaller firms. Against this background, while much of the adjustment is assumed in the MPR to take place through firm profits in the MPC's projection at least initially, it is unlikely that firms would be able to absorb the full increase in employment costs in profit margins. We do not, therefore, put any weight on this scenario.

Equally, the extent to which firms can pass on higher costs to consumer prices will depend on the strength of the economy and the competitive pressures they face. With demand currently subdued, intelligence from the Bank's Agents suggests that firms in consumer-facing industries face difficulties in passing through costs to prices. A 2% increase in employment costs could – everything else equal – be covered by an increase in the price level of about ¾%. But everything else will not be equal. Such an inflationary impulse would most likely require a monetary policy response, which this simple calculation does not account for, and it is not plausible to assume that demand would remain unaffected. Taking such effects into account, a simulation exercise in the Bank's core macroeconomic model suggests that the inflationary impact would be strictly less than half a percentage point in a counterfactual where all of the adjustment were initially through prices. But Bank staff caution that such stylised model simulations depend on heroic assumptions about the reasons why only prices should respond. Again, we do not put weight on this scenario either.

Limits to firms' ability to absorb increases in employment costs in their profit margins or to pass them on to consumer prices may point to the risk of stronger responses through the labour market. But it is also unlikely that a 2% increase in employment costs would be fully absorbed through a corresponding reduction in the aggregate wage bill, through either lower wage growth or employment. Even if most of the adjustment were to take place through the wage bill, this would most likely be through lower wage growth combined with a smaller fall in employment.

By far the most plausible assumption, supported by the survey evidence, is that firms will spread the adjustment along all four channels simultaneously. In the MPC's February projection, around a third of the increase in employment costs are passed on to consumer prices. In the early part of the forecast, the bulk of the remaining adjustment is through lower profit margins for firms. Gradually, more of the adjustment will be through the wage bill with lower wage growth and some adjustment in employment. This means that, by the end of the forecast horizon, profits, prices and wage growth will each account for around 30% of the direct effects of the increase in employer NICs with less than 10% accounted for by employment. There remain considerable uncertainties around how firms will respond, however. Labour market conditions are loosening, and it is possible that more of the adjustment could come through lower employment. It is too soon to judge based on the official data.

Taken as a whole, regulated price changes and the impact of government policies announced in the Autumn Budget are expected to add around half a percentage point to inflation in the near term. But the single largest driver of the near-term rise in inflation in the MPC's February projection is energy prices, reflecting upwards pressures on European wholesale energy prices through a colder winter. Monetary policy cannot prevent such short-term influences on headline inflation, nor should monetary policy respond to factors that will fade by the time monetary policy takes it effect. I can assure you, however, that the MPC remains focused on setting monetary policy to ensure that inflation will return sustainably to the 2% target over the medium term.

I am looking forward to our hearing next week.

Yours sincerely,

Andrew Bailey