



February 3, 2010

Honorable Robert P. Casey Jr.
United States Senate
Washington, DC 20510

Dear Senator:

This letter responds to questions you posed about policy options to increase employment by reducing employers' payroll taxes for firms that increase their payroll. Last month, the Congressional Budget Office (CBO) released a report that addressed such options, as well as other possible approaches to achieving that goal. This letter reviews the analysis in that report and discusses how key design elements of such a policy would affect the resulting gains in employment.

CBO's Assessment of a Policy Option to Reduce Employers' Payroll Taxes for Firms that Increase Their Payroll

Social Security (which consists of Old-Age, Survivors, and Disability Insurance) is financed by payroll taxes. Under current law, both employers and employees pay Social Security taxes equal to 6.2 percent of an employee's annual earnings, up to a maximum amount (currently \$106,800) that is adjusted each year for overall growth in wages. In its January 2010 report *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, CBO analyzed the effects of giving employers a one-year, nonrefundable credit against their payroll tax liability for increasing their payrolls in 2010 from their 2009 levels.

In CBO's analysis, the effect of that policy (and others) on employment was measured as the cumulative effect on years of full-time-equivalent employment for each dollar of a policy's total budgetary cost.¹ (A year of full-time-equivalent employment is 40 hours of employment per week for one year.) By focusing on full-time equivalents, the calculations included increases in hours among part-time workers, and possibly increases in overtime hours among full-time workers, as well as the hours worked by new hires. To account for uncertainty, the analysis included both a "low" estimate and a "high" estimate for the effect of each policy.

¹ The estimated budgetary cost of that policy reflected both the reduction in payroll taxes and the increase in income tax revenues resulting directly from that reduction in payroll taxes.

CBO estimated that reducing payroll taxes for firms that increased their payrolls would raise output (gross domestic product, or GDP) by a total of \$0.40 to \$1.30 between 2010 and 2015 for each dollar of budgetary cost. CBO also estimated that the policy would add 8 to 18 cumulative years of full-time-equivalent employment in 2010 and 2011 per million dollars of total budgetary cost. Thus, the cost of increasing employment by one full-time person for one year in 2010 and 2011 would probably be between \$56,000 and \$125,000. Although such a policy would have economic benefits in the short run, it would also add to already large projected budget deficits. Unless offsetting actions were taken to reverse the accumulation of additional government debt, future incomes would tend to be lower than they otherwise would have been.

CBO anticipated that firms would respond to a payroll tax credit through a combination of four channels:

- Some firms would react to lower employment costs by reducing the prices they charged in order to sell more goods or services. Higher sales would in turn spur production, which would lead to increases in hours worked and hiring.
- Some firms would pass the tax savings on to their employees in the form of higher wages or other types of compensation, which in turn would encourage more spending by those employees.
- Some firms would retain the tax savings as profits, which would be passed on to shareholders.
- Some firms would use slightly more labor during the period when it was temporarily less expensive.

Within that fourth channel, CBO accounted for several types of reactions that firms might have. Some firms would use additional labor to enhance the quality of their products or services in ways not reflected in GDP. Some would use additional labor to increase maintenance of their current plants and equipment (such as doing preventive maintenance work on motor vehicles), which would make those plants and equipment last longer and delay the need to invest in replacements. Depending on the type of products they made, some firms would also increase their use of labor that was temporarily less expensive while the policy was in effect and reduce their use of labor later. Moreover, some firms would hire slightly sooner to cover anticipated increases in their labor needs.

Compared with reducing employers' payroll taxes for all firms, limiting the reduction to companies that increased their payroll would produce a substantially larger rise in full-time-equivalent employment per dollar of budgetary cost because it would link tax benefits to payroll growth. In particular, fewer budget dollars would be used to cut employers' taxes for workers who would have been

employed anyway and more would be used to expand employment through that fourth channel.

Effects of Key Design Elements on Employment

The specific policy option that CBO analyzed in January would reduce an employer's payroll taxes for each quarter of calendar year 2010 in which the firm's payroll was higher than it had been four quarters earlier. All employers—including nonprofit organizations and state and local governments—would potentially be eligible, and the amount of the tax cut received by any particular employer would not be limited. CBO's estimates of the effects on employment per million dollars of budgetary cost apply to policy proposals with different rate reductions, such as having a tax credit equal to 5 percent or 10 percent of the increase in payroll.

The following discussion considers the impact on employment of various alternatives to those design elements. Each design element is analyzed separately—that is, the analysis assumes that all elements other than the one discussed are the same as in the policy option that CBO evaluated in January.

Capping the Size of the Tax Cut for Individual Firms Would Decrease the Employment Effect per Dollar of Budgetary Cost. One possible alternative to the option evaluated by CBO is to limit each firm's tax cut to a fixed dollar amount, a percentage of the firm's payroll in a base year, or both. Such a cap would reduce the policy's total budgetary cost, but it would also limit the incentives to increase employment. A firm that would have boosted its payroll in the absence of the policy by enough to reach the cap would receive the maximum tax cut under this alternative, but it would receive no additional tax cut for further expanding employment. Thus, the policy would give such a firm tax benefits but no extra incentive to hire more workers. Under those circumstances, CBO estimates, the tax benefits would probably be passed on to shareholders and would have little effect on prices or wages.

If all else was equal, the effect on employment of a policy that included a cap would be smaller than the effect of the no-cap policy that CBO analyzed by an amount roughly proportional to the total share of the tax cut received by firms at the cap. For example, if 20 percent of the total tax cut went to firms affected by the cap, the policy's effect on employment would be about 20 percent lower per dollar of budgetary cost than the policy examined in January, CBO estimates.

The effect of a cap would depend partly on the extent of the reduction in payroll taxes. A proposal that included a high cap and a low tax-credit rate for increases in payroll could have the same total budgetary cost as a proposal with a low cap and a high tax-credit rate for increases in payroll—but it would boost employment

by a larger amount because the higher cap would let firms continue to pay less for each additional worker or hour of work beyond the lower cap.²

Restricting Eligibility to Small Firms Would Decrease the Employment Effect per Dollar of Budgetary Cost. If the principal goal of the policy change was to help small businesses, the tax cut could be offered only to firms with a total number of employees or total revenues below a specified threshold. However, employment at small firms is especially volatile: Those firms exhibit high rates of job creation and job loss as well as high rates of entering and leaving the markets in which they sell their products. As a result, the average duration of jobs subsidized under such a targeted tax cut would probably be shorter than the average duration of jobs subsidized under a broad-based policy.

Because of that volatility, small firms that do expand have proportionally higher average payroll growth than large firms that expand. That means, in turn, that a larger fraction of the tax cut would fund payroll growth that would have occurred anyway, and a smaller fraction of the tax cut would provide an incentive for increasing employment. Specifically, CBO estimates that if eligibility for a tax cut was limited to existing firms with fewer than 100 workers, the employment effect would be 5 percent to 10 percent smaller per dollar of budgetary cost than if the policy applied to all firms with payroll growth. Alternatively, if eligibility was restricted to firms with at least 100 workers, the employment effect would be 15 percent to 20 percent greater per dollar of budgetary cost than the policy that CBO analyzed.

Similarly, providing a larger tax reduction for start-up firms would decrease the employment effect per dollar of budgetary cost. For start-ups, a cut in taxes for payroll growth would be effectively the same as an across-the-board cut in payroll taxes, which has an effect on employment that is about one-third lower per dollar of budgetary cost than the effect of reducing employers' payroll taxes only for growing firms. By contrast, if a policy was set so that a firm that began operating in the previous year would receive, for example, one-third the tax cut that an already existing firm of the same size would receive for the same amount of payroll growth, the employment effect per dollar of budgetary cost would be about 5 percent higher than the effect of a policy that set a uniform tax benefit for all firms that increased their payroll.

Limiting the Eligible Wage Base Would Alter the Types of Employment Fostered by the Policy. The choice of what maximum limit (if any) to impose on the amount of wages per worker eligible for the tax cut would affect the mix of additional hiring between low-wage and high-wage workers and between part-time and full-time workers. A low maximum would mean that the tax reduction

² If the tax-credit rate was low enough that many firms' total tax cuts were smaller than the administrative costs involved in claiming those cuts, the "high cap/low tax-credit rate" approach would have smaller effects on employment.

would apply essentially to the net change in the number of employees, which would especially encourage the hiring of low-wage and part-time workers. For example, the amount of the tax cut could be calculated using the wage base for federal unemployment taxes, which consists of the first \$7,000 of wages earned by each worker. In that case, firms might have an incentive to hire, say, two workers at 30 hours per week apiece instead of hiring one worker at 40 hours per week and employing a current worker for an additional 20 hours per week, because the former action would increase total wages eligible for the tax cut by \$14,000, whereas the latter action would increase such wages by only \$7,000. Using a higher maximum, such as the wage base for Social Security taxes (up to \$106,800 in annual earnings), would induce greater increases in hours per employee.

Basing Tax Cuts on the Total Payroll in 2010 for New Hires Rather than on the Net Change in a Firm's Payroll from 2009 to 2010 Would Have a Similar Employment Effect per Dollar of Budgetary Cost. An alternative to basing a tax cut on the net change in a firm's payroll, as CBO analyzed in January, is to base a tax cut on the total payroll for new hires (with a requirement that firms not decrease their total payroll). Such a policy would provide a greater share of the total tax cut to firms with high turnover.

CBO estimates that the total payroll in 2010 for new hires at growing firms would be about as large as the net change in payroll for those firms relative to a year ago.³ As a result, a similar share of the tax reduction would provide incentives for additional employment under both policies. Therefore, basing tax cuts on the total payroll in 2010 for new hires would have about the same impact on employment per dollar of budgetary cost as the policy that CBO analyzed in January. That result is specific to the time period used in the analysis (March through December 2010), and other policy durations would have different results.

Offering Larger Tax Cuts in Economically Depressed Areas Would Probably Not Significantly Alter the Employment Effect per Dollar of Budgetary Cost. Reducing payroll taxes for firms that increase their payroll would not create an incentive to maintain employment at firms that have been shrinking. Thus, such a policy would provide little incentive to preserve employment in industries and regions where the economy is weakest. Policies could be targeted, however, to provide greater assistance to such industries or regions.

³ That result stems from two offsetting effects. The net change in payroll would tend to be smaller because it would include the impact of job losses at those firms, whereas the payroll increase for new hires would not. But net payroll growth would tend to be larger because it would include all the growth relative to the firms' payrolls a year earlier, whereas the payroll for new hires would reflect growth only since the policy took effect (which in this case was assumed to be March 2010). Net payroll growth is also boosted because it reflects increases in hours and wages of existing employees, who would have higher average earnings than new hires.

Because payroll growth in the absence of the policy would be lower in those weak industries and regions, a smaller share of the tax reduction would flow to payroll growth that would have occurred anyway, and a larger share would represent incentives for firms to hire more workers. That pattern would strengthen the employment effect per dollar of budgetary cost. At the same time, the response of employers to a given increase in the incentive to hire would most likely be smaller in industries and regions with declining employment. Those factors would work in opposite directions, and CBO expects that they would probably be roughly offsetting, leaving the overall employment effect per dollar of budgetary cost roughly the same as for the policy that CBO analyzed in January.

Raising Awareness of the Tax Change Would Increase the Employment Effect per Dollar of Budgetary Cost. One of the lessons of the New Jobs Tax Credit of the 1970s was that many employers did not know about the credit until they filed their tax returns—at which point the credit could no longer affect hiring decisions. If a new payroll tax cut was enacted, an outreach campaign could make firms more aware of the tax benefits of expanding employment. Although such a campaign would require additional resources, an effective outreach program would probably increase the employment effect per dollar of overall budgetary cost.

Increasing the Complexity of the Tax Change Would Reduce the Employment Effect per Dollar of Budgetary Cost. Targeting the tax cuts to certain types of firms or capping the total amount of the tax reduction would require complicated rules to implement and increase the costs to firms of obtaining those credits. Greater complexity, especially if there are multiple elements of the policy that are complex, would reduce some firms' awareness of their eligibility for the tax cut, dampening the incentive to increase employment.

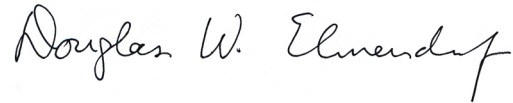
Interactions Between Design Elements. Specific policy options might involve combinations of caps, size restrictions, methods of measuring payroll growth, and other elements. This letter analyzed each design element separately, holding the others constant. Interactions between those elements, however, would probably result in different employment effects than simply adding together the separate effects of each element. CBO has not yet modeled those interactions.

Honorable Robert P. Casey Jr.

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I hope this information is useful to you. If you have questions, please contact me or Janet Holtzblatt (202-226-2668).

Sincerely,

A handwritten signature in black ink that reads "Douglas W. Elmendorf". The signature is written in a cursive style with a large, prominent 'D' and 'E'.

Douglas W. Elmendorf
Director

cc: Honorable Max Baucus
Chairman
Committee on Finance

Honorable Chuck Grassley
Ranking Member
Committee on Finance

Honorable Charles Rangel
Chairman
Committee on Ways and Means

Honorable Dave Camp
Ranking Member
Committee on Ways and Means