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Payroll Tax Cuts as Economic Stimulus: Past Experience and Economic Considerations

Molly F. Sherlock
Specialist in Public Finance

Donald J. Marples
Specialist in Public Finance

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A range of fiscal and monetary policy tools have been used in the past to respond to weak economic conditions and recessions. One of those policy tools, enacted as economic stimulus in December 2010, was a temporary employee payroll tax cut. On August 20, 2019, President Trump expressed interest in proposing a payroll tax cut, although subsequent reports indicate this may not be a policy the Administration intends to actively pursue at this time.

2011-2012 Payroll Tax Cut

Payroll taxes are collected to finance certain entitlement programs, including Social Security, parts of Medicare, and Unemployment Compensation (UC). Social Security's old age, survivors, and disability insurance (OASDI) payroll tax is paid by eligible workers and their employers. The tax equals 6.2% of wages, on the taxable earnings base ($132,900 in 2019). This tax is paid by both employers and employees (with self-employed individuals paying both the employer and the employee share, or 12.4%).

In December 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) enacted a payroll tax "holiday" that temporarily reduced the employee and self-employed shares of the OASDI payroll tax by two percentage points (from 6.2% to 4.2% for employees; and from 12.4% to 10.4% for the self-employed). The Social Security trust fund was "made whole" by a transfer of general revenue. 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-

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78). The temporary payroll tax cut was extended again through the end of 2012 by the Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96).

The temporary payroll tax cut in P.L. 111-312, effective for 2011, reduced federal tax revenue by $111.7 billion. The two-month extension for early 2012 reduced federal revenue by $20.8 billion, while extending the payroll tax cut through the remainder of 2012 reduced federal revenue by $93.2 billion.

Stimulus Effects of a Temporary Reduction in Payroll Taxes

Short-term fiscal stimulus measures aim to boost economic activity primarily through increases in the demand for goods and services. The Congressional Budget Office (CBO), in testimony before Congress, has previously identified three key criteria commonly used to assess the stimulative effects of policy proposals: (1) timing; (2) cost-effectiveness; and (3) consistency with long-term fiscal objectives. The following sections evaluate a payroll tax rate reduction using these criteria.

Timing

To be effective, short-term stimulus should affect the economy during a period of economic weakness. Recessions are historically short-lived (though recovery from a recession may take a longer period of time). Since recessions are typically short-lived, effective stimulus should also typically be short-lived. A reduction in payroll taxes could be implemented quickly and be designed to expire as the economy strengthens. If designed to increase the take-home pay of workers, the resulting increase in household income could occur quickly.

While some economic indicators signal a recession may be on the horizon, the economy remains in its longest period of economic expansion. With unemployment at its lowest levels since the 1960s, and strong consumer spending, a broad range of economists have questioned whether this is the right time to enact a payroll tax reduction. If the economy were to head into a recession, existing automatic stabilizers (such as UC benefits) and monetary stimulus can serve as "first lines of defense." Should a recession become severe or prolonged, a payroll tax cut might be reserved as a policy option to address ongoing economic stagnation. A challenge for the effectiveness of any fiscal stimulus is the lag between changes in economic conditions and the policy's implementation.

Cost-Effectiveness

Effective short-term stimulus maximizes the increase in output and employment per dollar of budgetary cost. This might colloquially be referred to as the policy's "bang for the buck." Economists more often cite multiplier effects. The effectiveness of a policy aimed at households would depend on 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 are often expected to be more cost-effective than broad tax rate reductions, as those facing financial constraints are more likely to fully spend any additional disposable income. Other factors, such as the amount of debt a household has, may also determine the degree to which a stimulus measure targeting household income, such as a payroll tax cut, leads to additional spending.

Compared with most other options to reduce taxes paid by households, a reduction in payroll taxes may be a cost-effective stimulus because, depending on the policy's design, it might reach more lower-income households than other tax cuts. That said, well-targeted direct government spending may be still more cost-effective, and a payroll tax reduction only directly helps those who are working. A 2011 study found a temporary payroll tax reduction to have among the highest multiplier effects among a variety of tax policy options. CBO estimated during the last recession that reducing payroll taxes would raise output cumulatively over 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.

A 2015 CBO working paper presented data suggesting that multipliers vary according to the strength of the economy—with the smallest multipliers occurring when the economy is at or near full employment. Thus a payroll tax cut enacted today, in a strong economy, would likely have less "bang for the buck" than the policy had in the past, when enacted in a weak economy.

Consistency with Long-Term Fiscal Objectives

Effective short-term stimulus should not hinder long-term fiscal sustainability. Any reduction in payroll taxes, by itself, adds to short-term budget deficits and could be at odds with the long-term goal of debt sustainability. This is a consideration, given that the budget deficit and federal debt are higher than their historical averages, relative to the size of the economy.

To address long-term fiscal objectives, a temporary reduction in payroll taxes could include offsets to reduce or eliminate the net budgetary cost of the proposals. Offsets are, by definition, contractionary, as they either cut spending or raise taxes—though the timing of the offsets could be designed to apply their contractionary effects in later years.