



Extending the Temporary Payroll Tax Reduction: A Brief Description and Economic Analysis

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Summary

Social Security is financed by payroll taxes, which are paid by covered workers and their employers. In the absence of a payroll tax reduction, employees and employers would each pay 6.2% of covered earnings, up to an annual limit, whereas self-employed individuals would pay 12.4% of net self-employment income, up to an annual limit.

In an effort to stimulate the economy, Congress, in December 2010, temporarily reduced the employee and self-employed shares by two points (to 4.2% for employees and 10.4% for the self-employed), with the Social Security trust funds “made whole” by a transfer of general revenue. The temporary reduction was scheduled to expire at the end of 2011, but the reduction was extended for two months as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78).

As part of the agreement on the Temporary Payroll Tax Cut Continuation Act of 2011, a conference committee to reconcile House-Senate differences in H.R. 3630 is considering a full-year extension of the payroll tax reduction. Extending the reduction through the end of 2012 would, by itself, increase the deficit by an estimated \$99.5 billion—raising concerns about the apparent incompatibility of an extension with long-term goals of fiscal sustainability.

Most proposals to extend the payroll tax reduction include some form of budgetary offset to reduce or eliminate the effect on the deficit and address concerns about long-term fiscal sustainability. Among the budgetary offsets mentioned in extension proposals are a surtax on high-income individuals (The Middle Class Tax Cut Act of 2011, S. 1917), freezing federal employee pay (The Temporary Tax Holiday and Government Reduction Act, S. 1931; and the Middle Class Tax Relief and Job Creation Act of 2011, H.R. 3630), and limiting certain federal benefits to high-income individuals (Temporary Tax Holiday and Government Reduction Act, S. 1931; the Middle Class Tax Cut Act of 2011, S. 1944; and the Middle Class Tax Relief and Job Creation Act of 2011, H.R. 3630). An exception to the inclusion of offsets is the Temporary Payroll Tax Cut Continuation Act of 2012 (H.R. 4013), which would extend the payroll tax rate reduction for the remainder of 2012 without offset.

Budgetary offsets are contractionary—as they either reduce spending or increase revenues. The degree to which they are contractionary in the short term, however, depends on design and the populations affected. For example, having offsets occur after the period of economic weakness has passed could limit short-term contractionary effects while simultaneously promoting long-term fiscal sustainability. In contrast, offsets that fall on individuals facing financial constraints would be expected to have larger contractionary effects.

This report briefly discusses economic stimulus considerations related to temporary payroll tax reductions. In addition, as the Social Security trust fund is made whole through a transfer from the general fund, select options to offset this increase in the deficit will be examined to illustrate how the choice of offsets can affect the net amount of economic stimulus provided. For a discussion of Social Security policy considerations concerning a temporary payroll tax reduction, see CRS Report R41648, *Social Security: Temporary Payroll Tax Reduction*, by Dawn Nuschler.

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Social Security is financed by payroll taxes, which are paid by covered workers and their employers.¹ In the absence of a payroll tax reduction, employees and employers would each pay 6.2% of covered earnings, up to an annual limit, whereas self-employed individuals would pay 12.4% of net self-employment income, up to an annual limit.²

In December 2010, Congress temporarily reduced the employee and self-employed shares by two percentage points (to 4.2% for employees and 10.4% for the self-employed), with the Social Security trust funds “made whole” by a transfer of general revenue.³ The temporary reduction was scheduled to expire at the end of 2011, but was extended for two months as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78).

As part of the agreement on the Temporary Payroll Tax Cut Continuation Act of 2011, a conference committee has been appointed to consider a full-year extension of the payroll tax reduction. In addition to an extension of the payroll tax rate reduction, the conferees are also considering a further extension of unemployment benefits⁴ and adjusting payments to doctors under Medicare.⁵ While there has been a general consensus on the need to extend these provisions, how these provisions should be paid for remains unsettled.

Whether to provide a full-year extension has prompted debate among policymakers. Concerns include those related to the potential of the temporary reduction to endanger the Social Security trust funds, signaling a departure from the self-finance structure of Social Security, while increasing the federal deficit. Supporters of an extension have emphasized the potential of an extension to stimulate the economy and the general revenue “repay” as a way to counter concerns about endangering the Social Security trust funds. However, if offsets are used to reduce the budgetary cost of repaying the Social Security trust funds, the choice of offset can reduce the net stimulative effect of the payroll tax reduction.

This report briefly discusses economic stimulus considerations related to temporary payroll tax reductions and efforts to offset the budgetary cost of an extension. For a discussion of Social Security policy considerations concerning a temporary payroll tax reduction, see CRS Report R41648, *Social Security: Temporary Payroll Tax Reduction*, by Dawn Nuschler.

¹ See CRS Report R42035, *Social Security Primer*, by Dawn Nuschler for more information on the Social Security program.

² The Social Security trust funds are also credited with tax revenues from the federal income taxes paid.

³ The temporary reduction was enacted as part of The Jobs Creation Act of 2010 (P.L. 111-312). The provision was itself a partial extension and modification of a temporary reduction enacted as part of the HIRE Act (P.L. 111-147). For more on the topic, see CRS Report R41648, *Social Security: Temporary Payroll Tax Reduction*, by Dawn Nuschler.

⁴ For additional background, see CRS Report RL34340, *Extending Unemployment Compensation Benefits During Recessions*, by Julie M. Whittaker and Katelin P. Isaacs.

⁵ CRS Report R40907, *Medicare Physician Payment Updates and the Sustainable Growth Rate (SGR) System*, by Jim Hahn and Janemarie Mulvey.

The Stimulus Effects of a Temporary Reduction in Payroll Taxes⁶

Short-term fiscal stimulus measures aim to boost economic activity primarily through increases in the demand for goods and services.⁷ The goal of these measures is to break a cycle of decreasing output leading to decreasing employment, resulting in lower consumption and leading to further decreases in output. Without stimulative policies the economy would eventually stabilize and recover, but recovery would take longer and the overall disruption to the economy would be greater.⁸

The Congressional Budget Office (CBO), in testimony before Congress, has identified three key criteria for assessing proposals to stimulate the economy.⁹ The criteria are timing, cost-effectiveness, and consistency with long-term fiscal objectives. The following sections evaluate the payroll tax rate reduction using these criteria.

Timing

Effective short-term stimulus should happen during the period of economic weakness. In addition, since recessions are historically short lived, effective stimulus should normally also be short lived.¹⁰

An extension of the reduction in payroll taxes could be implemented quickly and be designed to expire as the economy strengthens. The resulting increase in household income would be experienced quickly, as well. A modification of the reduction in payroll taxes, through either a greater reduction or an expansion to employer contributions, could be similarly designed.

Cost-Effectiveness

Effective short-term stimulus maximizes the increase in output and employment per dollar of budgetary cost. The effectiveness of a policy aimed at households would then depend upon the fraction of additional income spent (as opposed to saved) on goods and services relative to the lost federal revenue. Provisions targeted at low-income individuals or the unemployed should be more cost-effective than broad tax rate reductions, as those facing financial constraints are more

⁶ See CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by Thomas L. Hungerford and Jane G. Gravelle for a discussion of the effectiveness of other selected policy options to stimulate the economy.

⁷ In addition, existing programs often termed “automatic stabilizers” provide a measure of stimulus aimed at reducing the severity of an economic downturn in the absence of new stimulative measures. Examples of these programs are unemployment insurance and the Supplemental Nutrition Assistance Program (SNAP, formerly known as Food Stamps).

⁸ Testimony of Congressional Budget Office Director Douglas W. Elmendorf before the Committee on the Budget, U.S. House of Representatives, *The State of the Economy and Issues in Developing an Effective Policy Response*, January 29, 2009.

⁹ *Ibid.*

¹⁰ Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2012 and 2013*, November 2011, <http://www.cbo.gov/doc.cfm?index=12437>.

likely to fully spend any additional disposable income. In addition, theory suggests small recurring increases in income may be more likely to be spent than a similarly sized (in total) lump sum payment, but the empirical evidence to support this is weak.¹¹

An extension of the reduction in payroll taxes would not be targeted to those facing the greatest financial constraints, but the increase in disposable income would take the form of a small recurring increase. CBO estimated that a temporary reduction of payroll taxes would raise output cumulatively in the next two years by \$0.10 to \$0.90 per dollar of total budgetary cost and would increase employment by between one and nine jobs per million dollars of budgetary cost.¹² These estimates assume that the majority of the increase in disposable income would be saved or used to pay down debt rather than spent on goods and services.

Compared with other household tax reductions, an extension of the reduction in payroll taxes may be a cost-effective stimulus—though well-targeted direct spending may be still more cost-effective.¹³ According to CBO estimates, the short-term stimulative effect of an extension of the reduction in payroll taxes would be greater than the stimulative effects from extending the Bush Tax Cuts,¹⁴ on par with a one-year AMT patch,¹⁵ and less than an increase in refundable tax credits.¹⁶

Expanding the reduction in payroll taxes to include employer contributions—as proposed in S. 1660 and S. 1917—would be expected to provide a slightly greater degree of stimulus per unit of budgetary cost than an employee-side reduction, according to CBO.¹⁷ The policy could encourage hiring by temporarily reducing the cost of labor. However, other evidence suggests that subsidies provided on the employer side, whether to subsidize hiring or investment, may be relatively ineffective, because employers are unlikely to hire in the absence of increased demand.¹⁸ The cost-effectiveness of this policy would ultimately depend on firms' responses to the incentive.

¹¹ See CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle for a discussion of this literature and Jonathan Parker et al., "Consumer Spending and the Economic Stimulus Payments of 2008," *NBER Working Paper No. 16684*, January 2011, for a discussion on consumer spending from the 2008 economic stimulus payments.

¹² Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2012 and 2013*, November 2011, <http://www.cbo.gov/doc.cfm?index=12437>.

¹³ See CRS Report RS21136, *Government Spending or Tax Reduction: Which Might Add More Stimulus to the Economy?*, by Marc Labonte for information on the relative stimulative value of alternative fiscal policy levers.

¹⁴ See CRS Report R42020, *The 2001 and 2003 Bush Tax Cuts and Deficit Reduction*, by Thomas L. Hungerford for information on the Bush Tax Cuts.

¹⁵ An AMT (Alternative Minimum Tax) patch would effectively provide a cumulative inflation adjustment to the amount of income exempt from the AMT, reducing the number of taxpayers subject to the AMT. See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire for information on the Alternative Minimum Tax.

¹⁶ See CRS Report R41999, *The Impact of Refundable Tax Credits on Poverty Rates*, by Margot L. Crandall-Hollick for information on refundable tax credits and their effect on poverty.

¹⁷ Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2012 and 2013*, November 2011, <http://www.cbo.gov/doc.cfm?index=12437>.

¹⁸ See CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by Thomas L. Hungerford and Jane G. Gravelle for a full discussion.

Consistency with Long-Term Fiscal Objectives

Effective short-term stimulus should not hinder long-term fiscal sustainability. A further extension of the reduction in payroll taxes, by itself, would add to short-term budget deficits. The current two-month reduction was estimated to increase the deficit by \$20.8 billion.¹⁹ The 12-month extension and expansion provided by S. 1917, which includes employer-side payroll tax rate reductions, has been preliminarily estimated to cost \$265 billion.²⁰ Extending the current two percentage point payroll tax reduction through the end of 2012 would cost an estimated \$99.5 billion.²¹ By themselves, these proposals would be at odds with the long-term goal of deficit reduction and may signal to some a lack of resolve to reduce deficits to investors.²²

To address long-term fiscal objectives, most proposals to extend or expand the temporary reduction in payroll taxes include one or more offsets to reduce or eliminate the net budgetary cost of the proposals. These offsets are, by definition, contractionary as they either cut spending or raise taxes.²³

Tax Extenders

Dozens of other temporary tax provisions expired at the end of 2011.²⁴ Whether further extension of these other provisions should be included in a payroll tax rate reduction remains an issue for debate. Expired tax provisions lead to uncertainty for businesses and individual taxpayers. Furthermore, the potential for tax incentives to influence behavior, often the goal of tax policy, is diminished when expired tax incentives are reinstated retroactively.

One challenge posed by the potential inclusion of tax extenders in a payroll tax rate reduction extension is the cost of extending these expired provisions. The Joint Committee on Taxation has estimated that extending these other expiring provisions for one year, through December 31, 2012, would cost \$36.9 billion over the 2012 through 2021 budget window.²⁵ This figure does not include the cost of extending the payroll tax rate cut. This figure also does not include the cost of extending first-year bonus depreciation, which would cost an estimated \$21.1 billion over the 2012 through 2021 budget window, or the cost of adjusting the Alternative Minimum Tax (AMT) exemption amount for inflation, which is estimated to cost \$119.6 billion over the 10-year budget window.

¹⁹ Joint Committee on Taxation, *Estimated Revenue Effects Of The Revenue Provisions Contained In The "Temporary Payroll Tax Cut Continuation Act Of 2011,"* JCX-57-11, December 23, 2011.

²⁰ Joint Committee on Taxation, *Estimated Budget Effects of the "The Middle Class Tax Cuts Act of 2011,"* November 28, 2011.

²¹ See U.S. Congress, Joint Committee on Taxation, *Comparison Of The Estimated Revenue Effects Of The Revenue Provisions Contained In H.R. 3630, As Passed By The House Of Representatives And Amended By The Senate,* committee print, 112th Cong., January 11, 2012, JCX-3-12, <http://www.jct.gov/publications.html?func=startdown&id=4382>.

²² See CRS Report R40770, *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*, by Marc Labonte for information on the sustainability of the federal budget deficit.

²³ See CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford for more information.

²⁴ See CRS Report R42105, *Tax Provisions Expiring in 2011 and "Tax Extenders,"* by Molly F. Sherlock.

²⁵ See U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of an Extension of Certain Expiring Provisions Through December 31, 2012,* December 7, 2011, #11-1 167.

Paying for a Temporary Payroll Tax Reduction: Options and Considerations

Extending the current two percentage point payroll tax reduction through the end of 2012 would cost an estimated \$99.5 billion.²⁶ In considering a further extension of the payroll tax reduction, most proposals include some form of budgetary offset. The use of offsets is not, however, universal, as the Temporary Payroll Tax Cut Continuation Act of 2012 (H.R. 4013), introduced on February 13, 2012, does not contain any offsets. Offsets that reduce spending, or increase revenues, are contractionary.²⁷ While offsets address the issue of long-term fiscal sustainability, depending on design, they can diminish the short-term stimulative effects of the tax cut. Having offsets occur after the period of economic weakness has passed could limit short-term contractionary effects while simultaneously promoting long-term fiscal sustainability.

In addition to the aggregate economic impacts of the offset, there are distributional effects. The percentage increase in after-tax income and the percentage decrease in average federal tax liability is greater for low- and middle-income taxpayers, as compared to the highest-income taxpayers (see **Table 1**). Offsets that reduce income or benefits to low- and middle-income earners, or offsets that otherwise increase taxes, could diminish the potential benefit of the payroll tax rate reduction for affected groups.

Table 1. Distribution of Benefits from the Two-Month Extension of the Payroll Tax Rate Reduction

Cash Income Percentile	Tax Units With Tax Cut		All Tax Units		
	Percent of Total Taxpayers Receiving Benefit	Average Tax Cut Under Two-Month Extension	Average Tax Cut	Percent Change in After-Tax Income	Percent Change in Average Federal Tax Rate
Lowest Quintile	55.4	\$27	\$15	0.2	-0.2
2 nd Quintile	75.4	\$69	\$52	0.2	-0.2
3 rd Quintile	83.5	\$123	\$103	0.3	-0.2
4 th Quintile	88.3	\$216	\$191	0.3	-0.2
Highest Quintile	90.4	\$377	\$341	0.2	-0.1
All	75.7	\$153	\$116	0.2	-0.2

²⁶ This is in addition to the \$20.8 billion estimated cost of the two month payroll tax cut extension enacted in P.L. 112-78. See U.S. Congress, Joint Committee on Taxation, *Comparison Of The Estimated Revenue Effects Of The Revenue Provisions Contained In H.R. 3630, As Passed By The House Of Representatives And Amended By The Senate*, committee print, 112th Cong., January 11, 2012, JCX-3-12, <http://www.jct.gov/publications.html?func=startdown&id=4382> and Congressional Budget Office, *Budgetary Effects of the Temporary Payroll Tax Cut Continuation Act of 2011, as Posted on the Website of the House Committee on Rules on December 22, 2011*, December 22, 2011, <http://www.cbo.gov/ftpdocs/126xx/doc12646/Budgetaryeffectsofthetemporarypayrolltaxcutcontinuationactof2011.pdf>.

²⁷ See CRS Report R41849, *Can Contractionary Fiscal Policy Be Expansionary?*, by Jane G. Gravelle and Thomas L. Hungerford for more information.

Cash Income Percentile	Tax Units With Tax Cut		All Tax Units		
	Percent of Total Taxpayers Receiving Benefit	Average Tax Cut Under Two-Month Extension	Average Tax Cut	Percent Change in After-Tax Income	Percent Change in Average Federal Tax Rate
90 th –95 th	92.0	\$409	\$376	0.3	-0.2
95 th –99 th	90.0	\$422	\$380	0.2	-0.1
Top 1 Percent	88.8	\$446	\$396	0.0	0.0

Source: Tax Policy Center, Table T12-0006, Temporary Payroll Tax Cut Continuation Act of 2011, Available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3259>.

Notes: Cash income percentile breaks in 2011 dollars are as follows: 20% \$17,130; 40% \$34,174; 60% \$62,042; 80% \$104,401; 90% \$169,059; 95% \$216,085; 99% \$569,944. Average federal taxes include income taxes, payroll taxes, and the estate tax. Unit of analysis is the taxpayer.

Revenue Options

One option for offsetting the cost of extending the reduced payroll tax rate is to raise additional revenues. Some of the options discussed below have been proposed as part of payroll tax rate reduction legislation. Other options have been proposed by the Obama Administration, or have been part of comprehensive deficit reduction plans. These options represent a few of the dozens of policy options for raising additional revenues to finance an extension of reduced payroll tax rates.²⁸ Since the revenue options discussed below were not included in either the House-passed or Senate-passed versions of H.R. 3630, paying for an extension of the payroll tax rate cut extension with additional revenues will require conferees to consider measures that were not previously included in H.R. 3630.

Financing an extension of the two percentage point payroll tax reduction through the end of 2012 is expected to cost \$99.5 billion. The revenues that could be generated using the different options discussed below are summarized in **Table 2**.

High-Income Surtax

A specific option for raising revenues to pay for an extension of the temporary two percentage point payroll tax reduction is a high-income surtax. There have been several proposals to levy a high-income surtax in the 112th Congress. The American Jobs Act of 2011 (S. 1660) would levy a 5.6% high-income surtax on those with modified adjusted gross income in excess of \$1 million (\$500,000 for married individuals filing separate tax returns). This surtax would raise an estimated \$452.7 billion over the 2012 through 2021 budget window.²⁹

²⁸ The Congressional Budget Office (CBO) regularly issues a compendium of budget options to Congress. The most recent Budget Options volume contains more than 100 options for altering federal spending and revenues, most of which would reduce the budget deficit. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, DC, March 2011, <http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf>.

²⁹ See Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, to Honorable Harry Reid, Senate Majority Leader, October 7, 2011, <http://www.cbo.gov/ftpdocs/124xx/doc12471/s1660.pdf>.

A high-income surtax was also proposed in Senate legislation seeking to extend and expand the payroll tax rate reduction. The Middle Class Tax Cut Act of 2011 (S. 1917) proposed a 3.25% surtax on modified adjusted gross income above \$1 million (\$500,000 for married individuals filing separate tax returns). Imposing a 3.25% surtax on those earning in excess of \$1 million would generate an estimated \$267.5 million over the 2012 through 2021 budget window.³⁰

Imposing a surtax on high-income individuals could partially address concerns that some high-income individuals pay lower average tax rates than some middle-income earners.³¹ In 2006, 65% of taxpayers with incomes over \$1 million paid an average tax rate lower than those with less than \$100,000 in taxable income.

High-income taxpayer benefits from the payroll tax rate reduction are also limited. The 2012 wage cap is \$110,100, meaning that the 12.4% OASDI payroll tax is suspended for earnings above this threshold. High-income taxpayers would receive a maximum benefit of \$2,202 under a one-year, two percentage point payroll tax rate reduction. As a larger share of income is earned above the wage cap, benefits from the payroll tax rate reduction would be diminished. If, however, high-income earners were more likely to save payroll tax rate reduction benefits, rather than spend these benefits, recapturing these benefits through a high-income surtax would be less likely to dampen the stimulative impact of the payroll tax rate reduction.

One concern that has been raised regarding a high-income surtax is the potential effect on small businesses. However, very few tax returns reporting business income (roughly 1%) report adjusted gross income in excess of \$1 million.³²

Offsetting a temporary payroll tax reduction through a high-income surtax would mean that the costs associated with a tax benefit received by many would be paid for by a limited group. Nearly 76% of taxpayers benefitted from the two-month extension of the temporary payroll tax rate reduction (see **Table 1**). In 2009, 0.22% of tax returns filed had an adjusted gross income of at least \$1 million.³³

Limit Tax Expenditures

Individual income tax expenditures reduce income tax revenues by roughly \$1 trillion annually.³⁴ Thus, scaling back or eliminating certain tax expenditures could result in additional revenues. As examples, the Congressional Budget Office has estimated that gradually eliminating the mortgage interest deduction would result in an estimated \$214.6 billion over the 2012 through 2021 budget window.³⁵ Limiting the deduction for state and local income taxes to 2% of adjusted gross income

³⁰ Joint Committee on Taxation, *Estimated Budget Effects of the "The Middle Class Tax Cuts Act of 2011,"* November 28, 2011.

³¹ For further discussion of this issue, and analysis of this claim, see CRS Report R42043, *An Analysis of the "Buffett Rule,"* by Thomas L. Hungerford.

³² CRS Report R42043, *An Analysis of the "Buffett Rule,"* by Thomas L. Hungerford and Treasury Report: <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf>.

³³ Internal Revenue Service, *2010 Data Book*, Washington, DC, 2010, <http://www.irs.gov/pub/irs-soi/10databk.pdf>.

³⁴ U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by Congressional Research Service, 111th Cong., 2nd sess., December 2010, S. Prt. 111-58, p. 12.

³⁵ Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, DC, March 2011, (continued...)

(AGI) would raise an estimated \$629.3 billion over the 2012 through 2021 budget window. Limiting charitable contributions such that only contributions in excess of 2% of AGI would be deductible would raise \$219 billion over the 2012 through 2021 budget window.

Another option for limiting tax expenditures would be to limit the value of tax expenditures for higher-income taxpayers. The Obama Administration has proposed limiting the value of itemized deductions to 28%.³⁶ This proposal would reduce the value of itemized deductions for taxpayers in the 33% and 35% bracket in 2012.³⁷ Limiting the value of itemized deductions to 28% would raise an estimated \$293.3 billion over the 2012 through 2021 budget window.³⁸

Limiting the value of itemized deductions to 28% would increase the progressivity of the income tax system by increasing taxes paid by those at the upper end of the income distribution. For 2011, the 33% income tax rate applies to taxable income above \$212,300 for married filers (\$174,400 for single filers).³⁹ In 2009, the top 2% of returns filed were in the 33% or 35% tax brackets.⁴⁰

Estimates suggest that limiting the value of itemized deductions to 28% would leave tax liability unchanged for those with less than \$200,000 in income.⁴¹ Taxpayers with cash incomes between \$200,000 and \$500,000 would see income taxes increase by 0.1%, on average. For taxpayers with cash incomes between \$500,000 and \$1 million, average federal tax rates would increase by an estimated 0.4%, while average federal tax rates would increase by an estimated 0.6% for those with cash incomes in excess of \$1 million.

Similar to a high-income surtax, limiting itemized deductions to offset an extension of the payroll tax rate reduction would lead to an increased tax burden on the highest incomes. The higher tax burden, however, would result from scaling back the value of certain tax subsidies, which currently provide a greater benefit to higher-income taxpayers.

(...continued)

pp. 146–147.

³⁶ Department of the Treasury, *General Explanations of the Administration's FY2012 Revenue Proposals*, Washington, DC, February 2011, p. 148, <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf>.

³⁷ Under current law, the top two marginal tax rates are scheduled to increase to 36% and 39.6% in 2013. Thus, the 28% limitation for itemized deductions would apply to taxpayers in these two tax brackets beginning in 2013 (assuming the top marginal tax rates increase as scheduled under current law).

³⁸ U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects Of The Revenue Provisions Contained In The President's Fiscal Year 2012 Budget Proposal*, committee print, 112th Cong., March 17, 2011, JCX-19-11, <http://www.jct.gov/publications.html?func=startdown&id=3773>.

³⁹ For 2011, the 35% tax rate applies to taxable income above \$379,150, regardless of filing status.

⁴⁰ Internal Revenue Service, Statistics of Income, Table 3.4, available at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html>.

⁴¹ Tax Policy Center, T10-0064, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2655>. Changes in tax liability are reported relative to the current policy baseline. Using a current law baseline would result in larger increases in tax liability from limiting itemized deductions to 28%. See Tax Policy Center, T10-0062, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2653&DocTypeID=1>.

Re-Index the Tax Code

Another option for raising additional revenues is to modify how tax code parameters are adjusted for inflation. Current price level measures may overstate actual levels of inflation.⁴² A modified measure of inflation that more accurately reflects changes in the price level would change how provisions in the tax code, such as the standard deduction, personal exemptions, earned income and child tax credits, and IRA contribution limits, as well as tax brackets, are indexed for inflation. A re-indexing of the tax code was included in the deficit reduction packages presented by the President's Fiscal Commission and the Debt Reduction Task Force.⁴³

The Joint Committee on Taxation (JCT) has estimated that indexing the tax code for inflation using a chained consumer price index (CPI) would generate \$59.6 billion in additional revenues over the 2012 through 2021 budget window.⁴⁴

Applying a chained CPI to the tax code would result in increased tax liability for taxpayers at all income levels. Moderate income taxpayers (those with cash incomes between \$30,000 and \$40,000) would see average tax rates increase 0.3%.⁴⁵ Higher-income taxpayers (those with cash incomes between \$100,000 and \$200,000) would see average tax rates increase 0.2%. For taxpayers with incomes in excess of \$1 million, tax rates would not increase, on average.⁴⁶

Like the benefits of the reduced payroll tax rate, the additional tax burden imposed by re-indexing the tax code using a chained CPI is spread across the income distribution. Enacting a re-indexing of the tax code immediately could offset some of the stimulus provided by the payroll tax rate reduction. Much of the additional revenues, however, will be generated over time. Allowing the re-indexing to go into effect later in the budget window would postpone this contractionary effect, and would also reduce the revenues generated from the policy as measured within the 10-year budget window.

Increase the Payroll Tax Wage Cap

Another option for raising additional revenues is to increase the social security payroll tax base.⁴⁷ For 2012, Social Security payroll taxes apply to the first \$110,100 in wage income. In recent years, roughly 83% of employment earnings fell below the Social Security wage cap.⁴⁸

⁴² See CRS Report RL32293, *The Chained Consumer Price Index: What Is It and Would It Be Appropriate for Cost-of-Living Adjustments?*, by Linda Levine.

⁴³ See CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock.

⁴⁴ Joint Committee on Taxation, June 29, 2011, <http://democrats.waysandmeans.house.gov/media/pdf/112/6-29ResponseChainedCPI.pdf>.

⁴⁵ Tax Policy Center, Table T11-0233, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3104&DocTypeID=1>. The figures reported above are relative to the current policy baseline. For figures relative to the current law baseline, see Tax Policy Center, Table T11-0221, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3102&DocTypeID=1>

⁴⁶ The average increase in taxes paid for those with cash incomes of more than \$1 million is \$1,104. This increased tax liability relative to overall tax liability is small, such that the increase in average tax rates is less than 0.05%.

⁴⁷ See CRS Report RL33943, *Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens*, by Thomas L. Hungerford.

⁴⁸ Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, DC, March 2011, pp. 169-170.

When payroll taxes were first collected in 1937, 92% of earnings were covered. Over time, the share of covered earnings has fluctuated, falling below 80% in the 1960s. Legislation enacted in the late 1970s increased the tax base such that 91% of earnings were covered in 1983. Since the share of covered earnings has been allowed to decline since the 1980s, one option for raising additional revenues is to increase the share of total earnings subject to the Social Security payroll tax to 90%.⁴⁹ Like re-indexing the tax code, increasing the Social Security wage base was included in the deficit reduction plans presented by the President's Fiscal Commission and the Debt Reduction Task Force.⁵⁰

CBO estimates suggest that increasing the Social Security payroll tax base to cover 90% of earnings would have a net revenue impact of \$456.7 billion over the 2012 through 2021 budget window.⁵¹

Increasing the Social Security payroll tax cap would increase the tax burden on upper-middle income taxpayers. For taxpayers with earnings above the current payroll tax cap of \$110,100, enacting this option would offset some of the benefits associated with the payroll tax rate reduction. This measure would make the payroll tax less regressive, and over the longer term, improve the fiscal outlook of the Social Security trust fund.

Spending Options

The revenue cost associated with extending the payroll tax rate reduction could also be offset with spending reductions. Two specific options that have been discussed as possible offsets for a payroll tax rate reduction extension are reductions in federal worker compensation and war contingency funds. The options of reducing spending are also discussed in the context of discretionary and mandatory spending. The specifics of potential spending reductions are beyond the scope of this report. The revenue impacts of some of the specific proposals discussed below are summarized in **Table 2**.

Freezing Federal Workers' Salaries and Increasing Federal Workers' Retirement Contributions

The House-passed version of H.R. 3630 would extend the current freeze on statutory pay adjustments for federal employees for one year, through December 31, 2013.⁵² The House-passed version of H.R. 3630 would reduce the discretionary spending limits enacted under the BCA to achieve these savings. The CBO estimated that the provisions related to discretionary spending in the House-passed versions of H.R. 3630 would reduce spending by \$26.2 billion over 2011 through 2021 budget window.⁵³

⁴⁹ This would increase the Social Security wage cap to \$170,000 in 2012.

⁵⁰ See CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock.

⁵¹ Enacting this option would result in a change in outlays of \$11.1 billion over the 10-year budget window, while total revenues would increase by an estimated \$467.8 billion over 10 years.

⁵² Civilian pay increases were forgone for 2011 and 2012 as part of the Continuing Appropriations and Surface Transportation Extensions Act of 2011 (P.L. 111-322).

⁵³ Congressional Budget Office, *Effects on Revenues and Direct Spending of H.R. 3630, the Middle Class Tax Relief and Job Creation Act of 2011, Adjusted for the Enactment of H.R. 3765, the Temporary Payroll Tax Cut Continuation Act of 2011*, January 6, 2012, <http://www.cbo.gov/ftpdocs/126xx/doc12661/hr3630.pdf>.

Legislation introduced in the Senate, the Temporary Tax Holiday and Government Reduction Act (S. 1931), also proposed extending the current federal employee pay freeze, through 2015. The Congressional Budget Office estimated that under S. 1931, discretionary spending would be reduced by \$221.8 billion over the 2012 through 2021 budget window.⁵⁴ This savings comes from provisions that would freeze federal workers' salaries, reduce the size of the federal workforce, and reduce the discretionary spending caps as enacted under the Budget Control Act of 2011 (BCA; P.L. 112-25).

Another option for raising revenue by reducing federal civilian employee pay would be to reduce the amount of the annual pay adjustment as established under the Federal Employees Pay Comparability Act of 1990 (FEPCA; P.L. 101-509). Reducing the annual across-the-board adjustment expected to occur under FEPCA by 0.5 percentage points would reduce outlays by \$50.3 billion over the 2012-2016 budget window.⁵⁵

Freezing federal worker pay or reducing annual pay adjustments for federal workers would offset the benefits of the payroll tax rate reduction for a targeted group of wage earners. Regions with high concentrations of federal employees may receive less stimulative benefit from the payroll tax if a large proportion of employees have the payroll tax rate reduction offset through reduced wages. Trading future reductions in federal worker salaries for current revenue losses from a payroll tax rate reduction could make it more difficult for the federal government to recruit and retain highly qualified employees with technical and professional skills over the longer term.

War Contingency Funds

Another option for offsetting the revenue cost associated with the payroll tax rate reduction extension is to use savings from overseas contingency funds. In developing the budget baseline, the CBO assumes that discretionary spending grows with inflation. Thus, spending on Overseas Contingency Operations (OCO) is projected to grow over time.

For FY2012, an adjustment of \$126.5 billion was made to the discretionary spending cap set under the BCA for OCO.⁵⁶ Testimony presented by the CBO before the Joint Select Committee in October 2011, based on budget figures from the continuing resolution, projected the cost of overseas contingency operations over the 2012 through 2021 budget window at \$1.3 trillion.⁵⁷ If the drawdown in overseas military operations continues as expected, fewer funds will be needed for overseas contingency operations, resulting in budgetary savings relative to the CBO baseline.

⁵⁴ Congressional Budget Office, *Budgetary Effects for S. 1931, the Temporary Tax Holiday and Government Reduction Act*, December 1, 2011, <http://www.cbo.gov/ftpdocs/125xx/doc12578/s1931.pdf>.

⁵⁵ Additional analysis of this option, along with a discussion of some of the potential policy concerns, can be found in Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, DC, March 2011, p. 126.

⁵⁶ Congressional Budget Office, *Final Year Sequestration Report for Fiscal Year 2012*, Washington, DC, January 12, 2012, <http://www.cbo.gov/ftpdocs/126xx/doc12670/01-12-Sequestration.pdf>.

⁵⁷ The 2012 budget used to make this projection was \$119 billion. Since the budgeted amount for 2012 overseas contingency operations has increased, these projects are lower than what current CBO projections are likely to predict. See testimony before the Joint Select Committee on Deficit Reduction, *Discretionary Spending*, 112th Cong., October 26, 2011, http://www.cbo.gov/ftpdocs/124xx/doc12490/10-26-DiscretionarySpending_Testimony.pdf.

Discretionary Spending

Legislation in the 112th Congress has constrained anticipated growth in discretionary spending. The BCA included statutory caps on discretionary spending that resulted in \$917 billion in savings over the 2012 through 2021 budget window.⁵⁸ The BCA also established the Joint Select Committee on Deficit Reduction, tasked with finding an additional \$1.5 trillion in deficit reduction over the 10-year budget window. Failure of the Joint Select Committee to propose deficit reduction legislation has led to an automatic spending reduction process. Under this process, an additional \$1.1 trillion will be cut from the deficit over the 2013 through 2021 budget window.⁵⁹ Of this \$1.1 trillion, \$813 billion is from reduced discretionary spending (\$492 billion for defense, \$322 billion nondefense).⁶⁰

CBO's adjusted March 2011 baseline projected discretionary spending of \$11.0 trillion over the 2013 through 2021 budget window. Projected discretionary spending under the BCA caps and automatic spending reductions is \$9.4 trillion over the same time period. Thus, discretionary spending projections have been reduced by nearly 15% through BCA provisions. Offsetting the payroll tax rate reduction extension using discretionary spending cuts would require further reductions. Spending reductions are typically contractionary, implying that spending cuts enacted while the economy is still weak could offset the stimulative effect of the payroll tax rate reduction.

Mandatory Spending

Several payroll tax rate reduction extension bills proposed limiting certain federal benefits, including unemployment compensation, benefits under the Supplemental Nutrition Assistance Program (SNAP), and Medicare, based on income.

Measures to eliminate unemployment compensation for certain individuals based on income were included in the Temporary Tax Holiday and Government Reduction Act (S. 1931), the Middle Class Tax Cut Act of 2011 (S. 1944), and the Middle Class Tax Relief and Job Creation Act of 2011 (H.R. 3630), as introduced on December 9, 2011. In all cases, the legislation sought to limit or eliminate unemployment compensation for very high-income individuals. These three bills also sought to limit SNAP (formerly known as food stamps) for very high-income individuals. CBO estimates that the unemployment compensation and SNAP provisions contained in H.R. 3630 would generate \$0.1 billion over the 2012 through 2021 budget window.⁶¹

Two of the three aforementioned pieces of legislation contained provisions that would require high-income individuals to pay higher Medicare premiums (S. 1931 and H.R. 3630). CBO has estimated that provisions in H.R. 3630 to adjust the calculation of Medicare premiums and

⁵⁸ CRS Report R42013, *The Budget Control Act of 2011: Effects on Spending Levels and the Budget Deficit*, by Marc Labonte and Mindy R. Levit.

⁵⁹ While the BCA established a goal of \$1.2 trillion in deficit reduction, the CBO has estimated that the actual savings from this process will be \$1.1 trillion.

⁶⁰ Another \$171 billion is from reduced mandatory spending, while \$169 billion is from change in debt-service costs.

⁶¹ Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, to Honorable Dave Camp, Chairman, Committee on Ways and Means, December 9, 2011, <http://www.cbo.gov/ftpdocs/126xx/doc12609/hr3630.pdf>.

increase premiums for high-income beneficiaries would raise \$31.0 billion over the 2012 through 2021 budget window.⁶²

Generally, reducing spending (mandatory or discretionary) will tend to have a contractionary impact. Reducing mandatory spending through reductions in benefits for high-income individuals could have a contractionary impact if individuals reduce consumption to purchase services that were previously provided through the government. Alternatively, if high-income individuals instead purchase services out of savings, maintaining current consumption levels, the short-term contractionary impacts will be reduced.

Related Issues

A number of other issues are being considered alongside an extension of the payroll tax rate reduction. The Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78) also provided a temporary extension of emergency unemployment compensation and a temporary readjustment of physicians' Medicare reimbursements. Lawmakers have also considered including provisions that would extend the 100% bonus depreciation allowance to promote investment.⁶³ Extending the 100% bonus depreciation allowance would generate revenue losses. To avoid increasing the deficit, the cost of extending policies such as an extension of the 100% bonus depreciation allowance would require a budgetary offset. The Temporary Payroll Tax Cut Continuation Act of 2012 (H.R. 4013), however, would extend only the payroll tax rate reduction.

In addition to the issues mentioned in this report, legislation to extend the temporary payroll tax rate reduction has included provisions related to a number of other policy issues. Several of these issues are noted below (links to relevant CRS reports provided as footnotes):

- Environmental Protection Agency (EPA) regulations related to the Maximum Achievable Control Technology (MACT) standards for boiler and solid waste combustion units;⁶⁴
- Flood insurance reform;⁶⁵
- Spectrum reallocation and assignment and emergency communications;⁶⁶ and
- Keystone XL pipeline project.⁶⁷

⁶² Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, to Honorable Dave Camp, Chairman, Committee on Ways and Means, December 9, 2011, <http://www.cbo.gov/ftpdocs/126xx/doc12609/hr3630.pdf>.

⁶³ For more information, see CRS Report RL31852, *Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects*, by Gary Guenther.

⁶⁴ See CRS Report R41459, *EPA's Boiler MACT: Controlling Emissions of Hazardous Air Pollutants*, by James E. McCarthy.

⁶⁵ See CRS Report R40650, *National Flood Insurance Program: Background, Challenges, and Financial Status*, by Rawle O. King.

⁶⁶ See CRS Report R40674, *Spectrum Policy in the Age of Broadband: Issues for Congress*, by Linda K. Moore and CRS Report R41842, *Funding Emergency Communications: Technology and Policy Considerations*, by Linda K. Moore.

⁶⁷ See CRS Report R41668, *Keystone XL Pipeline Project: Key Issues*, by Paul W. Parfomak et al. and CRS Report R42124, *Proposed Keystone XL Pipeline: Legal Issues*, by Adam Vann et al.

Table 2. Potential Offsets for the Payroll Tax Rate Reduction

(billions of dollars)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012 - 2021
Extension of Payroll Tax Rate Reduction through 12/31/12^a	-74.8	-24.6									-99.5
Revenue Options											
High-Income Surtax (5.6%) ^b	1.0	28.5	25.5	44.4	49.2	53.3	57.1	60.6	64.6	68.6	452.7
High-Income Surtax (3.25%) ^c	0.8	18.1	13.4	26.3	29.1	31.5	33.7	35.9	38.2	40.6	267.5
Limit Tax Expenditures to 28% ^d	3.8	20.3	25.3	27.7	30.3	32.8	35.2	37.3	39.3	41.3	293.3
Re-Index the Tax Code ^e	0.0	0.6	1.9	4.1	5.7	6.6	7.7	9.5	11.3	12.4	59.6
Increase the Payroll Tax Wage Cap ^f	8.6	39.8	40.4	43.8	47.5	49.6	52.0	55.7	58.6	60.8	456.7
Spending Options											
Freeze Federal Workers' Salaries and Reduce Discretionary Spending Caps under the BCA (H.R. 3630) ^g	0.0	1.2	2.3	2.8	3.0	3.2	3.3	3.4	3.5	3.6	26.2
Freeze Federal Workers' Salaries and Reduce Discretionary Spending Caps under the BCA (S. 1931) ^h	0.0	6.6	15.1	22.2	25.7	28.2	29.3	30.2	31.6	32.9	221.8
Reduce Annual Across-the-Board Pay Adjustments for Federal Employees by 0.5 Percentage Points ⁱ	0.0	0.7	1.8	2.9	4.1	5.3	6.6	8.1	9.6	11.1	50.3
Limit Unemployment and SNAP Benefits for High-Income Earners ^g	(i)	(i)	(i)	(i)	(i)	(i)	(i)	(i)	(i)	(i)	0.1
Adjust Medicare Premiums and Increase Premiums for High-Income Beneficiaries ^g	0.0	0.0	0.0	0.0	0.0	2.2	4.1	4.7	8.6	11.4	30.1

Source: All revenues estimates provided by the Joint Committee on Taxation or the Congressional Budget Office.

Notes: Rows may not sum due to rounding. An (i) indicates less than \$50 million.

- a. This is in addition to the \$20.8 billion estimated cost of the two month payroll tax cut extension enacted in P.L. 112-78. See U.S. Congress, Joint Committee on Taxation, *Comparison Of The Estimated Revenue Effects Of The Revenue Provisions Contained In H.R. 3630, As Passed By The House Of Representatives And Amended By The Senate*, committee print, 112th Congress, January 11, 2012, JCX-3-12, <http://www.jct.gov/publications.html?func=startdown&id=4382>.

- b. As proposed in S. 1660. For the revenue estimate, see Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, to Honorable Harry Reid, Senate Majority Leader, October 7, 2011, <http://www.cbo.gov/ftpdocs/124xx/doc12471/s1660.pdf>.
- c. As proposed in S. 1917. For the revenue estimate, see Joint Committee on Taxation, *Estimated Budget Effects of the "The Middle Class Tax Cuts Act of 2011,"* November 28, 2011.
- d. As proposed in the President's FY2012 budget proposal. For the revenue estimate, see U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects Of The Revenue Provisions Contained In The President's Fiscal Year 2012 Budget Proposal*, committee print, 112th Congress, March 17, 2011, JCX-19-11, <http://www.jct.gov/publications.html?func=startdown&id=3773>.
- e. Applying chained CPI to the tax code. For the revenue estimate, see Joint Committee on Taxation, June 29, 2011, <http://democrats.waysandmeans.house.gov/media/pdf/112/6-29ResponseChainedCPI.pdf>.
- f. As presented in the CBO Budget Options. For the revenue estimate, see Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, DC, March 2011, pp. 169-170.
- g. As proposed in H.R. 3630. For the revenue estimate, see Congressional Budget Office, *Effects on Revenues and Direct Spending of H.R. 3630, the Middle Class Tax Relief and Job Creation Act of 2011, Adjusted for the Enactment of H.R. 3765, the Temporary Payroll Tax Cut Continuation Act of 2011, January 6, 2012*, <http://www.cbo.gov/ftpdocs/126xx/doc12661/hr3630.pdf>.
- h. As proposed in S. 1931. For the revenue estimate, see Congressional Budget Office, *Budgetary Effects for S. 1931, the Temporary Tax Holiday and Government Reduction Act*, December 1, 2011, <http://www.cbo.gov/ftpdocs/125xx/doc12578/s1931.pdf>.
- i. As presented in the CBO Budget Options. For the revenue estimate, see Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, DC, March 2011, p. 126.

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