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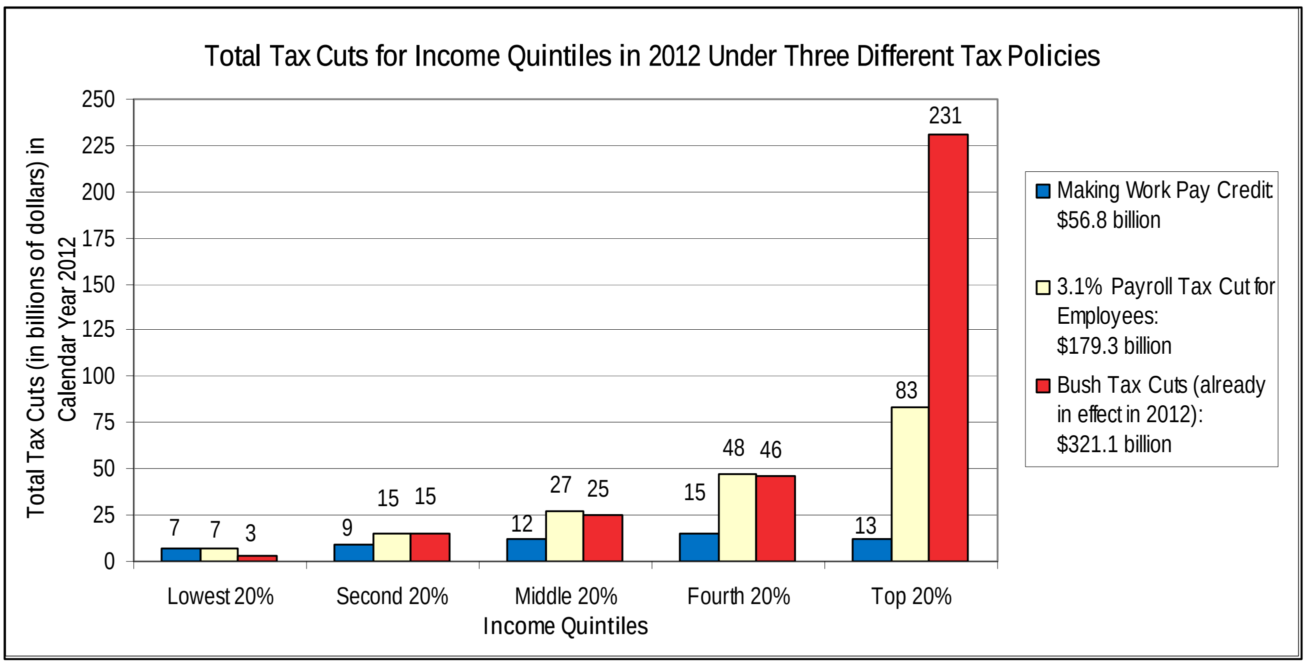
A More Effective Alternative to the Democrats' Payroll Tax Cut

How does the Senate Democrats' proposed payroll tax cut for workers compare to other tax cuts that are frequently debated? The answer depends on which tax cuts you compare it to. It's far more targeted towards working class people (and therefore a more effective economic stimulus) than the Bush tax cuts, but less targeted to working class people (and therefore less effective as economic stimulus) than the Making Work Pay Credit that expired at the end of 2010.

Government spending measures are the best way to reduce unemployment, but if lawmakers insist on using tax policy instead, they should revive the Making Work Pay Credit, as some Senators have discussed recently. A larger share of the resulting tax cut would go to low- and middle-income people, who are more likely to spend any money they receive, which will in turn increase the number of people employed to produce, ship and sell goods and services.



Notes: Estimates for the Making Work Pay Credit and payroll tax cut were calculated by the Institute on Taxation and Economic Policy (ITEP) tax model. Note that the total cost of the employee-side payroll tax cut ($179.3 billion) is slightly higher than the $175 billion projected by the Obama administration. Estimates for the Bush tax cuts are derived from the Congressional Budget Office and calculations by ITEP (to convert fiscal years to calendar years and to distribute the tax cuts among income groups).

■ Congressional Republicans' main proposal to address the economic crisis is to make permanent the income and estate tax cuts first enacted under President George W. Bush, which do not expire until the end of 2012. The best-off fifth of taxpayers will receive $231 billion of the Bush tax cuts in 2012 while the poorest fifth of taxpayers will receive only $3 billion that year. (These amounts are for one year and will be greater if these tax cuts are made permanent as Republicans propose.)

■ President Obama and Democratic leaders propose to extend and expand the 2011 cut in Social Security payroll taxes paid by workers. The richest fifth of taxpayers would receive $83 billion of this tax cut while the poorest fifth of taxpayers would receive just $7 billion.

■ If Congress instead revived the Making Work Pay Credit for 2012, the richest fifth of taxpayers would receive $13 billion and the poorest fifth would receive $7 billion, making this option less costly and also more evenly distributed.

■ The Senate Democrats' proposal has another component which is not illustrated here and which would be even less effective as economic stimulus: a cut in the payroll taxes paid by employers. This tax cut is likely to benefit owners of businesses and corporations, not workers, and is therefore less likely to provide the needed boost in consumer demand. *(See Technical Details on following page.)*

Background on Making Work Pay Credit and Payroll Tax Cuts

In 2009 and 2010, Congressional Republicans argued that a payroll tax cut was a better alternative to the less costly and less regressive Making Work Pay Credit, which was enacted along with the other provisions of the economic recovery act in 2009. At the end of 2010, President Obama and Congressional Democrats began to accommodate the Republicans by changing their position to support a temporary payroll tax cut, which was enacted along with a temporary extension of the Bush tax cuts.[1] As late as summer of 2010, the House Republican Study Committee endorsed a bill including a payroll tax cut.[2]

Now Republicans are hesitant to support the payroll tax cut concept they themselves introduced to the debate. This may be partly because it has now become a Democratic priority. As President Obama and Congressional Democratic leaders have shifted to the right, Republicans in Congress have shifted further to the right, even if that means opposing their own tax proposals.

Congressional Republicans also oppose the Democrats' proposal because it would offset the cost with a 3.25 percent surcharge on the portion of any taxpayer's adjusted gross income (AGI) in excess of $1 million starting in 2013. This means that a taxpayer with AGI of $1.1 million in 2013 would pay the surcharge equal to 3.25 percent of $100,000, which is $3,250 (less than one-third of one percent of the taxpayer's AGI). A taxpayer with AGI below $1 million would be unaffected.

See a related CTJ fact sheet with details and state-by-state estimates on the proposed 3.25 percent surcharge on millionaires. www.ctj.org/pdf/surcharge20111130.pdf

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[1] Citizens for Tax Justice, "Compromise Tax Plan Tilts Heavily in Favor of the Well-Off," December 9, 2010. http://www.ctj.org/pdf/taxcompromise2010.pdf

[2] Citizens for Tax Justice, "GOP Tax Cut Bill Would Add Almost $7 Trillion to America's National Debt to Further Enrich the Wealthiest," August 3, 2010. http://www.ctj.org/pdf/hr5029analysis.pdf

Technical Details

The Making Work Pay Credit

The credit, which was available in 2009 and 2010 as part of the American Recovery and Reinvestment Act of 2009, was equal to 6.2 percent of earnings up to a maximum credit of $400 for unmarried people and $800 for married couples. The credit was phased out for unmarried people with AGI between $75,000 and $95,000 and phased out for married couples with AGI between $150,000 and $190,000. We estimate that enacting the credit again for 2012 would cost $56.8 billion.

Democrats Proposed Payroll Tax Cut

The payroll tax cut for workers that is in effect in 2011 would be expanded and extended into 2012. The compromise legislation signed into law at the end of 2010 to extend the Bush tax cuts for two years also provided for a one-year cut in the Social Security payroll tax paid by employees, from 6.2 percent to 4.2 percent. Senate Democrats now proposed to cut the Social Security payroll tax paid by employees in 2012 from 6.2 percent to 3.1 percent. We estimate that this payroll tax cut for workers would cost $179.3 billion, which is slightly more than the $175 billion cost estimated by the Obama administration.

The Democrats have also proposed to cut the Social Security payroll tax paid by employers from 6.2 percent to 3.1 percent on the first $5 million in wages paid by an employer in 2012. Their bill would also eliminate the employer-paid Social Security taxes for the increases in wages paid, up to $50 million per employer in 2012. We have not estimated the cost of this payroll tax cut. The Obama administration estimated that it would cost $65 billion.

Economists do believe that even the employer-paid Social Security payroll tax is ultimately borne by employees in the form of lower wages and benefit — *in the long-run*. That means that a reduction in employer-paid payroll taxes that was in effect for several years would, *in the long-run*, result in increased wages and benefits. But it is unlikely that employers would respond to a one-year cut in employer-paid payroll taxes by increasing wages and compensation. Instead, employers themselves would likely retain the benefit.

The Bush Tax Cuts

The income tax cuts first enacted under President George W. Bush include:
- reduction of the 28%, 31%, 36% and 39.6% rates to 25%, 28%, 33% and 35%.
- introduction of the ten percent tax bracket (lowest bracket was previously 15 percent)
- rate reduction for capital gains and dividends
- expansion of Child Tax Credit
- elimination of "marriage penalty" in the standard deduction
- elimination of "marriage penalty" in the 15 percent rate bracket
- reduction in "marriage penalty" in the Earned Income Tax Credit.
- expansion of the Dependent Care Credit
- repeal of the personal exemption phase-out
- repeal of the itemized deduction disallowance
- increase in the exemptions in the Alternative Minimum Tax (AMT)

The estate tax cut enacted under President George W. Bush in 2001 gradually repealed the estate tax until causing it to completely disappear in 2010. The "compromise" signed into law at the end of 2010 did not fully extend the repeal of the estate tax but instead reduced the estate tax by increasing the estate tax exemption to $10 million for a married couple and reducing the estate tax rate to 35 percent. Our figures assume that these estate tax rules (the rules enacted as part of the compromise at the end of 2010) would be extended if the Bush tax cuts are extended again.

Based on Congressional Budget Office estimates and our calculations, the cost of the Bush tax cuts in 2012 is $321.1 billion. (This does not include increased interest payments that result because these tax cuts were not paid for.)