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Supporting the Engines of Economic Growth:

Payroll Tax Relief for Working Americans and Small Businesses

The U.S. economic recovery has been modest at best and a failure to extend the current two-percentage-point cut in the payroll tax for working Americans could further slow economic growth. By raising taxes on wage earners, allowing the payroll tax cut to lapse would further strain the budgets of individuals whose wages already do not stretch as far as they did only a year ago. Not extending the tax cut could further temper growth of consumer demand, leading businesses to shed rather than add jobs at a time when labor markets are already weak. Conversely, extending and expanding the payroll tax cut for workers could help sustain the U.S. recovery. Cutting payroll taxes for employers as well as employees would provide businesses with additional financial flexibility to hire workers. The tax cut could be particularly helpful for small businesses that face strained access to credit. Finally, targeted payroll tax cuts could increase incentives for businesses to hire more workers or increase the hours and wages of existing employees.

REPORT BY

THE U.S. CONGRESS JOINT ECONOMIC COMMITTEE CHAIRMAN'S STAFF

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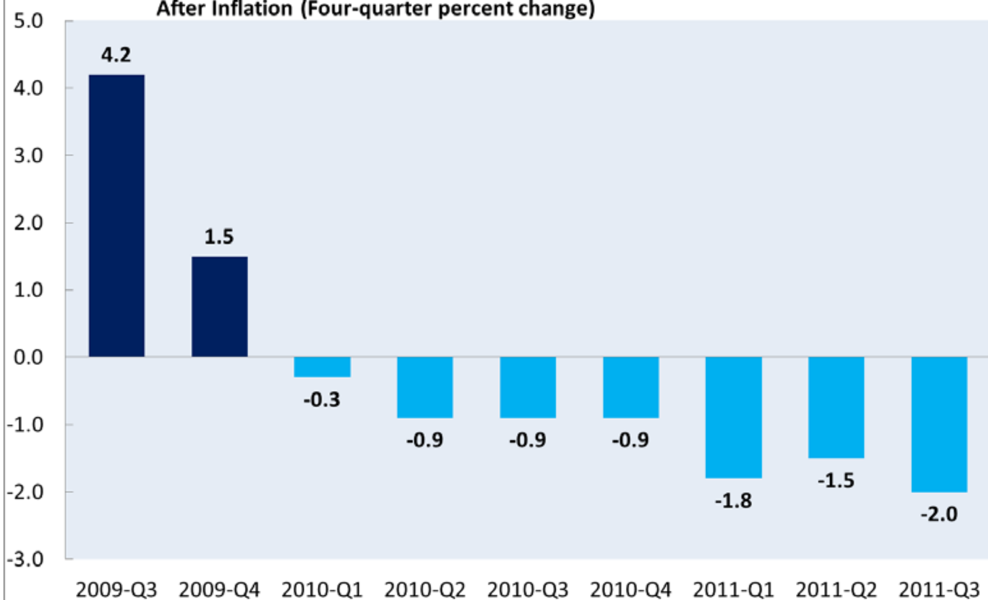
Failure to Extend Payroll Tax Cut Could Undermine the Recovery

Slow economic growth has led to slow increases in the number of jobs created and household incomes. Gross domestic product (GDP) grew by less than one percent at an annual rate in the first half of 2011, and grew at a subpar 2.0 percent pace in the third quarter.[1] Federal Reserve Chairman Ben Bernanke recently testified before the Joint Economic Committee that the recovery is "close to faltering," with turmoil in global financial markets posing an ongoing risk to U.S. growth.[2] The recovery so far has been too slowly-paced to have lowered the unemployment rate significantly: the unemployment rate has been stuck at or above nine percent since April.[3] High unemployment is also suppressing wage growth — growth of the typical weekly earnings of full-time wage and salary workers has been insufficient to keep up with changes in the cost of living since early 2010 (see **Figure 1**). Moreover, real (inflation-adjusted) disposable personal income declined at a 0.5 percent annual rate in the second quarter of 2011, and by 2.1 percent in the third quarter.[4]

Figure 1. Real Wages for Working Americans are Stagnant

Median Usual Weekly Earnings of Full-Time Wage and Salary Workers After Inflation (Four-quarter percent change)



Source: Chairman's staff of the Joint Economic Committee based on data from the Bureau of Labor Statistics.

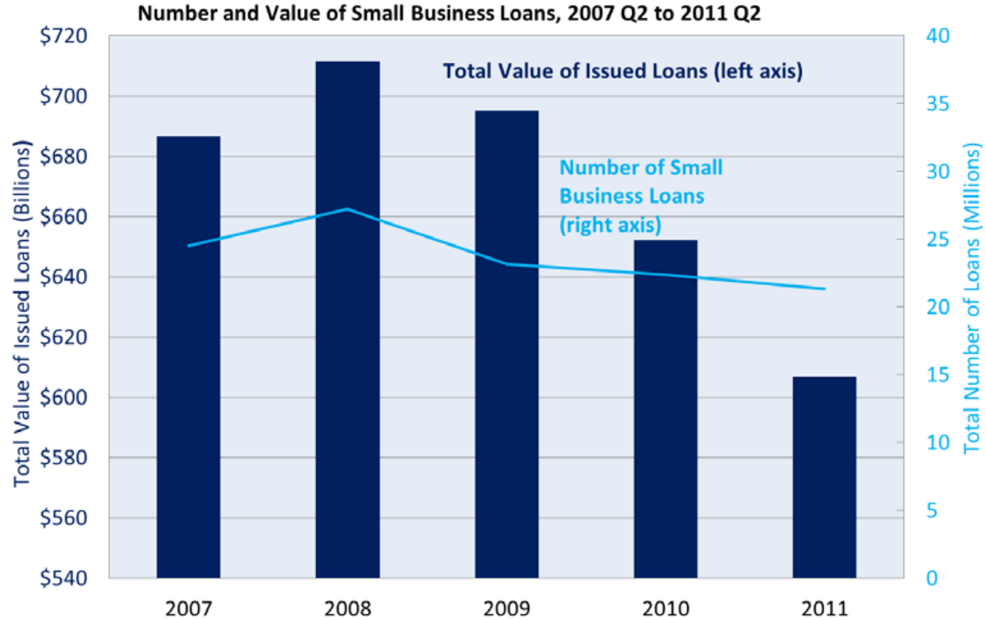
Economic models suggest that the reduction in payroll taxes of two percentage points in 2011 bolstered the economy against what would otherwise have been an even more painful period for American households and businesses.[5] Cutting payroll taxes immediately increases the take-home pay of everyone who receives a paycheck. Moreover, compared with a reduction in the income tax rates of the highest income brackets, payroll tax cuts put more money into the hands of middle- and lower-income Americans who are most likely to spend the additional income.[6] This additional spending by households raises demand for goods and services, leading businesses to hire more workers or keep current workers on the job.[7] Some households may also use the money to pay down debts, which would ease the burden of the painful but necessary deleveraging process in the aftermath of the credit boom and bust. This year, 121 million families will receive an average of $934 in additional take-home pay as a result of the tax cut.[8]

Failure to extend this tax cut for 2012 would hurt middle-class families and reduce economic growth. Noting the possibility that the U.S. payroll tax cuts could lapse, a recent International Monetary Fund report warned advanced economies against pursuing fiscal consolidation "at the expense of the disposable income of people with a high marginal propensity to consume."[9] Independent analysts estimate that not extending the two percent employee-side payroll tax cut would lower GDP growth in 2012 by as much two-thirds of a percent.[10] Cutting the payroll tax in half for all workers in 2012 — an expansion of the current two-percentage-point cut — would give the average family an additional $1,426 to spend.[11]

Tax Incentives for Employers Could Spur Hiring

Reductions in payroll taxes owed by employers — including a reduction in payroll tax rates and waivers for payroll taxes on expansions in payroll — could lead to additional hiring by reducing the cost of hiring workers and providing additional financial flexibility to businesses. Firms also might choose to increase hours or wages of existing employees or reduce prices in response to an across-the-board cut in payroll taxes.[12] Capping the amount of payroll on which tax cuts apply can more effectively target benefits to small businesses, which are more likely to be cash-strapped. Lending to small businesses has not yet recovered from the tightening of bank lending standards in the aftermath of the financial crisis (see **Figure 2**). The small business credit crunch is also due in part to declining housing and commercial real estate prices, since many small business owners use real estate as collateral to borrow.[13] The immediate boost to cash flow that a payroll tax cut would provide could be of real significance for small businesses.

Figure 2. Bank Lending to Small Businesses Remains Down
Number and Value of Small Business Loans, 2007 Q2 to 2011 Q2



Source: Chairman's staff of the Joint Economic Committee based on data from the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income, FDIC. The FDIC uses loans of $1 million or less as a proxy for small business loans.

The nonpartisan Congressional Budget Office recently testified that a well-designed tax credit for increasing payroll is among the most effective policies for promoting growth and putting people back to work while the recovery remains slow.[14] Current proposals also benefit from the lessons of past experiences with tax credits for adding workers or increasing payroll, which demonstrate that such credits are all the more effective to the extent that they are visible, straightforward, and provide significant benefits to businesses in a timely manner.[15]

Payroll tax credits have an advantage over general business tax credits in that they can be claimed quarterly, as well as by businesses not currently making a profit.[16] Moreover, providing credits for any payroll increases — hiring new workers, increasing hours or raising wages of existing employees — allows businesses flexibility to manage their workforces. Finally, using the payroll tax base as the basis for determining the value of the credit has the added benefit of targeting relief to middle- and lower-income workers, since credits would not be able to be claimed for increasing individual salaries beyond $110,100 in 2012.

Conclusion

With households and businesses still struggling and the prospect of further economic shocks emanating from Europe in the offing, there are real concerns that the United States could slide back into recession. Stagnant wage growth and high unemployment reduce disposable income, depress consumer spending and further lower economic growth. Extending and expanding the current employee-side payroll tax cut would support the economy by providing immediate benefits to working Americans struggling to pay their bills and provide for their families. And, by spurring demand, this tax cut could help to put people back to work. By adding an employer-side payroll tax cut and enacting a payroll tax credit for increasing payroll, policymakers can directly address the unemployment crisis and provide a real boost to the economy.

Sources:

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