AMERICAN ACTION FORUM

Primer: Payroll Tax Holidays

Gordon Gray l December 2011

On December 17, 2010, the president signed into law H.R.4853 – the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Among the Act's provisions is a temporary payroll tax reduction of 2 percentage points that is scheduled to expire at year's end. Given recent attention by the president and members of Congress to this issue, this area of tax policy warrants examination.

Payroll Taxes: In addition to income, capital gains, and other collections from the federal government, workers and employers pay FICA (Federal Insurance Contributions Act) taxes to fund the nation's large social insurance programs: Social Security and Medicare. Programmatically, FICA taxes have two components. The first component is the old age, survivors, and disability insurance ("OASDI") tax, which is the funding stream devoted to the Social Security program. It is comprised of both an employer and an employee levy of 6.2 percent for a combined rate of 12.4 percent.[1] It applies to the Social Security Wage Base, which is the maximum amount of earned income to which the tax rates are applied, which effectively caps the amount of taxable income subject to this tax. This wage base adjusts for inflation. In 2012 the wage base will increase to $110,100 from $106,800.[2]

The second programmatic component to FICA taxes is the tax levied on wages devoted to the hospital insurance (HI) trust fund under Medicare. This levy is 1.45 percent and is imposed on both the employer and employee, for a combined tax rate of 2.9 percent. Unlike the OASDI tax, this tax rate is applied to all earnings.[3],[4]

Combined, FICA taxes amount to a rate of 15.3 percent on all earnings up to $106,800 in 2010,[5] with the combined HI tax of 2.9 percent applied to any earnings beyond.

As a parallel to FICA taxes, self-employed individuals are also subject to payroll taxes, namely the Self-Employment Contributions Act ("SECA") tax. Acting as employees and employers, the self-employed are subject to the 15.3 percent combined rates for both OASDI and HI taxes.

Payroll Tax Rates

FICA Tax	Social Security (OASDI)*	Medicare (HI)	Total
Employer Contribution	6.2	1.45	7.65
Employee Contribution	6.2	1.45	7.65
Combined Rate	12.4	2.9	15.3
SECA Tax			
Self-Employed	12.4	2.9	15.3

*applies to a maximum wage base ($106,800 in 2010)

Current Payroll Tax Cut: Payroll tax holidays as economic stimulus have been proposed before. Indeed, one was proposed as an alternative to the American Recovery and Reinvestment Act of 2009 ("stimulus bill"), and other measures since. None were passed by the Congress however, until the enactment of a broader compromise bill at the end of 2010. The bill included a

[1] http://www.ssa.gov/pressoffice/factsheets/HowAreSocialSecurity.htm
[2] http://www.ssa.gov/pressoffice/pr/2012cola-pr.html
[3] http://www.ssa.gov/pressoffice/colafacts.htm
[4] The recently enacted health care law imposed an additional .9 percentage point tax on individuals making over $200,000 and joint filers making over $250,000. The law also would apply the combined 3.9 percent rate on capital income for the same cohort of tax payers. This policy does not go into effect until 2013, and is not included in this discussion.
[5] Note this is 2010, prior to the enactment of the 2 percentage point reduction on FICA/SECA taxes.

reduction in the employee OASDI tax rate under the FICA tax of two percentage points, reducing the employee rate to 4.2 percent for 2011. The SECA rate was also reduced by 2 percentage points. According to the Joint Committee on Taxation (JCT), this policy came with a budgetary cost of $111.7 billion.[6] Insofar as this policy reduces the funding stream for Social Security, the law provided for General Fund transfers to replace forgone payroll revenue that would be otherwise credited to the Social Security Trust Fund. Essentially, this means the U.S. will borrow more to finance the revenue shortfall.

Tax Holiday Proposals: Republicans and Democrats have offered competing proposals on how to address the expiration of the current payroll tax reduction. The president is actively campaigning for an extension and expansion of the current law. Senate Democrats recently introduced the president's proposal as, S. 1917, which would halve both the employee and employer payroll tax to 3.1 percent relative to the pre-2011 rate of 6.2 percent. This proposal is estimated by JCT to cost $241.4 billion. The legislation also contains an additional tax credit for new hiring. As a budgetary offset, S. 1917 included a 3.25 percent surtax on incomes above $1 million. Senate Republicans introduced a competing proposal, S. 1931, which would extend the current payroll reduction of 2 percentage points for an additional year. This is estimated to cost approximately $119 billion. It includes means testing of certain benefits and reductions in expenditures related to the federal workforce as budgetary offsets. These proposals were both defeated by procedural votes of 51-49 and 20-78, respectively, with 60 votes required for consideration. It remains unclear whether more recent proposals will be able to garner sufficient support for passage.

Economic Effects: It is unclear how much additional economic activity and hiring these proposals would generate. However, the Congressional Budget Office recently did a study on the employment effects per million dollars' expenditure on certain policies, and found a considerable range of possible employment effects from payroll tax relief.[7] The key distinction among payroll tax relief proposals is which component of the FICA tax is reduced, the employee side or the employer side. A reduction in the employee side of the FICA tax effectively raises a worker's cash wages. With more money in their pockets at the end of each pay-period, these workers should then spend more, boosting consumer demand, and ultimately hiring. Or so the theory goes. Stimulus measures passes in 2008 and 2009 took this approach, providing tax rebates to households. However, as one recent study noted, households tended to save rather than spend the tax rebates, which dulls the consumer-side stimulus. CBO estimated that employee-side payroll relief would be susceptible to this phenomenon, noting: "CBO expects that the majority of the temporary increase in take-home pay would be saved rather than spent."[8],[9]

Alternatively, payroll relief could be structured to reduce the employer side of the FICA tax. The effects of this policy would filter through the broader economy through four channels, according to CBO. First, firms may reduce prices, which would spur consumer spending. Second, firms may raise employee wages. Third, firms may retain the savings, which could improve a firm's stock price or encourage additional investment. And lastly, firms may add additional labor, though CBO estimates this effect could small. Compared to an employee-side payroll tax reduction CBO notes that, "the effects of reducing employers' payroll taxes would be somewhat larger per dollar of forgone revenues." This is largely driven by the estimated price reduction associated with the employer-side reduction that would boost consumer demand to a larger extent than an employee-side reduction.

In considering any macro-economic effect of any of these proposals, it is important to consider them in the context of existing policy. A payroll tax cut has been in place for one year, and was entirely deficit financed. It is unclear what the economic effect has been. However, given the state of the current labor market and

[6] http://www.jct.gov/publications.html?func=startdown&id=3715

[7] http://www.cbo.gov/ftpdocs/124xx/doc12437/11-15-Outlook_Stimulus_Testimony.pdf

[8] http://www.nber.org/papers/w15421

[9] http://www.cbo.gov/ftpdocs/124xx/doc12437/11-15-Outlook_Stimulus_Testimony.pdf

economy more broadly, any effect can reasonably be assumed to be modest, and it is unclear if it was worth the additional debt and associated interest. As such, any new policy must be considered relative to whatever modest effect is already in place. The Democrats' proposal does include an incremental expansion of the proposal, which would have some incremental effect over the initial payroll reduction, but at more than twice the cost. Meanwhile the Republican proposal would leave in place the current policy and forestall a tax increase at the end of the year at less of a cost, but would not have any incremental economic effect relative to the current policy.