

A BIGGER AND BETTER ECONOMIC BOOST

Replace the payroll tax cut with a targeted tax rebate

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Following the labor market's lackluster performance in May and June, the administration and some congressional leaders are pushing for an extension or expansion of the payroll tax cut enacted last December, possibly as part of a grand bargain to reduce the deficit. In a primetime speech on the debt ceiling impasse on July 25, President Obama explicitly endorsed extending the payroll tax cut for working families, although no additional economic support appears likely in a debt ceiling compromise—only economically harmful spending cuts. December's tax cut and unemployment insurance extension reduced payroll tax rates by two percentage points on the employee side and continued emergency unemployment insurance through 2011, but no stimulus has been enacted since. Weak employment growth and powerful economic headwinds should prompt Congress to seek more support for the economy, although job creation should not be contingent on or take a back seat to deficit reduction.

This issue brief highlights three problems with the payroll tax cut and proposes replacing the temporary payroll tax cut with a targeted, partially refundable tax rebate for 2012 to address all three concerns:

- **While more targeted than tax cuts for high-income earners, the payroll tax cut is not as targeted and therefore not as cost-effective as other tax cut designs.** Targeting tax cuts to working families, who are likely to spend, rather than save, extra disposable (after-tax) income would do more to strengthen the economy while also helping those most in need. Conversely, wealthy tax filers are only benefited by the payroll tax cut, which increases their disposable income more than any tax stimulus for any other group.
- **The payroll tax cut provides less help to tens of millions of working families than other tax stimulus measures that are no more expensive.** For example, relative to the Making Work Pay refundable tax credit that had been in effect, the payroll tax cut decreased disposable income for many low-income and working families. On net, replacing the MWP credit with the payroll tax cut reduced disposable income for tax-filers earning less than \$30,000 by roughly \$6.6 billion.

- **The payroll tax cut sets a bad precedent for the future of Social Security.** A temporary tax credit from the general fund would leave intact dedicated funding for Social Security, which is now partially reliant on general revenue because of the payroll tax cut.

We recommend replacing the payroll tax cut with a modified version of the targeted, partially refundable tax rebate enacted in 2008 under the Emergency Stimulus Act, which would cost roughly the same but generate considerably more economic activity. Replacing the payroll tax cut with the modified ESA rebate could be expected to increase payroll employment by 12% or more relative to an extension of the payroll tax cut.

Introduction

Since the recession began in December 2007, Congress has enacted multiple stimulus packages to partially cushion the downturn in private-sector demand resulting from the bursting of the housing bubble and ensuing financial crisis. While expansionary fiscal policy came nowhere close to filling the gap between potential and actual economic output, the downturn would have been considerably deeper and unemployment considerably higher without these deliberate policy responses (Bivens 2011).¹ The enacted fiscal stimulus has included a mix of temporary tax cuts, increased safety net spending (i.e., food stamps and unemployment benefits), state fiscal relief (increased federal Medicaid matching assistance and other grants to states), and, to a lesser degree, infrastructure investment.

The three largest stimulus packages—the Economic Stimulus Act (ESA) of 2008, the American Recovery and Reinvestment Act (the Recovery Act) of 2009, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010—all contained temporary tax cuts to increase disposable income relative to pre-recession tax policy (i.e., the Bush-era income tax cuts and the annual alternative minimum tax patch). The ESA included a partially refundable lump-sum tax rebate (a type of tax credit), the Recovery Act included a fully refundable Making Work Pay (MWP) tax credit, and the December 2010 tax cut and unemployment insurance extension included a payroll tax cut.

These tax stimulus policies varied considerably in design and impact on different tax filers and the economic recovery. President Obama and some members of Congress have suggested continuing or expanding the payroll tax cut, but a look at its design and impact suggests that there is a better alternative.

Why the payroll tax cut was not a good replacement for Making Work Pay

The two-percentage-point payroll tax cut being considered for extension or expansion replaced the MWP refundable tax credit—the largest tax provision of the Recovery Act. It refunded 6.2% of earned income up to a maximum credit of \$400 for individuals (\$800 for joint filers). (For the purposes of the credit, earned income is essentially wage and salary income.²)

Making Work Pay was essentially designed to refund workers' Social Security contributions on the first \$6,452 of earned income: Up to the maximum credit amount (\$400), it refunded earned income at the same rate (6.2%) as workers' portion of the Social Security payroll tax. (This 6.2% rate is called the phase-in rate.) The MWP credit was also reduced by 2% of adjusted gross income (AGI) above \$75,000 (\$150,000 for joint filers).³ Individuals with AGI above \$95,000 (\$190,000 for joint filers) exceeded this phase-out range and did not receive any credit. The credit, which was in effect for tax years 2009 and 2010, was estimated to cost \$117.2 billion over two years (JCT 2009).

While all workers owe payroll taxes—which are flat taxes automatically withheld from wages—many tax filers do not earn sufficient gross income to owe individual income tax after accounting for exemptions, deductions (typically the standard deduction), and credits. The Tax Policy Center (TPC) estimates that 46.4% of households will not pay income taxes in 2011, but nearly two-thirds of these households pay payroll taxes (TPC 2011).⁴ If the value of a refundable tax credit (or the refundable portion of a partially refundable tax credit) exceeds a tax filer's tax liability on taxable income, the refundable credit *increases* the tax filer's tax refund. Refundable tax credits, such as the Earned Income Tax Credit, are widely viewed as anti-poverty programs delivered to low-income workers

through the tax code, which allows for efficient means testing. A nonrefundable tax credit, on the other hand, cannot reduce income tax liability below zero.

Under the tax cut and unemployment insurance package negotiated by President Obama and congressional leadership last December, a one-year two-percentage-point payroll tax cut was substituted for the extension of the MWP credit proposed in the president's budget request for fiscal year 2011. The payroll tax cut reduced Social Security payroll taxes from 6.2% to 4.2% in calendar year 2011 (on the employee side only). The taxable earnings ceiling for Social Security payroll taxes is currently \$106,800—above which only the 1.45% Medicare Federal Insurance Contribution Act (FICA) tax is charged—so the payroll tax cut will increase disposable income by up to \$2,136.⁵

Because of the higher maximum credit and lack of a phase-out threshold for higher-income earners, the payroll tax cut increases disposable income for most tax filers and is considerably more expensive than the MWP credit. The IRS estimates that more than 155 million workers will receive a payroll tax cut (IRS 2011a) and the Tax Policy Center estimates that the average tax unit (filer, including joint filers and dependents as one unit) will receive \$934 under the payroll tax cut, up from \$508 under the MWP credit (TPC 2010a).⁶ Consequently, the one-year payroll tax cut for 2011 will cost an estimated \$111.7 billion (JCT 2010b), nearly twice the \$61.8 billion cost of the one-year MWP extension requested in the president's 2011 budget (JCT 2010c).

Three big payroll tax cut flaws argue for a different tax policy stimulus for 2012

The payroll tax cut reaches more tax filers and comes at a much higher price tag than the MWP credit, so it has a greater net impact on job creation. The payroll tax cut, however, has three critical flaws that should prompt policy-makers to replace it with a more cost-effective and equitable tax stimulus for 2012.

First flaw: The payroll tax cut is not as targeted as a refundable tax credit so it has less bang for the buck

Targeting tax cuts to working families—who are likely to spend, rather than save, an extra dollar of disposable

income—would be the most effective way to strengthen the economy while also helping those most in need. Intuitively, putting \$500 apiece into the pocket of two lower-income workers will result in more near-term spending than putting \$1,000 into the bank account of a millionaire. But the payroll tax cut gives billions of dollars to the wealthiest households—a giveaway with a high opportunity cost. Distributional analysis by the TPC suggests that the wealthiest 1% of tax units—filers with income above \$564,422—will receive \$2.7 billion (TPC 2010b) and tax units with cash income exceeding \$1 million will receive more than \$1 billion (TPC 2010a) as a result of the payroll tax cut.

Mark Zandi, chief economist of Moody's Analytics, recently estimated that a employee payroll tax cut like the one in the December 2010 deal would generate \$1.09 in economic activity for every dollar in revenue loss (Zandi 2010). This contrasts with a higher bang-per-buck of \$1.17 for the MWP credit and \$1.22 for a refundable lump-sum tax rebate (similar to the tax rebate in the 2008 stimulus bill) for every dollar in federal tax revenue lost or refunded.⁷ These results are broadly consistent with Congressional Budget Office estimates, which also suggest that targeted, refundable tax credits are more efficient stimulus tools.⁸

The Zandi multipliers show that a lump-sum tax rebate would generate roughly 12% more economic activity—and thus jobs—per dollar than the payroll tax cut. Based on the Zandi multipliers and standard macroeconomic analysis, we estimate that the 2011 payroll tax cut will increase nonfarm payroll employment by roughly 970,000 jobs, relative to what would have been the case without the cut.⁹ Enacting a lump-sum tax rebate would have generated roughly 115,000 more jobs (a total increase of 1,085,000) in 2011—averaging almost 10,000 more jobs created per month than currently being reported. Looking to 2012, we estimate that enacting a lump-sum tax rebate of the same cost to the federal budget as the 2011 payroll tax cut (\$111.7 billion) would generate just over 1 million nonfarm payroll jobs, compared with a one-year extension of the employee-side payroll tax cut, which would generate roughly 920,000 jobs—110,000 fewer (see **Table 1**).

Relative to targeted, refundable tax credits—particularly lump-sum rebates—the payroll tax cut is an inefficient policy for job creation. If creating jobs is the top economic

TABLE 1

Increase in nonfarm payroll employment under payroll tax cut vs. lump-sum tax rebate

Policy	2011 increase	2012 increase
<i>Payroll tax cut (\$111.7 billion cost)</i>	969,568	920,927
<i>Lump-sum tax rebate (\$111.7 billion cost)</i>	1,085,205	1,030,763
<i>Replacing payroll tax cut with lump-sum tax rebate (hypothetical)</i>	115,637	109,835

SOURCE: Author's analysis based on CBO projections and Mark Zandi's fiscal multipliers (CBO 2011c, Zandi 2011).

priority for Congress, as it should be, the payroll tax cut missed the mark. That said, the payroll tax cut is still more targeted than the Bush-era upper-income tax cuts because the Social Security payroll tax is regressive, both in its flat rate structure and maximum table earnings ceiling. Tax rate cuts to the progressive income tax, particularly to the top marginal tax rates, are considerably less targeted than the payroll tax cut.

Second flaw: Relative to the Making Work Pay credit, the payroll tax cut decreased disposable income for tens of low-income and working families

Relative to the MWP credit, the payroll tax cut is actually *lowering* disposable income for individuals earning less than \$20,000 and joint filers earning less than \$40,000 a year (Fieldhouse 2010). Because the payroll tax cut increases disposable income by 2% instead of 6.2% of earned income (up to the maximum credit), and because the credit is not reduced (or fully phased out) for upper-income tax filers, this round of tax stimulus benefited millionaires at the expense of tens of millions of working families. For example, a tax filer with earned income of \$10,000 would see a \$400 credit under MWP (having hit the maximum credit amount) but only a \$200 credit under the payroll tax cut. With earned income of \$20,000,

where the value of the 2% payroll tax cut would rise to the \$400 maximum credit under MWP, an individual filer is no longer penalized by the switch to the payroll tax cut. Thus, compared with then-current tax policy and the president's proposal to extend MWP, the payroll tax cut was a tax *increase* for all individual filers making less than \$20,000.

The number of tax filers adversely affected by this change in tax policy is significant. The TPC estimates that more than 51 million tax units would see a higher average benefit from MWP than from the payroll tax cut (TPC 2010a). Roughly 74% of these 51 million adversely affected tax units are estimated to have cash income of less than \$30,000. To look at the impact another way, 82% of tax units with incomes of less than \$30,000 would have been better off with the MWP credit.

On net, replacing the MWP credit with the payroll tax cut reduced disposable income for tax units earning less than \$30,000 by roughly \$6.6 billion. This poor policy design had real consequences. The Center on Budget and Policy Priorities estimated that continuing the refundable MWP tax credit instead of enacting a nonrefundable payroll tax cut would keep an additional 500,000 Americans above the federal poverty line (Sherman 2010), an important accomplishment with poverty at a 15-year high.

Third flaw: The payroll tax cut sets a bad precedent for the future of Social Security

Beyond efficiency and equity concerns, some members of Congress and many pundits objected to the payroll tax cut on political grounds, saying it set a bad precedent and introduces political risk to the dedicated funding source for Social Security. The Treasury Department was required to replace the reduced payroll tax receipts with general revenue funds, leaving unaffected the Old Age and Survivors Trust Fund and the Federal Disability Insurance Trust Fund, as well as future benefits. But by making the program partially dependent on general revenue, Social Security became exposed to greater political risk of benefit cuts and an accelerated depletion of the trust funds.

Social Security was designed as an off-budget program—both in terms of benefits and revenues—to shield the social insurance program from budget battles

and spending cuts, as best explained by President Franklin Delano Roosevelt: “We put those pay roll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program.” (DeWitt 2005). Conservative intransigence over allowing any temporary tax cut to expire, coupled with mixed congressional support for renewing the “temporary” cut, suggest that concerns about political precedent and risks to Social Security are well-founded.

Better tax stimulus alternatives are available: A look at two options

Replacing the payroll tax cut with a refundable tax credit could address some or all of the efficiency, equity, and Social Security protection objectives that should guide any tax-based stimulus, while also doing more to create jobs and boost the economy. The first policy option presented here is a refundable tax credit financed from the general fund that would mimic the economic impact of the payroll tax cut while maintaining the dedicated funding source for Social Security. It is designed to be revenue-neutral and distributionally neutral relative to an extension of the payroll tax cut. The second policy option is a modified version of the targeted, partially refundable ESA tax rebates enacted in 2008; this refundable tax credit is not only intended to be revenue-neutral, but also to address equity and efficiency concerns by targeting money to lower-income workers.

Before considering these alternatives, an important point about their structure needs to be explained.

Delivery mechanism: Lump-sum versus withholding

The effectiveness of a tax stimulus—how much economic activity is generated in the near-term per dollar of forgone revenue—is determined by how much of the transfer is saved versus spent. For most households, the MWP credit was administered in the form of reduced income tax withholding (retirees and some households received one-time payments). This design contrasted with the lump-sum tax rebates sent out as checks or electronic benefit transfers as

part of the 2008 Economic Stimulus Act. Policymakers thought that, for behavioral reasons, households might be inclined to save a greater portion of a lump-sum transfer, so instead they distributed MWP less visibly through a change in withholdings.

But based on a survey of households’ response to actual and theoretical transfers, Sahm, Shapiro and Slemrod (2010) find that households receiving one-time lump-sum payments have a higher spending rate than households with decreased withholdings. Survey participants were roughly half as likely to claim that they would mostly spend the 2009 rebate (13%) than they were to say that they would mostly spend the lump-sum 2008 rebate (25%). The authors conclude that the low visibility of the MWP credit reduced the propensity to consume associated with the transfer, which suggests that a lump-sum transfer is a more effective delivery mechanism for a tax stimulus. However, the maximum rebate under ESA was considerably larger than the maximum MWP credit, so the size of the refund may have altered behavioral responses. The tax withholding delivery mechanism of the MWP credit is essentially the same as the gradual delivery of the payroll tax cut (both increase disposable income from every paycheck), suggesting that replacing the payroll tax cut with a lump-sum refundable tax credit would generate more near-term economic activity than would a gradually distributed stimulus.

Policy 1: Replacing the payroll tax cut with an untargeted credit

Replacing the payroll tax cut with a revenue-neutral, distributionally neutral tax credit would require a refundable tax credit of up to \$2,136 per wage earner. Because the payroll tax cut reduces income tax liability for tax filers who owe no federal income tax, the credit would have to be refundable. The credit should be fully refundable rather than partially refundable because the earnings threshold for income tax liability varies so much by filing status (single or joint), number of dependents (which determines exemptions), and tax credits.

Like the payroll tax cut, the refundable tax credit would be applied at a rate of 2% of earned income as reported by employers on Form W-2 or by the self-

employed on Form 1040, up to the \$2,136 maximum credit amount. For joint filers, there should be no marriage penalty in the tax credit, as is the case for the payroll tax cut. (Marriage penalties, which occur when joint filers pay more in tax than they would if they each filed separately, are a result of a progressive tax system). Consequently, joint filers would receive a tax credit of 2% of work earnings up to a maximum credit of \$4,272 (for joint filers each with earned income of \$106,800 or more). Joint filers with combined work earnings exceeding \$213,600 would receive a smaller credit if one filer had less than \$106,800 in earned income.¹⁰ In effect, this credit would behave as the payroll tax cut but would be financed from the general revenue fund instead of reducing payroll tax revenue dedicated to Social Security; the IRS would simply reduce individuals' income tax withholdings by the amount of the reduced payroll tax contributions in each paycheck, or make an equivalent lump-sum transfer to individuals without withholdings.

Policy 2: Replacing the payroll tax cut with a targeted, progressive credit

Replacing the payroll tax cut with a tax credit that goes beyond simply addressing the Social Security concerns would be best accomplished with a modified version of the targeted, partially refundable ESA tax rebate enacted in 2008. This preferred policy option would cost roughly the same amount as the payroll tax cut but generate considerably more economic activity and do more to alleviate poverty. Even relative to the MWP credit, this type of rebate offers a better model for effective tax stimulus because it offers a higher maximum credit, provides additional support to families with children, increases disposable income for many individuals with qualified nonwage income, and is phased-out more progressively.

The 2008 rebate was designed as a lump-sum transfer equal to the lesser of net income tax liability or \$600 (\$1,200 for joint filers), with an additional \$300 for each eligible child living in the household.¹¹ The ESA rebate also included a minimum rebate of \$300 (\$600 for joint filers) for all tax filers with earned income of at least \$3,000. In essence, the ESA rebate was partially refundable; a low-income single filer with income tax liability less than \$600 was guaranteed a refund of at least \$300

(even if they owed no income tax liability), provided their earned income exceeded a \$3,000 threshold.

For purposes of the ESA rebate, earned income was also defined to include Social Security benefits and veterans' disability benefits, providing tax stimulus to a broader segment of the population than either the MWP credit or the payroll tax credit. By way of contrast, the MWP credit was adjusted downward for individuals also receiving economic recovery payments—another provision of the Recovery Act that provided a one-time \$250 payment to Social Security, Disability Insurance and Supplemental Security Income recipients as well as individuals receiving Veterans Affairs disability benefits and Railroad Retirement Board benefits.¹²

The principle for improving a tax stimulus is quite simple: target more money to lower-income individuals more likely than the wealthy to consume an additional dollar of disposable income. This principle was embodied in both the MWP credit and the ESA lump-sum transfers, both of which were phased out on AGI above \$75,000 for single filers (\$150,000 for joint filers). The ESA rebate was *more targeted* than the MWP credit because the rebate amount was drawn down more rapidly than was MWP for upper-income earners less likely to spend additional disposable income. (Beyond the AGI phase-out threshold, the ESA rebate was reduced at a rate of 5% of additional AGI rather than the rate of 2% for the MWP credit). For instance, joint filers with two qualifying children would not be eligible for an ESA rebate if their AGI exceeded \$186,000—slightly below the phase-out range for the MWP credit despite the considerably larger tax rebate.

According to the CBO, the 2008 rebate reduced revenue by \$75.0 billion and increased direct spending by an additional \$40.4 billion for a total cost of \$115.4 billion (CBO 2008), roughly the same cost as the one-year payroll tax cut (\$111.7 billion).

The best tax credit option: Modifying the ESA rebate for new economic realities

The ESA, signed into law by President George W. Bush in February 2008, was enacted out of concern about the unemployment rate, which had crept up to 5.0%—0.6 percentage points higher than in May 2007. In the two

years since the official end of the recession (June 2009, as determined by the National Bureau of Economic Research), the unemployment rate has averaged 9.5%. The economic deterioration and ensuing rise in unemployment since ESA's enactment calls for replacing the payroll tax cut with a more sensible tax stimulus—in the form of the 2008 tax rebate modified for new economic realities. (Today's historically high unemployment rate also suggests that the magnitude of this additional tax stimulus is far from adequate in dealing with the unemployment crisis.)

First and foremost, economy-wide wage and salary income has fallen in both nominal and real terms since the early months of the Great Recession. Wages and salaries totaled \$6.52 trillion in the first quarter of 2011, down 5.3% (in inflation-adjusted dollars) from the first quarter of 2008, when ESA was enacted (U.S. DOC 2011).¹³ Lower-income workers have been more adversely affected by the economic downturn, so this loss of income is almost certainly amplified for tax filers who would be eligible for the ESA rebate. The tax rebates are largely calculated on wages and salaries, suggesting that reinstating the ESA rebates would come at less cost than in 2008. Beyond the diminished wages of employed workers, more workers (particularly the unemployed) likely fall under the \$3,000 earnings threshold, reducing the number of individuals eligible for rebates, period.

To address these concerns and maximize the stimulative impact of the rebate, we propose expanding the ESA definition of earned income to include unemployment insurance benefits. Adding unemployment insurance benefits to wage and salary income in the National Income and Product Accounts, the modified definition of earned income has fallen 4.1% percent in real terms since the first quarter of 2008 (U.S. DOC 2011); even with this modification the tax rebates would remain in the ballpark of revenue-neutral compared with the payroll tax cut.

We also propose, at some additional cost, adding a “hold harmless” provision to the ESA rebate to ensure that no tax filers receive a smaller refund than they would receive were the MWP credit reinstated for 2012. (As discussed in the next section, some low-income tax filers without qualifying children would be better off with the MWP credit than the ESA rebate). Tax filers with income tax liability below \$400

would receive a refund of 6.2% of earned income, up to a credit of \$400 (\$800 for joint filers).

Comparing benefits under tax policies

Comparing the benefit of the MWP credit and payroll tax cut is relatively easy because both policies behave similarly and are calculated solely based on earned income (until the AGI phase-out ceiling is reached for the MWP credit). Comparisons with the ESA rebates are more difficult because the latter is also affected by the number of qualifying children and individual income tax liability. To enable broad comparisons of the impact of the three tax stimulus policies on nonelderly households' disposable income, **Table 2** depicts the value of all three tax policies for single and joint filers with and without qualifying children across various earned income levels. Earned income, adjusted gross income (AGI), and individual income tax liability have been approximated using IRS individual income tax returns from 2008 (see the **Appendix** for a methodological explanation).¹⁴

Lower-income workers are best off with the ESA rebate or MWP credit, depending on qualifying children and income tax liability. Working-class tax filers are best off with the ESA rebate, regardless of the number of qualifying children. Upper-middle-class tax filers are best off under the payroll tax cut, but are much better off with the ESA rebate than the MWP credit if they have qualifying children. Wealthy tax filers are only benefited by the payroll tax cut, which increases their disposable income more than any tax policy for any other group.

Conclusion: Replace payroll tax cut with a better tax stimulus

Beyond protecting Social Security from political risks, replacing the payroll tax cut with a targeted, partially refundable lump-sum tax rebate modeled after the ESA rebate would benefit the U.S. economy by: 1) increasing disposable income for individuals without wage earnings, 2) providing additional income to households with children, 3) providing a greater benefit to lower-income individuals more likely to spend a dollar of disposable income, 4) further reducing poverty, everything else being equal, and 5) avoiding the wastefulness of providing extra money to the wealthiest 5% of tax

TABLE 2

Impact of three tax policies on disposable income by filer status and income

Filer status	Earned income	ESA lump-sum tax rebate (2008)	Making Work Pay credit (2009-10)	Payroll tax cut (2011)
<i>Single filer</i>	\$7,346	\$300	\$400	\$147
	11,698	368	400	234
	21,251	600	400	425
	41,414	600	400	828
	75,364	29	172	1,507
	215,561	0	0	2,136
<i>Single filer, one child</i>	\$11,698	\$668	\$400	\$234
	21,251	900	400	425
	41,414	900	400	828
	75,364	329	172	1,507
	215,561	0	0	2,136
<i>Joint filer, no children</i>	\$11,698	\$600	\$725	\$234
	21,251	1,166	800	425
	41,414	1,200	800	828
	75,364	1,200	800	1,507
	215,561	0	0	4,272
<i>Joint filer, one child</i>	\$11,698	\$900	\$725	\$234
	21,251	1,466	800	425
	41,414	1,500	800	828
	75,364	1,500	800	1,507
	215,561	0	0	4,272
<i>Joint filer, two children</i>	\$11,698	\$1,200	\$725	\$234
	21,251	1,766	800	425
	41,414	1,800	800	828
	75,364	1,800	800	1,507
	215,561	0	0	4,272

SOURCE: Author's analysis based on 2008 tax return Statistics of Income (IRS 2011b, c).

filers (single and joint), earning above \$212,885 (TPC 2010b). Based on its policy design, replacing the payroll tax cut with the modified ESA rebate could be expected to increase payroll employment by 12% or more relative to an extension of the payroll tax cut.

Given the severity of un- and underemployment and the large gap between potential and actual economic output, neither an extended payroll tax cut nor this refundable lump-sum tax rebate is a sufficient policy response to the jobs crisis. Deficit-financed infrastructure

investment or additional state fiscal relief would also be a more cost-effective way to put Americans back to work. But compared with extending the payroll tax cut, this refundable tax rebate proposal would help working families and their children, the non-working elderly and veterans, the 25 million un- and underemployed workers, and the U.S. businesses in need of more customers. This amplified economic activity would also increase revenue, offsetting more of the cost of this policy—ultimately helping the federal budget.

Appendix

These calculations are based on tax return data from the Internal Revenue Service Statistics of Income for 2008 (IRS 2011b, 2011c). The IRS tables sort tax returns by 19 varying ranges of AGI. For each AGI range, calculations are made for average earned income (total salaries and wages divided by the number of tax return), average AGI (total AGI divided by the number of tax returns), and average income tax liability (total income tax divided by the number of returns). Using a handful of average earned-income levels as illustrative points (see endnote 14), we use the accompanying average AGI and income tax liability for each AGI level to calculate the average impact on disposable income of the ESA tax rebate, MWP credit, and payroll tax cut, based on 2008 tax returns.

Additionally, several broad comparisons can be made.

Assuming individual income-tax liability exceeds the maximum ESA lump-sum tax rebate, the earned-income breakeven point between the value of the payroll tax cut and the ESA rebate would be \$30,000 for single filers and \$60,000 for joint filers with no qualifying children. These breakeven points are 50% higher than the breakeven point between the value of the payroll tax cut and the MWP credit.

Again assuming individual income tax liability exceeds the maximum ESA lump-sum tax rebate, the earned-income breakeven point between the value of the payroll tax cut and the ESA rebate rises to \$60,000 for single filers and \$90,000 for joint filers with two qualifying children (eligible for rebates of \$1,200 and \$1800, respectively). Above the \$3,000 earnings threshold and below these earned-income levels, which are below the beginning of the ESA rebate AGI phase-out ranges, tax filers with multiple qualifying children are universally better off under the ESA rebate than the payroll tax cut.

Comparing the value of the MWP credit and ESA rebate for lower-income earners is more difficult because the value of the lump-sum tax rebate is dependent on tax liability, which is often but not necessarily negative for lower-income workers. Generally speaking, a single filer would be better off with the MWP credit with earned in-

come under \$3,000 (although this could be remedied with the “hold harmless” modification described in the paper), worse off with the MWP credit with earned income between \$3,001 and \$4,839, and slightly better off with the MWP credit with earned income above \$4,839 and income tax liability under \$300. All single or joint filers with one or more qualifying children and earned income above \$3,000 would be better off under the lump-sum tax rebate provided AGI fell below the phase-out range.¹⁵

For single filers without qualifying children and with income tax liability exceeding \$600 (thus receiving the maximum rebate) and AGI above the phase-out range, the ESA rebate increases disposable income by more than the MWP credit if their AGI falls below \$81,667, above which the steeper ESA phase-out more rapidly decreases the rebate value than the MWP phase-out. Similarly, joint filers with income tax liability exceeding \$1,200 and AGI above the phase-out range are better off with the ESA rebate if their AGI falls below \$163,333.

The comparison between the ESA rebate and either the MWP credit or the payroll tax cut is relatively straightforward for the elderly because only the former defines Social Security income as earned income. Any single filer with Social Security benefits above \$3,000, and with earned income below \$15,000, would be better off under the lump-sum tax rebate. Only Social Security recipients with earned income exceeding \$30,000 would be unequivocally better off under the payroll tax cut. (Between these two earned-income thresholds the amount of income tax liability determines the value of lump-sum tax rebate).

While Social Security accounts for much of the income for citizens over the retirement age, much of non-Social Security income is investment income that would also be ignored in the calculation of the MWP credit and payroll tax cut. Earned income among Social Security recipients also tends to be heavily concentrated in the top two earning quintiles. Economic recovery payment recipients who did not qualify for the MWP credit would also have been better off under the ESA rebate, provided they had qualified annual income exceeding \$3,000.

Endnotes

1. As projected by the CBO, the gap between actual and potential GDP peaked at more than \$1 trillion (-6.9%) in mid-2009 and registered \$765.8 billion (-4.9%) as of the first quarter of 2011 (CBO 2011b). See also Department of Commerce, Bureau of Economic Analysis, 2011, National Income and Product Accounts Table 1.1.5. Gross Domestic Product.
2. The definition of earned income is the same as used for calculating the Earned Income Tax Credit (wages, salaries, and tips included in gross income and net self-employment earnings), with two modifications. For the MWP credit, earned income excludes net earnings from self-employment that are not taken into account in calculating taxable income. Earned income also excludes certain combat pay excluded from gross income. See JCT (2010a).
3. Adjusted gross income (AGI) is gross income, which includes wages and other forms of income such as capital gains, dividends, interest, and rent, adjusted for above-the-line deductions such as IRA and health savings account contributions.
4. An estimated 18.1% of households pay neither income nor payroll taxes. These households are almost entirely composed of the elderly and nonelderly with incomes under \$20,000, accounting for 10.3% and 6.9% of all households, respectively (TPC 2011).
5. $\$106,800 \text{ multiplied by } 2\% = \$2,136$.
6. Tax Policy Center distributional analysis is measured in tax units rather than households. A tax unit represents either an individual filer or joint filers and their dependents.
7. The refundable portion of tax credits is booked as direct spending in budget scorekeeping.
8. In their most recent estimate of the impact of the Recovery Act, the CBO estimated that the two-year tax cuts for lower- and middle-income people (specifically MWP and the American Opportunity Tax Credit, a partially refundable college tuition credit) generate between \$0.60 and \$1.50 of economic activity (CBO 2011a). In a menu of policy options for increasing employment, the CBO had previously estimated that an employee-side payroll tax cut generates only between \$0.30 and \$0.90 of economic activity for every dollar in revenue loss (Elmendorf 2010). Averaging these fiscal multipliers, the MWP credit is estimated to generate 75% more economic activity per dollar than the payroll tax cut.
9. Specifically, we assume a 1% increase in gross domestic product corresponds with 1.2 million full-time nonfarm payroll job gains. This is consistent with CBO estimates of the impact of the 2009 Recovery Act and private-sector forecasts.
10. For instance, if joint filers documented work income of \$250,000 and \$50,000, respectively, the combined credit would be equal to \$3,136 ($= \$2,136 + \$50,000 \times 2\%$). Calculating the credit based on combined work income would result in a credit of \$4,272, but this would not be a revenue-neutral modification of the existing payroll tax cut.
11. Child eligibility was based on children qualifying for the existing child tax credit. Children must have been under the age of 17 as of December 31, 2007 (the end of the tax year preceding enactment of the ESA).
12. These transfer payments were estimated to cost \$14.2 billion. Refundable transfer payments to federal and state pensioners outside the Social Security system were estimated to cost an additional \$218 million (JCT 2009).
13. Quarterly wages and salaries in seasonally adjusted annual rates have been deflated using the seasonally adjusted consumer price index research series for all urban consumers (CPI-U-RS-SA).
14. The earned income levels in Table 2 reflect the average earned income across a range of AGI in the IRS Statistics of Income tables and have been chosen to illustrate a range of tax filers' benefits based on data limitations. In 2008, earned income averaged \$7,346 for tax filers with AGI between \$5,000 and \$10,000; \$11,698 for tax filers with AGI between \$10,000 and \$15,000; \$21,251 for tax filers with AGI between \$20,000 and \$25,000; \$41,414 for tax filers with AGI between \$40,000 and \$50,000; \$75,364 for tax filers with AGI between \$75,000 and \$100,000; \$215,561 for tax filers with AGI between \$200,000 and \$500,000 (IRS 2011b, 2011c). For the purposes of calculating the payroll tax cut for joint filers with earned income of \$215,561, it is assumed that earned income is split evenly between the two individuals.
15. With earned income below \$3,000, a single filer would receive a refund of up to \$186 ($\$3,000 \times 6.2\%$) with the MWP credit. With earned income above \$3,000, a single filer would receive a minimum ESA rebate of \$300, which would exceed the value of the MWP credit for individuals with earned income below \$4,839 ($\$300 / 6.2\%$). With earned income above \$4,839, a single filer would receive between \$300 and \$400 with the MWP credit, but would only receive a credit of equal or greater value with the ESA rebate if individual income tax liability exceeded \$300. A single filer with one or more qualifying children and income tax liability above \$3,000 would receive a minimum ESA rebate of \$600, exceeding the maximum MWP credit of \$400. Similarly, joint filers with one or more qualifying children and income tax liability above \$3,000 would receive a minimum ESA rebate of \$900, exceeding the maximum MWP credit of \$800.

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