Please, No More (Payroll Tax) Holidays!

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MarketWatch Blog by Alicia H. Munnell

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In January 2011, employees across America experienced a cut in their payroll tax from 6.2 percent to 4.2 percent on their earnings up to the Social Security maximum ($106,800). (The self-employed saw their tax go from 12.4 percent to 10.4 percent.) The cut is supposed to expire at the end of the year. In the meantime, the trust funds are reimbursed from the General Fund of the Treasury, so the "temporary" cut has no impact on the finances of the Social Security system. If the cut is indeed temporary, it's probably not worth making a fuss. But proposals are emerging to extend and expand the payroll tax cuts. Such proposals raise questions about whether payroll tax cuts are an effective mechanism to stimulate the economy, whether they are well targeted, and whether they will make the job of fixing Social Security more difficult.

The 2011 payroll tax cut emerged as a compromise when Congress refused to extend the Making Work Pay Tax Credit. This credit, which was effective in 2009 and 2010, was equal to 6.2 percent of earned income up to $400 per person and was phased out at higher income levels. The Making Work Pay Tax Credit, which was clearly targeted towards lower-paid individuals, cost about $60 billion per year. The 2-percentage point cut in the payroll tax – enjoyed by all workers – cost about $110 billion.

From the beginning, it was unclear how the tax was going to be restored as the nation enters an election year. As in the case of the Bush income tax cuts, the expiration of any reduction is characterized as a tax increase, and the resistance to tax increases is ferocious.

Now Larry Summers, former Treasury Secretary and former Director of President's Obama National Economic Council, has proposed extending the payroll tax cut for employees and initiating one for employers. The White House Press Secretary said such an idea was worth considering. And the White House Chief of Staff said that extending the payroll tax holiday was being discussed as part of the budget negotiations led by Vice President Biden.

Messing around with the payroll tax seems like a really bad idea. Before the 2011 cut, the Social Security financing story was one where the average cost rate for the next 75 years was 16.2 percent and the scheduled income rate was 14.0, producing a deficit of 2.2 percent. That figure means if the payroll tax were raised immediately by 2.2 percentage points – 1.1 percent each for the employer and employee – the government would be able to pay the current package of benefits for everyone who reaches retirement age through 2085.

Consider how a 2-percentage point cut in both the employer and the employee payroll tax changes the story. The deficit would become 6.2 percent of payrolls. Yes, general revenues are being credited to the trust funds to make up for foregone revenues in the short run, but the basic earmarked source of revenue – the payroll tax – has been decimated. Solving the problem on the revenue side, which last year looked trivial, now appears insurmountable. Thus, payroll tax holidays put future Social Security benefit levels at risk.

The question is whether the payroll tax cuts are compelling on any grounds. Certainly the employee's cut is not well targeted; people with Social Security maximum taxable earnings get $2,136 in 2011. In terms of a general stimulus, the route is circuitous if the goal is to reduce unemployment. Extending the tax cut to the employer would make sense if the reason that firms weren't hiring was the high cost of labor. That does not seem to be the case.

We should not extend the 2-percent cut for employees, and we should not introduce a cut for the employer. Let the employee cut expire at the end of 2011 and use the general revenues currently being used to reimburse the Social Security trust funds to create jobs directly for the long-term unemployed. These people could help out at schools, hospitals, construction sites, and elsewhere. The $110 billion of general fund reimbursement for the 2011 tax holiday would be sufficient to pay each of the 6 million long-term unemployed – who have been out of work for 27 weeks or more – a salary of almost $18,000. This money could serve as the basis, with some additional funding, for a 1930s' style (Works Progress Administration) WPA program. Such a program would help those who are losing their skills and their lives, and ensure that Social Security will be there when they need it.