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Doubling Down on the Payroll Tax Holiday Still Won't Create Jobs

J. D. Foster, Ph.D.

The August jobs report showing exactly zero net job creation and an unemployment rate hovering above 9 percent have reinforced the imperative among Washington policymakers to focus on job creation policies in the waning months of 2011. The focus is certainly right, but most of the policies under consideration would produce the same results as President Obama's jobs policies to date: no additional employment. No policies under consideration today offer a greater assurance of failure than the proposal to extend the existing payroll tax holiday—or to double down by extending that holiday to the so-called employer's share of the tax.

The Payroll Tax Holiday. On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This temporarily extended the Bush tax relief through 2012 for all taxpayers, extended other tax relief for middle-income citizens, and temporarily extended a number of provisions that were expiring or had expired. The legislation also provided a 2 percent reduction in employees' Social Security payroll tax for 2011, commonly known as the "payroll tax holiday."

The payroll tax holiday for 2011 expanded on an earlier policy signed into law by President Obama on March 18, 2010, in the Hiring Incentives to Restore Employment Act of 2010. This legislation, which proved equally ineffective, gave qualified employers an exemption from the hidden portion of the Social Security payroll tax that is collected directly from employers.

What It Was Supposed to Do—and Why It Did Not Work. Payroll tax relief is intended to stimulate the economy in two ways, neither of which works.

Cash in people's pockets. First, payroll tax relief reflects the faulty Keynesian stimulus philosophy of putting money in people's pockets that they would then spend, thereby increasing demand in the economy and ultimately increasing output and employment. The fundamental assumption of this theory is that since the economy is underperforming, total demand must be too low.

The theory prescribes tax cuts targeted at those who are most likely to spend and additional government spending that can be spent quickly. These policies then increase the budget deficit but are also intended to increase total demand in the economy, driving it back toward full employment. It works perfectly in some mathematical models. Unfortunately, reality is a bit more complicated, and on closer examination, the details void the whole theory.

The fundamental failing of the Keynesian stimulus theory is that it neatly ignores the presence of financial markets, which have as their primary purpose transferring savings from those who do

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not currently need to spend to those who need the funds, either to spend or to invest. In the Keynesian model, the money government borrows to finance the additional deficit spending magically appears in the form of cash in exchange for government bonds. In reality, this cash reflects savings that would otherwise be available to the private sector.

Under the Keynesian impetus, government spending certainly goes up while savings available for private use go down; government demand goes up, likely creating some jobs in the process, while private demand goes down (or net trade flow with the rest of the world deteriorates), thereby destroying some jobs in the process. The composition of total demand in the economy is unchanged but increasingly favors government.

Proponents harp on the jobs created by the deficit spending while ignoring the jobs destroyed by crowding out private spending. A good analogy is an investor who touts all the money he has invested—which may be a substantial sum, implying that he is a person of great wealth—while ignoring all the debt he carries because he borrowed to buy those same assets. Looking at both sides of the balance sheet reveals the investor to be dead broke. Keynesian stimulus is fiscal alchemy.

Lower cost of labor. The second way a payroll tax holiday is supposed to stimulate the economy is by making labor less expensive to hire, thus leading to additional hiring, more output, and increased incomes. Ironically, if the payroll tax holiday has any effect on labor markets at all, it is to raise the unemployment rate—once again, achieving no substantive results while achieving an appearance that is the opposite of what Washington intends.

The deciding question determining whether a payroll tax holiday raises or lowers unemployment is that of who bears the tax. If the tax is paid by employers, then it contributes to employers' labor costs, so lowering the tax should lower labor costs and thus encourage hiring. But if the tax is paid by workers—out of the total compensation employers are willing to pay—then the tax holiday increases the incentive to work, in which case the supply of workers will increase.

Under normal circumstances (meaning reasonably flexible markets and reasonably high employment), employers gauge how much they are willing to pay someone to do a particular job. This calculation establishes the total cost that employers are willing to incur to employ that worker, and the employer is indifferent to the composition of the pay package comprised of wages, benefits, and payroll taxes. The payroll tax therefore comes directly out of the employee's total compensation, and this is true whether the payroll tax is shown on the pay stub or disguised as "the employer's contribution." There is, in reality, no "employer's contribution." There is the part of the payroll tax paid by the employee that is shown, and there is the part that is paid by the employee in lower earnings that is hidden.

With persistently high unemployment, current circumstances are anything but normal. However, especially weak labor markets are not conducive to workers' forcing employers to bear some of the tax, just as especially weak labor markets do not provide a good environment in which to ask for a significant wage increase.

Thus, the payroll tax is subtracted from the employee's total pay, whether the tax is transparent or hidden. This is a point on which there is broad agreement among analysts of all ideological stripes.

Reducing the payroll tax therefore raises the returns to work, which under normal circumstances should result in an increase in the supply of labor and an increase in total output, with employers offering jobs to the additional workers. Not so, however, when there is high unemployment. In the current environment, increasing the supply of workers does nothing to increase the demand for workers, so it just means more unemployed workers. If anything, the payroll tax holiday likely increases the unemployment rate.[1]

To explain it another way, consider the opposite policy of raising the payroll tax rate. As the tax hike obviously would not raise worker productivity, employers would be unwilling and unable to bear the tax, and it would be passed on to workers in the form of reduced wages or benefits. Facing a decline in after-tax compensation, some individuals would drop out of the workforce, while others would choose to work fewer hours. Under normal circumstances, this reduction in the workforce would reduce output and incomes. Under the present circumstances of high unemployment, the net effect would again be to reduce the labor supply, reducing the ranks of the unemployed—not by helping them find jobs but by driving them from the workforce.

An Effective Stimulus Framework. There are tax policies the federal government could pursue to increase private-sector job creation. The key is to reduce the costs and uncertainties that employers face, not the taxes that employees pay.

Reducing employer costs and uncertainties will make employers more willing to pursue new opportunities in the economy, which is the key to growth, whereas reducing taxes on workers simply increases the number of individuals looking for jobs. For example, an effective pro-growth policy would be to make current individual income tax policy permanent, or at least to extend current policy until the unemployment rate approaches full employment or until 2016, whichever comes later, thereby avoiding a threatened tax hike and giving businesses some certainty about their taxes for the coming years.

What have not worked and will not work are economic policy gimmicks like the payroll tax holiday, the first-time homebuyers credit, the cash-for-clunkers program, or the many similarly well-named but poorly conceived nostrums that President Obama has pursued in recent years. The overarching framework for effective economic stimulus should be to do less harm: less harm through tax policy, less harm through regulatory policy, less harm through trade policy, less harm through excessive federal deficits. The private economy is both able and highly likely to resume strong growth once Washington decides to get out of the way.

Permanent Policy Improvements Are Needed. Two years after the end of the last recession, the economy should be producing strong, sustained job growth; yet growth has stalled as the economy appears to be stuck in a rut. This is certainly no time to be raising taxes, as President Obama has proposed on numerous occasions.

However, the nation's economy cannot wait on retreads of failed policies any more than America can afford to add to the massive federal budget deficit with ineffective tax relief. Congress should emphasize effective pro-growth tax policies, such as making the Bush tax cuts (set to expire at the end of 2012) permanent; reducing tax rates to improve incentives to produce; halting the regulatory onslaught; and cutting spending.

*—**J. D. Foster, Ph.D.,** is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

1. The unemployment rate is the ratio of the number of unemployed workers to the total workforce. If a payroll tax holiday increases the number of unemployed workers by a certain amount, then this amount will be added to both the numerator and the denominator in the ratio. For example, suppose there were 100 workers and nine of them are unemployed, so the unemployment rate is 9 percent. Suppose a payroll tax holiday increased the number of workers by one person to 101 and the additional worker remained unemployed, leaving 10 unemployed workers. The payroll tax holiday would increase the unemployment rate from 9 to 10 over 101, or 9.9 percent.