The Heritage Foundation
LEADERSHIP FOR AMERICA

ISSUE BRIEF

No. 3630 | JUNE 7, 2012

Four Basic Facts About the Pending Payroll Tax Hike

J. D. Foster, PhD

The Social Security payroll tax is scheduled to jump two percentage points on January 1, 2013, as part of Taxmageddon. Other elements of Taxmageddon include the simultaneous expiration of the 2001/2003 tax cuts, the expiration of a mostly motley collection of lesser provisions, and the imposition through the payroll tax of a highly harmful tax surcharge arising out of Obamacare.[1]

Unlike most elements in Taxmageddon that are fairly straightforward, there is some confusion surrounding the pending payroll tax hike and its implications for taxpayers and the economy. Here are four facts to set the record straight—but first, a brief history.

Origins of the Payroll Tax Cut. Early in 2010, President Obama encouraged Congress to enact additional stimulus tidbits in the face of a languishing economy. Congress responded by passing the HIRE Act, which included a two percentage point reduction in the "employer's share" of the payroll tax—but only for new hires. As expected, this legislation proved to be mostly symbolic and utterly ineffective in spurring job growth. Though the economy was well into an anemic recovery, the unemployment rate in the first quarter of 2010 was 9.6 percent, and by the fourth quarter it had fallen a mere 0.2 percentage points.

After the November 2010 election and with the economy continuing to sputter despite the full implementation of an unprecedented fiscal stimulus, President Obama shifted policy to a broadly available two percentage point reduction in the payroll tax for all workers. This broader policy was enacted for one year as part of the December 2010 legislation extending the 2001/2003 tax cuts, among other things. Toward the end of 2011, the payroll tax cut was extended again but for only two months due to an unfortunate sequence of political missteps. In February, Congress once again acted to prevent a payroll tax hike through December 31, 2012.

Fact 1: The 2011–2012 payroll tax cut has provided near zero stimulus to the economy. According to the Congressional Budget Office (CBO), the reduction in the payroll tax rate from 2011 through 2012 reduced tax revenues by $224 billion.[2] By any measure, this is an enormous tax cut. Yet quite predictably, the policy has had nearly zero effect on the economy for two simple reasons.

First, it was explicitly enacted as a temporary tax cut. Temporary tax reductions rarely have appreciable economic effects, because businesses and families do not materially change their behavior in response.[3] It is difficult to change economic outcomes without changing economic behaviors.

Second, even if the payroll tax cut had been put into effect for many years or even made permanent, it still would have had little to no near-term effect on job creation. In periods of high unemployment, a change in tax policy to directly induce an increase in hiring must reduce the cost to the employer of hiring a new employee. However, as is now well understood, the payroll tax is paid entirely by the employee. While half of the tax is referred to as the employer's share, this portion of the tax is collected by the employer out of what the employee would otherwise be paid in cash wages and

This paper, in its entirety, can be found at **http://report.heritage.org/ib3630**

Produced by the Thomas A. Roe Institute for Economic Policy Studies

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

benefits. Rather than referring to the employer's and employee's shares of the tax, it is much more accurate to refer to the hidden portion and the transparent portion of the employee's tax.

As the payroll tax is paid entirely by employees, reducing the tax cannot reduce costs to the employer. Instead, reducing the tax increases the after-tax wage for workers, which is certainly beneficial to workers and, in periods of tight labor markets, results in an increase in labor supply and employment.

In periods of high unemployment, the policy does almost nothing to encourage employment. Rather than increase the *demand* for labor, the payroll tax rate reduction increases the *supply* of labor. Rather than reduce the unemployment rate, if the payroll tax reduction had any effect at all on employment, it was to increase the supply of workers and thus increase the unemployment rate.

As difficult as it may be to imagine, the fact is Congress and the President targeted over $200 billion in tax relief over two years for little or no effect on jobs or the economy.

Fact 2: The payroll tax cut has no effect on the Social Security Trust Fund balances. The Social Security payroll tax is intended to fund Social Security benefits through the trust fund. Yet the reduction in the payroll tax has not reduced the flows into the trust fund by a single dollar. This budgetary paradox is resolved by the simple expedient that from the very beginning, every dollar of missing payroll tax revenue due to the payroll tax cut has been made up by a dollar from the Treasury's General Fund—i.e., from individual and corporate income tax revenues and other sources.

This hold-harmless arrangement is explained in the federal budget:

> In addition, the Social Security Trust Fund is held harmless and will receive transfers from the General Fund of the Treasury equal to any reduction in payroll taxes attributable to these reductions in the payroll tax rate.[4]

An important implication of this arrangement if it continues is that Social Security will have the same resources today, tomorrow, and indefinitely whether Congress acts to prevent a payroll tax hike in 2013 or allows current policy to expire.

Fact 3: Allowing the payroll tax cut to expire would impose a huge tax hike. Determining when a change in tax law is a tax hike should be simple, but it often is not. The issue is made unduly complicated and unintuitive by the poor construction of Congress's official starting point for comparison: the CBO revenue baseline. The CBO revenue baseline is based on *current law*, and in this case the law expires. In contrast, the revenue baseline presented by President Obama's Office of Management and Budget (OMB) more naturally uses as its point of reference the *current policy* baseline, much as CBO bases its spending baseline on current policy.

This difference can be easily understood by considering the tax policy put in effect in 2001 and 2003. Using the CBO current law baseline, the extension of this now 12-year-old policy is treated as a divergence from current law and therefore as a tax cut. In contrast, under the OMB revenue baseline, continuing current policy is assumed, whereas allowing some or all of the 2001 and 2003 tax changes to expire is properly treated as a tax hike.

Extending this to the payroll tax cut is made slightly more complicated because the policy was specifically intended to be temporary and has been in law for only two years, though Congress has twice extended the law and President Obama has twice signed the extensions.

The deciding factor as to whether Congress would be raising taxes by allowing the payroll tax rate to jump up is not a budgetary abstraction but the cold, hard reality of whether taxpayers see their taxes rise or not. If the payroll tax rate reduction expires, a taxpayer with $50,000 in taxable wages would see a $1,000 tax increase and would have $1,000 less cash to spend on the family's needs. A Washington-centric debate may leave the matter open

1. See Curtis S. Dubay, "Taxmageddon: Massive Tax Increase Coming in 2013," Heritage Foundation *Issue Brief* No. 3558, April 4, 2012, http://www.heritage.org/research/reports/2012/04/taxmageddon-massive-tax-increase-coming-in-2013.
2. See Congressional Budget Office, "Combined OASDI Trust Funds," March 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/43063_Old-AgeSurvivorsDisabiityInsuranceTrustFunds.pdf (accessed May 31, 2012).
3. One exception is a temporary tax reduction to spur the consumption of some particular good or service, such as the 2009 first-time homebuyer's credit, which did increase home purchases temporarily by shifting purchases forward in time, with little net change in purchases for the year. Thus, the only abiding effect was to confuse the price discovery process in real estate and thus slow the housing recovery significantly.
4. See U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives* (Washington, DC: U.S. Government Printing Office, 2012), p. 192, http://www.whitehouse.gov/omb/budget/Analytical_Perspectives (accessed May 31, 2012).

to interpretation, but around family dining tables the answer is obvious: Letting the payroll tax rate rise is a tax hike.

Fact 4: Raising taxes to reduce the budget deficit is the wrong prescription. The federal budget deficit today is due almost entirely to two causes. The first is excessive spending. The federal government is spending over 24 percent of gross domestic product, compared to a norm of about 20 percent. Alternatively, if federal spending were cut back to its historical share of the economy, the budget deficit would be about $700 billion lower in 2012.

The second main cause of the budget deficit is the enduring weak economy, which deprives the government of the normal level of revenues associated with a strong economy. Raising taxes through higher payroll taxes or otherwise would do nothing to reduce spending or improve the economy.

A Misguided Debate on an Important Policy. As the recent Social Security trustees' report indicates, Social Security is heading for a financial implosion. It is running a deficit today and will soon lack the resources to pay promised future benefits. This will be equally true if the payroll tax rate snaps back or not. It is also true that the economy will perform the same for the next few years whether the payroll tax rate snaps back or not.

The issue Congress and the President must decide is simply whether in an era of high unemployment and slow wage growth, it makes sense to raise payroll taxes on struggling families. The question almost answers itself.

*—**J. D. Foster, PhD,** 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.*